Executive Compensation Strategies to Win New Business

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HOW TO POSITION YOUR BUSINESS TO REAP THE BENEFITS OF A LIQUIDITY EVENT

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How to Position Your Business to Reap the Benefits of a Liquidity Event

- ☐ The Relevance of Executive Compensation
- ☐ Building a Saleable Business – Buyers Will Closely Scrutinize a Company's Business and Operations
- ☐ Big Picture Perspective
  - Value enhancers/risk factors (re employees) that build/ reduce company value
- ☐ Value Enhancers: Operational and Financial

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How to Position Your Business to Reap the Benefits of a Liquidity Event

☐Operational

- Strong management team & key employee base
  - willing to stay through sale of company transition
- Highly qualified employee base
  - security clearances
  - technical certifications
- Low employee turnover
- Quality and diversity of customer base
  - do top 5 clients account for most company revenue?
  - operating in federal priority sector markets?
- Strong sales & mktg/biz dev capabilities

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How to Position Your Business to Reap the Benefits of a Liquidity Event

☐ Financial

- Strong history of sales growth
- Portfolio of contracts and backlog
  - Constant and reliable revenue stream

Risk Factors: low marks in these "value enhancer" categories will negatively impact a company's overall value and saleability

For government contractors, 2 key drivers (among others) in dictating potential buyer pool and terms of sale:
(1) portfolio of contracts and backlog, <u>plus</u>
(2) owner(s) not being the epicenter of company's business and operations

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How to Position Your Business to Reap the Benefits of a Liquidity Event

- ☐ Key Question: have the owners positioned the company to access, recruit, retain and motivate the talent necessary to compete and succeed in this challenging federal marketplace?

- ☐ Use of executive and employee incentive compensation to develop a strong management team and key employee base

  - Demonstrate the company’s ability to succeed not dependent on owners

  - Buyers offer better exit/sale terms when line between owners’ existence and company’s is less blurred

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How to Position Your Business to Reap the Benefits of a Liquidity Event

- What is the right mix of executive compensation?
- Typically, it has 4 component parts:
  - Base salary
  - Annual incentive pay → examples:
    - bonus, 401(k) profit sharing or an NDQC "401(k) like" profit sharing plan
  - Long-term incentive pay → examples:
    - bonus payout upon sale of company
    - equity (eg, stock options) or equity-linked (eg, phantom equity or SARs)
  - Other benefits (payment of insurance premiums, car and/or phone allowance, etc.)

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HOW TO POSITION YOUR BUSINESS TO REAP THE BENEFITS OF A LIQUIDITY EVENT

- How Should Executive Compensation Be Set and Structured?

  - Base salary - annual increases?
    - locked in at a specified, pre-determined rate?
    - subject to BoD discretion?

  - Annual incentive pay/bonuses – annual increases guaranteed?
    - fixed amount or as percentage of base salary?

  - Performance based?
    - achievement of financial and non-financial targets?

How to Position Your Business to Reap the Benefits of a Liquidity Event

- Long-term incentive pay - equity or equity-linked?
  - what percentage is appropriate?
  - vesting schedule?
  - forfeiture (termination of employment – with/without cause, resignation)?
  - Limit to sale of the company event (what about death? disability? termination w/o cause?)

How to Position Your Business to Reap the Benefits of a Liquidity Event

- What Financial and Non-Financial Metrics Should Be Used?
  - Financial metrics
    - Revenue, operating cash flow, EPITDA, net income margin, return on assets etc.
  - Tension between "top line" versus "bottom line" metrics
    - "top line" – revenue increases do not necessarily translate into increased profitability
    - "bottom line" – executive cannot control all variables that affect and determine profitability
    - a fair and reasonable compromise – somewhere in between
      - for example, gross profit/operating profit/adjusted EBITDA are more representative of a company's core performance

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How to Position Your Business to Reap the Benefits of a Liquidity Event

- Spectrum between top line and bottom line
  - revenues (net sales)
  - gross profit (net sales – cost of goods sold)
  - operating profit (gross profit – selling, general and admin expenses (overhead))
  - net income (operating profit – all other expenses)

- Non-Financial (Operational) Metrics
  - entry into new market/new government customer
  - entry into new line of business
  - employee retention
  - shorten A/R collection cycle

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How to Position Your Business to Reap the Benefits of a Liquidity Event

- Adjust and set mix of financial and non-financial metrics to executive's role - for example, measure:
  - CFO performance against financial metrics (operating profit) and non-financial metrics (improved A/R collection)
  - COO performance against financial metrics (gross profit) and non-financial metrics (employee retention)
  - CMO performance against financial metrics (gross profit) and non-financial metrics (new market/new government customer)

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Determine the Appropriate "Starting Point"

- Income taxes
- Ownership and rights
- Entity structure
- Payroll taxes
- Securities laws and registration
- Federal acquisition regulation impacts
- Financial statements
- Who are you going reward?
- Valuation
- Administrative burden and cost
- Vesting, forfeitures
- And much more

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Strategic and Structuring Considerations (Executive/Employee Incentive Compensation)

- ☐ Does the company want to share real equity?
- ☐ How much of the company's equity or equity value is to be shared?
- ☐ Will awards be paid in stock or cash?
- ☐ Will executives/employees have to make a monetary contribution to get the equity value?
- ☐ How and when will liquidity events occur?
- ☐ How is the award earned and can the company take it away?

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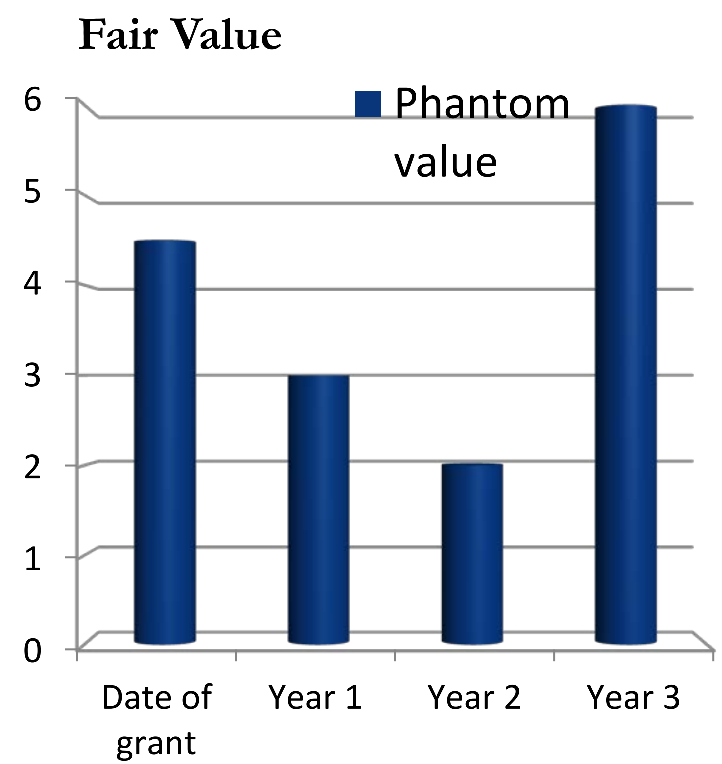
Equity Linked Incentives: Phantom Stock

- Not real equity/ownership
- Typically no capital investment required
- Typically structured for immediate value
- Typically established to balance motivation versus retention
- Separate account to track increases and decreases
- Benefit = full elevator ride in value
- No appreciation = should STILL PROVIDE BENEFIT



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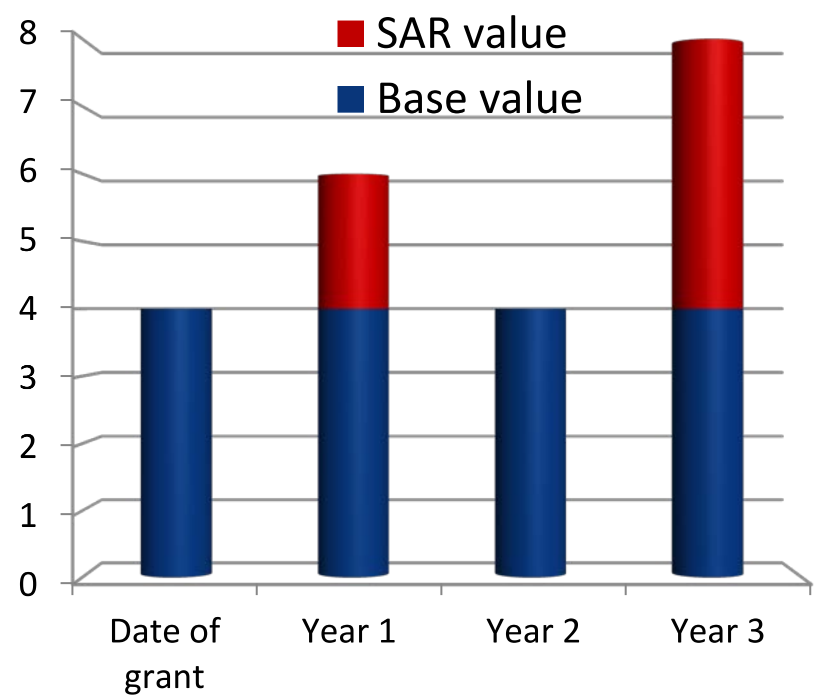
EQUITY LINKED INCENTIVES: STOCK APPRECIATION RIGHTS (SAR/UAR)

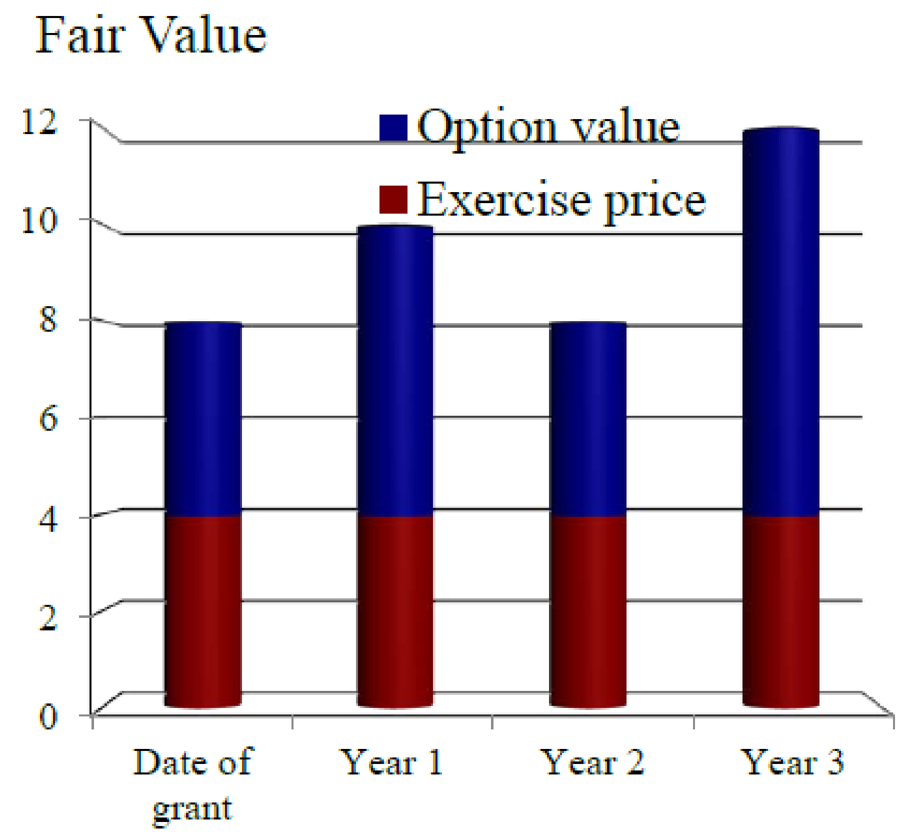
- Not real equity/ownership
- Base value fixed/set at date of grant
- No investment required
- Typically established to motivate increasing equity value (versus retention)
- Separate account to track increases and decreases
- Benefit = appreciation above floor value
- No appreciation = NO BENEFIT

Fair Value



Equity (Ownership) Incentives: Stock Option Plan

- Real equity/ownership occurs open exercise
- Typically some capital investment required (exercise); Recipient has financial investment at risk
- Can be structured for immediate and/or future value
- Benefit = full elevator ride in value, share in ownership rights
- No appreciation = may still provide benefit (non-statutory option)



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IMPORTANCE OF A GOOD EMPLOYMENT AGREEMENT
WHAT'S INSIDE? THE MEAT AND POTATOES

1. Scope of Employment
2. Salary
3. Bonus Structure
4. Benefits
5. Term and Termination – "at will" v. "term;" "cause" v. "w/o cause"
6. Liability Protection
7. Other Incentive Plans
8. Confidentiality
9. Invention Assignment
10. Restrictive Covenants
11. Breach
12. Dispute Resolution
13. Change of Control

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THE COMPLEX WORLD OF RESTRICTIONS

- ☐ Confidentiality
- ☐ Non-Disparagement
- ☐ Non-Competition
- ☐ Non-Solicitation
- ☐ Invention Protection and Assignment

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IMPORTANCE OF A GOOD EMPLOYMENT AGREEMENT
PITFALLS IN DRAFTING RESTRICTIONS

- ☐ Language matters
  - say the "magic words" (re "legitimate protectable interest)
  - creating flexibility on both sides
- ☐ Jurisdiction is key (re "legitimate protectable interest;" blue pencil or not)
- ☐ When a potential violation occurs
  - anticipating your tool kit

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We represent clients on business and corporate matters in all phases of their business life cycle, from start-up to sale of the company. We advise clients on entity formation and structure, draft documents that serve as the backbone for clients' companies as they grow, and assist with all aspects of an exit strategy.

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Employee Incentive Plans
- Stock Option Plans
- Equity Linked (Stock Appreciation Rights, Phantom Equity)

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Retirement Plan Design & Best Practices for Government Contractors

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Exit Strategies Timeline

Sale of Business

Executive Benefits

□SARS
□Restricted Stock
□Phantom Stock
□Nonqualified Deferred Compensation (Salary Deferral/SERPS)

Attract and retain key employees

Transfer of Stock

□GRATs
□FLPs
□IDGTs
□SCINs

Advanced estate planning is consistent with owners goals

Tax Planning

□Understanding tax implications of different entity types
□Asset sale vs Stock Sale
□Goodwill
□Ordinary Income Rates vs Capital Gains Rates
□Affects of Earn Out on taxes/timing

Tax planning for sale of business

Investment Management

□Create/Review financial plan
□Create/Review IPS (investment policy statement)
□Monte Carlo
□Tax considerations
□Alternative investment considerations

Create portfolio that is commensurate with need

Charitable Planning

□Foundation
□CRT
□CLT

Establish personal missions

Retirement Planning

Ensure retirement plans are maximized for owners and executives

□401(k)
□Matches
□PSP
□Combination Plans

Contingency Planning

Make sure proper contingency planning is in place

□Key Man
□Buy Sell
□Funding with Life and/or Disability Insurance

Estate Planning

Initial estate planning documents in place

□Revocable Trust
□Will
□Power of Attorney

Cash Flow Planning

Comprehensive Financial Plan

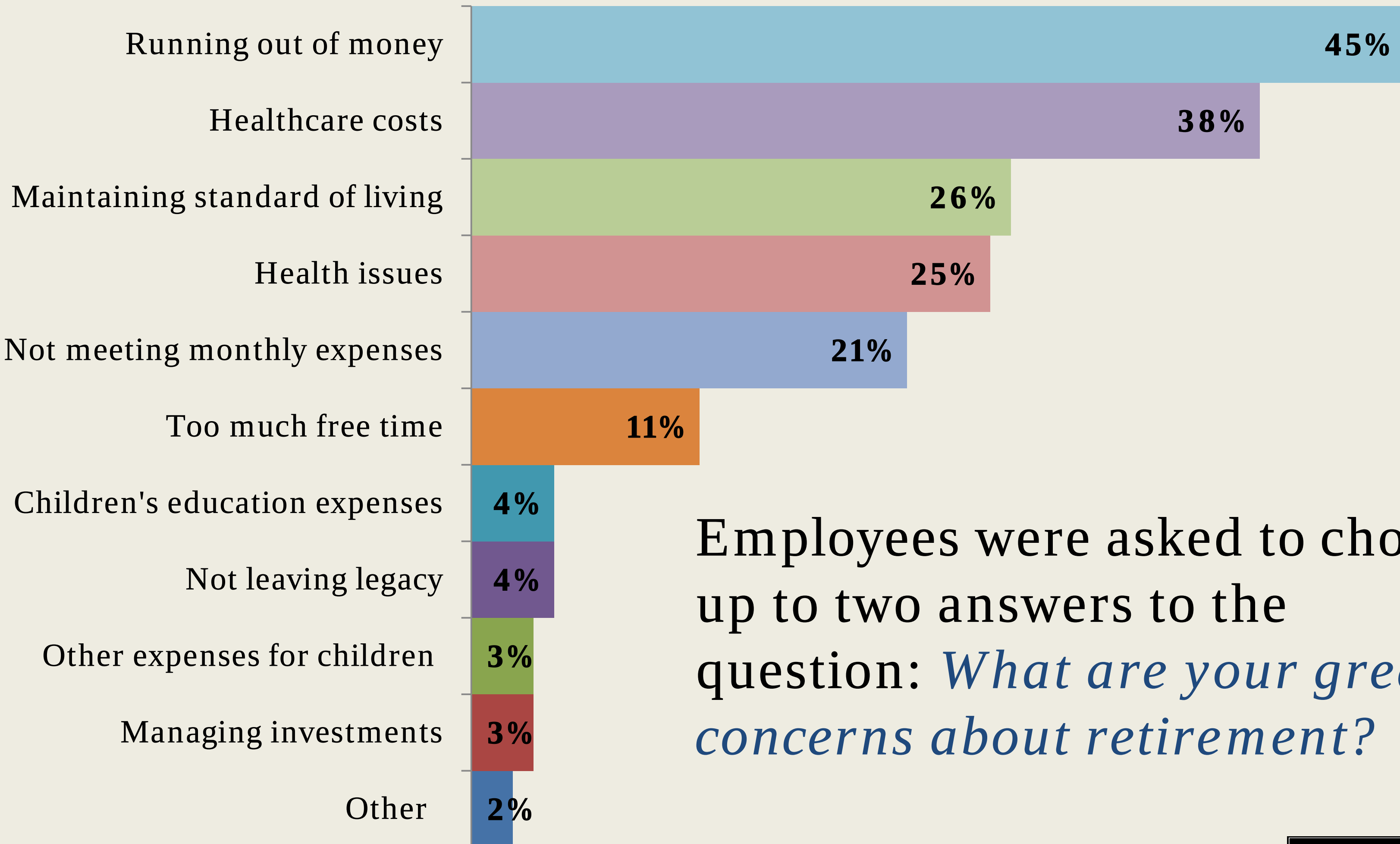
□4 Horseman Scenario
    High Taxes
    Inflation
    Monte Carlo
    Black Swan
□Outcome will determine appropriate internal rate of return

Advanced Estate Planning

Additional advanced planning of estate

□Estate tax reduction strategies
□Annual Gifting + Use of Lifetime Gifts
□Irrevocable Trusts
□Transfer techniques that involve discounting
□Insurance to fund tax liability where appropriate

Employees Biggest Concerns



Employees were asked to choose up to two answers to the question: *What are your greatest concerns about retirement?*

Source: Price Waterhouse Cooper *Gen X Employees Struggle Most*, June 2013

Retirement Savings Need

15%

The amount of
CURRENT EARNINGS
the average American needs to save EVERY YEAR to create a sufficient retirement income

80%

The amount of
CURRENT INCOME
the average American will need to REPLACE EVERY YEAR in retirement to live comfortably

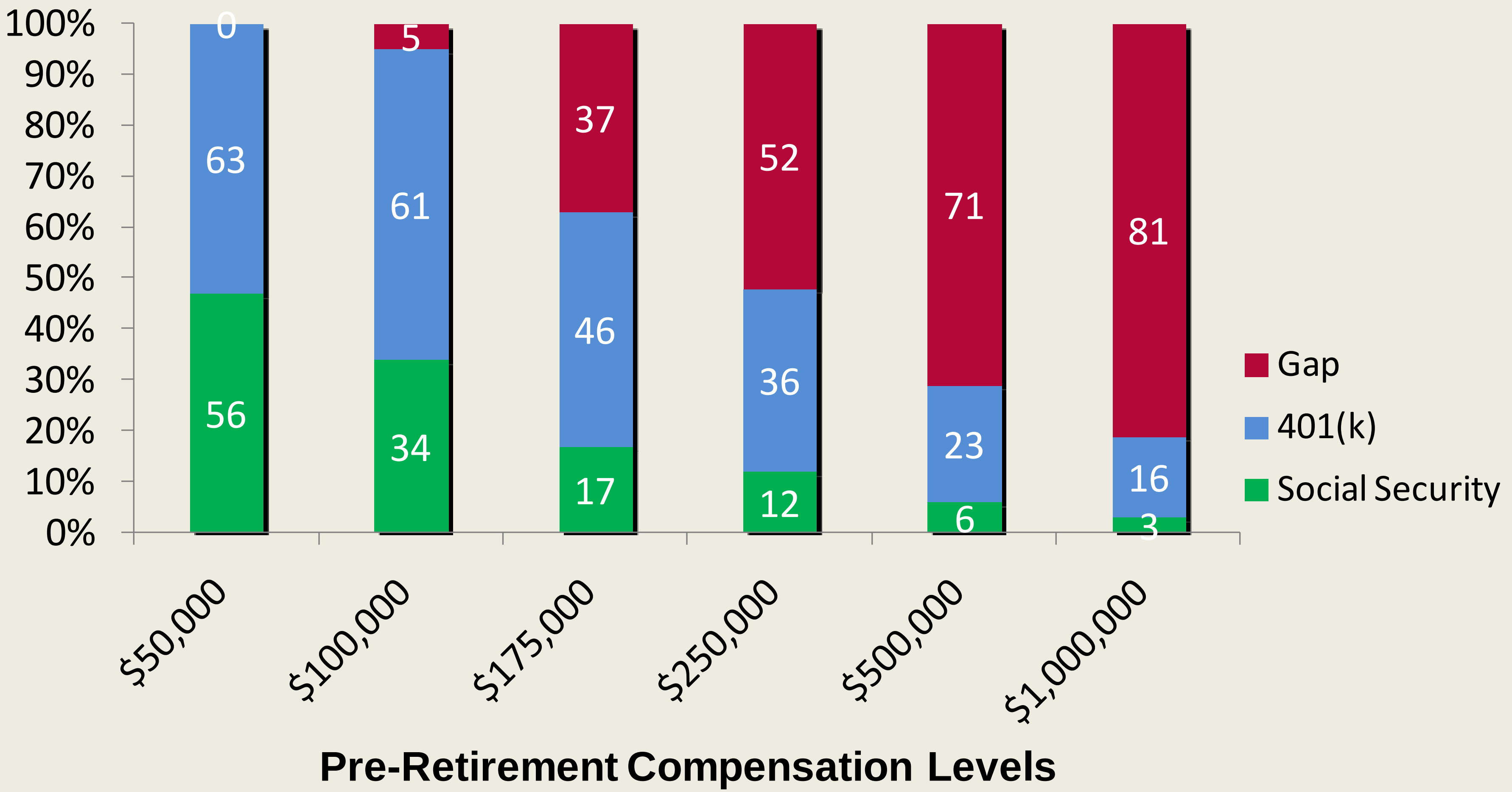
LESS THAN

25%

OF HIGHLY COMPENSATED EXECUTIVES MAX OUT THEIR 401(K) CONTRIBUTIONS

Source: Delotitte Annual 401(k) Benchmarking Survey, 2011 Edition.

Retirement Gap Widens for Executives



Source: Fidelity Research Institute 2007, Social Security Benefit Calculator

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Plan Designs

THAT BENEFIT OWNERS AND EXECUTIVES

Which Combination is Best?

Retirement Plans

- **Defined Contribution**
  - 401(k)
  - Profit Sharing Plan
  - Simple IRA
- **Defined Benefit**
  - Traditional
  - Cash Balance
- **ESOP**
  - Leveraged
  - Non-Leveraged
  - KSOP
- **Non-Qualified**
  - Equity Based
    - Stock Options
    - SARS
  - Non-Equity
    - Deferred Compensation
    - SERP
  - Financing Options

Case Study

	Contribution for Owners	Cost for Employees	Tax Savings @40%	Net Current Benefit (Cost)
Current Safe Harbor and 401(k)	$59,500	$26,580	$34,432	$7,852
Safe Harbor, 401(k) and top off with X-Tested Profit Sharing Plan	$105,500	$57,094	$65,038	$7,944
Combination Cash Balance/401(k) Profit Sharing Plan	$310,000	$100,358	$164,143	$63,785

Retirement Strategy

LOWER FRINGE COSTS BY RESTRUCTURING RETIREMENT PLANS

Company Profile

- $10,000,000 Revenue
- $6,000,000 Payroll
- 50% Participation
- 100 Active Participants
- Up to 4% Match
- Immediate Vesting

Considerations for Plan Design

- Use Auto Enrollment to increase participation to pass “testing issues”
- Reduce match ($.50 up to 4%)
- Remove your HCEs from match to provide ultimate flexibility

Typical Safe Harbor Retirement Plan

LPTA (or SCA's) 4%	CORE 4%	HCEs 4%
HCEs 4%	HCEs 4%	HCEs 4%

Redesigned Retirement Plan

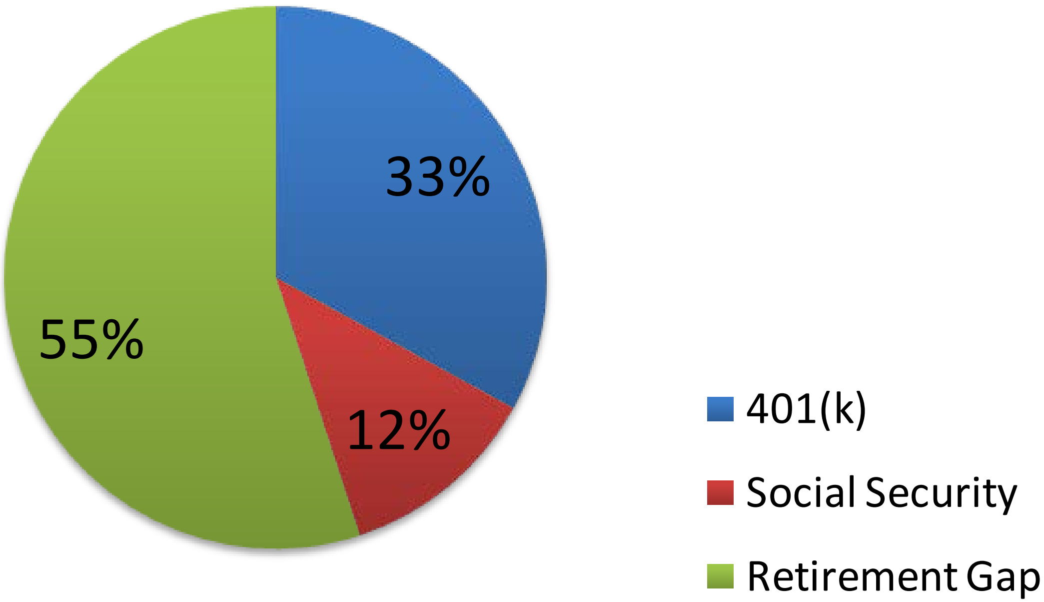
	LPTA (or SCA's) 0%	CORE $.50 up to 4%	HCEs 0%
Non-Qualified > Plan	HCEs 0%	HCEs 4%	HCEs 4%

Conclusion

Before	After
$6,000,000 Payroll	$6,000,000 Payroll
50% Participation	50% ≤ Participation
Cost = 2% Payroll	Cost ≤ 1% Payroll
Immediately vested	Vesting Schedule

Traditional Retirement Sources for Key Employees Leave a Gap

Retirement Replacement Ratio using traditional qualified plans and government sources



45% Replacement Ratio

Hypothetical Key Employee

Age 45

Earning $130,000 per year

Source: Principal Financial Group Replacement Ratio Calculator
Annual Statistical Supplements to the Social Security Bulletin www.ssa.gov

Non Qualified Plans

HOW TO USE THEM TO DECREASE FRINGE RATES

Non-Qualified Plans

What is the general purpose?

- "401(k) Repair"
- Save for retirement outside the limits of qualified plans
- Determine the timing for the payment of taxes
- Get control over the compensation of the most valuable employees
- Provide an ownership experience, without diluting actual ownership
- Provide insider options

Advantages of Non-Qualified Plans

- Ability for plan sponsor to fill retirement savings gap for highly compensated employees
- Help increase ability to recruit top talent by enhancing the attractiveness of total benefits package
- Encourage loyalty among key employees by helping secure their financial futures
- Help provide additional opportunities to reward employees financially, based on the structure of your non-qualified plan

Recruit – Retain – Reward

- 74% of plan sponsors feel that their plan assists in retaining key employees

- 80% of plan sponsors believe their retirement packages are an effective recruiting tool

Less than **35%** of plan sponsors think their retirement plan benefits are CAREFULLY CONSIDERED and CLOSELY ALIGNED with their corporate business strategy.

Source: Delotitte Annual 401(k) Benchmarking Survey, 2011 Edition.

Business Profile

- 20M+ and growing in revenue
- 50-100 employees
- Core group of 3-5 employees (been there from start, BD, key PM's)
- No set aside work
- Higher margin work (at least it used to be)

Executive Compensation Case Study

Business Goals

- Determine way to share profits with bigger group of core employees
- Consider sharing equity with small group
- Redesign generous bonus package from initial start up phase
- Ultimately provide an environment of a company that takes care of its employees financially.

Executive Compensation Case Study

Qualified strategies to accomplish Goals

- Initially utilized high end Qualified plan Match
  - Safe harbor + 3% non-discretionary match = 7% to employees retirement
    - 401k modified so employees can receive up to 5% to maintain margins and stay competitive on new bids
    - New contract work offers no match to 401k for new contracted employees

Non Qualified strategies to accomplish Goals

- Restructured bonuses paying >$50,000 to a half cash/ half restricted bonus (SERP) plan
  - Added new key employees to same structured benefit
  - Modified plan to allow for additional pretax contributions for home office HCE's
  - HCE 401k Match now contributed to SERP
  - Using this NQ plan to provide the 3% non discretionary match to HCE's
- Shared small portion of equity with select employees

- 40 year old executive
- Works until age 65
- 30% tax bracket (including state)
- 401(k) balance at $150,000
  - Contributing maximum $17,500 annually
  - Match plus 2% increase

Executive Case Study

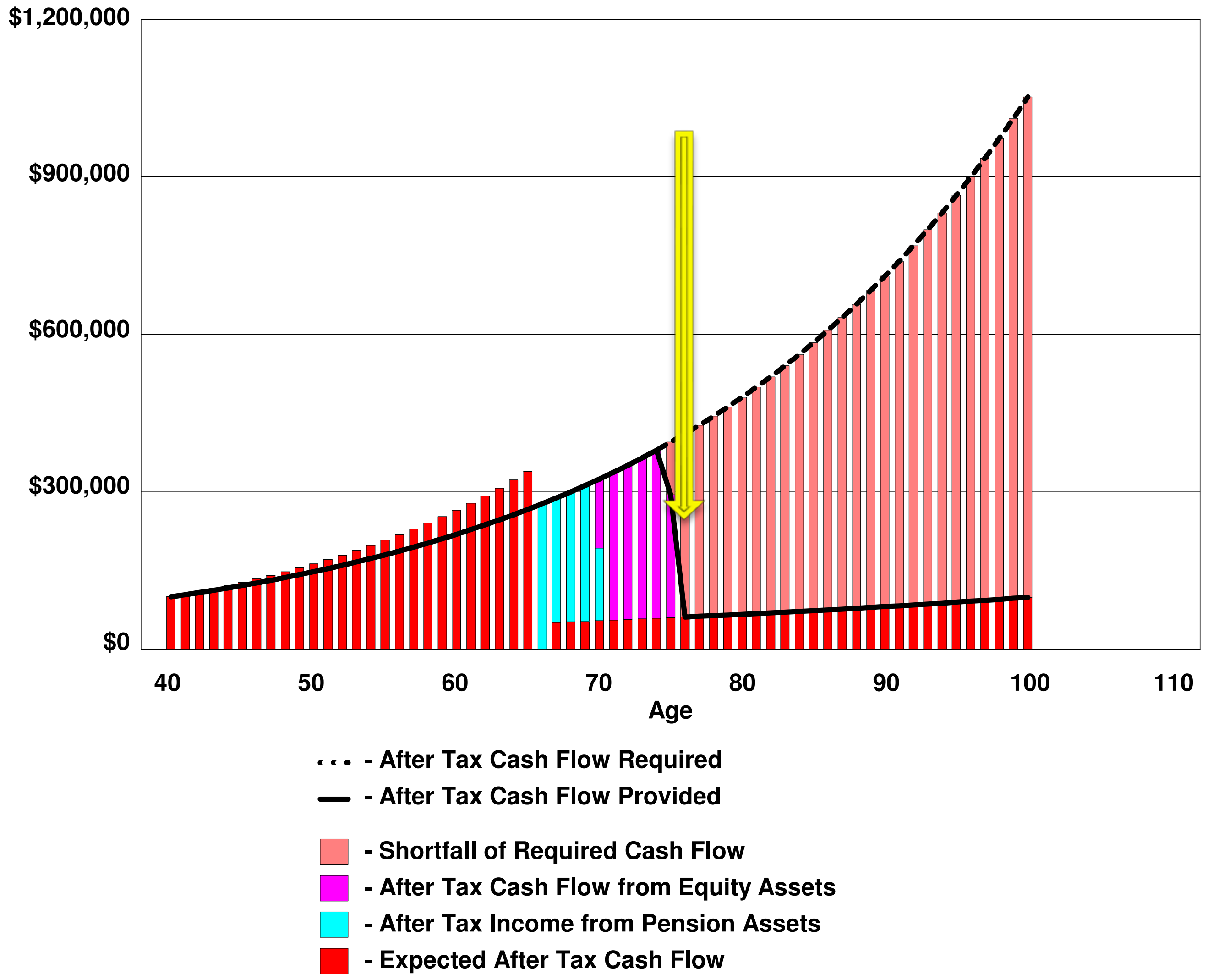
Case Study - Three scenarios

1. No executive benefit plan

2. Buyout from stock pays out $1.5M at age 60

3. Company invests $20,000 per year for executive into SERP plan for 25 years

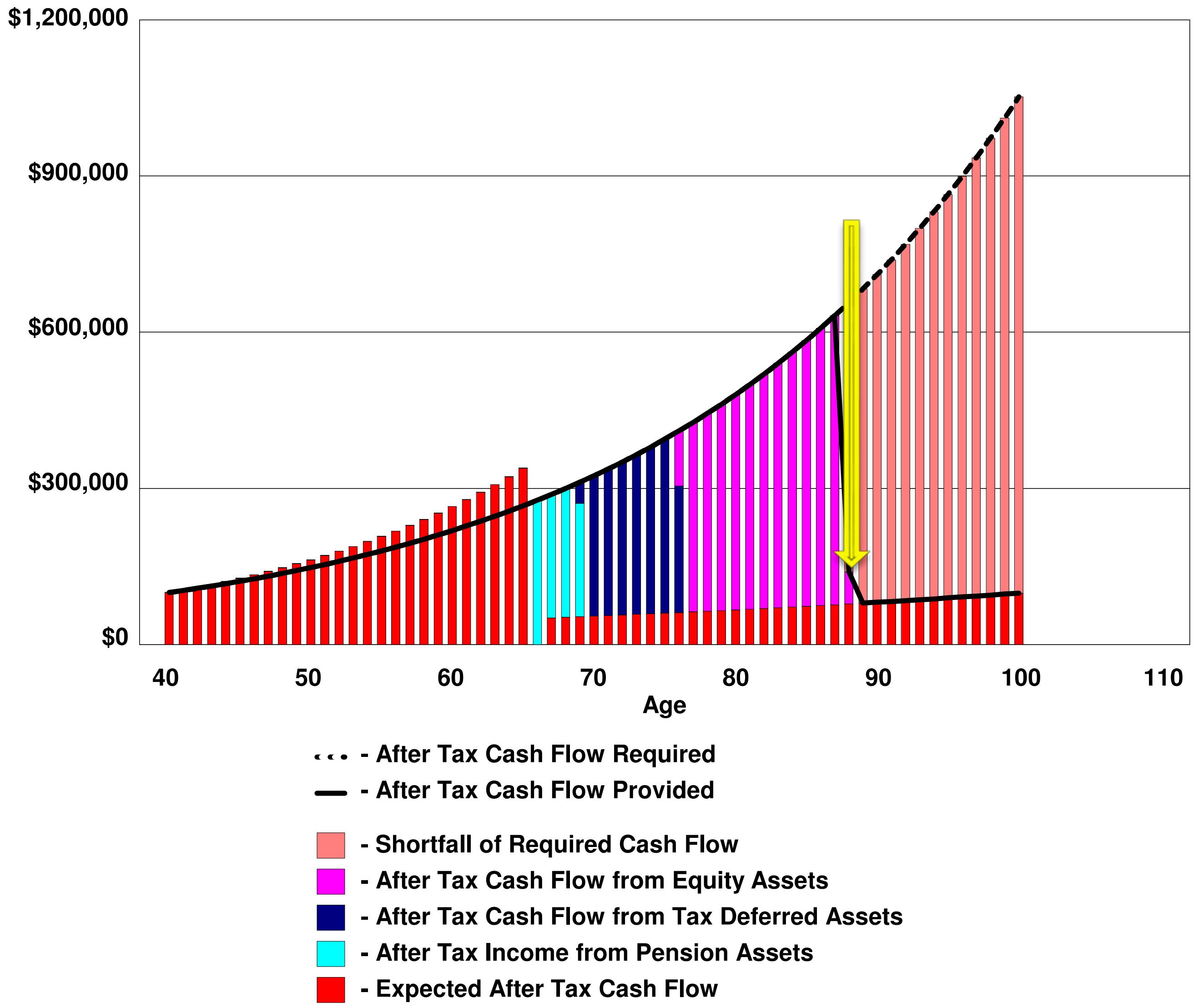
No Executive Benefit Plan



Retirement shortfall at age 75

Have your executives calculated their shortfall age?

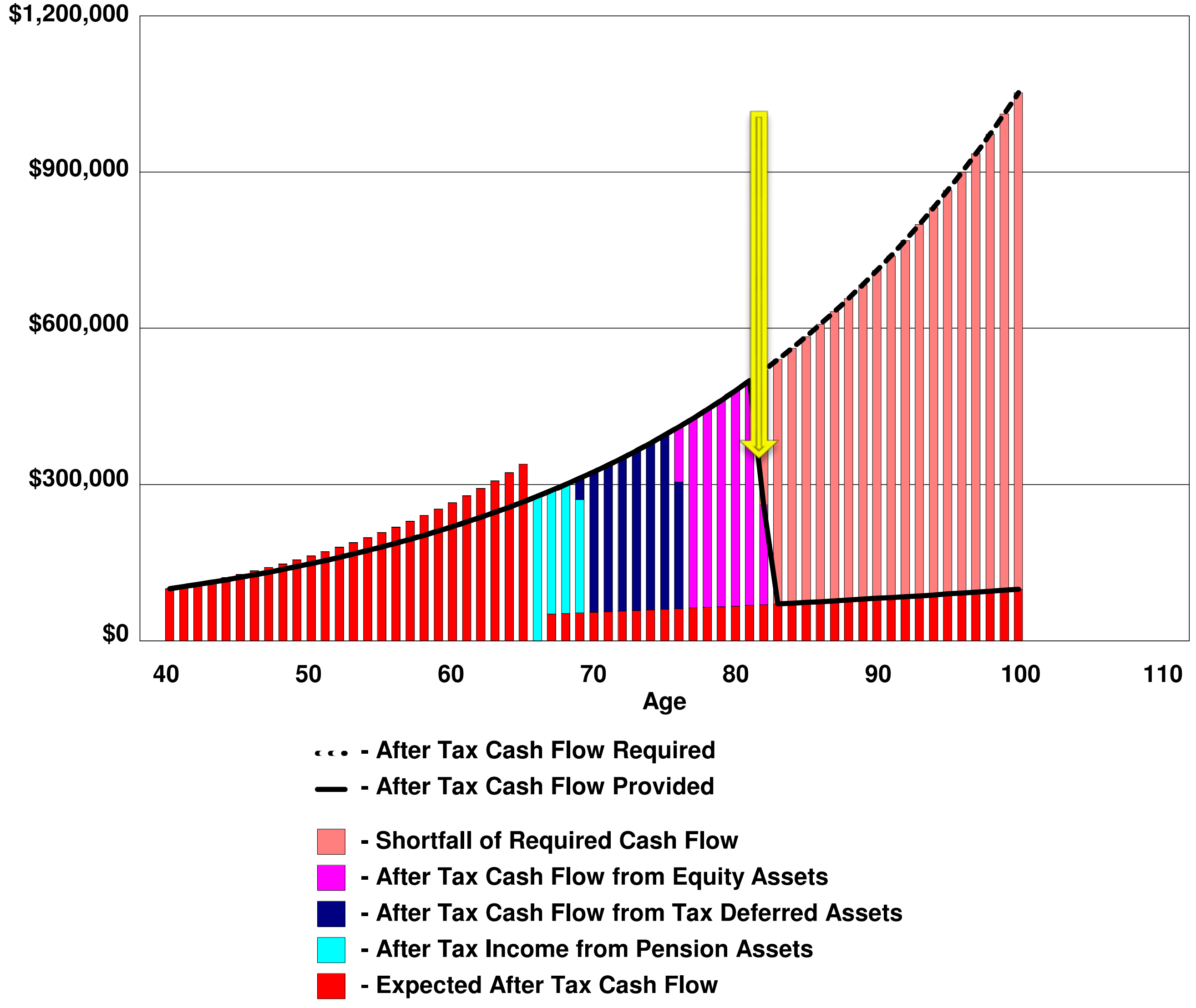
Buyout from Stock



Retirement shortfall at age 86

Contingent on sale of company at $1.5M

SERP



Retirement shortfall at age 83

Costs owner $20,000/year with no dilution of equity

Case Study Conclusions

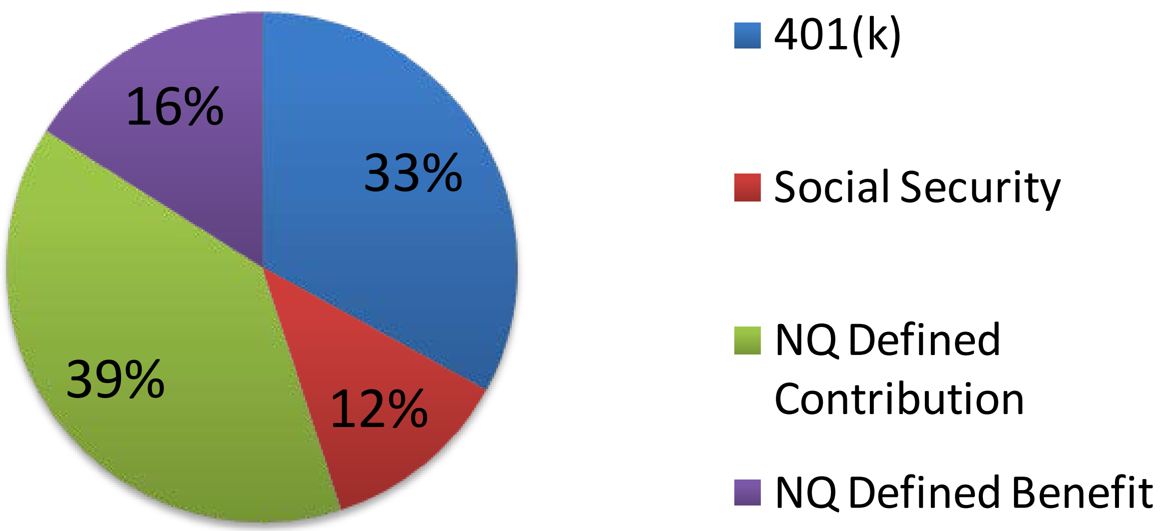
- Key employees fear of not having enough money in retirement are reality without any additional plan
- Stock plan only works if company sells or company can afford to buy stock back
  - Stock plan will cost $1.5M to the owner whether they buy it out or company is sold to a third party

Case Study Conclusions

- SERP Plan is a more cost effective tool to solve the retirement gap for your executive
  - $500,000 over 25 years
  - Provides some benefit if company does not sell or executive does not stick around to benefit from sale
- Stock buyout and SERP plan provide "golden handcuffs"

Non-Qualified Plans Fill the Gap

Retirement Replacement Ratio using traditional sources plus nonqualified deferred compensation plans



100% Replacement Ratio

Hypothetical Key Employee

Age 45

Earning $130,000 per year

Source: Principal Financial Group Replacement Ratio Calculator
Annual Statistical Supplements to the Social Security Bulletin www.ssa.gov

Key Takeaways

- Compliance
- Retirement Readiness
- Automation Features
- Plan Design
- Non-Qualified Plans

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- Annual Statistical Supplements to the Social Security Bulletin www.ssa.gov

Retirement Readiness Analysis

Breakdown: Salaries $0-$49,999							
Age	Average Income	Number of Participants	Employee Deferral	Employer Contribution	Average Balance	Retirement Ready 80%	Necessary Catch Up
20-30	$11,437	3	2.0%	2.0%	$2,181	YES	0.0%
30-40	$33,262	10	4.7%	2.4%	$9,287	CAUTION	2.7%
40-50	$33,737	14	4.3%	2.8%	$23,445	CAUTION	8.3%
50-60	$19,133	4	10.9%	3.1%	$15,173	CAUTION	22%
60-70	$30,921	3	4.0%	2.6%	$25,379	NO	145%

Breakdown: Salaries $50,000-$114,999							
Age	Average Income	Number of Participants	Employee Deferral	Employer Contribution	Average Balance	Retirement Ready 80%	Necessary Catch Up
20-30	$101,376	3	3.1%	3.1%	$21,139	YES	0.6%
30-40	$79,138	8	7.6%	3.5%	$29,086	YES	1.3%
40-50	$79,305	7	7.3%	3.6%	$26,882	CAUTION	14.4%
50-60	$84,942	11	8.2%	2.9%	$27,528	CAUTION	48.7%
60-70	$98,986	4	11.5%	3.1%	$37,712	NO	196.0%

Breakdown: Salaries $115,000 and Over							
Age	Average Income	Number of Participants	Employee Deferral	Employer Contribution	Average Balance	Retirement Ready 80%	Necessary Catch Up
20-30	$119,984	1	6.0%	3.1%	$34,297	YES	0.0%
30-40	$156,015	7	7.8%	3.3%	$79,451	YES	3.8%
40-50	$136,271	3	7.6%	3.5%	$80,475	CAUTION	18.1%
50-60	$137,903	3	8.1%	3.6%	$48,172	NO	56.9%
60-70	$132,167	2	24.0%	3.8%	$81,969	NO	198.0%

Thank you

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