What to Do About Long-Term Incentives in the Pandemic

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COVID-19 CONSIDERATIONS

A daunting compensation challenge is mounting for companies moderately to significantly affected by the Covid-19 pandemic. Many of them have dutifully followed common wisdom and provided long-term equity grants each year, tied at least 50% to performance. Providing a new grant every year gives executives an annual reset on performance and motivates them to incrementally higher effort. But now the pandemic has evaporated the performance-based value of most grants—not just for one year, but potentially for three.

That means these incentive programs have lost substantial holding and motivational power. Many executives may find it difficult to accept two years of hard work and strong performance wiped out by a pandemic that they could not predict or control. Directors may likewise argue that executives with solid performance should still receive some payout level to help keep them engaged. While many companies are considering using discretionary adjustments for similar shortfalls in their annual incentive plans this year (see this **article**), long-term incentives (LTI) don't lend themselves easily to that approach. What choices do Boards have?

No Easy Fixes for Performance-Based Awards

For most executives, LTI programs represent the vast majority of compensation, and performance stock units account for half or more of that opportunity. PSU shortfalls therefore change the realizable pay equation considerably, introducing a potential competitive gap and lost motivational opportunity. Investors have encouraged the use of PSUs because these introduce a higher performance bar for equity compensation: the shares are earned only if financial or stock price hurdles are achieved first. In that sense, PSUs are now operating exactly as intended. But many boards did not expect a coronavirus-type shortfall to "punish" executives three times over.

The most straightforward fix is to simply reset the goals to acknowledge the new reality. Boards could recalibrate the performance schedule (with lower target and maximum payouts) to create a fair alignment with shareholders in the new context. Yet, accounting and disclosure regulations make that kind of change less attractive. A reset is likely to be considered a modification for accounting purposes, which results in an additional grant disclosed in the Summary Compensation table.

More important, investors are leery of any changes that look like "forgiveness." Large institutional shareholders and proxy advisors have sent a strong message against adjustments to outstanding LTI cycles. Nike, for example, recently made a discretionary cash payout related to its 2018-2020 cycle and received a strong 'Against' recommendation from proxy advisors. Shareholders oppose "one-way executive pay-for-performance": when performance is good, everyone gets paid well, and when performance is bad, boards adjust awards to protect the downside. They are appropriately wary of that philosophy taking hold.

Boards must also acknowledge growing awareness of other stakeholders, especially employees. Many companies have cut employee pay or resorted to furloughs or outright layoffs. Any adjustments that appear to "make-up" for lost awards for executives in 2020, or to protect this pay as an entitlement, are likely to get outsized attention. The media are actively looking for stories of corporate greed in a pandemic, and even innocuous seeming changes, such as shifting some performance-based awards to time-based vesting, have resulted in negative stories.

Another possibility, as a major retailer just decided, is to cancel all 2020-2022 PSUs and replace their value with stock options. It's too soon to know how proxy advisors will respond to this more performance-based adjustment that perhaps is appropriate only for companies in severely challenged industries. This is only a partial fix in any case, as shortfalls for other cycles/years remain.

As a result, boards at most companies are likely to allow cycles ending in 2020 to play out "as is." Adjustments, where made, need a strong and clear rationale—such as factoring out the special costs to protect the health and safety of employees. Modifications for lost customer demand will be harder to support, especially where employees have suffered pay reductions or layoffs. In addition, adjustments outside of those allowed in the plan can result in incremental accounting expense and award disclosure in the Summary Compensation Table.

Of course, not all LTI cycles will be permanently affected by 2020. Plans tied to relative total shareholder returns (rTSR), for example, have a built-in mechanism to adjust for economic downturns and recoveries. Indeed, the pandemic is likely to re-invigorate the use of rTSR plans. Other examples are plans that do not use three-year average or cumulative results, making the results for multiple performance cycles less susceptible to the impact of just one year. For companies with these resilient designs, nothing may need to be done to keep the plans motivating and effective.

Looking Beyond 2020

Given the current sensitivities, we recommend that boards wait and see for now on the in-flight performance cycles ending after 2020. Investors will better understand boards' position after the fall outreach season. If the pandemic subsides, the economy begins to recover, and share prices rise further, proxy advisors may become more flexible on outstanding performance share plans and may even provide guidance on reasonable adjustments. Companies may be able to directly 'fix' in-process cycles without violating shareholders' pay-for-performance expectations and creating governance concerns.

The downside of waiting is that boards have nothing to offer to participants until the environment changes. It is hard to communicate a promise to 'do something in the future' if and when the context allows.

Some boards will likely want to do something now, to head off motivation and engagement problems with weakened 2021 and 2022 cycles. This will be especially true when the pandemic is brought under control and the economic environment improves. It will be hard to justify providing no rewards to executives when shareholders are again doing well.

In these cases, we recommend adjustments through only the fiscal 2021 equity grant. With prior awards largely out of the money, boards can thereby offer something tangible to participants sooner rather than later. The challenge is to calibrate the award to make it meaningful enough without being a complete 'make-whole.' Mechanisms will also be needed to avoid 'double-dipping' if the economy improves quickly—i.e., boards won't want to increase awards for 2021 while also allowing for a full recovery of in-flight cycles.

Here are some specific ways to enhance the fiscal 2021 LTI awards while minimizing external criticism:

ACTION	PURPOSE	DETAIL
Change LTI Mix	Add more time-based vested stock to the plan to provide greater certainty	• Reduce the proportion of performance shares and/or stock options in favor of time-based restricted shares • For senior executives, investors and proxy advisors will still expect at least 50% performance shares • The mix for broader employee populations is more flexible
Change Performance Metrics	Change the measurement approach to be resilient to uncertainty	• Add relative measures, whether TSR or financial, to address lingering economic uncertainty • Consider adjusting the calculation of results to be less susceptible to uncertainty (e.g., set a two-year goal rather than three years) • Replace some of the financial metrics with strategic goals
Consider wider payout/ performance ranges	Adapt goal setting to incorporate wider ranges of performance	• Lower the floor for performance awards, but then also lower the upside as a tradeoff (e.g., 125 or 150% maximum payout vs. 200%)
Enhance grant values	Provide greater opportunity for 2021 compared to normal grants	• Increase opportunity by ~25%-50% for next year's grants to 're-load' the long-term focus and motivation for the participants • Clearly communicate that this is a temporary, not permanent adjustment • This is most effective when aligned with a clear business rationale and strong, related performance expectations • Alternative might be targeted grants of time-based awards for select executives for true retention needs

Whatever boards decide, they will want to be clear and transparent on any substantial departures from usual practice. These changes will get more scrutiny than usual, with media and proxy advisors assuming the worst in the absence of a strong rationale. Adjustments are likely in most cases—whether to in-flight LTI designs or to new grants made in fiscal 2021.

In all cases, the principle of alignment with all stakeholders remains paramount. Companies that try to "make-whole" executives who have lost pay, while other employees face cuts or layoffs, will come under severe criticism. Companies with proportionate adjustments to their LTI, with pay still aligned to performance, should receive a better reception from their shareholders, customers, suppliers, and employees alike. ■

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