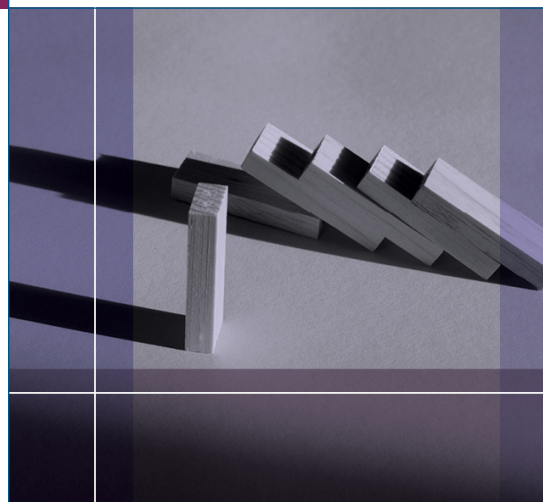


Make Your Compensation Program Resilient

LESSONS FROM THE PANDEMIC

DECEMBER 2021



Deborah Beckmann



Blair Jones

The Covid-19 pandemic forced many boards of directors to scramble. With conventional compensation plans likely to generate zero payouts for many executives—and therefore prompting talented executives to consider leaving—directors used discretion to allow some awards. Yet this sort of informal discretion is what boards try to use sparingly. By minimizing discretion, directors give consistent direction to management. They avoid what might be perceived as forgiving poor results and forestall potential criticism from proxy advisory firms.

As boards think about designing incentives for 2022 and beyond, now is a good time to take stock of what we've learned and seek a better approach. The pandemic looks to persist for some time, and new pressures from supply bottlenecks and inflation add to the uncertainty. How can boards preserve pay for performance while ensuring enough compensation to aid retention? De-risking a plan usually means limiting variable pay, but boards are trying out creative ways to preserve the motivational and directional aspects of compensation. They'd like to keep the majority of executive pay at risk, while rewarding leaders for contributing to organizational sustainability even without immediate financial results. Here are some options.

Annual Bonus

The pandemic wreaked havoc on the annual bonus, as year-end revenues and profitability sank at many companies. Some boards split the pay period in two, hoping for a return to normal conditions in fall 2020, to no avail. Seasonal compensation structures helped somewhat but are an interim solution at best. The uncertainty continued all through 2021.

With a little time to reflect throughout 2021, boards have come up with various changes to pay programs that can work in both crisis and stable years. They're aiming to prevent future scrambles by making structural changes and incorporating discretion deliberately, while still paying substantially for performance. That means resilient structures that still help to drive results.

One change is to set up longer runways for earning awards by widening the range of outcomes that trigger payouts. This approach allows for greater performance volatility with the opportunity for some payout at lower levels of performance, and a higher bar for maximum payouts. Performance at threshold levels might be as little as 70% of budgeted performance to create less of a cliff and help keep executives' heads in the game. Conversely, executives would earn maximum payouts only with truly exceptional performance, at well above target levels (e.g., 130% of budget).

In conjunction with this widening of performance targets, boards can shift down the payout curve. They can lower maximum payouts from as high as 200% of targeted bonus down to 125 of 150% depending on the level of absolute performance required, while setting the minimum payout at only 25% instead of the standard 50%. Similarly, a company might set up a flatter payment for performance around target, such as paying 100% of the target bonus for performance between 95 and 105% of budget, given how difficult it is in volatile times to set exact targets. That way executives can still earn a bonus under difficult conditions, but not receive windfalls if a crisis creates tailwinds. (This is in contrast to a typical approach which is to pay 50-200% of the target bonus for performance in the 90-110% range.)

Adjusting runways isn't a perfect solution. Executives at businesses suffering from near-total shutdowns might still fall short of any payout. But most companies would generate some award.

Another option is to increase the share of awards from non-financial metrics, usually through a scorecard. Scorecard measures can be strategic (such as boosting market share growth in targeted channels or setting up

new businesses), operational (cost management or productivity), ESG-related (especially environmental and social), or some combination of all of these. What matters is that these metrics strengthen the organization for the long term—and therefore represent true business priorities with motivational power and value to shareholders.

“... boards have come up with various changes to pay programs that can work in both crisis and stable years. They're aiming to prevent future scrambles by making structural changes and incorporating discretion deliberately, while still paying substantially for performance. That means resilient structures that still help to drive results.”

Properly constructed, scorecards can objectively measure non-financial results with a qualitative assessment. Boards do have to exercise some discretion, but they can develop a clear and disclosed framework for doing so. Scorecards enable boards to reward executives for meritorious contributions even when financial results fall short for the year. We're seeing scorecards vary from 10 to 30% of the total potential bonus payout.

Scorecards are superior to individual performance modifiers because boards can disclose the criteria in advance of payouts, and accountability for performance is shared across the senior group. And especially in light of recent social concerns, boards can connect scorecard metrics to the experiences of employees, communities, and suppliers. At most companies in the pandemic, these stakeholders took greater hits than executives, and boards will want to factor those experiences into account

for final incentive determinations. Shareholders are sensitive to board discretion, but with compelling criteria and strong disclosure, investors will likely accept these scorecards as a way to provide constructive discretion and fair pay for performance delivered.

Scorecards for executive pay have been used for several years in industries that already had discretionary approaches to executive pay, such as investment banking. The scorecards provide a framework that clarifies to executives and shareholders what is measured. *(See the sidebar for examples.)*

Extended runways and qualitative scorecards are not exclusive ideas, and boards may wish to try both of them out. As with any change in compensation design and administration, they should apply them carefully and regularly evaluate to ensure fair outcomes for performance delivered.

Long-Term Incentives

Despite their name, long-term incentive plans (LTI) are quite vulnerable to a single bad year. Most programs offer overlapping three-year cycles, so a severe underperformance in one year could affect three such cycles. With LTI alone accounting for the majority of an executive's pay, boards in pandemic-stricken companies came under enormous pressure last year to use discretion to increase awards. Some did so, despite clear shareholder messaging against LTI changes. However, the majority held out, creating more urgency for a long-term remedy.

One solution, similar to what's described above, is to broaden the metrics and time frames. As with annual bonus scorecards, additional metrics should reflect priorities that help strengthen the company for the long-term. For some companies, this might be an ESG metric such as sustainable sourcing or greenhouse gas emission reduction; others might push for stronger cash flow to ensure future investments. EBIT leverage can be a strong metric to demonstrate a turnaround and return toward profitable growth. Goals for

DISCRETION AT WORK: TWO SCORECARDS FOR THE ANNUAL BONUS

A large consumer goods company set its 2020 annual bonus at 80% conventional financial measures, and 20% “strategic” measures as presented in a scorecard. The scorecard had three parts: growth (especially market share and segment revenues), execution (especially pricing and productivity), and culture (especially talent and engagement). While revenues and profits were challenged, and the pandemic hurt productivity, the company gained market share and improved its talent development, especially gender diversity. The result was a payment from the scorecard to balance lower payouts on financial metrics.

In 2018, the board of a large commercial bank put all of its annual bonus pay metrics into a single scorecard. Five of these were the conventional financial metrics, all quantitative: income from continuing operations, efficiency ratio, return on tangible common equity, return on assets, and risk. But the scorecard included four other goals that were qualitative: “protect and enhance our reputation, develop client-relevant value propositions, produce extraordinary client experiences, and deliver our financial commitments.” These goals addressed 30% of the potential bonus, yielding a slightly above target payout, aligned with the company's financial performance. Note that a different mix of goals would enable boards to exercise discretion and reward executives who performed well even if outside headwinds led to poor financial results. ■

transformative new products might also be relevant, such as electric vehicle milestones in the auto industry. Boards may also include metrics with different time frames, such as four-year terms.

Relative metrics, such as market share, total shareholder return, EPS, or ROIC against a defined peer group, can also overcome the problem of external factors. These metrics can work for annual bonuses as well, though the calculations are less robust over a single year.

Yet, relative metrics have important limitations. It may be difficult to find truly comparable peer groups, as many such groups are not homogeneous. Aerospace companies with commercial exposure, for example, struggled in the pandemic far more than did their counterparts concentrated on defense. For TSR in particular, relative results can lag and put results out of synch with absolute accomplishments on the upside or downside.

Moreover, with industry boundaries blurring and companies working across sectors, many boards are looking for leaders to transcend their specific industry position. Relative metrics may limit management's focus to a narrow peer group versus a broader gross industry focus. In addition, companies with footholds in multiple industries or even sectors may have no direct rivals—and therefore should avoid relative metrics.

Alternatively, or in addition, boards can lower the LTI risk by reducing the plan's weighting of its performance component. As long as the majority of awards still come from achievement rather than tenure (50% or more from PSUs), investors likely won't object. One company had 75% performance shares, which pleased investors but left the company vulnerable in the pandemic. The board has now reduced the performance component to 60%—maintaining the spirit of higher performance weighting but with a better risk balance. Introducing or increasing the weight of RSUs in the non-performance based component of LTI (relative to stock options) can also help provide stability in volatile times.

The same broadening of performance curves for annual bonuses is relevant for long-term incentives as well, and maybe more so, given the volatility that can occur over three years. As the curves are broadened, it's important to make sure the payout opportunities are adjusted commensurately with the absolute performance achievement levels.

Boards are still learning the lessons of the ongoing pandemic. After years of pushing for ever greater pay for performance, directors are looking to recalibrate to build resilience into their programs. By adjusting some structures and broadening the range of performance considered, they can reduce risk while providing substantial motivation through pay. ■

For more information, visit us at [SEMLERBROSSY.COM](https://semlebrossy.com), or reach us at 310.481.0180.

Deborah Beckmann, Managing Director
dbeckman@semlebrossy.com

Blair Jones, Managing Director
bjones@semlebrossy.com

