Getting Back to the Long Term For Executive Compensation

By Roger Brossy and Blair Jones

With the coronavirus pandemic (we hope) tapering off this summer, boards are looking ahead to more normal compensation programs for 2022. They can pull back on the extraordinary measures and structures of 2020–21 and return to their long-term paths to strengthen or transform their organizations. Those paths were already a bit obscured by ongoing disruption in many industries, but then the pandemic pushed them decisively to the side. Companies can now get out of reactive mode and start to control their future again.

Still, it's important for boards to resist the temptation to pick up where they left off in 2019. The pandemic and other developments have changed the landscape for corporate behavior and strategy. Executive compensation must adapt accordingly for companies to capture fresh opportunities and overcome new challenges.

TAKING STOCK

2020 was especially difficult for many boards. For their compensation programs, many resorted to new measures, goals, and performance periods, or used discretion. Others introduced special awards to promote retention or maintain motivation. Many of these approaches veered from the typical path but were deemed necessary to administer relevant and fair rewards amid the crises.

Just as individuals have been doing, boards will benefit from taking stock of what they've learned from the experience. With executive compensation, how did their experiments in new measures, structures, and discretion play out? Were these one-off steps, or did they reveal approaches that should be maintained?

Rather than going back, boards can treat the pandemic as a turning point. How durable did your organization and its culture prove? What should you do differently when designing pay programs to position your company for long-term success? What did you learn?

In 2019, the typical plan emphasized financial metrics in both the annual bonus (tied to revenue, earnings, and cash flow) and the three-year long-term incentives (LTI) weighted to performance-based shares. In 2020, many boards added operational and strategic goals (linked to transformational milestones), as well as environmental, social, and governance (ESG) metrics. Boards also used discretion to look at results in the rear-view mirror. Those with COVID headwinds de-risked their equity plans in order to engage and retain talent when financial targets were unattainable. While some shareholders criticized these decisions, they did bring about constructive conversations about what matters in executive pay.

Most 2021 pay decisions have already been made, but for 2022, boards can build on those experiments to advance other measures and structures. These can involve reinforcing new strategies or goals, such as a health-care provider exploring further applications for telehealth, an aerospace company finding new uses for its materials, or industrial and energy companies aggressively reducing carbon emissions.

Boards can also reframe investor expectations about the process of compensation. They might begin resorting to year-end discretion on a regular basis, as long as they demonstrate to investors that discretion can be thoughtfully applied and result in negative as well as positive adjustments. They might shift LTI programs toward de-

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liberately building cycle over cycle toward long-term goals, rather than as an annual reset. They might even revive the use of truly long-term vehicles—whether targeted awards tied to progress toward 2030 aspirations, or more long-term value creation-oriented vehicles (e.g., price-based restricted stock units or stock options) in order to balance medium-term incentives.

All of these changes provide an opportunity to reset and recalibrate how companies tie pay to performance. Boards will want to take stock of the historical relationship and be clearer now about that relationship for the future. Where can the company truly differentiate its performance and create enduring shareholder wealth versus just being a ship rising with the tide? When will the company emphasize investment, and when will the payoffs from those investments occur?

Boards will want to carefully think through future programs that expose executives to downside pay consequences. They'll need to ensure they can live with these results, particularly when stacked against attractive opportunities on the upside.

Executive impact will vary across businesses. Some boards will want a great deal of variable pay, while others will promote relatively stable pay. Pay for performance is about adapting to the company and industry realities—paying when real progress is made and true differentiation and performance achieved.

Boards should also resist the urge simply to go with ideas of the moment. In the aftermath of George Floyd's death, boards faced tremendous momentum for adding diversity and inclusion (D&I) measures to incentive plans. These measures send a strong signal of a company's commitment to diversity and improving its culture. Yet companies should introduce diversity-oriented measures in ways that will make a difference—and not replace operational metrics that might do greater good (such as adding D&I criteria to promotions). Boards should also balance these metrics with other ESG goals to drive competitive advantage.

ADJUSTING TO THE STRATEGIC CHALLENGE

In shifting toward a long-term perspective, boards will want to consider their company's or industry's strategic landscape. Some companies are making big, even generational investments, while others seek steady innovation or growth, or must adapt to disruption. Just as these strategic landscapes differ, so do compensation solutions. These are not your traditional compensation plans. They generally move incentives from neutral to more prescriptive, with new, often nontraditional measures, and in some cases, with time frames beyond three years. Let's go through each group.

Big investments: Some companies do need a longer model than three years. A major telecom provider just paid tens of billions of dollars for a new spectrum. That is a generational bet, but one that

will certainly hit return on invested capital over the next few years. The same is true for another company spending $20 billion to build a semiconductor fabricating plant that will take it into new markets. Most of the major car makers are now moving toward the manufacture of electric vehicles. Any compensation model with the usual financial metrics will be challenged within the typical one- and three-year time frames. Prevailing pay cycles discourage this kind of bold investment.

Executives at these companies need to focus on keeping projects on schedule and delivering the promised returns long term. They also need to run their traditional businesses and transition them at the right pace to ensure there is cash to fund investments. So the boards might focus annual incentives on cash flow and productivity measures along with a customer metric such as a net promoter score to ensure that the transformation minimizes disruption to customers. Their performance shares can aim for progressively higher returns on capital (knowing there will be a dip near term), with key implementation milestones on the path to fully realizing the value of their investments. Stock options can round out the LTI, better capturing the long-term value creation of the investments than restricted stock.

This approach may mean that near-term incentive pay is less leveraged, fluctuating in only a small range around target, with the opportunity for larger payouts as the promise of the investments pays off for shareholders in later years. Long-term stakeholder metrics also have a role here, as these investments will likely improve customer access, strengthen supply chains, and reduce emissions.

Private-equity firms may offer insights here. These firms often have longer time horizons than boards at many public companies. They're laser-focused on transforming their acquisitions into stronger companies that attract a premium upon return to public markets—usually in five to seven years. For executive pay, they rely heavily on stock options tied to both time and return milestones. Their annual bonuses are typically smaller than in public companies, while longer-term rewards are generous. Public companies might adapt this approach to promote a longer-term view.

For example, a smaller health-care equipment supplier was acquired by a private-equity firm. The firm knew the supplier could transform the industry with additional scale and more national relationships. The industry was highly decentralized, composed of many regional players. So the private-equity firm directed the supplier to go on an acquisition spree, buying regional players and consolidating the industry. The strategy worked: with additional scale came more meaningful customers, and the company recently went public having considerably multiplied its value. The long-term compensation plan was a highly leveraged combination of stock options and performance share units (PSUs) earned based on earnings before interest, taxes, depreciation, and amortization (EBITDA) growth—but only liquid in the event of a transaction. The short-term plan promoted growth in new revenue and profits. Together the plans kept the growth moving forward, with moderate payouts as goals were achieved, along with the larger opportunity for executives coming from their stockholdings that grew as they helped increase the company's value.

Even outside of big investments, compensation can be an effective way to prompt executives out of incremental moves and toward transformation. Some companies have already made this work. A large services company was profitable, but its revenue growth had slowed in recent years. The company had carried out a series of bolt-on acquisitions, with minimal investment to integrate the various operations. Now the board wanted to energize management around a new strategy: boosting growth by consolidating operations, making these operations easier for customers to work with, and scaling up ancillary revenue lines.

RATHER THAN GOING BACK, BOARDS CAN TREAT THE PANDEMIC AS A TURNING POINT. HOW DURABLE DID YOUR ORGANIZATION AND ITS CULTURE PROVE? WHAT SHOULD YOU DO DIFFERENTLY WHEN DESIGNING PAY PROGRAMS TO POSITION YOUR COMPANY FOR LONG-TERM SUCCESS?

The board therefore made compensation significantly more aggressive. They doubled the upside for the LTI plan, increasing the maximum payout on performance shares from twice to four times the target, well outside the norm. Business-as-usual performance would result in only half of a target payout, instead of 100 percent. The main goals involved profitability, customer retention, and new revenue streams. Before proceeding, the board back-tested these goals against the top-decile growth rates of similarly large companies over multi-year periods to make sure the highest payouts were achieved only if the company's transformation put it at the top of the pack. The results were gratifying. Four years in, the company's market capitalization had doubled, with relative valuation achieving the targeted height above the 90th percentile. Executives received close to the four-time payout, and shareholders were rewarded. Proxy advisors did not contest these sizable rewards, and the say-on-pay votes maintained the same mid-90s percentage approvals as before the program. Pay was aligned with performance because the executives would have received far less if they had accomplished only ordinary results.

Steady growth: Even with a strong starting position, companies need incremental innovation and renewal to maintain their growth profile. This can be especially challenging for companies in cyclical sectors where the temptation to manage *to* the cycle, rather than *through* the cycle, is overwhelming.

Sales for large suppliers of semiconductor equipment, for example, can fluctuate dramatically over the course of several years. To support improvement across cycles, one board developed a metric for a long-term relative free cash-flow margin. To keep management from losing sight of short-term considerations, the annual bonus remained tied to market share. In this way, the company balanced innovation and investment to stay ahead of the competition. The long-term incentive keeps the company focused on technological leadership that enables it to price products at a premium, contributing to longer-term durability.

Other companies can maintain their growth only by attracting talented people looking for more than money. One way is to build up the "employer brand" by shifting compensation toward inspirational, mission-based metrics.

Starbucks made a bold move in 2020, putting serious money behind its public commitment to diversity, equity, and inclusion. The company switched its annual bonus from 70/30 financial versus nonfinancial goals to a 50/50 weighting. It specifically noted that the additional nonfinancial weighting in the individual component was to measure leaders' efforts to build inclusive environments. The board also tied PSU awards partly to accomplishing representation goals: meeting the goals leads to greater awards while staying flat results in a reduction. Starbucks is betting this commitment will build a better workplace, which in turn will result in better outcomes for customers and shareholders.

Adapting to disruption: These companies have to adjust to changing customer demand. Most notably, retailers and travel and hospitality companies need to offer new kinds of value or service in order to win back customers.

For retailers, the digital transformation was happening pre-pandemic. Post-pandemic, that transformation is the name of the game. They must figure out how to engage customers in this new world and at a higher level of profitability. At the same time, customers and employees alike are setting high standards for the places they frequent: they want to support companies that are socially responsible, and they will abandon those that don't rise to the occasion. For executive compensation, that means there is a lot to balance: digital growth and profitability, measures of customer engagement, sustainable sourcing, and a diverse work force.

In this vein, one retailer focused its annual plan on comparable sales growth, profits, and measures related to customer satisfaction and culture. For PSU criteria in the three-year plan, it included digital sales growth, sustainable sourcing, and relative total shareholder return (TSR). The board believes executives must directly align with emerging stakeholder priorities. If they can meet consumer and employee expectations and work with suppliers collaboratively, their TSR should outperform peers.

A large food distributor had to ramp up its relationships with customers—mostly restaurants—in order to keep its business from collapsing in 2020. The board redesigned its incentive plans around nonfinancial metrics. Key to its future success was building close ties with restaurants as their customers scrambled toward new dining approaches. By helping them source heating lamps, digital cloud kitchens, and "grocerant" formats, the distributor helped resolve pain points and kept its products in demand.

To focus management on these challenges, the board reset the typical financial metrics to nonfinancial metrics aimed at ensuring the company explored new channels and strengthened its customer ties, all while managing expenses. It also did special outreach to investors to explain the changes. The approach not only gained investors' confidence, but also gave the company a strong post-pandemic platform on which to develop additional offerings. Even as things return to normal, the board will maintain elements of the COVID response such that the annual bonus will continue to prod executives on effective execution, while the LTI establishes a clip for steady innovation.

Thanks to these and other efforts, the company's share price—which had cratered early in the pandemic—regained all of its value by early 2021, when many restaurants were only starting to reopen. Even companies facing pandemic headwinds can build for the long-term future.

REORIENTING FOR A DURABLE FUTURE

The pandemic and recent social unrest exposed the folly in many companies of multi-year goal setting for financial metrics such as revenue and earnings. But boards shouldn't respond by looking for the shortest measurement period they can target with confidence. Instead, they should consider other lessons from the ordeal. Longer time frames with mission-driven objectives can still work well. Getting compensation right for the long term requires discipline from boards and yearly reassessment. Is the plan working to drive incremental progress toward long-term strategy? Is it time for a new plan with a longer time frame? Whether objectives involve generational investments, incremental improvements sustained over time, or the building blocks of disruption, this long-term approach is a better road back to the future.

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