The state of M&A retention agreements in 2017: smart, selective and strategic

Insights from the 2017 Global M&A Retention Study

Willis Towers Watson

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Table of contents

Executive summary: smart, selective and strategic

Most large companies continue to make M&A a key part of their growth strategy for entering new markets, expanding both scale and scope of products and services, and acquiring new capabilities. They also continue to see M&A as a way to bring in new talent. For example, the first step many companies often take to become digital is to buy a company whose talent has the ability to drive the transformation. As a result, key talent retention remains a top priority issue for most deal makers.

In this, our third global M&A retention study since 2012, we continue to focus on financial retention agreements as a vehicle to ensure that the acquired talent remains with their new company. Reassuringly, the effectiveness of these agreements has improved over time. In 2014, nearly 70% of the participants indicated that they retained the talent who received agreements over the span of the retention period. This number has risen to about 80% in our 2017 study.

Companies today are smarter about how to construct a compelling agreement, including the use of nonfinancial actions. They are more selective about the number and type of retention award recipients and more strategic about how to use agreements to retain leaders and talent most critical to deal success. Our extensive consulting M&A experience confirms that acquirers are moving away from the broad strokes of providing retention agreements based on factors such as organizational levels and moving toward a more focused look at individuals who are critical to delivering on deal value, both in the short and long term. That said, we continue to see the need for companies to use an array of financial and nonfinancial vehicles to capture the hearts and minds of acquired talent.

Similar to 2014, we focus this global report on understanding the nuances of successful agreements. We highlight changes since 2014 and what high-retention companies do differently.

How we define high-retention companies

To qualify as a high-retention company, an acquirer must report retention rates of 80% or more for the full retention period. Low-retention companies report retention rates of less than 80%.

Key findings

Who is targeted for retention?

The principal targets are senior leaders, which include top executives and direct reports (54% of respondents), and other employees with key skills that could affect the success of the transaction (55%). Additional factors that help identify retention targets include: high-potential (25%) and performance (22%) status, job function (37%), job title/level (48%) and management discretion (23%).

When are retention agreements signed?

Senior leaders targeted for retention agreements are asked to sign earlier in the deal than other key employees.

What information is used to identify retention agreement recipients?

Almost all acquirers (90%) most frequently turn to the target company's senior leaders to identify employees appropriate for retention agreements. For 62% of acquirers, the input from these leaders is more effective than any other source of information.

What is the most common type of retention award?

Cash bonuses – most commonly expressed as a percentage of base salary – remain the primary financial award in retention agreements for senior leaders (77%) and other key employees (80%). The use of stock options to retain senior leaders is down significantly since 2014, from 32% in 2014 to 16%.

How are retention payouts set, measured and awarded?

Sixty-two percent of acquirers foot the whole bill for retention awards. The median retention budget declined from 1.9% of the total purchase price in 2014 to under 1%, likely reflecting higher average deal values as equity markets rose. The decline in overall budget percentages has had no effect on the cost of individual awards, which rose modestly from 2014 levels.

The median senior-leader retention award value in 2017 is 55% of salary versus 31% for other employees (in 2014, these median values were 48% and 27%, respectively). Notably, a wide range – nearly 40% – of senior executives received retention awards with a target value of over 80% of their base salary versus 11% for other key employees.

Companies are near equally split on the use of "cliff" vesting for retention awards (i.e., lump sum payment at the conclusion of the retention period) versus gradual vesting, which provides for partial payments at certain milestones throughout the retention period.

Time-vested awards are more prevalent than performance-based awards for both senior leaders and other key employees. Notably, for senior leaders, use of exclusively time-based agreements rose from 35% in 2014 to 48% in 2017.

The median retention period for senior leaders rose from about 15 months post-close to 18 months post-close, whereas for other employees, the median retention period remains 12 months post-close.

For performance-based retention agreements, payouts for both senior leaders (51%) and other key employees (34%) are most commonly based on the performance of the acquired company only. Payouts for senior leaders based on the entire acquiring company's performance (such as acquirer stock options or shares) are far less common (17%) than they were in 2014 (41%).

What drives employees to leave the company before the end of the retention period?

Far more companies (79%) are successful in meeting their retention goals of keeping at least 80% of people who have agreements until the end of the retention period than was reported in 2014 (68%). Of those who do leave, nearly half blame the new or changing culture (44%). Other top reasons include not liking their new role (25%) and being aggressively pursued by competitors (36%). Key employees understand their value in the marketplace, which raises the importance of additional retention tactics. The most successful acquirers realize that retention agreements alone can buy time – but not loyalty. As a result, in addition to agreements, they use personal outreach and enhanced career opportunities throughout the desired retention period to convince key people to stay for the longer term.

What high-retention companies do differently

High-retention companies behave differently from others in four critical ways.

1 **Specialized selection:** High-retention firms are more likely to target employees below the executive level with key skills than low-retention firms (61% versus 47%), while low-retention firms are more likely to give awards to those identified as high potential (33% versus 23%) or high performance (30% versus 21%).

2 **Early communication:** At high-retention acquirers, 28% of senior leaders are asked to sign before the initial signing versus only 11% for low-retention acquirers.

3 **Standardized awards:** High-retention companies are less likely to take values earned at sale (e.g., shares owned or accelerated stock awards) into account when determining retention values.

4 **Delayed vesting:** High-retention acquirers are more likely to pay out in full only at the conclusion of the retention period (53% senior leadership/61% other employees), while low-retention acquirers use interim vesting/payment terms (35% senior leadership/ 39% other employees).

Global findings

Best practice: Identify retention candidates who matter to the deal

Senior leaders (54%) and employees below the executive level with key skills considered critical to the transition (55%) run neck and neck as the groups most likely to be offered retention agreements *(Figure 1).* Notably, high-retention companies (61%) are more likely to consider nonexecutive employees with key skills than low retention companies (47%). Who are these key-skills people? It depends on the organization and its goals, but they can range across roles, including shared services, client-facing staff, technical experts and other key contributors.

In our experience, acquirers look at many job families and employee levels in establishing retention bonus participation. With the cost and risk rising of finding, hiring and integrating new talent during or just after an acquisition, it is clearly more efficient and effective to take the steps necessary to keep key talent than to recruit externally. And in regions, industries and specific job categories where the competition for talent is fierce, keeping the right people becomes even more critical to success.

Figure 1. **Having key skills or being on a leadership team are the main factors for retention agreement eligibility**

Increasingly, acquirers turn to leaders of the company they are acquiring as the primary information source for recipients of retention agreements, rising from 76% in 2014 to 90% in 2017. Notably, this is considered the most useful strategy by most acquirers (62%). Acquirers are not as likely to utilize purely data-driven criteria, such as salary-grade structures, performance ratings or job descriptions, when selecting retention plan participants. High-potential (25%) and high-performance (22%) status are seen as less important than in our 2014 study (45% and 39%, respectively).

Best practice: Focus initial retention efforts on senior leaders

There are several compelling reasons to start the retention process by focusing on senior leaders. First, they tend to be the group leading the transaction pre-close, and most responsible for getting the deal done. To make sure they are not distracted by concerns about their own futures, it's critical to get them on board and aligned with the goals and strategies of the acquisition. Retention agreements provide a clear personal stake in the success of the new company.

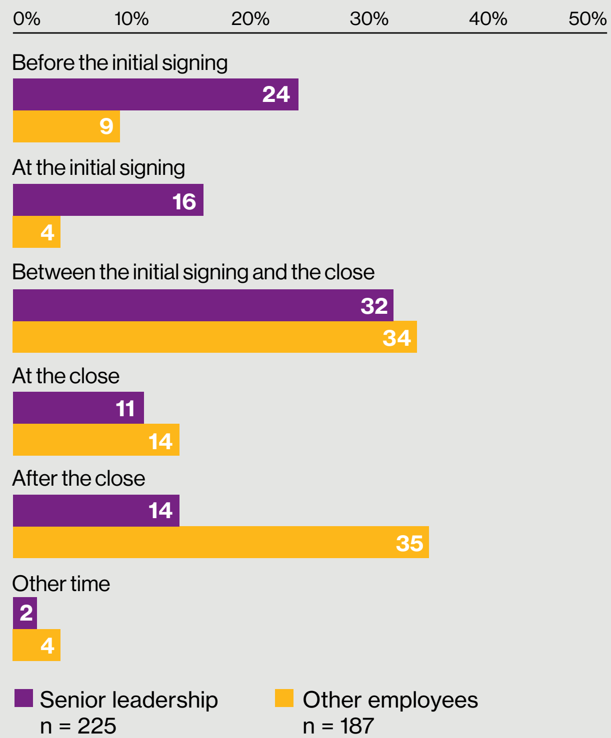
That's why nearly a quarter (24%) of respondents to our 2017 study ask senior leaders at target companies to sign retention agreements before the initial merger agreement signing and 16% at the initial signing *(Figure 2).* The percentage seeking pre-close signing is higher at high-retention acquirers with 28% of senior leaders asked to sign before the initial signing versus only 11% at low-retention companies.

In total, the percentage of acquirers asking senior leaders to sign early in the deal process is down to 40% in 2017 when compared with 2014, when 54% of acquirers asked senior leaders to sign either before (32%) or at (22%) the initial signing.

Outside executive ranks, far fewer companies ask other key employees to sign before the initial signing (9%) or at the signing (4%). And as with senior leaders, prevalence for this group is also down from 12% and 14%, respectively, in 2014. However, more than a third (35%) are asked to sign after the close, compared with only 14% of leaders, which is about the same as 2014. Since most employees at the acquired company are not aware of the sale until after the announcement, it is reasonable to expect that most retention awards for nonexecutives would be signed post-announcement.

Retention agreements provide a clear personal stake in the success of the new company.

Figure 2. **Senior leaders are asked to sign retention agreements earlier in the deal than other key employees**



Our data show other critical differences between retention agreements for senior leaders and those for other employees:

- While acquirers are slightly more likely to provide cash to key nonexecutives (80%) than leaders (77%), they are much more likely to provide additional incentives to leaders, including time-vested shares (29% versus 18% for others) and stock options (16% versus 6% for others).
- For companies that include time-based (i.e., pay-to-stay) metrics in their retention agreements, senior leaders have longer retention periods than other employees. A retention period of over 18 months after close is imposed on senior leaders by 44% of companies with pay-to-stay provisions, while only 31% of companies impose this on other employees. That prevalence is up slightly from 2014 for both groups (41% for senior leaders, 24% for other employees). Eighteen months is now the median time frame for leaders versus 15 months in 2014; 12 months remains the median time frame for nonexecutives.

- Average award size for senior leaders remains significantly higher than for other employees. The median retention bonus value as a percentage of base salary is 55% of base salary for senior leaders, versus 31% for other employees. Both are up modestly from 2014, when the percentage was 48% for leaders and 27% for all others.

Best practice: Cash is king

While a combination of cash and other types of awards is common, cash continues to dominate *(Figure 3)* with 77% of acquirers globally giving senior leaders cash awards and 80% giving cash to other key employees, about the same as 2014. In the U.S., companies are more likely than the rest of the world to provide cash bonuses (83% for senior leaders, 89% for others). The use of stock options as a retention tool for senior leaders fell in half since 2014, when 32% of acquirers gave them, compared with only 16% now. The reduction in the prevalence of stock options as retention awards is likely due to a desire by companies to simplify their approach to retention compensation, and cash serves as the most straightforward tool to use.

Figure 3. **Cash bonuses are by far the most common financial award used in retention agreements**

Cash bonuses are most commonly set as a percentage of base salary for both leaders (40%) and other employees (45%). Fixed-amount cash bonuses are the next most popular with 35% of companies giving them to both executives and nonexecutives.

Best practice: Balance pay to stay with pay to perform

Since 2014, the use of time-based agreements for senior executives has grown from 35% to 48%, while performance-only plans have decreased from 14% to 8% for senior executives and from 16% to 6% for nonexecutives. Companies' use of a combination of time-based and performance-based awards has also decreased in favor of time-based, from 48% to 43% for senior executives and 33% to 30% for nonexecutives.

Including performance metrics in a retention agreement is tempting, especially given stakeholders' expectations of quick and measurable financial success for a merger or acquisition. In fact, between our two studies in 2012 and 2014, we saw a trend toward more performance-based agreements that has now dissipated. In 2012, only 1% of companies used performance-based only and 46% used time-based only, but by 2014 some companies abandoned pay-to-stay agreements altogether in favor of those based purely on financial performance.

However, that swing toward performance-based did not appear to improve retention rates, and in fact, in 2014, high-retention respondents were more likely to use combination agreements of pay-to-stay and pay-to-perform metrics (59%), while low-retention firms were more likely to use purely performance-based agreements (42%).

While the theory behind performance-based metrics, such as an "earn-out" plan, makes sense, overusing them can backfire. Employees who are measured on metrics that are unattainable or out of their control are more likely to forgo the diminished bonus opportunity and seek employment elsewhere. Alternatively, they may stay with the company but feel less engaged in their work than they might have been had the performance measures been more attainable when established.

The challenge is to get the right balance between encouraging top performance and setting reasonable performance metrics – that is, those that reflect the employee's job level, role and skills, and the degree to which he or she can reasonably be expected to influence company performance. And currently, that's where most acquirers seem to have landed, especially in the U.S. where time-based agreements are more prevalent (57% for leadership and 72% other employees) versus non-U.S.-based companies (40% senior leadership/56% other employees).

What's the right budget for retention bonuses?

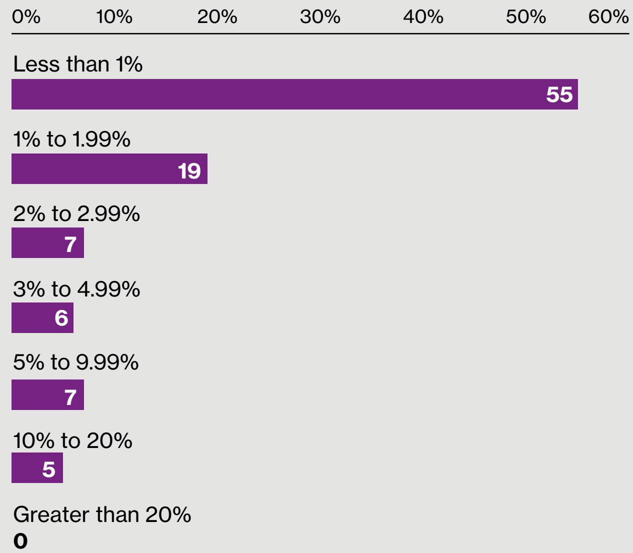
More than half of acquirers (55%) have a retention budget of less than 1% of the total transaction cost *(Figure 4)* – that's nearly 50% lower than 2014, when the budget median value was 1.9%. This reduction may reflect higher average deal values due to a rising equities market, and doesn't reflect a reduction in the total cost of retention awards. Individual award values are up modestly with median awards for senior executives at 55% of salary versus 48% in 2014 and 31% of salary for other employees versus 27% in 2014.

The higher the deal value, in general, the lower the relative size of the retention budget. Most companies reach for a sweet spot that encourages retention by an optimal number of key employees – not the maximum number of employees – so that individual values can be meaningful to the participant without overspending in the aggregate. With that said, it is also possible to both underspend and overspend at the individual level: Too little and there's no incentive to stay; too much and employees' focus turns to the bonus payout date and not on integrating with the new combined company.

The higher the deal value, in general, the lower the relative size of the retention budget.

In addition, companies need to understand the role of the purchase price in keeping top executives. Some companies don't provide a retention bonus for top executives who are already going to profit from the company's sale. Their rationale: Why provide an additional bonus to an executive who may be making a significant profit on the sale of the company – especially if that profit dwarfs the bonus? The retention bonus alone won't keep the executive who plans to leave, making it a needless expense. However, in our experience, companies that determine retention eligibility and target values independently from individual earnings upon sale are more effective at retaining their targeted employees than those that tinker with individual values based on personal financial circumstances.

Figure 4. **More than half have a retention budget less than 1% of the total transaction cost**



Beyond the bonus: Keeping employees over the long term

While 79% of respondents indicate they are able to retain a high percentage of employees (over 80%) for the full retention period, we know from previous research that only about one-half of those high-retention companies maintain that rate one year later. This raises a crucial question: How well are companies using the retention period to build employee engagement, develop and communicate a positive culture, work individually with key employees to keep them on board for the long term – and help ensure the success of the merger over a longer period?

Retention bonuses are important – at least for the length of the retention period – but they're only part of the equation. In our experience, personal outreach by leaders and managers, strategic promotions of some individuals and employees' participation on task forces are also beneficial. And let's not forget the role of Total Rewards – particularly learning and development, career opportunities for high-potential candidates and a Total Rewards philosophy that holistically meets employees' needs while providing for pay differentiation among high performers. Local and regional customs also come into play. Multinational acquirers that build a culture and compensation philosophy that is global but allows for regional and local variations can make key employees feel comfortable – and wanted – in the new environment.

Helping new employees understand and navigate the new culture is important, especially when a large company acquires a smaller one, where the culture is likely to have been very different.

In fact, the factors that are critical for retaining and engaging employees are the same whether or not a company is in the midst of a merger or acquisition. Our 2016 Global Workforce Study, which garnered responses from more than 31,000 employees in 29 markets, shows the importance of these workplace attributes in driving retention, and reinforces the link between high rates of retention and employee engagement. For example, respondents who have experienced a merger or acquisition in the past year said:

- The top driver of employee retention for employees in both the acquiring and target companies in all parts of the world is base pay. The other two top retention drivers continue to reflect the fundamentals: career advancement and trust/confidence in senior leaders, in that order.
- Sustainable engagement requires strong leaders and managers. In companies where both leaders and managers are perceived by employees as effective, 67% of employees are highly engaged.

Organizations keen to retain top talent during and after a merger could increase their success rate by focusing on cultural issues, including a clear articulation of the employment deal and frequent communication from senior leadership, combined with manager training that emphasizes people skills. They would also do well to pay attention to career development and pay differentiation for top performers.

Our point of view

Develop a thoughtful retention strategy based on the deal objectives.

It's almost impossible to be dogmatic about a retention strategy; there are simply too many unknowns. But companies can go a long way toward positioning the transaction for success if they:

- Start with a clear strategy that reflects the business goals of the transaction
- Identify the senior leaders who can provide the most thoughtful input into key employees and serve as deal champions
- Set a budget and timeline for retention awards that allow for a vigorous selection process while not over-promising on award levels
- Assign roles and responsibilities for developing and administering the process
- Remain flexible along the way as they gain new information about both the acquired company and its talent

Retention should start with executives.

By solidifying retention agreements with senior leaders first, companies can keep them engaged in the merger process. The behavior of senior leaders is critical to the retention and engagement of employees. Easing their concerns early will help to roll out an effective retention strategy for their teams. While agreements don't necessarily need to be signed before close, don't wait too long. They should be completed very quickly after the merger.

Senior leaders require different retention plans than other employees.

The strategies for these two groups should be designed separately, taking into consideration such factors as bonus size and form (with an emphasis on time-vested cash for nonexecutives), length of retention period (generally, longer for executives) and the degree to which performance metrics should be part of the agreement (and may result in a greater emphasis on performance for executives).

Think beyond the financial payout.

Finally, companies should pay close attention to the factors that retain employees for the long term, including interpersonal communication and access to key leaders, expanded career development opportunities (including lateral moves that may not have been possible pre-acquisition), pay differentiation for top performers and a clearly articulated employment deal. Helping employees understand and navigate the new culture is important, especially when a large company acquires a smaller one, where the culture is likely to have been very different.

About the study

The 2017 Global M&A Retention Study, our third in the past five years (surveys were also conducted in 2012 and 2014), examines the structure, use and effectiveness of retention agreements during an acquisition or merger, with a particular focus on the financial elements of those agreements.

To qualify for the study, organizations must employ at least 500 people (1,000 if based in the United States), complete either a merger or an acquisition within the past two years, and use employee retention agreements for at least one of those transactions *(Figure 5).*

The study collected data between March and May 2017, from 244 respondents across 24 different countries in Asia, the Americas and Europe. Within the past two years, 91% of the respondents had acquired another organization, 10% had merged with another organization and 6% had been acquired by another organization. More than half the acquirers (56%) and 47% of the sellers are based outside the United States. They represent virtually every industry *(Figure 6).* Seventy-one percent of the acquirers are publicly held. Thirty-six percent of transactions were global, and 64% were regional. Less than half (44%) of the transactions were worth more than half a billion dollars.

Figure 5. **Number of full-time workers employed by acquiring organization**

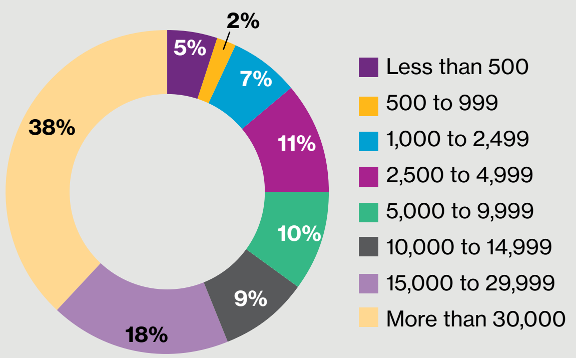
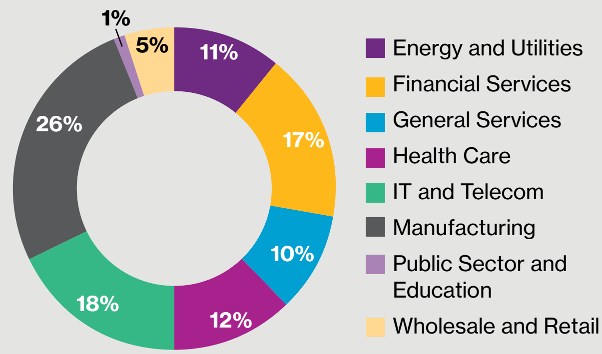


Figure 6. **Respondents for industry groups**



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