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Compensation Strategies in the Era of COVID-19

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Managing 2020 Payouts and Setting Go-Forward Pay Strategies in the Pandemic

As the economic repercussions of the pandemic continue to play out around the globe, one thing is clear: the impact of COVID-19 on businesses varies greatly both within and across industries. Broadly, the effect has been negative, with many companies unexpectedly realizing either flat or negative growth over the past year. While those hit hardest by lockdowns experienced an immediate and devastating revenue hit, the change was moderate to neutral for many. Some companies even benefitted from an uptick due to a pandemic-fueled spike in demand for products or services or the ability to pivot to access growth opportunities.

Those disparate outcomes factored heavily in how companies are approaching closing the books on fiscal 2020 and planning for 2021, Ryan Hourihan, a principal in Pearl Meyer's Los Angeles office, told CEOs gathered for a recent roundtable discussion on compensation co-sponsored by Chief Executive Group and Pearl Meyer. "Among those negatively impacted, many are using discretion, in light of the fact that performance goals set at the beginning of the year were clearly unattainable by the middle of March onward," he said. "In terms of the positively impacted companies, such as PPE manufacturers, ecommerce, medical suppliers, and grocery chains, some have opted to exercise negative discretion, taking incentive payouts down a bit to acknowledge the pain and suffering going on outside the four walls of the business."

Adjusting in the Aftermath

For companies adversely impacted, the fallout is likely to play out over multiple years. Stoneridge, for example, was forced to modify production schedules due to the pandemic's impact on the automotive component manufacturer's plant operations. The company instituted a temporary delay in merit pay, which it has since restored. But the experience raised ongoing concerns about both its annual bonus and long-term incentive plans, reported CHRO Susan Benedict. "For the short term, we're asking our board about the potential for some discretionary award based on the fact that we had this major external uncontrollable force," she said. "But our long-term incentive plan impacts multiple years and while we can start to make predictions, we don't know the results yet."

Stoneridge is far from alone in that dilemma. The unanticipated impact of the covid crisis is wreaking havoc on multi-year performance plans at both public and private companies. "We've had clients who, two years into a three-year performance plan, saw performance crater and, as a result, the plan not paying out despite two years trending above target," said

Hourihan, who points out that the issue is particularly thorny for public companies who face loss of tax deduction ramifications when employing positive discretion.

In such cases, he suggests companies consider letting their plan run its course and making adjustments for future years. “You may want to shift the mix a little bit, taking out some of the performance-based equity and putting it into a time-based program, whether that be stock options or restricted stock,” he said, noting that Glass Lewis and ISS don’t view stock options as performance-based equity. “You might also weigh making future grants slightly larger to acknowledge some of the lost value rather than take on the difficulty of making changes to what is currently outstanding.”

Heading into 2021, many companies are choosing to mitigate uncertainty by adopting shorter target timeframes or changing performance metrics. “We’ve had clients decide that setting goals for a year out simply wasn’t realistic, so they opted to start with a six-month bonus plan and reevaluate mid-year,” said Hourihan, who noted that concern about the ability to attract and retain employees also factored into changes to incentive targets. “Some companies address that concern by moving from the financial metrics they typically use to strategic subjective measures related to coping successfully with covid.”

Navigating Neutral

Retention has long been an issue for farm and construction equipment distribution company Berry Companies, which struggles to find service technicians and mechanics. All of the company’s 900 employees participate in a profit-sharing bonus plan, with some receiving as much as two to three times their base pay in bonus compensation. Fortunately, the company was among those that ultimately benefitted from the pandemic due to a housing market boom during the crisis. However, watching the pandemic impact other industries has CEO Walter Berry wondering how employees who’ve grown accustomed to expecting hefty yearly bonuses would fare in similar circumstances. “We’re trying to teach them that you need to set some of this bonus aside for a rainy day because we’ve had a lot of good years now and, as my 92-year-old father likes to say, ‘Trees do not grow to the sky,’” said Berry. “He’s been saying that more and more lately.”

S.R. Smith, which also emerged from 2020 with revenues intact, is taking a cautious approach to 2021. For the pool supply company, a dampening in commercial business due to pool closures was quickly offset by an uptick in residential markets, as consumers in lockdown put money into home improvements. As a result, the company was able to remove pay freezes, reinstate pay cut early in the pandemic and reward employees for managing through the crisis—moves that helped alleviate concern about losing employees to competitors. “Our goal with comp is to attract and retain people because we have great people, and we want to keep them happy,” said CFO Mike DeDona, who is cautiously optimistic about the company meeting the expectations of its private equity owners. “When they acquired the business in 2017, the goal was to double our bottom line EBITDA in five years, and I think we’ll be there next year.”

The company’s incentive targets are linked to that goalpost, with separate payout levels for management versus executives to incent those seen as having more control over driving the business. “For the executives, it’s pretty draconian,” said DeDona. “If we hit 90 percent of the EBITDA target, we get a 50 percent payout—at 89 percent, we get zip. It accelerates pretty heavily on the upside. Then for management, director-level folks, it’s half as punitive, so they get a payout down to 80 percent—but it’s also half as rich on the upside.”

Delayed Dampening

Some companies that weathered covid relatively well so far, due largely to having locked in business before lockdowns scuttled demand, are now bracing themselves for trouble. While Cosmetic Group USA experienced an "all-time record year in 2020," COO Julio Lara attributes the boon to orders that were already in the pipeline when the pandemic hit. "The lead times in our products are very long, so what we are selling are orders taken in October 2019 through February 2020, launches from big brands, the L'Oreals and Estée Lauders of the world, and that are sold in Sephora, at malls and by online makeup artists and influencers," he said. "As a result, we had a tremendous 2020, but we're being very cautious about 2021 because brands are being very cautious about launches for next year, and we don't have enough visibility to know what will happen."

In addition to pivoting to manufacturing hand sanitizer, Cosmetic Group USA is addressing that concern by putting countermeasures in place, including a hiring freeze and cost-cutting measures. To guard against triggering bonus payouts it can't afford, the company is adding a cash-flow threshold that must be hit to release bonus payouts that are typically linked to revenue and EBITDA, reported Lara. "It's a bit nerve-wracking, not knowing what 2021 has in stake for us."

The level of uncertainty that companies like Cosmetic Group are facing warrant such measures, noted Hourihan, who suggests considering a wider range of payout outcomes, as well as adjustments to payout practices at either ends of the scale. "You may want to give a little bit more wiggle room on the downside ability to achieve [a payout], but maybe on the upside make it so that you really need to hit the ball out of the park to max out the bonus program."

For public companies, disclosure of the rationale behind discretionary adjustments to 2020 compensation and any changes to normal compensation practices going forward will be critical. In addition to robust disclosure in CD&As, companies may want to conduct proactive shareholder outreach to explain and build support for compensation decisions.

"Given the economic uncertainty created by COVID-19, which will likely last through most of 2021," Hourihan notes, "designing go-forward compensation strategies will require a re-evaluation and closer examination than is usually the case."

About the Author

Ryan Hourihan is a managing director with Pearl Meyer. He has over ten years of experience advising boards and senior management on incentive compensation design, corporate governance, and performance measurement with the objective of supporting business strategy, value creation, and shareholder interests. Ryan is particularly experienced in compensation challenges unique to privately held firms seeking to compete with publicly traded firms. His clients have included Fortune 500 organizations, privately held companies, and pre-IPO ventures across an array of industries.

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