COVID-19 and Short-Term Incentive Designs

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Our Meridian Client Update published May 28, 2020 discussed the impact of COVID-19 on ***2020*** Short-Term Incentive (STI) plans and how Committees may determine appropriate payouts (if any) at year-end. Payout decisions for 2020 STI in many instances will be impacted and driven by liquidity constraints, affordability, relative performance and/or investor expectations.

The design for *2021* will hinge on how to best motivate executives in a dramatically altered business environment.

There are three overarching features of any short-term incentive plan that most Committees will review:

1. Performance metrics;
2. Target performance goal setting; and
3. Performance and payout leverage (i.e., *spread* around target)

While performance goals are often driven by the annual budgeting process, we also discuss several non-traditional goal setting approaches to consider at companies that are particularly distressed or facing continued uncertainty.

Performance Metrics

In any economic environment, the performance metrics used in executive STI plans should reflect both key drivers of long-term value and optimal alignment with company strategy. However, due to the extraordinary *external* situation in light of COVID-19 and the related economic impact, it is prudent to *consider* whether the current metrics remain ideal. Broadly, in this assessment there are two issues:

1. What *behaviors* do we want to highlight?

If desired behaviors are properly motivated by current metrics, program design may remain relatively unchanged (though goal setting and leverage may be re-examined as discussed below).

If desired behaviors need adjustment, is it best accomplished with:

- A different *financial* metric; or
- A different *type* of metric (e.g., strategic, operational, individual)?

2. Is sufficient *liquidity* a concern?

- Liquidity pressures are a major symptom of the crisis
- Assess whether a cash flow/liquidity metric is relevant and practical
- If existing STI plan includes a cash flow metric, examine its weightings, goals and structure; are there opportunities for refinement?

- If a liquidity metric is needed, which metric best addresses the concerns?
- Possibilities may include:
  - — EBITDA
  - — Expense management
  - — Cash flow from operations
  - — Free cash flow
  - — Cash flow margin

If a company plans to change its STI performance metrics in 2021, consider the following:

1. **Stakeholder Perceptions** – Both internal and external; convey confidence and responsiveness
2. **Alignment of Pay with Corporate Performance** – Ensure any use of discretion serves to better align pay and performance and is not used solely to keep executives “whole”
3. **Metric Overlap** – Minimize duplicating existing LTI metrics
4. **Proxy Disclosure** – Detailed rationale for design changes will be crucial

Target Performance Goal Setting

Whatever the metrics, an effective STI plan needs to find a delicate balance of "challenging but attainable" goals. This is a challenge in any environment, but will likely prove to be even more difficult in 2021.

In calibrating and "stress-testing" performance goals several perspectives are useful. While no single one of these will likely define the answer, an overlap of outcomes can emerge, suggesting a plausible and defensible range:

- Historical Performance
- Performance vs. Peers
- External Expectations
- Strategic Aspirations

Historical Performance

Typically historical performance could be analyzed over a 5- to 7-+ year period to gauge long-run trends, cyclicality and the probability of goal achievement. However, for 2021, the usefulness of historical performance benchmarks may be considerably more limited. The objective is to estimate the trajectory of possible improvement from current business conditions with informed, immediately recent history and/or other substantial crises. Therefore, the following may be most useful:

- **2020 (annual)** – Most recent year actual performance vs target.
- **2020 (quarterly)** – Analyze trend line over last several quarters (especially Q3 and Q4 for calendar year companies); how is the business rebounding and at what rate?
- **2008/2009** – While the current circumstances are materially different, the financial crisis represents another recent instance of significant financial stress. Review how 2009 target performance compared to 2008 actual and to 2008 target.

Performance vs. Peers

The performance of industry peers (profitability declines, margin contraction, and the extent of sales declines) may help a company understand how well they weathered the storm and similarly what might reasonably be expected for the upcoming year. Here too, examining quarterly results for 2020 (if available) will better inform trend lines for a relevant group of peers and the likely trajectory of business conditions.

External Expectations

Ordinarily, it is a widespread convention – indeed an *expectation* – that next year's profitability should be greater than the prior year. However, this expectation may not hold true for 2021. Depending on how bad 2020 was and, similarly, how swift the anticipated *pace* of recovery, 2021 results could be similar to, worse, or better than 2020. Variations are likely to be considerable by industry and even by company, depending on exposure to certain sectors. For this reason, having an understanding of analyst and investor expectations may be valuable in setting 2021 goals. We suggest:

- Considering analyst consensus estimates (both top-line revenue and profitability expectations) for both your enterprise as well as a collection of relevant peer companies
- Analyzing the *range* of those expectations across analysts
- Assessing those consensus estimates against implied improvements and what has been transpiring over the preceding quarters at your company. Do they seem credible? What information do you have that analysts may not have, and how would that impact projections?

Companies should exercise extreme caution before setting 2021 performance targets as a growth rate (including those that have used that convention historically). As explained above, setting target higher than prior year actual may be unrealistic in 2021. Targeting a lower dollar value (e.g., $95 million in operating profit following a year with $100 million results) may be viewed more favorably by external stakeholders than targeting a negative growth rate (e.g., a negative 5% growth target). In either case, however, a robust explanation of the rationale behind the goal will be crucial to gaining external support.

Strategic Aspirations

Near-term goals are invariably milestones toward a longer-term vision. While long-run strategic aspirations may remain unchanged, the expected timetable for attaining them may need to be adjusted. If the outlook for the company or the industry has been fundamentally altered (e.g., airlines, cruise ships, hospitality, entertainment, certain types of retail, etc.), then goals should be considered in this light.

Performance and Payout Leverage

Although an achievable target performance goal is critical, motivation is quickly lost if projected performance falls outside the payout range, especially following a low or zero bonus outcome for 2020 results. Below are several items to consider when establishing “spread” around target.

Threshold Performance and Payout

We anticipate threshold performance levels will be set using a *wider range* than might ordinarily be the case (e.g., 75% of target performance rather than 85%). At the same time, Committees will want to determine if it is appropriate to maintain the same threshold payout levels (e.g., 50% of target) for a wider/lower threshold performance, or if the payout “entry point” should decrease as well, (e.g., 25% of target rather than 50%). In this regard, historical market data on threshold performance goals (as a percent of target) may not be as relevant in 2021.

Maximum Performance and Payout

Maximum performance goals in terms of ***dollar values*** (or growth rates) will likely shift downward along with target and threshold to reflect new business realities. However, maximum goals as a ***percent of target*** may remain unchanged or even widen somewhat to avoid the prospect of inadvertently high payouts on more conservative performance expectations. It is important to note that the slope of the payout curve below target *does not* need to be uniform with the slope above target.

Degree of Sharing

The implied degree of sharing in profitability is a common mechanism to assess the appropriateness of STI goals. If the implied allocation to management is more than directors view as affordable/fitting, there are only three choices – cut participant pay opportunities, remove participants, or raise the goals. Practically speaking, only a change in the goals is a viable choice for most companies.

There are two metrics that are important in measuring the degree of sharing (for simplicity sake, assume the profit metric is operating income):

1. **At target**: Target incentive value ÷ (operating income + target incentive value)

2. **At maximum**: *Incremental* sharing = $\dfrac{\text{(max incentive value – target incentive value)}}{\text{[operating income + (max incentive – target incentive)]}}$

The latter metric tends to receive greater emphasis. It is measuring the *incremental* sharing in profitability *above* target (i.e., percentage of each incremental dollar of profitability that is shared with participants vs. shareholders). In effect, it is a tool for directors to judge whether maximum goal is sufficiently challenging.

Given the importance in 2021 of sufficient liquidity and cost management, measuring incremental sharing is a valuable tool for Committees.

Three points are worth examining in these measures:

- **Pre-Tax or After-Tax**: If the profit metrics are in pre-tax terms (e.g., operating income, EBIT, EBITDA) the incentive costs need to be in pre-tax terms. If the profitability metrics are in after-tax terms (e.g., net income, EPS) then the incentive costs need to be in after-tax terms.
- **Profit Pool**: To properly measure the degree of sharing, the metric needs to be *prior* to the incentives being included in the cost. The "profit pool" (i.e., the denominator) needs to be *before* the cost of the incentives themselves. Incentives need to be added back.
- **Total Cost**: The sharing being calibrated is not just with executives but with all participants in the plan. The purpose is to gauge how much is being shared with *all* participants and whether the goals are adequately challenging.

Ultimately, whether the degree of sharing is proper, fitting and affordable requires judgment. There is no formal survey, external edict, or readily available benchmark to answer this question. This does not make it unimportant, but like many issues requires careful consideration of company circumstances, affordability, and basic proportionality. Reviewing this data over a company's history provides valuable perspective on the range of historical sharing in different economic and performance environments.

Non-Traditional Goal Setting Approaches

In addition to the considerations and approaches noted above, the following less-common goal setting approaches may prove useful in certain situations:

1. **Target Range**: Rather than setting a single target value (e.g., EBIT of $200M), set target as a range of potential outcomes (e.g., EBIT of $180M - $220M).
2. **Limited Upside**: Set accommodating target (and threshold) in exchange for limited to no upside.
3. **Sliding Target**: Hold "goalposts" constant, but allow target to slide based on industry demand. This approach requires a reliable industry forecast to compare actual demand to projected demand at the time performance goals were established.

For those companies particularly distressed or facing continued uncertainty, these approaches could be effective in both aligning pay with performance and improving retention prospects.

Summary

Despite having far less monetary value than LTI awards, STI plans may be viewed as the single-most motivational aspect of executive pay. More than any other pay component, STI plans are structured to i) communicate critical success factors, ii) promote pay-for-performance and iii) encourage participants to achieve higher levels of success. Given the economic uncertainty created by COVID-19 and the related economic impact, designing 2021 STI plans may require a re-evaluation and closer examination than is usually the case. Review of performance metrics, goal setting and payout leverage are particularly important in this evaluation process. In an environment where many LTI plans have lost a considerable amount of perceived value, along with the value of executive stock holdings in general, the 2021 STI plan may prove to be particularly important in retaining and motivating essential talent.

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