Compensation

Rewarding Strategic Investment

By Blair Jones and Roger Brossy

Consider an all-too-common business dilemma: a company faces significant operational headwinds after a string of consecutive years of growth. The CEO can see a market disruption on the horizon, and it is getting harder and harder to squeeze continued gains from the business. She realizes that the company needs to pivot, but doing so requires heavy investment—which lowers what the predicted near-term profits or losses might be. Any reduction in expectations will likely send shares of the company tumbling, creating investor backlash.

For boards, encouraging investment to fulfill future strategy when short-term forces push executives in the opposite direction is a prevalent problem. A paper from FCLT Global, a consortium of companies focused on researching methods to sustain long-term economic growth, suggests that 87 percent of C-level executives and board members feel compelled to deliver strong financial results within two years. That's an 8 percent increase since 2013, and it means that more CEOs may feel compelled to underinvest in an effort to boost near-term financial results.

Perhaps most alarming are results from a McKinsey study that found that 55 percent of directors and executives at companies with a short-term orientation said that they would reduce investment in future growth opportunities to meet current quarterly targets, even if that meant sacrificing future value.

Is it possible for boards to encourage executives' best efforts in the interest of both short-term success and long-term strategic investment? Existing compensation plans often become ineffective when a company makes a strategic pivot. They may even motivate executives to continue with myopic quarterly target-hitting. This is where a thoughtful compensation plan redesign can support and drive change.

We see four situations in which compensation committees can use pay plan redesign to champion long-term strategic investment.

Companies investing in current success. In this first situation, incentive pay can act as a valuable stimulant while the wave of success keeps rolling. For a time, markets won't penalize the company for not investing in future market positioning. Take, for example, the case of a financial information firm. It delayed investing in its technology platforms, partially due to the financial crisis and partially to maintain high operating margins; however, its financials were strong during the market rebound.

But the firm's analysis showed that upgrading its technology systems would allow it to better integrate its multiple business lines. The integration would create more cross-selling opportunities. With this new insight, the board created an incentive plan that included an annual incentive based on meeting strategic and operational goals tied to systems improvements as well as enhancing the depth and maintenance of client relationships. The strategic goals related directly to the integration process and expected behavioral changes.

The board also granted to the leadership team front-loaded, multi-year performance share awards based on sustained, absolute total shareholder return. The plan increased the percentage of at-risk equity to 100 percent in performance shares for the CEO and a majority in performance shares for other executives. The performance shares provided the opportunity for significant payouts if the technology investments paid off and led to market-leading value creation.

Companies investing in the future. A second situation in which compensation committees can play a big role in strategic investment is when a company faces looming, identifiable disruptions, whose precise imprint on future markets may not be apparent. The ramifications may include the streamlining of expensive processes, radical changes in the way consumers use a product, or even collapsing consumer demand for a product altogether.

Pay programs must then motivate executives to focus immediately on long-term market positioning rather than short-term profit goals. For example, the automotive industry is facing disruption in the form of autonomous vehicles. While nobody knows the exact timing or scale of impact, we can predict that the industry will be radically changed.

Auto manufacturers are moving quickly to adopt a strategy that stresses not just vehicles but transportation services in the new world of digital and mobile technologies. One manufacturer, compelled to highlight the importance of investments in technology common in upstarts like Google and Tesla, granted its CEO an award of performance shares contingent upon the achievement of qualitative, strategic measures in large part based on investing in autonomous vehicle research and the success of new digital transportation services.

The incentive plan is now targeted at an urgent repositioning of the company for future success by embracing the largest growth opportunities and transitioning to a digital company of the future. The compensation committee balanced the special performance share design with an annual tranche of performance shares and awards in the annual incentive plan, both of which contain traditional operational and financial goals. Together, the short- and long-term incentives underscore that the core business must continue to excel to fund future investments.

Companies in "reset" mode. A third situation in which the compensation committee can play a role is when a company is in a "hard reset" mode. For example, for retailers, large-scale disruptions include declining mall traffic, the rise of online retail, and a growing consumer appetite for experiences instead of physical goods. Existing compensation plans often exacerbate the problem by disincentivizing large, up-front investments needed to recalibrate product and service delivery. This situation presents a prime opportunity for retail-company boards to establish a special award or unique incentive plan design to motivate the executive team and highlight the criticality of a transformation.

One large retail company elected to cut future earnings guidance and to instead reinvest a large amount of operating expertise and capital into its stores format, digital technology, and direct-to-consumer infrastructure. Recognizing the leadership team's eagerness to implement its "reset" plan, the board granted a special, one-time award of price-vested options. The price condition was set at a level near the company's peak, before it announced its reset. The tacit understanding is that the options will provide substantial value to both executives and shareholders once the capital investments are in full effect. Short-term incentives will include proof of execution measures and long-term incentives will continue to reward for performance relative to retail peers.

Companies in a turnaround. Finally, and perhaps most daunting, is the situation where a company is in a full turnaround effort. An across-the-board corporate overhaul typically requires heavy investment and a multi-year time horizon, making it an ideal situation for a custom-tailored, strategy-focused compensation plan.

For example, in a period of decreasing margins and increasing competition, a distribution company was required to undergo a strategic turnaround. In doing so, the board knew the company would face tough times near-term, with limited ability to provide incentive payments. The solution? The company granted special performance share awards to maintain incentives to executives during the recovery. These awards are only earned if the company hits certain earnings per share milestones over the transformation period that are related to returning to traditional levels of annual growth, or at the highest payout level, returning to the original earnings curve communicated to investors prior to the company's decline.

Though the company expects a difficult transition—and executives expect low payouts on outstanding incentive compensation—the special awards continue to engage executives' hearts and minds, incenting them to successfully guide the company into a new chapter, with a restored growth trajectory.

We believe that three key design principles can help guide successful compensation plans through a long-term investment scenario.

First, any pay program is more powerful if aligned with a bold statement to the market about future strategy. The pay program communicates that a company is putting its money where its mouth is, directly reinforcing commitments to investors.

Second, once the bold statement is made, the pay program and the strategy have more integrity if performance stays on a positive trajectory. Pay programs lose credibility if they are too forgiving of performance that falls short of goal or is reset if performance declines.

Finally, transformations and turnarounds are multi-year processes. Pay programs can and should reward for achieving interim goals—just at more modest levels until the ultimate goals are hit. No executive in the current environment likes to face the dilemma of performing today while sacrificing tomorrow. But pay program design, when thoughtful, aids the board in keeping executives on an investment program that will reward shareholders both today and tomorrow.

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