Pearl Meyer

CASE STUDY

Business Transformation in the Technology Industry

The Company

The company is a U.S-based globally-operating company listed on the NYSE with a market cap of approximately $2.5B and more than 10,000 employees worldwide. Its primary offerings are integrated hardware and software solutions for business.

The Business Challenge and Strategic Approach

The company's traditional hardware product line was quickly becoming a commodity, with margins eroding at a fast clip. The overall tech market appetite—particularly in the enterprise space—for more "integrated" solutions was a rising trend that the company was not well-positioned to capitalize on.

The company made a decisive strategic move to ramp down sole reliance on hardware, begin to exit its consumer-focused markets, and grow in a new direction with B2B-focused integrated hardware/software solutions. This integration would largely come from in-house hardware know-how augmented by software acquisitions.

The strategy would in time allow the company to deploy enterprise-class, integrated, and vertically-focused solutions for their growing business customer base. It was designed at the outset to be transformative and not only stave off obsolescence, but spur the company to become a high-growth, high-margin, and high-shareholder-value organization. It had to be implemented quickly and demanded fast results.

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The Compensation Challenge: Business Strategy, Leadership, and Talent Retention

The company was a spin-out from one of the largest hardware-focused corporations in the world at the time and over ensuing decades, it retained the legacy of a very traditional approach to compensation. Stock options were eventually supplanted by restricted stock units (RSUs) as the sole component of its equity incentive program. Within the annual cash

incentive program, 100 percent of the metrics were focused on lagging financial measures (e.g., profit contribution), with no spur to forward-looking plans.

As such, its management team had little direct motivation to enact a risky turn of the ship and lead the larger employee base on the mission.

Finally, the company was aware that the acquisition strategy would rely heavily on retaining the institutional knowledge and technical talent of the companies brought into the fold. And that these key personnel were likely conditioned—largely by their compensation—to a start-up market rather than an entrenched and well-established corporation. As emerging growth companies, many entered the parent company fold with compensation programs characterized by stock options for the equity component, and revenue growth, product development, and pipeline metrics in the annual bonus program.

The Solution: Incentive, Base, and “Special Case” Programs

The solution featured three innovative approaches that addressed each of the business strategy, leadership, and talent retention issues.

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Business Strategy – Annual Incentive Plan

First, a detailed gap analysis of the current incentive plan was conducted, looking at the actions and results it would drive if left in place, versus what value-drivers were necessary for adoption and execution of the new business strategy.

An annual incentive plan with a balanced mix of lead and lag metrics was proposed, with 50 percent lagging financial metrics to encourage execution on existing products and services and 50 percent leading metrics to encourage decisions and performance forward in a new direction. It was a radical approach for this traditional company, yet clearly innovative and designed to advance the company successfully toward its transformation.

Leading measures that were required for growth, but not likely to show immediate financial return, were implemented and represented 50 percent of the incentive plan:

- Success in industry vertical penetration and build out of industry platforms;
- Success adding markets and new geographies; and
- Targeting, acquisition, and successful integration of new software companies.

This reduced lagging or financial metrics from 100 percent to 50 percent. These traditional measures—operating income and cash flow—were clearly important to maintaining short- and medium-term viability and shareholder support. They were also critical to enabling the aggressive acquisition goals, but alone would not drive the long-term strategy, nor were they likely to provide long-term returns.

Business Strategy – Accountability for Results through Long-term Incentive Plan

Ultimately, the success of the company's strategic transformation would be reflected in generating returns above the cost of investments and outperformance in total shareholder return (TSR). Accordingly, the long-term incentive program was constructed using two primary metrics: a long-term cash incentive plan based on three-year return on invested capital (ROIC) relative to the S&P 500 technology index and relative TSR in comparison to that same index. In the operating environment for this company, these represented the two best indicators of the long-term success of the company's strategy.

Leadership Strategy – Base Pay

The existing management team was modeled against the hypothetical executive group that would be needed to implement the turnaround and then to lead the future company. This new model included broad traits such as agility and ability to execute in a changing market, and also demanded executives willing and able to collaborate and successfully integrate the planned acquisitions. A solid plan for clear communication, education, and leadership training was deployed.

Compensation through merit increases was used as an incentive to change. Performance reviews and salary increases were then based on willingness to adapt and demonstration of the new desired competencies.

Talent Retention – "Special Case Equity"

With the integration of numerous software products at the core of the transformation strategy, retaining key engineering talent after an acquisition was critical. Many of the targeted companies were relatively small in comparison and tended to operate in a high-risk, high-reward environment, where compensation is often heavily weighted to future stock gains.

In order to entice this vital talent group to stay on board and to create ongoing connection as they were integrated into the larger enterprise, a plan was developed to mimic the start-up market's approach to long-term high-value stock-based equity. Incentives using phantom stock appreciation rights (SARs) allowed the company to offer a similar level and type of performance-based pay that resonated with these employees and provided strong impetus to achieve revenue and profit objectives.

The Results

Implementation of the new compensation plan occurred within a single year. The plan was fully designed and approved in 2011 for roll-out in the 2012 fiscal year. Despite an expected and initially rocky transition year, the company subsequently made steady, deliberate, and successful strides toward its reinvention goals:

- Successful acquisition and integration of more than 10 companies;
- Margin expansion among the acquired entities and growth of the integrated solutions business, which now represents more than a third of the company's total revenue;
- Outperformance of the goal to shift product mix to 80 percent hardware and 20 percent software;
- The company has achieved its cash and capital allocation goals, including more than three years of consistent quarterly dividends; and
- In the three years since the strategy was enacted, the stock price has risen approximately 32 percent.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.

NEW YORK
570 Lexington Avenue, 7th Floor
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, NE, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON
93 Worcester Street, Suite 100
Wellesley, MA 02481
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
123 N. Wacker Drive, Suite 860
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LONDON
3rd Floor
58 Grosvenor Street
London W1K 3JA
+44 (0)20 3384 6711
london@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

SAN FRANCISCO
595 Market Street, Suite 1340
San Francisco, CA 94105
(415) 651-4560
sanfrancisco@pearlmeyer.com

For more information on Pearl Meyer, visit us at www.pearlmeyer.com or contact us at (212) 644-2300.

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