In Compensation Philosophy

Getting Executive Compensation Right in M&A

JULY 2018

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Global mergers and acquisitions are on a record-breaking pace with over $2 trillion in deals already announced in 2018. CEO confidence appears to be at a high point, the tax cut and repatriation of earnings is helping fuel deal-making, and worries presented by government regulation have lessened with the recent approval of AT&T's acquisition of Time Warner. Like the AT&T-Time Warner deal, many recently announced deals involve bringing together two large, established companies with their own distinct cultures and executive compensation programs. Large deals such as these—as opposed to tuck-in acquisitions—present unique executive compensation challenges. During a large acquisition, the company asks a lot from its leaders while those leaders' individual prospects may be uncertain. We have seen firsthand how critical it is to get compensation right in these situations.

Large transactions certainly can include a wide variety of compensation and benefit issues. In this article, we focus on the executive compensation implications that apply to the most senior executives down to the VP- or director-level. We have grouped the executive compensation aspects of M&A into pre-close and post-close considerations.

Pre-close considerations

Compensation can be a powerful tool to help support the pre-close and integration process. Two different types of compensation tools—retention awards and transition incentives—are typically used to supplement other incentive or severance programs that might already be in place. Retention awards are typically vested at specific milestones (e.g., close of transaction, 6 months after close). Transition incentives are often vested based on achieving specific objectives (e.g., achieving synergy goals, integrating systems). In many cases, a combination of both awards are appropriate, particularly if the change-in-control severance program does not offer an adequate retention incentive.

Table 1

	First Tier	Second Tier	Third Tier
Criticality	High	High	Medium
Difficulty to replace	High	High	High to Medium
Retention risk	High to Medium	Medium	Medium
Performance / Potential	High	High to Medium	Medium
Example Award Size (as multiple of annual LTI)	**1.0-2.0x**	**0.5-1.5x**	**0.25-1.0x**

A simple framework based on four criteria helps ensure these supplemental programs are targeted at the right employees.

1) Criticality of the role
2) Difficulty of replacing the individual
3) Retention risk
4) Performance and potential

Eligible executives can be assessed against these criteria, with award tiers calibrated based on the assessment. *(Table 1)*

Awards are typically denominated as a multiple of salary, bonus, or long-term incentive (LTI) opportunity. The specific amounts and design elements—vesting, performance metrics, etc—vary depending on the unique circumstances of the transaction and the timeline to complete the close and integration activities. The timelines are longer with many of the large acquisitions taking place today (especially if extensive regulatory review is required), which raises the stakes for retaining and motivating executives who are taking on more work in the face of more personal uncertainty.

Post-close considerations

Post-close considerations involve developing a new program for the new business and evaluating whether executives are adequately staked in the new organization.

Developing a new program includes aligning 1) pay levels and mix, 2) bonus plan metrics and design, and 3) long-term incentive vehicles and vesting with the new business objectives. We have seen occasions where the acquiring company's plans are applied to the new organization without due consideration for the objectives of the new entity or the combined impact on the executive compensation program. We have found that a nuanced, targeted approach leads to programs that endure and better support the business going forward.

Effective harmonization and program development involves the following:

1 **Review pay philosophy in light of business strategy and objectives:** Does the company's pay philosophy and strategy reflect the new businesses' strategic objectives? To the extent the business changes a lot following the acquisition, pay programs may require more extensive re-design (e.g., new performance measures, different equity vehicles).

2 **Review pay levels in context of expanded responsibilities and new market levels:** A big acquisition can change the competitive landscape for executive pay. It may be appropriate to change market references used to benchmark pay to include larger companies or companies in different industries. If pay changes are appropriate, gradual adjustment over time allows for assessment of whether executives are capable of handling the expanded responsibilities and helps manage the overall cost impact to the organization.

3 **Analyze programs holistically to understand gives and takes:** Often a series of trade-offs are required to effectively integrate the programs to support the new business, and may require changes to both companies' legacy programs. A comprehensive understanding of the changes is important to avoid getting one element out of synch with the others or creating situations where the most or least generous programs are always selected, unnecessarily increasing costs or creating potential retention issues.

Staking awards can be another important consideration after the close of the transaction. Staking awards can quickly increase alignment with the new company, but may not be necessary if executives roll over a meaningful amount of unvested equity. Staking awards are often most appropriate when targeted at new executives or recently promoted executives who likely have smaller equity stakes and represent the next generation of leadership. Of course, staking awards for any executive disclosed in the proxy need to be considered carefully.

Compensation can be a powerful tool to help support the success of a merger or acquisition. A combination of pre-close retention awards and incentives, combined with a thoughtful evaluation of the program post-close, can help a company weather an uncertain and potentially tumultuous time by ensuring that executive compensation is appropriately aligned and supports a successful close and integration process.

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