Principles for Paying Incentives in the Midst of Covid-19

JULY 17, 2020

COVID-19 CONSIDERATIONS

Executive incentives are important management tools: they highlight business priorities and reward performance, aiding in attracting and retaining employees over time. Unfortunately, the Covid crisis has thrown a monkey wrench in the equation. While the business priorities remain, the goals in many cases are now unattainable. As the crisis extends, Boards are challenged with how to forecast, and how to keep executives motivated to ensure their companies are as well positioned as possible to gain traction in the ultimate recovery, or in extreme cases, even stay afloat until the crisis abates.

As a result, many directors are wondering how to adjust annual incentive plans for their executives. In early April, three-fifths of companies we surveyed were considering some sort of adjustment to annual incentives. Proxy advisors have shown some openness to adjustments in the annual incentive, as long as these are proportionate to the outcomes of investors, employees, and broader stakeholders.[1]

Companies have been taking a "wait and see" approach on approving specific adjustments. Now that we are in the second half of the calendar year, Compensation Committees can start discussions about the principles to guide any adjustments, whether formulaic or discretionary. Here are four principles to consider.

1 Set Awards Proportionate to Broader Stakeholders' Outcomes

With struggling employees, suppliers, and customers, boards will want to avoid the perception that executives are benefitting to the detriment of other stakeholders. As the pandemic moves into its fourth full month in the United

[1] *This openness does not extend in the same way to adjustments to long-term incentives, which frequently result in accounting changes and disclosures in the Summary Compensation tables.*

States, calls for sharing the burden will continue. We are already seeing concerns voiced by proxy advisors and the media about the extent of dividends, stock buybacks, and executive pay while employees are furloughed or permanently laid off. Many companies accepted proportionality early on, by reducingexecutive salaries and/or board retainers while carrying out furloughs or layoffs. End-of-year incentive decisions will benefit from similar sensitivity to employee, shareholder, and other stakeholder outcomes.

Boards should especially be cautious about appearing opportunistic. Because of executives' additional work during the crisis, companies may be inclined to increase pay indirectly—such as by accelerating equity awards from 2021, replacing forgone salary with additional equity awards at depressed prices, or revising incentive targets. These moves could backfire in the court of public opinion if they are viewed as smoke and mirrors or disproportionally beneficial to senior leaders.

2 Look at the Pay Program Holistically

While a lot of attention has focused on "broken" 2020 annual incentives or in-flight performance share awards, those programs are often only a portion of the overall compensation package. We urge companies to take a holistic view, evaluating the total compensation package as a percentage of the full target and the potential value that could be delivered over time. Many companies have shifted to balanced programs, with a portfolio of metrics and vehicles in the long-term incentive program to complement the annual incentive. This balance may reduce the need to make adjustments to the annual incentive now.

Thus companies with a portfolio of long-term incentives, such as options, time-based shares, and performance shares, may find that the pandemic (so far) affects total executive compensation only moderately. Options granted in the last few years may be underwater at today's prices, but with several years left on the term, much less affected on a Black-Scholes or gain-opportunity basis. Also, options grants made earlier in the year may have significant in-the-money value if the stock price has recovered to pre-pandemic levels. And while goals tied to absolute financial metrics may be unachievable, many companies have added relative total shareholder return as a metric, so executives can still earn awards if they outperform peers.

3 Maintain Alignment with Results

Even with a balanced program, some boards may feel it necessary to adjust incentives or to use discretion at year end. With all the uncertainty related to the pandemic, directors should be wary of acting early in making formal adjustments. Too much relief now might result in "lost quarters" later due to reduced accountability for results.

On the other hand, the priorities for many companies will shift as a result of the pandemic. Employee safety and business continuity have become critical. Some companies previously oriented to growth have needed to focus on cash flow, liquidity, and profitability. Those companies may need to consider new balance-sheet or recovery-related metrics.

Other companies may consider separate incentive plans for the second half of the year or just the fourth quarter. That way they can focus on realistic targets where the company has more visibility into performance. In these cases, reducing the overall incentive opportunity to the shorter time period, as a "second chance," will help keep the overall pay-to-performance alignment in the program. A second-half plan might provide the opportunity to earn 50% of the normal annual incentive, perhaps with an upside limited to 120% rather than 200% of target. Alternatively, a company whose updated forecast is 70% of the original revenue goal might offer executives the opportunity to earn 70% of their original incentives.

If the outlook remains challenging to predict, exercising discretion at year-end might be the best approach. However, this discretion will be most effectively applied if assessed in a structured way, against a dashboard of objective measures that evaluate items like progress towards financials, performance relative to competitors, and the achievement of strategic and operational priorities that position the company for the future.

4 Consider the Long-Term Effects

Overall, board decisions should minimize short-term pay actions and support a long-term sustainable business. Boards may be concerned about retaining their most talented executives. But adjustments in pay now could affect how customers and employees perceive the company over the long run.

In practice, that means not just caution on upward adjustments for hard-hit companies, but also aggressiveness in dealing with businesses with a pandemic bump. For the “winners” who happen to be in the right place at the right time, or where adjustments to incentives resulted in higher than expected payouts, it may be appropriate to pay any bonuses above target partially in stock with vesting requirements, rather than in cash.

Providing grants at depressed prices can help create attractive near-term gains that are retentive and provide a long-term make-up of forgone values. But boards should also limit the perception of windfalls in subsequent years. Equity grants during the depths of the financial crisis in 2009 resulted in awards that appear in retrospect to have created windfalls. With the increased scrutiny on executive pay now a decade later, companies will need to be more sensitive to external perceptions. Companies need to balance programs that can provide retention with dilution and affordability concerns as well.

Novel incentive plan designs may be appropriate for some companies at this point in time. But they should not be novel for novel’s sake, or just to ensure short-term pay stability. Instead, novel plans provide an opportunity for companies to change the dialogue and refocus executive efforts on areas that will reposition the company for the long-term. Here, and in all changes that boards make, they can protect themselves with a compelling and transparent rationale.

In more normal years, many boards limit their discretion. But with so many annual incentive plans out of the money this year, a number of companies will consider adjustments. Using a clear set of guiding principles will help ground those decisions so that they contribute not only to near-term engagement, but also to long-term value for all stakeholders. ■

For more information, visit us at SEMLERBROSSY.COM, *or reach us at 310.481.0180.*

Greg Arnold, Managing Director
garnold@semlerbrossy.com

Blair Jones, Managing Director
bjones@semlerbrossy.com

SEMLER BROSSY
LOS ANGELES | NEW YORK