THOUGHT LEADERSHIP FROM FW COOK

INCENTIVE PAY IN UNCERTAIN TIMES

When the world changes, does your compensation plan need to change with it?

A YEAR AGO, while many businesses were still reeling from Covid-19's catastrophic impact, the possibility of returning to a more stable operating environment seemed within reach. If not under control, the pandemic had begun to feel manageable. As fears faded, the practices that companies adopted to manage through the crisis seemed likely to be viewed as anomalies rather than become part of a new, ongoing reality. In short, getting back to relative normalcy seemed attainable.

Compensation committees of companies whose incentive pay programs had been upended by what was roundly viewed as an unforeseeable black swan event would have welcomed such a reprieve. Instead, however, new external threats emerged. "Economic uncertainty, labor market challenges and market volatility are external issues having a massive impact on the ability to meet performance goals," notes Alexa Kierzkowski, a managing director at FW Cook, who adds that supply chain disruption, the Russia-Ukraine conflict and inflation are all contributing to uncertainty. "It's essentially been an extension of what we saw in 2020 with Covid, with external factors playing into compensation more than they ever have before."

As with the pandemic, while the forces at play are affecting virtually every company, the type and degree of impact on incentive programs varies by industry. At many biotechnology companies, for example, options are underwater due to declining market valuations. Meanwhile, companies in the technology space whose performance soared during the pandemic are struggling to determine realistic goals.

"It is typical for a development-stage biotech company that's been hitting all of their internal milestones, but their share price is down 50 to 80 percent because the market has taken a beating," says Kierzkowski. "Even though the talent market has softened somewhat, it's still incredibly competitive in their space, so that represents a real challenge for retention and recruitment. Whether it's evaluating an incentive plan that's under water or setting goals, the challenge now is how to thread the needle between keeping employees engaged and focused on realistic objectives and at the same time maintaining the integrity of your incentive plan and making sure participants and pay delivery still aligned with shareholders?"

MITIGATING UNCERTAINTY

It is important to note that external conditions that have unforeseen—and unfortunate—effects on compensation outcomes are to be expected on occasion. "The rule of thumb is that even with a well-designed plan, you will probably miss your threshold performance goal once in 10 years and probably hit your maximum once in 10 years," says Rachel Gibbons, a principal at FW Cook. "That doesn't mean the plan was too easy or too hard; that's just the mechanics of how a plan will work."

And even in the current environment, making officer-level adjustments to an established pay framework is not common or advisable, adds Kierzkowski. "Actions like changing goals that have already been set or granting special awards for top executives will attract scrutiny from the outside," she notes. "ISS has reiterated that they're not going to be very sympathetic to that type of action. However, deeper in the organization, some companies are applying discretion to bonus-funding criteria or restaking participants with additional equity in order to attract and retain key talent."

More common, however, is for companies that recognize the likelihood of ongoing uncertainty and volatility to take a hard look at current incentive plan challenges and weigh potential changes going forward (See table, opposite page). Some companies sought to address the issue during goal setting for 2022 by flattening the slopes of payout curves for incentive plans, either around the target or for the

Designing for Disruption

COMPENSATION COMMITTEES CONCERNED ABOUT UNCERTAINTY ARE CONSIDERING:

- Increasing the use/weighting of strategic measures in cash-based incentive plans
- Diversifying performance measures in incentive plans
- Setting wider goal ranges (flattening slopes)
- Using relative performance measures
- Adding pre-determined exclusions to incentive calculations to address disruptions and minimize discretion
- Delaying goal setting

COMPENSATION COMMITTEES GRAPPLING WITH EQUITY MARKET VOLATILITY ARE CONSIDERING:

- Using stock prices other than the fair market value on the date of grant to convert dollars into shares (e.g., a multi-day or week average
- Price-averaging by spreading awards across multiple pre-planned grant dates throughout the year
- Reconsidering equity grant type mix (e.g., less options, more full-value awards)
- Shortening vesting schedules, increasing the tangibility of awards (especially among technology companies)
- Extending bonus and LTI programs deeper into the organization

curve as a whole. Widening the range of performance that earned some degree of incentive payout provided executives with some downside protection against volatility in executive pay delivery, while also making maximum performance more difficult to attain. This balance is important to prevent simply protecting payouts at the expense of shareholders.

Diversifying performance measures is another approach. "Some companies are adding strategic measures in cash-based incentive plans or increasing the weighting on such measures. This can be a good opportunity to add or increase the emphasis on a well-thought-out ESG measure in an annual incentive plan, for example," says Kierzkowski. "Others are diversifying performance measures that might have previously focused on a single profitability metric by adding in a relative measure, such as relative TSR. In a down market, the company might not have strong TSR on an absolute basis but still be outperforming a preset group of peer companies. From an investor perspective, that performance metric still aligns with shareholders." However, making such changes to incentive plans come at the expense of additional complexity, so companies should weigh the pros and cons carefully.

Finally, delaying goal setting is a way for companies to temporarily stave off decision making around performance metrics and awards in the hope that a murky picture might crystallize. However, any delay should be balanced with making sure a meaningful performance period still remains once goals are set.

ADDRESSING MARKET VOLATILITY

As with a disruptive global event, stock price declines have been far more significant for some industries than others. Faced with large declines or share price volatility likely to linger, some compensation committees are reevaluating the effectiveness of their equity programs and refining their tactical approaches to granting equity.

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—Alexa Kierzkowski, FW Cook

Those that use a dollar-denominated grant value, for example, might look for ways to mitigate short-term volatility. Basing the number of shares granted on a multi-day or week average value rather than fair market value on the grant date is one way to help address short-term daily price fluctuations. Another alternative might be to shift from an annual grant to two or even more smaller grants spaced out over the course of a year, especially for options. "That effectively provides executives with a portfolio of exercise prices, with some more advantageous than others," explains Kierzkowski. "It helps with short-term volatility, but the downside is that it adds complication to the program." These approaches are not major program changes, but they shouldn't draw scrutiny from outsiders, either.

Shifting from stock options to full-value awards and shortening vesting schedules are other ways companies can help address equity market volatility. Restricted stock units, for example, represent the most stable vehicle, one that promises to provide some value for continued employment even during a market drop unless the stock bottoms out completely.

Companies whose share prices have dropped significantly should also be mindful of the fact that equity grants with a similar grantvalue as the prior year are now more dilutive to shareholders and will use more stock plan shares than they may have planned. "Companies aren't going to be able to dramatically increase their burn rates and outstanding dilution indefinitely," points out Gibbons. "And if they deplete their stock plan authorization, they will need approval from their shareholders to replenish the pool. So while there is some tolerance for some incremental additional dilution, those are things companies really need to keep an eye on."

At a time of ongoing economic uncertainty and market volatility, it seems clear that compensation committees will be grappling with these issues for the foreseeable future, notes Kierzkowski, who urges compensation committees to tread carefully when adapting pay programs. "After such an extended bull market, we're entering a more difficult time and there will be some pain that comes with that," she notes. "But companies need to take a cautious and responsible approach when weighing whether and how to adapt compensation plans to that new normal."

Alexa Kierzkowski is managing director at FW Cook.

Rachel Gibbons is a principal at FW Cook.