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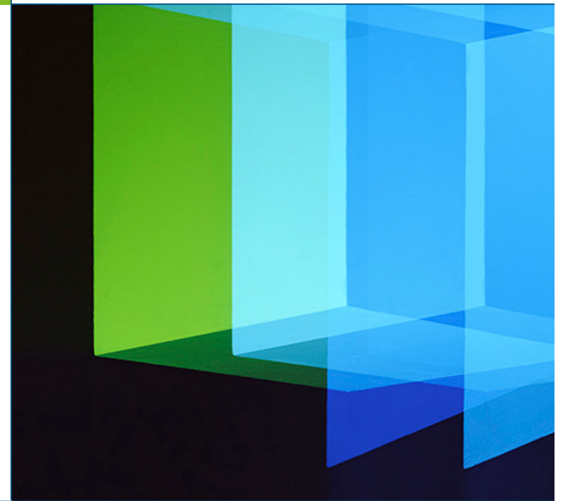

Compensation as a Lever for Transformation in the Retail Industry

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Brick-and-mortar retailers have faced a mounting set of challenges in recent years as they've sought to adapt to an increasingly omnichannel ecosystem. While the trend was slow-moving at first, the pandemic's impacts on consumer behavior has been anything but—accelerating the growth of digital channels and driving changes from which there is no turning back. The pandemic may now be subsiding, but shifting preferences for how and where customers wish to shop are here to stay. Retailers will need to continue to transform if they are to remain relevant and survive.

With this heightened urgency, how can retailers use executive compensation to support this ongoing transformation? Traditional financial metrics such as growth and profitability still hold management accountable to overall performance, but lack specific linkages to strategic priorities and how investments in those priorities will affect the top- and bottom-line.

Not surprisingly, retailers are at varying stages of this transformation and there is no "one size fits all" solution. In all cases though, the thoughtful calibration of incentive metrics, milestones, and other compensation elements can support transformation initiatives and retain the talent responsible for driving those efforts, while reassuring investors that the company is "putting their money where their mouth is" and paying for performance that matters.

Retailers will face this challenge head-on when planning for FY22 compensation design in a few months. It is critical that boards begin to analyze how best to tie compensation to these, and perhaps other, transformation priorities.

Transformation in Three Phases—Understanding Where You Are

Compensation can be a key lever to support any major corporate effort. At its best, it serves as a roadmap for where the organization is headed. The first step of the process is for boards to assess where they are in their multi-year transformation. As the company moves along the journey, the metrics and rewards should evolve to support the changing talent needs and business priorities.

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We typically see transformation in three stages. The first is "Stabilization," where management recognizes the need for significant change and lays out the mission-critical foundations and interim milestones for success. The Stabilization phase is about "finding bottom" and earning the right to grow again. From a talent perspective, it is also critical to identify and retain (and reassure) the people needed to execute the transformation.

Once early efforts take hold and initial milestones are hit, it is time for the second phase, "Transformation." This phase is all about delivering more consistent performance and demonstrating the ability to grow revenue and profits again. Analysts will start to notice the discipline and reliability.

The final stage is "Acceleration," when the company's various investments gain momentum and underpin new levels of profitability and a more competitive posture in the market.

While intentional compensation design can support each of these three phases, we advise boards to set management's expectations that compensation will be more fluid than in steady state. It's always difficult to make big (and frequent) changes in compensation, but awards need to reflect where the company is in its journey. Advance communication of the compensation plan can reassure participants and investors alike.

Stabilization

Compensation in the *Stabilization* phase aims primarily to provide management some security at a time when the ultimate payoff seems far off. That often means selecting short-term metrics with greater line-of-sight, and establishing goals with a reasonable likelihood of at least threshold achievement (even if target or maximum achievement is unlikely). It also generally means a higher than typical weighting of time-based equity, particularly deeper in the organization. Deferred cash programs can also be an attractive alternative to equity when a company has a depressed share price.

Of course, the use of cash must be balanced with expectations for long-term shareholder alignment and, potentially, the constraints of reduced cash flows. Companies will also need to be diligent about identifying critical talent, and they may set pay opportunities above market rates for these roles when incentive payouts are less certain or generous.

A specialty retailer followed this playbook from 2015 to 2017, when it invested in omnichannel capabilities, consolidated its network of American stores, and expanded overseas. The board shifted compensation heavily toward the annual bonus. The bonus performance target was set at a stretch goal, above budget, but the long and gradual slope between threshold and target

meant executives had a realistic opportunity to earn a payout for reasonable progress. Although the board kept the relative-TSR-based long-term incentive plan in place (where payouts were, initially, much lower), the prospect of small wins in the annual bonus was critical to motivating executives.

Similarly, the board at another large mall-based retailer shaped its annual bonus to measure more specific metrics that encouraged executives to invest in the company's best-performing locations, as well as in digitization, while consolidating its other stores. To that end, incentive metrics included consideration of sales and profit growth at the investment stores as well as digital channel sales growth. Executives were better able to connect to a mix of financial and strategic goals in this phase, as the balance of metrics gave them more control to make difficult decisions in a time of uncertainty.

Transformation

With the potential for healthier (albeit possibly still depressed) results in the *Transformation* phase, priorities now shift toward actually attaining incentive targets. Steady, forward progress on a clear trajectory helps to win over investors for target-level payouts, while absolute results may still be below historical levels.

Whereas goal-setting in the Stabilization phase might anchor heavily to the enterprise level, goal-setting now can extend to the divisional/brand level—increasing accountability deeper in the organization.

Financially, the company may still be moving only to break-even, but the work is crucial, and people need motivation to stretch themselves. At this stage, companies may want to signal commitments to transformation milestones by granting a special performance-based equity grant in lockstep with those communicated objectives.

This was the approach taken by a luxury retailer whose previous push into the outlet channel had reduced profitability and diluted the brand's appeal. The new strategy invested heavily in the luxury experience, with fully redesigned stores, less emphasis on outlet sales, and a greater push internationally. The company reintroduced PSUs and set metrics tied to average dollars-per-transaction, stores remodeled or opened according to the new concept, and sales growth overseas.

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Acceleration

The *Acceleration* phase gradually takes the company back to "normal" annual and long-term incentive pay practices. Compensation should once again emphasize performance-based rewards over time-based grants. Boards can establish steeper performance curves with narrower expectations of performance. Executives need to see how they can share in wealth creation by continuing to push the strategy along.

Likewise for retention, as management gains confidence, boards can shift from "defense" (generous RSUs) to "offense" (generous PSUs). That's what happened at a large retailer that had first stabilized the business and then transformed following stagnant sales and digital disruption. The board granted price-vested options coming out of the transformation phase linked to regaining the share level before the company's disastrous physical expansion a few years earlier.

These aggressive targets wouldn't have worked in an earlier phase, but management had gained confidence in the strategy. Now they served to prod management to finish the journey of transformation.

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Managing Expectations

The journey of transformation isn't a steady climb. Business plans will evolve throughout the transformation, and compensation should evolve as well. Boards will need to step up their communication with executives in this area.

The good news is that moving to each new phase of transformation signals a step towards company success, with greater potential rewards each time. Compensation, of course, is only one tool for promoting transformation, but can certainly reinforce the larger message and rally the organization around key priorities.

This multi-phase approach to compensation in support of transformation can work beyond retail, in industries from energy and automotive to consumer-packaged-goods and entertainment. But with the severe disruption to retail brought on by the recent pandemic, retailers must act with intention to be sure they aren't left behind. ■

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