Setting pay through strategic transitions

Establishing performance standards and setting and managing executive pay is never easy. But what happens in a period of structural change? How do boards measure a moving target?

By Ken Hugessen with Guillaume Poulin and Erin Poeta

Over the last few years, many traditional business models have been threatened by obsolescence, including, to name a few, travel agencies, print media and more recently, coal-fired power plants. Boards and management teams in such sectors are often faced with the challenge of maintaining day-to-day operations of their declining businesses, while urgently trying to reinvent themselves.

Executive compensation, always a sensitive topic, is even more complicated during such transitions. To assist boards in navigating this process, this column examines the compensation decisions to be considered in the process's two phases—contraction of revenue and decreasing valuation, followed by repositioning or reinvention.

1. Contraction. When a company sees its business model disrupted, it can quickly find itself in strategic and financial limbo, faced with decreasing revenue and negative earnings. At this stage, the focus is often on reducing costs by downsizing and on short-term retention of key talent, the latter often accomplished through one-off awards (typically with six- to 12-month vesting). Retention awards when shareholder returns are negative and the future is murky may well attract negative attention from shareholders and proxy advisers, so boards must decide: are such awards really necessary for the company's survival?

Evaluating the executive team's performance in this environment can be challenging, as performance against metrics tied to achieving the yearly budget (based on revenue, EBITDA, EPS, etc.) may well fall short. As a result, the board might be asked to approve lower performance targets for the same bonus payout, a situation which will require careful explanation to shareholders.

In some instances, the board and management must accept that the company is no longer able to maintain existing pay levels and structures. Should this occur, the board will have little choice to not only realign performance standards, but also reduce pay to meet the new reality by:

- Gradually changing pay by grandfathering retained executives while bringing in new talent under a lower pay structure;
- Giving notice to everyone (up to two years, depending on seniority and position) and adjusting pay downwards after the notice period;
- Immediately cutting pay, which may risk wrongful dismissal issues.

The urgency of the company's situation will determine the approach taken. The company may also need to reconsider how pay is delivered—for example, if the company is cash-strapped, part of the bonus may be paid in treasury settled stock. In extreme cases, part of salaries may also be deferred in stock. In making these pay decisions, the board should consider the value of outstanding long-term awards and the intrinsic value of any future awards.

2. Repositioning/reinvention. The beginning of the second stage is marked by ongoing uncertainty as the company tries to reposition or reinvent itself. The board may realize that existing management is unsuited to lead the transformation, creating a new conundrum: the need to bring in new talent. Creative approaches to compensation may be required to lure candidates from high-growth, high-paying industries.

During this phase, the board may be challenged to effectively judge performance on traditional hard metrics. Qualitative goals may need to be relied on, either through the assessment of strategic milestones or individual objectives, and senior management may need to be incentivized through approaches more commonly observed among start-ups (e.g., more stock options or other similar highly leveraged instruments). In some instances, cash flow generated by the "old" business is used to fund the new business. In these cases, considerations should be given to differentiate the compensation programs of the two divisions.

> In some instances, management and the board must accept that the company is no longer what it used be. From there, the board will have little choice but to realign performance standards and reduce pay to meet the new reality.

In all, the board may end up adjusting compensation plans two or three times to ensure ongoing effectiveness of performance metrics and alignment to strategy. And as the new business stabilizes, the board may once again need to assess the appropriate fit of existing management and the structure of pay.

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