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Breaking the Link Between Budgets and Pay

INTRODUCTION

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Operating plans are the natural starting point for most companies in setting performance goals for incentive plans. Whether the source is annual budgets or long-range plans, using such operating objectives for target-setting establishes clear accountability for achieving the business goals that have been mutually agreed upon by management and the Board. However, budgets are not the only way to set incentive plan targets. Given the issues we have seen at companies that base their goals exclusively on business plans, we believe there are other alternatives that might better serve some companies and their shareholders.

WHAT'S THE BIG IDEA?

Consider eliminating budgets as the starting point for your incentive plan goal-setting process:

- Reduces gaming in the budgeting process
- Focuses on what creates value rather than what appears "doable"
- Provides a clearer definition of "stretch"
- Supports a strong pay for performance philosophy

The Problem with Budget-based Goals

At the start of each year, Compensation Committees grapple with the difficulty of the goals being used to determine executive bonuses, the vast majority of which (over 80%) are linked to a company's business plans. For example, a common approach to set incentive goals for financial metrics might be "target performance equals plan +/- 10% or 15%". The appeal of this approach is obvious — it reflects the company's planned actions for the year, represents the commitments of the key managers in the business, has been approved by the whole Board, and generally is the basis for the guidance given to the Street.

However, a frequent concern of Compensation Committees is that goals may have been "sandbagged," with lower targets than are actually expected or achievable to help managers look good at year-end and/or ensure larger bonuses. Even CEOs often fret that linking incentives to business plans turns the whole planning process into a negotiation, rather than a realistic assessment of the business and opportunities. This can be an important consideration in environments where forecasting is particularly opaque. And even if goals do represent adequate stretch, the amount being paid for achieving the goals may not be consistent with the value received by shareholders or may not be enough to drive reasonable stock returns and dividends in the future.

Although using business plans for goal setting can work, there are other approaches available which may often be a better starting point for setting targets for incentive plans. These alternative goal setting approaches may be effective for annual incentive plans or, perhaps even more often, for long-term incentive plans, given that long-range planning is notoriously inaccurate and fraught with uncertainty.

Some Alternative Starting Points for Goal Setting

We highlight four approaches for setting goals outside of the budgeting process. These approaches set targets that are based on one of the following:

- A fixed amount of or percentage improvement over prior performance;
- Exceeding the company's capital costs by a specified amount;
- A target percentile or the best performers in the industry; or
- At or above analyst expectations for the industry.

The first two approaches offered are focused on expectations for the company's own performance, while the last two focus on external benchmarks. We estimate that roughly 20% of companies now use one or more of these alternative approaches, sometimes in conjunction with one another. Which approach is best depends on the company's specific business characteristics, industry, and overall compensation philosophy. What ties these approaches together is that each has the benefit of focusing the company on desired levels of performance, emphasizing what the company believes ***needs*** to be done on a sustained basis, rather than limiting it to what management believes ***can*** be done. Each also eliminates the "guesstimating" that is inherently embedded in most planning processes.

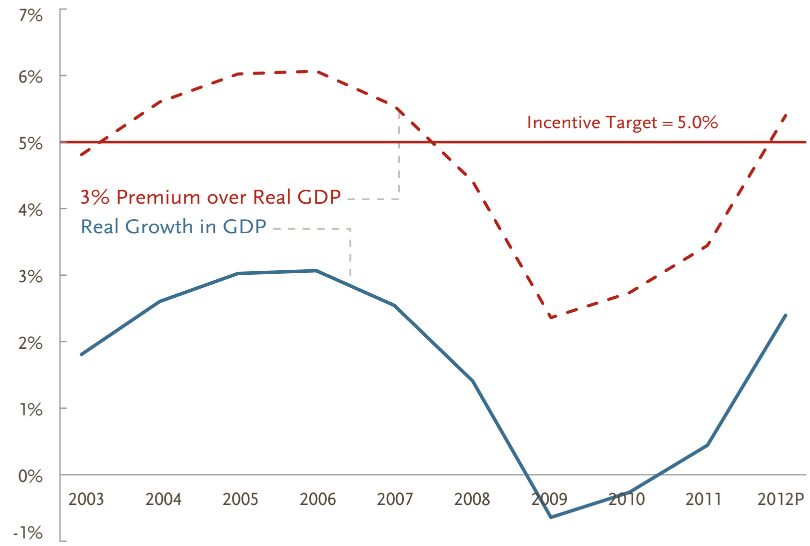
Each approach is discussed in more detail below:

Set targets that represent a fixed amount of or percentage improvement over prior performance.

Fixed rates of improvement should represent the company's long-term performance aspirations and focus on continuous improvement. Such goals can be derived from long-term trends of the industry or the sector in which the company operates or by the improvement rates of the top performers in the industry or sector. This works particularly well for companies in cyclical industries that have an explicit long-term growth strategy.

For example, we work with one company in a highly economically sensitive business that decided to set profit growth goals for their long-term incentive plan based on outperforming growth in GDP over time, rather than trying to forecast actual business results for any given cycle. They also considered past performance for the company and peers and the rate of growth needed to consistently meet or exceed their cost of capital, among other factors.

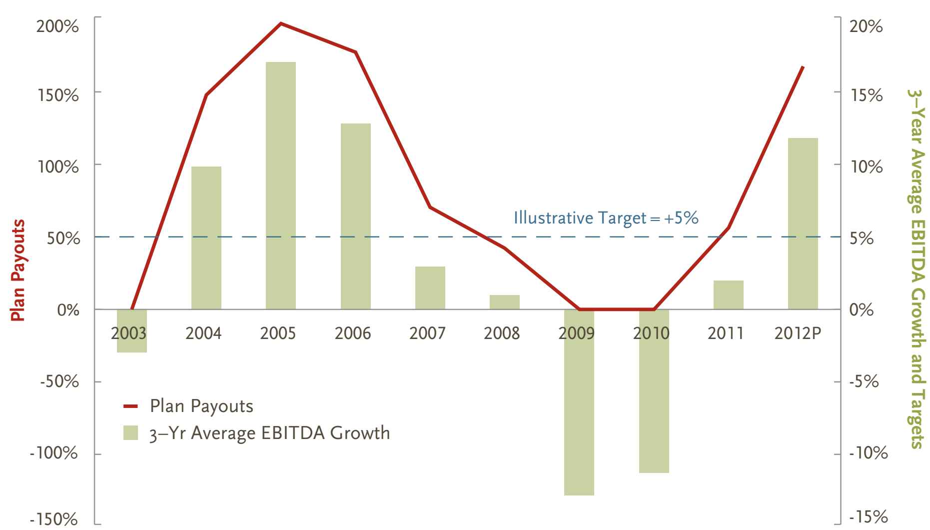
Figure 1. **Historical 3-Yr Avg. Real GDP Growth**



Based on a long-term performance goal of growing EBITDA at 3% faster rate than the economy overall, on average, over time, the company determined to use a constant growth target of 5%, regardless of near term business expectations (Fig 1).

The net result of this approach is that it can often result in pay being very volatile through the course of a business cycle, as shown in Fig 2.

Figure 2. **Illustrative Plan Payouts over Time**



However, the benefit of this approach is that there is no need for annual negotiation over each three-year cycle, and management can be confident that they will be rewarded for a return to growth following any short-term downturn. From a shareholder perspective, average performance needs to be at or above target over the long-term for management to earn a competitive compensation opportunity, which aligns well with their interests.

Set targets that exceed the company's capital costs by a specified amount.

A related approach is to use the cost of capital as the basis for setting performance goals. This approach is designed to ensure that shareholders receive an adequate return on their investment in the business. It is especially attractive for capital intensive companies in competitive markets, where consistently beating the cost of capital may be a challenge, or in high risk businesses or volatile markets, where the needed rate of return is high.

For example, we work with a company (Fig 3) that uses a matrix of Return on Capital and Operating Income Growth in their annual plan to ensure efficient growth in profitability over time. While the target can change based on expectations for the year, the threshold is always set at the weighted average cost of capital (weighted average cost of equity and debt = 10% in the example below) to ensure that growth never comes at the expense of low return investments.

Figure 3. **Return on Capital and Operating Income Growth Matrix – Payouts as % of Target**

		OPERATING INCOME GROWTH [%]						
		≤0	5	10	15	20	≥25	
RETURN ON CAPITAL [%]	>20.0	75%	100%	125%	150%	175%	200%	
	15.0	50%	75%	100%	125%	150%	175%	
	12.5	25%	50%	75%	100%	125%	150%	
	10.0	0%	25%	50%	75%	100%	125%	
	<10.0	0%	0%	0%	0%	0%	0%	← No payout for any returns below the cost of capital, regardless of profit growth.

Another approach would be to use the cost of capital as the basis for a fixed incentive target over time, such as "target always equals the performance needed to achieve returns of 200 basis points above the cost of capital."

Similar to the first alternative, the benefit of this approach is that the cost of capital serves as an anchor-point for setting targets, minimizing negotiations (i.e., there is no reason to even discuss a business plan with returns below the cost of capital). In addition, using the cost of capital as the basis creates an explicit link between rewards and returns for shareholders in industries with heavy capital investment needs.

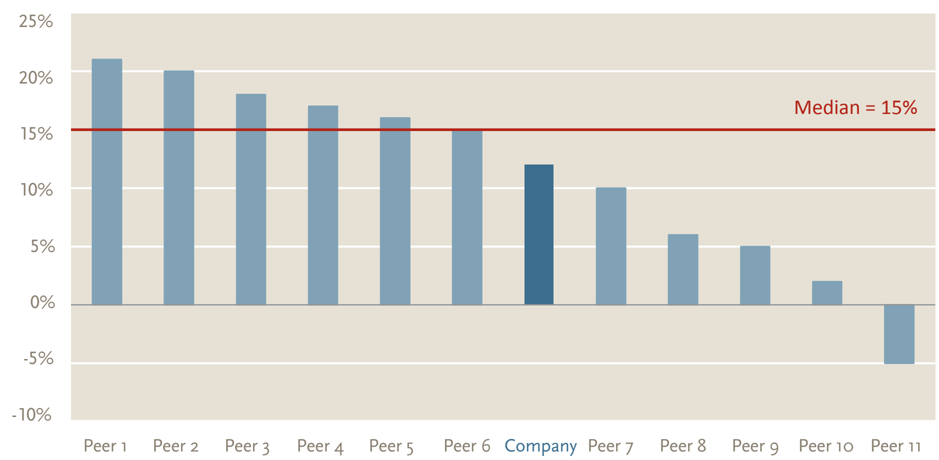
Set targets that reflect a target percentile or the best performers in the industry.

The third approach uses recent industry performance as the primary basis for goal setting, with new goals set at the beginning of each year as industry conditions change, regardless of company specific plans or expectations. Targets are often set at a specified percentile of the industry (e.g., 50th or 60th percentile) or, for companies that are expected to outperform the industry average or have high pay relative to peers, goals can even be set in the upper quartile or decile. This approach is not the same as relative performance measures (where performance is measured after the fact by reference to a peer group), but it is similar.

The approach works best in relatively stable industries, where past performance is a reasonable prediction of the future for the company and its peers. However, this approach also requires that the industry has a sufficient number of direct peers (e.g., 10 or more) to effectively assess industry trends.

For example, if we look at a company that has typically grown earnings at a rate of 12% on average in an industry where the 50th percentile performer has historically been able to achieve a 15% earnings growth rate, then we might set the annual performance target at the market median — regardless of the company's own plans or expectations — requiring "stretch" performance for target pay, as shown in Fig 4.

Figure 4. **Historical Average Earnings Growth Company and Industry Peers**



The benefit of this approach is that it makes an explicit link to industry standards in setting performance targets, rather than relying on the company's own performance history to gauge degree of difficulty. It works well for companies that have either consistently underperformed market standards, where just relying on budgets may not be "good enough" to re-align with the peers, or for companies that are already top performers, where setting outperformance standards can motivate surpassing peers on a continuing basis.

Set targets that are at or above analyst expectations for the industry.

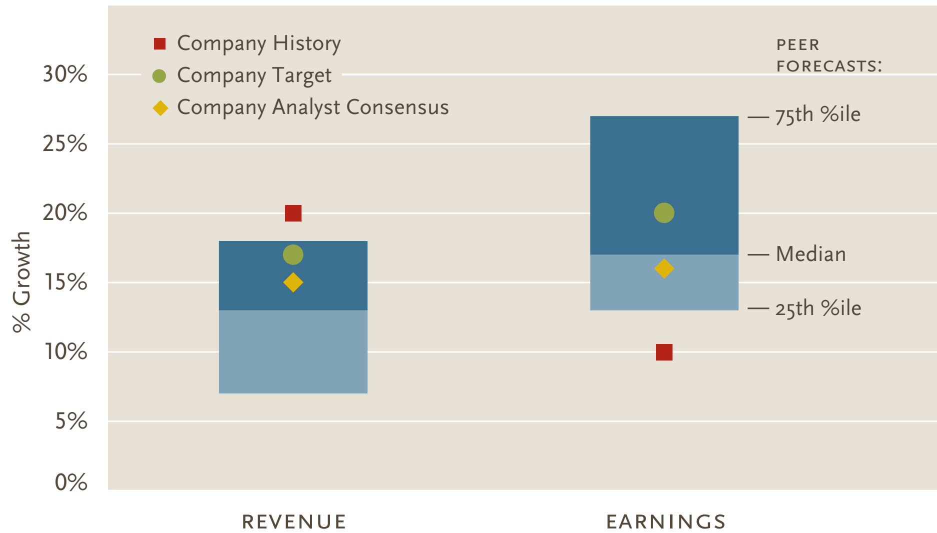
This fourth and final approach is similar to the above in that performance is benchmarked relative to peers. However, rather than using backward looking performance as the basis for setting goals, forward looking expectations as defined by stock analysts are used as the starting point for discussion. The focus should be broader than the expectations for the company itself given that the company helps shape these expectations.

This approach works better than the historical performance approach in high growth and highly dynamic industries such as technology, where past performance is not necessarily a good predictor of the future, and where the price for missing analyst expectations is high. If a company is a good performer, it can set targets that strive for above market performance.

For example, we worked with one company in a high technology business where the analysts were forecasting a decrease in the rate of revenue growth, but offset by expectations for higher earnings growth, for both the company and its peers. The company in question intentionally set performance goals above the analyst consensus both in order to beat the Street's expectations and to remain an above median performer in the industry (Fig 5).

The advantage of this approach versus the prior is that analyst expectations are forward looking and reflect what the market requires for the company and its competitors to sustain their market valuations, rather than just looking to the past as a gauge of reasonableness.

Figure 5. **Historical Average Earnings Growth Company and Industry Peers**



In Summary

The alternatives outlined above might not be appropriate in all cases. However, given the negotiations and uncertainties many companies experience with budget-linked incentives, we believe they are worthy of serious consideration where the advantages outlined are deemed desirable.

What Happens if Budgets Vary Significantly From Incentive Targets?

Even though the business plan is not the starting point, it is still important to compare the budget to the incentive targets to assess gaps. If there is a large gap, it needs to be determined if the problem is that the targets are too tough or the budget is not sufficiently aggressive.

If the former is the case, then a transition period may be needed during which targets are "ramped up" in stages to desired levels. If the latter is the case, then setting more aggressive performance targets than suggested by the operating plan may lead management to "rethink" their business plan and develop revised plans to help achieve the required performance levels.

ADVANTAGES

- Less gaming in the budgeting process
- May drive higher levels of performance vs. settling for what is doable
- Better aligns pay and performance
- Emphasizes pay for performance vs. entitlement

DISADVANTAGES

- Increases volatility of payouts
- May cause confusion through multiple goals (e.g., incentive goals different than business plan)
- Reduces commitment and accountability for achieving business plans

In particular, these approaches might be helpful for companies in industries that are difficult to forecast effectively, especially when setting multi-year incentive goals for vehicles such as performance shares, where setting long-term performance goals are notoriously difficult.

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