Building management teams - Part 1

By **Phil Peters**

Are stock options still a powerful recruitment tool?

Publicly quoted technology companies have not performed well in the years following the dot com crash in 2001 compared with the previous five years. As a consequence, options in quoted technology companies are often perceived by candidates as less valuable than they were in the past. But does this mean that options are no longer a powerful recruitment tool for venture backed technology companies? Are options the only option?

It is true that exit prices for venture backed technology companies usually track public valuations. However, candidates who receive options in venture backed technology companies do not need to be as pessimistic about their value compared with candidates joining publicly quoted companies. Actually, times have never been better. Since the dot com boom there has been a spectacular global collapse in average pre-money valuations of private technology companies and there are no indications this will change in the near future.

Take a look at the table which tells the story of a lucky CEO who got a low pre-money valuation, and an unlucky CEO who did not. Both CEO's were granted 5% in options in companies and both companies subsequently raised €11m in three rounds. Each company was then acquired for €30m. The lucky CEO made €592,000 from the sale of options but the unlucky CEO only made €311,000. The only difference was the valuation of the company when they joined, as opposed to when they exited. Therefore when recruiting a new member of the management team it is worth pointing out to the candidate that he/she is likely to be receiving options at a discount to historic prices.

TABLE 1: THE PERILS OF HIGH PRE-MONEY VALUATIONS

	Seed	A	B	EXIT
Pre-money valuation (m)	**€3.0**	€9.0	€15.0	€30.0
Cash Invested (m)	€1.0	€4.0	€6.0	
Post money valuation (m)	€4.0	€13.0	€21.0	
Lucky CEO Options - After Dilution	5.0%	3.5%	2.5%	2.5%
Value (k)	€0	€300	€369	€**592**

	Seed	A	B	EXIT
Pre-money valuation (m)	**€12.0**	€15.0	€20.0	€30.0

Cash Invested (m)	€1.0	€4.0	€6.0	
Post money valuation (m)	€13.0	€19.0	€26.0	
Unlucky CEO Options - After Dilution	5.0%	3.9%	3.0%	3.0%
Value (k)	€0	€150	€189	€**311**

Source: Norman Broadbent

Restricted stock is becoming an increasingly popular alternative to options, for quoted technology companies, in an attempt to address the issue of “underwater” or worthless options and the mass exodus of talent that ensues. The question for boards of venture backed technology companies is whether restricted stock should be used as a recruitment tool when building management teams. In my experience, restricted stock is perceived to be more like “salary” than “options” because of the size of the grants, which are fairly modest. This factor along with personal taxation issues in many European countries has made it an unattractive choice for private companies. Therefore, to attract candidates to venture backed technology companies the board has to ensure that potential candidates perceive the future value of the company’s shares to be significantly higher than they are today.

History teaches us that valuing a private company has never been easy and it is not a new problem. In 1613 there were no public stock exchanges and the establishment of private companies had just begun. The English East India Company and The Dutch East India Company had both been founded a few years earlier and both companies had fleets of ships which were engaged in a bloody military battle with each other to secure trade in nutmeg and cloves with the East Indies.

Annual consumption of spices had risen to €890,000 in Western Europe by 1613 (reference 2) as people believed that this precious commodity could cure fatal diseases such as the London Plague. Spain and Portugal were about to enter the market and the respective boards of The English East India Company and The Dutch East India Company met in Holland to discuss a merger. The merger would enable both fleets to massively outnumber the Spanish and Portuguese who, as new entrants to the market, were small. The merger was aimed at securing an effective monopoly in what was then the world’s fastest growing technology business.

However, the merger failed because the boards of The English East India Company and The Dutch East India Company could not agree on a valuation. As an aside, The Dutch East India Company had seventeen non-executive directors – a daunting backdrop for negotiations and decision making compared to current day practice.

Today there is evidence that the boards of venture capital backed companies are taking a more realistic view on the value of their portfolio companies compared to their private competitors. A good example of this is the 50-50 merger earlier in 2006 of Video Island (backed by Balderton, Index and DFJ Esprit) and LOVEFiLM (backed by Arts Alliance). The deal gave the combined company more than 400,000 DVD rental subscribers in Europe, a lower cost base, greater efficiencies of scale and a more benign competitive environment.

In private companies, if the perceived value of a company varies from one investor to another it is hardly surprising that the perceived value of options also varies from one candidate to another. However, in my view private companies have rarely been in a stronger position to attract the best talent from quoted companies. The challenge, during the recruitment process, is to ensure that

potential candidates perceive the value of the options they are offered to be incredibly valuable. This is more likely to happen if the company has defined its exit strategy, compiled a list of relevant trade sales and prices, identified publicly quoted companies with which it can be compared, and can in this way assist the candidate to value the options being offered. Surprisingly few companies, however, do this before they begin recruiting.

The question of how many options should be made available to attract the right person for the job often arises and the table below is a reference point. Even though average valuations of venture backed companies fluctuate wildly over an economic cycle the amount of options that are offered to candidates joining the management team remains fairly stable. The data below is based on three quantitative surveys, in separate years, of 150 venture backed technology companies (reference 1). In addition Norman Broadbent International has managed the candidate negotiations in over 100 different searches for venture backed companies, which we have also used to compile the table below.

TABLE 2: NORMAN BROADBENT'S GUIDELINES – OPTIONS FOR NEW JOINERS

	Seed	A	B	IPO
Typical Post money valuation (m)	**€5**	**€15**	**€25**	**€40**
CEO	7.9%	5.5%	3.9%	2.9%
CTO	3.0%	2.1%	1.5%	1.1%
CFO	3.0%	2.1%	1.5%	1.1%
VP Sales & Marketing	4.2%	2.9%	2.1%	1.6%
Non-Executive Chairman	2.0%	1.5%	1.0%	0.5%

Source: Norman Broadbent

Phil Peters is Director of the Technology Practice at executive search firm Norman Broadbent and works closely with the Venture Capital community to provide executive search services to their portfolio companies.

Reference 1 : 2003 Survey of Technology Entrepreneurs & their Companies
www.normanbroadbent.com/technology

Reference 2 : Nathaniel's Nutmeg: How One Man's Courage Changed the Course of History: by Giles Milton

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Building management teams - Part 2

By **Phil Peters**

How to recruit a first class CEO

In my view the best approach to recruiting a CEO to a venture backed company is, initially, to do all the things that would normally be necessary to attract a new investor. Think of the new CEO as being no different to a venture capitalist except that the new CEO will be investing his/her time rather than their money. Recruitment at a senior level should be just like fundraising in the sense that both should be high integrity sales processes.

Strategy
The strongest candidates will be attracted to a business, which has a clear strategy and a board that is united behind it. It should not be the short-term goal of the CEO to develop the strategy unless the business is in need of a “turn-around”. What kind of exit valuation is the board looking for and can this be supported with a coherent exit strategy? What comparable companies have been acquired or IPO'd and how were they valued. What are the key questions that a strong candidate should ask and make sure the board and ultimately the search firm has answers. Strong candidates will not pursue the opportunity if they do not believe in the business plan and it is vital that the search firm is sufficiently well briefed to avoid a low yield, due to lack of information, in the early stages of the search.

Candidate Profile and Search Plan
The candidate profile should initially focus on the "hard" criteria (e.g. has profit/loss experience for a €10m+ company) and not the "soft" criteria (e.g. is a strong leader). This is because the "hard" criteria initially drive the search strategy. Be clear on what "hard" criteria is mandatory (ideally no more than 4 or 5 points) versus what is "nice to have". Describe where the "ideal candidate" is currently working and what job he/she is doing. Give specific names, as examples, if possible. If other candidates have been met and were rejected or withdrew, prior to engaging a search firm, then explain what you liked / disliked about them.

In a typical search around 100 people may be approached. 10 to 15 will meet the search consultant and the balance will reject the opportunity or be rejected as failing to meet the "hard" criteria. A shortlist of 3 to 5 should then come from this. A search plan must therefore comprise 100 "search sites" which is the number of companies on the search plan multiplied by the number of employees (past and present) of that company who would be potential candidates. Assuming the company has a strong business plan the biggest single reason why a search is compromised is the inability of the search firm to create a

sufficient number of search sites due to poor quality research. The board is well positioned to give input to the search plan. It may have market research reports it can share and it can help to develop a list of competitors or partners to add to the search plan. Getting the search plan right is the single most important aspect of a search.

Founders & Organisation Structure
When a new CEO is recruited he/she usually displaces one or more of the founders. Sometimes it is inevitable that these displaced individual(s) will leave, however, a lot of thought should be put into defining the new role(s) of the displaced individual(s). This should include written job descriptions for these people and not just for the incoming CEO. A clear organisation structure needs to be presented to the candidate, including any gaps that the board envisages on appointment. This minimises the new CEO feeling that he/she is "herding cats".

Objectives
What are the financial goals that the CEO will be expected to deliver in the short term and long term. What are the strategic goals (e.g. international expansion, securing "early adopter" customers, building the management team etc)? What is the company's current financial position, especially revenue history and forecast as well as cash and cash burn. Will the company need additional funding and, if so, when will this be needed and will it come from existing or new investors.

Interview Process and Selling The Opportunity
Who will meet the candidates at first interview. How many interview stages will there be and who will be involved at each stage. The same process should be followed for all candidates unless there are exceptional circumstances. Typically it takes 30 to 45 days to deliver a shortlist and 60 to 120 days, from the start to acceptance of offer. A lot of time can be wasted after the shortlist is delivered through indecision and inefficient management of the interview process and this may determine if the search finishes on day 60 or day 120. It is not wise to assume that a candidate will accept the position even if he/she is made a generous offer. It is therefore good practice to ensure that the interview team is fully briefed on each of the candidates' "hot buttons" and that care is taken to ensure that these are covered and that any other concerns are uncovered. The strongest candidates have the largest number of employer choices. Hot buttons include people issues, funding, product strategy, competition and capital gains from options.

Compensation
Try to be open minded about cash and equity compensation, however, if there are reasons why it would be difficult to exceed a given range then state the range and the reasons at the outset of the search. It is unlikely the successful candidate will accept a cut in his/her cash compensation (salary, bonus, pension, car allowance etc) unless this individual is a high net worth who has made money from a previous venture. The argument that the candidate "should be prepared to take a salary sacrifice because the founders are paid very little and/or there is not much cash in the business" will result in severely restricting the candidate pool. However, it is reasonable to match rather than increase the successful candidate's current cash compensation as the only true motive for joining a venture backed company is, in my view, to make a life changing amount of money from options.

The data below is based on three quantitative surveys, in separate years, of 150 venture backed technology companies (reference 1). In addition Norman Broadbent International has managed the candidate negotiations in over 100

different searches for venture-backed companies, which we have also used to compile the table below. Note that although the level of share options awarded varies by stage and post money valuation this is not true of cash compensation. Cash varies by industry sector.

Table 1: Norman Broadbent's Guidelines - Cash for New Joiners (1000's)

Software & IT Services	**Salary Range**	**Bonus**	**Benefits**
CEO	€193 - €233	40% - 50%	10% - 15%
CTO	€175 - €212	25% - 35%	10% - 15%
CFO	€175 - €212	25% - 35%	10% - 15%
VP Sales & Marketing	€157 - €193	80% - 100%	10% - 15%
Non-Executive Chairman	€71 - €88	0%	0%
New Materials, Semicon-ductors & IT Equipment	**Salary Range**	**Bonus**	**Benefits**
CEO	€154 - €188	30% - 40%	10% - 15%
CTO	€141 - €181	25% - 35%	10% - 15%
CFO	€141 - €181	25% - 35%	10% - 15%
VP Sales & Marketing	€126 - €154	50% - 70%	10% - 15%
Non-Executive Chairman	€57 - €70	0%	0%
Network Operators & Media Content	**Salary Range**	**Bonus**	**Benefits**
CEO	€168 - €205	35% - 45%	10% - 15%
CTO	€154 - €188	25% - 35%	10% - 15%
CFO	€154 - €188	25% - 35%	10% - 15%
VP Sales & Marketing	€138 - €170	65% to 85%	10% - 15%
Non-Executive Chairman	€63 - €77	0%	0%

Source: Norman Broadbent, 2008

In table 1 Benefits are defined as a percentage of Salary and includes the cash value of pension contributions, car allowance, life assurance and private health. Bonus is typically performance related and also defined as a percentage of Salary.

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