OPINION

Viewpoint on Executive Compensation

Shifting Variable Pay from Annual to Long-Term Incentives

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This Viewpoint is one in a series of ongoing articles Pay Governance will be publishing regarding the impact of COVID-19 on compensation programs. All of our Viewpoints can be found on our website at www.paygovernance.com.

Introduction

As uncertainty over the future of the COVID-19 pandemic continues, organizations may struggle to develop an accurate earnings forecast for their next fiscal year — particularly companies with a new fiscal year starting in calendar year 2020. Many high-profile companies like Abbott, ConocoPhillips, and PepsiCo have already suspended future earnings guidance, citing the uncertainty surrounding the extent and length of the pandemic's impact on business operations. Several of our recent Viewpoints have explored options to address the challenges of dealing with 2020 incentive plan goals established prior to the pandemic, including placing a higher scorecard weighting on non-financial goals and using discretion in determining payouts. Looking to 2021, companies facing continual challenges in setting financial goals may want to consider shifting the mix of an executive's variable pay from annual incentives to long-term incentives (LTI).

Options for Shifting Variable Pay Mix

We believe there are two alternative approaches for modifying an executive's variable pay mix:

- Alternative 1: Shift the portion of the annual incentive opportunity based on financial goals to an LTI award while keeping the portion based on non-financial goals
- Alternative 2: Deliver the entire target bonus opportunity in an LTI grant

Alternative 1 may be appropriate for companies that have a meaningful weighting on non-financial goals (e.g., 25%+) whereas alternative 2 could be applicable at companies where financial goals comprise a larger majority of the annual plan (e.g., 80%+).

In terms of delivering the additional LTI compensation, two potential options include:

- Grant additional LTI awards based on the current LTI mix
- Skew additional LTI awards toward restricted shares

Since the majority of companies deliver at least 50% of their LTI awards in performance shares, granting the incremental award based on the current LTI mix ensures that the majority of incentive pay is performance based.

However, increasing the weighting on restricted shares may be appropriate: restricted shares provide more payout certainty during a time of significant uncertainty while the ultimate value at vesting is aligned with shareholder gains (or losses). Increasing the restricted share weighting would make particular sense at companies where the overall weighting on performance shares would remain at 50%+.

Additional considerations associated with shifting variable pay towards LTI include:

- If no portion of the current LTI awards vest one year from grant date, consider granting cash-settled restricted stock units that vest after one year with a value equal to an executive's foregone target annual incentive award in order to keep their overall payout timing consistent with current incentive awards.
- If the enhanced LTI opportunity is delivered in restricted shares, it may be appropriate to "discount" the additional LTI opportunity given the lack of a performance component.

Companies with broad participation in their annual incentive plan or a separate plan will need to decide on an approach for these employees. Alternatives could include a lump cash opportunity that is discounted from target (e.g., 10%) or restricted shares with a 1-year vesting period.

Conclusion

While we normally would not suggest transitioning compensation from annual to long-term pay, these are not normal times and this approach could provide certain advantages. For example, it may eliminate or mitigate the need for committee discretion in determining annual incentive payouts. Further, not only would it eliminate the need for setting one-year financial goals, it would also eliminate the possibility of a significant payout on goal achievement that is below historical levels. In an earlier Viewpoint, we suggested that "Everything Should Be On The Table" in formulating a response to the impact of the pandemic. As companies begin looking ahead to 2021, given the unprecedented disruption, we believe shifting the compensation mix should be part of the discussion.

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