The following is based on a panel discussion with David Bixby, a managing director in Pearl Meyer’s Houston office, at the 24th Annual NASPP (National Association of Stock Plan Professionals) Conference and Exhibition.

Q. What’s the primary concern for a compensation committee when a sharp stock price drop affects the equity holdings of the organization’s executives?

A: There are several concerns tied together. First, if there’s a significant downturn, not only is the executive team’s equity affected, the stockholders are losing money and all decisions are going to be made in that context.

But speaking specifically about management, executives may be holding unvested long-term incentive awards that have suddenly become far less meaningful. At the same time, salaries may be stagnant and annual incentives, if they are paid at all, are likely to be below target.

And of course, this is happening at a time when tensions are quite high, running the business is becoming much more difficult, and instability among the top management team may be especially damaging to shareholder value. In this situation, retention and engagement can become serious concerns.

One key question the compensation committee needs to ask is: “Do we have the right team in place to preserve shareholder value and to position the company to capitalize on the eventual recovery?” If that answer is “yes”, then there are a few things to look at that can help with retention through the downturn.

Q. What sorts of compensation tools are available to help with the short-term issues?

A: Long-term incentive awards are forward-looking incentives; the value of the initial grant is generally intended to reflect a “competitive” level of target pay for a particular position in a company of a certain size and complexity. The eventual “realized” value of the award is contingent upon company performance from that point forward. Simply because a company is hit by an industry downturn does not mean that the position in question has become any less complex, the associated responsibilities any less important, or the incumbent any less valuable to the company.

In keeping with this point of view, one common approach which we saw many companies in the oil & gas industry take during the most recent downturn was an overall hold-the-line approach on long-term incentives. Stability in the long-term incentive program can help combat uncertainty elsewhere. Perhaps more importantly, keeping grant values constant as stock prices drop puts more shares and options in the hands of management—helping to replace value lost in...
outstanding awards and providing a supercharged incentive to stay and help the company bounce back, all within the bounds of the existing program and without resorting to any special retention awards.

For some companies, however, holding the line is not a viable alternative—particularly if the downturn is extended. There may not be enough shares available to make historical grants, and shareholders may be particularly sensitive to further dilution through equity incentive awards. In these circumstances a more nuanced course may be required and every component of the program may be on the table for reevaluation.

Annual incentives can be rebalanced. They may need to reflect the reality of possibly poor financial performance over the short term and reward executives for achieving the operational goals needed to keep the organization moving forward and perhaps better positioned for success when the market turns. This can be tricky because it involves plan changes or the use of discretion. In the long-term program, cash may be used in place of equity, more emphasis may be placed on time-based awards, performance periods may be shortened, or compensation may be shifted more heavily to short-term incentives. In some cases, compensation may simply need to be cut back temporarily. It is important to balance any increased number of shares or cash with a look at your plan reserves and liquidity, and to understand the anticipated reaction of shareholders and proxy advisors. Modeling some of the considered changes is always a good idea.

Whatever the solution, to be successful, clear and constant communication on the rationale of the plan is critical and should include the compensation committee, the full board, management, and shareholders.

Q. To that end, what can companies do to head off external pushback?

A: Proxy advisory firms do not typically place the same importance on executive retention as do compensation committees. They also expect to see compensation decline as industry fortunes decline. Bonuses should not be paying out above target and both grant values of equity awards and numbers of shares granted should be declining. Perhaps most troubling, however, is the advisory firms’ reliance on grant date equity values in evaluating the alignment of pay with performance. Their models do not account for the fact that in an industry downturn, equity awards granted to management over the past three years are typically worth much less at the time of measurement than they were at the grant date.

Faced with these challenges, companies mired in a downturn not only have to be concerned with executive retention and engagement, but they have a significantly increased risk of external pushback for any compensation decisions that do not involve cutting back compensation for their named executive officers.

Once again, communication is critical. Management should set expectations with the compensation committee about the potential range of outcomes for any anticipated changes. If changes are being considered early enough in the year, off-season outreach to the advisory firms may be beneficial—to discuss company strategy, rationale for change, and to better understand how solutions may be crafted to
address internal needs while mitigating advisory firm concerns. Companies nearing the end of the fiscal year should also be testing outcomes under advisory firm models, anticipating potential problem areas, and tailoring the narrative and charts in the compensation discussion and analysis (CD&A) to address those concerns.

Finally, and most importantly, don’t miss out on opportunities to discuss the alignment of compensation and strategy with key shareholders. Opening a regular line of communication with shareholders is perhaps the best defense against the disruption that can be caused by an unexpected negative vote recommendation from an advisory firm.

About David Bixby

David Bixby is a managing director in Pearl Meyer’s Houston office with more than 15 years’ experience advising compensation committees and management teams on compensation program design and governance. Mr. Bixby consults extensively with compensation committees and senior management teams on the assessment and design of executive and director pay programs, compensation strategy and philosophy development, annual and long-term incentive plan design, employment and severance agreements, pay and performance alignment, competitive pay analyses, and corporate governance. He has worked with both public and private companies of varying sizes across a range of industries, with a focus on oil and gas and the broader energy sector.

Prior to joining Pearl Meyer, Mr. Bixby was a senior consultant in the Houston office of Towers Perrin (later Towers Watson). He is a member of WorldatWork and the National Association of Stock Plan Professionals (NASPP). He is a Certified Executive Compensation Professional (CECP), and is a member of Board Advisory Services for the National Association of Corporate Directors (NACD).

Mr. Bixby holds a BA in Economics and an MBA from Rice University.

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.