Under pressure

Compensation and retention during a turbulent economy

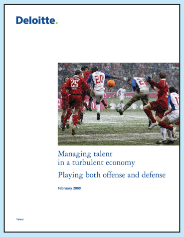
December 2009

Talent/Human Capital

Contents

You may be interested in our *Managing Talent in a Turbulent Economy* Survey Series

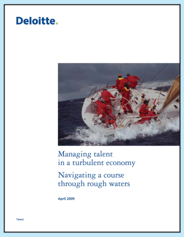
This is a year-long longitudinal series conducted for Deloitte Consulting LLP by Forbes Insights surveying global executives across all industries, at large businesses worldwide in the Americas, Asia Pacific, and Europe, the Middle East, and Africa. The talent pulse survey research, as well as Deloitte's position on the impending resume tsunami, has gained both U.S. and global recognition (e.g., *USA Today, The Wall Street Journal,* and *Management Issues*).



Playing Both Offense and Defense

Part one in the series, conducted in January 2009, surveyed 326 executives from businesses worldwide on how they are planning and managing their workforces in today's challenging economic environment. The report was published in February 2009 and includes a spotlight focus on workforce planning and analytics.

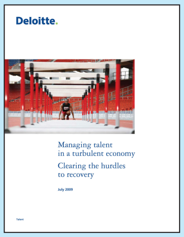
Read *Playing Both Offense and Defense*



Navigating a Course Through Rough Waters

Part two in the series, conducted in March 2009, examined how 397 executives have changed strategic priorities and talent tactics since the initial January survey. The report was published in April 2009 and features a spotlight focus on talent and risk.

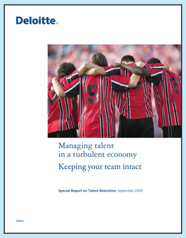
Read *Navigating a Course Through Rough Waters*



Clearing the Hurdles to Recovery

Part three in the series, conducted in May 2009, focused on retention and continued to track and compare how 319 global business leaders have shifted their talent priorities and strategies since the January and March surveys. This report was published in July 2009.

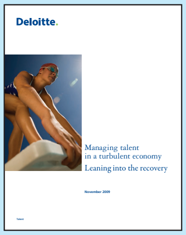
Read *Clearing the Hurdles to Recovery*



Keeping Your Team Intact

A special report in the series compared the results of an August 2009 survey of 368 employees at large enterprises worldwide with the May 2009 survey of executives. The study examines employees' perspectives on retention, their turnover intentions, and how their responses varied across the different workforce generations. This report was published in September 2009.

Read *Keeping Your Team Intact*



Leaning into the Recovery

This latest survey in the longitudinal study published in November 2009 reveals a clear divide between companies that are positioning themselves effectively for the economic recovery and those that are in danger of being left behind. Companies that remain in a defensive posture will risk losing the increasingly critical fight for talent. Those that also embrace a talent strategy to drive innovation will separate leaders from laggards.

Read *Leaning into the Recovery*

Key findings

Over the past year, companies have confronted the most difficult economic environment in a generation. Among the many challenges executives have faced: How to motivate and retain key talent when a dismal economy is wreaking havoc with traditional compensation plans?

To explore this issue, Deloitte conducted a survey in October 2009 of more than 200 executives at U.S. companies spanning a range of industries. This survey, which updates Deloitte's September 2008 study, "*Retention Strategies during Difficult Economic Conditions*," revealed several key findings. According to survey participants:

- While the macro-economic outlook may have brightened, the recovery has been uneven – and pessimism about the past, rather than optimism about the future, appears to be driving corporate compensation strategies.

- Every component of compensation remains under pressure – from base pay, bonuses, and retirement plans to stock options and restricted stock grants.

- Companies appear to have little appetite for modifying compensation plans in order to increase payouts to employees, even to top talent. Retention programs remain a relatively low priority for companies in many industries that believe employees "are lucky they have jobs" in a tough economy.

- Some companies, however, are holding compensation packages steady or even increasing them, positioning themselves for a turn in the economy when the talent market heats up. Organizations that adjust their compensation and retention strategies now stand to benefit as the recovery takes hold.

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An uneven recovery persists

The recession may have officially ended, but there are signs the U.S. economic recovery has been uneven at best. The stock market, for example, is up nearly 60% from its low, but unemployment stands at 10% for the first time in more than two decades.

This dichotomy was evident in the 2009 survey results. A nearly equal number of executives surveyed reported business conditions for their companies have improved over the past 12 months (40%) compared to those who reported conditions have gotten worse (43%) (Figure 1).

Looking ahead, the economic outlook brightens somewhat. By a 4:1 ratio, surveyed executives were more likely to predict over the next 12 months "the worst is behind us, our company is on the upswing" (22%) than to believe "business conditions will get worse before they improve" (5%). Nevertheless, 66% believe business will remain tough for a while (Figure 2).

Figure 1. How are business conditions for your company compared to 12 months ago?

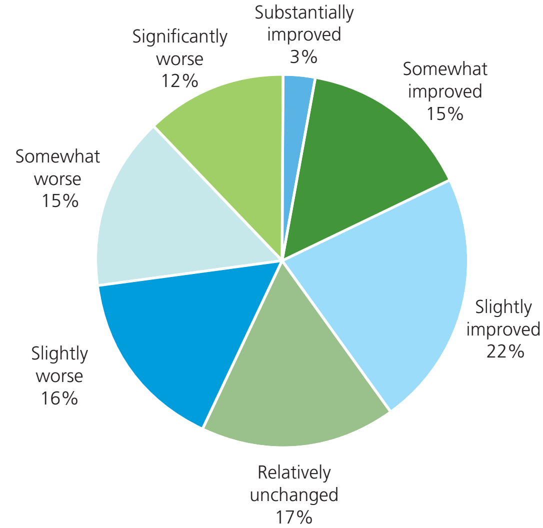
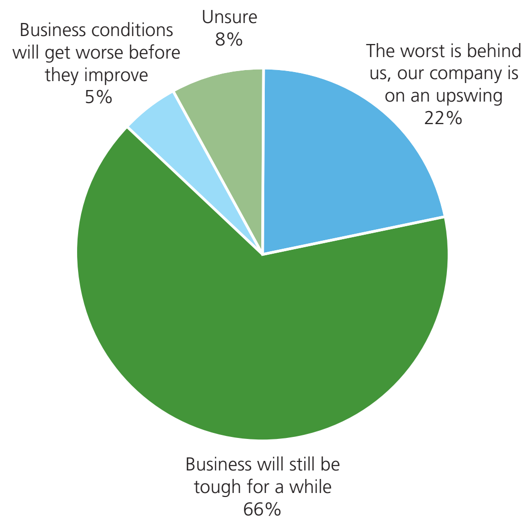


Figure 2. What is the outlook for your company's business over the coming 12 months?



Compensation strategies are still driven by past pessimism, not future optimism

For most companies, according to survey participants, every component of compensation appears to have been negatively impacted by the difficult economy. While performance-based pay (such as annual bonuses and long-term incentives) typically takes a hit during economic downturns, many companies are scaling back base salary increases as well – and employees have little hope of making up lost income.

Base Salaries

According to our survey participants, at least 85% of companies will not provide standard merit increases on base salaries in 2009. Executives fare somewhat worse than employees, with two out of three (66%) seeing either no increase in base salary or a salary reduction (compared to 54% for employees) (Figure 3). Seventy percent of executives surveyed report their companies have no plan to compensate employees down the road for salaries that were frozen or reduced in the teeth of the recession.

> "We froze salaries and wages for 2009..."
> "Salaries over $70,000 are frozen..."
>
> – Survey Respondents

The prospects for base salary increases improve somewhat in 2010, although raises will likely be smaller than in more robust economic times. Looking ahead to next year, 30% of surveyed respondents anticipate standard base salary increases of 3-5% for employees and 28% plan similar raises for executives. A majority of survey respondents (54%) plan to make smaller than normal salary increases for employees next year, while 44% indicate executives can expect a smaller salary bump (Figure 4).

Figure 3. Merit increase pool for Fiscal Year 2009

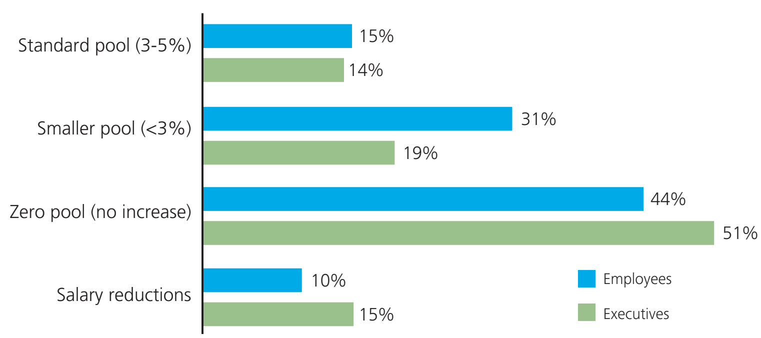
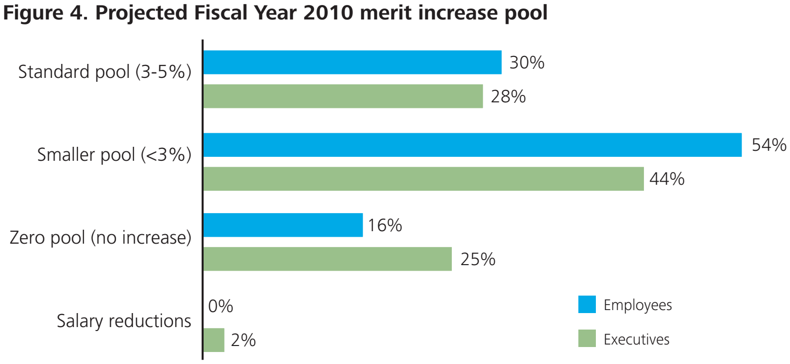


Figure 4. Projected Fiscal Year 2010 merit increase pool

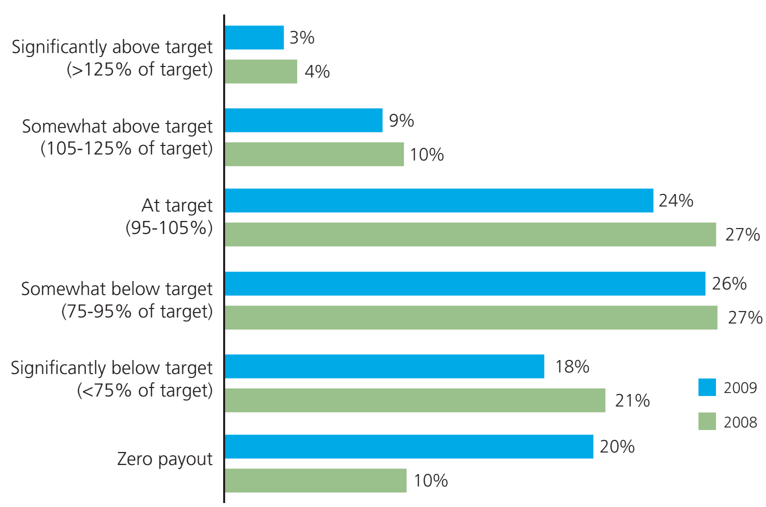


Annual Incentive Plans

Given the tight rein on base pay increases, it was not surprising that more than six out of 10 executives (64%) surveyed reported their companies plan to award bonuses below target this year. Fully 20% reported they plan to forego bonuses altogether – double the number of companies that zeroed out bonuses last year. Nevertheless, 36% project annual bonuses at or above target – a strong minority, but still a decline from 41% in 2008 (Figure 5).

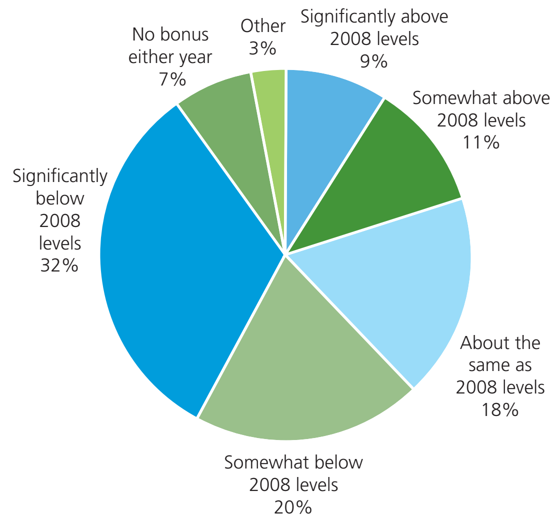
> "Company exceeded its 2008 targets but management decided not to pay bonuses in light of economy."
>
> – Survey Respondent

Figure 5. Projected annual bonus as a percent of target bonus



Even for those employees fortunate enough to receive bonuses this year, the economic downturn will take its toll. More than half (52%) of the executives who participated in this survey reported bonuses will be smaller than in 2008, compared to just 20% who believe they will be higher (Figure 6).

Figure 6. Fiscal year 2009 projected bonuses compared to fiscal year 2008 actual bonuses



Digging Deeper: With executive compensation under fire in the wake of the financial crisis, some companies are undertaking "shareholder-friendly" compensation reforms. Of the companies surveyed, 11% have implemented "clawback" provisions and 9% have eliminated executive perks.

Long-Term Incentives

As part of their overall compensation strategies, 67% of the companies participating in this survey offer long-term incentives to motivate and compensate high-performing employees and executives. Of these companies, 64% grant stock options; 67% award restricted stock; and 45% offer multi-year performance plans payable in cash or stock.

But with other compensation components under pressure, long-term incentives are taking a hit as well.

Figure 7. How do 2009 long-term incentive grant values compare to 2008?

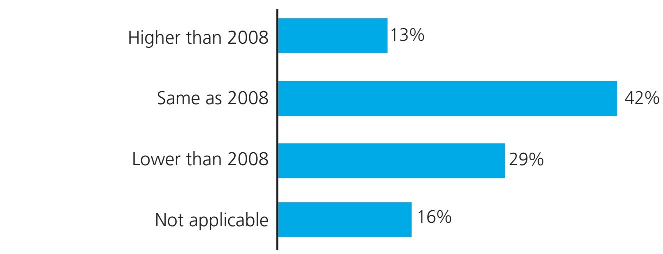
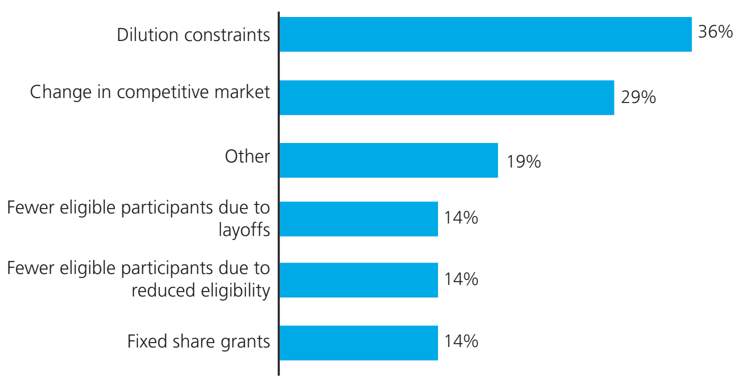


Figure 8. Reasons why grant values will be lower in 2009*



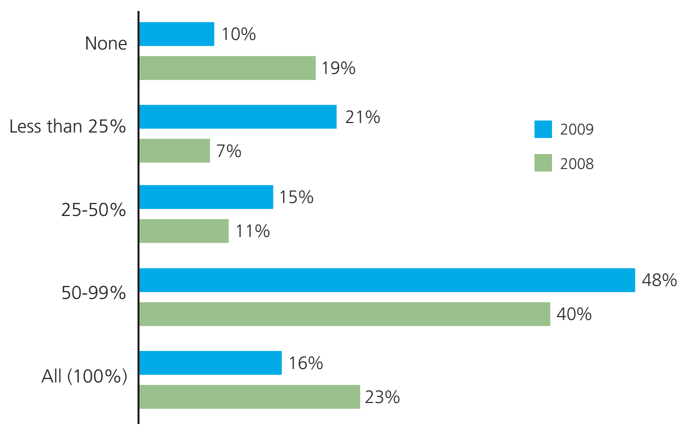
*Among 29% of companies projecting a lower grant value in 2009

In recent years, companies have struggled to maintain the overall value of long-term incentives. As stock prices fall, companies must increase the number of shares granted to preserve the value of these incentives. With stock prices recovering, 55% of executives surveyed report that the value of long-term incentives granted in 2009 will meet or exceed the value of 2008 grants (Figure 7).

Still, nearly one-third (29%) of executives surveyed indicated grant values will drop from last year, reflecting the unevenness of the current recovery. When asked to name the reason for this decline, 36% of survey participants cited "dilution constraints;" 29% listed a "change in the competitive market;" and 14% cited "fewer eligible participants due to layoffs or reduced eligibility" (Figure 8).

Stock options have also taken a significant hit during the recession. Nearly two out of three executives surveyed (64%) responded that most of their company's stock options were "underwater" (where the exercise price is higher than the current price). Only 10% could report that "none" of their company's options were underwater, suggesting the rising tide of stock prices has yet to lift the long-term compensation incentives of many employees (Figure 9).

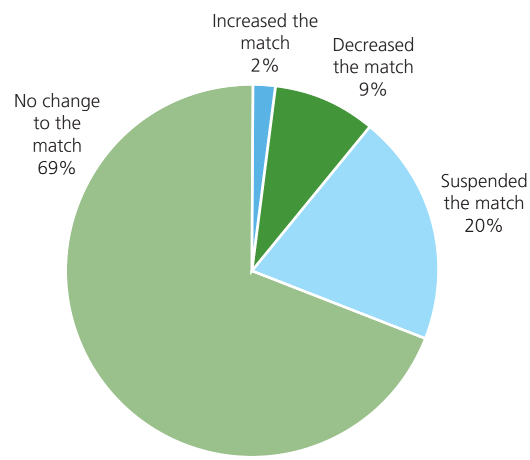
Figure 9. Percentage of stock options currently "underwater"



Retirement Benefits

Even retirement benefits have suffered due to the weak economy. Nearly one in three executives surveyed (29%) stated their companies either decreased (9%) or suspended (20%) 401(k) matches in 2009 (Figure 10).

Figure 10. Did your company make changes to its 401(k) match in 2009?



"Our 2009 401(k) match may be reduced or suspended."

– Survey Respondent

Little evidence companies are adjusting compensation plans to motivate employees

In an environment of frozen salaries, below-target bonuses and underwater stock options, are companies looking for creative ways to boost compensation for employees? Not according to the 2009 survey results. Rather than launching new programs or modifying existing ones, according to survey participants, companies appear content to hold the line on current compensation practices, while making only selective tweaks around the edges.

- **Few Discretionary Bonus Pools:** Only 13% of executives surveyed, for example, report their companies plan to establish a discretionary bonus pool outside of the regular incentive plan, down from 22% in 2008. For those few that do, most (60%) expect the pool to be small – 25% or less of the value of the annual bonus pool.

"Holding our own now is our primary goal."

– Survey Respondent

- **Little Relief for Underwater Options:** Employees hoping to see their options above water will receive little help from employers. Only 17% of executives surveyed plan to make adjustments to underwater stock options. Less than 5% intend to re-price, cash-out or re-issue options to increase their value to employees.

- **Marginal Changes to Performance Plans:** The majority of companies surveyed (54%) do not expect to make any modifications to their performance plans to boost the opportunity for greater payouts. Only 5% anticipate altering the performance target goals of current plans, while 2% plan on modifying performance measures.

- **Restricting Restricted Stock:** Just 12% of survey participants boosted restricted stock grants for employees and only 11% increased these awards for senior executives, compared to 20% and 19% last year, respectively.

The primary area of flexibility appears to be with annual bonus awards. While just over one-half of executives surveyed (55%) report their companies will make no changes to the current annual incentive plan, a sizable minority (20%) indicate senior management will exercise discretion in awarding annual bonuses.

Companies do not expect many changes to annual incentive plans in the year ahead. One in five (21%) survey participants report they are not planning any adjustments to next year's annual incentive plan, while 36% are undecided.

Are Some Companies Positioning for a Recovery?

While austerity measures dominate the corporate response to a tough economy, a sizable minority of survey participants report that their companies are taking steps now to rebalance their compensation portfolios ahead of an economic upturn. In addition to adjusting bonus pools and stock options and increasing restricted stock grants, some executives in our survey are also improving base pay, paying larger bonuses, and enhancing long-term incentives:

- **Increase salaries 3-5% in 2009:** According to survey respondents, standard merit increases will be paid for employees (15%) and executives (10%).

- **Pay annual bonus above 2009 target:** Companies expect to increase annual bonus payments above 2009 targets indicate 12% of surveyed executives.

- **Pay annual bonuses above 2008 levels:** One in five executives (20%) report this year's bonus will be above 2008 levels.

- **Retain top talent:** 17% of survey participants report they are implementing retention programs for senior executives now and 13% report they are doing so for middle management, 11% for select business units.

Retention plans remain on the back-burner, even for key employees

Previous Deloitte survey results in the *Managing Talent in a Turbulent Economy* series have suggested a "resume tsunami" may be building, with critical employees biding their time until the economy rebounds and they can leave their current employers for better opportunities elsewhere. Yet despite the pressures on compensation programs and a nascent recovery, according to survey participants, few of their companies are being proactive when it comes to retaining top talent.

Nearly seven out of ten of executives surveyed (69%) reported that their companies currently have no plan in place to retain top talent. Although 26% may consider adopting such a retention strategy, 43% suggested their companies "have no plans to do so." If anything, retention appears to be even less of a priority this year than last; the percentage of companies with "no plans" to develop a retention program jumped 16 percentage points compared to 2008 (Figure 11).

Why are companies showing such little concern about losing top talent? A sizable majority (72%) indicate retention has not been an issue for their companies. Some seem to believe key employees have nowhere to go in a weak economy. As one survey respondent put it: "Our CEO says we should be lucky we have jobs!" Nearly one in five (19%) survey participants suggest retention programs are simply a luxury they cannot afford (Figure 12).

Figure 11. Has your company implemented any retention programs for your employees?

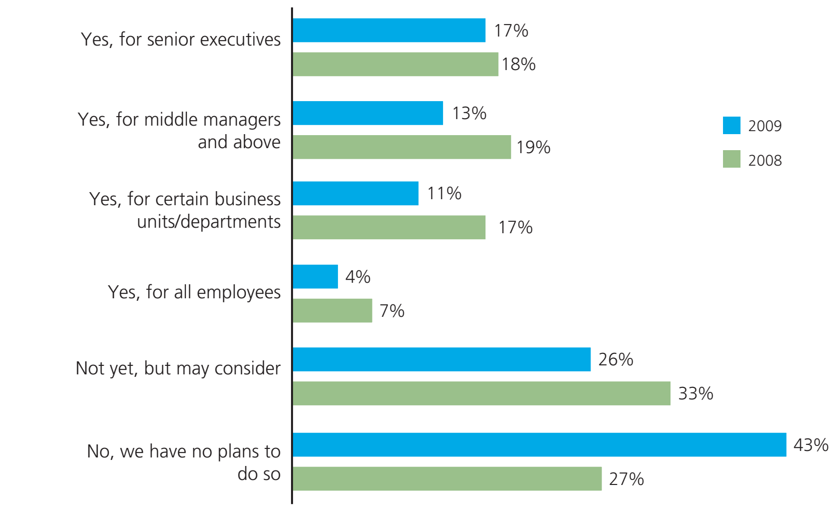
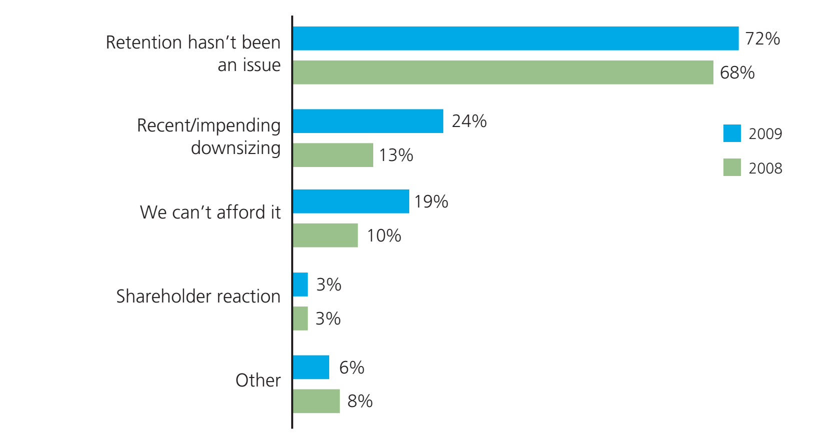
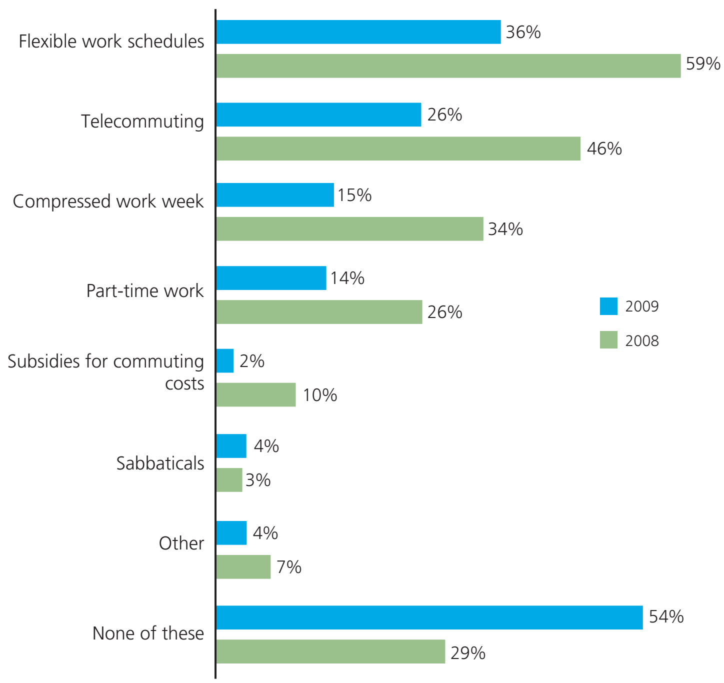


Figure 12. What is your primary reason for not implementing a retention program?



Even interest in non-compensation-based retention tactics have dropped off significantly compared to 2008. The percentage of companies surveyed implementing flexible work schedules declined from 59% to 36%, while telecommuting programs fell from 46% to 26%. Meanwhile, the percentage of companies not implementing or expanding any of the most popular workforce programs jumped by 25 points – from 29% in 2008 to 54% this year (Figure 13).

Figure 13. Has your company considered implementing or expanding other workforce programs to help retain employees?



Digging Deeper: Peer pressure? Not when it comes to compensation and retention practices. Only one in four survey respondents cited “peer company practices” as a reason for altering retention programs – well below the 39% who listed this factor in 2008. When asked what determined the payment of discretionary bonuses, a scant 4% of respondents cited “company performance relative to peer group.” Instead, discretionary awards are being based on internal strategic or operational milestones and employees’ individual performance, not upon competition in the talent marketplace.

Focused on the bottom line, but what about the future?

This year's survey reveals that many companies focused their compensation strategies to cope with the recession and not necessarily to prepare for the coming recovery. Across the board, pay and incentives are down with deeper cuts in 2009 than 2008. At the same time, respondents to the 2009 survey did not reveal a major effort toward retention planning or retention strategies—with one in five respondents reporting they could not afford to implement retention programs.

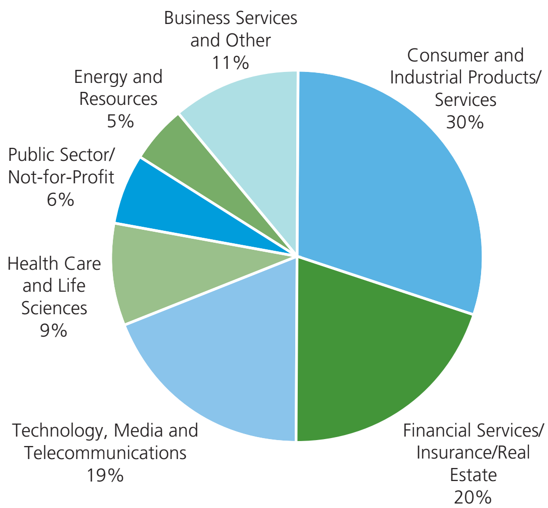
Against this background, a significant minority of about 20% of surveyed companies are performing at a level that allows them to increase base salaries and annual bonuses, improving their ability to retain key employees. A smaller percentage of companies are implementing retention cash or equity arrangements to keep top talent engaged.

Looking at these results another way, the 2009 survey suggests that a majority of companies may risk seeing their top talent recruited by higher performing companies or companies attempting to upgrade their capabilities and work through a difficult economic environment. Companies counting on a soft job market alone to retain employees may be blindsided unless they reposition themselves to keep top talent as the economy rebounds. Deloitte believes these preparations may play a significant role in determining which companies prosper and which get left behind as the recovery, however uneven, continues to gather strength.

Survey participants/ demographics

The 212 survey participants in the October 2009 survey worked across a range of industries, located primarily in the U.S. Most participants held senior positions in Human Resources at the manager/director level or above. The Consumer and Industrial Products/Services, Financial Services, and Technology/Media/Telecommunications industries were heavily represented (Figure 14).

Figure 14. What is your company's primary industry?



Companies with revenues between $1 billion and $5 billion were most heavily represented, with significant input from companies in the $100 million to $1 billion revenue range (Figure 15).

Approximately one-quarter (24%) of companies had more than 10,000 employees, while a nearly equal percentage (26%) had less than 500 (Figure 16).

Figure 15. What was your company's revenue during the most recent fiscal year?

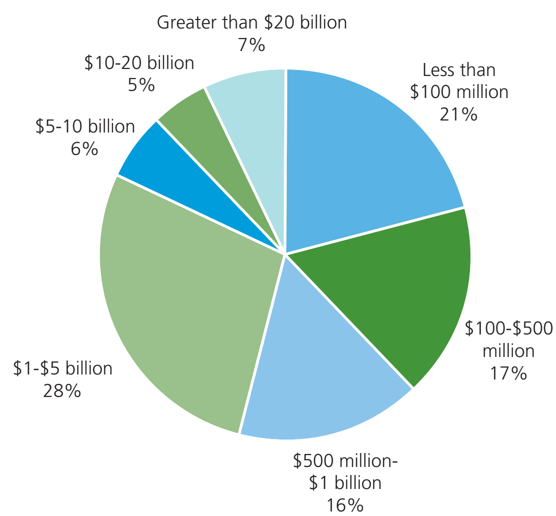
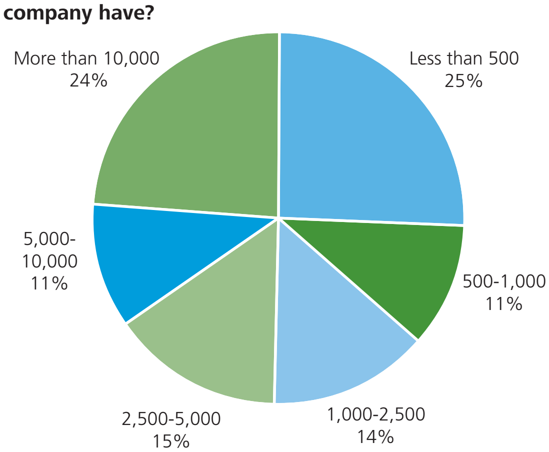


Figure 16. How many employees does your company have?



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About the Survey

This survey was conducted online during October 2009 and the results were tabulated by Deloitte. The vast majority of the 212 survey participants hold senior positions at U.S. companies, primarily in Human Resources at the manager/director level or higher.