Executive Compensation

Reinventing Compensation in Transformative Times

By Robin Ferracone

With the onslaught of technological, workforce, economic, and other disruptive forces, no company can afford to be complacent with respect to its executive compensation plans. However, investors take a dim view of perennial changes to executive compensation, citing complexity as a pet peeve. As management teams respond to disruption by developing transformative strategies, more and more boards are asking how, when, and to what extent their companies should change their executive compensation plans.

While no company can afford to remain static in its business, the degree and rate of change vary greatly. In the normal course of doing business, companies tend to change aspects of their short- and long-term incentive plans (usually measures and weightings) about once every three or four years. Conventional wisdom might suggest that companies undergoing major transformations need to change their incentive plans more frequently. However, this is not the case. Companies going through "life-changing" events often will reinvent a system and then stick with it throughout the transformation period or even indefinitely. The trick is to design the right system in the first place.

Pay Models in Transformative Situations

In working with companies in transformative situations, Farient identified three basic pay models that companies use. While each of these models differs considerably, there are a number of plan design features that are shared. The three basic models include:

- A completely reinvented plan applied to all executives.
- A one-time transformation plan, whereby a separate pay plan sits alongside the normal pay system.
- A dual track system, whereby the corporate executives operate under a more conventional pay plan and other executives focused on the disruptive aspects of the business operate under a transformative pay model.

The most disruptive pay model is complete reinvention, although it is the model that is used infrequently. Amazon.com, for example, blew up its pay system in the mid-2000s in a quest for extreme flexibility and simplicity. The system, which still operates today, is characterized by low salaries, no bonuses, and very large, episodic restricted stock grants with five- or six-year uneven (i.e., not ratable) vesting. Moreover, these grants are given to executives on an individual basis, with only certain executives receiving grants each year. This system has supported transformation for the past 15 or so years by providing for extreme strategic flexibility in the retail, technology, and supply chain arenas experiencing seismic change, and by instilling a long-term ownership mentality in executives. Investors are supportive of the system because they have reaped exceptional returns, while the CEO's wealth has increased through stock ownership rather than compensation.

A one-time transformation plan is used more frequently. One-time systems generally take the form of pay plans that are specifically designed for the transformation. Once the transformation is complete, the plan goes away. These types of plans are geared to the success of the transformation over a time horizon that is considerably longer than that of a conventional three-year plan. For example, one company that spun off from its parent in an initial public offering wanted to grow its core business through digital transformation. The company implemented a five-year, performance-based restricted stock plan that vests upon the achievement of two key long-term milestones. This performance plan, coupled with an ongoing mix of stock options and restricted shares, is designed to keep executives focused on the long-term, large-scale transformation at hand while rewarding the heavy lifting required to get it done.

A third pay model, the dual track system, is invoked when a specific disruptive initiative must be nurtured without interference from a sizable parent-company infrastructure. For example, a large industrial company with a dual track system operates a traditional pay plan for corporate executives and an entirely different pay plan for the subsidiary executives who are driving the disruption. The subsidiary's transformation pay plan is characterized by a 10-year time horizon, contingent vesting upon achievement of valuation milestones, and significant awards for success. The investment community generally does not opine on these transformation plans, as the plans usually apply to those who are not among the top five named executive officers.

Characteristics of Transformation Pay Plans

While there are many variations on the transformation pay models, there are seven

key themes that characterize them:

1. **Fit for purpose.** Most companies would argue that their pay plans are fit for purpose. However, it is critically important that any transformation pay plan be laser-focused on the desired behaviors and outcomes. In the case of Amazon, the program is fit for purpose in that it is designed to provide for significant latitude for experimentation, encourage managers to think like owners in balancing trade-offs and making decisions, and retain those individuals who are driving game-changing initiatives. In the case of the spin-off company, the transformation plan focuses on whether the company makes major inroads into a largely greenfield market and creates significant value for shareholders.

2. **Flexible.** Farient's research indicates that large-scale transformation plans provide for significant degrees of freedom in how results are achieved. This means that the measures and time horizons are not unduly specific. This is because there is generally a great deal of uncertainty in realizing large-scale transformations. That is why we most often see companies using big-picture milestones, flexible or long-term time horizons, and very broad measures (or, in Amazon's case, no measures at all).

3. **Longer-term.** No transformation occurs overnight, and the time it takes to accomplish a transformation is, at best, uncertain. While the conventional long-term incentive plans use three-year performance cycles, most transformation plans look out over five to ten years.

4. **Ownership-oriented.** Extensive research in the academic community shows that companies perform better when their executives have significant ownership. This is because executives who own large amounts of company stock are more aligned with shareholder interests, rendering them more likely to make value-enhancing decisions. Almost all transformation pay plans use equity as their currency of choice, thereby more powerfully aligning executive and shareholder interests.

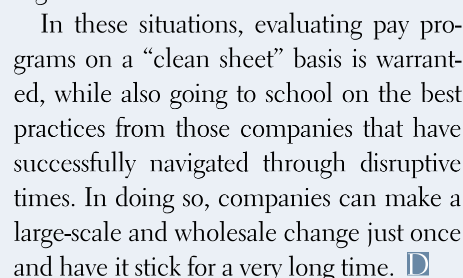
5. **Risk-oriented.** Companies undergoing large-scale transformations are taking big bets on behalf of shareholders. As a result, most transformation plans layer additional risk onto an already risk-oriented executive pay package. In the case of Amazon, risk is augmented by the pay mix—low salaries, no bonuses, and high long-term incentives—coupled with a longer-term time horizon. In the case of the spin-off company, risk is augmented by the use of audacious milestones on a long-term transformation journey.

6. **Individual grants coupled with team-based currency.** Oftentimes, new CEOs are brought in to design and lead a transformation effort. These CEOs typically handpick their team members. As a result, the transformative organization is most often populated by a team of winners at the top. All individuals need to be accountable for delivering their results, and the team together needs to deliver their collective results. Equity grants can be differentiated by individual to reinforce the accountability message, and longer-term vesting on equity grants further reinforces accountability.

7. **Large quantums.** Pulling off large-scale transformations and winning through disruption can be of great value to shareholders. For example, transformative companies that have created exceptional value to shareholders include Amazon, whose stock price has increased eight-fold over the past five years, and Netflix, whose stock price has averaged an annual gain of nearly 50 percent over the past 10 years. As a result, investors are generally willing to pay for such feats, but only if success is proven. Conversely, investors dislike large, one-time special payouts to CEOs that vest immediately. There are a number of ways to provide a large, incremental upside award, although caution is advised. These include:

- Trade off large, risky transformation pay for conventional pay components.
- Put greater upside and downside risk in the plan leverage.
- Exclude the CEO and perhaps the next four named executive officers from the transformation plan. (This applies primarily to a dual track situation.)
- Require top quartile performance for incremental transformation pay.
- Amortize transformation pay over a long-term time horizon so that annualized pay is within a reasonable range.

It is incumbent on boards to regularly evaluate the strategic fit of pay programs. Over the course of four of five years, most companies can expect to update certain aspects of their pay plan design, including performance measures, weightings, pay-for-performance calibration, and perhaps even the long-term incentive vehicle mix. However, given today's disruptive environment, more and more companies are transforming themselves in the extreme.



In these situations, evaluating pay programs on a "clean sheet" basis is warranted, while also going to school on the best practices from those companies that have successfully navigated through disruptive times. In doing so, companies can make a large-scale and wholesale change just once and have it stick for a very long time.

Robin Ferracone is the founder and CEO of Farient Advisors, an executive compensation, performance, and corporate governance advisory firm. She is the author of *Fair Pay, Fair Play: Aligning Executive Performance and Pay* (Jossey-Bass, 2010).