Search edition

Building resilience
into executive compensation plans

In a volatile economic climate, where strategic priorities can change fast, companies need to be clear about what they are compensating their executives for. To find out how to build a resilient executive compensation programme, Jim Banks asks **Jamie McGough** and **Jared Berman** of **Meridian Compensation Partners** what is required in these uncertain times.

It seems that today's world is defined by a series of crises, each following hot on the heels of the last. After more than two years of disruption thanks to the Covid-19 pandemic, the spectre of recession looms large, while the much-vaunted Great Resignation is putting the pressure on employers seeking to attract and retain top talent.

Rising inflation in many developed markets is putting pressure on both businesses and consumers, and is further complicated by rising energy prices and disrupted supply chains caused by the war in Ukraine. The list, in short, goes on.

In such a climate, many businesses have been forced to rethink their strategic priorities. The pursuit of profitability has given way to cost-cutting and cash generation, while prioritising growth is being abandoned in favour of boosting return on capital.

With such dramatic shifts in strategy, how can a company ensure that its compensation plan is rewarding its executives for their performance?

"What are they paying for – effort or results?", asks Jared Berman of Meridian Compensation Partners. "Given the crazy macroeconomic events coming at us, and the swing of power between employers and employees in the recruitment market, some companies have put their executive compensation programmes into upheaval to attract or retain the right talent."

"In a growing, stable economy, it is easy to mistake success in a particular financial metric as being directly tied to executive actions. Further, there may be a belief that management teams have been the principal reason for strong results, thus discounting a strong bull market," Berman continues. "Covid has put stress on the typical design of pay programmes, where plans once tracking above target seemingly overnight were underperforming threshold. It begs the question, what should we be paying for – effort or results?"

Resilience is the right approach

Finding the right metrics for executive compensation is a crucial first step when designing an effective plan – but a resilient programme is one that also incorporates some flexibility given changing corporate strategy and the possibility of industry or economy-wide shocks.

"Resilience is the ability to withstand a multitude of shocks," says Jamie McGough of Meridian Compensation Partners. "Companies are trying to create incentive programmes that do a lot of things, so they have a lot of moving parts. They take into account different performance measures, a range of acceptable performance, motivation and retention considerations. Balancing all of these objectives while being responsible stewards for shareholders is a challenging task."

Flexibility comes from understanding the different levers that can be pulled to reward executives. The cash elements tend to increase steadily over time. But the variable elements of short and long-term incentives (LTI) – the latter often being stock or stock options – are reflective of performance over time and of course tend to be more volatile.

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"The main event is variable pay, which is the largest chunk of the total compensation pie beyond a salary," explains McGough. "With short and long-term incentives, resilience comes from performance goals that can withstand at least some of the shocks that can come along. Therefore, when setting goals, committee's need to (and often do) reflect on the potential variability in possible outcomes. Understanding long range company and industry variability for any one metric is a critical component of creating resilience in any incentive arrangement. Some events are beyond anticipating – global pandemics, warfare – but many other business fluctuations and shocks have occurred over time and analysing historical results can reveal this variability. This 'noise' in historical results can be embedded in any set of goals going forward and therefore we can build in a level of durability in the goals that keeps incentive arrangements effective and relevant."

But there are also strategic shifts to incentive arrangements that plans often need to reflect, not just the level of the goals. McGough gives the example of a fast-food chain that recognised the unique opportunity the pandemic created. Specifically, with real estate costs declining rapidly and the shift in consumer preferences for carry-out cuisine, there was a unique opportunity to substantially expand the number of outlets (not just same store sales). The substantial growth in aggregate and long-term profitability in turn presented a substantial opportunity to grow long-term value and expand a competitive advantage.

Similarly, he points out that in the oil and gas industry, the growth phase has ended for now, and the industry-wide emphasis is on increasing free cash flow and return on capital and, consequently, increasing dividends and/or expanding share repurchases. In these instances, both the metrics and the underlying goals are often adjusted to adapt to changes in industry economics.

"The central focus of executive compensation is variable pay, so is that component resilient?", he stresses. "What measures are we using, and do they fit our economic circumstances? Metrics and/or goals can change quickly. External variables such as more substantial levels of inflation for most companies will be reflected in new incentive cycles. Predicting inflation is of course very difficult, but trying to calibrate whether revenues will increase more quickly than expenses (or vise-versa) is essential in crafting new incentive goals?".

Companies must also consider whether the appropriate weighting facilitates both retention and performance. The key factor is recognising that, when the market is good, it can be easy to look past

A number of industries are now facing an end to growth phases, and are instead looking to increase free cash flow and return on capital.

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missed targets. And, when things go bad, it is easy to blame external events. In a resilient compensation programme, the links between performance and rewards are clear, transparent and easy to interpret.

"Generally, companies don't do enough stress testing," says Berman. "They don't often ask whether programmes can withstand changing circumstances. People were bullish on the stock market when things were good, but now that performance awards are tracking lower and the market is down, all we hear about is retention concerns. So, there is naturally a shift to more restricted stock. We are in a very reactive society."

"It can be useful to perform sensitivity analysis, whether it is using a realistic set of assumptions or worst-case scenarios," Berman adds. "Is there room for risk-adjusted programmes? It also helps to look at what can go very well. How are programmes affected if expectations are confounded?".

Credibility over certainty

As a committee member deciding how executives should be compensated, it is unhelpful to try to predict the future too accurately. Instead, the focus should be on delivering a resilient compensation programme that can flex with the changing times.

"You are trying to ensure credibility, not certainty," McGough indicates, drawing a distinction between them. "Programmes have to adapt to changes in demand, so you must establish credible goals that maintain balance between shareholder expectations and programme effectiveness."

"Covid taught us that companies are paying for things that go beyond the bottom line and are setting up a business for future success," adds Berman. "It is about positioning a business for success and delivering on strategic goals. That is what defines a credible plan for executive compensation."

All too often, companies end up paying people for being the best budget setters or the best adjusters. Instead, they must pay for the results of the business – compared to what is going on in the world around it.

That is where an external consultant such as Meridian can be of great benefit. A third-party review of compensation programmes can not only bring to bear years of experience, but also take an objective look at the business, its risk profile and its goals.

"Typically, when I talk to a new client, we spend little to no time talking about the stock market," says Berman. "We talk about the business, its strategy, its risks and then about what has and has not worked with the current compensation programmes. Then we go back to looking at the business. It is not mainly about the market or the industry."

"Market data, which is often used for planning compensation programmes, gives us the fairway for reasonableness but not the answer for any particular client," he adds. "How much salary to pay is not really the priority, as it is dictated by a person's prior job, market benchmarks and so on. What should the company be paying if as much as 80% of an executive pay package might be tied to variable incentives? Do these programmes have credibility? These are the questions to ask." ●

There are a lot of variables that can determine executive compensation packages, but they should all reward business results.