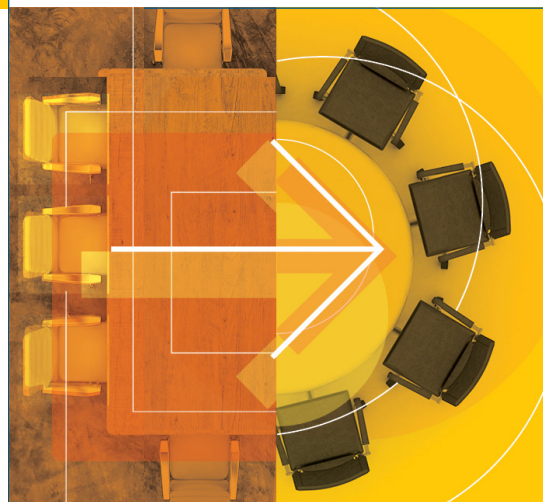


Pivoting with Purpose

HOW BOARDS CAN HELP THEIR COMPANIES
DESIGN TRANSFORMATIONAL INCENTIVE PROGRAMS

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Whether sparked by technological innovations, geopolitical events or leadership transitions, most companies will undergo a major transformation at some point. During such transformational periods, incentive programs are a powerful tool that can help organizations align toward new goals, motivate employees, and drive performance. Whenever a company's goals and priorities change, incentive programs will likely need to change with them.

The Core Principles of Effective Incentive Plans

Great incentive programs are tailored to specific company needs and cultures, especially during a strategic pivot, but all of them share several key characteristics:

- **Company-first.** Incentives should reward a successful, company-wide transition, not individuals.
- **Motivational.** Metrics are realistic and transparent—employees should believe there's a reasonable chance of payout—and demonstrate a clear-enough trajectory that assures shareholders of the company's commitment to the new direction.
- **Agile.** Plans should have room to grow with the organization as it shifts and avoid tethering the company to goals that may become obsolete.

We've also identified specific strategies that companies frequently rely on when designing transformational incentive programs. The following four approaches, used individually or in combination, can help align a company's compensation program with its transformational objectives.

STRATEGY 1 | Emphasize Stock Price Returns

The most common strategy companies employ is emphasizing stock price returns, since the end goal of a transformation is to reignite shareholder value creation. Incentives can be tied to relative performance (rTSR), absolute price targets, or a combination of both. Tying incentives to the company's relative performance against a market index or specific comparator group reinforces transformational objectives without the challenge of setting interim financial or strategic goals during periods of change. Absolute stock price targets, on the other hand, are attractive when a company aims to return to previous high-performance levels or when a new CEO is hired to change strategy and drive shareholder returns.

While investors expect at least 50% performance-based equity, a portion of time-based equity, especially early in transformations, can offer some certainty and stability during volatile periods. Time-based equity is often weighted 40-50% and more heavily for nonexecutives.

STRATEGY 2 | Align Incentives with Clear Transformation Measures

Compensation programs can help communicate new business priorities by linking incentives to financial goals, strategic goals, and external commitments. For example, a company that needs cash to invest in growth and transformation might tie performance stock units to increasing free cash flow. These metrics should be objective, but they can be nonfinancial. Milestone-based metrics often focus on key initiatives and/or business unit priorities, like a company trying to improve its SaaS revenue by tying PSUs to new subscriber growth.

This approach can create Say on Pay (SOP) risk if the metrics feel like softballs or the link to financial results is unclear. Companies sometimes use strategic measures as modifiers, balancing shareholder buy-in with the push toward new strategic priorities.

EXAMPLE: A luxury goods brand discovered that consumers stopped associating them with high-end fashion and hoped to restrengthen its luxury appeal globally. Prior to their transformation, PSUs were tied to earnings per share. Going forward, the company teased out new performance indicators, such as average price per transaction and international sales growth, to directly address critical transformation drivers. Awards were further tied to a strategic rTSR modifier, ensuring that the effect of the company's new initiatives showed up in stock returns.

STRATEGY 3 | Shorten Performance Period

Sometimes, transformation targets have milestones that occur within a shorter period than the traditional three-year PSU performance window, and some transformations require companies to act so quickly that the timeline to achieve new goals is unclear. Temporarily shortening the performance period allows organizations to focus on near-term goals, incentivizes quick action, and offers flexibility as the business changes.

Proxy advisors frequently scrutinize companies that do not use a true three-year performance period, and it is imperative to provide clear rationale and milestones for shorter periods. Discrete one-year performance periods (sometimes known as 1+1+1 goals) can be the hardest to defend. Combining shortened performance periods with a three-year modifier (e.g., rTSR) and/or establishing each year's goals or growth rate prior to the beginning of the performance period can ease near-term concerns. Regardless, these shorter periods are always temporary solutions and are most likely to be accepted early in a transformation.

STRATEGY 4 | Overlay a Special Transformation Award

Highly tailored awards and unique incentives can galvanize companies in a new direction. While these awards should be used sparingly, transformation awards may provide an added boost of urgency, shift focus to key areas of change, and help retain valuable talent. To avoid negative

SOP pressure, special awards should require performance that goes above and beyond the standard PSU plan, allowing shareholders to get something extra for the extra dollars. Other prudent strategies include targeting only high-impact roles and individuals.

EXAMPLE: *A communications company needed to rapidly improve its networks, boost capital, and retain key executives following a CEO transition. To do so, it granted several named executive officers a one-time, up-front equity award comprised primarily of performance-based stock options. The target value of each award was equal to five times executives' annual long-term incentive guidelines and was provided in lieu of five years of ongoing equity grants. By tying the mega awards to rigorous, multiyear stock price hurdles and externally communicated growth initiatives, the company disclosed a clear rationale to investors.*

Conclusion

In some cases, combining multiple strategies is the best solution. Mixing and matching allows companies to solidify their messaging and mitigate pitfalls associated with individual strategies. Other combinations include annual incentives that emphasize key financial and strategic milestones and PSUs that reinforce financial outcomes and relative TSR performance.

All transformations require a coordinated set of efforts to succeed. Designed right, incentive programs can rally the troops while highlighting key priorities and critical milestones along the way. As the business transforms, so, too, should its incentive programs, ensuring long-term stability and growth in the next phase. ■

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