Reevaluating Health Care Compensation: Talent and Rewards Strategy in Support of a Diversified Business Strategy

John Collins, Principal, SullivanCotter

Bruce Greenblatt, Managing Director and
Executive Workforce Practice Leader, SullivanCotter

Introduction

Not-for-profit (NFP) health care organizations face an extremely challenging operating environment and sustained financial headwinds. Labor and other operational costs are increasing, while organic revenue growth opportunities are limited by patient access challenges, increasing competition and payor reimbursement. As a result, average operating margins for the industry are near or only slightly above break even, compromising organizations' ability to invest and meet their future clinical, teaching and research objectives.

NFP health care organizations seek opportunities to diversify and grow revenue to ensure their financial sustainability and meet their missions. Some key opportunities being explored include commercializing internal innovations and intellectual capital, acquiring or spinning off operating companies into subsidiary businesses, and starting venture capital (VC) or private equity (PE) style investment funds.

While in some cases, health care organizations may create joint ventures to further these objectives, in many situations, these diversified businesses are embedded within the NFP health care organization or a for-profit subsidiary. These businesses often require talent sourced from different markets beyond health care. In addition, their business strategies and operating objectives often differ from traditional health system goals, and thus, performance expectations may be unique to the diversified business.

Tailored compensation arrangements and incentive programs that vary from the core health system program are required to effectively recruit, retain and motivate leaders within these new businesses. Over the past several years, many health systems have implemented such distinct programs. Below we review compensation strategies and program design considerations for leaders of such businesses.

Key Issues that Inform Compensation Philosophy and Design for Leaders of Diversified Businesses

When determining how to compensate leaders of a diversified business, several questions about the organization structure, operating character and strategic/financial intent of the business need to be considered to inform an appropriate compensation philosophy and program design:

Key Design Issues	Considerations	Implications for Rewards
Consistency	• Is a separate compensation approach needed to support talent attraction, retention and engagement in the new business? • Does creating a different compensation program create any issues with internal equity?	• Determination of whether a distinct compensation program is necessary and appropriate.
Operating Status	• Is the diversified business a defined operating unit or select individuals? • How might this change over time?	• If select individuals within the NFP, a variation of the NFP Corporate plan may be appropriate (e.g., using individual goals to reward for unique business focus). • If there is a separate operating unit, a distinct compensation plan could be utilized.

Incorporation Status	• Will the business be created as a for-profit (FP) enterprise, or will it operate as a part of the NFP parent company? • If a FP subsidiary exists, will it be formed as an LLC, C-Corp., S-Corp., etc.?	• NFP businesses utilize cash compensation vehicles. • FP businesses could use cash plans or other forms of compensation (e.g., equity, profits interest, carried interest, etc.) based on the incorporation status of the business unit and its business strategy and operating objectives.
Strategic Focus	• Is the business a long-term operating asset of the parent? • Is the business an operating company that may be sold or IPO? • Is this a capital fund to invest in businesses (i.e., a portfolio company in a VC/PE type of fund)? • How might this evolve over time?	• A long-term strategic operating business (i.e., no monetization event) lends itself more to using a cash long-term incentive. • If there is likely to be a sale, IPO, equity compensation may be appropriate. • If the business is a financial investment in a portfolio, a return on investment or carried interest program may be appropriate.
Funding	• Will investment be sought by outside partners (whether other NFP health care partners or other investment partners)?	• If the NFP is fully capitalizing the company, it will have greater flexibility as to the compensation plan. • If outside investors are involved, they will likely have perspectives on the appropriate compensation vehicles.
Operating Priorities	• What are the indicators of success for the business or mission? • How does this vary from the NFP parent's business? • Are there interdependencies with the parent company's operations?	• The priorities of the business inform potential incentive measures under the plan. • If there are operating interdependencies with the parent, it may be appropriate to have shared goals with the parent in the leadership plan to support alignment.
Talent Market	• Who are the competitors for talent? • Will the diversified business be hiring from outside the NFP parent?	• The sources of talent will inform the total required compensation and the mix of compensation between salary, incentive compensation, and benefits.

Compensation Philosophy and Program Design Considerations

Based on a review of the attributes of the business, the organization should develop a specific compensation philosophy and program design for the diversified business. The following areas should be considered:

Compensation Philosophy

If a separate compensation program is developed for the diversified business, a compensation philosophy should be articulated to set the guiding principles for the program. Attributes of the compensation philosophy include the following:

- Competitive Talent Market: Define the talent markets from which leaders will be recruited. The applicable markets will inform benchmarking of overall pay levels (e.g., health care, managed care, for-profit general industry, etc.).

- Desired Target Pay Levels: Determine the desired positioning of base salary, total cash compensation (salary plus annual incentive), total direct compensation (cash compensation plus long-term incentive) and total compensation (direct compensation plus benefits).

- Mix of Fixed vs. Variable Pay: Determine how much pay will focus on performance-based incentive compensation versus salary. For high-growth businesses where a monetization event is planned, base salaries typically are a smaller portion of pay, while incentives are more significant. For a strategic operating business, there may be more balance between fixed and variable pay.

- Mix of Annual vs. Long-Term Incentives: Determine the desired emphasis on annual versus long-term incentives For a business expected to be sold or monetized, there is typically a greater emphasis on LTI compensation and more modest annual incentives. The mix between annual and LTI is more balanced for businesses that are long-term operating companies.

- Variation from NFP Parent Philosophy: Validate that the parent organization is comfortable with a distinct philosophy for the diversified business. A distinct philosophy is more common where the diversified business is operationally independent of the parent, and where there will be limited talent transfer between the parent and the diversified business.

Incentive Design

Annual Incentives –Annual incentive program design should consider whether the diversified business will have its own plan or use the NFP parent company's annual incentive program.

- A separate plan is typically used when there are limited interdependencies between the NFP parent and the diversified business or if the diversified business's success indicators are distinct from the NFP parent.
- Where there are interdependencies between the NFP parent and the diversified business, the diversified business typically utilizes the NFP parent's annual incentive with accountability for shared system goals, plus the plan may include a distinct component tied to the diversified business.

Long-Term Incentives –The specific long-term incentive vehicle implemented will be influenced by the various issues noted above (incorporation status, talent market, exit strategy, etc.). Participants in the long-term incentive plan (LTIP) typically are limited to employees of the diversified business. The most common approaches in the market are summarized below. These alternatives should be carefully considered based on the structure and objectives of the diversified business.

- NFP Parent Cash LTIP
  - » The Parent NFP's corporate LTIP plan may be used by a diversified business that has significant interdependencies with the NFP parent.
  - » Parent company cash LTIPs typically have performance periods of three years, participants are limited to the most senior executives, and performance measures typically include a select number (2-4) of critical multi-year objectives. The diversified business should have a meaningful impact on the parent company's long-term performance outcomes.
- Separate Cash LTIP for the Diversified Business
  - » The diversified business may have a separate cash-based LTIP when the business is an operating company (i.e., not an investment management company) that will be run as a long-term asset with no plans to IPO or sell.
  - » These plans are structured similarly to an NFP parent cash LTIP, with a 3-year focus that includes several multi-year performance objectives.
  - » For newly formed companies with unclear financial objectives, the cash LTIP often focuses on strategic objectives and growth metrics.
  - » For more established operations, the cash LTIP is typically tied to earnings (e.g., EBITDA, operating income, etc.) and growth metrics (e.g., revenue, membership, etc.).
- Equity LTI Awards
  - » Equity compensation may be used for FP subsidiaries with a plan for a monetization event (e.g., sale or IPO).
  - » Stock options are the most commonly used vehicle to align the diversified company's employees with value-creation objectives. Other equity may also be used in appropriate situations (e.g., restricted stock, performance-based restricted stock).
  - » Equity typically is not used if no monetization event is planned due to the potential for cash drain from operations. A buyer via sale or the equity markets via IPO is the best way to fund award buyouts, to ensure affordability.

- Profits Interest
  - A profits interest is similar to a stock option award. It can only be utilized where the diversified business has been formed as a Limited Liability Company (LLC) rather than an S-Corporation or C-Corporation.
  - Profits interests are typically structured like stock options in that they reward for increases in company value, and do not convey any ownership rights to the recipient.
  - Like equity awards, since profit interests are based on company value, they typically only realize value in the event of a company sale or IPO, since a buyer or equity market is the preferred approach for funding award cash-outs.
  - Profits interest offer an additional benefit over other forms of compensation in that any proceeds received from a profits interest award are taxed at capital gains tax rates.
- Phantom Equity
  - Phantom Equity is a cash LTIP program that is designed to mimic equity by rewarding value creation.
  - Phantom Equity programs rely on a formulaic approach to calculating the value of the diversified business. Such programs can be designed in various ways like options, restricted stock, or performance-based restricted stock.
  - Such programs are rarely used because they are complex to design and administer.
  - Since they are tied to a formula valuation and are paid in cash, they may result in a liquidity drain on the company. The value realized by the executive team may not be aligned with the parent company's actual returns.
- Carried Interest/Return on Invested Capital (ROIC) Plan
  - In the case of a corporate venture capital or private equity business, where the organization invests capital in 3rd party start-ups or mature companies and seeks to maximize the return on its investment, the incentive plans may be structured similarly to venture capital or private equity firms.
  - Such plans include Carried Interest and ROIC Plans, where rewards to the business leaders are tied to realized returns on the portfolio of investments, often over a minimum required return (hurdle).

Other Considerations

As incentives are developed for the leaders within a diversified business, the following additional issues should be considered:

- Parent NFP Executive Participation
  - Participation in the special incentive programs typically is limited to employees of the diversified business, with NFP parent executives not eligible to participate.
  - The typical reason for excluding the participation of NFP parent executives is to manage conflict of interest and ensure that the NFP parent executives' incentives are aligned with the parent organization's objectives.
  - In addition, if the subsidiary is a for-profit organization, there may be legal issues related to the parent's NFP status that limit the possibility of granting awards to the parent executives due to prohibited inurement issues.
    - NFP parent executives do not typically participate in equity arrangements unless they dedicate more than 50% of their time to FP entity activities. In these cases, organizations often split the pay such that part of the compensation is received from the subsidiary and part is from the NFP parent.
    - Reasonableness and private inurement issues would apply to compensation received for services to the NFP parent.

    - Legal counsel should be engaged if the NFP parent is considering providing awards to their executives.
- Intermediate Sanctions, Fair Market Value (FMV) and Other Regulatory Considerations
    - As a NFP organization, parent organizations should assess if there are implications for the reasonableness of compensation for diversified business employees.
    - In addition, FMV and Commercial Reasonableness considerations may be necessary for physician leaders.

Conclusion

As NFP health care organizations seek to expand their revenue streams, many are leveraging innovations to further their mission. A natural evolution of this trend is the development of start-up businesses that require significant parent-company capital investment and may be further supported by external investors or joint ventures. Separate compensation programs tailored to the diversified business needs can be an effective tool to recruit, retain and engage leadership talent. Careful consideration should be given to such programs as they are developed to ensure they are tailored to support the organization's operating model; performance expectations and talent needs.