Principles of Executive Compensation

Chapter 4

The Unique Compensation Needs of Biotechnology Start-Ups

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Designing effective compensation systems at rising biotechnology companies must reflect many challenges, including volatile stock prices, a shifting ownership base that includes founders with large equity ownership and a heavy reliance on stock options as long-term incentives. This chapter describes the application of the overarching and operating principles of executive compensation (EC) at biotech companies using the example of BioCore, a fast-growing, U.S. biotech company that offers promising gene-therapy compounds. To redesign the company's incentive system, senior management sought to balance and maximize alignment and engagement by offering incentives with a large, relatively stable upside that reflected stock-price swings, the ongoing need to attract strong talent and the challenge of evolving with a growing company facing increased leadership, regulatory and other challenges.

BioCore, based on the U.S. West Coast, is a biotech company that offers life-altering gene therapies for a wide range of neurodegenerative diseases, including Alzheimer's, Parkinson's and macular degeneration.[1] The business was spun off from a major California-based health care facility before completing a successful IPO. By 2016, BioCore had over 200 employees and several promising products in the pipeline.

Like many biotech companies, BioCore faces high product-related and growth expectations from investors, employees and industry observers. The IPO was one of the most successful in the industry for many years and resulted in a valuation of over $1 billion after the first day of trading. Since then, as is typical for early-stage biotechs, the company's stock price experienced significant volatility, peaking at over $75 per share but dropping to less than half that within a year.

Given these circumstances, BioCore was interested in enhancing its EC system. Although an inspiring mission and purpose engaged executives and other employees, attractive compensation packages were important to entice, engage and retain key talent over the arduous journey faced by most nascent biotech entrants to product commercialization, and ultimately, profitability. Most of BioCore's employees remain vested in the company's mission and success as evidenced by their willingness to spend longer out-of-the-money periods than if that strong, meaningful mission was lacking. Still, it was important to ensure motivation *firmwide*.

BioCore's compensation philosophy and system were fairly boilerplate. For example, it targeted market median for all elements of cash- and equity-based compensation. Management recognized the

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[1] "BioCore" is not a real company, but rather a composite of several U.S.-based biotechnology companies.

need for a more strategic, flexible incentive system, especially as the diversity of hires grew, but had to think carefully about how to proceed toward this objective.

What makes biotechs distinct?

This chapter focuses on biotechnology businesses, especially early-stage, pre-revenue entrants with less than 500 employees and offerings in phases one, two or three of the product development process. They could be pre- or relatively recently post-IPO (in the last one to five years), and typically have venture capital (VC) backing and VC representation on the board and/or compensation committee. Their objectives in most cases are either to "get to commercial" by themselves, which usually requires an IPO or other financial backing, or to be acquired by a larger biopharma company.

When designing or modifying executive compensation systems, biotechnology companies are often the *exception* rather than the rule, as best-practice or market-typical program designs and mechanisms in other industries or organizations are either difficult to implement or simply not appropriate in an early-stage biotech environment. It's critical to keep in mind the following:

- *Inevitable volatility:* Early-stage biotech companies face significant challenges delivering equity-based compensation due to their extremely volatile stock prices. The large swings in stock price are typically rooted in fluctuating valuations based on perceived strength of product pipeline (because these companies are almost always pre-revenue), rather than more typical valuation approaches such as earnings before interest, taxes, depreciation and amortization (EBITDA) or revenue multiples.

- *Shifting, disparate, hands-on shareholder base:* These businesses tend to have a heterogeneous, shifting base of shareholders—founders and early employees, VC firms, angel investors, public shareholders and others—that may differ on key dimensions, including time horizon (founders may be more amenable to longer out-of-the-money periods than others, for example), risk tolerance and the like. There is also large potential disparity in wealth creation opportunities between those who joined the organization from the beginning (or at a very early stage), when the company valuation was relatively low, and those who joined later; this brings up the issue of equity "winners and losers," making it difficult to keep everyone engaged. Similarly, if the founder(s) own a large part of the company, granting them additional options may not be particularly motivating. But at the same time, the ownership tends to be very hands-on, with lines often blurred among ownership, management and governance, with some individuals occupying two or all three of these domains. This can challenge companies when designing the right incentive systems to promote alignment of shareholders and management.

- *Divergent workforce:* Biotechnology companies usually have a mix of employees at all levels, with some from academic/scientific and research backgrounds and others with business-related experience from other early-stage biotechs and/or from large pharmaceutical companies. Disparate mindsets and objectives can create an ongoing challenge to engage this broad workforce through the business's purpose and its incentive system.

- *Emphasis on options:* Most early-stage biotechnology companies rely heavily on time-based stock options. Thus long-term incentives are often composed entirely of options. Determining the best way to deploy long-term incentives means dealing with such key dimensions as grant guidelines, vesting and how to handle early-stage founders' packages.

- *Balancing alignment with engagement:* The mission and purpose of many biotech businesses are to improve health significantly for one or more target populations. This meaningful purpose can serve to attract, retain and engage high-level talent: It's a strong component of the overall employee value proposition. But financial incentives can also be important drivers of engagement. Given the volatility noted earlier, their values tend to be ever-changing, and the challenge is to use financial incentives to ensure executives and employees are aligned with shareholders' interests and are also continually engaged so that they perform.

- *The challenge of target-setting:* The challenge of using conventional performance-based equity compensation is the difficulty in setting multiyear performance targets. Biotechnology companies often have no revenue or profitability, opting instead to use milestone-based metrics, such as pipeline development and FDA filings. Although unlikely, there is the risk of incentivizing speed at the expense of quality. Similarly, a milestone such as a filing may increase the stock price, but the gain is yet to be monetized, inflating the paper value of any all-stock incentives and strengthening the case for using options over full shares.

- *The power of discretion:* Because most companies in this stage don't operate with the concept of incentive plan funding and may use a combination of quantitative and qualitative, milestone-based metrics, they typically opt for discretionary rather than formula-based variable pay outcomes used by more mature organizations. This preference reflects the possibility that a purely formulaic approach might not sufficiently align compensation outcomes with organizational performance on an annual basis and would have to be overridden regularly. For example, if the goal is to achieve an IPO in a certain year but the company fulfills that objective early in the next year, a discretion-based system (based on actions as well as outcomes) would still reward executives for reaching that milestone. Biotech start-ups generally benefit from more flexible, discretionary compensation frameworks given their smaller head counts, valuation volatility, meaningful purpose and other factors. As they grow, more conventional approaches to compensation may be more appropriate.

The next sections illustrate the use of Willis Towers Watson's overarching and operating guiding principles to ensure and balance alignment and engagement at BioCore.

BioCore's path to building a better incentive plan

Just to recap, BioCore had a fairly boilerplate incentive philosophy and system and, like most biotech companies, used stock options to offer the vast majority of long-term incentives (LTIs) for executives. For example, the CEO's total compensation composition was 10% salary, 10% bonus and 80% time-based stock options.

Also as previewed earlier, BioCore had a highly discretionary bonus plan without clearly specified targets and metrics, more of a "trust us to compensate you fairly" approach. In rethinking the incentive system, the company introduced the idea of more rigorous target-setting at the organizational level; the concept was to gain clarity on what the business hoped to achieve at the macro level, and then to have the goals cascade down through the broader organization. BioCore management also wanted to communicate big-picture goals more clearly and broadly. These were big steps for the company, which had no truly formal incentive system in place until that point.

After discussing multiple incentive system models, leadership opted to introduce a basic *multiplicative cash-based plan* built on a combination of corporate and individual metrics. Whereas an *additive* model weights corporate and individual metrics independently in determining compensation, a multiplicative system takes the company's overall performance against set targets and multiplies that by participants' performance against their individual metrics to determine individual bonus payouts. The team believed an additive plan might encourage free-riding, whereas a multiplicative plan would support a pay-for-performance culture. Multiplicative plans require a robust approach to performance management, with good clarity and measurement regarding goals at the individual level, as these figure heavily into compensation.

To implement the system, BioCore used a corporate performance measure based on a scorecard that included metrics related to pipeline development, commercial activity and other areas; for example, the number of compounds progressing through the pipeline in a given time frame was assessed. There were very few financial metrics to use, given the business's developmental stage. At both the corporate and individual levels, reaching the goal threshold would result in 75% payout; the maximum payout level was 125% of target. This narrow range of payout levels, versus the more typical 50% to 200% used in other industries, was conducive to the multiplicative model, as it limited the possibility of extreme variation in payout among employees or time periods. In this sense, the narrow payout range acted as a safety rail for the incentive system. Overall, the shift from a discretionary system to a multiplicative plan improved alignment (enhanced corporate results affected payout) and engagement (individual performance also affected payout) while increasing variability in payouts, within limits.

Regarding long-term incentives, BioCore had to establish new annual equity grant guidelines. The vast majority of industries, including large pharmaceuticals, have fixed-*value* grant guidelines versus fixed-*share* grant guidelines. That is, equity awards are typically defined as a value, such as (1) $1 million in shares or (2) equity representing some percentage of salary. But early-stage biotech companies define the equity award as a *number* of options with value based on the time they were granted and a Black-Scholes or other valuation approach to determine their fair value or accounting value. This reflects the sector's market volatility and the need to avoid the unintended consequence of defining a specific dollar value for an equity award and then having a big swing in share price change the number of shares or options in question. For example, the doubling of share price would result in an individual receiving only half the number of shares or options originally suggested by the value stipulated.

BioCore had developed some pre-IPO equity award guidelines with outside advisors based on the projected post-IPO stock price. But a closer examination revealed those guidelines would have granted excessive equity to employees in the case of a successful IPO, under a fixed-share system. To safeguard against such outcomes, leaders developed threshold, target and theoretical maximum awards for each employee level, rather than using a single number of options for a given level of employee. Individual performance could then be rewarded based on the criticality of role and assessment of potential (perceived future contribution). In general, BioCore recalibrated equity award levels based on detailed modeling that projected out new hires and the value of each award, along with market competitiveness, affordability and other factors. This enabled the business to offer equity awards that attracted new hires and promoted engagement but were also affordable.

Everyone at BioCore, at all levels, was granted options as part of their compensation. The practice aligned everyone around the company's purpose, mission and strategy, creating a broad base of engagement and sense of "We're all in it together." Having a system of option-based awards also helped BioCore address the "winners versus losers" dynamic typical in early-stage biotechs. This challenge arises when employees who join a company in its later stages are typically granted options with a higher strike price than earlier hires, creating less potential upside (though they can still be engaged by the idea of creating value for the company and themselves). To address this issue, BioCore established a "CEO recognition pool" of discretionary options. High-performing late joiners would receive annual option grants plus these discretionary grants, boosting differentiation and engagement for these valuable employees.

The company also established new-hire equity grant guidelines to attract strong talent as competition from peer employers intensified. Where many companies merely prorate annual grants for new employees, BioCore offered up to double a typical annual award at a given organizational level for new hires, further highlighting the power of equity in early-stage biotech.

As part of the new system, to ensure the board retained some discretion to award incentives, BioCore introduced a new framework that provided more structure but still offered some flexibility in deciding rewards based on non-formulaic elements, thus going beyond a basis purely in metrics/numbers. In line with this, the CEO noted that incentives-related metrics needn't be "to the decimal point," and communicated a system that used red, yellow and green as indicators of progress or performance in specific areas. In general, the leadership team embraced the theme of "structure plus flexibility" for the incentive system.

In the same way, BioCore moved from established targeting of the 50th percentile of market for compensation targets, to using a range based on competitiveness around the median of market rates. This again represented an approach incorporating both structure and flexibility.

BioCore made sure to communicate the new incentive plan widely as well. This was especially important for new recruits, as a further means of alignment and engagement.

Given the large volume of options granted to existing employees and new recruits, the business also maintained an evergreen facility typical of companies of its industry and stage. The facility stipulated that 4% of outstanding shares could be offered as options to existing and new hires. The facility helped BioCore to bring new people on, while ensuring they didn't risk awards for established employees. Larger, well-established companies don't commonly feature this facility and would require approval from shareholders to use a given pool of options in this way.

BioCore and the operating principles

BioCore's approach to developing its new incentive system exemplified the operating principles below in support of the broader, overarching EC principles.

Section I: Governing Objective and EC Philosophy

Operating Principle 4: EC programs should also be aligned with the organization's culture and individual employee characteristics and, when possible, consider stakeholder preferences. [Purpose, Alignment]

Operating Principle 5: EC decisions should be informed by — but not driven by — market practices. [Engagement]

BioCore recognized that its EC program had to reflect its culture of dynamism and highly purpose-driven work, along with employee characteristics including alignment with the firm's mission but also a desire for compensation based on individual performance. The business took these into account by developing a new incentive system that balanced alignment and engagement by using options-based incentives that offered upside while remaining affordable for the company, under the broad theme of "structure plus flexibility." At the time of this writing, BioCore had moved to offering restricted-stock incentives due to burn rate restrictions; delivering options at the ongoing rate would have exceeded the evergreen facility of 4%. This reinforces how BioCore aimed to follow competitive market practices but adapted these to the company's specific situation and established compensation guidelines.

Section II: Pay Level Reference Group Selection and Benchmarking

Operating Principle 6: Organizations should consider a defined range, as opposed to a single data point, when assessing direct compensation competitiveness. [Accountability, Engagement]

BioCore moved from a compensation philosophy targeting the 50th percentile based on market competitiveness to using a range around the median of market rates. Because market data move year to year, it was important to use a competitive range to more flexibly account for performance, tenure, criticality of role and other factors.

Section III: Performance-Based Pay

Operating Principle 3: The incentive plan design should reflect the organization's desired balance of shareholder alignment and line-of-sight-related objectives through the selection of LTI vehicles and the weighting and selection of incentive measures. [Trade-off between Alignment and Engagement]

The word "balance" implies that a mix of different incentive vehicles is typically most appropriate, but awards of solely time-based (i.e., without additional performance measures) stock options are prevalent and often represent the most appropriate way for early-stage biotechs to provide focus on the organization's primary objective. In line with this, BioCore's options were purely time-based.

Operating Principle 8: Individual performance should be considered in performance-based pay decisions at all organizational levels. [Engagement]

BioCore took individual performance into greater account in its new incentive structure by making this component part of its multiplicative incentive system, such that compensation was influenced significantly by individual-level performance against targets, along with corporate-level performance.

Operating Principle 10: While there is no predefined set of measures that are appropriate for a particular type of organization, incentive plan funding and design must consider each of the following types of financial measures: (i) earnings, (ii) revenue growth, (iii) balance-sheet-linked financial returns, (iv) cash flow and liquidity, and (v) cost of capital. [Accountability]

As BioCore's story illustrates, this is not true of most early-stage biotechs, which do not have revenue or earnings. In such cases, milestone-based metrics associated with pipeline development are more relevant, such as those incorporated into BioCore's incentive system.

Key takeaways

Here are the main things to keep in mind when designing incentive systems for biotech companies:

- *Maintain flexibility in program design and philosophy:* Things change quickly in most rising biotech companies: stock price, head count growth, product developments and other areas. Thus, it's important to modify EC systems through a flexible approach, recognizing that such change is not a sign of problems but of necessary and often welcome evolution.
- *Understand and optimize the employee value proposition:* This value proposition should incorporate the company's mission, vision and values; current cash compensation for a given employee level; and potential creation of significant future wealth. So it's critical to get the balance right between monetary and nonmonetary compensation elements, as both are critical: A strong vision or mission won't necessarily compensate for poor monetary compensation terms, and vice versa. Moreover, because such companies are less likely to emphasize HR benefits, options must be sufficiently large and priced appropriately to engage people in the company's mission, strategy and objectives.
- *It's about evolution:* Greater success creates greater size and complexity, including leadership and regulatory challenges. To incorporate the two previous takeaways requires a compensation system capable of evolving to accommodate progressive growth phases. A careful, strategic adaptation of this system and the broader employee value proposition is needed as the biotech moves from an early-stage player likely offering incentives based purely on options to a large, accelerated filer including options and restricted stock in its EC plan.

Pitfalls of designing compensation systems for biotechs

Here are common biotech compensation mistakes or missteps to avoid:

- *Don't be blinded by typical market practices:* Early-stage biotechs face different challenges than most other start-ups, including their larger pharmaceutical "cousins," so the blind application of typical compensation practices is not recommended. This may include processes such as allowing established governance protocols or tax implications to dictate rather than inform compensation-system decisions, or using fixed-value approaches to long-term incentives because these are standard in other industries (but less relevant in biotech).

- *Avoid premature performance-based equity:* Some biotech companies may make the mistake of switching to corporate, performance-based equity rewards too soon, when the focus should remain sharply on stock-price appreciation, as reflected in the use of time-based options.

- *The "war for talent" can kill you:* Biotechs risk aiming for a 100% recruitment hit rate, potentially promising too much to attract new talent from the open market or other high-growth peers. Compensation system designs should safeguard against this tendency, bounded by share pool limitations, other restrictions and prudent judgment.

Things to remember

- Rising biotechs are generally surrounded by high product-related and growth expectations from investors, employees and industry observers, which makes designing optimal EC systems critical and challenging.

- Among the unique features that figure into incentive systems at biotechs are high stock-price volatility; a shifting, hands-on shareholder base often including a founder or founders with large equity ownership; the potential for a winners-and-losers dynamic due to large disparity in compensation upside among employees; pre-revenue status making for challenging performance-target setting; and a tendency to rely on options over restricted stock for long-term incentives.

- In this context, it's critical to balance alignment and engagement; the challenge is to use incentives to align executives and employees with shareholder goals and to engage the entire workforce with a true performance mindset.

- Specific incentive system elements that may be appropriate for a biotech include an approach that emphasizes "structure plus flexibility," multiplicative (versus additive) cash-based plans combining corporate and individual performance metrics, fixed-value (versus fixed-share) grant guidelines and an evergreen facility stipulating the proportion of options that can be offered as incentives.

- A flexible approach to EC can help balance monetary and nonmonetary components of the employee value proposition and enable the incentive system to evolve with the growing company's needs and limitations.

- Biotech incentive system pitfalls include blind application of broader market practices and premature implementation of corporate, performance-based equity rewards.

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