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Expert Updating and Guidance on Reward & Corporate Governance

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New Year's Remuneration Resolutions

As businesses get back to work Cliff Weight, ECB advisory board member, author of the Directors' Remuneration Handbook and director of ShareSoc, takes a personal look back at 2020 and forward to 2021, with six rousing calls for action from remuneration committees.

2020 was a roller-coaster for remuneration committees. The FTSE100 index entered 2020 at 7,542.40. By the start of the first lockdown in March, it had dropped to 4,993.90, a fall of 34 per cent. At year-end 2020, the FTSE has risen to 6,460, up nearly 35 per cent from its low, but 14 per cent below where it was at the start of the year. In contrast, US (S&P) was up 13 per cent in 2020 (in $ but not so good in £) and NASDAQ up by nearly 50 per cent.

But averages only tell part of the story of winners, losers and survivors. A number of pharma, high tech and media companies did very well, such as Novacyt, Synairgen, Zoom, Tesla and Amazon.

In the midst of all the turmoil, remuneration committees had to deal with the perennial triumvirate of attracting, retaining and motivating the talent needed to keep their businesses running successfully. All in the face of a virus, the likes of which have not been seen before and unanswerable questions: what effect will the pandemic have on our business, our suppliers, our markets, investors and life in general?

So, here are my six remuneration resolutions for 2021:

1. Skin in the game

Since I retired as a remuneration consultant I have a new hobby: investing in shares. This has given me a new and great insight into remuneration. The issue of alignment with shareholders and its sister issue of agency theory are in my headlights and central to whether I want to buy and hold a company's shares.

I like to see skin in the game. Remuneration committees should focus on skin in the game. If the directors are willing to invest their money in the company then this is a good sign for other investors. If they are not, then I invest with care, nay suspicion.

Over a successful long-term career, mid-level and senior executives should build up a significant ownership stake in the company in which they choose to work.

New hires may not be able to afford to buy significant ownership stakes, so they should be given options, because these asymmetric remuneration vehicles deliver upside alignment and incentives. There is an asymmetric incentive effect of options, but it is for the remuneration committee and the board to monitor, vigorously challenge and control executives to ensure that undue risk is not created. The alternative of new hires with high salaries and no accountability does not bear thinking about.

2. ESG: do what you say, say what you do

Green is good. Climate change is bad. CO2 emissions will raise temperatures. Hotter Earth will melt polar ice. Sea levels will rise. People will die in low-lying areas. Mass migration will lead to more deaths. Water wars will happen. The economic loss is incalculable.

ESG is crucial. So, ESG performance measures should be part of both annual and long-term incentive plans. The introduction of such measures sends a powerful signal of what is important in the organisation (don't forget the power of sign, symbols, systems, strategy, and so on to convey what you want people to do).

There is no point changing your incentive plan unless you shout about it from the rooftops. A footnote in the annual remuneration report fails the test. If you really mean it shout about it.

A case study is relevant here. Aviva has an ESG problem: governance. It proposed to cancel its irredeemable preference shares, a reckless and irresponsible act the knock-on effects of which caused investors losses of a billion pounds or more. It is now proposing to review its remuneration policy. I have written an open letter to Aviva on behalf of individual investors to say they need to claw back previous bonuses - Aviva and others need to do what they say. A trivial reduction in bonus in 2018 is not enough; it fails to reflect the seriousness of the FCA censure.

The ESG star will continue to rise; so have a clear view about how the business impacts the environment and society and about the appropriate corporate governance framework for the business. Assess the extent to which measurable and relevant ESG targets can be built-in to pay.

3. Motivate, retain, attract and exit at reasonable cost

My third resolution is go back to basics. The old goal of remuneration was "attract, retain and motivate". In these modern media times, you have to put the most important first. So the order must be motivate, retain and attract. Also the fourth goal of exit, also at reasonable cost must be added.

At the beginning of each year the remuneration committee should ask itself "how well did we do against these goals last year and do we need to do anything different next year"?

4. Specify your CEO's role and remunerate accordingly

Steward or entrepreneur? The question is over-simplistic, but highlights the issue. What do you want the CEO to do? What is the strategy of the company and what is it that the CEO must do to make it happen?

Some investors will focus on preservation of capital. The emphasis will be on the stewardship aspect. Rewards should be in shares held for substantial amounts of time. The focus is on teams, not superstars or oligarchs. Options and highly geared incentives are not needed here, but skin in the game is still crucial, albeit with a much longer-term focus.

If the company is in a growth phase, then different incentives are needed. Investments will need to be made, managed and returns optimised. With start-ups and companies where profits are low, then cost control is crucial and salaries and bonuses should be de-emphasised, with most of rewards resulting from shares price increases. In such cases, options, growth shares and highly-geared LTIPs should be considered.

5. Adapt remuneration to fit the CV19 spectrum: from growth via battle on to mothball

Some companies do not need to adjust their remuneration plans because of the pandemic. The impact has been positive for some companies and disastrous for others. Some have only had a bit of impact. I call this the CV19 spectrum. As noted above, a number of pharma, high tech and media companies have benefited. Incentive plans will be well in the money. The remuneration committee needs to focus on retention and the delivering the next phase of growth.

Bars, hotels, leisure and travel have suffered hugely and some operations have been mothballed. Cash flow management and fund raisings have been crucial. Remuneration has not been a priority. But if these businesses survive, then the remuneration committee will need to work hard to get the rewards right.

6. Use judgement

I have never been a fan of formulaic annual incentive plans. These pandemic times have shown how unpredictable life can be. So the exercise of judgement and discretion may be warranted.

One word of warning. Remuneration committees should keep a record for at least the past 10 years (for large companies, but for smaller dynamic companies a shorter time series may be OK). This will show when adjustments have been made, how many and by how much.

It will highlight if adjustments have only been in favour of management. You should have a policy of adjustments averaging to zero, not to be net positive to management.

In summary, carefully evaluate your circumstances and do what it is right for you.

Retention In M&A - New Survey

Willis Towers Watson reports that 166 organisations across 18 countries and eight industry sectors representing a combined total of 800 completed transactions in the last two years participated in a recent survey. Most of the survey participants are large publicly listed serial acquirers that purchased smaller, privately held companies; about half of the transactions covered had a purchase price of less than $250 million and many of these deals focused on the acquisition of key skills and talent.

The most common retention tool remains a straightforward pay-to-stay approach, used by 84 per cent of survey respondents. This is typically in the form of a time-based (as opposed to performance-based) cash bonus (as opposed to shares or options), denominated as a percentage of base salary (as opposed to a fixed amount) and paid 100 per cent at the end of the retention period, which was reported as somewhat longer in 2020 than it was in 2017.

In addition to cash retention bonuses, many companies also use a variety of financial and nonfinancial retention tools.

Budget and individual awards:

- Consistent with findings in 2014 (but higher than in 2017), the median retention budget is 1 per cent to 2 per cent of total purchase price
- The percentage tends to be lower for larger deals. The median award is 60 per cent of salary for senior leaders and 30 per cent to 40 per cent for others. However, practices range widely, with a significant number of companies paying senior leaders an award of two or more times their base salary
- The median coverage is about 5 per cent of the employees in a target organisation, though a significant number of companies cover as many as 20 per cent of the employees in a target organisation

Retention period:

The retention period is typically one to three years post-close, depending on factors such as seniority and criticality. Of note is that one-third of the survey respondents use a three-year period and another one-third use a two-year period - both longer than the typical period seen in the last survey, of one year or less. Using performance criteria in paying retention bonuses is not common. If used, they are typically in the form of earn-outs for owners of the acquired company. More often for senior leaders but still a minority practice, stock awards may be used in lieu of, or in combination with, cash.