2022 Life Sciences:

Key Executive Compensation Trends

Incentive Compensation for the Life Sciences Industry's Unique Needs in the Pre- and Post-Commercial Phases

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Common Elements of Executive Compensation

Incentives

- Base Salary
- Annual Bonus/Short-Term Incentives
- Long-Term Incentives (often equity based)

Protection

- Severance
- Change in Control Benefits
- Executive Retirement Benefits

Life Sciences Executive Compensation

- Stages:
  1. Drug discovery
  2. Clinical trials
  3. Treatments to market (commercialization)
- Clinical trial phases (could be decades long):
  1. Safety, minimum effective dose
  2. Does it work?
  3. Better than others available?
- Valuations can triple on progressing to next phase
- Within the Life Sciences industry:
  - Biotech companies: median pay is much higher than other companies
    - For example, median pay at Madrigal is $791,000
  - Pharma companies:
    - CEOs are paid higher than CEOs at other life sciences companies
    - Median employees are paid less
    - Large equity-based signing bonuses, vesting over several years

Pre-Commercialization Pay Practices

- Investors focus on clinical trial phases and progress rather than income statements
- Base salaries are modest and standardized
- Short-term incentives:
  - Performance goals focus on scorecards of progress and pipeline of discoveries
  - Awards are non-formulaic
  - Amounts are small compared to total comp (i.e., 55% of base salary)
- Long-term incentives:
  - Stock options predominate
  - Time-based or performance-based RSUs are rare
  - Target awards based on % of outstanding shares
  - Comprise most of total compensation
  - Typical equity plans:
    - 5% burn rate
    - 20% overhang
    - Evergreens are common

Post-Commercialization Pay Practices

- Focus on revenue
- Base salaries correlate with total revenue
- Short-term incentives:
  - Performance goals are formulaic
  - Based on revenues, sales, income, R&D goals, pipelines, and/or earnings per shares
  - Amounts equal to or greater than base salaries
- Long-term incentives:
  - Time-based or performance-based RSUs predominate
  - Performance goals based on relative TSR, sales, or income
  - Target awards are based on grant date value
  - Make up most (60-70%) of total compensation

Once a company goes public, executive compensation tends to homogenize with other industries due to say-on-pay and ISS voting recommendations

Compensation Consultants

- Good at:
  - Benchmarking and peer group data
  - Latest trends
  - Design of performance metrics
  - Pinpoint competitive executive compensation programs
  - ISS scorecards for equity plans
    - Equity plan modeling, overhang, burn rates
    - How many shares to include in equity plan
- Caution: some design incentives may not comply with legal requirements
  - Lawyers need final say on legality
- Versus executive compensation counsel:
  - Shareholder and corporate governance concerns
  - Investor relations, stock exchange rules, tax and legal considerations

Tax Compliance

- Tax Planning: when taxed; as ordinary income or capital gains
- Section 409A – Deferred compensation
  - 20% excise tax in addition to income taxes
  - Violated when arrangement contains certain designs or is operated outside of 409A rules
  - Payable by the executive
- Section 280G – Golden Parachute Excise Taxes
  - Private: shareholder vote
  - Public: no shareholder vote possible to cleanse excise tax
- ISOs/Employee Stock Purchase Plans (ESPPs)
  - Shareholder approval
  - Holding period requirements
  - Limits on amounts vesting each year

Section 409A – Deferred Compensation

- Non-qualified deferred compensation must comply with the 409A rules regarding the timing of deferrals and the time and form of payment
- May apply to equity, bonuses, severance, nonqualified retirement, deferral of salary
  - Annual bonuses, salary, stock options, stock appreciation rights, ESPPs and restricted stock generally exempt from 409A
- Equity awards are exempt from 409A if they fit into "stock rights" exemption:
  - Not exempt from 409A as a stock right:
    - Restricted stock units (RSUs)
    - Performance stock units (PSUs)
    - But awards can be designed to be exempt from 409A under the short-term deferral exemption
  - If subject to 409A, must comply
    - Automatically exercise or settle on set date or a 409A permissible payment event

Common Issues

- Annual and/or long-term performance objectives not clearly aligned with strategic plan or long-term intent.
- Executive compensation plans are excessively expensive.
- Non-alignment of vesting/payout schedules with strategic time horizon.
- Retention exposures:
  - No analysis of impact of underwater or diminished value equity awards on morale and retention.
  - Too little unvested value remains within an executive's total equity allotment.
  - Vesting periods too short.
- Change in control exposures:
  - Lucrative CIC payouts that potentially dissuade potential bidders.
  - Lucrative CIC payouts that potentially motivate management to settle for less than optimal transaction pricing.
  - Unclear definition of CIC or definition that could result in payouts without CIC actually occurring.
  - No Board or Compensation Committee discretion in determining consequences of a CIC.

Risk Reduction Factors

- Mix of compensation, with focus on rewarding long-term performance
- Use of multiple performance metrics that align with strategic business goals (including top-line, bottom-line, etc.)
- Exercise of downward discretion
- Caps on incentive compensation arrangements; relatively flat payout curve
- Multi-year time vesting on equity awards
- Company policies, such as code of conduct, internal controls, etc.
- Inclusion of corporate-wide goals
- Role of independent compensation committee
- Recovery/clawback policies
- Stock ownership/holding requirements
- Use of benchmarking

Clawbacks

1. Prohibited conduct
2. Restatement of financial results
3. Appropriate scope

Equity

- Incentive stock options (ISOs)
- Nonqualified stock options (NQSOs)
- Restricted stock
- Restricted stock units (RSUs)
- Performance stock units (PSUs)
- Stock appreciation rights (SARs)
- ESPPs (employee stock purchase plans)

ISOs, NQSOs and Stock Appreciation Rights

- ISOs and NQSOs ("Options") and Stock Appreciation Rights:
  - Valuable to recipient only if stock price goes up
  - Not deferred compensation for 409A purposes if granted at fair market value and based on common stock
  - May incent management to take greater risks
  - May lose incentive/retentive value if deeply underwater
- Options:
  - Allows recipient to control the timing of income recognition for income tax purposes
  - ISOs permit employees to receive long-term capital gains tax treatment if ISO holding period and other requirements are met
  - Requires payment of the option exercise price
  - Typically, large number of shares subject to awards creates "overhang" and dilution issues
- Stock Appreciation Rights
  - Receive price appreciation on a specified number of shares between grant date and exercise date
  - Taxed as ordinary income; cash-based -- don't use any equity

RSUs and PSUs

- RSUs
  - Each unit represents right to receive a share of stock (or the cash value of a share of stock); may be forfeited if employment ends before vesting
  - Taxable to recipient at time unit is settled in stock or cash, which may be when unit vests or a later time
  - Continue to have value even if stock price decreases
- PSUs
  - Vesting is based on meeting performance conditions
  - Performance conditions are usually financial metrics such as:
    - TSR
    - Sales
    - Number of stores opened
    - Increase in profit levels
  - Vest in different amounts depending on performance against metrics

Restricted Stock

- Actual issuance of shares of stock that may be forfeited if employment ends before vesting (or other performance conditions, if any, are not satisfied).
- Continue to have value even if stock price decreases.
- Not deferred compensation for 409A purposes.
- Taxable at vesting unless 83(b) election made (then taxable at grant).
- Awards involve fewer shares, less dilution than options.
- Proxy advisory services/institutional investors want limits on “full value” awards like restricted stock.

Employee Stock Purchase Plan

- Employees are permitted to contribute between 1% and 15% of their earnings (most commonly after-tax) each paycheck.
- Accumulated contributions made during an “offering period” are used to purchase stock on the pre-established “purchase dates.”
  - Most offering periods have several purchase dates - commonly at equal six-month intervals.
- Purchases are at a discount of up to 15% on the fair market value of the stock. The discount price can be based on:
  - the lesser of fair market value at the beginning of the offering period or the purchase date, or
  - on the lowest closing price of the stock during the purchase period.
- Exempt from 409A as a stock right.

Questions?

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