

Linking Reward Systems to a Business Turnaround At



When companies primarily focus on revenue growth, they often make substantial reinvestments in the business or keep prices low to gain market share. The challenge is to sustain sufficient capital to invest and manage cash flow effectively until growth in both revenue and profitability can be sustained. This is a study of a unique technology company that achieved market dominance and faced a number of business issues. When new leaders were selected, they instituted an effective turnaround effort. Their reward systems were a critical link to the implementation of the strategy. The company is Avid Technology, Inc.

Company Background

In 1987 a company by the name Avid Technology was founded. With a dream of revolutionizing the film and video editing industry, it shipped its first product in 1989. Motion pictures, commercials, broadcast news, and TV shows were edited in a labor intensive way by cutting and pasting film segments together prior to Avid's formation. Avid created software that enabled this entire process to be done digitally, using the computer to edit the film and later to add graphics and special effects. The company's growth was phenomenal as the market saw the clear advantages of digital, nonlinear, real-time editing of film and video. In 1989 revenues grew from \$1 million to more than \$400 million by 1995 and the number of employees grew from the starting founders to more than 1,500. Six companies were acquired with sales offices opening up across the globe. In 1994, the company earned the distinction of being named in the top 10 of the Fortune 100 hot-growth companies and was later named to the Fortune list of "Cool Companies to Work For." The technology was so advanced that it became the standard for the industry. This was effective in driving out major competitors. This growth, however, was not without its costs. In a concentrated effort to increase market share and dominate competitors, the company drove revenues with a passion. This strategy was highly successful and led to dramatic increases in sales. Yet it also resulted in minimal profitability.

Avid focused on making major investments in technology development and sales and marketing. Investments in the infrastructure (e.g., human resources systems, financial reporting, information systems, manufacturing quality), so crucial to a rapidly growing company, were neglected. When problems surfaced, customer confidence and profitability eroded. There was little established protocol to address customer concerns and manage costs.

The compensation systems supported this drive for growth. Stock options were used extensively as an inexpensive way to attract and retain growth-oriented individuals. To retain the effectiveness of the options, the company needed continual growth in market value. If they were effective in growing share value, this would counteract any dilution effect of these options on the share price.

When the growth started slipping, shareholders started placing increased pressure to improve the firm's profitability. Additionally, cash-based incentive plans began to cause additional problems as the company faced declining cash flow. With this in mind, the board of directors decided to take several bold steps and put a new leadership team in place. Curt Rawley, the Chief Executive and Technological Visionary, became Vice Chairman of the Board and Bill Miller, former CEO of Quantum, the multibillion-dollar disk-drive manufacturer, was appointed as CEO.

Reasons for Changes in the Compensation Programs

The company was facing substantial difficulties when Bill Miller took over the leadership of Avid in April 1996. The company had an expenditure profile that would mean it would soon run out of cash. Employee turnover had climbed to 25% on an annualized basis. The declining share price made it difficult to use stock options for retention of top talent, and many of the outstanding options were below their exercise price. The company was facing significant losses, revenue growth was minimal, and an informal survey revealed that many critical employees were disillusioned. Direct industry competitors, as well as companies in the surrounding labor market, started attracting key talent away from Avid, further placing any recovery at risk. Upon assuming control of the company, Miller knew that while he had taken over a company with outstanding technology and market leadership, he had to make changes quickly and decisively. He decided to form three core strategies. First, he needed to address cash flow concerns and restore the company to profitability. Second, he wanted to return Avid to being a great place to work and stem employee turnover. And third, he needed to retain its technological leadership and make significant investments in the infrastructure of the company. Within several months of assuming control, Bill Miller had assembled a new senior leadership team and crafted the details of his strategy for the company. He worked with the vice president of human resources and the director of compensation and benefits to develop new compensation systems to support the changes he had initiated.

How the New Compensation Programs Work

The director of compensation and benefits developed the new compensation system, in conjunction with an internal compensation and benefits committee and an outside consulting firm. This committee was composed of vice presidents and directors within the company and was chartered to provide senior-level involvement in the design. They developed several programs to better align the compensation system with new business objectives.

First, the management incentive program, in which all directors and vice presidents in the company participated, was changed from a plan based on earnings-per-share to focus on return on invested capital (ROIC).

This change was instituted to focus on both profitability and effective asset management, two areas the company desperately needed to improve. Second, all other employees in the company became eligible for a profit-sharing program based on the same measure as the senior management incentive program—return on invested capital. This program was instituted in the company to ensure that everyone had a stake in the same goals—increasing profitability and effectively managing the assets of the company. All employees attended presentations that educated them on the ROIC concepts, and extensive written communication materials were developed to explain what actions would lead to improved performance. Each area of the company discussed the critical actions it could take to improve the profitability of the firm. Third, the stock option program was completely redesigned to reward key performers and retain critical talent, while at the same time reducing share usage and concerns about dilution.

These provisions were accomplished in several ways. First, the share distribution, which had been heavily weighted to grants for new hires, shifted more toward grants based on performance of existing staff. This would recognize exceptional contributions of existing employees and help retain critical talent. New hire grants continued to be given, but they went to a more limited population—those hired into key technical staff and major leadership roles. To align employees with the new business strategy and increase retention efforts, a performance-accelerated restricted stock award plan was adopted. The program was applied to approximately 150 key executives, managers, and individual contributors. It used five-year vesting restrictions with an opportunity to accelerate vesting based on the corporation achieving certain stock price objectives and financial returns. Furthermore, if the company achieved specific stock price objectives, individuals would receive additional stock grants. This ensured that shareholders would realize exceptional gains in stock value before more shares were granted to executives and key employees.

Finally, a targeted cash compensation strategy was implemented for critical hardware and software development talent. It was imperative to meet new product development schedules, support the current customer base, and retain highly talented individuals. This strategy included adjustments to base salaries and instituting retention bonuses. For base salaries, pay levels for all positions were targeted at the market average in the technical community; however, individuals identified as critical performers were targeted at the 75th percentile of the competitive marketplace and special pay adjustments were made accordingly. Selected individuals were also granted substantial cash-based retention bonuses if they stayed through the completion of critical projects. If they left before the project completion, they would forfeit a significant amount of money.

Results of the Programs

The results of these programs have been dramatic. Overall corporate turnover has dropped from 25% to just over 12%, or slightly under the labor market average. More important, turnover of critical talent has virtually halted. In 1997, turnover of critical employees was a remarkable 3%. From a business perspective, the company results have been even better. Until Q1 (first quarter) 1997, the company had reported five consecutive quarters of losses. In Q1 1997, the company returned to profitability, substantially beating analyst projections. This occurred again in Q2 of 1997. In Q3, while revenue growth fell short of expectations, profitability was at record levels. Return on invested capital also soared, due to intense management and employee actions. Inventories came under control, accounts receivable fell, duplicative capital spending was reduced, inventory turns increased, and days-of-sales-outstanding dropped markedly. As a result, the company's cash position quadrupled in 15 months. After two years of no bonus payouts, the executive and senior management incentive plan anticipates making payouts well above target levels. Employee profit-sharing should also pay out over target, yielding an attractive reward for employees. In early 1997, the stock price rose from a \$9 per share to a \$45 per share, this was a remarkable performance achievement for Avid.

Lessons Learned for the Future

The compensation system provided tremendous support to changing the business and achieving key objectives. It was closely aligned with effectively executed strategies. Effective communication of the programs, along with continual reinforcement and reporting on progress, was critical to success. Avid managers were effective in providing strong rollout communications and continual updates and reinforcements of efforts. The CEO and other executives were actively engaged in these communication and recognition efforts. Avid learned that using several levers at once and instituting significant changes at one time can work. If the business is undergoing major change, human resources and compensation systems must also undergo fundamental change.

If Avid executives limited their bold actions who knows whether the turnaround goals would have been achieved, so the new executive team decided that taking risks was the only option they had. The risk of upsetting internal equity, shareholder backlash, and the risk of infusing too much change in too short a time. The risks were carefully managed and the executive team led many of the discussions within the company. Their involvement and ability to engage others led everyone to understand the importance of their tasks. It is safe to say that the company has achieved a remarkable turnaround and that the compensation system played an important role in making it happen. It gave people a clear stake in the success of their efforts. While compensation is but one of the levers in helping achieve business change and the accomplishment of business objectives, it is a lever that should not be underestimated or overlooked.