COVID-19's Incentive Impact: While Most Companies Wait, Companies with Early FYEs are Forced to Act

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When the COVID-19 pandemic started to spread across the United States, boards of directors initially focused on ensuring the safety of their employees and customers and managing to stabilize their businesses for uncertain times ahead. Early on, many companies were in "survival mode," with liquidity concerns driving decisions, particularly for companies in those industries that were hit the hardest.

But now, several months into the pandemic, regardless of industry or the severity of COVID-19's impact on corporate prospects and valuations, most companies have started reviewing their compensation programs in light of the pandemic. We are increasingly participating in board-level discussions focused on how to ensure that management teams stay focused, engaged and properly incentivized.

Compensation Committees are seeking to ensure incentive plans remain relevant, while also supporting company strategy. Key priorities may have changed and/or continue to be fluid, further increasing complexity and the need for nimble programs that can provide flexibility. In addition to discussions related to in-cycle/outstanding short-term incentive (STI) and long-term incentive (LTI) plans, Compensation Committees are also exploring potential design changes for the next fiscal year, which will become top of mind, as COVID-19 uncertainty continues into the Fall and Winter.

Although "wait and see" continues to be the most common approach for organizations with calendar fiscal year ends (FYEs), companies with earlier FYEs are being forced to make tough decisions sooner. To provide real-time insights into how these issues are being addressed, Meridian conducted a survey of our clients with FYEs between March and September 2020. We collected information related to COVID-19's impact on each company, current STI and LTI payouts/expectations, as well as preparations for next year's incentive designs. We believe this information on how "early movers" are navigating through compensation decisions during COVID-19 will provide valuable insights.

STI Plans

Companies with FYEs through June 2020

For companies with completed fiscal years, approximately 85% paid less than target. See the table below for further details regarding those that paid below target.

Payout Level (% of Target)	Prevalence of Companies that Paid Less than Target
50 - 99%	10%
0 - 50%	60%
0%	30%

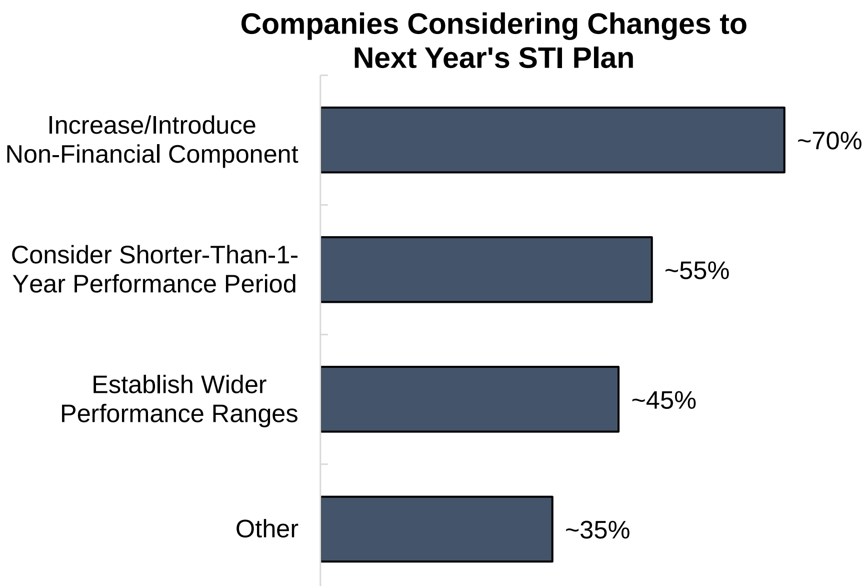
Interestingly, most of these companies decided <u>not</u> to formally alter their current-year plans and the payouts were generally based on each company's pre-established formula/structure. In other words, companies that had only 2 – 3 months left in their FY at the onset of the pandemic, typically allowed the plan to play out the way it was originally designed.

Companies with FYEs between July and September 2020

For companies with FYEs that will be ending in the next 1 – 2 months, 65% are expecting to pay less than target (in most cases, less than 50%) or believe it is too early to make a determination. The remaining 35% are expecting to pay at or above target, although most acknowledge that final results may vary depending on performance during the remainder of the fiscal year. The companies expecting to pay at least target are generally less negatively impacted by COVID-19 and are estimating that payouts will be based entirely on pre-established formulas. These expectations reinforce the idea that although the pandemic has had a catastrophic impact on many companies, there is a significant portion of the market that has faced less severe consequences. Of the companies expecting to pay less than target, around half are expecting payouts to be modified from the pre-established formulas (which would have likely resulted in zero payout). These companies are most often employing discretion, but other approaches also include the use of non-financial goals to provide *some* payout and adjustment to goals (which is less common).

Go Forward Potential Plan Design Changes

As we expected, companies that were more negatively impacted by COVID-19 are more likely to change next year's STI design. In fact, all of the companies that were categorized as experiencing moderate or severe COVID-19 impact are considering changes, in addition to many less impacted organizations. In total, around 50% of all respondents plan to make changes to their respective STI plans for next fiscal year. The prevalence of adjustments that companies are considering is summarized in the chart below.



Other includes: ease performance threshold level, change weighting of financial metrics, and re-evaluate the merits of a financial goal that measures YoY performance improvement

LTI Plans

Nearly all of our respondents have performance-based equity programs that comprise a significant portion of the company's LTI program, most often 50% or more of the total LTI mix. Most companies are likely facing challenges in achieving pre-set financial performance goals for multiple cycles, particularly given that about 75% of respondents have 3-year cumulative performance periods. In contrast, relative TSR metrics/modifiers will likely "run their course" at most organizations.

Companies with FYEs through June 2020

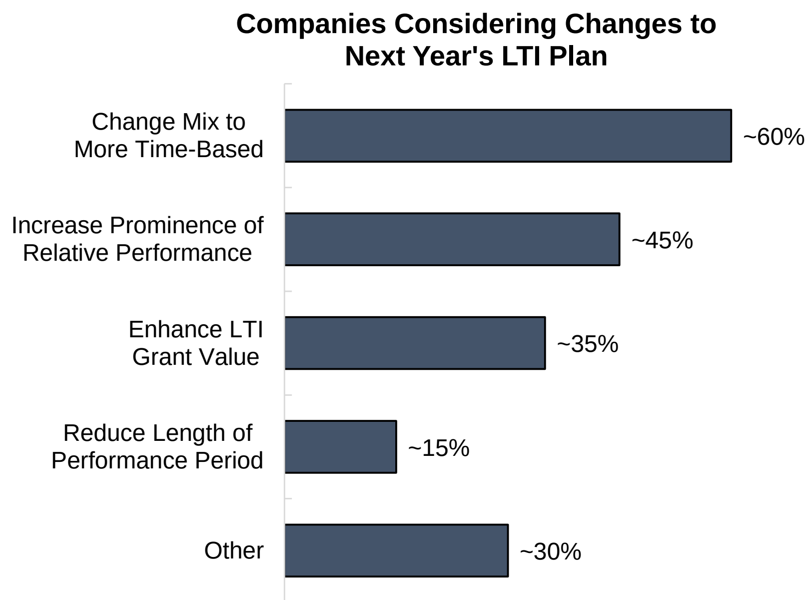
For companies with completed fiscal years, about half paid less than 50% of target, 25% paid at least target, and the results are not yet clear for the remaining 25% of companies. For this group of companies, it is clear that COVID-19 has had a less significant impact on LTI payouts as compared to STI payouts, presumably due to the longer performance period linked to LTI programs. In other words, a smaller portion of the performance period was impacted by COVID-19. In most cases, payouts were based on the company's pre-established formula/structure, likely reflective of accounting and disclosure complexities that are associated with adjustments to outstanding LTI plans.

Companies with FYEs between July and September 2020

For companies with FYEs that will be ending in the next 1 – 2 months, expectations are highly variable, with about 40% of the companies expecting no payout for the cycle that is ending soon, and mixed results for other respondents.

Go Forward Potential Plan Design Changes

Similar to STI, all of the companies that were categorized as experiencing moderate or severe COVID-19 impact are considering changes to LTI for the grant in the new fiscal year, in addition to many less impacted organizations. Overall, around 50% of all respondents plan to make changes to their LTI mix, metrics, or designs for next fiscal year. The prevalence of adjustments that companies plan to make is summarized in the chart below.



Other includes: change weighting of financial metrics, change plan metrics, and modify financial goals to measure YoY performance improvement

Our respondent companies are making their way out of the "wait and see" phase and into the "take action" phase. This is a challenging situation for compensation committees of early FYE companies, as they are forced to make decisions with fewer points of reference than they would like. We will continue to monitor these early decisions as more information becomes available. It will be interesting to follow the actions taken by compensation committees over the next few months, as these preliminary actions of companies with early FYEs will likely be a key guidepost in the decision-making process for calendar-year companies.