THOUGHT LEADERSHIP FROM FW COOK

PREPPING FOR A POST-PANDEMIC PROXY SEASON

Covid-19's impact on businesses varies by industry—and so should efforts to adjust compensation programs.

BY NOW, virtually every company has been affected by the global pandemic. Yet, the nature and degree of that impact ranges broadly. In the hardest hit industries—retail, airline, restaurant and hospitality businesses—companies unable to resume normal operations continue to hemorrhage cash, despite efforts to slash expenses and reduce headcount. Many of those in less vulnerable sectors are faring better, although still struggling to adapt to challenges like reduced demand and supply chain interruptions. And some, buoyed by increased demand for staples or the ability to pivot to growth areas, are even seeing a performance boon.

However, where companies fall across this wide spectrum of impact may have little connection to the performance goals set forth in their 2020 incentive pay programs, notes Steve Harris, president and head of FW Cook's Atlanta office. "These goals were set in January or February before anyone really knew the substantial impact of Covid-19," he says. "So, the question is, what do you do with those goals, and how do you approach any potential adjustment?"

CONTEMPLATING CHANGES

It's a thorny decision for companies, one made all the more difficult by the guidelines recently issued by proxy firms. ISS and Glass Lewis have long tended to look askance at mid-stream adjustments to metrics, goals or option prices, and Covid-19, thus far, hasn't seemed to change that. ISS has not indicated support for companies making changes to long-term incentive plan awards, and also indicated that it may not provide additional flexibility for companies to apply discretion. Glass Lewis went even further, stating that companies that make adjustments may very well face adverse recommendations for their say-on-pay proposal.

Still, several situations merit acknowledgement of the disruption's impact. "While it's still early for companies to make a decision on exactly what they might do, it's not too early to start thinking about potential adjustments," notes Harris. Those in hard-hit industries may well want to rethink incentives designed for a business-as-usual year, factoring in new challenges such as the degree to which management was able to mitigate Covid-19's impact or pivot to address changes in demand or distribution challenges.

Doing that without drawing the ire of shareholders, however, will require care. "The sensible approach is for companies to inject performance into whatever they do in lieu of the normal compensation program," says Harris, who notes that changes should align with shareholder interests and represent a sound business case. "So, rather than simply provide automatic grants of stock that will vest for employees who stay with the company, they should base earn-outs on performance metrics that relate to positioning the company to get through the pandemic in the best possible shape."

"In other words, figure out what you *can* do during this time—restructuring offerings, adding efficiency, reducing the daily cash burn—that will provide a post-pandemic competitive advantage versus your peers," he advises. "If you reward based on accomplishing those things, the business case could be made that you're providing value aligned with shareholder interest."

On the flip side of the spectrum, there are companies that actually benefitted from disruption, such as packaged goods and delivery service companies that saw spikes in demand. That unanticipated boon has raised the question: Should such a tailwind actually warrant a negative discretion?

Generally, the answer is no—or at least not yet. "Broadly, these better results have not occurred by accident, and how they will net out over time remains to be seen," says Harris. "Demand was fueled by binge buying during the pandemic, but teams

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had to work very hard and creatively to meet that demand, so the view is that performance has been earned.” What’s more, there is also the possibility of a dip in demand due to stockpiling when the market normalizes that will offset those gains.

Thornier still is the compensation situation for large portfolio companies in which one division prospered during the pandemic while the others remained flat or faltered. Should organizations reward portions of the business that outperformed the others? “We’ve gotten that question a lot,” says Eric Henken, principal at FW Cook. “In many cases, yes, there should be an incremental reward for any part of the business that had to kind of rise to the occasion to meet increased demand.”

For companies with compensation programs that already tied portions of incentive pay to business segment performance, letting the metrics in place play out may be sufficient to recognize the additional effort required. Others may require adjustments that acknowledge the impact of the disruption on a specific division and reward its employees accordingly.

Talent concerns should also be considered when weighing compensation adjustments, particularly for companies adversely affected by the pandemic. A drop in equity value can make changing employers more palatable for executives whose skills sets enable them to move easily between industry sectors, such as those in finance, legal, R&D or technology positions.

“If you’re sitting in an industry that’s been hurt and the value of your equity is depressed, leaving becomes more attractive,” says Harris. “Recruitment is much easier when someone can essentially reprice the equity you hold. That’s something companies need to be concerned about for select positions that are fungible across business sectors.” Companies that forego compensation adjustments risk being more vulnerable to the poaching of top talent, which will make recovery more challenging.

SAY ON PAY FALLOUT

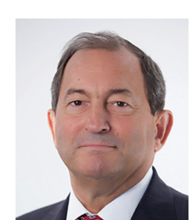
For the moment, conversations around modifications to compensation programs should be just that—conversations. Companies and boards should start having them, but not necessarily move forward on implementing changes, notes Harris. “What’s key is not to be reactive, but instead to go through a thoughtful, structured process of considering what should or should not be done,” he says. “Those conversations can then feed into an ultimate decision about how to respond to something that no one predicted so that when you get to the end of the year, any decision is a well-informed, business based decision.”

Even when reconsideration might seem warranted, some companies may opt against applications of judgment and discretion to avoid earning the ire of shareholders. While recent years have seen a relatively stable Say on Pay environment, with just 2 percent of companies receiving a “no” vote, the pandemic has the potential to upset that trend if proxy firms react negatively to adjustments.

“Historically, ISS recommends a ‘no’ Say on Pay vote for about 10 percent of the S&P 500 each year,” Henken explains. “A negative recommendation typically deteriorates Say on Pay support for a company by between 25 percent to 30 percent, so a meaningful uptick in that 10 percent rate may correlate to a higher Say on Pay failure rate.”

Companies may be willing to risk that negative reaction in order to get through the pandemic in the best possible shape and gain a competitive advantage versus their peers once it passes. It’s critical, however, that boards and management teams understand that possibility and prepare for it by developing appropriate metrics and preparing robust disclosure that makes the best possible business case for the path they choose, notes Harris.

“Some companies will take the position, ‘We have to do what we have to do to maintain our talent and our business,’ and that very well may be true,” he says. “So, they should be trying to ensure that they can make a compelling argument about the rationale—what management did to mitigate the impact of the pandemic and how, as a result, the company is positioned to rebuild share valuation more quickly, both of which align with shareholder interests.”



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