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Covid-19 + Compensation

What to Do About Annual Incentive Plans in the Pandemic

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COVID-19 CONSIDERATIONS

When the Covid-19 pandemic began in March 2020, its economic impact significantly affected the annual incentive plans at many companies. In those early days, thinking the pandemic's impact would be short-lived, directors discussed several ways to respond. Ideas included resetting goals in light of the macroeconomic impact, calculating bonuses on a ten-month basis (excluding the worst of March and April), or setting a new six-month plan for the second half of the year.

Now, with more than half of the year already past, the level of uncertainty remains extraordinarily high for many companies and industries. A 'reset' or other adjustment to incentive plans under 'business as usual' is fraught with challenges; for most companies, it is practically impossible for management and Boards to adjust existing plan goals or establish new goals for the second half of the year. That said, Boards can still work to ensure they position their companies as well as possible to enter FY2021. Some companies, facing financial constraints, will decide they just can't pay bonuses this year, but others want to recognize management's herculean efforts to preserve the company's ability to thrive in the future. How can the Board best keep management motivated in these circumstances?

Different Companies, Different Issues

The response to Covid-19 will vary by company and depend to a large extent on the degree of impact and the specific structure of the incentive plans. Companies less affected by the crisis can simply let their plans pay out according to formula. Those facing substantial, but not existential crisis will want to consider creative actions. *Figure 1* shows the challenges along a spectrum of the pandemic's impact across companies.

FIGURE 1: *How the Pandemic Has Affected Companies and Their Incentives Differently*

DEGREE OF IMPACT	IMPLICATIONS FOR INCENTIVES
Neutral/Positive Impact	• "Business as usual" for most pay decisions • Incentive plans are likely well above target if not at maximum • Care should be given to the optics of making out too well from a pandemic, especially in contexts where front-line workers may be at risk • Discretionary reductions or deferrals may be appropriate to avoid over-rewarding in a crisis
Moderate Negative Impact *Some near-term impact, but business expected to "bounce back" later this year*	• Elements of the annual incentive plan may still be in play for the year • Moderate adjustments to financial results might be needed to address one-time costs associated with the pandemic, but the overall program can operate under the normal course, even if payouts are somewhat lower than usual
Significant Impact *Material near-term impact to stock price and financials with concerns/uncertainty about long-term*	• Variable pay plans are likely out of the money due to financial results below threshold • To the extent that the plan has material non-financial components (strategic or individual incentives) some opportunity may still be in play • Committee might consider more discretionary incentives for the year
Fight for Survival *Existential crisis, could require bailout, significant bankruptcy risk*	• Variable incentive plans have been cancelled • Pay discussions focused on the future of a post-pandemic world

The Role of Discretionary Incentives

For companies that have been significantly impacted by the pandemic, the 2020 annual plan is "broken." Management continues to work hard to operate the business and respond to an extraordinarily difficult environment. Boards naturally and appropriately want to maintain focus on critical efforts and create some form of incentive for the year.

With revised financial plans subject to many unknowns, these boards will need to apply discretion to determine incentives for the year. Adjusting out the impact of Covid-19 from financials and then recalculating results to determine bonus payouts may be possible where pandemic-related impacts are discrete and measurable, but in most cases, these costs are dwarfed by the impact of lost revenue.

In past years, investors have often considered discretion a "dirty word." However, in this context, discretion can be used to re-focus organizations on those key activities and outcomes that will support a stronger future. Investors and proxy advisors to date have sent a strong message against adjustments to in-cycle long-term incentives, but they have signaled openness to discretionary adjustments to annual bonuses for 2020/2021 fiscal years.

Some company plans already have a non-financial component, so boards can rely on that framework even when the financials are underwater. Other companies will need a new framework focused on the financial, operational, and strategic accomplishments that will reassure investors while properly engaging and focusing management.

In developing the criteria for discretion, boards might find it helpful to set up a dashboard of key elements: financial performance relative to peers, absolute and relative shareholder outcomes, stakeholder concerns, progress against strategic initiatives (including human capital management and other ESG elements), leaders' performance in the crisis, and the current macro environment (including the pandemic). *Figure 2* has a simplified version of one such dashboard.

FIGURE 2: *Illustrative Dashboard Elements*

DASHBOARD ELEMENT	DESCRIPTION
Financial Performance	• Relative performance vs. closest peers • How financial results were achieved (e.g., were the results primarily from operational gains?) • Year-end performance and trajectory of recovery
Shareholder Experience	• Stock price performance relative to pre-crisis levels • Relative performance vs. closest peers • Continuation of dividends and buybacks
Other Stakeholder Sentiment	• Alignment with employee specific actions (e.g., did the Company have to do layoffs/furloughs? Are employees back to work? Did front line workers receive additional compensation? Have any broad-based reductions in pay been restored?) • Consideration of experiences of communities in which the company operates • Philanthropic support
Progress Against Strategic Initiatives	• Product lines and mix • Customers/channels • Development of key capabilities
Crisis Leadership	• Extent to which management was prepared • Agility in decision making • Ability to maintain safe work environment • Facilitation of work from home experience • Extent to which able company is on a path to be successful in the recovery
External Environment	• Continued experience with Covid-19 • Macroeconomic environment
Human Capital Management and Environmental, Social, and Governance response (HCM & ESG)	• Progress against HCM and other ESG goals, particularly those directly connected to company mission and strategy

For boards considering exercising discretion, we recommend they create the framework for discretion now, rather than wait until year end to "decide what to do." Setting these criteria gives clarity to participants on what they should focus on and where they can make a difference. A discretionary framework thus provides an incentive for performance, not just a reward for outcomes. Clarity now also creates the ability to gather objective data about accomplishments, providing boards with a stronger basis for year-end decisions and sound rationale for external constituents.

For most, we expect any discretionary awards to be modest (25-75% of target), unless a company gets back on its original performance curves from the beginning of the year, or relative outperformance is extraordinary. Many companies will be looking at protecting the incomes and safety of employees first, and considering executives only in the context of the rest of the company. Boards should seek to make awards proportionate to stakeholders' outcomes, to look at pay programs holistically, to maintain alignment with results, and to consider long-term effects. Cost cutting at many companies has already led to reductions in merit pay, benefits, and retirement contribution, in the midst of sizeable employee furloughs and layoffs. These companies expect to recover eventually, but budgets will be tight for a while. Less generous protections for executives relative to the rank-and-file are likely to be the norm.

Planning for Fiscal 2021

For many companies, a high degree of uncertainty seems likely to continue into year end and early fiscal 2021. Setting annual incentive plan goals for the next 12-month period may be more difficult than at any time in recent history. Many companies without fiscal-year-ends at December 31 have already had to struggle with this challenge, and other companies can learn from them. *Figure 3* includes some common frameworks being implemented for fiscal 2021.

FIGURE 3: *Frameworks for Fiscal 2021 Bonus Program*

ACTION	PURPOSE	DETAIL
Increase the emphasis on non-financial components to incentive plans	• Increase flexibility to incorporate strategic goals that set the company up for success in the future where financial volatility may persist	• Add or increase the weighting of non-financial components in the annual plan (e.g., 30%-50%) • Ensure rigorous performance evaluation for non-financial objectives tied to critical strategic objectives
Set biannual goals	• Increased line of sight for goal setting	• Provide hope and opportunity of hitting some targets • Consider reducing the target payout opportunity or capping awards, due to the shorter-time frame, the potentially greater certainty of goals, and the overall expected declines for the year
Set wider performance ranges	• Adapt goal setting to incorporate wider ranges of performanc	• Possibly lower upside as a tradeoff (e.g., 150% maximum payout vs. 200%)

Some companies, such as FedEx, have implemented more extraordinary changes for the next fiscal year, cancelling the annual incentive plan completely and issuing time-based restricted shares instead. For most companies, we anticipate that less extreme departures from the past should be sufficient and effective at responding to uncertainty.

At the end of the day, Boards will want to develop solutions that are fair to all stakeholders and keep employees motivated to work in the long-term interests of the company. For fiscal 2020, this will likely involve discretion, but Boards will want to support discretionary rewards with clear and transparent criteria that are balanced and proportional to the impacts on all stakeholders. For 2021, plans will need to be resilient to continued uncertainty, which may involve both discretionary elements as well as an emphasis on controllable financial results.

In all cases, Boards will want to continue to make balanced decisions. It will be important to keep employees and executives engaged and motivated during the continued challenges of operating in the middle of a pandemic and dealing with the associated economic impacts. Yet, any rewards granted must be proportionate and aligned with the broader impact of Covid-19 on shareholders, on employees, and on society at large. ■

For more information, visit us at SEMLERBROSSY.COM, *or reach us at 310.481.0180.*

Blair Jones, Managing Director
bjones@semlerbrossy.com

John Borneman, Managing Director
jborneman@semlerbrossy.com

Andres Ibarra, Senior Consultant
aibarra@semlerbrossy.com

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LOS ANGELES | NEW YORK