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Down Rounds are on the Rise, Forcing Pre-IPO Firms to Explore New Retention Strategies

When valuations fall, pre-IPO companies need to explore new ways to motivate and retain employees concerned about the liquidity of their underwater stock options.

Private technology and life sciences companies on the road to an initial public offering (IPO) are having a harder time securing funding. Down rounds— when a company raises new funds at a lower overall business valuation than previous financing rounds— are increasingly common, and at the same time, a handful of high-profile IPOs in the past year haven't been able to hold their expected value as public companies.

There is wide consensus among venture capitalists, startup executives and board members that private financing had become too easy to obtain, resulting in a saturated market of competitors offering similar services in almost every category (e.g., online food service and delivery providers). In many cases, the market opportunity was overestimated or technology moved faster than investors and businesses could predict.

From a human resources perspective, this environment creates new challenges in motivating employees who have a large portion of their pay tied to illiquid company stock. Importantly, financing terms that ensure founders and investors are made whole upon a sale of the company at the expense of employees have been publicized in recent transactions and only exacerbate workforce morale issues.

Fortunately, there are a number of approaches pre-IPO companies can take to keep their workforce engaged during one of the most important stages in a company's lifecycle. The most effective retention strategy may include a combination of the alternatives below.

- **Exchange or reprice underwater options.** Employee stock options at pre-IPO companies are typically valued based on the latest round of funding. If a company goes through a down round, employees' recently-granted stock options are likely to be underwater. There is also the chance a pre-IPO company will be purchased for less than its estimated value at the time options were awarded. The devastating impact this can have on employees has been well documented in publicized details of private transactions, such as at Good Technology. When it becomes evident that employee stock options are underwater, companies can consider repricing the underwater options for stock options with a lower strike price or exchanging them for restricted stock units (RSUs). While a company can make a powerful statement in support of employees by implementing an exchange when the value of the company is falling, there are a number questions to ask first, including:

- Should the repricing include executives and directors? They are rarely included at public companies due to institutional investor concerns. In a private company setting, this may be more acceptable, depending on the investors' view of management criticality.

- Should there be changes to the terms of repriced awards, such as increased vesting terms or new terms of exercisability for departing employees, etc.? The investors have the ability to extend the "glue" on employees in exchange for the increased value.

- How much additional dilution will investors tolerate? Will a repricing/exchange be more, or less costly than additional grants to lock in talent?

- When does the company plan to go public? If an IPO is relatively near (i.e., within the next 12 to 18 months), there is a chance public investors will flag the repricing or exchange as a governance concern and question whether management might do it again in the future.

- When the company goes public, should the equity plan include the ability to reprice or exchange options without the approval of shareholders? This is a red flag for proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis, but many companies still go public with these capabilities in place.

▪ **Replace underwater stock options with a cash payout to select employees.** There are clear advantages to a cash payout: it provides immediate liquidity to employees and reduces equity overhang for investors— thus, freeing up new shares to be issued. On the other hand, pre-IPO companies tend to reserve cash for other capital-raising needs as they push to go public. Cash awards also lack a long-term retentive value unless payments are made in installments over a period of time or tied to some type of vesting event. Additionally, a cash payout lessens the retentive hold on employees.

▪ **Additional equity awards.** Outstanding equity awards— including underwater options— aren't cancelled, but the company grants additional equity awards. If the additional grants are in the form of options, they would typically have an exercise price closer to the per share value of the down round financing. In order to award additional equity, employers need to determine if they have adequate shares available and often may need to work with investors/shareholders to get authorization for additional shares. Additional long-term incentives can be very good for the retention of employees because they will see their overall potential stake in the company increase. For investors, however, this will be dilutive, and may be viewed as a windfall to employees unavailable to shareholders.

▪ **Establish or increase existing bonus pool.** This approach is in the spotlight after the CEOs of LinkedIn and Twitter donated their annual bonuses to the general employee bonus pools. Increasing the bonus pool does not require executives to leave their bonus on the table; however, doing so is a great gesture to the general employee population that company leadership values their service and is willing to make sacrifices to keep employees content and motivated. Unfortunately, not all pre-IPO companies have an annual bonus pool. Again, cash is a precious commodity for most emerging, private companies. However, even a small bonus plan can provide immediate liquidity to employees and boost morale. The downside is that if payments aren't consistently made, employees have less incentive to stick around at the company.

One last option is to maintain the status quo. This option should be weighed against the pros and cons of taking any of the other actions. If you don't think your company's value has hit bottom, or if you think your future financing rounds will be at a higher value, then canceling or repricing underwater stock options might be premature and send the wrong message to employees. As with so many compensation decisions for pre-IPO companies, timing is everything.

Regardless of what action is taken (or none at all), it's important for senior leaders to make sure they are effective in communicating the long-term vision of the company and their confidence in that plan. Management's job is to ensure employees understand, buy into, and feel secure about the company's future. If leadership fails to communicate effectively to their employees about the long-term future of the company and respond, as necessary, to negative news about the firm in the media or from competitors, employees will naturally feel insecure about their future at the company.

To learn more about participating in the Radford US Pre-IPO/Venture-Backed Survey, please contact our team. To speak with a member of our compensation consulting group, please write to consulting@radford.com.

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