Applying Method to the Madness: Tools for Managing 2020 Payouts and Setting 2021 Target Compensation

A *Compensation Committee Series* Webinar
Presented by NACD and Pearl Meyer

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Meet the Presenters

Richard Schapiro has 35 years of investment banking experience as a trusted advisor in the health care and financial services sectors, principally at Salomon Brothers and Bank of America Merrill Lynch (retired 2014). He currently serves as an independent director on the boards of Molina Healthcare and Transamerica, chairing the compensation committee and serving as a member of the audit committee for both organizations. In addition, he serves on the finance committee of Molina Healthcare. Schapiro is an NACD Board Leadership Fellow and has received the CERT Certificate in Cybersecurity Oversight. Schapiro was named to the NACD Directorship 100 in 2018.

Jannice Koors is a senior managing director with Pearl Meyer and president of the firm's Western region. She has more than 25 years of experience in executive compensation and governance, and has consulted to companies of all sizes and industries. She advises company boards and management teams on all aspects of executive and director compensation design, performance measure selection and calibration, and related corporate governance issues. Jan is an NACD Governance Fellow, serves as faculty for the NACD's Director Professionalism and Master Class programs, and was recently named again to the NACD D100 list of the most influential people in corporate governance.

Jane Park, a principal in the New York office at Pearl Meyer, has more than 15 years' experience advising clients on executive pay and non-employee director compensation. Her work is focused on incentive plan design, pay-for-performance alignment, compensation benchmarking, proxy analysis, pay governance. She has deep experience working with companies on special programs for IPO and M&A transactions and works across multiple ownership models and industries, including oil & gas and chemicals. Jane is a frequent speaker on executive compensation and leadership development issues for the NACD and WCD.

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Agenda

- A Lot Has Changed Since March
- Balancing All Stakeholders is Critical
- Consider Holistic Approach – 2020 and 2021 Compensation
- Early Compensation Disclosures
- Analytics to Inform Discretion and Plan Design
- ISS and Glass Lewis Considerations
- Case Studies

A Lot Has Changed Since March

- In April, we noted that a company’s approach to compensation would vary based on the degree of impact from the pandemic.

Severely Negatively Impacted	Moderately Negatively Impacted	Positively Impacted

- Some companies with initial negative impacts had better-than-expected second and/or third quarters.
  - Were some too quick to respond at the beginning of the pandemic?
- 2020 incentive plan payouts continue to be evaluated
- We are advising a holistic assessment of 2020 and 2021 compensation actions and today, we have more information to go on than in in March:
  - Market practices from non-calendar year filers
  - A better sense for how the proxy advisory firms will react

Balance is Key: Constituents and Other Factors

Management Considerations		External Considerations	
Plan otherwise set to pay out before the pandemic	Fairness	Workforce Experience	Furloughs/Layoffs Comp for Essential Workers
How do we keep participants focused on the right metrics?	Engagement	Shareholder Experience	Absolute/Relative TSR Financials
Retention concerns from underwater equity. Are companies ready with succession plans (beyond CEO)?	Retention / Succession	Proxy Advisory / Media / Other	ISS/GL: • Open to discretion on STI (but watch out for above target payouts) • Less open to discretion for PSUs

Philosophical Question: Should all participants be made whole? Should we differentiate by level (rank and file, managers, NEOs?)

Consider a Holistic Approach to Assess Comp Plans

	2020	2021
	Focus is on incentive plans and whether discretion will be used	Focus is on goal-setting and whether there is enough visibility to establish new one- and three-year targets and retention through new equity awards
Base	Restore, if reduced	Merit?

STI	Assess Payouts for Fairness
	• What is the projected payout? (including and excluding COVID)
	• Was a new 2nd half plan established?
	• Consider discretion or "let it lie"?
	  • If discretion, what criteria should be considered?
	  • Should use of discretion vary by participant level?
		Visibility to Establish New Target / Increase Likelihood of Some Payout
		• Performance period (annual, semi-annual, quarterly)
		• Revisit financial measures/weights
		• Increase non-financial measures / ESG
		• Leverage curve (threshold to max)
		• Delay goal-setting
		• Cancel STI in favor of more equity

LTI	Assess Payouts for Fairness / Retention • What is projected PSUs payout for all open cycles? • Consider discretion or "let it lie"? • What is current value of other (time-vesting) equity? • Retention Grants? • Check retirement vesting	PSUs: Visibility to Establish New Target / Increase Likelihood of Payout • Performance period (1, 2 or 3 years?) • Revisit financial measures/weights • Consider relative measures • Leverage curve (threshold to max) • Delay goal-setting • Eliminate PSUs for 2021 only Retention / Other • Change LTI mix: More RSUs/options • Increase LTI value modestly • Use cash if burn rate is an issue • No grant if retention grant in 2020

Examples of Holistic Decision-Making

	2020	2021
Brinker	**Base Salary:** Temporary reduction **Bonus:** Exclude impact of COVID; negative discretion to reduce payouts to 91%	**Bonus and PSUs:** Quarterly performance measurement **LTI Mix:** 80% RSUs / 20% PSUs • 2020 Mix: 50% PSUs / 25% options / 25% RSUs • Expect to resume "normal" LTI mix in 2022
Darden	**Base Salary:** Temporary reduction **Bonus:** Exclude impact of COVID; 94% payout	**Merit:** None **Bonus:** Measure 2nd half financials (goals TBD); non-financial measures for 1st half will be a modifier on financials • Same target bonus payout as 2020 **LTI:** Same value as 2020
Estee Lauder	**Base Salary:** Temporary reduction **Bonus:** No discretion (22-65% payouts) **PSUs:** No discretion (109.9% payout)	**Bonus:** Increased max payout (150% to 165%) and introduced a 50% floor payout; eliminated ROIC as a measure **LTI:** Higher grant value; incremental value based on what the 2020 bonus would have paid assuming a 40% BU floor and 90% corporate floor • Increased max payout (150% to 175%) and eliminated ROIC
FedEx	**Base Salary:** Temporary reduction **Bonus / PSUs:** No discretion (no payout)	**Bonus:** No plan **Retention Grants:** FMV options for CEO; RSUs for others (4-year vest) **PSUs:** New measures emphasize capital efficiency and capital deployment – EPS and CapEx to Revenue

Polling Question #1

Q1: Do you expect to exercise discretion in the STI plan?

- Positive discretion
- Negative discretion
- No

Polling Question #2:

Q2: Do you expect to exercise discretion on PSUs on any or all cycles?

- 2018-20
- 2019-21
- 2020-22
- No

Early Disclosures

We found a precedent for nearly all actions but no prevalent market trend.

Each company and industry will respond based on their own facts and circumstances.

Majority of the early disclosure companies are in the severely negatively impacted sectors (consumer discretionary and industrials)

2020 Compensation Actions

STI Plans

6% Cancelled STI	6% Created New Plan	17+% Exercised Discretion

LTI Plans

9% Modified PSUs	17% Special Grant (restore cash/retention)

2021 Compensation Actions

STI Plans

5% Cancelled STI	8% Delayed Goal-Setting	9% Include Non-Fin'l Measure

LTI Plans

5% >50% Mix in RSUs	2% No Grant	2% PSUs w/ <3 yr perf	8% PSUs only measure rTSR	5% Delayed PSUs Grant

Questions for Management and the Consultant

How are the incentive plans tracking, to date?

- Can we exclude the impact of the pandemic?
- If 3rd and 4th quarters are stronger than expected, what if we only exclude 1st and 2nd quarters of 2020?
- No need for "one-size-fits-all" approach; consider tailoring adjustments by level (rank and file vs. NEOs).

Track other performance factors

- Financial and non-financial

Tally sheets: What is the actual impact on retention?

- One-page document, by individual, summarizing last 3-5 years of target compensation, realized compensation and current value of equity awards (YTD performance for PSUs, in-the-money value of options, current value of RSUs)
- Check retirement/other termination vesting provisions. Are individuals better off retiring because PSUs are tracking at zero and retirement provides target vesting?

Pay vs. performance analysis: Would compensation actions/payouts be aligned with performance?

- Model/test proposed incentive plan payouts

Other External Considerations

ISS/GL have indicated they will be more favorably disposed to STI adjustments and less so toward adjustments to multi-year long-term incentives but will review on a case-by-case basis.

Recently, ISS published COVID-19 FAQs to address how they may view various pay actions related to COVID-19; key takeaways for incentive adjustments include:

Key Annual and Long-Term (LTI) Incentive Themes

Disclose rationale for changes/awards and why the approach was chosen instead of other choices

- Boilerplate language on "retention concerns" or "strong leadership during challenging times" is not sufficient

Explain how actions taken will further investors' interests

- Discuss what the original payout would have been and how final payouts align with performance, especially if goals were lowered without lowering payout opportunities
- Above-target payouts under changed programs will be closely scrutinized

Changes to LTI performance cycles will generally be viewed negatively

- Includes changes to in-progress 2018-20 and 2019-21 cycles; and
- More drastic changes to the 2020-22 cycle, e.g., shift to time-vesting or shorter periods

One-time, discretionary awards should be performance-based, with guardrails to avoid windfalls

Likely "Third Rail" Actions

- Modify all outstanding PSUs now
- Positive discretion on STI resulting in max payout (or above target payout) without sufficient explanation
- Lowering performance goals, without decreasing payout opportunities
- Other unexplained discretionary bonuses
- Stock option repricing
- Reducing PSUs in the 2021 CEO LTI mix to <50%

Case Study #1 – Consumer Goods

Fiscal Year	STI Discretion	LTI Discretion	ISS Vote	Glass Lewis Vote	SOP Vote Outcome
March 31	Yes	Yes	For	Against	90%

Proxy Filed June 2020

Annual Incentive Program	The committee used discretion to set the 2020 STI funding at 90% of target, reflecting on (1) above-target performance in the first nine months of the year; and (2) the estimated financial impact of COVID-19 on the last three months of the year.
Long-Term Incentive Program	The committee again used discretion for the 2018-20 LTI cycle to establish fiscal 2020 performance at 90% of target (same as with annual incentive) and then averaged 2020 with actual results for 2019 (200%) and 2018 (142%), resulting in a 144% of target attainment for the fiscal 2018-2020 LTI cycle.
ISS Recommendation	**FOR**. ISS did not comment on use of discretion on the STI or LTI programs. ISS looked favorably at the positive alignment of pay and performance. Quantitative tests yielded "Low Concern."
Glass-Lewis Recommendation	**AGAINST**. Unlike ISS, Glass Lewis identified concerns with the Company's weak disclosure of incentive goals and use of discretion. GL criticized the fact that the company did not disclose what results would have been if not for the use of discretion.

Case Study #2 - Retail

Fiscal Year	STI Discretion	LTI Discretion	ISS Vote	Glass Lewis Vote	SOP Vote Outcome
March 31	Yes	Yes	For	For	97%

Proxy Filed July 2020

Annual Incentive Program	Additional discretionary bonuses were paid to impacted NEOs in the amount equal to the difference between 1) 50% of the projected bonus achievement prior to COVID-19 and 2) the bonus earned. All bonus payments were deferred until such time the committee or board determines.
Long-Term Incentive Program	The number of performance shares vesting on June 1, 2020 were increased by the excess of the projected vested percentage over the actual vested percentage.
ISS Recommendation	**FOR**, *with caution*. ISS cited concerns on the limited disclosure around performance metric targets and actual performance for the STI and LTIP programs. However, the discretionary adjustments were modest and overall payouts in both programs were well-below target. Quantitative tests yielded "High Concern."
Glass-Lewis Recommendation	**FOR**. Glass Lewis noted that increases to STI and LTIP due to COVID-19 warranted scrutiny but acknowledge a reasonable level of disclosure and the extraordinary circumstances at the time of its FYE. No concerns were raised given the pay and performance alignment which resulted in a "C" grade.

Case Study #3 – Consumer Goods

Fiscal Year	STI Discretion	LTI Discretion	ISS Vote	Glass Lewis Vote	SOP Vote Outcome
May 31	Yes	Yes	Against	Against	54%

Proxy Filed July 2020

Annual Incentive Program	Annual bonus payout increased from 0% to 100% to approximate Adjusted EBIT performance during the first three quarters of fiscal 2020 (June 1, 2019 – February 29, 2020).
Long-Term Incentive Program	LTIP payout was increased from 0% to 75% to approximate Adjusted Revenue and Adjusted EPS performance during the first eleven quarters of the period spanning fiscal 2018-2020. The 2020 – 2022 LTIP cycle is based solely on rTSR (previously based on revenues and EPS).
ISS Recommendation	**AGAINST**. ISS criticized that large discretionary bonuses were awarded when payouts were not earned under the 2020 STI and 2018-2020 LTI program without sufficient explanation. Quantitative tests yielded "Low Concern."
Glass-Lewis Recommendation	**AGAINST**. Glass Lewis cited the quantum of awards granted during the year and the continued use of one-off discretionary awards as areas of concern. Pay and performance test resulted in a "F" grade.

Key Takeaways

- Time to evaluate 2020 payouts
  - Many companies took "wait and see" approach
  - Many performed better than anticipated in 3Q and 4Q
- Don't decide in a vacuum - 2020 decisions may impact 2021 target compensation and plan design
- Balance all stakeholders
  - Management, workforce, and shareholders
- Early disclosures demonstrate precedence, but not prevalence
  - Reflects decision-making tailored to individual facts and circumstances
  - Benchmarking will not be as helpful in decision making for 2021
- Prepare for direct shareholder engagement
  - Additional disclosure in proxy with committee's rationale for pay decisions and business challenges/successes through the pandemic
  - ISS and Glass Lewis expectations have not materially changed; while they may be more open minded in 2020, direct shareholder engagement will support a positive say-on-pay outcome

Questions

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