

a new day for executive compensation

the

new SEC disclosure requirements will compel companies to share more information about their executive compensation plans, including the rationale behind plan designs and their link to the business strategy.

Some may view the requirements as intrusive and burdensome. Yet they provide an opportunity to hold a mirror up to the structure and reasoning behind the executive compensation program and articulate how the program helps the business. In these turbulent times, a company needs a firm grasp on that mirror, rather than await the image reflected by the media or institutional shareholder groups.

Unfortunately, too many companies may miss the chance to scrutinize executive pay and shore up its connection to business strategy. When it comes to compensation design, companies often prefer the “known” to the unknown. Change can be threatening, and executive compensation design is complex. Consequently, if the current plan poses no risk to the company, the safe decision is to stick with the status quo, rather than shake things up. When companies decide to make a change, they prematurely may adopt

QUICK LOOK

- ⇒ “One size fits all” has never been the right answer to executive pay. Different business models dictate different approaches.
- ⇒ Consider three areas in compensation design: The company’s business situation and market characteristics, talent requirements and desired performance and rewards strategy.
- ⇒ As the face of the company evolves, so should the compensation approach.

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popular plan designs, citing “competitive reasons,” rather than decipher their true needs and construct a plan that acts as a strategic business tool to reinforce desired performance. Consider the following:

- A company relies on a plan that worked in the past, even though the plan is beyond its prime given changes in business strategy and structure.
- A “corporate” plan applies to all business units even though the businesses operate differently and have different strategies.
- Attention focuses solely on long-term incentives (LTI), forgetting long- and short-term plans must harmonize—driving annual operational performance that ultimately will create longer-term financial success.

Companies should take the new SEC disclosure as an opportunity to eschew indistinguishable plan design, overused measures and safe pay-delivery choices. Instead, view the requirements as a chance to reassess the link between compensation design and business strategy, and do what is right for the organization. The feared unknowns will become less intimidating when a company asks the right questions,

considers its business model and uses compensation to advance strategy.

Ask the Right Questions

What’s the *right* compensation design? A strategic approach to executive compensation considers the following three areas:

1. The company’s business situation and market characteristics
2. Talent requirements
3. Desired performance and rewards strategy.

Answering some pointed questions about each can lay the groundwork for discovering the right direction and building pay and performance alignment. Figure 1 on page 17 identifies many of the questions to ask and explains how the answers will influence plan design. The answers can shape all aspects of program design, from objectives to measures to incentive vehicles.

Consider the Business Model

“One size fits all” has never been the right answer to executive pay. Different business models dictate different approaches. Companies that overlook or minimize

this link by viewing compensation as a neutral influence at best, or as a distraction at worst, take a dangerously shortsighted outlook. Similarly, companies swayed by “best practices” to adopt the plan “du jour” and stay under the radar miss the opportunity to advance the achievement of business goals.

Take for example companies “X” and “Y.” While they have extremely different business situations, both employ the same compensation approach—time-vested restricted stock. By clinging to easy solutions, these two companies miss the opportunity to use compensation strategically.

Company X, a reasonably mature company in the hospitality industry, follows a strategy of “stay the course.” The strategy is clearly working, as the company has experienced steady stock price growth through recent up and down markets. The company returns value to shareholders through buybacks rather than dividends. Management is stable, with no history or expected risk of executive turnover. Pay prominence is moderate, indicating no need for a behavioral shift. Executive stock ownership guidelines require executives to hold meaningful amounts of stock, thus linking them tightly to business success.

Given this profile, time-vested restricted stock is at best a neutral solution, or, when coupled with significant ownership guidelines, possibly inches toward positive. A *better* approach for a growth company like this is an equity vehicle focused on stock-price appreciation, such as stock options. Time-vested restricted stock does reward retention. But these executives are not intent on leaving. Stock options, on the other hand, spur continual motivation to build on past success. By providing executives the opportunity to share directly in the incremental wealth generated, stock options drive the creation of even more value.

FIGURE 1: CONSIDERATIONS IN DESIGNING EXECUTIVE COMPENSATION

Business and Market Characteristic	Impact on Program Design
1. What are the company's business stage (start up, mature, decline), performance and prospects (industry leader, solid performer, distressed/turnaround)?	Influences the degree of leverage (i.e., how much pay varies with performance) that needs to be built into the program.
2. Are major shifts in strategy ahead?	Determines how specific the messages need to be to guide new behaviors.
3. Is the company and/or its sector volatile and/or cyclical?	Suggests the potential need for indexing or other mechanisms to control for factors beyond management's influence.
4. What is the company's strategy for delivering returns to shareholders (i.e., the relative emphasis on stock price appreciation and dividends)?	Helps to determine the appropriate focus of equity-based vehicles, i.e., stock price appreciation alone, or whether dividends should also be included.
5. What is the organization structure and decision rights (e.g., centralized, single business versus several autonomous business units)?	Helps determine the level of performance measurement, i.e., for the overall company or individual business units, or some combination.

Talent Requirements	Impact on Program Design
<ol style="list-style-type: none"> Does the company need to attract outside talent to replace or support the current leadership team? Does it need to retain existing talent, because either the current executive value proposition is deteriorating, or outside competitors are targeting the company? Does it risk turnover of executives in critical, strategic positions? What degree of behavioral change is needed? 	<p>All influence:</p> <ol style="list-style-type: none"> Types of vehicles chosen, e.g., full-value shares may be more important to include when retention is key or compensation packages from another employer need to be bought out to attract top outside talent; stock options may be more attractive when attracting talent to help with a turnaround or in an entrepreneurial culture. Vesting/performance provisions, e.g., vesting should be longer if the purpose of a vehicle is retention; performance requirements may be structured differently depending on the situation.

Performance and Rewards Strategy	Impact on Program Design
1. What is the desired role of pay in influencing behavior, especially if material changes in behavior and decision-making are required?	Influences the amount of leverage and performance orientation.
2. What level of alignment is desired between executive and shareholder gains?	Influences the relative weighting of the equity portion of the program and the inclusion of elements that ensure executive net worth at risk (e.g., executive stock ownership or holding requirements).

Time-vested restricted stock alone is a suboptimal answer for Company Y, a diversified manufacturer with a lagging stock price and uncertain future. The company experienced a fundamental strategic shift when it repositioned itself as a services and solution provider. This new direction demands demonstrable growth and some new talent to achieve it. The stakes are high, and the contributions of executives are critical. Performance-vested restricted stock—tied to metrics that reflect the company’s repositioning—plus some stock options provides a better answer. The combination creates the urgency to achieve key milestones and realize the longer-term benefits for the repositioning effort. A small portion of pay (e.g., 20 percent) delivered in time-vested restricted stock could be appropriate to reward executives for sticking with the company during the repositioning while they drive performance forward.

Never assume the old model fits today’s challenges. As the face of the company evolves, so should the compensation approach.

Using Compensation to Advance Strategy

The following examples show how the right compensation strategy can advance business strategy. In each scenario, the company specifically chose vehicles and metrics to send a message critical to its business and talent needs at the time.

Same Industry; Different Performance

Companies often look to successful industry competitors for hints on incentive plan design. Yet plans are not interchangeable. As the following examples demonstrate, company strategy and situation, not the competition, should dictate compensation approach.

An established “Grande Dame” retail conglomerate had a historical record of aggressive and profitable growth,

generating significant wealth for shareholders. The company acquired and successfully operated new locations ... for awhile. Then consumers discovered outlets and discounters. The big-store market flattened and then dived. The company suffered mightily from consumer defection—same-store sales soon lagged the competition.

Turning around the company required a high degree of behavioral change. Management style needed to shift from a pattern of strict operational control to one promoting innovation and customer responsiveness. Yet, old habits are hard to break, and the veteran executive team initially resisted the new focus. The reward strategy, which had catered to the needs and desires of individual executives, had long since splintered as company strategy disintegrated and results faltered. So a new rewards strategy was defined to promote unity and drive key company metrics, with an emphasis on profitable same-store sales growth. The company began to combat discounters by stressing superior service and simplified quality merchandise assortments. The annual plan directly and aggressively rewarded same-store sales growth. As a counterbalance, and to motivate profitable growth, LTIs rewarded sustained earnings growth and returns. Stock option grants complemented these metrics by reinforcing the new behavior that contributed to an improved financial outcome.

In a contrasting example, another retailer has enjoyed continual profitable sales (experiencing a brief dip in the late 1990s). The company relies on its hallmark strategy, yet desires a firmer position as an industry leader. Leadership is committed to a more aggressive pursuit of strategy, and turnover is not an issue. The company wants to continue its attractive value proposition, not change behavior. Salaries graze the market median or fall just below,

depending on a job’s strategic importance. Real rewards come from incentives. The annual incentive plan is highly leveraged, paying out superior rewards for earnings and return on capital targets, which are set above industry medians. The executive LTI is also highly leveraged, consisting predominately of stock options, which focus on continued growth in total return to shareholders and relative performance that consistently exceeds peers. Metrics for the next management layer include complementary financial and nonfinancial measures that will drive bottom-line profitability. The two plans work in concert to reinforce the strategy.

As these examples demonstrate, if the goal is to change strategy or improve performance, the annual and LTI metrics must explicitly define the desired outcomes. If the company wants to sustain superior performance, it should set goals high and provide high rewards for meeting them. The department store conglomerate is holding its own against discounters; the upscale retailer continues to step ahead of its competition. The custom compensation plans are not neutral influencers of change, but true drivers of behavior change and performance results.

Same Company;

Different Circumstances Over Time

As the retailers recognized, a shift in strategy should trigger a reassessment of the executive compensation plan. Yet what if the strategy remains viable while other circumstances change? The next example shows that even a successful plan design requires rethinking to keep pace with talent demands and business realities.

A health-care company had a record of dramatic growth until an accounting scandal depressed its stock and reduced morale. A new pay program was in order: one that would meet the needs

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of stakeholders—from disillusioned executives to angry shareholders—and pass muster with regulators. In this time of turmoil, the company had to hold onto key talent to lead the turnaround, restore trust, and rebuild the business and its reputation. To strengthen retention, the company de-emphasized the annual plan and delivered LTI rewards through performance-restricted stock and options. The LTI combined controllable metrics with key shareholder outcomes, leading to a handsome payoff if the turnaround succeeded. Measures for performance-restricted stock included a balanced mix of hard financials with operational and stakeholder metrics geared toward ensuring operational excellence and constituent satisfaction—returning the company to its mission of providing economical quality care.


Once in place, the compensation plan performed as designed. The company rose like a phoenix to deliver improved financials. Flash forward several years: Growth has moderated and the company is now more a value versus growth investment. Competitors are looking over the company's talented

leaders, intent on luring them away. The company has updated its executive compensation plan to match current circumstances and demands. Today's focus is on sustained value creation through continuous improvements in productivity, optimized performance in select facilities and a strong bottom line that allows for continued stock price growth but also strong dividend yields for shareholders. A new annual incentive plan drives these results through financial and nonfinancial measures. In the new LTI, options are less prominent now that the turnaround has succeeded. A larger portion of equity comes from performance-vested restricted stock focused on a balance of earnings growth and overall returns. Selected leaders in key strategic roles also receive grants of time-restricted stock.

Even if a plan appears to be delivering results, it is important to keep an eye on changes in business and talent requirements and the implications they hold for incentive design. A reassessment every three years would not be unusual in these fast-moving times.

Dust Off the Compensation Philosophy

This is a time of opportunity. The SEC disclosure requirements coming on the heels of recent accounting changes under FAS123R create a clear impetus for re-examining executive pay. Companies that missed the earlier opportunity now get a second chance to make sure their incentive plans are designed to make a difference.

The strongest message a company can deliver in its proxy is to show how the executive compensation program deliberately supports the business goals. Making that cause and effect evident speaks volumes to employees and to shareholders. Jump on their bandwagon; do not let this opportunity pass by. 

EDITOR'S NOTE:

More information about the new day for executive compensation will be published in part two of this article in the February issue of *workspan*.

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Part 2 a new day for executive compensation

Driving Business-Unit Strategy Through Executive Pay Design

By Blair Jones and Seymour Burchman,
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Rather than bemoan recent disclosure and accounting requirements, smart companies are viewing the changes as an opportunity to re-examine their compensation philosophy and clearly align executive compensation with business strategy. The aim is not to mimic plans that have worked for other businesses or competitors, but to find the design that speaks to a company's strategy, stakeholders, and pay and performance aspirations.

Part one of this series focused on corporate plan design, examining how a company's business situation, market characteristics, talent requirements, and performance and rewards strategy should influence pay design. Part two looks deeper into the organization at the business-unit (BU) level—where the same rules apply—to determine when it is appropriate to establish separate business-unit incentives and how they can be structured to further support business strategy and talent requirements.

First, a quick history lesson: BUs came into their own in the 1980s. With the

merger and acquisition boom, formerly stand-alone companies became giant business units of even more massive conglomerates. Companies also began experimenting with autonomous business units to help spawn new ventures. Since then, companies have gone through cycles of growth and shrinkage, yet BUs have remained a key element of the corporate landscape. Using a BU as the launching pad for new ventures and/or spinoffs is a newer phenomenon that fully underscores the importance of the BU to executing business strategy.

Understanding the BU and how it competes and collaborates with other units or functions autonomously is critical. From an HR perspective, the degree to which units collaborate for market success, share resources and trade talent back and forth has an important influence on HR programs and, in particular, compensation design.

Determine the Value of Business-Unit Incentive Design

With the recognition that BUs are often where the battle is won or lost, compa-

nies have recognized that corporate incentives may not always create a strong enough link between performance and pay for those who manage the BU. The compensation program must send the right signals about the priorities for the BU. And plan designers must consider whether to focus BU executives on their own results, on overarching corporate results or some combination of the two.

Corporate programs often do not consider the realities of how the BU operates, what talent differences it requires and what its executives need in the way of rewards. A BU's strategy

QUICK LOOK

- ➔ From an HR perspective, the degree to which business units collaborate for market success, share resources and trade talent back and forth has an important influence on HR programs and, in particular, compensation design.
- ➔ A uniform plan for all businesses within one company may not work when the business-unit circumstances differ.
- ➔ Effective BU plans recognize the strategic approach of the corporation and each BU's unique circumstances.



and its critical success factors may need their own emphasis in addition to the parent's. In determining its approach to compensation, a company must determine whether a corporatwide incentive for all BUs makes sense, whether a BU plan is the best approach or whether some combination of corporate and BU incentives is the optimum driver of strategy. Figure 1 identifies the key factors in making this decision: 1) decision autonomy, 2) shared resources and 3) coordination across units.

Decision autonomy refers to the degree to which BU heads are given the freedom to independently make key decisions, including operational decisions, investment decisions, acquisitions/divestitures, etc. Shared resources may include key elements of the value chain such as sourcing, manufacturing, logistics, sales and service, and distribution. It also includes the sharing of people (e.g., for purposes of development, succession, etc.). Coordination across units is in part driven by the first two factors, but also encompasses activities that require coordination relating to external stakeholders such as customers and suppliers.

Understand How the Organization Operates

Once the decision is made to offer BU incentives, determining the optimum plan design requires looking beyond the organization chart. The role and interrelationships among the BUs must be understood and considered. While one corporation may mirror another's structure, the two may operate dissimilarly, requiring very different incentive approaches. For example, consider the business models of two highly decentralized companies with multiple business units that represent different ends of the spectrum. In one case, BU coordination represents a critical success factor, while in the second, key values are BU autonomy and performance optimiza-

tion within the BU. The incentive plan must respect those differences and incent the right behavior.

The company that needs BU coordination is a diversified, decentralized agribusiness, in which the businesses operate similarly. People move freely from one BU to another, and the cooperation among the BUs helps to exploit global value chains. Accordingly, the compensation program is balanced to recognize the contributions of the different BUs, but also motivate executives to recognize the linkages across the BUs. The annual plan rewards BU results, as does the long-term incentive (LTI)—up to a point. Half of the LTI is delivered in restricted stock earned on BU metrics; half is provided in stock options. Paying the performance portion in restricted stock sends an additional signal that BU results should not be optimized at the expense of the team.

In contrast, a highly decentralized manufacturer of industrial products finds little coordination among its autonomous BUs. Like the company above, annual plans focus exclusively on BU measures. The LTI design reinforces significant autonomy in its units as well. While executives receive a small stock option grant, the primary LTI is a three-year cash award, linked exclu-

sively to BU results. The plan is a true motivator and sends the message that all BUs must maximize their performance in order to build corporate results.

In both companies, the annual plans pay out on BU measures; the LTI programs move in different directions. To emphasize BU coordination, the agribusiness delivers half of the LTI reward based on corporate results and pays the BU portion in restricted stock. In contrast, the manufacturer rewards executives primarily for the results they create in their own business.

Determine the Optimum Approach

Will one design work for all BUs or do differences in circumstances suggest the need for customization? A uniform plan for all businesses within one company may not work when the BU circumstances differ. Plan design must consider the nature of the parts as well as the whole.

For example, the decentralized manufacturer cited above used a common BU incentive throughout the company. Although the lines of business were different, all the BUs were manufacturers with generally similar levels of maturity. The company believed that all units should be given similar challenges for growth and returns on investment. Thus, all BUs were held to the same



standards for growth and returns in a single, common “matrix.”

In contrast, a leading consumer products company wanted to maintain its history of growth. To do so, its four autonomous businesses needed to shift their focus to stronger top-line and bottom-line results. The businesses could only support growth to varying degrees. “Business A” faced stagnation in a key product line as well as complications in the others. The stagnating line was in danger of fading for lack of shelf space. To thrive, “Business A” desperately needed to leverage the customer base of “Business B,” which offered related, market-leading products. “Business C” and “Business D” would benefit from the strength of “Business B” but also needed to innovate to promote further growth.

To support this strategy, executive compensation had to balance a corporate focus with strong BU results. Stock options focused the businesses on the ultimate goal of corporate growth. Then to drive critical BU milestones for improvement, a special annual incentive targeted each product line’s “must do” behaviors. For product lines “A” and “B,” these behaviors were closely related. Because of the different opportunities in the different businesses, these incentives and the associated leverage were different. Finally, each business had a performance-vested restricted stock plan. The metrics were tied to BU performance, but some metrics held commonalities across businesses to encourage teamwork where it would be mutually beneficial. The ultimate value of the performance-restricted stock also reinforced teamwork since it relied on the company stock price.

The business strategy and compensation strategy have served the company well. The stagnating product line has innovated, and is beating the competition. And the overall company has

benefited from the sum of the parts.

In another example, a marketing corporation established a completely separate executive incentive plan for a startup business. The plan matched compensation to the life cycle of the business, providing appropriate motivation for a successful launch. However, in year five, when the launch phase was complete, the executives would transition to the corporate compensation program.

The startup incentive was designed to ensure alignment between compensation for the new business and the value created for the corporation and its shareholders. It reflected the real economics of the startup and provided appropriate risk/reward trade-off for participants. In fact, the pay mix skewed toward BU-based LTIs with a premium for increased risk. While the corporate LTI was stock options, the startup plan offered only a small corporate stock option grant. The BU incentive included both an annual and long-term component. The annual component was tied to the achievement of key startup milestones, which included financial goals (measured by revenue, account margin and profit or cash flow) and nonfinancial goals. The LTI was based on a formula valuation of the business, with participants sharing in a percentage of the value created after covering the investment in the business (which included the cost of both the annual and the long-term incentive plan), as well as a hurdle rate of return on this investment.

Final Thoughts

Effective BU plans recognize the strategic approach of the corporation and each BU’s unique circumstances. Such plans must complement the organizational structure and relationship of the BUs to the parent. They must use measures that capture the

value of the company and recognize and reward executives for strategic actions that gain results.

In these transparent times, an executive compensation plan that is not aligned with strategy is a time bomb, with the potential to wreck a company’s reputation in the market and its shareholders’ value. Rather than risk collateral damage, companies should take the opportunity to thoughtfully examine which pay approach best meets the specific needs and circumstances of the business as a whole, as well as their BUs, and adopt an authentic approach that will drive company and BU strategy as well as serve the interests of executives and shareholders. 

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