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Planning for Victory

Winning the war for executive talent

By George B. Paulin

MERIDIAN COMPENSATION PARTNERS, LLC

Competition in the executive labor market is intense. Companies are commonly experiencing attrition at 50% to 100% above recent years, while rapid escalation in new-hire packages for ongoing compensation and buyouts of forfeited equity values is real-time and not yet fully reflected in competitive pay data.

Making matters worse for established companies, the battle is being fought on two fronts. They are competing against their direct peers on the one hand and on the other hand against well-funded, developing and growth-stage companies—including IPOs that are offering enticing upside opportunities in a supportive equity market. Winning this war for executive talent requires companies to understand the following trends in compensation.

Obsolete Traditional Retention Approaches

Unvested equity is the primary retention vehicle used by established public companies. This supports their rationale for granting a large portion of long-term incentives in the form of restricted stock, and making long-term incentive grants annually with overlapping, multi-year vesting schedules. Companies often track these unvested amounts as "walk-away" values and make supplemental grants when they are insufficient to provide a meaningful hold.

There are valid reasons for granting restricted stock and making annual long-term incentive grants with overlapping vesting related to providing a tax-effective ownership interest, mitigating compensation-related risk and rewarding the underlying growth in shareholder value reflected in the underlying shares and dividend rights. But "golden handcuffs" are an anachronism.

Common and accepted practice now is to buy out unvested equity values in executive recruiting packages with make-whole payments and grants that emulate the amounts, form and timing of whatever was forfeited from the prior employer. Furthermore, this is not just for CEOs. There are many examples of recent buyouts well into eight figures for CFOs and other proxy officers, as well. The effect is that unvested equity no longer has real employment-related risk for executives. They are likely to receive the value if they stay employed in their current jobs and vest, or leave for new positions and receive a make-whole.

Strategic Recruiting and Retention

Companies need to review their executive pay strategies for competitive advantage in today's market. The following are practical ideas to consider alongside other human capital initiatives related to development, training, engagement, selection, diversity, succession planning, etc., recognizing that pay is just one element of a broader set of considerations:

1. **Structure effective packages for new hires and promotions.** Our experience suggests that companies often overpay outside hires to attract the candidate, and underpay internal promotions because the increases are large enough that it is not necessary to come all the way up to the market median. It also is common to focus on the individual packages rather than on broader internal pay relationships and equitability. All of this needs to be avoided.

For outside hires, three principles should be followed:

- Set ongoing target pay at a level and mix consistent with existing company practice for others to maintain internal equitability.
- Buy out forfeited compensation with the objective of making candidates no better or worse off than if they had stayed with their prior employer (i.e., make them whole).
- Provide additional one-time inducement only if necessary to make the deal. For key roles, a general rule of thumb for reasonability is 3–5x salary, or 1x regular annual long-term incentive grant value for senior executive lateral moves. Where the position being offered is at a higher level or in a bigger, more complex organization with higher ongoing pay, this is often inducement enough.

For internal promotions, start with target annual incentive and long-term grant values at or close to median, and leave room for growth in salary. Here, the rule of thumb is that the promoted executive should be at median overall in two to three years with satisfactory performance, recognizing that upward market movement is likely in the interim.

2. **Leverage long-term incentives to increase real pay delivery for outperformance.** A strong business strategy that provides opportunity for compelling real, earned pay from equity is one of today's keys to attracting and retaining talent. This is apparent from the growing prevalence of executives leaving secure, long-term employers for startups and IPOs. They see the potential upside leverage as more than offsetting the potential downside risk.

Companies need to review the structure of their long-term incentives in response, especially where there is heavy reliance on restricted stock and performance shares designed to regularly payout in the target range. Such reviews should recognize that there are two ways to enhance potential pay delivery for high performance without increasing the grant value. The first is structuring performance shares with higher maximum payout opportunities than the standard 200% of target shares, with steeper performance curves for outperforming and underperforming against financial (i.e., non-market-based)

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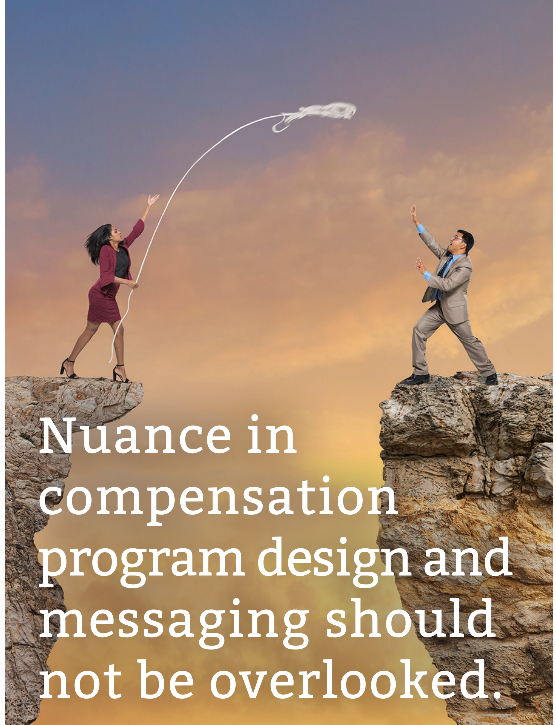


metrics. The second is setting high-risk goals for relative and/or absolute total shareholder return (i.e., market-based) metrics. This shifts the GAAP valuation of shares/units being granted from face value to Monte Carlo value. Under the Monte Model, the higher the performance risk, the lower the grant value per share and the more shares that can be granted and subsequently earned at a multiple for above-target performance.

3 **Use selective, performance-based special awards.** One-time special awards are made for various reasons including support for critical strategic initiatives, recognition and retention of high performers and new-hire inducement.

Below the proxy-officer level, primary considerations are precedent, internal, equitability and cost. However, an additional consideration for proxy officers is Say on Pay risk, recognizing that there is required disclosure to an audience that includes large investment funds and the proxy advisors who are generally opposed to rewards outside the "regular" program. For example, Vanguard amended its voting policy with a negative provision on special awards in 2019. BlackRock took similar action in 2021, warning of increased scrutiny of special awards going forward.

Several recent Say on Pay failures have occurred in years when CEOs and other proxy officers received special awards, although this was not always the case. Meridian research shows that in addition to avoiding excessive amounts and having significant vesting/earnout periods, successful companies have used performance-based award structures designed to clearly deliver on-top pay for on-top performance.[1] The disclosed rationale is also important and should go beyond simple retention because the commonality of buyouts is well understood.

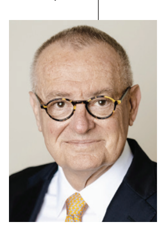
4 **Differentiate high-performing businesses and individuals.** The bias seems to be toward treating everyone the same, especially proxy officers, among whom differences are disclosed to be seen publicly and interpreted. This underscores the importance of designing pay structures to provide and encourage differentiation.

An example of a simple and effective provision for companies that have typical 0%–200% of target annual incentive funding is to allow individual awards for outstanding performers up to 250% of target within the funded pool. Another is for companies that use executive salary ranges to raise the maximums for high performers who do not have immediate or foreseeable advancement potential. It is also increasingly common to recognize business and/or individual performance in annual long-term incentive grant values.

5 **Refine peer groups.** Where executive talent-market competition extendstogrowth companies and successful recent IPOs, these companies should be in the peer groups, if not to directly benchmark executive pay levels, then at least to know their pay practices. For example, it is common sense that established financial services companies should be looking at fintech, and Big Pharma should be looking at drug discovery companies. The fact that there may be exceptions to the standard revenue-size and market- cap thresholds in peer-group selection criteria should not be the determining factor.

6 **Put teeth in restrictive covenants.** Finally, there is an important set of considerations unrelated to direct pay. Current hypercompetitive labor markets warrant a review of post-employment restrictive covenants. For executives who leave voluntarily without "cause" or for "good reason," this should include the use of noncompete provisions in states where enforceable, as well as confidentiality, nonsolicitation and mutual nondisparagement provisions. Executives who qualify for retirement under equity grants that accelerate or continue vesting should be included as well.

Business strategy and corporate culture are undoubtedly the key factors in successfully competing for executive talent. Meanwhile, compensation is a major support element, especially for retaining and recruiting high performers when market demand is strong. Nuance in compensation program design and messaging should not be overlooked. CS



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[1] *See Meridian publication by Donald Kalfen and George Paulin, "Special Awards to Senior Executives" at* ***meridiancp.com/insights/perspectives-on-one-time-special-executive-awards****.*

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