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Opinion

Forward-Thinking Comp Committees Build Value for the Future

By Sarah Keohane Williamson   July 27, 2020

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The unpredictability of 2020 has sent management reeling as they try to stabilize their workforces, customer bases, supply chains and many of the components that keep a company afloat. This uncertainty has even stretched as far as the C-suite — according to a May survey by Compensation Advisory Partners, Equity Methods and Board Prospects, two out of three companies are considering resetting performance metrics for their CEOs. Short-term rewards are not meant to offset short-term disruptions. If two thirds of all companies were to reset their existing performance metrics, the loss of long-term focus and value creation could be more costly to the company than the crisis itself.

Rather than worrying about addressing near-term compensation shortfalls, compensation committees can use long-term incentives to keep executives focused on their business' long-term strategy.

Adjusting performance metrics is nothing new, as we know from a 2017 report from Robert C. Pozen and S.P. Kothari highlighting the rampant inconsistency of earnings per share and total shareholder return metrics. And the crisis is prompting companies to change targets outright. Many compensation committees are rushing to reset their metrics during this incredibly turbulent year, despite the risk of undermining the long-term strategic goals of the company.

In contrast, some companies appear to be staying the course, with an eye toward the long term.

Some 26% of respondents of the same survey indicated that they have no plans to alter the way in which they award long-term compensation packages. This acknowledges that while awarded pay is going to fall and difficult conversations may arise, they are paying their executives to steer the company toward sustained success rather than perform in a given year.

There are recent examples of companies — many of them household names — explicitly indicating that their executives' compensation is tied to long-term success. From Walmart:

"Our executive compensation program is built upon our global compensation framework [including]: Align management interests with the long-term interests of our shareholders by providing long-term incentives in the form of equity, combined with robust stock ownership guidelines."

In 2017, Unilever restructured its compensation packages to better reflect the long-term goals of the company. Tech giants like Amazon and Microsoft also emphasize long-range incentives in their proxy statements.

Staying the course is not without its consequences. Executive pay likely will plummet and stock options may vest out of the money for many companies affected by Covid-19. One in every four companies (according to Equilar) uses EPS as a criterion for compensation — driving down total compensation given the adverse market conditions brought on by the pandemic. Similarly, TSR targets, used by one in two companies, will be difficult to hit.

Far-sighted executives and directors will recognize that this outcome is a necessary part of the process; down years are expected when agreeing to any package grounded in multi-year success.

Of course, this crisis has impacted every company differently, some more significantly than others. If the downturn has fundamentally disrupted a company's business model and strategy, the compensation committee will want to align executives' pay structures with the new long-term strategy.

Staying the course, and motivating business leaders to build value in the future, is how to find our way out of the doldrums of 2020.