Post #52: Compensation Implications of the Current Environment

From Chris Havey, Partner, The Woodlands, Texas

That was rough…

The week of March 9, 2020 may have marked the single worst week for oil and gas stocks on record. A lot has changed, and the only thing certain is that more change will come. Here is what we feel confident of:

- E&P companies will re-set 2020 capital programs; early announcers appear to average 30+% reductions to their already-conservative initial programs, which will have a corresponding effect on the services industry.
- Cash cost savings will be a high priority, and G&A costs are likely a prime target.
- Most companies' recently approved 2020 annual incentive goals now feature obsolete or unrealistic targets.
- Most companies just awarded LTI grants in January or February that are now worth significantly less than they were at grant, and the value of unvested LTI awards has dropped dramatically.

The situation remains far from stable, and we caution against overreacting in the short-term. Instead, we suggest companies consider the following questions for their specific situations:

- Will the revised business plan focus on new metrics (e.g. cash cost management rather than production)? Should we redefine and reset the 2020 incentive goals?
  - For E&P companies, does cash preservation become the most important metric? How does this affect some initial forays into the use of ESG as a metric?
  - For oilfield services companies, particularly those focused on U.S. onshore, are recently set EBITDA goals now unrealistic? If so, does that matter?
- If we still have some 2020 LTI grants yet to make, (e.g., to directors, to employees), how should we approach those in this environment? How should this approach compare to others within the company that have already received grants?
- How big of a concern is "retention" in an environment where costs will need to come down and significant industry layoffs are possible?
- How will 2019 actions be viewed in the upcoming proxy filing in light of the current environment?

Based on our recent conversations, here are some initial thoughts on what might be important to consider:

- Changing bonus metrics can send a message about shifting priorities; however, we suggest caution in establishing new goals to avoid an unintended windfall if the environment changes for the positive.
- With significant uncertainty, both the board and management may want to reserve more discretion than in "normal" years to evaluate outcomes at year-end.
- Retention is not likely a primary consideration in this environment; we don't expect companies to react to the loss of retention value from lower stock prices.
- Companies may rescind some or all 2020 salary and/or target bonus increases and may consider further cuts (a few examples have been disclosed to date).
- For upcoming planned LTI awards, companies should consider a (higher) trailing average price to determine the number of shares or a similar approach to reflect the current environment.
- Some companies may want to prepare compensation programs for a potential restructuring or bankruptcy.
- If possible, companies may want to insert an acknowledgement in the upcoming proxy about the stock price decrease. Lead-in commentary may help remind readers that the proxy describes 2019 compensation. 2020 compensation (described in next year's proxy) will align with the current environment. Any forward-looking disclosures to that effect would be helpful.

We're hopeful that this will be a temporary setback for the industry, but we think that prudent actions will be well received by shareholders and other industry observers.

Archived copies of previous Energy Insights can be found at www.meridiancp.com/insights/energy.

To have your name removed from our Energy Insights email list, please contact jlawler@meridiancp.com.