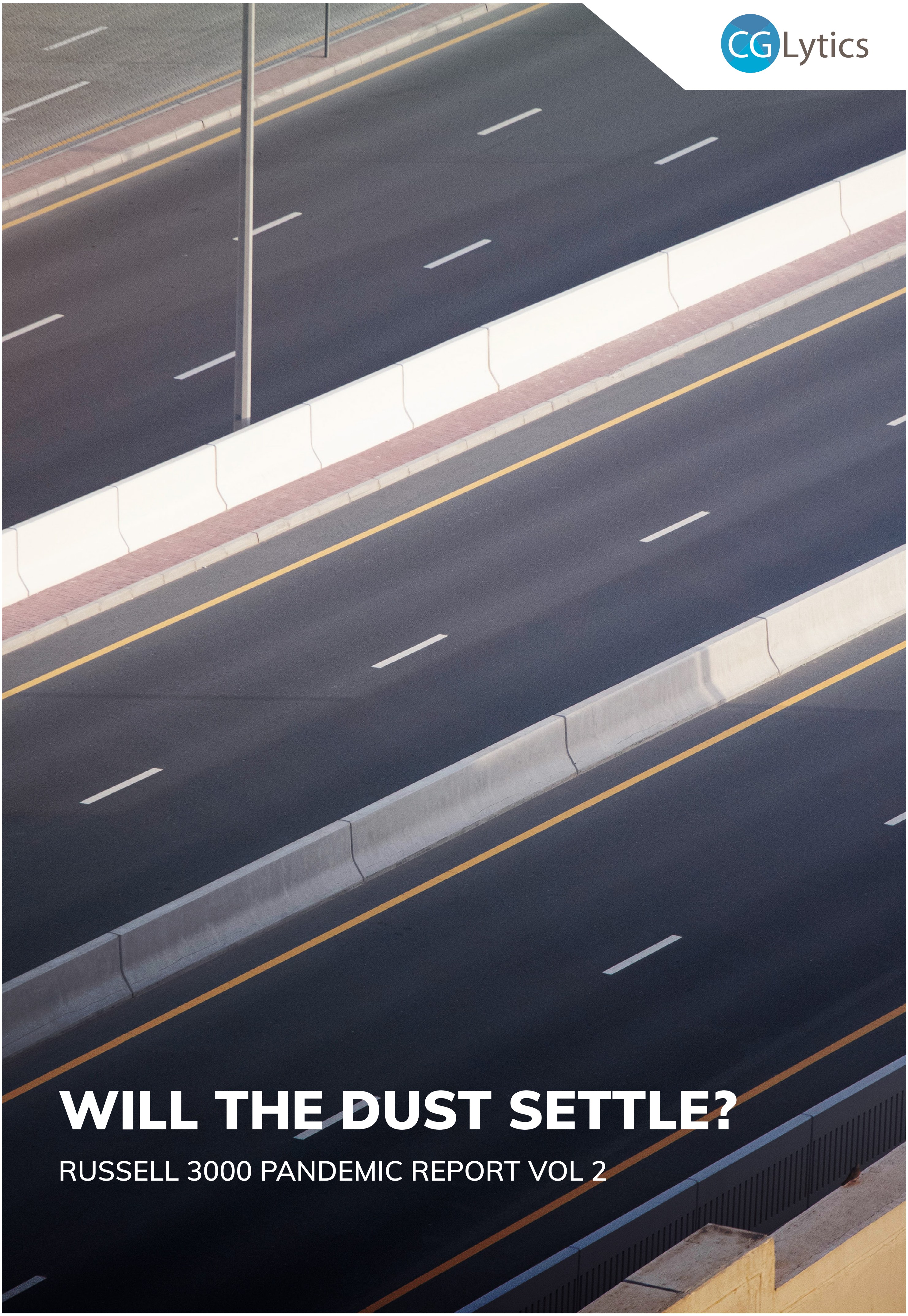

WILL THE DUST SETTLE?

RUSSELL 3000 PANDEMIC REPORT VOL 2

About CGLytics

CGLytics is transforming the way corporate governance decisions are made, for effective oversight and competitive edge. Combining the broadest governance and executive compensation data set in the market with powerful analytics tools, CGLytics enables organizations to make better informed, data-driven decisions.

CGLytics provides real-time data for an independent analysis of companies' governance practices including peer benchmarking, executive compensation analysis, proxy advisor models, and board effectiveness scores. CGLytics is the source of global compensation data and analytics for Glass Lewis' voting recommendations and is a trusted Diligent partner.

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Introduction

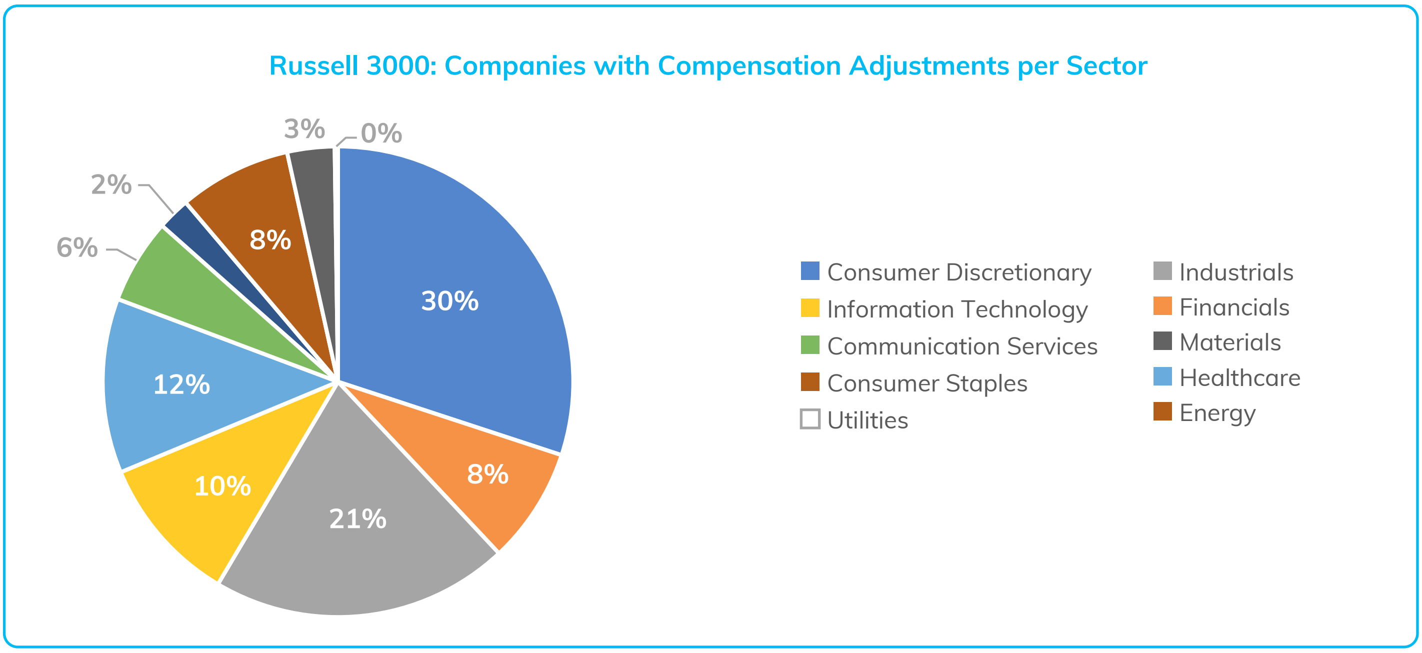
Although 2020 has ended, the impact of COVID-19 on society, the economy, and businesses continues to linger. While some businesses and their stock prices are well on the road to recovery, thousands of others are still struggling to survive. As a result, many businesses are putting cost containment measures in place to help them stay afloat; furloughs and salary freezes are being extended, and lay-offs are being increased. During this time when employees and the bottom line are taking a hit, the issue of executive compensation is garnering more attention than ever.

Executive Compensation Adjustments – An Overview

Up until May 2020, we saw 554 companies listed on the Russell 3000 Index issue some type of pay adjustments to executives and to their board of directors. Our previous Russell 3000 report examined the pay actions taken by these companies and questioned whether enough is being done in light of the pandemic.

Since then, we have seen a total of 762 companies listed on the Russell 3000 index issue some type of actions to executive compensation due to COVID-19. In particular, 647 companies have adjusted executive base salary and/or board of director fees, 115 companies announced changes to incentive plans, and 132 companies took measures regarding both base salary and incentive plans.

The graph below shows the sector breakdown of companies, which implemented changes to executive compensation, including base salary reductions and changes to short- and long-term incentive plans. Consumer Discretionary, which includes Hospitality, Restaurants & Leisure, Retail, and Industrials, which includes Airlines, have been the hardest hit sectors by the pandemic. Evidently, these two sectors have seen the majority of actions taken on executive compensation, despite them comprising about a quarter of the companies on the Russell 3000.



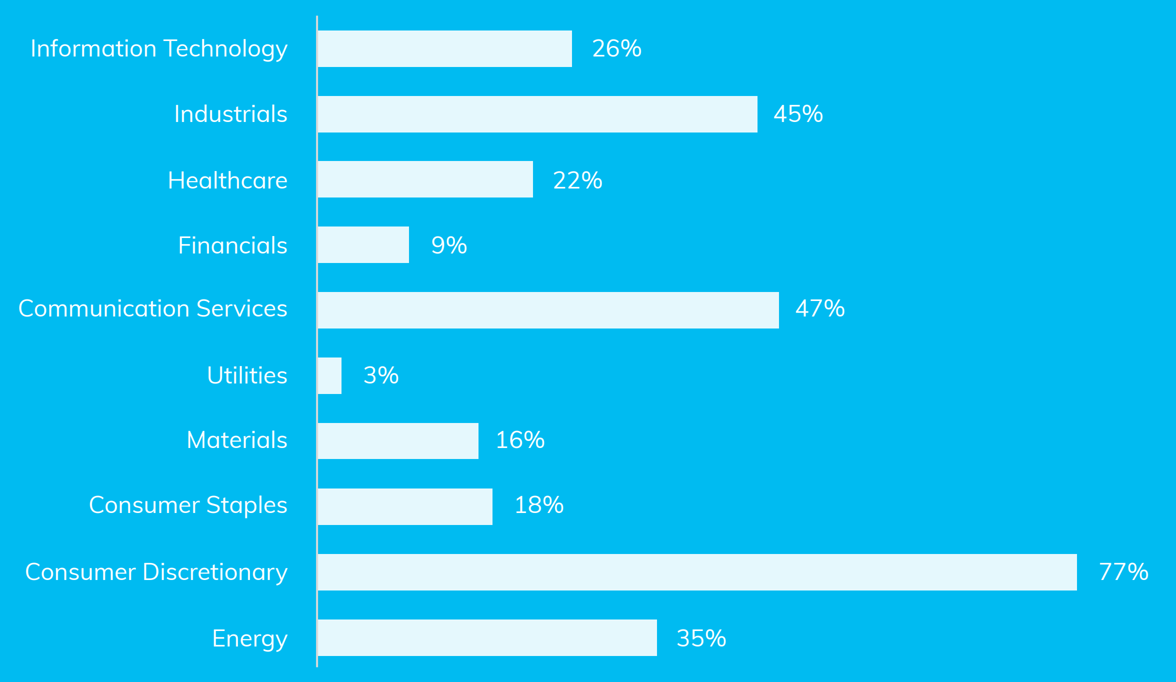
In fact, about 77% of Consumer Discretionary companies on the Russell 3000 have imposed some type of adjustments to their executive compensation plans, and 45% of Industrials companies have done so.

Interestingly, Healthcare, though not a hard-hit industry, has been the sector with the third highest number of companies enforcing executive pay changes. Additionally, the Communication Services sector, generally less impacted by the pandemic, has seen nearly half of its companies on the Russell 3000 making executive pay adjustments.

Utilities and Consumer Staples (Food, Household, and Personal Product companies) remain the least affected sectors as sheltering at home continues. As a result, the least number of companies from these sectors took actions to reduce executive compensation.

In the following sections, we will discuss in detail each change made to executive compensation in light of the pandemic.

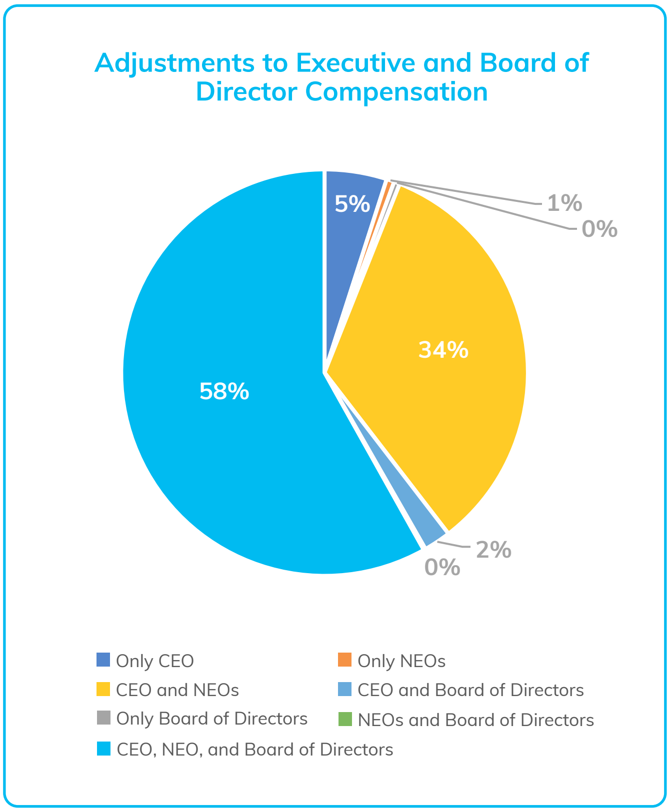
Russell 3000: Percentage of Companies with Compensation Adjustments per Sector vs. Total Number of Companies per Sector

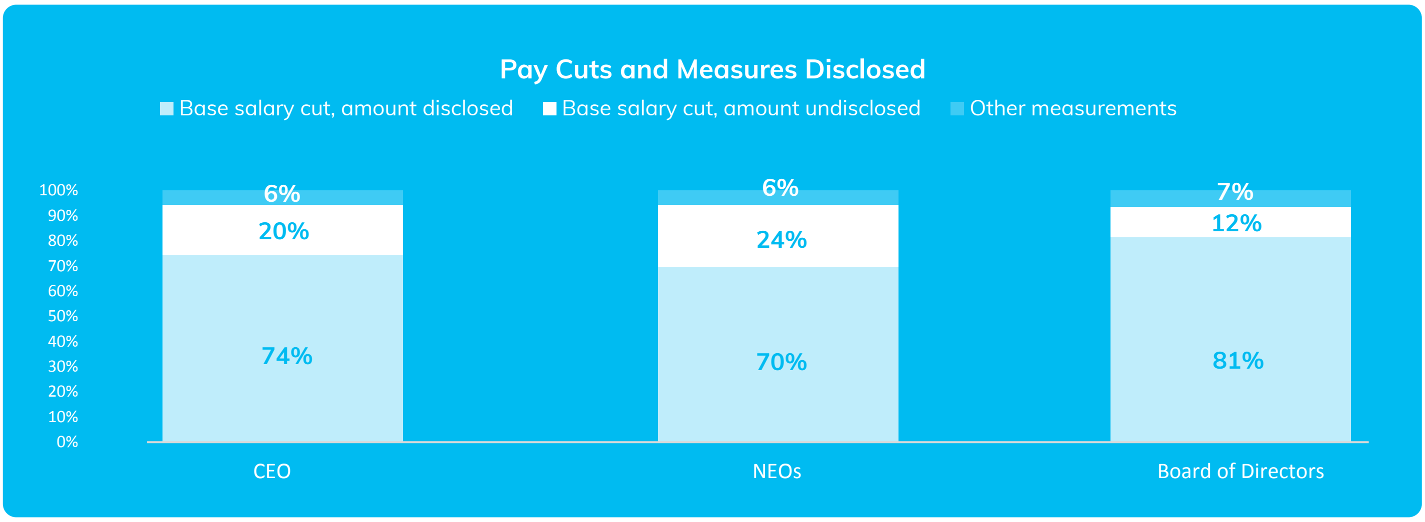


Adjustments to Executive and Board of Director Base Compensation

As discussed in our previous report, measures regarding base salary and/or director cash fee have been widely adopted by companies to immediately preserve cash. Of the 647 companies in the Russell 3000 that exercised changes to base salary as of November 31, 2020, 58% adjusted base pay for the CEO, Named Executive Officers (NEOs), and the board of directors. Over a third of companies adjusted salary for only executives and 5% changed salary for only the CEO.

Most of the changes to executive and board of director base salaries and fees were in the form of direct reduction, ranging from 10% to 100%. However, not all companies disclosed exactly how much of a cut their executives and directors are taking. Of the companies that imposed base salary changes affecting the CEO, one-fifth did not disclose the specifics of the pay reduction. That number is 24% for NEOs and 12% for the board of directors. A number of companies (41) utilized different measures to base salary, mainly deferral of base salary, payment of base salary in Restricted Stock Units (RSUs), or a combination of two measures, such as base salary cuts and deferral of salary. A small group of companies (22) also opted to defer board fees or pay them in RSUs.

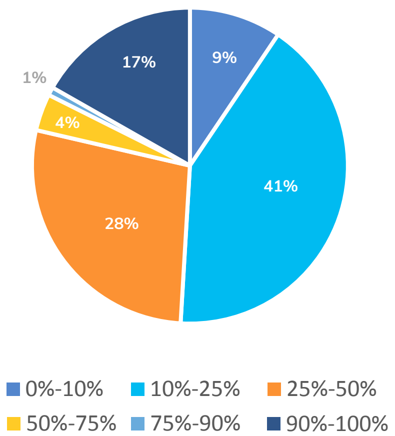




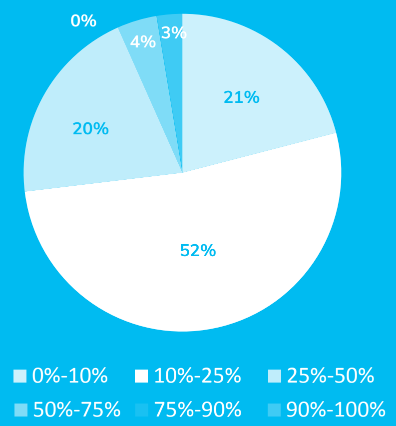
Adjustments to Executive and Board of Director Base Compensation

Looking at companies that disclosed base salary reductions, we computed the annual figure of the cuts based on the announced length of time of the cuts and found that nearly 22% of the companies reduced their CEO's annual base salary by more than 50%. About 17% of companies cut the CEO's base salary completely for the full year. Furthermore, on an annual basis, most base salary cuts are only within the 10%-25% range.

CEO Annualized Base Salary Reduction



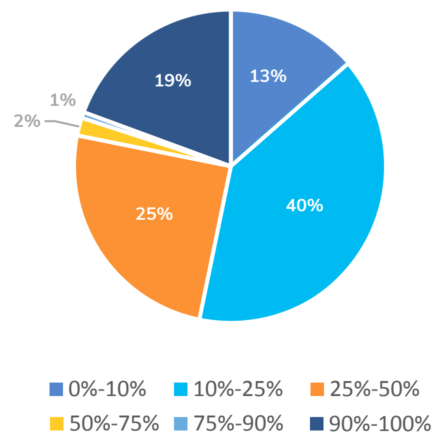
NEO Annualized Base Salary Reduction



Almost three-quarters of the base salary cuts for NEOs are below 25%. Similar to CEO cuts, annualized reductions for NEOs are primarily between 10% and 25%. Merely 3% of companies reduced annual base salary for NEOs between 90% to 100%.

Board of director cash fee reductions follow the same trend as CEO base salary reductions. 22% of the companies slashed board fees by more than half and nearly one-fifth of companies cut 100% of cash fees for directors.

Board of Directors Annualized Base Salary Reduction

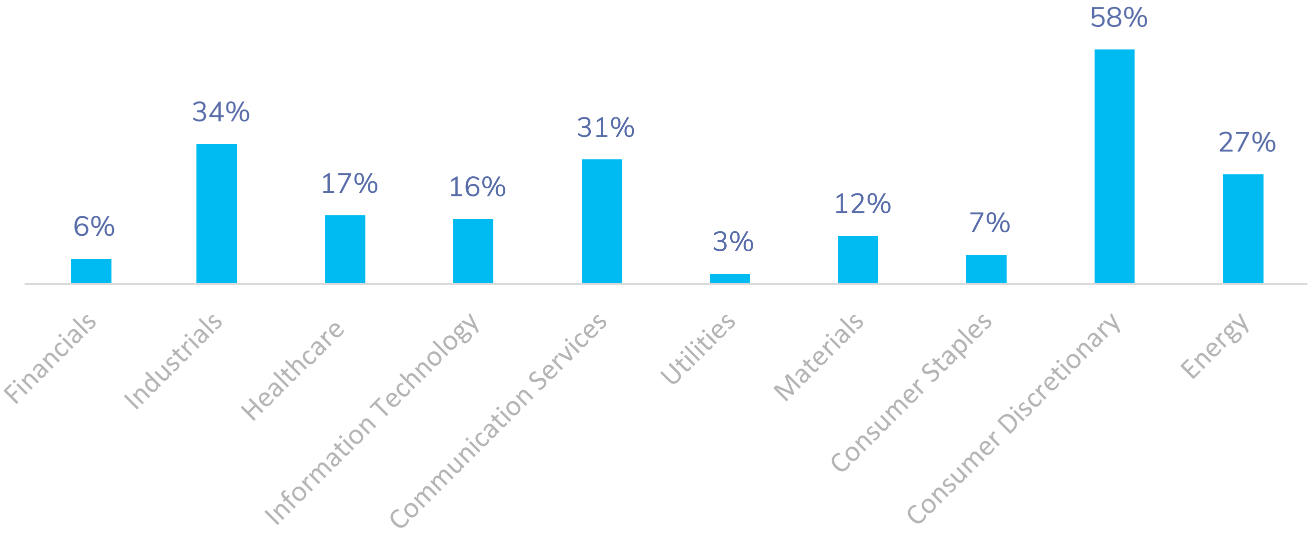


Adjustments to Executive and Board of Director Base Compensation

So far, 58% of the companies within the Consumer Discretionary sector in the Russell 3000 have declared some form of base salary adjustments to executives and/or to the board. Comparatively, in the Industrials sector, our data suggests that 34% of the companies have also issued base pay adjustments to their board of directors, NEO, and/or CEO pay. Both figures have increased since May 2020 as the pandemic and its related restrictions prolong

On the other hand, only 3% of the Utilities companies and 7% of the Consumer Staples companies have implemented base salary reductions to executives and/or their boards, as these essential sectors were less impacted by the pandemic.

Russell 3000: Percentage of Companies with Base Salary Adjustments per Sector vs. Total number of Companies per Sector

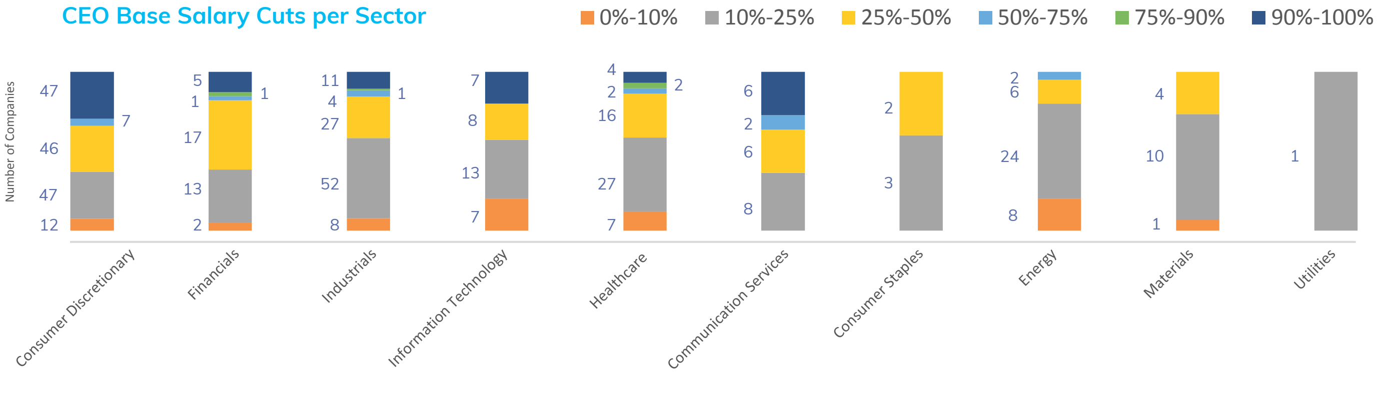


Pay Reductions in the Hardest Hit Industries

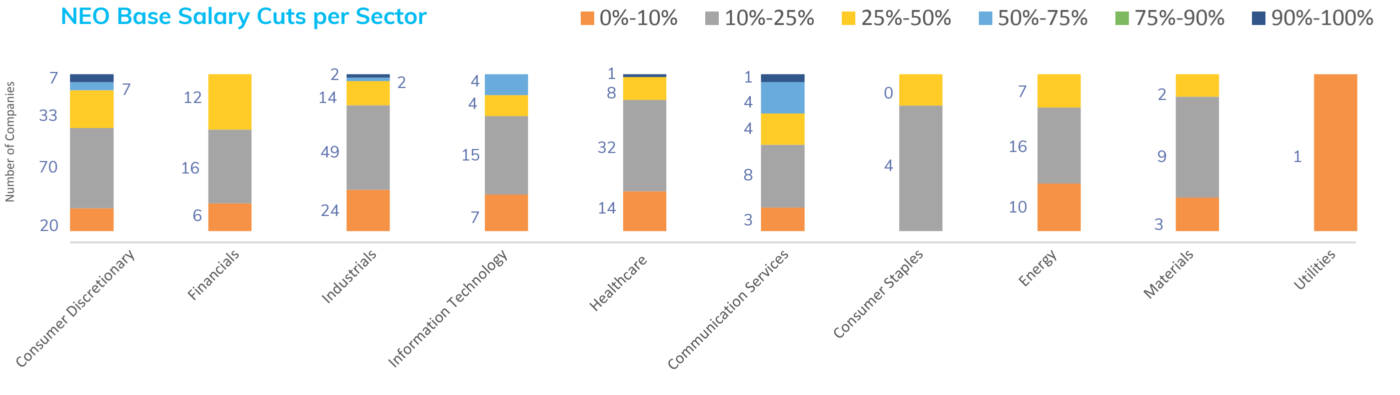
Considering only the companies that referred to specific compensation cuts, Consumer Discretionary CEOs received relatively the highest annualized base salary reduction than CEOs in any other sectors. 47 CEOs in this sector gave up 100% of their base salary for the whole year. Cash fee reductions for the board of directors in this sector follow the same pattern; over one-third of the boards of directors in the Consumer Discretionary sector had their annual fees cut by 100%. In contrast, annualized base salary reductions for NEOs in this sector are generally milder, primarily between 10% and 25%.

The picture is quite different for the second hardest hit industry – Industrials. The majority of the annualized salary and board fee reductions in this sector are under 50%, and most fall between the 10%-25% range. Nevertheless, most Industrials companies that cut salary and board fees completely for a year are Airlines and Transportation companies, who have seen disruption from the pandemic.

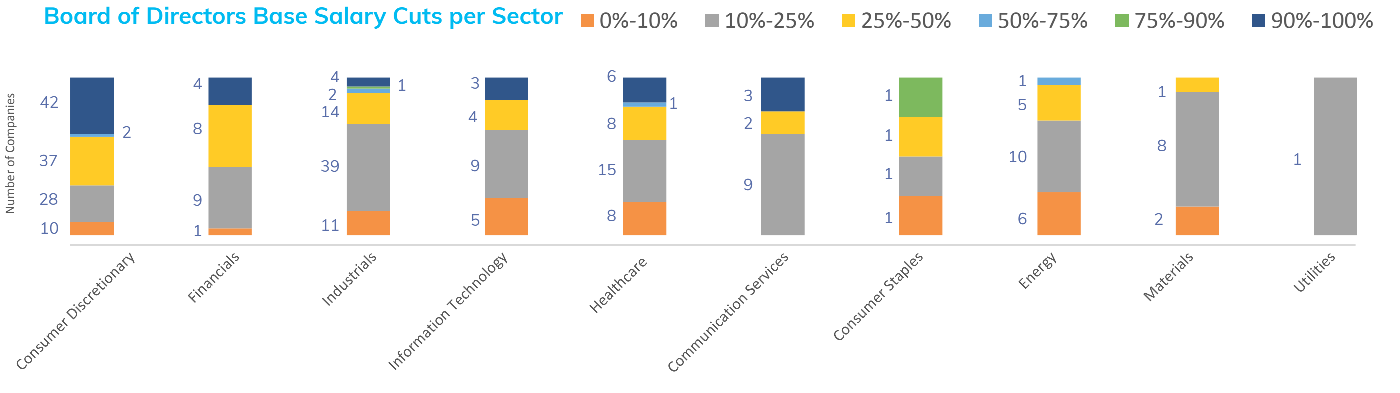
CEO Base Salary Cuts per Sector



NEO Base Salary Cuts per Sector



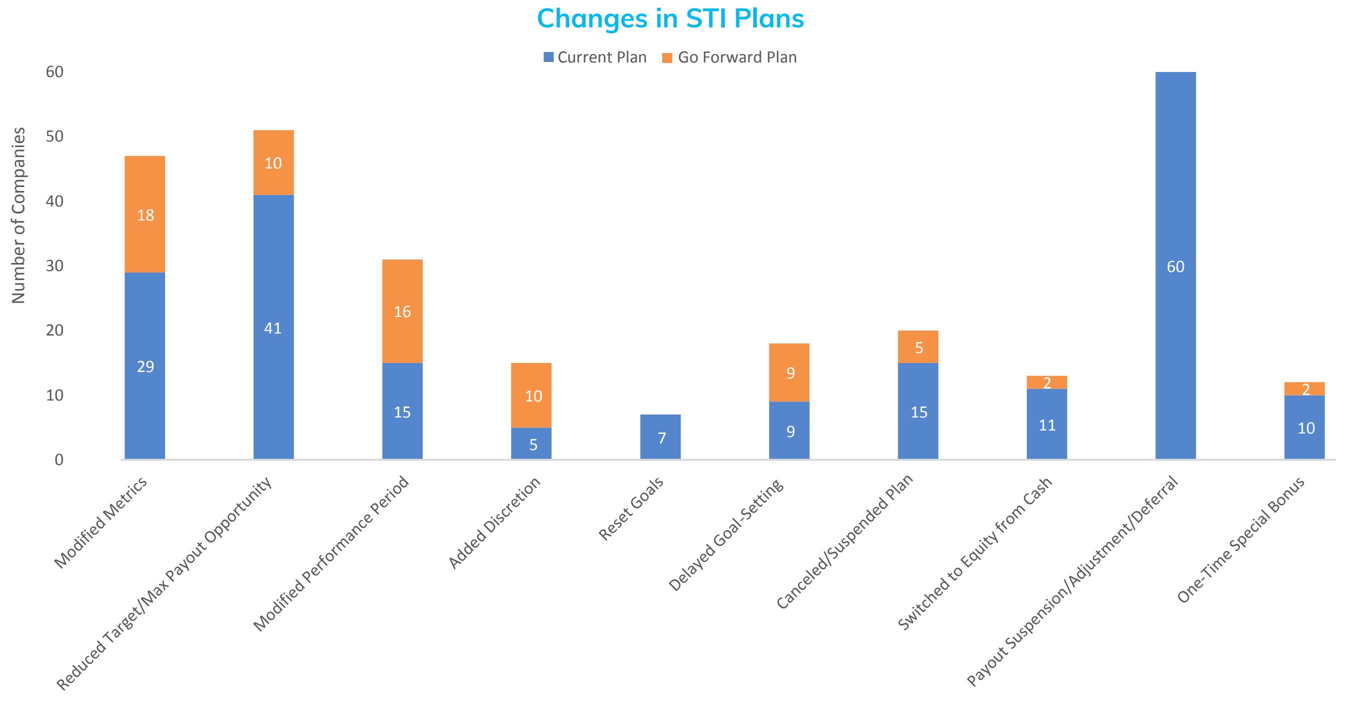
Board of Directors Base Salary Cuts per Sector



Adjustments to Executive Incentive Plans

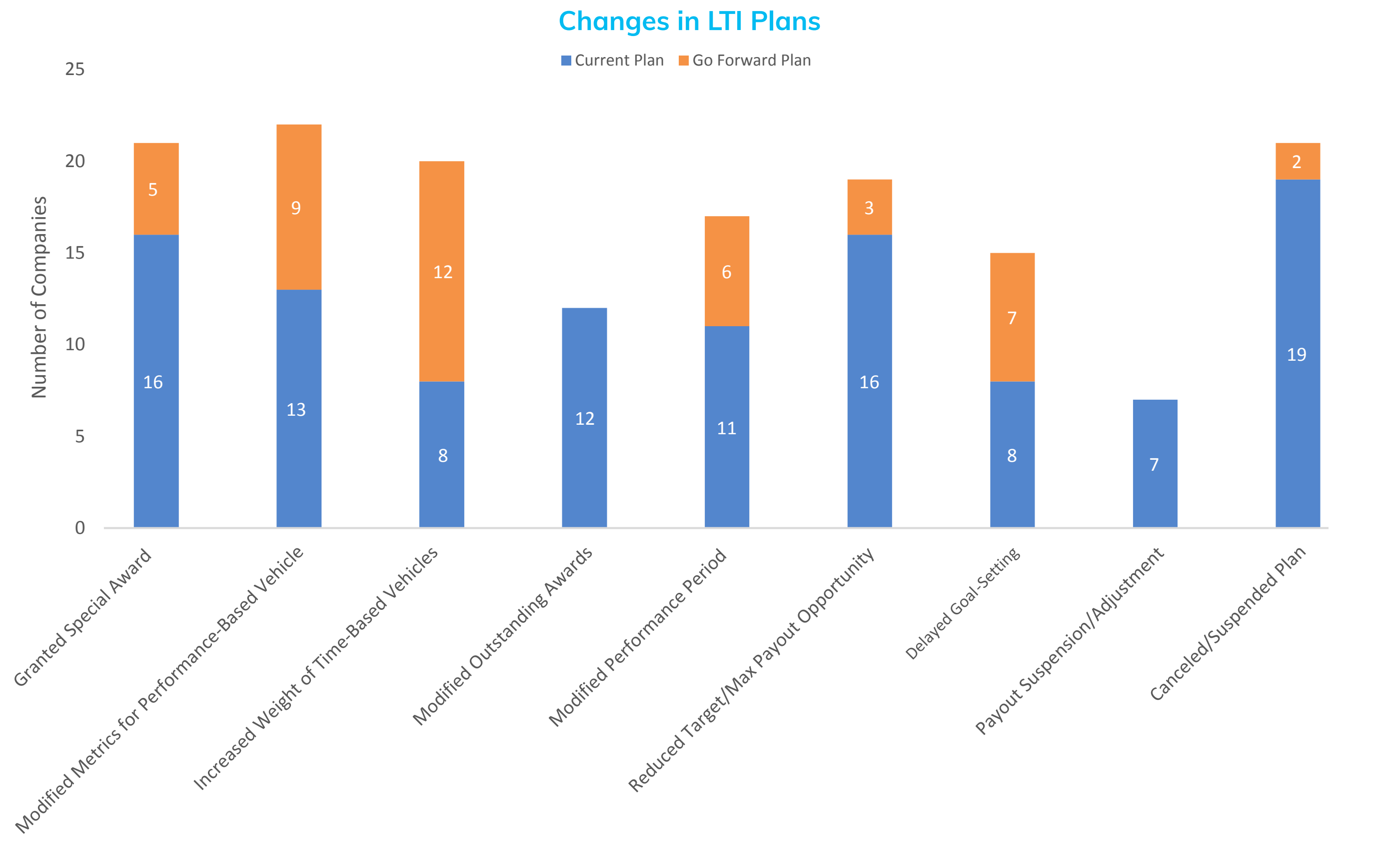
As the financial and non-financial impact of COVID-19 is becoming clearer, 246 companies have adjusted their incentive plans to reflect an unusual performance year. We have identified 10 types of adjustments that were made to Short-Term Incentive (STI) plans and 9 types of adjustments that were made to Long-Term Incentive (LTI) plans.

Most companies applied these measures to existing plans, which will affect 2020 compensation. Some other companies decided to change the plans going forward starting with the next fiscal year.



The most common changes to STI plans were the suspension, adjustment, or deferral of 2020 STI payouts, which was used by 60 companies, followed by reductions in Target and/or Max payout of STI. 47 companies also modified performance metrics to reflect the extraordinary economic situation.

Some of the modifications are the use of two separate six-month performance periods instead of the full year and an increase in weights of strategic and non-financial objectives that are less susceptible to the impact of the pandemic.



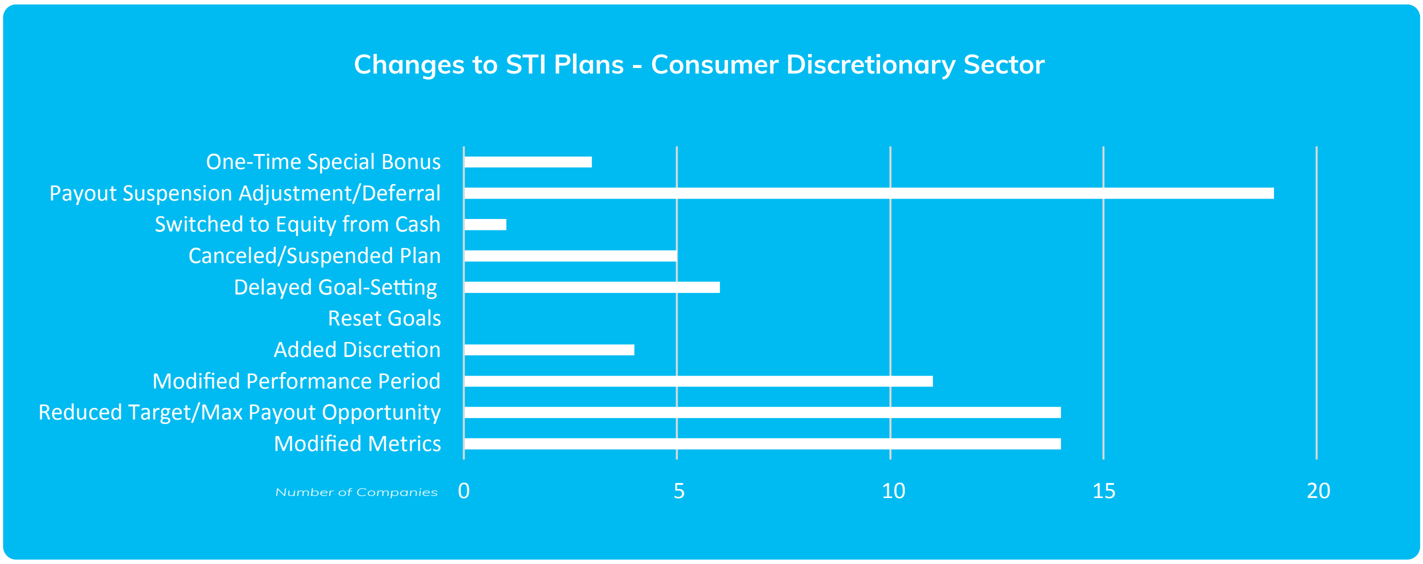
Fewer changes were made to LTI plans compared to STI plans. Most companies modified metrics attached to performance incentives and canceled/suspended LTI plans. New metrics for performance vehicles favor relative performance evaluation such as Relative Total Shareholder Return measured against peers, rather than absolute metrics that were hit hard by business disruptions.

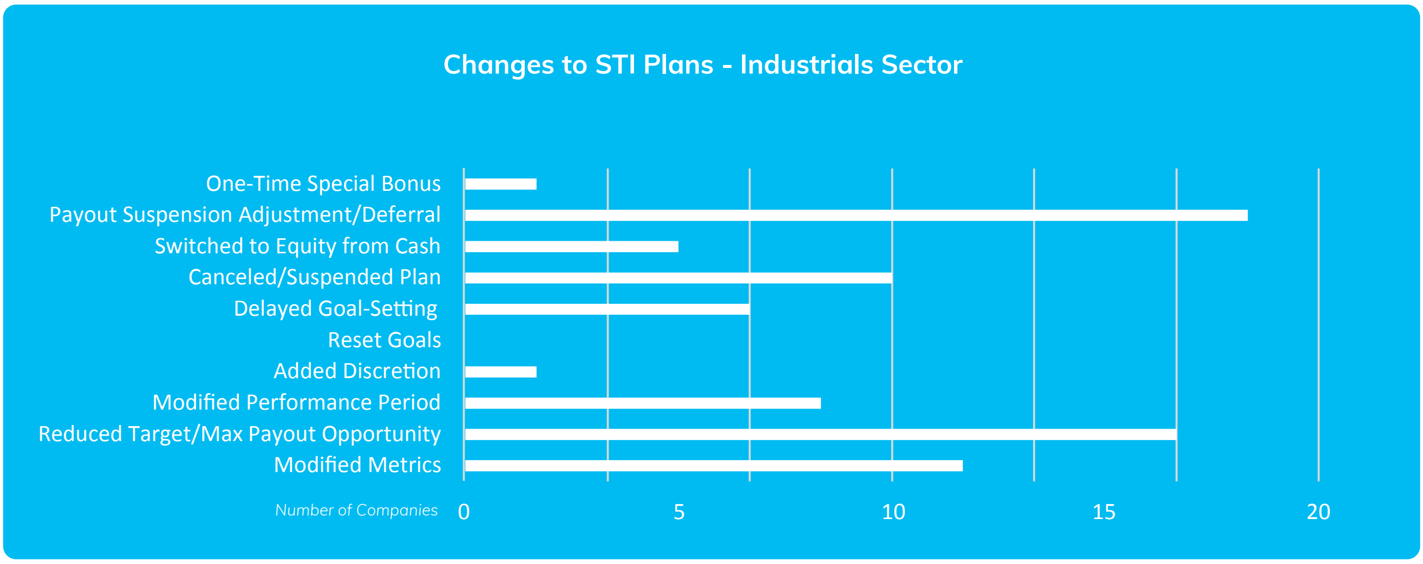
To mitigate the impact of COVID-19 on long-term compensation and for retention purposes, some companies chose to increase the weight of time-based vehicles for executives. Special grants are another instrument used to retain key executives. However, these special grants raised questions as to whether they are just a means to compensate executives who are supposedly "sacrificing" their salaries.

Adjustments to Executive Incentive Plans in the Hardest Hit Industries

Consumer Discretionary and Industrial sectors remain the top industries in which the most companies made adjustments to executive incentive plans.

Of the 246 companies that modified incentive plans due to COVID-19, 27% are in the Consumer Discretionary sector, and 17% are in the Industrials sector.

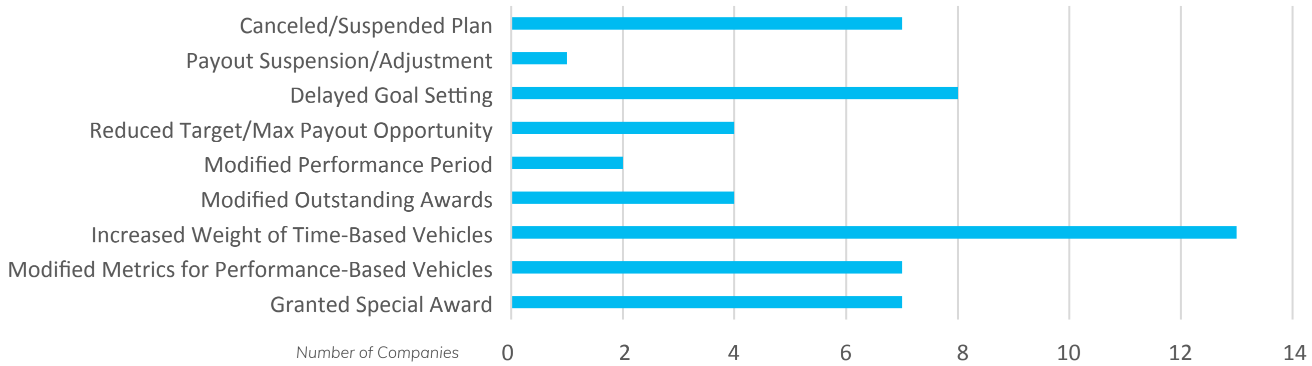




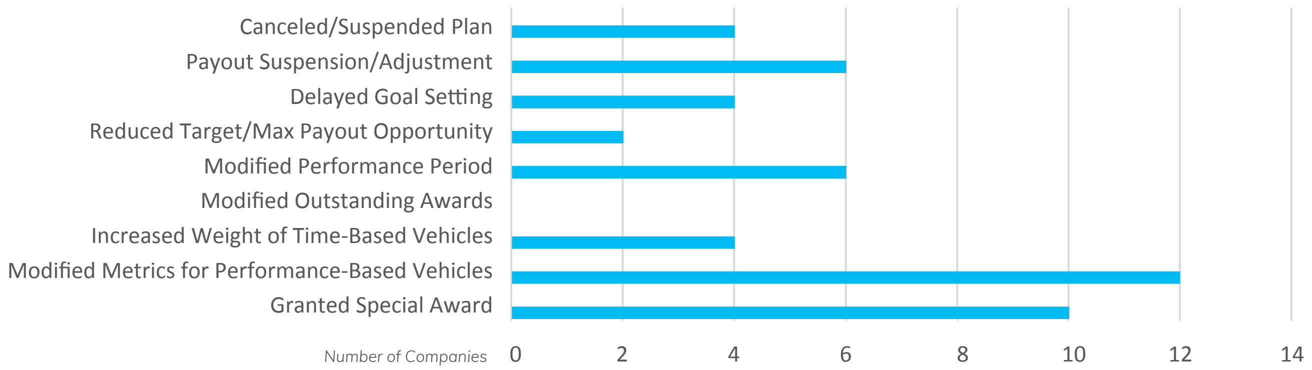
In terms of changes to STI plans, most Consumer Discretionary companies suspended or deferred payout with regards to 2020 performance. Most Industrials companies used the same measure.

Adjustments to Executive Incentive Plans in the Hardest Hit Industries

Changes to LTI Plans - Consumer Discretionary Sector



Changes to LTI Plans - Industrials Sector



For LTI plans, the most common change that the Consumer Discretionary sector implemented was the increased weight of time-based vehicles. For the Industrials sector, the data suggests that most companies changed metrics for performance equity grants.

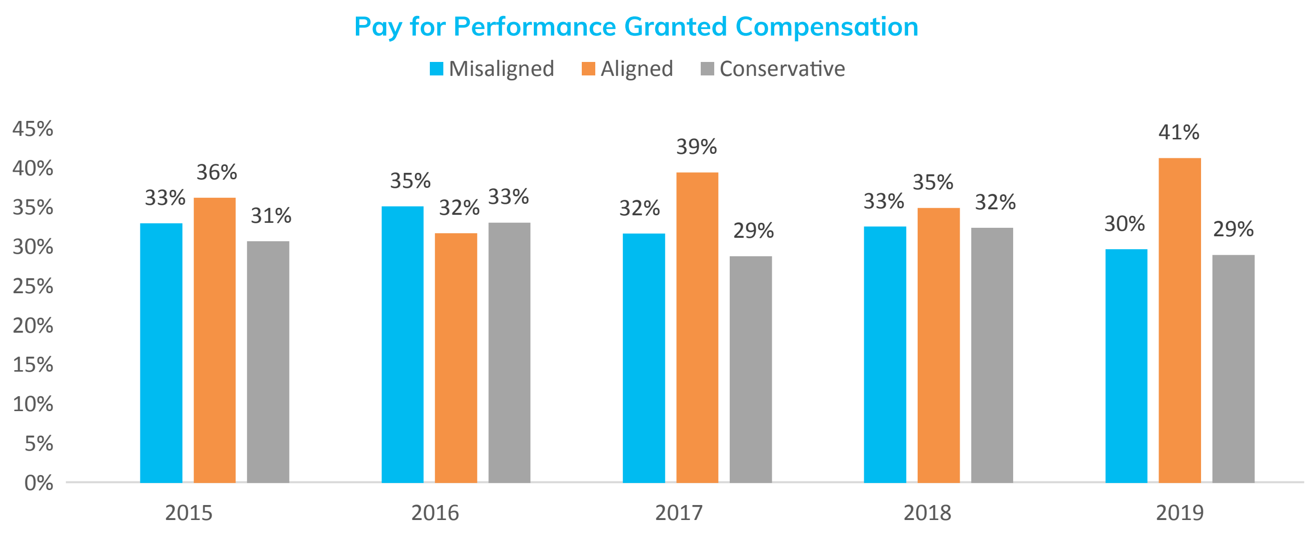
There are 132 companies who made changes to incentive plans along with reducing executive salary and board fees.

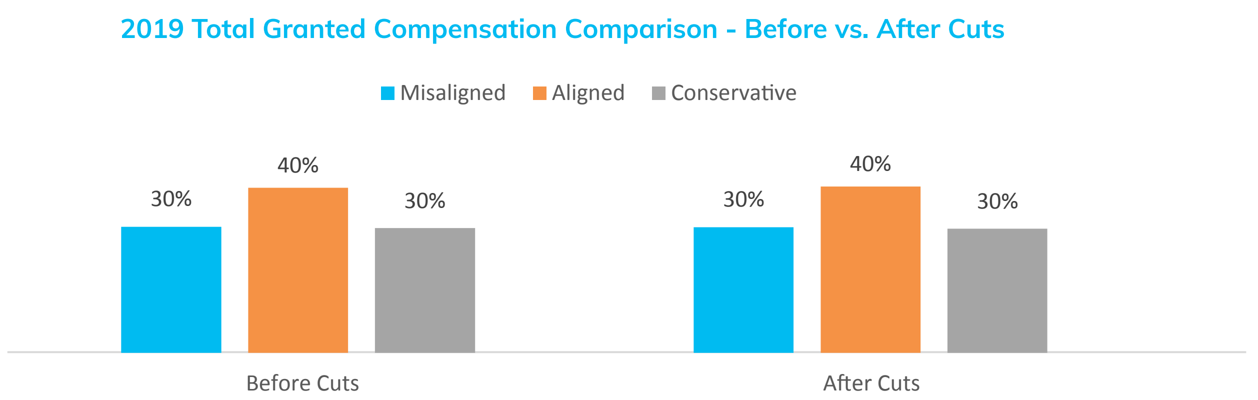
Again, the majority of these companies, 60%, are from the two hardest hit industries: Consumer Discretionary and Industrials. This again suggests that companies in these sectors are trying to match executive compensation to business operations in times of uncertainty.

Base Salary Cut Has Little Impact on Pay for Performance Alignment

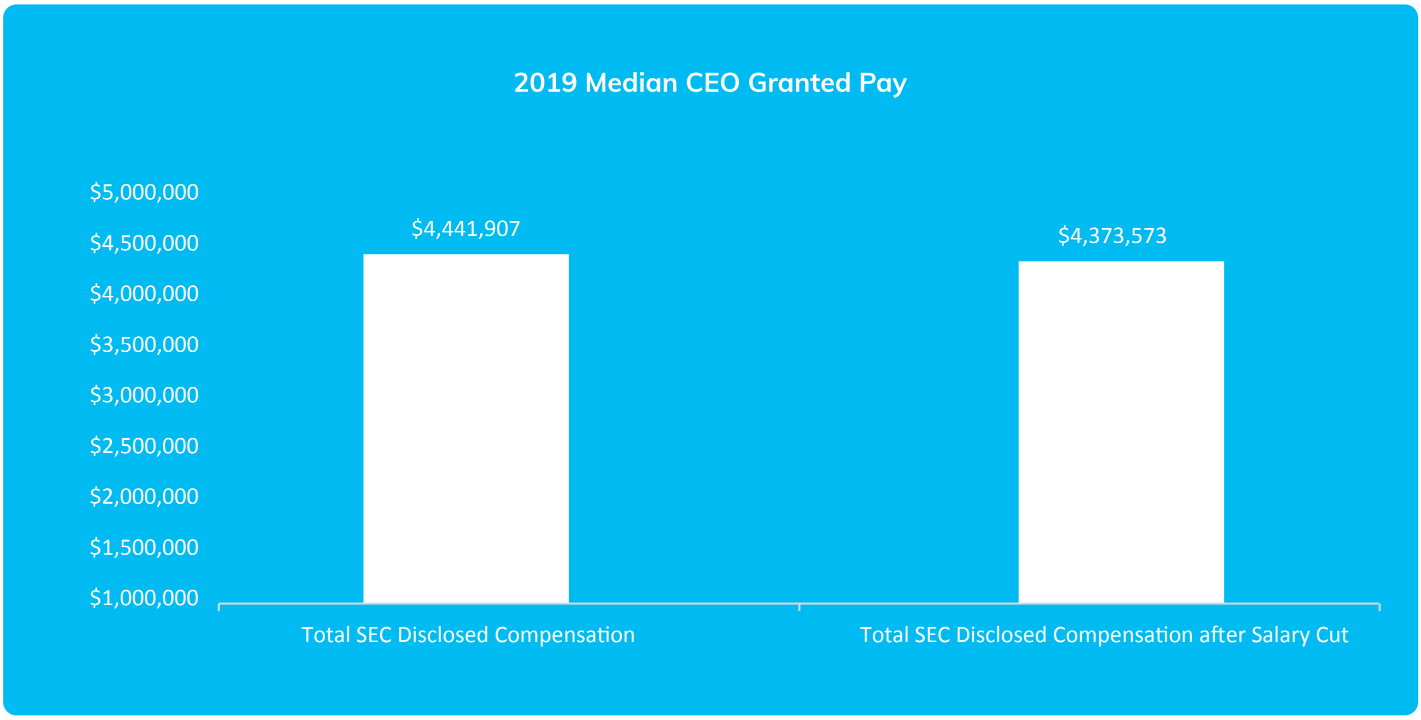
Over the past five years, more companies have been paying their executives the amount that is considered "aligned" with the market. As a result, the percentage of companies who either overpay or underpay their executives has dropped. Due to the pandemic, a large number of companies have cut executive base salary by a certain amount or completely.

However, these cuts do little to the overall pay for performance alignment given that base salary represents a very small part of the total compensation package. Since we do not have a complete overview of 2020 executive pay disclosures, we have made the assumptions that 2020 pay levels are the same levels as 2019. Based on this, we have deducted the 2020 pay reductions due to COVID-19 and have rerun the pay alignment models.





Based on our findings, salary cuts only brought the median CEO granted compensation down by about 68,000 USD, which is fairly insignificant.



Base Salary Cuts as Window Dressing

Base salary reduction has so far been the most popular pay change made to executives. However, as mentioned before, base salary is only a small fraction of compensation packages. Consequently, base salary cuts save companies little in cash if cash preservation is the main purpose of the cuts. In fact, the average amount of base salary reduction for the CEO only makes up about 7.8% of their Total Granted Compensation for 2019 and 10.6% of their Total Realized Compensation for the same year.

If CEOs in hard-hit businesses would like to help their companies save cash and support employees, bigger sacrifices, such as returning part of their compensation packages or taking bonus cuts and reductions in other short-term cash incentives, may be impactful.

Few Companies Take Action

The COVID-19 pandemic has set in for well over nine months and has affected most industries in some ways, yet few companies have taken actions to change their executive pay. Only 25% of Russell 3000 companies have made changes to executive compensation, and just 8% of companies have re-evaluated factors in their incentive plans.

The public and investors are waiting for more actions and are curious how this unprecedented event will lead executive compensation down a new path. Hopefully, with more information stemming from disclosures released for the 2021 proxy season, the full picture of the impact of the pandemic on executive compensation will become clearer.

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To obtain further information or to request a demo, please contact us at:

Tel US:	**+1 646 968 6660**
Tel Europe:	**+44 (0) 20 7660 1530**
Tel Australia:	**+61 (0)2 9373 9600**
Email:	**info@cglytics.com**
Web:	**cglytics.com**

Article produced by

Thao Nguyen
Corporate Governance Analyst, Americas

Edna Frimpong
Head of Research, EMEA

Iris Gushi
Head of Research, Americas
Research Operations Lead