How to Set Threshold and Maximum Payouts That Are Tailor-Made For Your Company

by Blair Jones and Seymour Burchman | May 4, 2015

Compensation committees sometimes feel challenged by the task of setting targets for annual goals. Not only do they have to address the upside potential and downside risk in the company’s business plan, but also other factors that include external headwinds and tailwinds associated with macroeconomic factors, competitive opportunities and threats, technological disruptions, and regulatory changes. That said, the task of setting annual targets can become quite complex.

The greater challenge may be setting the range of payouts around target, especially payouts at threshold and maximum levels. The threshold defines what level of performance warrants any payout at all while the maximum defines what level of performance is exceptional. Neither level is easy to set by using a formula, yet they are arguably even more important than the target. This raises the question: What is the best way to set those numbers?

Compensation committees are often tempted to follow conventional wisdom and follow how other companies, especially peers, have traditionally structured their payouts, using either a symmetric payout curve, or a payout curve with equal ranges above and below target. Two practices are common: using 90 percent of target for threshold and 110 percent of target for maximum or using 80 percent of target for threshold and 120 percent of target for maximum. Executives then usually get 50 percent of their target bonuses if they achieve the lower level and 150 or 200 percent if they achieve the higher one. A cap of 200 percent helps compensation committees avoid encouraging unacceptable risk-taking and paying too much for windfalls.

Because thresholds and maximum payout levels need to take into account many factors, particularly the relative predictability and volatility of performance outcomes as well as investor expectations, compensation committees need to move beyond conventional practices. They should instead use analyses that are tailored to their company.
For example, consider the case of a branded food company with stable revenues. This company has launched several high-growth, albeit unproven, initiatives to develop innovative products in new categories in addition to expanding geographically. For years, executives have delivered predictable results which were rewarded by payouts fitting a narrow symmetric payout curve, one with a 95 percent threshold and 105 percent maximum. (See Figure 1.) As a result, the compensation committee considers whether, and how, to adjust the range in light of the shift to a strategy with less predictable outcomes.

To arrive at an answer, the compensation committee can ask two sets of questions. The first set focuses on the top-down questions on how the company needs to perform overall.

1. What do Wall Street analysts expect? The answer can vary from most bullish to most bearish.

2. What performance levels have their peers delivered in the last three to five years? To find this answer, the branded food company looks at peer performance at the 25th, median, and 75th percentile performance levels.

3. What has been the company’s own historical performance? Recent performance serves as a yardstick for defining the minimum acceptable performance levels while historic highs are a reference for outstanding performance levels.

4. Do the growth initiatives yield returns that exceed the company’s return-on-investment requirements? The answer indicates whether the anticipated initiatives have adequate payback.

5. Does the range of payouts result in a fair sharing of gains between executives and shareholders? This defines what is equitable to shareholders.

The second set of questions focus on what managers in each business unit believe they can deliver. Managers’ answers depend on budgets that take into account a range of possible scenarios from the most optimistic to the most pessimistic, reflecting the managers’ own actions as well as the external headwinds and tailwinds that buffet their businesses. The compensation committee can use can use internal (e.g., the best the unit has done in the past) or external (e.g., best-in-class
In the case of the branded food company, executives and directors are able to glean four things from their analyses:

1. The opportunities for growth are higher, but the risks of failure are greater.
2. The company's targets pass the litmus tests of exceeding historical and competitor levels, and also satisfy the range of expectations of Wall Street analysts.
3. The growth initiatives yield a range of potential upside outcomes that exceed historical highs, while downside risks, though greater than the past, are acceptable.
4. The target level of growth surpasses the return-on-investment hurdles for new investment.

Based on the above, the company's compensation committee chooses to widen the performance range. It tentatively resets the threshold payout to 90 percent and maximum payout to 115 percent. (See Figure 2.) This change is in keeping with the intention to pursue a more aggressive growth strategy, one that has much more upside yet poses increased uncertainty. The committee's choice assures that the company delivers on analyst expectations, remains competitive with peers, fits the realistic performance of the business units, and ensures the 90 percent threshold figure exceeds the previous year's results.

As a final check, directors test payouts to ensure that executives and shareholders equitably share in gains as performance improves. The committee looks at the ratio of the aggregate bonus payouts to the company's pre-tax, pre-bonus profit. It also checks the incremental bonus spend to each incremental dollar of pre-tax, pre-bonus profit. It finds the average spend of profit is 5 percent to 8 percent, the incremental spend, 20 percent to 30 percent. Both are reasonable based on competitive data.

Other companies might come to very different conclusions by conducting their own analyses in setting threshold and maximum levels. For example, those businesses facing more turbulent business environments, those with unsophisticated planning processes, and those with less predictable results because they are highly susceptible to external factors, or are less mature,
would probably have wider ranges. In any case, through a detailed analysis that asks both the top-down and bottom-up questions, boards can gain the confidence to move beyond conventional wisdom to reasoned alternatives they can explain to both executives and inquisitive investors.

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**Threshold-Maximum Guidelines**

The more volatile the economic and business background, the more likely a board will set a wider range for threshold and maximum percentages. Even so, the “average” company in an “average” year will set percentages using certain guidelines.

Guidelines for Threshold Payouts

- Set at the lower end of a company’s peer-performance range (25th percentile).
- Set at the lower end of analyst expectations.
- Set above the previous year’s results.
- Set high enough to create some modest value for shareholders.
- Set at a point on the performance curve where executives have a 90-percent chance of triggering the minimum payout.

Guidelines for Maximum Payouts

- Set at the top end of peer performance (75th percentile).
- Set at the top end of analyst expectations.
- Set in line with record-level company performance as is appropriate.
- Set at a level that will create significant value for shareholders compared to peer and historical performance.
- Set at a point where executives have only a 10 percent chance of hitting the maximum.

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