COVID IMPACT ON EXECUTIVE COMPENSATION

By Chris Havey

RECENT HEADLINES have highlighted companies disclosing extraordinary changes to their annual or long-term incentive plans in light of the pandemic. We anticipate additional disclosures as calendar year companies begin to file their proxies in the coming months. But how prevalent are these changes?

Our year-end cross-industry study of nearly 300 companies reveals that, in spite of much talk about potential changes to incentive compensation in response to the pandemic, a majority of companies made no substantial changes in 2020 to existing annual or long-term incentives, and 2021 design changes are anticipated to be modest. The likelihood of executive pay changes appears to vary significantly by industry tied to the significance of the pandemic's impact.

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ANNUAL INCENTIVE PLAN CHANGES

2020 Bonus

Our study results indicate that a minority of companies (25 percent) made mid-year changes to their annual bonus programs. These are generally companies that were more significantly impacted by the pandemic. Examples of changes include adopting new metrics or goals, shortening the performance measurement period, and/or lowering the payout opportunity.

The lack of companies formally adopting changes may be due to a few factors:

- While the pandemic was disruptive for nearly all businesses, its financial impact was focused on certain areas of the economy (e.g., travel, hospitality, retail, oil & gas).
- Even in harder-hit industries, some companies were hesitant to make changes due to concerns about adverse shareholder and advisory firm reactions.
- For companies that might have wanted to make changes mid-year, they may have been challenged to set new goals due to the significant level of uncertainty about when their business would recover.

For these reasons, a greater number of companies (nearly half) reported expecting an increased application of discretion for 2020. This may include positive discretion applied to the original goals, negative discretion applied to revised goals or simply an overall discretionary assessment. Each situation will be different. In addition, a better Q4 than forecasted this summer enabled many companies to advance reasonable bonus outcomes without a heavy dose of discretion.

2021 Bonus

The study also revealed that while a majority of companies are considering changes to their 2021 annual bonus plan, the changes are expected to be moderate. The most common expected change is to widen the ranges for financial targets between threshold, target and maximum, which increases the probability of paying a bonus, while reducing the probability of generating a windfall maximum payout if 2021 is better than expected. In addition, some are adding a non-financial component of the bonus program tied to ESG and/or human capital metrics.

Very few companies (<5 percent) were considering more drastic changes such as switching to a shorter performance period (e.g., quarterly or semi-annually) in 2021.

LONG-TERM INCENTIVES

Outstanding Awards

Our study showed that less than 10 percent of companies have made changes to outstanding performance share awards. This low percentage is likely due to a number of factors:

- The long-term nature of these awards, which may limit the impact of short-term disruptions;
- The higher prevalence of relative metrics, which neutralizes for macro trends;
- The adverse accounting and disclosure implications of modifying outstanding awards; and
- Concern about adverse shareholder and advisory firm reactions.

Those that took action were likely to have long-term incentive awards solely tied to absolute financial metrics, with the pandemic often resulting in multiple years of zero or very low payouts.

2021 Long-Term Incentive Approach

Nearly 80 percent of companies anticipate no material changes to long-term incentive design for 2021, and nearly 75 percent anticipate no material change to long-term incentive grant levels for 2021. Among those considering changes, the most common are greater weighting on time-based awards (likely to help with retention given uncertainty) and the introduction of new metrics, either relative TSR or financial. These anticipated changes are likely to be industry-specific.

HEADLINES DON'T TELL THE WHOLE STORY

There will likely be more headlines to come about companies that made unusual adjustments to their compensation programs due to the impact of Covid-19. There are likely appropriate reasons for making adjustments in many of these cases. However, companies that did not make adjustments should not feel that they are necessarily in the minority. In fact, these companies likely represent the majority of Corporate America.

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