Considerations in issuing retention grants

As useful as such grants can be in some situations, they should be approached with skepticism.

BY JENNIFER KADES AND ROGER BROSSY

To issue a retention grant or not? And how generously? Have you struggled with these questions recently?

You should have, and for good reasons: the loss of key officers can shake investor confidence, and worse, jeopardize the execution of a company's strategy and ability to perform. Retention grants can offer cheap insurance against executive flight. What might cost a few million in pay can protect hundreds of millions in revenue, or even more in market cap.

THE DATA CHALLENGE THE CONVENTIONAL NARRATIVE THAT EXECUTIVES ARE HIGH FLIGHT RISKS.

Here's the catch: Retention grants are overprescribed. Many either a) mistakenly attempt to address problems that cannot be solved with cash or stock awards, or b) are unnecessary because the retention risk is much smaller than perceived. Indeed, the facts suggest the risk of top executives "jumping ship" is actually quite small. The real risk is issuing grants that don't have any effect at all.

Before considering a retention grant, understand *why* an executive may be plotting an exit. The risk of flight generally stems from "push" or "pull" factors. Conditions of the job may push an executive towards the door: a new CEO, a lack of will to face financial straits, perceived blockage to advancement. The siren songs of attractive circumstances pull from the outside: a bigger role, more meaningful work, perhaps retirement.

You can't stop an executive from leaving in many push or pull circumstances with just economic incentives. If an executive is unhappy, "golden handcuffs" don't glitter with appeal. While they may convince an apathetic C-suiter to stay on, they can't elicit passion. They may also backfire. Behavioral economic research shows that, in some cases, *extrinsic* motivation (e.g., higher pay) crowds out *intrinsic* motivation to work: executives infer the extra pay compensates for negative work.

The overall risk of an executive departure is low. Semler Brossy research finds that from 2013 to 2015, executive attrition rates among the top 50 S&P 500 companies was just 10%. (Calculated as the number of Named Executive Officer (NEO) departures disclosed for each group for calendar years 2013-2015, divided by the total number of NEOs for each group — 5 NEOs x 50 companies — for each year. Data is based on the FactSet database of 8-K filings required for all public-company NEO departures.)

Poaching made up just 10% of that; in other words, just 1% of named executive officers left for another company. (Departures were coded as a "poaching" if the executive began working in a similar capacity at a different company within six months after leaving. Exiting CEOs who went on to become CEOs at a different company are included. Separately, seven non-CEOs in the Mid Cap group left to become CEOs, and six non-CEOs in the S&P 500 left to become CEOs.) In mid-caps, the rate is only somewhat higher. For the bottom 50 companies in the S&P Mid Cap, attrition was 12%, and 27% of those — just over 3% of named executive officers — left for another company.

The data challenge the conventional narrative that executives are high flight risks due to their rare and widely sought-after combination of talent and experience.

The flight-risk fear would probably be justified if people were perfectly rational, switching jobs whenever the expected utility of doing so outweighed that of staying put. But like everyone else, executives are plagued by bias, which often makes them less likely to quit:

• ***Status quo bias:*** People don't like and avoid change. Inertia often wins out.

• ***Sunk cost fallacy:*** Everyone becomes attached to things they've invested in. To be sure, the investment may be a sunk cost, immaterial to future calculations of utility, but when you've sacrificed a lot to achieve something, you value that sunk investment anyway, especially the years you spent representing a company to customers, candidates, and your own teams.

• ***Endowment effect:*** We overvalue things that already belong to us. Consider the delusional asking prices of residential homes: sellers almost always believe their house is worth more than the market price. This same glow of ownership shades our estimation of our job's value.

Executives, all things equal, are unlikely to leave their current posts because of such psychological quirks. However useful retention grants are in some situations, they should therefore be approached with skepticism. Rigorously investigate, first, how valid the perceived flight risk is, and, second, whether it's something that money can actually solve.

Getting to such root motivations will pay off in compensation practices that favor long-term executive — and company — performance. ■

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