Tailoring Executive Compensation Plans for Your Unique Business

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Today, there are 3,671 publicly traded companies in the United States. That number seems high, but it is the latest benchmark on a downward trend. (There were 7,322 in 1996). Executive compensation is consistently a hot topic in the media. But how are journalists supposed to communicate the nuances of compensation programs across highly unique organizations? They usually take a large-scale data and trends, leading to misinterpretation of compensation practices in the public.

Proxy advisors and, to some extent, institutional investor voting policies also take a macro perspective when assessing compensation plans. They offer standardized views across a large swath of industries and companies. Their standards for evaluating organizations are easily available, and voting guidelines are regularly disseminated and discussed in compensation committee meetings. Proxy advisors provide a template for evaluating compensation decisions, which is incredibly useful to some organizations but fails to account for differences across industries and unique business scenarios.

This issue has been the subject of debate—are proxy advisor perspectives useful across industries? Not always. For example, proxy advisors have a methodology for assessing peer group selection, but the factors that make organizations "peers" are highly industry-dependent. This means that while organizations can look to proxy advisors for guidance and information, they must tailor executive pay programs to meet the unique needs of the business, its stakeholders, and its shareholders. The pay mix will vary across industries and even across companies in the same industry. Other factors like company stage also play a role.

Many companies exhibit compensation programs that seem to go "against the grain" relative to both large-scale data and trends and proxy advisor preferred approaches. However, such programs may be entirely logical and effective within the context of sector-specific or company-specific challenges and opportunities.

Industry and Stage Considerations for Short-Term Incentives

Financial services and consumer discretionary businesses are two examples of industries that can benefit from an emphasis on short-term incentives. In the banking industry, earnings measures, e.g. earnings per share (EPS) net income, continue to be the most prevalent and highest-weighted performance measure in annual incentive plans, followed closely by expense management. Easily measurable financial goals are best suited for short-term plans.

Consumer discretionary businesses, especially season-dependent retailers, measure their success by their sales numbers. Annual financial goals help build a roadmap for executive behavior and encourage specific action steps to achieve these outcomes. Every executive knows exactly what needs to happen on a day-to-day basis to make those goals a reality. This creates a sense of urgency to maximize opportunities for revenue every single day.

Companies in distress should also prioritize short-term incentives. By incentivizing performance in the short term, executives are motivated to build a strong organization. If they do well, it will accrete to long-term value, measured as the company recovers.

Cash-strapped early-stage companies may be hesitant to place significant emphasis on short-term incentives, and there is some truth to the stereotype that start-ups prefer to load up their executive teams with equity-denominated awards in lieu of robust salaries and cash-settled bonuses. However, these companies also need to foster a focus on the day-to-day activities required to get the business up and running. Sponsors and owners may find balance by tailoring the size of these equity awards in part based on how well the management team does in executing against short-term sales and revenue goals. As these companies mature and generate the cash flow necessary to fund market-competitive annual bonuses, emphasis on short-term incentives can increase organically.

Industry and Stage Considerations for Long-Term Incentives

Inherently risky business models, such as software or biotech companies, tend to favor long-term, equity-based incentives. For example, in a biotech company, decisions made today may not accrue benefits for years to come. In some cases, they may have a negative impact in the short term, but short-term losses can be mitigated by progress toward value-creating opportunities. A medication can take years to get to market but, when it does, the financial impact is profound. In this industry, there are clear justifications for granting executives equity and stock options to a greater degree than other sectors. The ultimate indicator of success is shareholder value created, especially after the debut of a new product.

Identifying Industry-Specific Metrics

The metrics by which organizations will evaluate performance must reflect the short- and long-term value drivers. They must align with and support the company's business strategy. In most companies, annual incentive plans focus on key financial, operational, and strategic metrics over which management has a greater ability for control in the near term. For example, high-growth technology companies are likely to combine revenue goals with some measure of profit—such as EBIT or EBITDA—that ensures growth does not come via "empty calories," while more capital-intensive sectors are likely to include returns-based measures such as ROIC or ROE.

Long-term incentive programs are intended to establish clear alignment between shareholder value and organizational performance. They should be the primary emphasis of incentive plans for established organizations. Companies look for measures that are both predictable over a multi-year period and help to explain—or are at least correlated to—shareholder value creation over time. For example, mature financial sector companies will often link the vesting of equity-denominated long-term incentives to the achievement of capital efficiency measures, while consumer discretionary companies are more likely to focus on measures of profit.

The incorporation of ESG metrics into incentive design has quickly evolved from a relative rarity to a majority practice among the S&P 500. These metrics most commonly find a place in the annual incentive program and have relatively modest weighting, accounting for perhaps 10% of the annual incentive opportunity. Specific metrics may vary by sector. For example, consumer products may focus on sustainability such as recycling initiatives, energy companies may goal their teams on carbon footprint reductions, and software companies may have scorecards that track racial and gender DE&I progress.

Oddities in Executive Compensation

As companies design their compensation plans, they must strike a balance between short-term and long-term incentives. The pay mix is unique to the facts, circumstances, and strategic priorities of the organization. Companies in unique circumstances, however, must measure performance with a very different set of metrics.

Consider the biotech example. In most organizations, revenue is a key financial metric in annual incentive plans. A company that has been in business for years cannot be evaluated on income statements because there is no revenue until the drug hits the market. Instead, executives may be measured based on metrics like progress toward a clinical trial or FDA approval, while also maintaining effective cash flow management.

What if a company is trying to shrink? If a company's objective is to manage the balance sheet down effectively, typical models of growth and profitability don't apply. This situation calls for a very unique set of metrics, oftentimes metrics that mitigate the downside.

From Annual to Long Term: the Three Year Milestone

In general, incentive plans that vest in three or more years are considered long-term. Anything less than three years is considered short-term. In today's rapidly evolving economy, a three-year revenue or EBITDA goal may just be a three-year guess. Anything could happen in the next few quarters, knocking goals out of alignment and adding another level of complexity to the executive compensation design process.

Software companies have implemented several creative solutions for overcoming this challenge. Some companies have one-year goals but add on additional service-based time before an executive can earn the reward. Others have parallel one-year, two-year, and three-year performance periods. In a long-term plan, total shareholder return (TSR) is the most prevalent performance measure; steady increases or decreases in stock prices over time can help inform and prioritize behavior-driven annual performance goals. Some companies have found it effective to essentially "bolt on" a three-year TSR modifier to a core one-year financial measure to combine accountability for meeting short-term income statement commitments with a longer-term shareholder value creation mandate.

These creative solutions for achieving a balance between annual and long-term incentive programs may lead to pushback from proxy advisors who are concerned about whether long-term performance is truly being assessed. It is incumbent on companies that break the mold to put significant effort into storytelling. They must offer a clear, concise rationale for compensation decisions to investors. They must articulate why they chose a particular plan design, why that design is in the best interests of shareholders, and how it holds management accountable for achieving the desired outcomes.

Stock Options in the Pay Mix

The use of stock options in executive compensation has been trending downward for several reasons, including changes in accounting rules and increased emphasis on dilution and overhang from share plans. Stock options and the weightings of options have been replaced in large part by performance shares.

Despite this trend, there are plenty of reasons to include stock options in a long-term compensation plan. For example, biotech and other industries experience high volatility and long cycles from investment to returns. Stock options provide a way to foster alignment between shareholders and the business over the long term.

Identifying Industry-Specific ESG Metrics

The pillars of ESG (Environmental, Social, Governance) apply to every company in every industry. Relevant ESG metrics are highly industry-dependent and constantly evolving. For example, within the oil and gas industry, there has been a significant focus on metrics like environmental health and safety, spills, or workplace injuries. Today, those metrics are table stakes. Investors and shareholders are keenly interested in metrics around emissions and carbon footprint, but it is difficult to measure that kind of metric. In other industries like consumer services, metrics related to the E pillar of ESG can be less relevant. The social element includes initiatives like employee engagement, diversity and inclusion, and brand and reputation.

Because of the variation in ESG metrics across industries and across individual companies, the most important step is to articulate an ESG strategy that clearly explains why the chosen ESG metrics will drive the company forward.

Compensation Oddities and Proxy Advisors

As organizations tailor their executive compensation programs, their unique scenarios and business needs may cause the plan to deviate further and further from proxy advisor norms and expectations. That is not to say companies should dismiss proxy advisor perspectives, but they should be mindful of the gap. Some companies, like those with insiders who have a significant ownership position, are somewhat insulated from criticism.

Companies can overcome misaligned feedback from proxy advisors through strategic communications. Underperforming organizations’ pay plans are subject to more scrutiny, but public companies in general have come a long way in proactively communicating with shareholders regularly on compensation and other issues. They reach shareholders and stakeholders across multiple platforms to paint a clear picture of *why* the company does what it does.

The proxy statement is the primary outlet for companies to tell their stories. Investors and stakeholders expect more from these documents than they used to—they are marketing tools as well as financial statements. They explain the unique circumstances that influence compensation plan designs and provide justification for deviation from proxy advisors’ preferences. It behooves organizations to articulate this story clearly in the proxy statement and reinforce the narrative across other channels like websites and email campaigns to shareholders and stakeholders to garner support.

A company's rationale for its executive compensation programs is critical for influencing the Say-on-Pay vote. If the plan differs significantly from what proxy advisors expect, the absence of a clear narrative leaves a vacuum in which proxy advisors will tell the story for you. This can be detrimental—Meridian's research shows that an *against* recommendations on Say-on-Pay from ISS was correlated with a 38% decline for S&P 500 companies and a 33% decline for Russell 3000 companies in 2021 (vs. a decline of "only" 10% for each group in 2019). Through June 1, 2021, 4% of S&P 500 companies had failed Say-on-Pay, vs. only 1.5% in 2019. Garnering shareholder support with a compensation program that is misaligned with proxy advisor expectations has clearly been an uphill battle, *and yet:* every moment in the boardroom spent on figuring out where there is proxy advisor misalignment is a minute *not* spent on reviewing strategic activities that drive the business forward.

Conclusion

How can companies reconcile the clear risks involved with pay programs that "go against the grain" with the advantages that accrue from crafting programs that are unique to the business? The answer is via a disciplined approach that is informed by *both* internal priorities *and* external considerations. The focus should be on balance; undue emphasis on either side of the equation is detrimental.

Executive compensation strategies are highly unique to individual organizations. Proxy advisors' preferences provide a high-level template, but they are broad enough to have limited applicability across industries. Companies should tailor their compensation plans by building a pay mix that includes annual, long-term, and discretionary elements, and selecting metrics that reflect the business's strategic goals.

The hardest part of the executive compensation design process is articulating performance priorities, or what problems the business needs to solve. What does success look like? The answer to this question informs everything that happens next, from choosing the right metrics to giving shareholders and stakeholders a window into the workings of the organization. It is critical not to skip this step and look outward before looking inward. It may seem easier to borrow elements from other companies' programs, but even a company's closest competitor can have an entirely different set of strategic priorities and be solving different problems.

Highly tailored plans may deviate from proxy advisor preferences and recommendations, risking negative feedback and against Say-on-Pay votes. Clear, concise messaging around the company's strategic goals and executive compensation plans is critical. It gives proxy advisors a clear understanding of your approach, builds confidence in investors and shareholders, and allows unique organizations the freedom to measure what really matters for the future of the business.