A New Framework for Evaluating Executive Talent Risk

By Robin A. Ferracone

Forewarned is forearmed. The ability to analyze talent retention and vulnerability raises an opportunity for boards to better understand—and anticipate—the loss of a valued executive. Such insights would also ensure that succession is being properly managed in the event of departure.

In 2022, turnover increased among the three most senior C-suite roles. Departures rose most rapidly among CEOs, increasing by three percentage points to 13.2 percent, according to Altrata's *2023 Spotlight on C-suite Turnover in the US*. Turnover among the Fortune 1000 rose to 13 percent among CEOs, 15.9 percent for chief financial officers (CFOs), and 27.2 percent for chief operating officers. Altrata reasoned that the increased turnover of CEOs and CFOs especially was "likely to have been caused, in part, by a build-up of delayed retirements, in turn, caused by the pandemic and subsequent geopolitical disruption."

Ensuring a company has the right talent at the top is a board's primary responsibility—and increasingly puts pressure on the compensation committee to identify and prioritize which executives may be retention risks and what might be done to keep them. The need to attract, retain, and appropriately compensate top talent sometimes results in tension or outright conflict with the need for good governance, which discourages the use of special retention awards. Compensation committees, particularly those serving large-cap companies that often receive the most scrutiny, are caught in the middle of this "collision course."

Recent examples culled by Farient from the most recent proxy season illustrate this collision course between good governance and compensation plans. Consider these failed or declining say-on-pay votes at three companies:

- At Broadcom Corp., objections were prompted by a one-time performance share grant on top of a $44 million annual award. Broadcom received a vote of just 32.3 percent largely due to the public service undertaking grant of $10 million in addition to the annual award.
- At Ingersoll Rand, four equity grants valued at $43.5 million were part of new employment agreements. The say-on-pay vote declined significantly to 58.6 percent from 2021's 95.6 percent and the 2018 vote of a near-perfect 99.3 percent. (Ingersoll Rand held say-on-pay voting every three years but in its most recent proxy reported it would hold annual votes moving forward.)
- At Live Nation, a failed say-on-pay vote of 46.4 percent was attributed to a new contract to retain CEO Michael Rapino through 2027. His compensation for 2022 included a $6 million signing bonus, and his base salary increased to $3 million from $2.1 million in 2021. He also received a $12 million cash performance bonus and stock awards of $116 million for total compensation of approximately $139 million.

The High Cost of Talent

In the war for executive talent—and the specter of the collision course between compensation and governance—corporate executives and their boards need to rethink how they manage and assess risks in executive talent retention and its costly opposite, turnover.

Farient views talent from the perspective of a portfolio—much like an investor or money manager evaluates their holdings and potential investments. Farient's Talent Vulnerability Framework™ depicts which executives may be at risk of leaving, and what the "opportunity gap," i.e., the cost of retaining each executive, might be. The inputs into the framework show each executive's pay positioning vis-à-vis the market, as well as how much holding power the company has on the individual.

Holding power can be looked at as how much the executive would leave on the table if they were to walk away, or how much a company would need to pay to make the executive whole. Farient also estimates what the executive might earn if they were to be recruited away for a position at another company one or two levels up, or for a similar position at a larger company. In this analysis, Farient considers the following:

- What is the likelihood an executive might leave for a higher-paying position elsewhere?

> The top reasons executives voluntarily leave to join another company:
>
> - Culture and values
> - Career advancement
> - Compensation opportunity
> - Company performance and risk
> - Personal reasons (e.g., stress, lifestyle, career change)

- If they are not the top executive of their business unit or department, would they consider a position elsewhere with greater responsibility?
- Might they have a personal reason for making a career change?

Inputs that influence the decision to retain talent include performance, experience, and how they factor into succession plans (as shown in the chart to the right).

Assessing Departure Risks

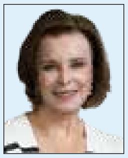
Gauging talent vulnerability, or retention risk, requires managers and the board to understand two concepts: holding power and pay positioning. Holding power is the current value of unvested long-term incentive grants, often expressed as a percentage of target annualized long-term incentive value. Pay positioning is how an executive's total direct compensation is valued against the market. Organizing the data in a heat map for senior executives illustrates who is extremely vulnerable, moderately vulnerable, or relatively safe.

In the market for talent, particularly for high-demand positions, the ability to assess talent vulnerability, holding power, and pay positioning may spell the difference between retention and replacement. The Farient Talent Vulnerability Framework provides compensation committees and their board colleagues with keener insights into what might be bubbling beneath the surface as it relates to executive holding power. It can also help inform decision-making about where to invest and how to be selective when it comes to executive pay.

Boards should also consider the following:

- Think about executive talent as an asset rather than an expense.
- Think about the efficient use of investment dollars when it comes to retention, i.e., how much to spend and where to place awards.
- Link your vulnerability assessment both externally to the market, as well as internally to the company's succession plans.
- In making retention awards to any named executive officers who will be included in the proxy, clearly articulate the rationale for any special awards.

Following these guidelines will help boards better evaluate executive talent risk. D



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Farient Advisors is a NACD partner, providing directors with critical and timely information, and perspectives. Farient Advisors is a financial supporter of the NACD.

Inputs Into the Framework

Fundamental Question	Information or Analytic
How important is the executive relative to other executives in this organization?	■ Next-generation talent or succession plan candidate ■ Position key to the company's future strategy/success
How has this individual been performing?	■ Performance rating history ■ Target and actual incentive pay ■ Salary history
How has the company been performing?	■ Realizable pay
What position(s) could this individual move into?	■ Logical career path positions
How much do these positions pay compared to the executive's current position?	■ "Opportunity gap" in total direct compensation
What is the probability that an external company would view this individual as a potential candidate? For what position(s)?	■ Retention risk
How is this individual paid vs. the market?	■ Competitive pay positioning
How much would this individual lose in compensation, or would another company need to pay, to make the executive whole if they left today?	■ Holding power to executive ■ Frictional cost to another company

SOURCE: FARIENT ADVISORS

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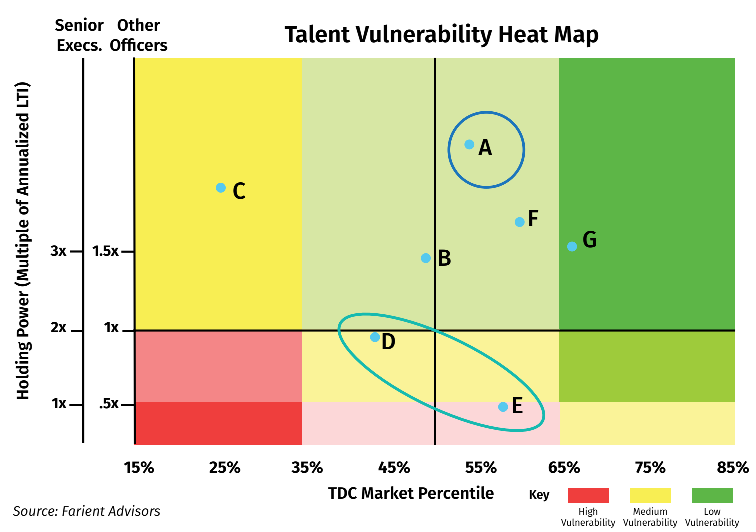

Source: Farient Advisors