Strategic Pay Solutions for Today's Tough Challenges

Throughout most sectors of the economy, there is a pervasive sense that the party is over. While this appears to be true for many, the current economy and the uncertain stock market present a whole breadth of new opportunities.

For the managers and Boards of public companies, one of the opportunities is to re-focus around fundamentals. The topic of executive compensation looks and feels like a bad car accident for those feeling the pain of unrealistically priced options.

However, there are ways and means of using pay to help get everyone back to the basics of creating real and sustainable growth in shareholder value.

We maintain that the universal starting point in pay design is company strategy.

While today's environment offers a host of complications - ranging from a severely mixed bag of still-rising stock prices, to dramatically declining stock prices, and just plain, volatile stock prices - pay must still be linked to the actions required to realize value.

The following scenarios outline many of the challenges facing companies today, with some thoughts on how companies should respond, especially from an executive compensation perspective.

Whatever the situation, the right solution must be led by the business case. Quick fixes are just that - they cannot be considered a substitute for re-thinking the compensation design vis-à-vis the current and future realities of the business.

One-time "silver bullets" can be fatal to the organization's long-term health and success.

Scenario #1:
Stock price in the tank; strategic overhaul underway

The last few years in Asia (particularly in India and China) have been similar to those of the heady times in the Silicon Valley during the late 1990s and early 2000s. On a similar premise, many organizations in Asia have ventured into a public stock offering.

Yet, very few start-ups and project-based firms across the region have made money, given that the launch of the public offering was based on the promise that all their projects will be executed on time.

The rise in these organizations' market value "was" stunning. The profitable and immediate success of their planned revenue and profit models was similarly impressive during a time when clicks and eyeballs and promises from renowned business leaders were, to investors, a sufficient proxy for future profits. But the model has quickly become challenged, and revenue from planned projects has dropped precipitously.

Today, many of these organizations are contemplating replacing current executives and are in the midst of overhauling their business model to return to profitability. Shares for many of these firms are trading some 75 percent off their peak and some are even trading below book value.

These types of companies are prime examples of organizations that could use pay as a significant lever in affecting a turnaround.

Most of the attention on the pay programs has focused on underwater options. Nevertheless, companies in this type of situation can benefit tremendously by introducing both annual and long-term incentives focused on the few key performance measures that are the levers of a new strategy. The stock market's response to a strategic shift may well be delayed; the market may require sustained signs of success before it rewards a company with renewed interest.

Annual and intermediate plans that pay in cash or in a stock with a low basis can be effective tools in galvanizing a management team around a new strategy.

Indeed, companies in this position also need to address their underwater options. Some options may need to be replaced, which is not easily accomplished under the current and future accounting rules. The investment community will be scrutinizing overhang (the sum of options currently granted and in employees' hands plus the remaining shares authorized to be granted to employees).

To manage overhang to a lower level, many companies must find ways to cancel outstanding options if they are going to replace them with new options that have a realistic chance of being valuable to the holder.

Finally, companies undergoing strategic surgery also need specialized pay packages to help manage the attrition and attraction of talent. Some individuals' skills may be redundant in the new business model, and therefore will need to be managed out. Other individuals may be important in a transition but not in the long term.

In addition, new skills that are not resident currently in the organization may be required.

Tailored severance packages, stay or project-completion bonuses, and new hire packages may all be required simultaneously to address talent issues.

Scenario #2:
Business model is okay, but needs near-term adjustments to weather a downturn

An India-based homebuilder is well positioned for the long term, or so it seems. The prospects for home building are strong. The company's target customer segment has good long-term prospects. Its land inventories are plentiful and bear moderate carrying costs. Its execution ability is strong and improving.

Despite the positive horizon, a potentially serious threat exists: several of its geographic markets are being hit hard by layoffs, particularly in areas where technology is a large employer.

From a business perspective, the company needs to re-balance its focus. Where it previously wanted maximum growth from each of its geographic divisions, it now wants to refocus on those markets least affected by the downturn.

It needs to manage its risk in other markets by slowing its building activity and shifting from a spec-build mode to build-on-order approach. It is also keen to use these market circumstances to increase its share and presence in key still-growing markets.

Finally, without taking wholesale hits to its organization, it inevitably must tighten its belt and shrink expenses to help maintain margins.

From a talent perspective, the company's challenge is to quickly refocus the organization on these near-term priorities. To use pay to this effect, the company first needs to alter its annual incentive plans to reflect the need for focus on margins.

It also needs to shift away from a "one size fits all" approach for its geographic division plans. Those divisions in still-growing markets may be relatively untouched, although market share may be added as a measure of success, while margins might receive increased weight as a balance.

In the challenged geographies, the division management teams need to be re-focused away from all-out growth in volumes and revenue. Profit per home and margins may take precedence over the top line. At the same time, local management may be encouraged to stockpile land inventory, taking advantage of falling land values, even though the increased carrying cost hits the short-term P&L.

As far as pay mix is concerned, a shift to more variable pay may be in order. When a greater percentage of pay is delivered through variable means, pressure on salary increases is lower, and salaries may be held flat. Instead, target annual incentive amounts may be increased, leaving the company with a more leveraged pay program.

Equity programs might be largely unaffected in this scenario. While option holders may be disappointed that older grants have gone underwater or lost much of their positive spread, a strong communication program can explain how standard grants made during this time could have a big upside.

In some cases, targeted restricted stock grants may be granted to key strategic contributors, but the grants should be severely limited for maximum impact.

Scenario #3:
Business is performing well but the stock price is caught in the downdraft

Perhaps one of the most frustrating positions to be in today is to be part of the team leading a company to sustained success but, nonetheless, having the stock caught in the downdraft.

The large majority of non-financial services related firms across the region have been recording sustained quarter-over-quarter improvements in their earnings but are still getting penalized in their stock price.

The business implications for companies in this position are largely to stay on course while the investor relations experts try to get the investment community to notice.

From a talent perspective, the challenge is to maintain the motivation of the whole team and hold on to any key executives who may be at risk.

One of the dangers that companies face in this scenario, and even in some turnarounds, is the near panic over what it will take to keep a team focused and in their seats.

Companies may selectively re-stake or provide retention grants (usually restricted shares), but should do so cautiously. If they choose this course, they may find later that they have another problem, namely multi-millionaires with new and very high expectations about what a compensation program should deliver.

Communication should be the first line of defense. The elements of an effective communication program include financial education that highlights the continued growth opportunities in share price drivers (e.g., earnings before interest, taxes, depreciation, and amortization [EBITDA], return on capital employed and top-line growth potential) along with historic bands of valuation for the sector.

This understanding can help option holders develop their own view of the stock's future potential and the gain opportunities therein. This will help build recognition of the future spreads that may be achieved on new and, potentially, on earlier, option grants.

Scenario #4:
Company stock under-performing in the wake of mixed unit performance

A tough stock market may be especially unkind to companies that are perceived to have a mixed or unfocused portfolio of businesses.

For example, a leading Chinese organization, a diversified manufacturer with multiple autonomous business units had a track record of creating significant shareholder wealth. However, it needed to continually demonstrate a strong growth trajectory to drive shareholder value even further.

With a perception among analysts that it was too patient with some of its units, the company sought to find a way to sharpen focus across the board and get all of its businesses operating with full margins and on good growth trajectories.

In this scenario, the company needs to refocus the organization on key value drivers and milestones plus do so with greater line of sight to the results that managers can impact.

In this example, the company knew it needed to achieve growth at the business unit level. A history of small, independent business units had left the company with weaker accountability than it thought was desirable.

There was also a sense among the various management teams that their decisions and actions had limited impact on the stock price.

To encourage stronger growth in each of its business units, the company introduced a two-part long-term incentive plan.

Part one was based on a matrix that measured a business unit's real earnings growth and return on investment performance.

Payments within the matrix were calibrated to actual value creation and then "tilted" slightly to encourage growth over return on investment. (The business units had historically been conservative and valued returns over growth. The new payout matrix sought to reinforce growth.)

This part of the plan measured each business' contribution to shareholder value and represented the most significant opportunity in the two-part plan.

The second part of the plan provided annual non-qualified stock option grants. The grants reinforced the tie to overall company results as well as the need to translate individual business performance into long-term shareholder value creation.

Finally, the company made some adjustments to annual incentive programs for business unit leadership, introducing milestones related to identifying and opening up growth opportunities.

While education and communication around stock price potential plays a part in this scenario, the emphasis is more internal (e.g., getting managers focused on what they do that drives shareholder value).

Scenario #5:
Economic downturn prompts portfolio adjustment or redeployment

The last business cycle seemed to emphasize the market's attraction to "pure plays".

Private equity investments, spin-offs, and divestments of businesses reached record levels in many parts of the world during 2005 to 2007. Nonetheless, record mergers and acquisition activity also led to the creation of behemoth organizations designed to achieve broad dominance and synergy:

Most of these behemoth organizations will find assets that do not fit or cannot meet their performance expectations. A new wave of spin-offs and divestitures will ensue, which is exactly what we have been witnessing in the past several weeks across the globe.

Spin-offs and divestitures each present their own sets of issues with regard to keeping talent and keeping talent focused. Some business spin-offs or sales present 'trophy assets' to a new owner (or set of owners), but the management team is not always part of the trophy.

Management teams may be needed through the transaction but not wanted after it. Conversely a strong management team may greatly increase the value of the asset in question.

The importance of the management leads to a wide variety of possible approaches for the seller.

On the short end, it may require nothing more than stay bonuses to get through a transition.

Other permutations vary with the form of the transaction and may include a stake in the sale price, a re-staking in the buyer's entity or in an actual public offering, or a whole new set of equity programs geared both to the IPO and the long-term success of a new, independent entity.

Shekhar Purohit