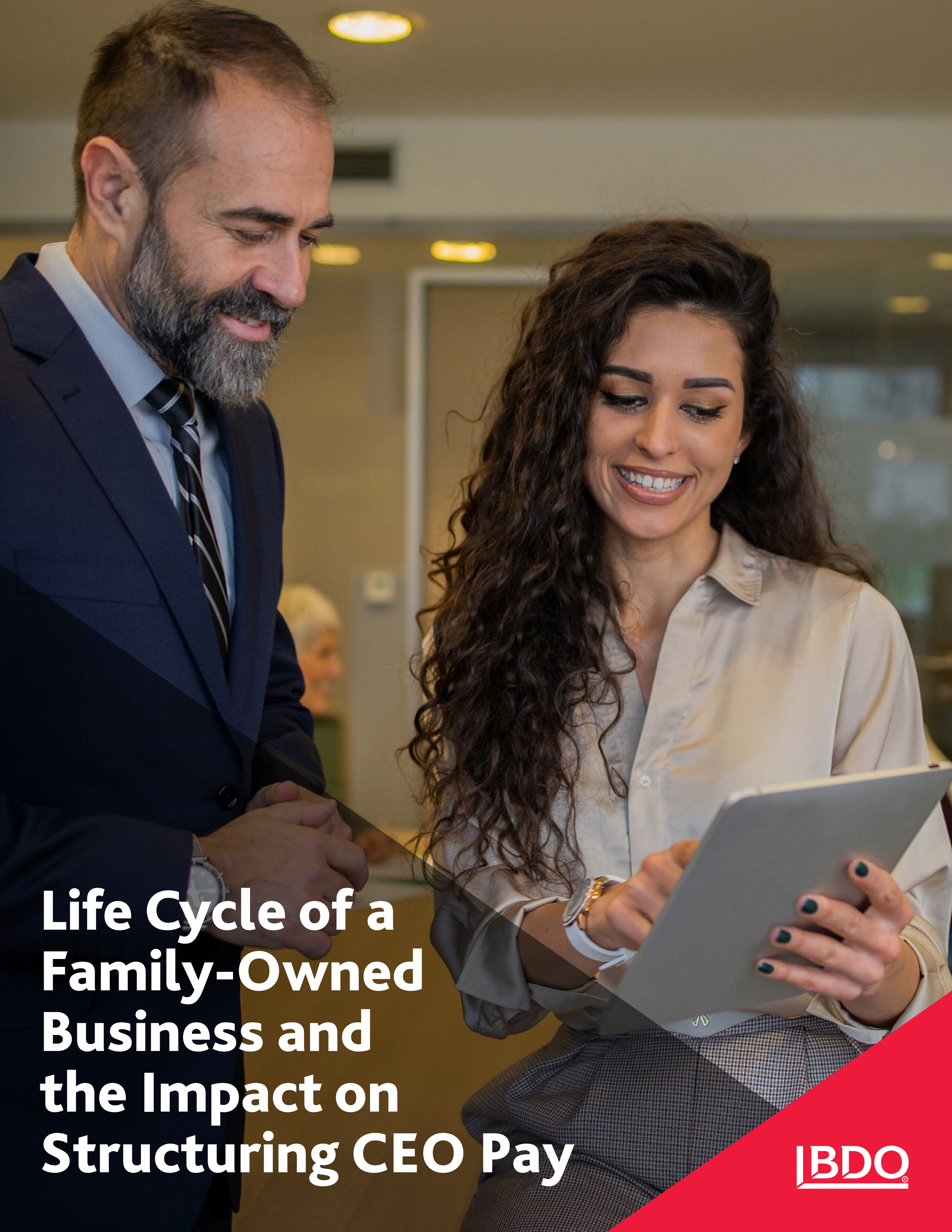

Life Cycle of a Family-Owned Business and the Impact on Structuring CEO Pay

Running a family-owned business is no easy feat.

Among the many challenges is determining the right salary and compensation structure for top executives.

But here's the catch: The topic of pay is a sensitive one, especially when it involves the founder, family members, and other stakeholders. So how do you strike the perfect balance? Data-driven methodologies are key to help ensure emotion doesn't overshadow fact.

Executive compensation information also tends to be scarce for privately held companies, hence, BDO launched its inaugural ***2023 Private Company Executive Compensation Survey***. Using data and analysis from the survey, this article will explore the many factors that drive CEO compensation within the family-owned business.

LIFE CYCLE OF A FAMILY-OWNED BUSINESS

Compensation structures for family-owned companies typically go through several phases of evolution. These phases are often delineated by the founder's involvement in the development of the initial concept, the introduction of other family members or external hires into leadership roles, the retirement of the founder, and the possibility of an exit or liquidity event.

ONE
Founding of company under CEO's leadership

TWO
Growth and expansion of leadership team

THREE
Retirement of CEO and succession to another family member or external hire

FOUR
Potential exit or liquidity event

Each phase requires a tailored approach to designing CEO pay. Family-owned businesses need a clear understanding of how pay is structured, including the use of long-term incentives, within public, private equity, and other types of ownership. This is essential to attract and retain the best talent that will set the business up for future success.

WHAT DRIVES PRIVATE COMPANY CEO PAY?

- **Size Matters:** Of those surveyed, private companies with revenues of $50 million to $100 million pay about 38% higher salary and 70% higher total cash than companies with revenue below $25 million.
- **Industry Impact:** CEOs of privately held life science/pharma/healthcare-related companies in our survey paid the highest cash compensation, but real estate companies paid the highest total direct compensation.
- **Ownership Stake:** Those who own a significant portion of the company will focus on having an adequate level of cash compensation and typically not expect grants of equity.
- **Location, Location, Location:** We found that private companies located in large metro areas pay 20% to 30% more in cash compensation.
- **Ownership Structure:** Family-owned companies in the $100 million to $500 million range pay slightly more in cash compensation than private companies overall but the same in total direct compensation. Private companies tend to pay less than public, especially with regard to total direct compensation, as they do not have actively traded equity available. CEOs of private equity-owned companies tend to have much higher equity compensation than the average CEO of a private company.

Key Terms to Know

- **Total cash compensation (TCC):** salary plus any bonus / annual incentives earned.
- **Long-term incentives (LTIs):** includes stock options, full-value stock awards, and other LTIs.
- **Total direct compensation (TDC):** sum of salary, bonus / annual incentives, and LTIs.

FOUNDING OF COMPANY UNDER CEO'S LEADERSHIP

The survey collected and reported key demographics of CEOs of small to medium-sized family-owned private companies:

	CEO Profile of Small to Medium-Sized Family-Owned Businesses	Comparison CEO Profile
Average Tenure	18 years	9 years at public companies
% Who are Founders	41%	29% private companies overall
% Who Have an Ownership Stake	79%	61% private companies overall
Average Percent Ownership	61%	33% private companies overall

As shown in the survey statistics above, founders and CEOs of family-owned companies are usually long tenured and have a high level of company ownership, the value of which is typically created through “sweat equity.” However, this equity is not liquid, and the topic of an exit strategy or liquidity event is often quite taboo in family-owned businesses. This raises the question of how to determine the appropriate level and form of cash compensation that is fair and equitable to the CEO and other company owners. This can become a sensitive topic, especially in cases where there are family members or others who have an ownership stake but are not working for the company. Solid market data can help avert uncomfortable conversations.

GROWTH AND EXPANSION OF LEADERSHIP TEAM

As the company grows, the CEO will need a strong leadership team. This typically involves hiring key executives in operations, finance, and sales. Filling these roles requires offering a competitive compensation package. If the CEO is underpaid, this can create a compression issue, making it difficult to attract and retain top talent. For instance, the competitive pay package for a CFO at a private company typically runs 60% to 75% of the CEO's. So, if the CEO pay is low, it may be hard to maintain the optimal relationship in pay levels. The other issue is whether the CEO or family is willing to give up any of their equity to entice new talent to join the team.

RETIREMENT OF CEO AND SUCCESSION TO ANOTHER FAMILY MEMBER OR EXTERNAL HIRE

The next phase is when the founder/CEO is planning to retire. At this time, there are key decisions that need to be made:

- Is the board structure adequate, and are there members outside of the family and/or management who can remain impartial third parties?
- How will the current, soon-to-retire CEO access the value that they created over the years?
- If ownership is being passed to the next generation, what are their financial needs and career priorities?
- Are the primary shareholders in agreement with regard to the value of the company and the ongoing ownership structure?

Once the company is ready to identify their successor, it is essential to develop a package that will attract the appropriate talent with the needed skill sets. For instance, the competencies of a CEO who would manage the company in its current structure versus a CEO who would take it public are different, and thus, the structure of the compensation needs to be different.

The package typically includes a mix of base salary and incentives. The dollar amount and balance of these pay elements is very much driven by the strategic plans of the company. Based on the BDO survey, for example, the average CEO pay package is composed of 23% long-term incentives/equity for private companies compared to 51% for a private equity-backed firm. Pay mix may include:

- Salary
- Annual performance bonus
- A way to link CEO performance to the long-term success of the company, typically through real equity or a form of phantom equity (an award that references equity but does not entitle the recipient to actual ownership in a company).
- Retention is also a consideration. This can be addressed through the real or phantom equity, a long-term cash bonus plan, or through a vehicle such as a split dollar life plan, which allows the sharing of the cost of a premium for a permanent life insurance policy.

The key stakeholders (current CEO, board, owners) need to keep in mind that an external hire may not have an ownership stake; thus, it is not unusual for the pay package to be higher than that of the current founder/owner CEO. For instance, for a company between $25 million and $50 million in revenues, our survey found that:

- Total cash compensation averages 17% higher for non-founder CEOs
- Total direct compensation is 13% higher for non-founder CEOs

Whether it is a family member or an external candidate, I've seen successful leadership transitions happen when the new leader cares deeply about the company's brand, mission, employees and long-term growth. With that said, executives with a proven track record of success will expect a combination of cash and equity compensation in line with their contributions. Since many family-owned businesses are not used to sharing equity, it is important that they devise a compensation structure that offers a competitive mix of short- and long-term incentives.

TRISTEN DUNMIRE
BDO Private Client Services
Managing Director

POTENTIAL EXIT OR PARTIAL LIQUIDITY EVENT

In some cases, the final phase of a private company may be a full or partial liquidity event. This could come in any one of several forms, such as selling to another company, a private equity firm, to the employees, or going public. For an employee stock ownership plan (ESOP) or public company, there are alternative compensation arrangements such as the ESOP benefit or, for public companies, stock options and restricted stock of actively traded shares. In addition, there are rules and regulations regarding compensation delivery mechanisms, pay levels, and reporting that come into play.

A family-owned company considering an ESOP can reap numerous benefits, such as the ability to gradually transition ownership to employees while maintaining the company's legacy. It can boost company morale and have a positive impact on retention, as it fosters a sense of ownership and loyalty among employees as they become direct stakeholders in the company's success. By implementing an ESOP, family-owned companies can create a win-win situation, helping provide a smooth transition and retaining talented individuals who are invested in the company's long-term success.

BLAKE HEAD
Managing Director and Group
Head ESOP Advisory Services,
BDO Capital Advisors

MOVING FORWARD: CHARTING A CLEAR PATH

Starting and growing a company is exciting but also hard work and full of risk. Success is rewarding unto itself; however, those who succeed generally want to ensure that they reap the financial gains while also figuring out how to hand over the reins to a competent successor. As a result, two primary compensation issues emerge for both the founder and their successor:

- How much compensation should be provided?
- How should compensation be delivered?

For private companies and especially family-owned companies, there are several confounding factors that add to the complexity:

- The investment of time by the founder and how this should translate into the value that the founder is eligible to receive.
- An appropriate pay package for their successor that is competitive relative to the market.
- Perception of fair and appropriate pay by family members who are owners. Coupled with this is the need to determine if equity will be distributed to the new CEO, how much, and in what form.
- How to create a long-term pay strategy for the new CEO to create the sense of ownership and encourage retention.

Developing a competitive pay package requires a clear path forward for the company and market information that allows for data-driven decisions. Download the BDO *2023 Private Company Executive Compensation Survey Insights Report* and contact us to learn more about how we can help with compensation design and workforce strategy.