The Long-Tailed Impact of the COVID-19 Pandemic on Compensation

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COVID-19 CONSIDERATIONS

Public companies across all industries continue to grapple with the COVID-19 crisis and its effects on their operations, cash flow, and balance sheet. Balance sheet health and the near-term cash flow impact of COVID-19 are the two primary factors driving the scale and scope of human capital actions during the crisis across all industries.

Those hit the hardest and the fastest have had no choice but to significantly reduce cash outlays, including employee layoffs, furloughs, and cuts to compensation and benefits. These "do-or-die" actions have garnered much of the media attention on the business response to the COVID-19 crisis though they are a minority across all sectors and industries.

Perhaps we focus on these extreme cases because we fear our future in their present. And perhaps it's because we know that the employee/employer relationship, including compensation and benefits, somehow will be radically different in the post-COVID-19 world. Perhaps it's a little bit of both.

Varying Degrees of Corporate Financial Readiness Makes a Crisis-Driven Downturn Different for All

Debt has been a cheap source of financing for more than a decade. The low interest rate environment has supported an economic boom unrivaled since the Baby Boom post-World War II. Access to cheap debt has supported, among other things, massive expansion and consolidation in the airline industry, a full boom-bust cycle for shale-focused oil and gas companies, and a variety of growth- or shareholder-focused initiatives in the retail world.

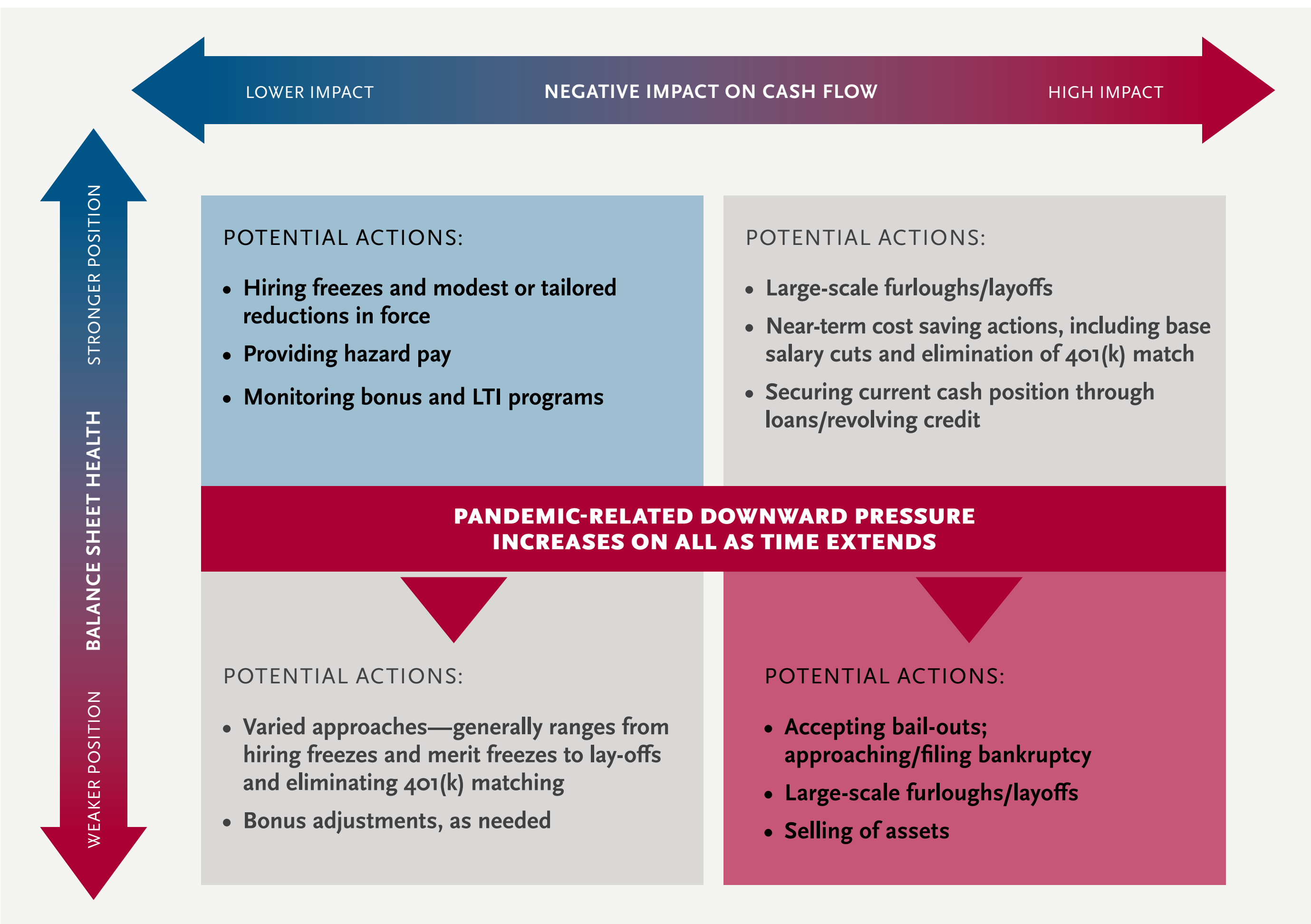
The sudden decline in economic activity is showing that what worked in a prolonged period of economic growth and cheap capital is now creating massive headaches for companies. The COVID-19 hit to cash flows has exposed the danger of a leveraged capital structure purpose-built for high growth (or recovery) with little safety net other than the anticipation of increasing revenue.

Companies highly impacted by COVID-19 and with material levels of debt have limited access to additional cash outside of government intervention to fund operations in the near future. They have no choice but to turn to immediate cost-cutting, including compensation and employment cuts, to preserve cash in an attempt to remain viable into the future.

Others sit on the precipice of financial distress. These companies are shoring-up their cash balances and taking preliminary moves to reduce compensation expenses. And fewer companies sit in the "goldilocks" zone where the COVID-19 impact is less severe and balance sheets are flush with liquid capital.

Balance sheet health and cash flow generation are dynamic, so one's position on this matrix is a point-in-time snapshot. More companies will slide into distress as reduced economic activity and changing consumer patterns continue into the spring and, to some degree, may become permanent. Expense reductions by these companies create a vicious cycle, driving unemployment higher and further exacerbating negative cash flow impacts.

Of importance, companies are likely to take on more debt during the COVID-19 pandemic, some through emergency federal programs. While this allows operations to continue, it pushes the balance sheet to an even weaker position as the pandemic runs its course. This is concerning. A recent analysis by the Organisation for Economic Cooperation and Development (OECD) shows that the quality of corporate debt is lower than before the financial crisis of 2008[1]. This lower quality of debt,



[1] http://www.oecd.org/corporate/corporate-bond-market-trends-emerging-risks-and-monetary-policy.htm

in turn, could lead to additional actions by the federal government and Federal Reserve to support companies or industries that fall into crisis.

COVID-19 May Increase Momentum towards a Stakeholder-Centric Operating Model

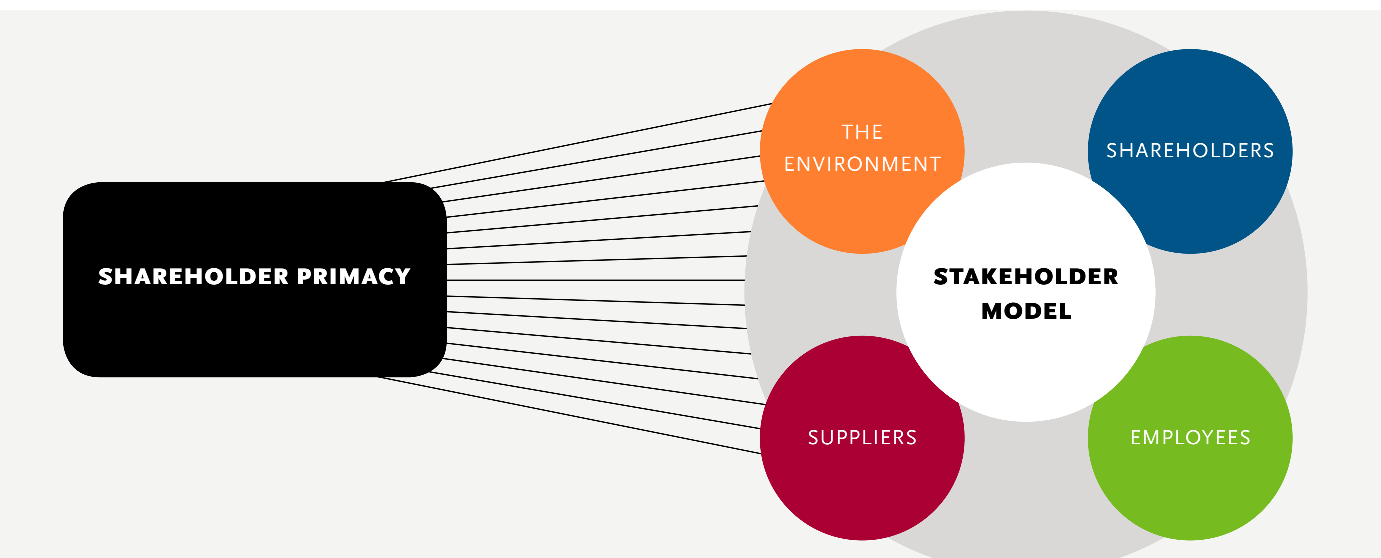
No logical choice exists but to better prepare for the next—and inevitable—pandemic or public health crisis. This will lead to bolstering balance sheets with increasing levels of cash or other highly-liquid investments with smaller returns. Companies will continue to re-imagine their supply chains and pivot to a less "just-in-time" manufacturing model. Potential financial returns will be depressed as companies chart safer courses.

The days of prioritizing consistent growth and annual returns above all else are likely to be tempered. Companies and investors will take a longer-term lens when considering what constitutes "strong" performance and will remain cautious, especially with weaker balance sheets and a long-tailed impact on the global economy.

The shift from the shareholder-centric model will be prompted by the current "rank-and-file" employee experience and likely increase in companies with weaker balance sheets. Society will have higher expectations of preparedness for companies and governments moving forward. This evolution is unknown, but it is reasonable to expect a shift to a safer business model with broader input from various stakeholders.

Expectations around Human Capital Management reporting are likely to increase. Human capital decisions during the COVID-19 crisis—most of which are driven by balance sheet and operational limitations—are likely to garner additional scrutiny as the world recovers. Over time, expect the reaction to the COVID-19 pandemic to drive increased standardization of Human Capital Management disclosures. These disclosures may be borne out of new federal regulations, passive investor requests, or new guidelines by bodies like the Sustainability Accounting Standards Board (SASB).

Potential standardized analyses that could arise in the coming years include those that measure: job quality offered by employers, the relationship between a company's lowest-paid employee and local cost of living, the "all-in" pay of the median employee (e.g., their compensation less insurance premiums, etc.), new ways of evaluating executive pay relative to broad-employee groups, or comparisons of broad-based merit pool increases to year-over-year increases in CEO pay. Prepare for those companies hit the hardest by the pandemic to, on average, fare the worst on these new measures.



Observations and Looking Forward

Rank-and-file employees stand to benefit in the long-term from the transition to a stakeholder model despite short-term dislocation and reduced employment levels. The following takeaways are a good starting point for understanding how compensation will evolve in response.

TAKEAWAY NO. 1:
Distressed Companies are Taking Drastic Immediate Actions

Companies with unhealthy balance sheets and/ or facing the largest cash flow hits are taking the most aggressive actions to immediately reduce cash burn. To date this group is primarily comprised of specialty retailers, oil and gas companies, hospitality and travel companies, and certain REITs. These companies were immediately put in a "do-or-die" situation in which every dollar saved matters.

Slashing executive pay signals solidarity with other employees whose jobs have been impacted by the COVID-19 pandemic in addition to saving hundreds of thousands or millions of dollars over a 6-9-month period. Cutting employee benefits—including the 401(k) match—can save millions more but results in "broken promises" to employees that cannot be taken lightly.

Many of these companies are also evaluating other cost-saving actions that have implications for employees, such as furloughs, layoffs, or government bailouts. Each furlough situation involves a host of secondary considerations that trade-off cash flow considerations for employee flexibility. And government bailouts come with additional strings attached and a requirement to maintain staffing levels and associated cost until September 30, 2020.

TAKEAWAY NO. 2:
A Majority of Companies Have More Time to Monitor their Cash Flow and Capital and to Consider Actions that Balance Employee and Shareholder Needs

According to Semler Brossy data, 90% of Russell 3000 companies had not announced executive compensation-related adjustments as of April 9 and are better positioned to withstand the current headwinds for the next couple of months. These companies likely have stronger balance sheets and/or are facing less severe operational impacts from the COVID-19 crisis.

This group is considering ways to: (i) right-size the business (through hiring freezes, etc.), and (ii) engage employees in the turnaround (with employee safety serving as the paramount consideration). The compensation-related questions these companies are asking themselves focus around whether incentive plans remain motivating and aligned with the shareholder experience.

We previously wrote about how to address incentive plans being impacted by the COVID-19 crisis in the article "Coronavirus and Compensation: What Should Companies Do Now?" Finding the "right" balance between employee motivation and shareholder expectations will be a delicate task, particularly if any employees are furloughed or laid-off (even if the events are unrelated to managing through the COVID-19 crisis).

Conversations with investors, Management, and the Compensation Committee should take place right now on how to address incentive programs. We continue to suggest preparing early and acting as late as practicable to eliminate as much uncertainty as possible.

TAKEAWAY NO. 3:
Look at the Worst-Case Scenarios and Plan Ahead

The actions taken by and lessons learned from the most distressed companies can be a road map for others to consider when planning for worst-case scenarios. Goldman Sachs analysts recently estimated that 31% of

US companies will need new rounds of financing to keep them viable for more than six months. Not all of these companies will be on the brink of bankruptcy in six months, though it is likely that a portion of them will fall into the weak balance sheet/ significant hit to cash flow quadrant of the matrix, which in turn will necessitate reducing cash burn.

Companies should create contingency plans now for this worst-case scenario, particularly if they have already drawn from revolving credit lines or have material levels of outstanding debt. The last month shows that operations can destabilize quickly and create difficult human capital choice points that need quick responses. Formulating a plan now and stress-testing for various economic and funding scenarios will reduce the pressure of planning and communicating a response when emergency hits. Preparation is key to crisis-time decision-making and leadership.

Companies should also start preparing for the post-COVID world. There will be winners and losers in the war for talent. Employers that treat their employees well through the crisis will have a "leg-up" in the talent war—the public and job seekers will reward those who were generous. Additionally, companies that emerge relatively unscathed will win by being able to offer the best benefits and compensation packages to prospective employees. In turn, other companies will need to ensure investment in the competitiveness of their offerings.

TAKEAWAY NO. 4:

Prepare for a Radical Transformation of Executive Compensation After the Crisis

Executive pay is likely to be impacted materially by changing sentiments towards a corporation's "purpose" and performance. We expect popular responses and regulations from the pandemic similar to what was experienced in the period after the 2008 financial crisis, which led to the sweeping Dodd-Frank legislation and reduction in the use of stock options (and associated rise in performance share usage) among senior executives. It's too early to know the true impact, but we outline three major factors that will shape the discussion:

1. **Pay, especially restricted stock and stock options, may be less lucrative going forward as companies invest in "fortress" balance sheets and employee well-being.** Any reduction in potential stock returns (through increased investment in other areas, in this case) will decrease the likelihood of a stock increasing over time. This will have the largest impact on the highest-paid employees, many of whom receive more than 75% of their pay in the form of long-term incentives.

2. **Companies will need to re-engage the C-suite using tools other than pay.** Companies have acclimated to retaining executives with one-time cash and stock awards. Moving forward, expect retention concerns for the "top of the house" to be dealt with similarly to those for rank-and-file employees: through engaging work, responsive and motivating bosses, and pay differentiation through qualitative aspects of incentive plans. The days of annual CEO pay increases outpacing merit increases may be over. The focus moving forward might be about creating and fostering an "ownership mindset" rather than creating a highly-leveraged performance share plan or options grant. This dynamic would come in the form of de-risked compensation programs that provide more stability but with more strings attached (e.g., longer-tailed vesting, holding requirements, etc.).

3. **Investors will adjust voting behavior on proxy-level ballot initiatives.** A key driver of the evolution from a shareholder-centric to a stakeholder-centric operating model will be passive investors' voting behavior. This impact will be the most pronounced on environmental, social, and governance (ESG) proposals, but the change in voting behavior will have a flow-through impact on pay-related proposals, director election vote outcomes (particularly if

a passive investor feels a director is not adopting a stakeholder view), and Say on Pay. There will likely be a window for companies to begin adjusting to the "new normal," but expect passive investors to continue drafting more prescriptive stakeholder voting guidelines over the next five years.

The COVID-19 crisis has rapidly thrust change onto the world and is forcing companies and individuals to reimagine their priorities, capabilities, and role in society. This self-reflection will propel what was once a slow-moving progression into the spotlight: the segue from a shareholder-centric operating model to a stakeholder-centric operating model. The "consistent growth and returns" mantra will still be a voice in day-to-day operations, but it will now be complemented by a number of balancing voices that represent other stakeholders in the economic-individual-environmental dynamic. ■

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