EXECUTIVE COMPENSATION IN TIMES OF UNCERTAINTY

March 2025

Recent tariff announcements and discussions concerning a trade war, along with broader geopolitical risks, are contributing to increased market volatility and economic uncertainty. Although tariffs will affect industries in different ways, the resulting economic uncertainty may lead to reduced consumer spending, and fluctuations in interest and exchange rates could have significant impacts on Canadian companies. As organizations navigate potential changes in share price and financial outcomes caused by tariffs and market volatility, Human Resources and Compensation Committees (HRCCs) might have inquiries regarding the implications for executive compensation design.

Insights gained from the financial crisis and the COVID-19 pandemic can serve as a foundation for considering executive compensation during periods of uncertainty. The areas of focus can be categorized into proactive and reactive measures.

PROACTIVE STEPS

In times of uncertainty, the HRCC may wish to review the executive compensation design, considering the following:

Maintain variability in compensation. To balance maintaining a competitive compensation program with the need to ensure pay programs are affordable during times of challenged performance, it may be appropriate to provide lower merit increases and/or shift a greater portion of compensation into variable pay. Companies could also consider splitting merit increases into multiple periods, with future increases dependent on company performance throughout the period.

Diversify through use of multiple performance metrics. Incentive plans with multiple performance metrics tend to have less volatility in payouts as weaker performance on one metric may be somewhat offset by stronger performance on another. When adding metrics, it is important to ensure weight on each metric remains meaningful (e.g., 20%+).

Introduce other performance metrics. During periods of uncertainty, there may be new areas of focus for the executive team. These may include strategic/operational imperatives that are required for the organization to emerge successfully. Other financial metrics such as cash flow or debt ratios may also be relevant.

Review performance targets. When there is uncertainty around financial outcomes, it can be more challenging to set appropriate targets, and targets that were previously set may no longer be realistic. For short-term incentive awards, if targets are no longer achievable due to economic / market volatility, consider in-year adjustments to ensure incentives remain motivating for participants. It may also be challenging to set longer-term targets, so companies could consider temporarily implementing a practice of setting three one-year targets for Performance Share Units (PSUs) vs. setting a three-year target upfront.

Widen performance ranges. In periods of uncertainty, companies may wish to use wider performance ranges that account for greater variability in outcomes. When reviewing performance ranges, testing various performance scenarios and resulting payouts can help the HRCC become comfortable with the range of possible outcomes.

Balance performance and retention in the long-term incentive plan. Given challenges with setting appropriate long-term targets for PSUs, companies could consider shifting more weight to restricted share units (RSUs) vs. PSUs to increase the retentive value of the long-term incentive plan.

REACTIVE STEPS

In addition to reviewing the go-forward executive compensation design, adjustments to outstanding awards may be warranted.

Structured Discretion

Unforeseen economic / market impacts may require HRCCs to consider the use of discretion to ensure payouts are appropriate. When contemplating the use of discretion, consider the following:

Review regularly. It is common for the HRCC to receive regular updates on how the company is tracking against incentive plan metrics. These regular updates (e.g., quarterly) provide an opportunity for the Committee to discuss what is driving performance, the impact of economic / market conditions, and potential adjustments to incentive plan payouts. Although final decision making is reserved for year end, regular touchpoints can allow the HRCC time for thoughtful discussions and more informed decision making.

Use a framework. A framework for the use of discretion can support the Committee in its decision-making responsibility by helping to think through various considerations and perspectives and also providing a range of potential adjustments (e.g., +/-20% to 30%). This can lead to more balanced outcomes and support with communicating decisions to stakeholders (e.g., executives, investors).

Consider positive and negative discretion. While discretion is most thought of in terms of positive discretion (i.e., adjusting calculated payouts upward), discretion should be considered in terms of both positive and negative adjustments. For example, during the COVID-19 pandemic, some companies were less impacted financially and had incentive plan payouts with calculated outcomes well above target. Given global circumstances, some HRCCs did not feel these payouts were appropriate, and used negative discretion to cap payouts at target. Uncertainty may also cause companies to adjust performance targets in anticipation of poorer than expected financial outcomes, which may end up having not been necessary.

Communicate clear rationale. When performance is challenged, executive compensation is more likely to be scrutinized. Therefore, when communicating the use of discretion, the HRCC should clearly outline their decision-making process and rationale for applying discretion. Clear rationale can help shareholders to understand the Committee's perspective and minimize negative publicity.

Retention Awards

During periods of uncertainty, share price performance may be challenged. In this case, outstanding long-term incentive awards may have substantially reduced value or be underwater, thus reducing their retentive value. An equity holding analysis can summarize the leave behind (what would be forfeited if they resign) and walk away (what can they take with them) values by executive to potentially assess the degree of retention risk. In this scenario, it may be appropriate to grant retention awards (e.g., RSUs) to key employees where there is a business continuity risk. These awards are typically granted on a selective basis, with special consideration of disclosure impact for Named Executive Officers (NEOs), given that shareholders and their advisors (ISS and Glass Lewis) are generally skeptical of special awards and will carefully consider their use on a grant-by-grant basis.

FINAL THOUGHTS

It can be challenging to predict how tariffs and market volatility will impact companies' financial and share price performance. At this time, many companies have just been through year-end performance discussions, with salary increases awarded and 2025 incentive plans communicated. This, and continued uncertainty about the scope and timing of tariffs, may suggest a "wait and see" approach. Monitoring performance closely, understanding the potential effect of external factors, and reviewing executive compensation program impacts can ensure the HRCC is prepared to respond if necessary.

ABOUT US

Southlea Group is a national independent compensation consulting firm that provides global perspectives as a GECN Group company working with over 150 compensation professionals in fifteen countries. We are headquartered in Toronto with offices in Montreal and Vancouver and clients across Canada, representing all industries and organization structures. Our team of advisors is multi-disciplined with diverse backgrounds and experiences. We are proud to be a certified Women's Business Enterprise by WBE Canada and to be Rainbow Registered as an LGBT+ friendly organization.

We would be pleased to address any questions and/or explore how we can support your challenging compensation needs. Please email us at hello@southlea.com and we will follow up to set-up a time to discuss further.