AGENDA

A Window Into One Board’s Executive Comp Overhaul

By Amanda Gerut   November 4, 2019

As a significant investor in hair salon operator Regis Corp., board member Daniel Beltzman was often asked to speak “on behalf of shareholders,” he says. But Beltzman believed that if the board and management wanted to know what investors were thinking about issues such as compensation and strategy, they should ask investors directly.

What was less clear, however, was the best way for the board to go about it.

Beltzman reached out to peer mentor and friend Matt Botein, former chief investment officer of the alternative investment unit of BlackRock.

“I said to him, I’m sitting in a boardroom and I see tremendous opportunity for input from other large owners,” Beltzman recalls. Botein told Beltzman, “What you’re talking about is at the very center of corporate governance right now,” recalls Botein.

That conversation sparked a nearly 22-month exploration by the Regis board, led by comp committee members Beltzman and Ann Rhoades, a culture, values and human resources expert and author. Beltzman and Rhoades held a series of meetings, without management present, with multiple institutional investors, researchers at proxy advisory firm Glass Lewis and nonprofit think tank FCLTGlobal, outside advisors from law firm Wachtell, Lipton, Rosen & Katz and other experts to discuss how best to engage with investors and the alignment of strategy and long-term compensation plans. Eventually, Beltzman and Rhoades — along with the full board, its comp consultant and the management team — created a completely reimagined compensation concept for the company. The duo then met with investors in a new round of meetings to get feedback on the concept, all while communicating with Regis Corp. CEO Hugh Sawyer, members of Sawyer’s team who would be compensated under the new plan and the full board.

“When people say ‘shareholder engagement,’ they’re really talking about calling on the shareholders on a quarterly or more frequent basis and going and sitting and listening to what they have to say, which is highly valuable,” says one outsider who observed the board’s nearly two-year process. “This really took shareholder engagement to another level. It wasn’t just calling on the shareholders to hear what they had to say, but it was a true dialogue with them around understanding their perspective and their particular problems with compensation and the sorts of things the board wanted to do."

The shareholders were viewed as a key constituent, says the outside observer, rather than a distant party to be appeased by the board's following guidelines from proxy advisory firms. In addition, the board had to communicate carefully and clearly with management, who were nearly all new to the company — some with tenures as short as six and eight months — and had been recruited under a completely different comp plan.

"We did keep the CEO apprised of what we were doing," explains Rhoades, who previously held executive roles at JetBlue Airways and Southwest Airlines and served as comp committee chair at both JetBlue and P.F. Chang's China Bistro. "I don't think you can do this in a total vacuum. The management, comp committee and the full board were, honestly, very supportive." Rhoades also notes that the new management team recruited by Sawyer was ready to take on the challenge of helping turn the company around and that the execs showed courage in allowing the board to rework the way they thought they would be compensated when they agreed to join the struggling hair care company.

Shampoo, Rinse

By 2016, the Minneapolis-based beauty services company had suffered several years of lackluster performance. The stock price in November 2015 reached $18.04, but by May 2017, just after Sawyer's appointment, the stock had dropped to $9.13. The hair styling company, whose brands include Supercuts, Regis Salons and Sassoon, among others, suffered from declining mall traffic, a shortage of stylists and numerous other challenges.

With Sawyer at the helm, the company began a massive digital transformation and turnaround. The board had previously hired Sawyer as an outside consultant to help the company formulate a new strategic plan, including transitioning from company-owned and-operated salons to franchised salons. As CEO, Sawyer recruited new executives to fill the roles of chief financial officer, chief technology officer, chief human resources officer, general counsel and corporate secretary, and promoted the company's president of franchise, chief marketing officer and chief accounting officer, among other executive changes. The board appointed Dave Williams, CFO of Chemed Corp., as its independent chair in 2016, and recruited Virginia Gambale, a tech expert and experienced director, as a board member in 2018. The board also established a technology committee in July 2018 and named Gambale as chair.

Sawyer's team initiated operational turnarounds of underperforming salons, sold its mall-based salons and closed roughly 600 underperforming stores. In the past year, the company has announced a partnership with Google and launched an “Open Salon” mobile app, linking to it in the company proxy statement for readers who want to book a hair appointment.

However, as plans were being made and executed, the activities gave rise to conversations among board members about whether the company’s compensation plan was aligned with its strategic plan. Beltzman, who took on the role of comp committee chair in late 2017, asked all the committee members whether they would pay executives differently if Regis were a private company.

“To a person, almost everyone said they would do something different,” says Beltzman. However, directors believed that because the company was public, the board had to follow certain practices.

Beltzman’s investment advisory firm, Birch Run Capital, manages investments for a handful of wealthy families with a long-term business orientation. Beltzman, who at 44 is the youngest Regis director, didn’t have much board experience before Regis, but says he was asked to join the board because of long-term nature of the capital behind Birch Run. As an investor, Beltzman had often found that compensation for executives wasn’t tied to a duration strategy.

“You read about short-termism all the time today, but what we found was that although we would have CEOs talking about where they wanted to bring the business, how they and the management team got paid was not in line with their strategy,” says Beltzman. “Strategy plays out over a multi-year period — it doesn’t play out over a single year.”

The board began contemplating how compensation plans could create more duration and the types of comp structures that would align with the company’s strategy so that “effectively everybody was in the same boat, and moving in the same direction,” says Beltzman. The board wanted a duration that would align the owners of the business and the management team, says Rhoades. At the time, the Regis plan had an average duration for total compensation including salary, bonus and performance pay that averaged about 1.3 years. The board decided that duration didn’t make sense, given the company’s turnaround plans.

“If people aren’t incentivized to think longer-term, they won’t,” says Beltzman.

An Invigorating Tea-Tree Oil Scalp Massage

After Beltzman reached out to Botein, he put Beltzman and Rhoades in touch with his former BlackRock colleague Michelle Edkins, managing director and global head of BlackRock’s investment stewardship team. BlackRock owns 13.9% of Regis Corp.’s outstanding shares, second only to the 29.6% owned by Birch Run Capital Advisors, where Beltzman is general partner.

Edkins, in turn, gave the Regis board "a first-class education," according to Beltzman and Rhoades. Edkins referred the Regis board to *The Company Chairman*, a book written by Sir Adrian Cadbury, eponymous former chairman of chocolatier and confectionery Cadbury. (Please see a list of research reviewed by Regis board members in the *Agenda* research vault.)

Beltzman and Rhoades then met with a series of large institutional owners, human capital experts, researchers and other governance thinkers — without any members of management present — in a bid to collaborate in determining the best way for the board to create a compensation scheme that aligned with the strategic goals outlined in the company's turnaround plan.

The duo, who consulted with outside lawyers to avoid Reg FD and other legal issues, discussed with investors a "straw man pitch," which was a preliminary sketch of potential ideas for the company's compensation plan. The board discussed the straw man pitch with members of management to solicit feedback and also discussed the pitch with investors. The process was iterative, say Beltzman and Rhoades. They would hear good ideas, conduct more research, seek more input from management and investors, and rework their concepts.

Ultimately, the changes made were extensive — it was essentially a reimaging of the entire long-term incentive plan and overall compensation approach at Regis. In short, the new LTI plan involved giving executives large initial equity grants that were closely tied to the company's position in 60 months, rather than six to 12 months. Portions of annual bonus pay could be used to purchase more stock, which would then be matched in certain percentages by the company. The initial grants were 30% lower than what executives would have received under the previous plan.

While investors appeared to relish the opportunity to weigh in before a plan had been adopted, and supported a longer-term horizon on executive compensation, they discussed their concerns about the risks with the Regis board. Such grants — negatively referred to as "mega grants" in the past — could be seen as a wealth transfer without it being earned, or as simply paying executives more stock. Such a structure puts pressure on the compensation committee to ensure that the board tightly oversees the goal-setting process, and holds management accountable for achieving challenging objectives in earning annual bonuses.

After talking with one investor who pledged the hold the board accountable if the plan didn't work as intended, Rhoades quipped to Beltzman as they left the meeting, "I think we just got threatened." "Mildly," Beltzman responded.

Still, the feedback Beltzman and Rhoades got was "phenomenal," they say.

The meetings with large institutional investors allowed the board to build on the knowledge it had and obtain feedback on what the board had conceived, says Rhoades. “We were trying to align strategy and remuneration so that if management wins, the owners win,” she says. She also notes that Beltzman’s perspective as a shareholder in the company added an additional layer of credibility to conversations with investors in explaining how the board would oversee the goals executives would have to achieve.

A Haircut and Hot Towel Refresher

Despite the thorough, inclusive process, it was also a negotiation between, management, investors and the board based on the feedback and input from investors, executives, board members and corporate governance experts the board worked with.

“Nobody got everything they wanted,” says Beltzman.

The 2017 proxy shows that Regis’s compensation plan previously consisted of a base salary paid in cash, an annual cash bonus tied to cash flow per share that made up 70% of bonus pay with the remaining 30% tied to same-store sales. The LTI plan, which had a three-year performance period, consisted of 60% performance stock units (PSUs) based on adjusted earnings per share, and 40% restricted stock units whose values were driven by stock price. That plan was the revised version that had been adopted after the 2015 say-on-pay vote saw one third of investors give Regis a thumbs-down on compensation.

In July 2017, the board hired **Pay Governance** as its new compensation consultant, and thus began its extensive review.

By 2018, the company’s proxy opened with a letter signed by all seven independent directors formally introducing shareholders to the newly reimagined compensation plan. It was based on two tenets: “Shares that people buy with their own money create a much stronger alignment than shares that are awarded as part of an overall pay plan.” And, secondly, “Shares that can be quickly sold off after short vesting periods, and get replenished every year, do not align interests as strongly as shares that are awarded less often and come with longer measuring, vesting, and holding requirements.”

In the new comp plan, the board abandoned automatic annual equity grants and replaced them with a single, larger initial equity grant at the start of a five-year period. The value of the initial equity grant was approximately 3.5 times the value of executives’ fiscal 2018 grant. However, the annualized value of the initial equity grant over the five-year period equates to approximately 70% of the fiscal 2018 grant.

According to the 2019 proxy, 75% of the fiscal 2019 equity grant was in the form of PSUs, which must meet a three-year stock price performance goal. After the three-year period, executives have to wait an additional two years to achieve vesting. The remaining 25% of the grant is in the form of RSUs that cliff vest after three years.

In addition, and in conjunction with the first tenet, executives can use up to half of their earned annual bonus pay, net of taxes, to buy Regis stock under the company's new stock purchase matching program. Starting with executives' bonuses in fiscal 2019, the company now provides matching grants of RSUs with a value of up to 200% of the executive's pre-tax contribution if executives buy company stock with their incentive pay. Therefore, executives would be compensated for the 30% reduction in long-term grant value by purchasing stock that would be matched by the company, thereby providing them with incremental value to make them whole — or better than whole. The matching RSU grants cliff vest over five years and executives have to hold the underlying shares for that five-year period.

"Therefore, if executives do not participate in the matching share program on an annual basis, their five-year pay for the period running from fiscal 2019 to fiscal 2023 will be below what they would have received under the fiscal 2018 program," the proxy states.

Executives who buy stock using 25% of their earned bonus pay, net of taxes, receive a 100% RSU match, while executives who buy stock using 50% of their bonus pay will receive a 200% match. The company warns that the magnitude of executives' earned bonuses may change year-to-year, which would impact the amounts that could be contributed to the matching grant program.

Under the new plan, no equity will vest until three years after the date of the initial grant, and the majority of the grant is subject to five-year cliff vesting. Under the previous plan, RSUs vested over a three-year period, and performance awards were earned and vested at the end of three years.

Sawyer must hold all the shares granted to him until he retires from Regis.

Pay Governance managing partner **Ben Stradley**, the board's comp consultant, explains that the plan's design emphasizes long-term performance in several ways. First, the size of the initial grant and its five-year vesting term immediately lengthens the duration of the company's pay program, he says.

Second, the matching share program gives executives a "strong economic motivation" to contribute their bonus pay toward the purchase of shares, which are also subject to five-year vesting, which doubly reinforces a long-term perspective. Importantly, notes Stradley, executives must continually deliver results based on their goals in order to earn annual bonuses that allow them the opportunity to benefit from the matching share program.

In addition, the bonus plan goals provide a critical linkage between achieving short-term objectives and supporting Regis’s longer-term strategic vision, he says. The overall comp plan incorporates near-term financial and operational objectives coupled with a weighting on measurable individual goals (MBOs) organized around strategic objectives the company has determined will be impactful in the future. The emphasis on individual performance also ensures that executives who truly contribute to the company's success have the opportunity to participate in the matching share program to a greater dollar extent.

Working closely with Stradley, Rhoades made sure each individual member of management understood precisely how they would be compensated under the new LTI plan. Stradley prepared 15-page analyses for each executive explaining how they would be treated under the new plan, including in the event of death or disability, for example, explains Rhoades. Executives needed to understand, with their families, how they would be impacted under the new structure, she says. The entire board listened to every executive’s thoughts about the plan, which included valid concerns, explains Rhoades.

“There were a couple of points made by the CEO and the team members that were not only legitimate, but impactful to their agreeing to this plan,” she says.

Under the fiscal 2019 plan, 60% of executives’ annual bonuses was based on meeting financial and operational objectives, while the remaining 40% was based on meeting individual goals related to the go-forward strategy. The management team was credited with meeting one of its three operational and financial goals. Among the individual goals the CEO’s direct reports had to hit, the board determined that execs met their individual performance opportunity at percentages ranging from 150% to 66%. The board used discretion to increase the reward on executives' "over-achievement" of the key company goal and individual MBOs, the proxy states.

Super Color, Style, Waxing

One of the most apparent changes so far is the cohesiveness of the management team, say Beltzman and Rhoades. Executives are working and thinking more holistically rather than focusing on the goals they need to hit to make their annual numbers, and their thinking is more in line with sustainable results and maximizing the value of their initial grants, the board members say.

Indeed, in board chair Williams’s letter to shareholders this year, he noted that Regis sold $54 million in non-core, underproducing assets and restructured its insurance to generate an additional $16 million that allowed the company to repurchase more than 20% of its outstanding shares.

Beltzman and Rhoades say that the board will likely learn and may make small modifications to the plan over time. Both are optimistic about the process and the alignment between the management team, board and shareholders. In addition, having the company’s largest shareholders engaged in how the company will execute a transformational strategy also lends another layer of confidence to the process.

Having a strategy in which the CEO and management team are aligned and put their “money where their mouth is” in executing against the plan leads to a far better probability of success than a strategy and comp plan in which “heads they win, and tails they sure don’t lose,” says Beltzman. “I also think having the support of the largest shareholders in the process allows management to attack their strategy with conviction,” he says.