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THE SECRET SAUCE OF THE MOST SUCCESSFUL FIRMS: EFFECTIVE LONG–TERM INCENTIVE STRATEGIES

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In today's competitive environment, integrated communications and digital firms are on the lookout for effective ways to attract, retain and incentivize their key employees. An increasingly important component of the overall compensation package is long–term incentive arrangements. Implemented properly, long-term incentive arrangements can enhance individual performance, improve firm revenue growth and profitability, and aid in the retention of key employees. There are many different long–term incentive vehicles that a company can choose from; contract equity and long-term incentive plans (LTIPs) are the two most important.

Why Implement a Long-Term Incentive Arrangement?

What differentiates the top performing integrated communications firms from all others? Surprisingly, it is not the size of the firm, its specialty, location or whether they are independent or part of a public company. Rather, the top performing firms — regardless of all these significant differences — have one thing in common. The overwhelming number of these top performing firms have implemented a long-term incentive strategy, according to both data and our experience. In a 2019 survey of 133 firms, two-thirds of the firms

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that implemented either a long-term incentive plan (LTIP) or contract equity program saw more than a 5% increase in **both** revenue and profit. Even through the tough times of last year's pandemic, more than half of the firms that implemented either an LTIP or contract equity program increased their profits in the first eight months of 2020, according to the 2020 survey.

What accounts for this surprising data? Long-term incentive arrangements aid in the retention of key employees while also aligning key employees' financial incentives with the long-term growth and profitability of the company. This is one of the reasons the potential acquirers in the M&A market find firms with these long-term incentive arrangements attractive. Additionally, these types of long-term incentives, because they are typically not paid out in full annually, enhance a company's overall compensation package without immediately impacting cash flow or profit margin. However, in order to achieve their aim, long-term incentive arrangements must be properly structured. There are a number of pitfalls that must be avoided, and if not properly structured, long-term incentive arrangements may have adverse tax consequences or securities law implications, among others.

Contract Equity

While many companies think of real equity — such as stock options and restricted stock — in order to incentivize key employees, real equity presents a number of challenges, including additional regulatory compliance issues. In contrast, contract equity is subject to much less regulation and is much more flexible. It also has the advantages of ease of implementation.

Contract equity can be granted by any type of entity, such as an S corporation or an LLC. In its simplest form, contract equity entitles a recipient to a percentage of the net sale proceeds from a sale of the company. For example, if a recipient received a contract equity grant entitling him or her to 2% of the net sales proceeds and the company is sold for $15 million, the recipient would be entitled to $300,000. Firms can also provide that recipients will only participate in the net sale proceeds if the company appreciates in value over a specified threshold. Including this type of provision may be more equitable for some key employees — including newly promoted employees or new strategic hires of an ongoing successful firm. This is because recipients participate in the value that they have helped to create, but not what was created before they arrived on the scene or in a position of leadership. Since contract equity is typically only paid if the recipient remains employed on the payment date, it also serves as a valuable retention tool.

Contract equity can also be tied to various restrictions, such as requiring that the recipient enter into an employment agreement with the company's purchaser if requested. Since it is a new benefit, it can also be consideration for entering into new or revised protective covenants.

From a tax perspective, contract equity is subject to ordinary income taxation when it is actually paid, meaning that recipients will not be in the position of having to pay taxes on illiquid stock. Additionally, participants do not have to pay anything for the award (unlike, for example, stock options). However, unlike real equity, there is no opportunity for capital gains treatment.

From the company's perspective, contract equity presents similar financial benefits to participants as real equity, but since recipients do not have an ownership interest, they do not have the right to review the books and records of the issuing company. Additionally, this form of incentive is attractive to the company since it can take a deduction for the payment to the key employee. The employee, in turn, is taxed on the proceeds if and only upon receipt of the payment as ordinary income.

Long-Term Incentive Programs

While contract equity is typically tied to a sale of the company (though, in some instances, it may provide short or long-term incentives as well), companies may also want to consider a long-term incentive program (LTIP). These arrangements are typically designed to pay out based on the achievement of various performance criteria and vest over a specified period, commonly around three years.

Payment is typically contingent upon a recipient remaining employed with the company on the payment date. Thus, LTIPs provide a valuable retention tool. Additionally, the payment date is specified in the award, giving recipients a concrete deadline, which may serve as a valuable motivating factor. A sale of the company may happen in six months or 15 years, but an LTIP participant knows when the payment will be made if the criteria are met.

LTIPs also allow integrated communication firms to motivate key employees to work toward broader company goals (as opposed to purely individual or divisional/practice group goals). The performance criteria are not static and may be established on an annual or grant basis. This means that these goals can be tailored to the needs of the company at any given point in time. Moreover, they can be individualized based on the recipient's role in the company, allowing companies to tailor the plans to their specific needs and goals.

Three common company targets that can be used alone, or in conjunction with each other, are:

- Revenue growth
- EBITDA growth
- Profit margins

Individual targets may include completion of a specific project or a specified increase in new clients. Thus, companies will typically only pay out LTIP awards when there has been bottom line improvement in company performance.

LTIPs and contract equity programs are valuable tools for companies to consider when designing their overall compensation packages. Depending on a company's needs, either or both may be appropriate to properly incentivize key employees and improve retention rates.