Executive Pay Decisions Ripple Throughout Companies

Compensation committees need to consider impact on all employees.

BY MARGARET HYLAS AND BARRY SULLIVAN

A mid-sized consumer products company introduced a relative total shareholder return (TSR) measure to its long-term incentive program. The company had an "all-for-one, and one-for-all" culture, so all managers in the organization carried that same relative TSR metric. After a few years of challenged market performance, several mid-level managers left the company, seeing their unvested equity values fall and having a general sense that their individual contributions were too distant to affect relative TSR.

The lesson: Board decisions on executive pay can have big impacts on the broader employee population.

With the ever-increasing pace of change in business today, it's more important than ever for boards to consider the broader implications of executive pay decisions. The "Say on Pay" era puts even more pressure on boards to get executive pay right but, at times, these external pressures can introduce gaps between what makes sense for executives and what works for the broader organization.

Public-company boards too often make executive pay decisions without a full sense of the potential implications deeper into the organization. As a result, the top of the house and the broader employee base can lose sight of shared business needs and objectives. In extreme cases, the two groups can end up working at cross purposes.

Consider the example of a long-established aerospace and defense business. The company's strategy depended on growth through acquisitions and the cost synergies in integrating those newly acquired businesses. The board rewarded executives for top- and bottom-line growth, while the broader base of employees was held accountable for operating efficiencies. Meanwhile, the company ran its individual business units in silos, making synergies difficult to realize.

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Over time, executives executed acquisitions for growth, in-field operators squeezed efficiencies into their individual businesses and the entire organization lost sight of fully integrating newly acquired businesses.

While individual executives scored a "win" based on growth, the broader population fell short of efficiency goals — in part because those efficiency goals already assumed synergies for the newly acquired businesses. The business grew steadily through acquisition, but selling, general and administrative expenses became bloated and the company gave up several points of margin. After a full accounting of the situation, the business has since reorganized into fewer units, embraced a more balanced measurement and rewards framework and is rebuilding its margins while still pursuing growth.

The lesson: Measurement gaps between the executive and broader organization can get in the way of strategy and smart business decisions.

New talent pressures intensify these timeworn tensions between executive and broad-based talent needs today. Today, many long-established industries demand more technology talent to remain competitive. At the same time, technology companies are sourcing talent from more conventional markets. As broad-based pay practices recalibrate to meet these new pressures, executives and the broader employee base are at risk of drifting further apart.

Consider the state of play in retail today, where traditional brick-and-mortar stores are competing with online powerhouses and the newer, smaller competitors those online platforms enable. In response, many conventional retailers are placing big bets on e-commerce. And to be successful, retailers must compete for mission-critical talent with major technology players. Traditional retailers are building distinct e-commerce teams, with measurement and rewards in line with the technology industry rather than conventional brick-and-mortar practices.

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The most adaptive and successful competitors will draw connections in their measurement and rewards systems between their new technology talent, their more traditional retail workforce and their executive leadership. These connections — up, down and across the organization — will help to ensure the entire organization can drive the organization forward.

The lesson: Absent tight connections in the performance measurement and rewards system, different employee groups within the organization cannot fully come together in support of the business strategy, and success will remain out of reach.

We think these questions around talent and strategy will become more important as the nature of labor continues evolving. Automation, the 'gig economy', big data — all will impact talent needs and compensation tools. More than ever, compensation committees need to engage with these large-scale talent issues, with a well-considered appreciation that board-level compensation discussion cannot focus solely on executives anymore. ■

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