Executive Compensation in an Uncertain Economy: Strategies for Building Flexible Incentive Plans

This time last year, many of us were hopeful that the pandemic would have waned and, as a result, the economy would have stabilized. Unfortunately, 2021 was another year of volatility, uncertainty, and challenging economic conditions for many organizations. Despite its catastrophic impact on society and its toll on human lives, executives' concerns have shifted from the impact of Covid-19 to the disruptive technological, societal, and economic challenges that their businesses must face in the years to come. (Alix Partners).

As they look to the future, executives' top concerns include supply chain disruptions, inflation, expected tax increases, labor shortages, higher energy costs, and increases in prices of raw materials. For the third consecutive month, CEO optimism in the business environment has declined in response to these pressures (Chief Executive). Despite these concerns, executives, boards of directors, and compensation committees have work to do—they must figure out how to reward performance for yet another unpredictable year.

Looking back at 2021, external factors negatively impacted a variety of financial metrics in certain industries. As compensation committees attempt to determine what adjustments should be made in order to calculate a bonus payout that is reasonable and fair, they are faced with challenging decisions around how to account for these economic disruptions that were almost impossible to predict at the beginning of the year. Often these decisions are somewhat influenced by compensation outcomes in 2020. In other words, if organizations paid out well in 2020, they may be less likely to provide forgiveness in 2021 if things did not go as planned. For organizations that performed poorly (and paid minimal bonuses, if at all) in 2020, the thought of not paying well again in 2021 becomes concerning. Retention becomes a significant risk, as the challenges faced are not consistent across companies. In addition, leadership teams are still working harder than ever to overcome business challenges.

For long-term incentives, most organizations are still holding course and paying according to plan, even though challenges continue to impact performance for outstanding cycles. In situations where payouts have been impacted, most organizations are looking ahead to future awards to potentially compensate for softer payouts in prior cycles. In fact, it is rare for companies to make changes to awards currently in process. On top of accounting implications, investors view these actions negatively. In its latest annual policy survey, ISS asked asset managers and large institutional investors about their views on making changes to performance awards mid-cycle. More than half of respondents continue to view these adjustments as problematic, even in challenging economic circumstances. Companies that do make changes to plans mid-cycle will invite extra scrutiny from investors and proxy advisors.

As companies prepare for 2022, they must evaluate how they will approach annual plans, long-term plans, and how discretion should be leveraged in each.

Incentive Design Considerations for 2022: Annual Incentive Plans

There are a few different ways companies are changing annual incentive plan design, given the continued uncertainty that exists in the market. Unlike long-term incentive programs, which tend to be more rigid due to accounting and disclosure concerns, annual incentive plans allow for much more flexibility. While numerous levers can be pulled, three of the more common approaches companies are considering when struggling with uncertainty are:

1. *Widen pay and performance goal ranges*. Whereas ranges of 90%–110% or 85%–115% of target for achieving performance at threshold or maximum are fairly standard, compensation committees are considering further widening those ranges for future years. This additional buffer zone allows companies to set reasonable targets, remain nimble enough to align performance rewards with strategic goals, and still be realistic about the current environment and how unpredictable it remains.

2. *Shortening the goal-setting cycle.* Rather than establishing 12-month targets, some companies (e.g., retail industry) are setting goals for the first half of the year and then a new goal for the second half. Shorter goal cycles provide companies greater visibility and allow for adjustments mid-year based on changing circumstances that may have been unpredictable at the beginning of the year.

3. *Setting "target" as a range (rather than a single point).* Most annual incentive plans have a target goal, for example, $100M in EBITDA, and then a threshold and maximum goal for under or overperformance (with an associated range of payouts). Some companies are now setting a tight range around the target for which 100% of bonus is paid—and increasing or decreasing from there for threshold and maximum. For example, instead of target performance being set at $100M in EBITDA, the target range may be $97M–

$103M in EBITDA, so that any result within this performance range earns a target payout. Setting a range for target performance rather than an absolute value allows for some movement in assumptions and some level of unpredictability to occur—without penalizing management. This is similar to how companies typically provide a range of earnings that is acceptable when guidance is provided externally.

Incentive Design Considerations for 2022: Long-Term Incentive Plans

Companies have more complicated decisions to make with the in-cycle (unvested) long-term performance awards. For most companies, performance-based awards comprise 50%–60% or more of the total LTI value. In 2020, performance award payouts were lower than expected for many companies due to the impact of Covid-19. While some companies have rebounded—with stock prices recovering and projected payouts closer to what was anticipated pre-Covid—other companies continue to face poor performance outcomes and lower-than-expected payouts. For these organizations, concern over lack of retention hooks is creating a need for ensuring that 2022 performance cycles are set in a challenging but realistic manner, particularly where continued uncertainty exists.

Several strategies have been implemented by compensation committees to address this continued uncertainty within long-term incentive programs, including:

1. *Use of relative metrics.* Companies that use relative measures in their long-term incentive plans, such as total shareholder return, may find that these programs are built to stand the test of time (and withstand market disruptions). As long as a company has an appropriately structured peer group (i.e., one where all companies are similarly impacted by macro-economic influences), market fluctuations or disruptions should impact all companies in that group similarly.

2. *Shorter performance measurement periods.* For some companies, using a one-year or a two-year performance period (with additional vesting requirements post earning) may provide a temporary solution for weathering a potentially volatile future environment.

3. *Year-over-year growth based on prior year actuals.* The annual growth goals are determined at the beginning of the cycle but applied to each year's prior actual performance, with achievement locked in each year and paid at the end of the full cycle. This approach allows for volatility in financial performance without zeroing out the full three-year award. For example, performance goals would be set at the beginning of the three-year cycle, with year one based on an absolute target value. Performance goals for years two and three would be based on a growth percentage of the prior year actual results. If year one results are below budget, the target for year two would be lower than initially projected; whereas strong performance in year one would require additional growth to achieve target performance in year two. This method tends to result in a tighter payout band around target than a more traditional design, lessening the potential for payouts at the extremes (i.e., no payout or maximum payout).

4. *Increase weight on time-based restricted stock units (RSUs), primarily to increase the retentive aspect of the LTI awards.* As compensation committees plan for 2022, this trend will likely continue—companies that increased the weighting on time-based RSUs in 2021 are likely to maintain the same weighting, while others may implement this strategy for the first time. Proxy advisors are critical of companies that grant less than one-half of the long-term incentive value in performance awards and, therefore, most companies will consider 50% weighting the low end for performance awards in the pay mix discussion.

If executive retention is a critical risk, some companies may provide a one-time increase in value (e.g., 1.25x or 1.3x regular grant) of the annual long-term incentive grant compared to what would have been granted in a "normal" year. Special off-cycle retention grants may also come into play, with some performance contingency built into the award structure. However, these types of special grants should be awarded with caution, given the negative scrutiny that may be received from investors and proxy advisors (depending on design and quantum).

Using Discretion in Annual and Long-Term Plans

One of the biggest trends we have seen over the past two years is the increased use of discretion, particularly with respect to short-term incentive plan payouts. The use of discretion (particularly positive discretion), used to be somewhat frowned upon, but today's economic climate is changing opinions. Large institutional investors are starting to expect committees to exercise discretion in certain circumstances—after all, committees exist to make difficult decisions and think innovatively when pre-determined formulas do not produce reasonable outcomes that are aligned with shareholder experiences.

It is much easier for companies to use both positive and negative discretion in short-term plans. The use of discretion is rare in long-term performance plans. In previous years, Internal Revenue Code Section 162(m) regulations limited the extent to which companies could utilize positive discretion. The Tax Cuts and Jobs Act, signed into law in December 2017, included significant changes to Section 162(m) rules and eliminated the regulatory hurdles around the use of positive discretion. Without those barriers, companies are more confident in recommending the use of discretion, especially during times of uncertainty and volatility.

With that said, discretion cannot be entirely subjective. There needs to be a framework with established use cases and expected outcomes. We already know that companies must provide reasonable and thorough justifications for the use of discretion, a task that becomes exponentially more difficult if it is not part of the company's plan at the beginning—for example, within individual performance goals or operational scorecards. There are many questions to consider. Where might the financials have ended up without negative external impacts? What do payouts look like using the formulaic approach? What adjustments can be made that are appropriate and realistic? In addition, most companies that have used positive discretion to increase payouts are doing so in moderation, and generally not increasing payouts above target when the formulaic calculation resulted in a below target payout.

Discretion is not intended to lessen risk or reduce the impact of external factors. No company can eliminate every potential risk and there will always be external pressures over which management has no control. The purpose of discretion is to allow compensation committees to align incentive payouts more closely with overall company performance. If shareholders have experienced losses due to poor stock price performance, the organization will appear out of touch or insensitive if executives' pay is not aligned to that performance to a certain degree. On the other hand, if shareholders are doing well but performance metrics are below target, compensation committees must examine the cause of that disconnect and assess whether upward adjustments are appropriate.

Conclusion

As we head into another unpredictable year, this is the ideal opportunity for compensation committees to closely examine their processes for designing compensation plans. Thinking creatively about how to take into consideration the potential for continued disruptions will be critical for some companies. It will be important to test the performance curve extremes to ensure proper flexibility is afforded, particularly if volatility in results is anticipated, and set realistic budgets based on sensitivity analyses and investor expectations. At the end of the day, payouts should be fair and reasonable and align with the experience of shareholders.