Set Goals That Meet Stakeholder Expectations

Develop a road map to achieve results.

In recent years, no subject in executive compensation has gotten greater focus than the shift toward formulaic, performance-based incentive plans. The advent of annual say on pay, coupled with the increasing attention of institutional investors and proxy advisers, has accelerated this trend and now made this practice the norm. The focus has thus changed to ensuring that the goals underlying such programs are sufficiently rigorous and robust. While goal-setting has been a perennial...
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challenge for issuers, the new expectations have raised the bar for “getting it right.”

With so much at stake, what is a company to do? The solution is within reach if companies follow three major steps:

1 Identify and respond to stakeholder expectations
2 Satisfy constraints imposed by organizational capabilities and the business environment
3 Remain cognizant of benchmarks and standards of success.

1 Identify and respond to stakeholder expectations.
   Companies should first focus on what is required to (i) advance key shareholder priorities, (ii) meet talent needs and (iii) satisfy key customers, suppliers, regulators, and the community at large. The demands of two of the primary stakeholders — shareholders and employees — often carry the most weight.

SHAREHOLDERS: Traditionally, shareholder priorities have been narrowly defined as creating shareholder value through stock price appreciation and dividends. However, an examination of the drivers of sustainable value creation helps to provide a broader range of factors that should generally be addressed:

- **Financial drivers**: the fundamentals that influence stock-price performance
- **Strategic drivers**: factors that create a sustainable competitive advantage
- **Operational drivers**: aspects of operational excellence (e.g., timeliness, reliability, quality) that contribute to both financial results and the success of strategic initiatives.

EMPLOYEES: An organization’s goals should enable the company to attract, retain, and motivate the unique talent it needs. For example, a struggling brick-and-mortar retailer making a foray into e-commerce might appeal to “expert upon hire” e-commerce talent through pay plans insulated from the results of the company’s brick-and-mortar operations.

2 Satisfy constraints imposed by organizational capabilities and the business environment.
   In this step, the objective is to ensure the goals reflect (i) the organization’s strengths and weaknesses and (ii) the constraints and opportunities presented by the operating environment.

   Organizational capabilities include the company’s talent, brand, infrastructure and intellectual property. These include what is available in house and through outside partnerships. The business environment requires an assessment to identify the headwinds and tailwinds that exist outside the company. The assessment covers a spectrum of factors, including macroeconomic health and trends, competitive influences, technological advances and regulatory developments.

3 Remain cognizant of benchmarks and standards of success.
   Benchmarks are the references against which the business measures itself and others measure it. They endure over
the long term and through economic cycles. In this third and final step, the aim is to calibrate the goals against these standards. Common references include:

- Historical performance of the company (e.g., average, best ever) and peers (e.g., top-quartile)
- “Best-in-class” performance within the company’s own business units, including benchmarks for key parts of the value chain, regardless of industry (e.g., benchmarks established by firms that are exceptional in supply chain, inventory management, etc.)
- Analyst expectations for the company, its peers, and the industry.

The most effective standards are established through rigorous benchmarking over a timeline that is sufficient to encompass multiple economic cycles and aligns with the timeframes relevant to key stakeholders. The benchmarking process starts with identifying the high-level financial drivers of value creation, then delves into the operational and strategic factors that drive the financials.

Following this three-step process will deliver goals that:

1. Are sufficient to generate returns above the company’s risk-adjusted cost of capital
2. Calibrate pay and performance relative to that at peer companies
3. Provide the basis for incentive plan payouts that represent a fair sharing of the value created between executives and shareholders
4. Promise payouts sufficient to keep executives retained, motivated and engaged.

**Case Study: An Industry-Leading Retail Performer**

A retailer had delivered industry-leading growth in profitability and shareholder returns with a strategy focused on constantly improving its customers’ experience and making long-term investments in a seamlessly integrated omnichannel presence (i.e., both brick-and-mortar and e-commerce operations). This strategy was supported by a results-oriented culture that sought constant improvement without shying from aggressive goals. The result was that executives earned well-deserved praise from shareholders for delivering regular and reliable returns.

The challenge was two-fold: (1) Drive continued and sustained returns for shareholders. (2) Ensure the alignment of pay with absolute and relative performance. Ironically, the challenge was complicated by the company’s track record, which created a high bar from which to grow. If not careful, the company could easily find itself paying executives at either the market median for performance materially above competitive levels or paying little or nothing for average performance. Neither would be a good outcome, demotivating to executives and potentially lowering risk.

**Stakeholder Expectations**

Shareholders expected the company to sustain its industry-leading performance. To do this, the company needed to (i) continue its disciplined investment in the omnichannel strategy, (ii) continue to deliver an outstanding customer experience, and (iii) seek to retain and motivate the existing leadership team, which the board and shareholders valued greatly.

From the perspective of executives, pay and performance needed to be aligned so that pay was commensurate with results on both an absolute and relative basis. Goal-setting and incentive design (e.g., target pay opportunities, payout leverage) needed to be calibrated so that industry-leading performance was rewarded with industry-leading pay, while industry-matching performance resulted in industry-competitive pay. The goals also needed to align with the high-performance culture.

**Organizational Capabilities and Business Environment**

Thanks to an established and revered brand, outstanding talent, great store locations and a well-integrated e-commerce platform, the company maintained a position of strength. Its ability to continually raise the bar, however, was becoming increasingly constrained because the “low-hanging fruit” had already been harvested (for example, the pool of desirable store locations had shrunk considerably).

Part of the challenge was the difference between the near- and long-term outlooks. Although forecasts indicated that the challenging market environment would make year-over-year improvement difficult, over a
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three-year timeframe, the market environment was forecast to brighten considerably.

Benchmarking
The company had a history of performing at or above the 75th percentile on all high-level financial metrics, such as revenue, earnings, and return on invested capital (ROIC). Also, it had consistently improved performance over prior years and beaten analyst expectations, leading to top-quartile shareholder returns. Continuing to set historically high targets for revenue or earnings growth, however, did not seem appropriate since the continuous compounding of high growth would eventually require unrealistic increases on a dollar value basis. Instead, the company focused on ensuring continued discipline in its investments and improvements to operational efficiency by establishing a targeted ROIC of 5 percent to 7.5 percent above the weighted average cost of capital (WACC). (See Figure 1.)

The company’s benchmarking had shown that the company consistently underperformed peers on inventory turns and payroll as a percent of sales. (Both factors were attributable to its long-standing focus on customer experience.) Executives realized that new technologies could reduce payroll costs and inventory levels with minimal customer impact. Further, the company could reap additional benefits from the continued expansion of its omni-channel platform. Improvements in these areas would allow the company to deliver returns in the targeted range.

A Solution
Given the changing nature of the challenge to improve company performance, both the new annual and long-term incentives were designed to maintain the company’s best-in-class performance, while ensuring that pay was aligned with higher performance in the targeted areas of operational improvement. The annual plan also focused on key strategic initiatives needed to support this performance.

The key financial metric in the annual incentive plan was operating income. The target goal, deliberately divorced from the budgeting process, was set at what was considered to be median performance, and it yielded a target (i.e., 100 percent) payout. However, internally, all budgeting and planning were focused on providing the progress needed to meet the ROIC goal of WACC plus 5 percent to 7.5 percent, which was also generally consistent with

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**Figure 1**  **Illustrative Annual Incentive Leverage Curve**

- **STEP 1**  Company establishes a “stretch” budget that is representative of 75th percentile performance.
- **STEP 2**  A review of competitive pay data suggests that a 150 percent of target payout would typically deliver 75th percentile pay.
- **STEP 3**  Payout leverage curve is shifted to deliver a 150 percent of target payout for achieving the “stretch” budget.
- **STEP 4**  Company reaffirms that the sharing rates are appropriate above/below target and that the 100 percent payout is representative of what is typically considered to be 50th percentile performance.


75th percentile earnings growth (determined to be about 15 percent above median levels).

Based on historical analysis of peers, this level of earnings performance was consistent with a payout at 150 percent of median. Thus, the payout curve was structured so it paid target for median performance and 150 percent of target for stretch performance. (See Figure 2.) Knowing that the macroeconomic environment presented headwinds for the coming year, planned first-year growth was relatively modest. Subsequent growth goals were set more aggressively to ensure that the annual goals delivered the targeted multiyear performance.

Meanwhile, nonfinancial objectives were used to drive improvements in inventory turns, employee productivity and the omnichannel rollout. Goals for the first two metrics were initially targeted at peer levels and later to exceed them. To ensure that the goals were met without diminishing the company’s very positive customer experience, a modifier was added to reduce payouts if customer satisfaction scores dropped.

The long-term incentive plan focused on ROIC. The ROIC goal was also set at median, but again, internal planning was organized around delivering stretch 75th percentile performance (i.e., the targeted return of 5 percent to 7.5 percent above WACC). The trajectory of annual operating income and inventory turn goals was established to ensure that executives would achieve the long-term ROIC goal.

Using a Framework That Achieves Results

Goal setting can be both simplified and made more effective through a three-step goal-setting framework: (i) Focusing on the expectations of key stakeholders; (ii) satisfying organizational and environmental constraints; and (iii) remaining cognizant of benchmarks and standards of success. These steps provide a simple roadmap to overcome the goal-setting challenges so many companies now face.

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