Client Briefing

Another Analytical Approach to Making Your 2020 Bonus Plan Work

EXEQUITY

Independent Board and Management Advisors

A few short months ago, and in some cases merely weeks ago, companies established performance frameworks for 2020 incentive compensation plans. Then, seemingly overnight, the COVID-19 pandemic gripped the world and many business forecasts and operating budgets were severely impacted. And, before the end of the first quarter, incentive plan performance goals were suddenly deemed unattainable. While most companies are not currently considering adjusting in-cycle incentive plan performance goals, due either to concerns about external optics or a lack of sufficient context, assessing performance for the purposes of incentive plan payouts will be a deeply deliberated topic during year-end pay discussions.

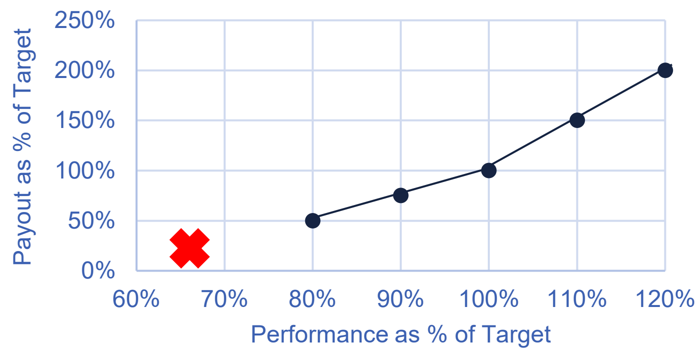
As Exequity observed in our April 8 *Client Briefing* entitled "A Framework for Discretion" (https://www.exqty.com/newsroom/a-framework-for-discretion), we expect that for many companies, incentive plan performance assessment is likely to include the application of backward-looking discretion, informed by a comprehensive review of a variety of quantitative and qualitative factors. However, many companies will likely be uncomfortable with both the ambiguity of an undefined and arbitrary "discretionary" review process and the well-established negative connotations associated with the exercise of discretion in setting pay. As a result, many companies will be looking for well-reasoned, easily articulated approaches to applying discretion.

In Exequity's April 13 *Client Briefing*, "One Approach to Making Your 2020 Bonus Plan Work" (https://www.exqty.com/newsroom/how-covid-19-is-impacting-pay), we identified one type of analytical framework that companies may apply in evaluating 2020 performance while maintaining pre-COVID-19 performance frameworks. Below we offer another analytical approach that leverages an existing performance framework in a slightly different manner.

A Sample Pre-COVID-19 Bonus Plan

The table below summarizes a sample bonus plan design, assuming a single metric and a common pay-for-performance framework.

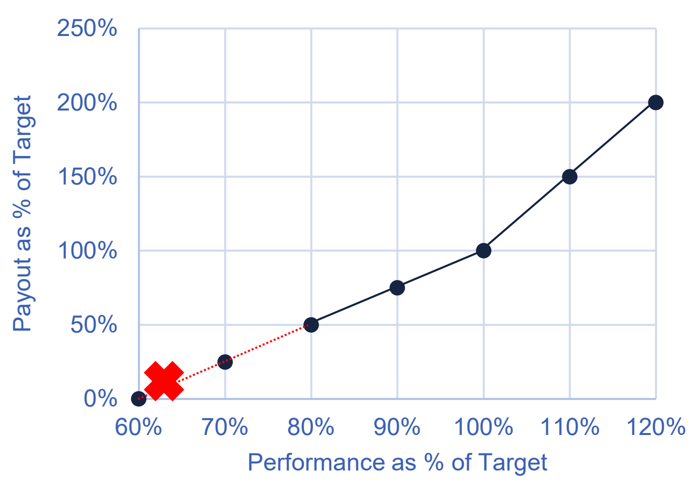
EBITDA Performance		Payout as % of Target
Threshold (80%)	$400M	50%
Target (100%)	$500M	100%
Maximum (120%)	$600M	200%
Assumed 2020 Actual	**$330M**	**0%**
EBITDA of $330M (66% of target) is below threshold and results in a zero payout.		



A Refined Approach That Could Be Applied for the Purposes of Exercising Discretion

Having guided many companies through times of economic uncertainty—e.g., business turnarounds, the recession spanning late 2008 into 2010—Exequity has observed various alternative design concepts. Among those most commonly applied when establishing performance frameworks in particularly volatile or uncertain situations is to broaden incentive plan performance ranges. This same concept can also be applied as part of the application of discretion on the back end as the volatility and uncertainty appeared after original goals had been established. One approach to such an adjustment is shown below.

EBITDA Performance		Payout as % of Target
New Threshold (60%)	$300M	0%
Old Threshold (80%)	$400M	50%
Target (100%)	$500M	100%
Maximum (120%)	$600M	200%
Assumed 2020 Actual	**$330M**	**15%**
Based on the broadened/extended performance range, EBITDA of $330M (66% of target) results in a payout of 15% of target.		



As shown above, this approach starts with the pre-COVID-19 performance framework, while simply extending the pay-for-performance line downward based on the original slope. The upside of this approach is that it is responsive to exacerbated uncertainty and volatility because it increases the likelihood of some payout. Further, if applied mid-year, this approach would restore some degree of performance-based incentive to continue to drive 2020 performance. One downside to this approach is the perception that incentive plan participants are being at least partly, and perhaps inappropriately, insulated from the impact of the pandemic on operating results. Another is that the modest payouts that may result from the modified approach might not be worth the potential negative optics associated with adjusting the performance framework.

As companies deliberate potential approaches such as this, it will be important that they consider the potential carry-over impact on future incentive arrangements. For example, if an approach such as the above provides for payouts that might not otherwise have been conveyed, would a company consider building potential counterbalancing measures into 2021 incentive arrangements? Examples might include:

- Reducing maximum potential payouts (e.g., from 200% of target to 150% of target); or
- Flattening the slope of the performance curve to reduce the likelihood of payouts significantly above target (e.g., maximum payout would occur at performance of 140% of target rather than 120% of target).

Conclusions

Acknowledging that there is not likely to be a generally accepted “best practice” for determining 2020 annual bonus awards, many companies will be seeking creative methods for appropriately rewarding employee performance in a year of unprecedented volatility and uncertainty. To the extent that business performance has generally recovered by Q1 2021, most employees are back to work, and a large portion of lost shareholder value has been restored, incentive plan analytics that are able to somehow isolate or exclude the impact of COVID-19 on financial/operational results are likely to be deemed both logical and reasonable approaches to applying discretion. As always, it will be critical for companies to clearly articulate the rationale for such approaches in executive compensation-related disclosures, and to ensure that pay decisions properly balance considerations related to rewarding employee performance and aligning with shareholder interests.

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