

# A total reward strategy in challenging times

by John Egan

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*Egan Associates consulting and research experience in the period up to the end of the first quarter in 2008 revealed little or no change in market practices when compared to the past five years. Base salaries had progressively increased and annual bonus opportunities had also increased on the back of improved performances across most sectors in respect of profit and revenue. Equity based long term incentives were also a continuing and important feature of executive reward, with value increasing year on year as a result of both rising share prices and more substantial grants of equity.*

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Following the end of the June 2008 financial year, at which time companies reported on the prior twelve month earnings and their executives' reward for that period, there was continued evidence of growth in base salaries, annual incentives and the level of awards under long term incentive programs. By the beginning of 2009 calendar year much has changed. Global economies are facing considerable uncertainty, capital markets have declined dramatically and businesses' ability to forecast the future has become far more problematic.

Equally, a significant number of organisations have received less than positive feedback from shareholders in relation to their 2008 Remuneration Reports. Many shareholders have voiced a view that executives and boards have made an inadequate response to the dilemmas which their organisations face, including a loss in the value of their investment in the order of 30% to 50% or more over the 2008 calendar year.

At the time of planning for the 2009 financial year in April/May of 2008 few boards or executive teams would have anticipated the current state of global bourses or the probability of widespread recession. Consequently, many organisations simply retained reward programs that had worked well over the previous triennium. Boards are now faced with unique challenges in the current climate of not having the certainty in relation to a company's future prospects or profitability, particularly if there is a dependence on international economies.

While we have written separately on a framework for managing salary increases in the current climate, the budgets and business plans, and determination of performance hurdles in respect of annual and long term incentive programs, both cash and equity based, for many organisations were established in the first half of 2008.

In hindsight many of these performance hurdles, predicated on profit estimations and growth expectations will prove to be more than challenging and in many companies will be unobtainable.

In this circumstance Boards, in collaboration with their Chief Executive and the senior executive team, are facing the real challenge of managing their costs while concurrently retaining their top talent. A significant issue will be maintaining motivation in an environment where earnings expectations arising from the anticipated vesting of equity based long term incentives have the distinct prospect of evaporating.

While annual incentive plans, budgets and related performance considerations were locked in several months ago, corporations are now in the process of reviewing their long term incentive plans and the allocation of equity under those programs. Concurrently, many organisations are observing a significant proportion of prior awards being substantially 'under water', or where the company's relative performance remains intact, the value of those rights or options will be substantially diminished when compared to earlier expectations or the value of awards which vested in or prior to the 2007 calendar year.

What are some of the issues and strategies which Boards can adopt in these uncertain times where a view of the future no longer represents foreshadowed outcomes?

## Annual Incentive Plans

Annual incentive or bonus plans (STIs) have typically been heavily weighted towards financial outcomes with the emphasis on strategic, tactical and operational outcomes being less significant, with their weighting typically representing between 20% and 40% of an annual incentive plan outcome with a substantial proportion of any leverage for above target performance being a derivative of financial out-performance.

All organisations will be facing a unique set of circumstances though some of the more widespread considerations that Board Remuneration Committees should consider include the following:

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- Is the foreshadowed performance of the company likely to be below plan arising from circumstances completely beyond the executive team?
- If the company fails to achieve its 2009 targets due to reasons other than market conditions should the committee resolve to retain the status quo?

If on the other hand the company's performance is primarily due to market conditions then further questions may need to be posed, including:

- Does the current financial circumstance of the company and management's achievements in the context of more broadly based economic conditions justify the payment of any annual incentive or bonus?
- Are there retention risks if bonuses are not paid?
- If the response to this question is affirmative, can these be addressed in another way, without resorting to 'pay for stay' (for example by the issue of 'long tail' share rights or restricted shares?)
- How will shareholders and their advisers respond if bonuses are paid when profit performance or share price has not improved?
- Should elements of the STI be reweighted to respond to the effectiveness of management's stewardship of the economic downturn?

## Long Term Incentive Plans

As noted above, many existing long term equity based incentive plans may be 'out of the money', not as a result of the company's earnings growth or relative performance on the stock market, but rather, from the issue price at the time of grant at some time prior to December 2007.

How should the company address issues being faced by many executives for the first time? Responses that might be considered by the company could include:

- Do nothing, as the relative benefit to executives under these plans over the last three to five years has been considerable.
- Review a range of issues:
  - Is the enterprise's prevailing share price primarily due to global or domestic market factors?
  - Could general market speculation or a general short term increase in share price eliminate the 'out of the money' value of the share options?
  - Are executives in receipt of competitive levels of participation under long term equity based incentive plans?
  - Is the plan design delivering the expected outcome?
  - Are there an appropriate number of options or rights available under the long term incentive plan without seeking shareholder approval for an elevation in the proportion of equity available to staff?
  - Is the company faced with challenges of relative competitiveness arising from an industry sector glitch which may disadvantage them in securing top talent in a number of key executive roles?
  - Should a cash based long term incentive be introduced with the end benefit paid in restricted shares? What are appropriate performance considerations for the next 3 to 5 years?
  - Should the term of 'long term incentives' be reviewed upwards i.e. from 3-5 years?

Notwithstanding the above questions, Boards will also need to address the basis of their allocation of equity under long term incentive plans where the foreshadowed grants are greater than past grants due to substantially lower share prices. Is this an appropriate outcome?