Getting Post-M&A Executive Compensation Right

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Successfully designing and executing a post-transaction reward program

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The announcement of a proposed merger or acquisition generates unbounded excitement about potential opportunity. Yet the success of that transaction can rest in large part on the strength and accuracy of the pre-M&A legwork. Careful and precise consideration of all the variables influences whether a transaction will live up to its potential or get lost in the pack, a disappointing also-ran.

Executive compensation is a critical variable requiring consideration early on. Executive compensation decisions will help signal what will be important in the new organization and lay some groundwork for how to get there. Done right, executive compensation can facilitate strategy achievement. Done wrong, executive compensation will be, at best, a neutral contributor to future success or, at worst, a drag against progress.

Where Companies Fail

Unfortunately, in their rush to get their deal done and move on, many companies spend too little time considering how executive compensation can help the integration process. Instead, they pursue practices, such as the following, that lead to suboptimized executive compensation solutions:

Imposing legacy practices on the acquired company or vice versa.

Companies frequently force a "best of both" design or adopt the acquiring company's pay program without thoroughly thinking it through. While adopting one company's practices may make sense, the decision should spring from seasoned analysis, which subsequently is made transparent to executives. Buy-in and a higher probability of implementation success require laying the groundwork in a fact-based manner and evaluating the characteristics of the new combined entity and what they may imply for appropriate compensation design.

For example, an established department store chain acquired a specialty retailer, but smartly recognized that imposing its practices could impede the specialty retailer's entrepreneurial culture. Therefore, the department store added some legacy benefits but maintained the entrepreneurial incentive designs to keep executives comfortable yet energized.

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Following the leader.

Competitive benchmarking can identify potential vulnerabilities versus the competition and appropriate overhang and dilution levels. Yet what worked in one transaction is not necessarily applicable to others. Therefore, merging companies must evaluate "typical" practices in the context of the new entity's business situation and talent needs. For example, while stock options often are effective at the time of transaction, other incentives that reinforce achievement of key post-transaction milestones, such as performance-restricted stock, may hold more motivational power.

Feeling pressure to provide all rewards up front.

Often, companies are inclined to make executive compensation as big an event as the transaction itself. Executives may view this as their "one big chance." However, business circumstances and talent needs evolve over time. Therefore, a three- to five year plan for how executive compensation will play out better supports business strategy rather than providing all awards up front. That way, if goals prove easier or more difficult to achieve than expected and/or if incumbents in key roles change over time, pay design can respond to current needs. For example, executives in an acquisition that initially gets a good reception but then takes longer to realize expected benefits may experience significant declines in morale if heavily front-end loaded incentives fail to deliver as quickly as anticipated.

Getting it Right

Successful design and execution of a post-transaction reward program requires a holistic approach to program design. This means understanding the ultimate vision for the transaction by considering four factors:

Strategy and Financial Structure

- What will be the new entity's major business strategy, its critical success factors, major challenges and time horizon?
- What is driving the transaction (e.g., industry consolidation, access to capital markets or other financing sources, exit strategy)?
- What is the optimum balance between the potentially competing interests of shareholders, executives, employees, and the financial community?
- How will the balance sheet be transformed by the transaction?
- What are the key metrics?
- What is the urgency and stretch of goals?
- What are the time frames for measurement?
- How prominent is the pay needed to drive strategy and results?

Leadership Style

- What are the values, leadership qualities, and cultural characteristics that the company needs to develop in order to achieve the articulated business strategy?
- What prominence pay will need to take vs. other management levers in driving performance?
- What are the incentive vehicles that will work?

Competitive Landscape

- How will the profile/skills of employees need to change post-transaction?
- What implications will that have on sourcing new talent and business/ financial/human capital benchmarking?

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- What are the competitive pay levels and opportunities?
- How have other organizations addressed these issues in analogous transactions?
- What are the human capital programs of relevant benchmark companies?
- What are the critical positions and skills and how should they be paid?
- What is the guidance on pay levels, overhang, and dilution?
- How might peer groups need to change?
- What's the importance of following competitive practices regarding mix of pay?

Legal/Regulatory Requirements and Restrictions

- How will regulatory, tax, and accounting issues affect human capital programs?
- What kinds of legal documentation need to be crafted?
- What new corporate governance structures need to be created?
- What are the legal and regulatory requirements and constraints for the company and employees?

The answers provide the context for clarifying the new entity's compensation philosophy and designing programs that sustain focus and performance both during and after the transaction. For equity programs in particular, the questions help to inform which vehicles will be most effective in motivating and retaining talent, what levels of overhang and dilution are acceptable, who should receive equity, and in what amounts. Since the answers to these questions will be different for different companies, the range of solutions should differ as well.

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