JOHNSON ASSOCIATES, INC.

2020 Compensation Challenges and Opportunities

Financial Markets Total Rewards Group

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Johnson Associates

Trusted Experts. Independent. Forward-thinking.

Johnson Associates is a leading independent financial services compensation consulting firm specializing in strategic advice, innovative design, and a full range of solutions to help clients achieve their goals. Across business cycles, advise Compensation Committees and design company programs

- **Broad Range of Consulting Services**
  - Competitive market benchmarking (magnitudes and composition)
  - Annual and long-term incentive designs (amounts, terms, mechanics)
  - Funding rate / fee allocation assessments
  - Partnership structures / generational planning / leadership transitions
  - Turnover and headcount analyses
  - Special situations (transactions, bankruptcy, litigation, etc.)
  - Employment agreements

- **Clients across Financial Services Industry**
  - Asset Management
  - Hedge Funds / Private Equity / Real Estate / Other Alternatives
  - Wealth Management and Family Offices
  - Investment and Commercial Banks
  - Institutional and Retail Brokerages
  - Insurance Companies
  - Fintech

2019 Industry Incentive Changes*

2019 incentives uneven despite strong economy and markets, reflecting longer-term dynamics

- Asset Management: -3%
  - Slowing revenues and product shifts
  - Cost pressures and challenges demonstrating value
  - Wealth management flat

- Hedge Funds: Flat to +5%
  - Mildly positive with stronger performance
  - Quant funds struggling
  - Continued consolidation and pessimism

- Private Equity and Real Estate: Flat to +5%
  - Positive fundraising but slowing realizations
  - Economies of scale dominate

- Major bank incentives driven down by equities and underwriting
  - Fixed income and other areas also negative

Broad forward looking view:
2020 difficult compensation year due to changing fundamentals, and global market pressures

*% change from 2018 "same store"

Systemic Market Changes Impact Compensation

Market Changes Impact Compensation

Lower Revenue → Price competition, efficiencies, product shift

Lower Headcount → Impact of technology and focused strategies; crisis duration

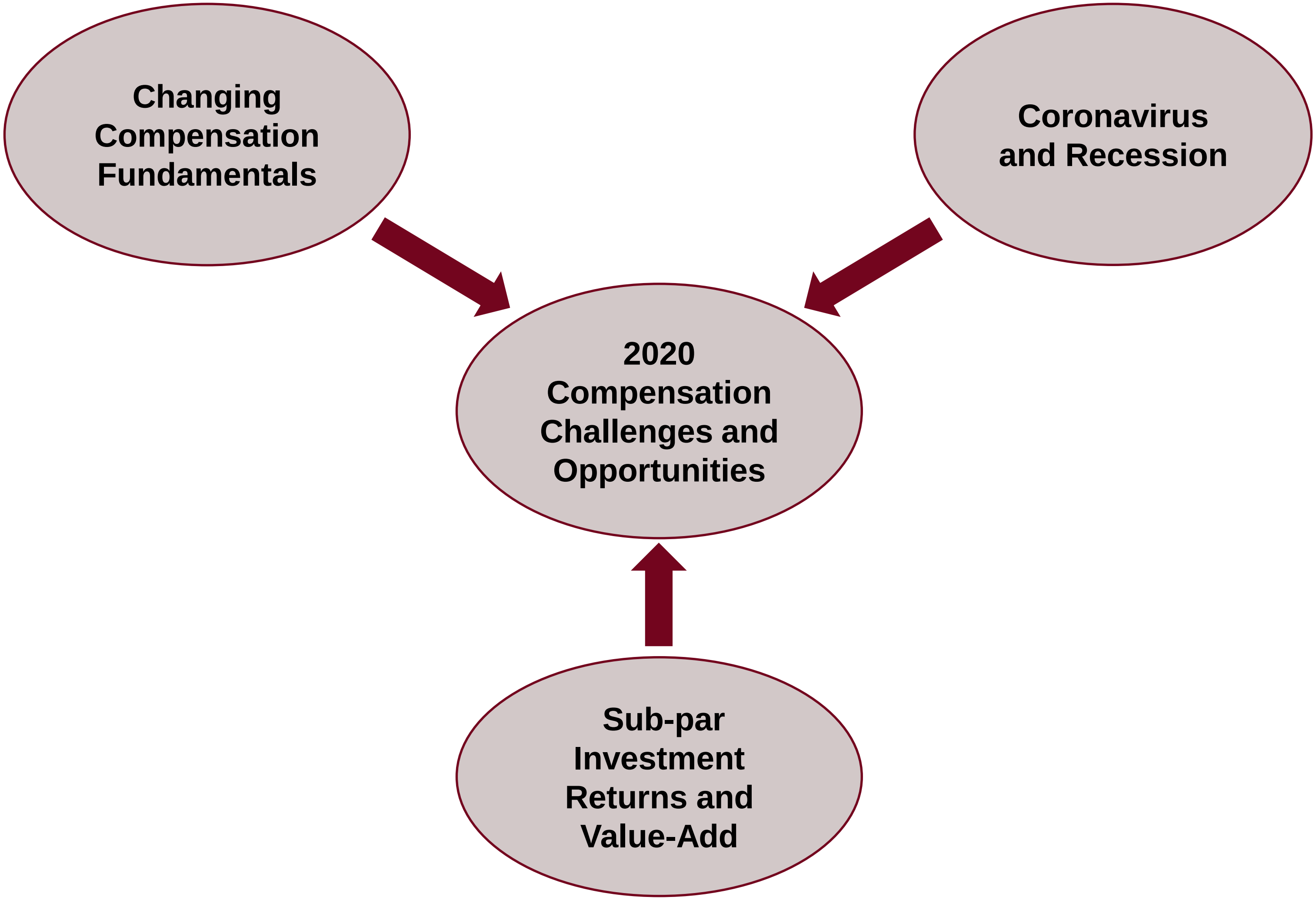
Higher Product Costs → Product development / management and innovation

High-End Talent → Increased demand across entire economy; expensive

Clear Reality:

- Difficult to fund pay for average performers
- Business changes complicate comparisons and norms
- Cost of great talent and accompanying challenges

2020 Brings the "Perfect Storm"



Changing Compensation Fundamentals

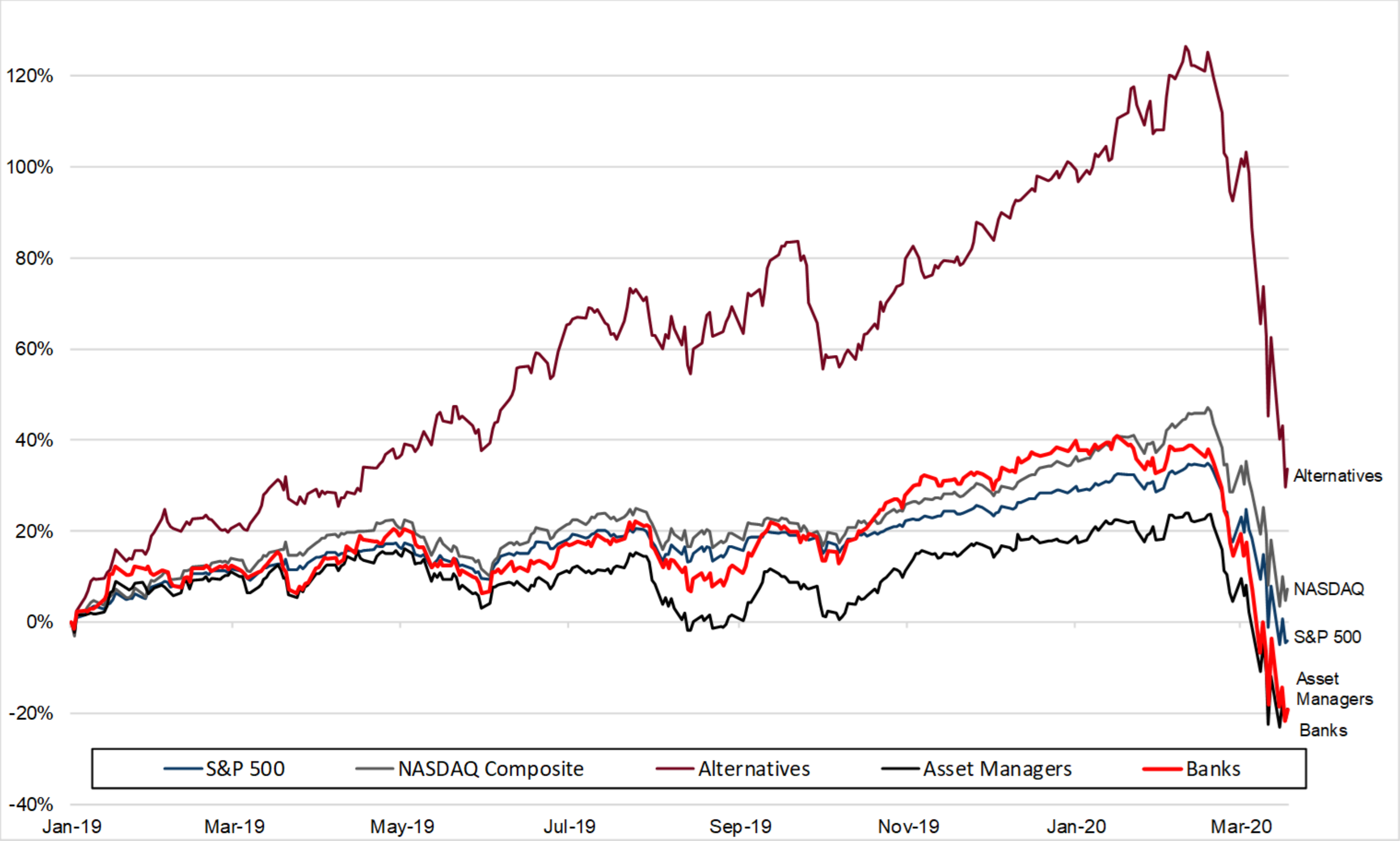
Coronavirus and Recession

2020 Compensation Challenges and Opportunities

Sub-par Investment Returns and Value-Add

Unusually Important Compensation Year
Sets stage for a new market landscape and expectations

Market Sending Clear Signals



Observations from "Take Your Pick" Situations

- Compensation and headcount planning and modeling begins soon
  - Scenarios and decision paths
  - Prepare for necessary (and unpopular) decisions
  - Enhanced communication

- Imperative to reassess Human Capital strategy
  - Talent levels, headcount, and outsourcing

- <u>Not</u> the time for focusing on average performers
  - Don't hope for normal number of voluntary quits
  - Avoid premature guarantees and promises

- Opportunity for equity program reassessment
  - Loosening of Founder mindsets
  - Realistic valuations and upside potential

- Deferred compensation can be your friend
  - Customized mix of cash and deferrals (products / equity)

- Recognize current market rates
  - 2019 compensation not year-end 2020 norms

Alternative contexts, like other crises or anomalies, in our lifetimes, (or the Great Depression…) too early to know or understand

Observations from “Take Your Pick” Situations

- Not the time to reduce base salaries
  - Ensure base salaries are market competitive

- Avoid the obvious dumb mistakes:
  - Take away snacks after we move into Hudson Yards
  - Talk about reducing medical benefits

- Avoid premature adjustments / changes
  - Hiring freeze
  - Repricing options or changing equity terms (beyond poor governance/optics)

- Provide opportunity to reshape organization
  - Address low performance or contribution issues

- Inflection point on working from home
  - Predictable Human Resources challenges

- Be prepared for multi-year implications
  - Economics
  - Morale / uncertainty

2020 Illustrative Funding and Allocations

Potential Business Scenario:

1. Business results necessitate 30% decrease in incentive pool funding
2. HR teams and Senior Management forced to make significant and difficult decisions on differentiation well beyond normal approaches
3. Decision to utilize supplemental deferrals to help manage cash flows and retention

Allocation Illustration (Pool Down 30%)

Individual Contributor	2020 Incentive Change	Supplemental Deferral
“Great”	-15%	Meaningful
“Very Good”	-25%	Moderate
“Good/Average”	-40%	None
“Sub-par”	-50%+ *(or terminated)*	None

Fearless Predictions

- Incentive compensation will drop 30% - 40% (or more) this year
- Will see implosion of several well-known alternatives firms
    - Slow down in Private Equity and Venture Capital
- Industry shake-up accelerates – uncertainty continues
- More line-of-sight incentive designs and metrics
    - For many, the right decision
- Some firms will make "dumb" compensation and Human Resources decisions
- Desire to believe recovery will be rapid (i.e. the financial crisis) – excuse not to change
    - Becoming “institutionalized” grows more difficult / elusive
    - Investment mispricing generates opportunities
- "TARP-like" restrictions put forward on executive compensation
    - Expectation for enhanced scrutiny / polarization of compensation decisions
- Movement accelerates out of high cost geographies
    - Working from home reduces office space demand
- Great uncertainty on where to invest now – movement into bonds over intermediate term

Asset Management

- Full "triple impact"
  - Coronavirus and recession
  - Systemic industry changes
  - Sectors with disappointing investment returns

- Critical integrated business decisions
  - Level of investment needed at the expense of margins
  - Product and geographical reach
  - Operating efficiencies and outsourcing

- Real commitment to alternatives (or not)
  - Carry and other compensation complications
  - Timeframes and investment required

- Need for bespoke incentive funding approach
  - Need to deviate from typical norms (year-over-year)
  - Commitment to the right investment teams

- Long-term vehicles and magnitudes
  - Stock options (or equivalents) on the table
  - Select supplemental awards

Business Evolution and Consolidation:
New strategies and products to mitigate shrinking margins on core assets?
Advisory platforms? Alternatives?

Hedge Funds

- Impact of select firm collapses
  - Ability to reassure investors and employees

- Investors skeptical of continually disappointing returns
  - Pattern of under-performance
  - Dramatic increase in “Haves” and “Have Nots” among firms

- More “direct drive” incentives focusing on individuals/teams
  - Recognition many firms are at performance inflection point

- Reconsider fundamental business model
  - Value-add vs. competitors / other strategies

- Review talent and headcount
  - Trend towards higher-end talent and leaner headcount
  - Necessity of office locations

Existential Question:
Over the next five years how can the firm provide real value to investors?
Need clear concise answer to guide decision making

Private Equity

- Industry has benefited significantly since financial crisis
  - Favorable returns
  - Massive fundraising and scale

- Significant entitlements
  - High compensation expectations / demands
  - “Millennial Disease” – early / mid-level professionals with extraordinary expectations
  - Favorable carry tax treatments

- Value of existing transactions and outstanding Carry has dramatically declined
  - Massive amounts of available funds (i.e. “dry powder”)

- Renewed focus needed on existing issues
  - Performance management
  - Incentive allocations
  - Lack of entrepreneurial behaviors

- Opportunity for greater use of leveraged co-investment
  - Can provide different alignment than Carry

Age Old Question:

Can Firms avoid indiscriminate investing with their dry powder?
Experience has shown it won’t happen naturally and could require intervention

Insurance Companies

- Core Insurance remains challenging
  - Impact of low interest rates
  - Coronavirus impact on health insurance sector

- Generally structured compensation approaches
  - Target-based systems less equipped to adapt in rapidly changing markets
  - 2020 / 2021 will stress test ability of programs to work

Potential Outcomes

Maintain current programs (2021 targets may start above market)

One-off adjustments to 2020 year-end

Fundamental changes to program going forward

- Attractive benefits will come under greater scrutiny
  - Given higher prevalence, focus will be on traditional pension
  - Medical untouched due to Coronavirus

- Expansion into other businesses becomes more necessary but riskier
  - Building and buying are more affordable but require determination
  - Growth in asset management requires appropriate compensation design

Sales Compensation

- Greater commitment needed from senior management and portfolio managers
  - Increase interaction with key clients and channels
  - Far more prominent role required

- Sales compensation has been subsidized for years
  - 2020 – 2021 market conditions increases the need

- Movement to hybrid compensation programs has accelerated
  - Movement will continue

- Many products are unsalable due to investment performance
  - Continue to refocus sales efforts on core strategies
  - Sales cycles become longer

- Advice and solution skills continue to be valued

- Opportunity to relook at sales/marketing for the medium term

2020 Additional Compensation Tools

Difficult situation combined with evolving fundamentals creates need to consider "out-of-the box" solutions

- Supplemental deferred compensation / equity to augment normal year-end pay
  - Selective targeted amounts with vesting over the next 1 – 3 years

- Additional Firm equity awards at new current valuations
  - Share in potential upside with long vesting
  - Accounting costs of new stock options understated (backward looking volatility)

- Enforce plan provisions on "clawbacks" for portfolio manager investment losses, and re-grant with 3-year vesting

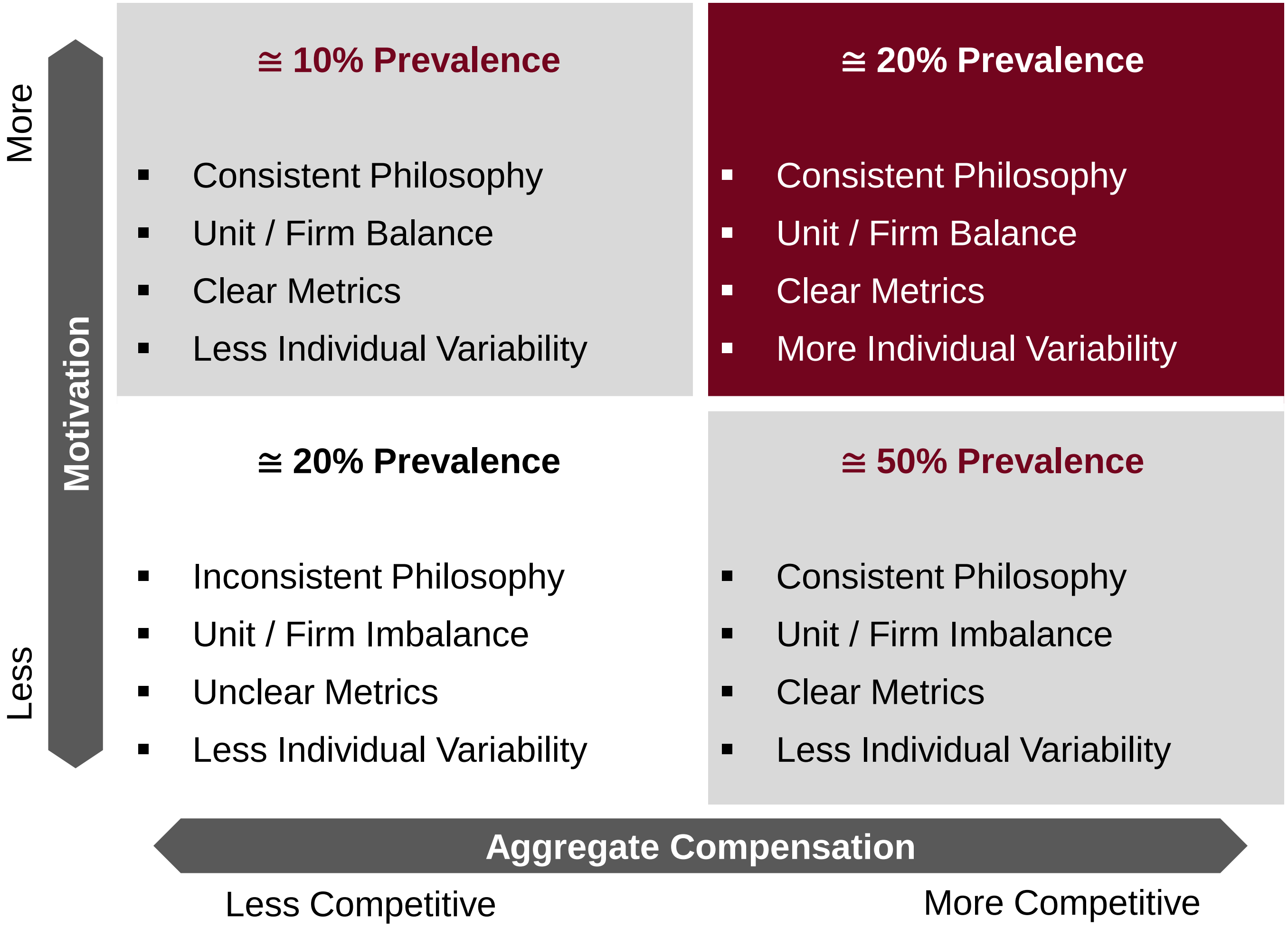
- Increase magnitude of leveraged co-investment program
  - Additional incentive on future performance and provides alignment
  - Provides go-forward opportunity especially for disappointing funds/portfolios
  - Refresh plan terms (i.e., leverage, amounts, vesting, etc.)

Market Data – Points to Consider

Increased Importance: Understand Market Positioning in Challenging Situations	▪ Loss of recent reference points (i.e. Position X makes $Y) ▪ Address facts and make informed decisions
2020 Survey Data reflects 2019 Year-End Market	▪ By Fall 2020, 2019 raw data already significantly out of date ▪ Upcoming decline in 2020 incentives not reflected
Significant Adjustments Needed for Historical Data	▪ Broad 30%+ decline would have to be integrated into analyses ▪ Important to consider variable impacts by position / area
2019 Compensation Less Relevant for Recruiting	▪ For example, to change jobs, compensation flat over 2019 might reflect a very good increase over actual 2020
Challenges in 2021 for Setting Structured Programs	▪ 2020 outcomes impact decision-making ▪ Total compensation and pay component targets

Annual Incentive Effectiveness *

Greater recognition that existing designs require reassessment



More

Motivation

Less

≅ 10% Prevalence

- Consistent Philosophy
- Unit / Firm Balance
- Clear Metrics
- Less Individual Variability

≅ 20% Prevalence

- Consistent Philosophy
- Unit / Firm Balance
- Clear Metrics
- More Individual Variability

≅ 20% Prevalence

- Inconsistent Philosophy
- Unit / Firm Imbalance
- Unclear Metrics
- Less Individual Variability

≅ 50% Prevalence

- Consistent Philosophy
- Unit / Firm Imbalance
- Clear Metrics
- Less Individual Variability

Aggregate Compensation

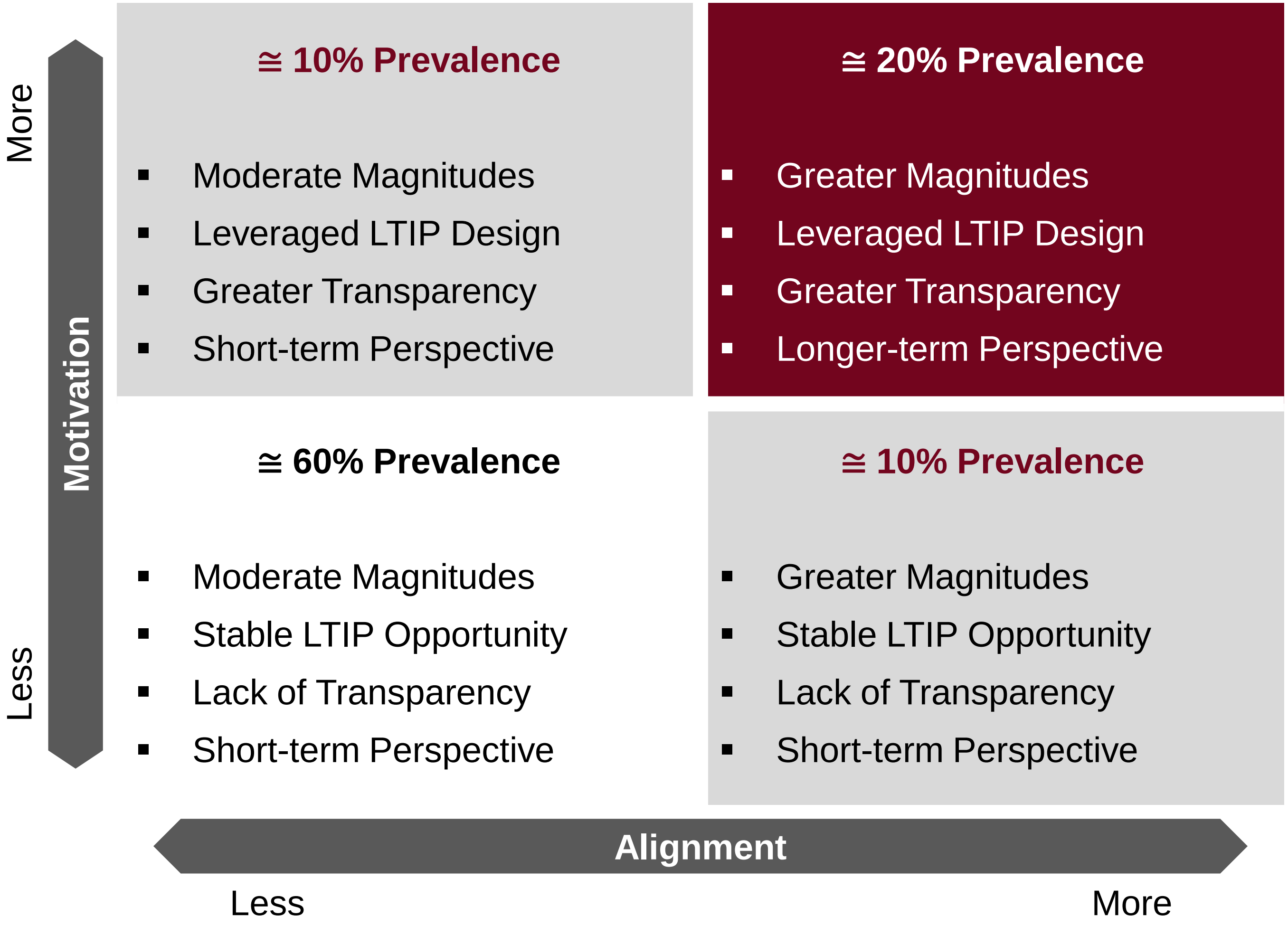
Less Competitive

More Competitive

** Focus on private firms. Public firms often have similar issues but limited by shareholder advisory groups, regulators, and institutional shareholders*

Long-term Incentive/Equity Effectiveness *

Greater recognition that existing designs require reassessment



≅ 10% Prevalence

- Moderate Magnitudes
- Leveraged LTIP Design
- Greater Transparency
- Short-term Perspective

≅ 20% Prevalence

- Greater Magnitudes
- Leveraged LTIP Design
- Greater Transparency
- Longer-term Perspective

≅ 60% Prevalence

- Moderate Magnitudes
- Stable LTIP Opportunity
- Lack of Transparency
- Short-term Perspective

≅ 10% Prevalence

- Greater Magnitudes
- Stable LTIP Opportunity
- Lack of Transparency
- Short-term Perspective

**Focus on private firms. Public firms often have similar issues but limited by shareholder advisory groups, regulators, and institutional shareholders*

Final Thoughts

- Crisis and aftermath requires creativity and determination

- Important to begin modeling and planning early
  - Provides time for thoughtful decision-making and buy-in

- Recognize variety of compensation tools available outside the norm

- Avoid the dumb mistakes even if others are making them

- Helpful mantra: Real upside if you and company both succeed going forward
  - Requires utilizing the right compensation tools today and communication

- The worst outcome is not people that quit and leave. It's people who quit and stay. Don't obsess over voluntary turnover

- Take advantage of the opportunity to change programs, metrics, philosophy, and communication

- Opportunity for talented professionals to demonstrate value across multiple dimensions. Knowledge, creativity, sense of fairness, integrity and backbone, and sense of humor, come to mind