Using Long-Term Incentives as a Strategic Driver

Clear and differentiated business strategy is critical to a company’s long-term success. The same is true for a well-differentiated strategy for long-term incentive compensation. A tailored and thoughtful approach to long-term incentives can be a valuable management tool — reinforcing for both executives and company stakeholders the company’s key performance imperatives.

To be sure, long-term and annual incentive plans work in coordination. Together, they communicate strategic priorities, hold people accountable for achieving stated goals, and guide the company in developing talent. Typically, the short-term incentive works mainly to reinforce key near-term drivers of performance, and the long-term plan works mainly to reinforce critical mid- and long-term outcomes. In this way, they send a message about what’s important and what will lead to sustained success.

At their core, equity-based long-term incentives (which make up the vast majority of long-term incentives) provide a mechanism for rewarding executives for creating shareholder value (i.e., stock-price performance). Well-crafted plans can do this but also much more. They can be a critical business management tool — a loudspeaker and spur to the fulfillment of more specific strategic objectives. If the long-term incentive plan mirrors the messages the CEO is communicating to Wall Street and internally, executives will operate with clear marching orders on how to proceed to create maximum value.

WHAT’S THE BIG IDEA?

To maximize their impact, long-term incentive plans should be tailored to a company’s specific situation and grounded in the strategic context.

- Long-term incentives can be a critical business management tool — a loudspeaker and spur to the fulfillment of more specific strategic objectives.
- But many companies sub-optimize the effectiveness of their long-term incentive programs by “following the pack.”
- Companies should be willing to embrace being different.
- When designed thoughtfully, customized long-term incentive programs focus executives on strategic priorities, reinforce the strategy externally, and drive sustainable shareholder value.
Avoiding the Temptation to Simply ‘Follow the Pack’

Unfortunately, many companies sub-optimize the effectiveness of their long-term incentive programs by “following the pack.” The temptation is easy to understand. In the world of Say on Pay and heavy criticism of executive compensation, it’s easy to mimic competitors and/or follow advisory group guidelines on best practices. Adopting a “standard” long-term incentive design (e.g., performance shares that pay out based on earnings or relative shareholder return over three years) will minimize the risks of external criticism and unfavorable Say on Pay votes.

Companies that take a defensive approach and adopt a copycat plan may be missing a valuable opportunity to focus executives on key priorities and reinforce the strategic direction of the company. In fact, in more extreme circumstances, following the pack may actually subvert, rather than support, the strategy. Executives can be confused about what’s important and/or become disillusioned over their inability to impact results. For example, some companies have found that payouts based on relative total shareholder return can actually end up generating results out of sync with the company’s underlying financials, risking participant confusion and frustration. The plans meanwhile cost the company in accounting expenses and share dilution.

Although plans adopted by other companies provide useful ideas and key insight into the talent market, they should not be the sole basis for design, as they won’t necessarily make sense in a particular company’s business context. For example, in some industries many competitors use earnings growth as a key metric. But if your company needs to focus on improving returns instead, using earnings growth may conflict with your strategy. In fact, not including a return metric in the long-term design could encourage executives to make decisions that improve earnings (e.g., add-on acquisitions, selling more of the same low-margin businesses), but not meaningfully move return on capital.

Establishing the Strategic Foundation

The design of long-term incentive plans needs to balance a number of factors. Companies should start by grounding the design in the internal context around strategy and talent management. The external perspectives are important inputs, but are often better applied as tests of reasonableness or boundaries.

In our experience, too many companies let the external factors drive the design, using their unique company context and strategy to make modifications on the margin. Bowing to external influences is often the path of least resistance, as the external parties are so vocal in this era of Say on Pay. The external influence easiest to accept is competitive practice, as in many instances it may result in reasonable designs that deliver fair compensation outcomes. However, companies that simply copy competitors miss the opportunity to further galvanize employees around the long-term strategy.

To make the most of the long-term incentive plan, and before contemplating specific design choices, we recommend compensation committees go through an explicit exercise to develop a strategic foundation, as shown in Figure 1.
Figure 1. Establishing A Strategic Foundation: Questions to Guide Long-Term Incentive Plan Design

<table>
<thead>
<tr>
<th><strong>from the internal perspective (starting point)</strong></th>
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<tbody>
<tr>
<td><strong>What are the company's key strategic objectives?</strong></td>
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<tr>
<td>a. What’s the company’s strategy for differentiating itself from competitors?</td>
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<tr>
<td>b. What has the company communicated to investors and analysts?</td>
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<tr>
<td>c. What are the key competitive and economic trends the company should be prepared to manage through?</td>
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<tr>
<td>d. What measures will most effectively capture the successful execution of the strategy?</td>
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<td><strong>What is the strategic time horizon?</strong></td>
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<td>a. Over what period will the strategy play out?</td>
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<td>b. Are there key points at which success can be measured or where priorities will shift?</td>
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<td>c. Does the strategy call for nimbleness? Or are the objectives clear and unchanging?</td>
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<td><strong>How prominent should the pay program be in motivating behavior and attracting and retaining the talent profile the company seeks?</strong></td>
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<tr>
<td>a. Does the company believe more in incentives (i.e., prospective metrics aimed at driving specific behaviors) or rewards (i.e., after-the-fact validation of results)?</td>
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<td>b. To what extent is the compensation program used to drive behaviors versus other tools such as clear messaging and tight performance-management systems?</td>
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<td><strong>What is the role of the long-term incentive plan in the broader pay program?</strong></td>
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<tr>
<td>a. What measures and behaviors are captured in other elements of the pay program, particularly the annual incentive plan?</td>
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<td>b. Are there measures or behaviors not adequately captured in other plans?</td>
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<table>
<thead>
<tr>
<th><strong>from the external perspective (establish boundaries and test reasonableness)</strong></th>
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<tbody>
<tr>
<td><strong>What is common practice in the competitive market for talent?</strong></td>
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<tr>
<td>a. What designs are used by peers — particularly direct competitors?</td>
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<tr>
<td>b. How does the company want to communicate the benefits of its pay program relative to peers?</td>
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<tr>
<td><strong>What are the perspectives of investors and shareholder advisory groups?</strong></td>
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<tr>
<td>a. What design boundaries are “must haves” (e.g., types of measurement, performance and/or vesting period, dilution)?</td>
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<tr>
<td>b. Is the program appropriately affordable from an investor perspective?</td>
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<tr>
<td>c. What choices might require more explanation because they deviate from typical practice?</td>
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Case Study
Maintaining Flexibility in a Turnaround

Company Context
A small technology company with rich holdings of intellectual property had lost its edge. It had relied on strategic partnerships to feed its product pipeline, and when a series of deals fell through, its product line dried up, and its stock price plunged. With a change of leadership, the company developed a new strategy to leverage its intellectual property portfolio in the face of uncertainty over when and what assets would return the best yield. The company needed to be ready to strike when the right opportunities emerged, meanwhile exercising enough patience to maximize the value of its assets. Although the path and near-term time horizon were uncertain, the decisions on how to employ the existing intellectual property were going to be vital to the long-term success and viability of the company.

Competitive Practices
Among its high-tech peers, the common currency for executives was stock options and restricted shares. Select talent competitors had introduced performance shares — typically measuring absolute earnings or margin performance. The board believed the company should avoid implementing specific long-term financial or operational goals, given the need to stay nimble and the uncertain path and time horizon. A traditional performance share program could actually create incentives that might run counter to executing the company’s strategy (i.e., an incentive to pursue an opportunity in the short-term to meet the performance result when it might be sub-optimum for the long-term). Further, the board was concerned with the potential for poor alignment with shareholders under the more traditional vehicles of stock options and restricted stock. Because of the steep decline in price, directors created substantial upside opportunity for executives even if the stock price only partially recovered to previous levels.

Company Approach
The compensation committee approved a one-time performance-based stock option program, that paid off only with substantial outperformance. The options would vest only if the executives returned stock prices to historical levels. Half of the shares vested at the low end of the company’s historical trading range, half at the high end. The price hurdles needed to be achieved within five years of grant — which provided flexibility to account for the uncertain time horizon, while also communicating the urgency to execute.

This special grant was supplemented with smaller, below-market grants of stock options and restricted stock to introduce a moderate level of retention power and diversity.
CASE STUDY

OPTIMIZING INCENTIVES FOR A CYCLICAL INDUSTRY

Company Context
A company in a highly volatile industry could see revenue fluctuations of 30 percent to 40 percent in any given year, depending on how the industry cycle swung. To make things even more challenging, detecting when the cycle might turn was limited. In response, the company adopted a strategy that focused on capturing as much market share as possible while maintaining a flexible cost structure during market upswings. On the downswings, the strategy was focused on rightsizing the organizational cost structure quickly and effectively. Pushing too hard on the upswing or cutting too much on the downswing could leave the company in a poor position when the cycle turned. The company had to be nimble yet long-term minded.

Competitive Practices
In its industry, the vehicle of choice had long been stock options, although they were starting to lose favor. More companies were starting to use performance shares, often with a short-term focus on earnings. The board was concerned that stock options could inappropriately reward for volatility instead of sustained shareholder value. Additionally, the more traditional performance share approach presented two key risks. First, a one- or two-year measurement period could be too short-term focused. Second, the absolute nature of the goals could lead to unintended behaviors and a high risk of “broken” cycles.

Company Approach
The compensation committee decided to move from options to a mix of restricted shares and performance shares. The restricted shares provided a stable base of retention value that would be impacted less by market swings than options of performance shares. The performance share program was simple, but specifically tailored to the company’s situation:

- Payouts were determined based on a single measure — relative margin.
- The relative goal “self-corrected” for shifts in the cycle. Because performance was measured against peers, goals would generally be lower during times of market contraction and higher during market expansion.
- The long-term plan complemented the short-term plan, which included a heavy emphasis on key short-term objectives, many of which were more qualitative in nature (e.g., new product development, backlog/pipeline, customer penetration, and talent development).
- The compensation committee set three-year goals and required an additional fourth year of service to fully vest, which reinforced the importance of a long-term focus.
- The company had historically been a strong performer on relative margin. To ensure reasonable stretch and emphasize the importance of maintaining a competitive edge, goals were set more aggressively. For example, the company needed to perform above the median of peers for executives to receive a full target payout.

The resulting plan provided direct reinforcement of the strategy and created an incentive for executives to manage the current cycle effectively, while emphasizing the importance of a long-term perspective and positioning the company to be successful beyond the current cycle.
CASE STUDY

CREATING ALIGNMENT IN A TURNAROUND

Company Context
A financial services company with $40 billion in assets was reeling even several years after the financial crisis, beset by analyst downgrades and hampered in its ability to sell traditional products. The company faced an urgent short-term goal to restore stability in the business and among employees. It established a complementary long-term strategy focused on three strategic priorities: building balance sheet strength, maintaining current client relationships, and diversifying its revenue base.

Competitive Practices
The traditional plans among the company’s peers measured performance over three years and focused on return on equity (ROE). Further, relative total shareholder return plans were just starting to gain popularity. Although the company hoped to perform well on both of those measures, it was concerned that the measures wouldn’t provide the line of sight or direct focus that the company needed during this vital period. Furthermore, from a relative standpoint, few peers were directly comparable. The belief was that strong execution on the strategic priorities was the best way to drive returns over the long run.

Company Approach
The compensation committee developed a customized approach that responded to its specific circumstances. In particular, directors made the following differentiated design decisions:

- Payouts were directly tied to the execution of the strategic priorities through four specific measures: risk-based capital ratio, current client maintenance, structural cost management, and growth in earnings from non-traditional business lines.
- To align with and emphasize the shorter strategic time horizon, performance was measured over one year.
- Performance measures were identical to those used in the annual incentive plan (at least for the first two years of the turnaround), underscoring the urgency of demonstrating consistent annual progress and the importance of those priorities in determining the company’s long-term survival.
- To create a longer-term focus and alignment with shareholders, payouts were deferred for two additional years and subject to stock-price performance during the extended vesting period.
- Goals were set to be reasonably achievable, but demanded strong strategic performance. Because performance expectations in the near-term were materially lower than previous years, the payouts for above-target performance were reduced, creating greater alignment and more appropriate “sharing rates” with shareholders. For each period, targets were increased steadily to reinforce the need for consistent improvement.

The resulting approach was clearly differentiated from peer practice. In fact, a number of the design provisions countered investor advisory group guidelines. However, the urgent and unique circumstances called for a differentiated design that directors considered clearly worth the risk.
CASE STUDY
REWARDING TRANSFORMATIONAL GROWTH

Company Context
A large consumer products company had recently adopted a strategy focused on transformational growth: double in size in the next seven years. The company was facing increasing competition in its core markets as well as challenges to its business model. To maintain its competitive positioning, the company determined it needed to optimize its current model and expand into adjacent spaces, with the ultimate objectives of expanding the customer base and entering new channels for growth.

The strategy called for a combination of meaningful acquisitions and aggressive organic growth. Additionally, the company established a key principle that the growth needed to be profitable in the short term (i.e., no growth just for growth’s sake) and expand the company’s profit margin over time (a key area of focus for analysts).

Competitive Practices
Peers had coalesced around a narrow range of practices. A substantial majority of companies used stock options in combination with performance shares. The performance shares typically measured earnings growth over a three-year period.

The committee had three concerns with the typical peer approach. First, the use of stock options might dilute the emphasis or focus on the key measures in the performance share plan. Second, option values could be affected in the short term currency fluctuations in the company’s international markets, a source of potential distortions on earnings. Finally, a traditional performance share approach focused on earnings growth would not fully reflect the cost of capital needed to pursue the company’s highly acquisitive path.

Company Approach
The compensation committee eliminated stock options and introduced a new performance share plan that comprised 100 percent of the long-term incentive opportunity for executives. Payouts were determined based on growth in revenue and economic profit (earnings less a capital charge). The use of economic profit was a more appropriate and comprehensive measure for the company given its acquisition plans.

The two measures were used in a matrix, rather than independently. This allowed the company to adjust the potential trade-offs between revenue growth and profitability by customizing the performance level in each cell in the matrix. For example, the company was willing to trade off some level of profitability for extremely strong revenue growth. For more normal levels of growth, the acceptable trade-off was much lower.

Lastly, the company included a threshold “circuit breaker” based on absolute profit margin. If margin performance was below some threshold level of performance, there would be no payouts — regardless of the level of growth. The threshold reinforced the message that the strategy needed to be achieved profitably and aligned with analyst expectations.

Overall, the plan created a clear set of marching orders to executives and ensured that executives would have the incentive to make decisions and trade-offs that were consistent with the long-term strategic objective.
The Promise of Long-Term Incentives

As the case studies demonstrate, a thoughtfully tailored long-term incentive approach can be an extremely valuable management tool. Companies should be willing to embrace being different. In fact, investors are usually supportive of unique incentive design approaches when the rationale for the plan is compelling and communicated clearly. This is particularly true when the design resonates with investors during shareholder-outreach conversations related to strategy and company performance metrics.

When designed thoughtfully, customized long-term incentive programs will focus executives on strategic priorities, reinforce the strategy to external stakeholders, and drive long-term sustainable shareholder value.