Executive Compensation

# It's Time to Think Less Conventionally About Long-Term Incentive Plans

By Dayna Harris

Taking a different approach to compensation plan design may help to better position a company in a swiftly changing marketplace.

In times of transition or business overhaul, the modern executive long-term incentive plan (LTIP) may be inadequate to support a business's imperatives. On one hand, today's typical plan is simple, and likely to garner support under say on pay with both proxy advisor firms and shareholders. On the other hand, a less conventional LTIP plan design may provide better support for achieving long-term objectives.

A typical LTIP usually has the following design elements:

- A three-year performance period.
- A relative total shareholder return (TSR) measure that either stands alone or is paired with a financial measure.
- If a relative TSR measure is present, a financial measure such as a three-year earnings or earnings growth measure or a return on capital measure

A less conventional LTIP, however, is hallmarked by strategic measures or focused financial or operational measures. These measures typically target something more specific than the company or the business unit as a whole. They also may include elements such as certain geographies, customer markets, and product lines.

In many instances, a typical LTIP is sufficient, especially when the company is doing well and on the path to achieving its long-term business strategy. At other times, a company might be better served by using an LTIP to focus the executive team on specific business imperatives that will sustain the company for the long term, particularly when the company is undergoing or in need of a major overhaul.

Further, a less conventional LTIP may be better suited in situations where a business is experiencing significant, if not radical, changes.

### Thrive or Survive

From retail to healthcare to auto manufacturing, disrupted industries are making headlines every day. New entrants to many industries are bringing efficiencies or new products to market more effectively than ever before.

Brick and mortar retailers are struggling under the onslaught of well-established online retailers. Major auto manufacturers are recognizing that their strategies need to address electric vehicles and self-driving cars in a big way. Oil and gas companies are realizing the longer-term threat from renewable energy concepts, including hybrid and electric cars and the electric power industry with its promise of reliance on greener energy sources in the future. Healthcare service providers in the United States are attempting to plan strategies around shifting government policies and regulations to address increasing healthcare costs, patient affordability, and provider accessibility.

When your business is disrupted, it is time to compete differently, or, to reference a slogan for a well-known disrupter, "Think different." Moving executives and their teams to reevaluate everything from product development to the go-to-market strategy means rethinking what the traditional LTIPs are focused on. Now more than ever, it is critical to get the organization focused on competing products (e.g., electric and hybrid cars) or distribution and business model operations (e.g., omni-channel retail). Sometimes this requires investing in entirely new or nascent businesses (e.g., solar, wind, geothermal, or other forms of renewable energy), and sometimes anticipating operating more efficiently in the future (e.g., evolving from being standalone hospitals or medical facilities to become an integrated health system).

Change is difficult, and nothing accelerates change more than a disrupted market. Therefore, it is important for companies to develop the appropriate long-term strategies to keep teams focused, motivated, and incentivized. For an LTIP, compensation committees may want to consider including key strategic or focused financial measures that emphasize new product development, more effective distribution channels, reliable infrastructure architecture, or a new business model or organizational structure that will keep the company competitive among new industry entrants and disrupters.

Situations that might call for less conventional LTIPs include major acquisitions, markets expansions, and diversification of businesses, products, and customers.

**Major acquisitions.** The three most common challenges a company faces after a major acquisition are debt load (assuming debt was part of the purchase deal), integrating the acquired company, and getting the acquired company to perform at the expected level. To ensure that these challenges are being addressed, an LTIP could include performance measures such as debt reduction; acquired company earnings or returns within the deal's expected time frame; and operational, qualitative, or milestone measures that assess successful integration.

**Market expansions.** These may reflect geography, customer segment, or expansion of current market share. Annual growth in these areas may be incremental, as significant changes often require a longer time frame to evaluate, especially if it is a new market and infrastructure needs to be developed in order to expand. Example performance measures include:

- Market share (percentage or dollar amount).
- New market revenue and earnings.
- Higher revenue and earnings in existing markets that are expanding.
- New customer segment revenue and earnings.
- Distribution and infrastructure milestones.

**Diversification of businesses, products, and customers.** This often requires the development of products for a new line of business, higher-margin products, or alternatively, acquiring existing businesses with such products. It may also mean acquiring new or adjacent businesses with the potential of diversifying the customer base. Example performance measures include:

- Research and development (e.g., patents and successful prototypes).
- New product or higher-margin product revenue and earnings.
- A process for identification and vetting of acquisition targets.
- Successful acquisitions.

With strategic measures or focused financial or operational measures in the LTIP that target something more specific than the company or business unit as a whole (e.g., certain geographies, customer markets, and product lines), there has to be an overall check on the affordability of the LTIP. Using relative TSR, overall company earnings over the performance period, or an earnings hurdle to pay any award in the design can serve this purpose.

### Revisit Your LTIPs

Disrupted businesses are becoming daily headlines. When it's not "business as usual" and major changes and adjustments to the business are necessary to thrive or survive, management and compensation committees may want to consider how the LTIP supports the sustainability of the business over the long term.

We recommend that management and the board work together to review and, if needed, revise the long-term business strategy and identify measures that will focus management on key business requirements.

Combining these requirements with an affordability measure (e.g., earnings hurdle or measure) or a direct shareholder alignment measure (e.g., relative TSR) will ensure that the strategic or focused financial or operational measures are really working. Testing the measures and goals under different performance scenarios will demonstrate the potential for success and provide the rationale for a less conventional LTIP in future proxy disclosures.

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