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MERIDIAN COMPENSATION PARTNERS

Are Your Compensation Programs Ready for a Business Transformation?

To maintain or secure competitive advantages, companies must constantly adapt and evolve – sometimes requiring a major transformation. This issue of the Beacon examines the most common types of transformation and provides insights into how compensation programs can be designed to help support their success.

There are a wide range of business transformations from the launch of a major new product or service to the acquisition or disposition of a major business line.

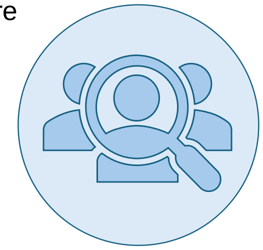
From a compensation standpoint, there are three fundamental questions to consider when preparing for any business transformation:

Attracting Talent

Companies must balance their talent needs with pay philosophy, competitive position and cost. Some of the initial questions to address are:

- Are we benchmarking to the appropriate external markets for talent (e.g., appropriate size, industry and company characteristics)?
- Does our pay philosophy (pay level relative to market and approach to incentive design) enable us to attract the talent we need?

Market data is an essential reference point. When business changes are modest, the current peer group may well be sufficient. However, when changes in strategy, company size or competitive pressures are more significant, properly defining the new market (via the peer group) is important to understand the true competitive landscape. For example, a company transforming from a manufacturing-focus to a technology- or service-focus may need to benchmark to different markets to meet its talent needs.



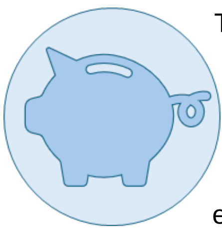
Although market data is essential, during a transformation, roles that are critical to the success of the transformation may require a different approach to retention. Determining where to position compensation within the range of market practices, as well as the form of awards and the relevant performance criteria, are essential business judgments for management and the Committee.

Common parameters such as “market practice,” “market median” and “best practices” may not be adequate – above market compensation may be required to retain talent given the uncertainty associated with a transformation and the impact of losing talent critical to the success of the transformation.

Retaining Talent

The key factors for assessing retention risk in a transformation context are:

- Do our executives have sufficient unvested equity awards (“holding power” or “retention glue”)?
- Is our compensation competitive with (or better than) market?
- Do we have the right severance and Change-in-Control termination protections?
- The answers to these questions help companies assess whether they need special retention awards for critical executives?



There are a variety of circumstances that can lead to retention risks – insufficient “skin in the game,” recent business challenges, uncertainty and risk in the transformation itself, etc. Whatever the cause – insufficient equity holding power increases the risk of losing key personnel.

Equity holdings also create an incentive for achieving company objectives and reward executives for the longer-term value created for shareholders from the transformation.

Ensuring that ongoing compensation is market-competitive reduces an executive’s incentive to look for alternative opportunities.

Business transformation may increase employee concern with loss of employment. Reasonable severance protections can mitigate these concerns, keep key leaders focused on the business and the transformation and reduce retention risk.

A well-designed executive pay program should link executive rewards with shareholder value creation, but the risks, uncertainties and challenges of a transformation may require special retention awards to retain employees whose loss could jeopardize the outcome or delay the achievement of the transformation.

Motivating Talent

Once a company has the right executive talent in place for the transformation and has addressed retention risks, a company must ensure that its pay programs are designed to focus the executives on the objectives that will ensure the transformation’s success. This generally raises the following questions:

- Are we paying for the right outcomes (i.e., correct performance metrics)?
- Are we setting the right performance goals?
- Does our payout curve provide adequate upside while balancing risk and uncertainty?

Metrics

Long-term value creation is the overarching goal. The twin pillars (drivers) of value creation are returns/profitability and growth. The ideal balance of these two pillars varies from company to company. Examining the metrics used based on company circumstances, asset mix and strategy will give rise to the blend of metrics to be used for short- and long-term incentives.

Return metrics should carefully reviewed to ensure that a return metric is appropriate during a transformation and that targets reflect anticipated investments and timing of returns, as return metrics can otherwise be a disincentive to invest in growth or transformation.

Goals & Payout Curve

Performance objectives and the corresponding payout curve are usually a blend of analytical rigor and business judgment, with business judgment more important in the transformation context. Companies use the following tools to assess whether goals are properly set include:

- **The stated case for the transformation as approved to the Board:** What are the expected investments, benefits, synergies and timing of the transformation?
- **Performance of Peers:** What performance have similar businesses demonstrated over the long-term?
- **Long-run Performance of the Company:** What results has company achieved over time?
- **Investor Expectations:** What do our shareholders expect over the long-term?
- **Sustainable Levels of Sharing:** For any set of goals is the implied level of sharing between management and shareholders reasonable.

These criteria in combination can assist the company to assess and stress-test goals to hold management accountable to deliver the expected results of the transformation, while providing balanced rewards for both management/participants and shareholders.

Conclusion

A systematic approach to considering these questions can help determine if your compensation programs are designed to support a successful business transformation. Your compensation program should be tailored to your company's unique circumstances, particularly in a transformation scenario. A business focused review of your pay program is a critical part of getting ready for a business transformation.

Meridian can support the evaluation of your pay programs and design in the context of your business strategy to help ensure they will effectively support achieving your strategic goals and objectives.

Be sure to check out Meridian's podcasts for additional insights on these topics:

- What Board Members Need to Know About Annual Incentive Plans
- Effective Goal Setting for Incentive Plans
- Setting Performance Goals for Long-Term Incentive Plans
- Understanding Performance Measurement in Executive Compensation
- Compensation Plan | Tailoring Executive Compensation
- A Holistic View of Executive Retention
- Evaluating Executive Pay Relative to Company Performance
- Executive Compensation Actions You Should Be Taking Now to Prepare for a Merger

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The ***Meridian Beacon*** is prepared by Meridian Compensation Partners. Questions regarding this Meridian Beacon may be directed to Ed Hauder at 224-775-4852 or ehauder@meridiancp.com.

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