

## SETTING SHAREHOLDER- FOCUSED PERFORMANCE TARGETS

BY MATT TURNER

Until recently, setting performance targets for executive incentive compensation plans was too often a perfunctory and one-way process. Typically, Corporate Finance would prepare the annual operating plan and determine “planned” performance with respect to standard financial performance measures such as revenue and earnings per share.

These figures (or a set of related Street “commit” numbers) were then reported to the Compensation Committee and plugged into the annual incentive plan. Threshold and superior levels of performance might be set based on a fixed percentage above or below target for each metric. The process was similar for a cash-based long-term plan, possibly with a nod toward longer-term “required” performance.

Those days are over. Heightened shareholder activism, increased disclosure requirements and an overall market skepticism regarding “pay-for-performance” requires that companies embrace a more rigorous, shareholder-focused approach to ensuring that both performance measures and targets are appropriate and effective. The goals of engag-

ing in a more systematic and thoughtful approach include:

- Validating the performance measures used in incentive compensation plans;
- Grounding the target-setting process in a clear understanding of shareholder expectations; and
- Involving all of the relevant people in the process — early and often.

### Validate the Performance Measures

Most financial performance measures baked into annual incentive plans are based on a combination of historical usage, industry practice and compatibility with analysts’ coverage of the company. While intended to reflect shareholder value, too many companies fail to ever validate whether or not performance against such measures will actually create shareholder value.

Validating performance measures need not be rocket science, but should involve at least some statistical analysis. The analytic process starts with a strong understanding of the economics of the relevant industry, along with a command of the



Setting executive compensation targets has changed. The process now reflects the new environment of heightened shareholder activism, increased disclosure requirements and overall market skepticism.

company's specific business strategy and value chain. One can then identify what specific performance measures might best correlate to long-term value creation for the company, using regression and time-series analyses to test that value link.

However, relying on regression analysis to the exclusion of other factors that impact the link between pay and performance is never sufficient. The review also needs a critical evaluation of the analysis in light of knowledge that is specific to the company and industry.

For example, one specialty chemical company concluded from its initial analysis that return on net assets (RONA) showed a stronger correlation to market-to-book ratios than return on gross assets (ROGA). However, closer inspection of its peer group revealed a remarkable similarity between each company's asset age-to-life ratio that temporarily minimized accounting distortions within the sector.

Moreover, the company's executives repeatedly had stressed that manufacturing process innovation was accelerating and that increased investment was critical to its future. Therefore, while the regression analysis appeared to point to RONA as the best measure of performance, over the longer term, a cash return measure actually offered a more direct link to real value, while also providing management with the flexibility to make needed investments.

Critical evaluation of the regression analysis can also help explain weak results. For example, one high-tech company initially found only a weak link between net margin and sales multiples.

However, a closer inspection of the regression scatter-plots, taking into account industry knowledge, revealed that rather than a single weak relationship, there were actually two strong relationships. Companies with demonstrated high growth simply carried a higher sales multiple for a given net margin.

In each of the above cases, management was able to demonstrate to both the Compensation Committee and to outside shareholder groups that the performance measures chosen for executive incentive compensation plans were truly associated with

the creation of shareholder value. Moreover, both management and the Compensation Committee improved their understanding of the power and the limitations of various measures in an incentive context.

Such a process need not be done annually, but is called for any time there is a sense that the industry has changed or the company's strategy has materially shifted.

### **Ensure that the Target-Setting Process Is Grounded**

A budget- or plan-driven process may result in inconsistency of performance targets in different years. "Bottom-up" plans — which often assume year-over-year growth is always required — may end up ratcheting targets unrealistically following good years (making future targets difficult to achieve) or result in lowball targets following a year of poor performance. Also, comparisons of performance across an industry may result in unreasonably tough or overly lax performance assumptions, due to the very different economics among industry competitors.

This lack of consistency can result in "excessive" payments for lackluster performance in one year, while executives might be underpaid despite Herculean efforts and results in a tough year. One only needs to read *The New York Times* or *The Wall Street Journal* to guess which case gets the most attention. Moreover, knowing that the budget begets incentive targets can encourage the gaming of targets (such as "sandbagging") at various levels in the bottom-up process. The whole exercise can become a political negotiation.

"Grounding" performance targets requires that interested parties identify, examine and agree on the information used to develop performance targets, resulting in more robust and meaningful hurdles. The budget process need not be completely divorced from incentive target-setting, but it should not be of primary importance. Other perspectives, such as longer-term required performance (cost of capital), should be factored in. Incorporating multiple perspectives can help create more robust and relevant targets.

The most neglected perspective in setting performance targets is

shareholder expectations, as revealed in current market valuations. The process begins with an understanding of what drives shareholder value, after which the company can develop a specialized valuation tool that allows for the modeling of performance against the incentive measures.

The model can then be utilized to identify a multi-year “plan” of performance that will meet shareholder expectations under specific assumptions. Additional modeling can identify plans of performance that will exceed (or fall below) shareholder expectations, resulting in returns above (or below) the cost of equity. These alternative plans can help guide the creation of threshold and superior levels of performance. With such a tool, companies may now speak about various levels of financial performance in terms of expected impact on shareholder value.

Care must be taken in such modeling to ensure that other factors affecting company value are fully considered. Failure to acknowledge such factors can lead to radically incorrect assessments of shareholder expectations. For example, a retail company with a very strong brand value used a specialized valuation tool to assess expected return on net assets over a five-year period. However, the tool indicated outrageously high levels of expected performance (assuming that returns significantly above the cost of capital could not be sustained indefinitely).

In this case, it was important to adjust the model to recognize the brand value as an asset so that more reasonable levels of expected performance were identified. In another case, a utility company discovered that market expectations of consumer power rates were at odds with internal estimates built into its value model, leading to an important discussion about the impact of exogenous factors on performance evaluation.

In each of the above cases, the companies gained a better understanding of the relationship between their incentive plan performance

and shareholder value. This understanding allowed for a more productive discussion of “pay for performance,” because the involved parties spoke the same language of value.

Moreover, the companies had a better appreciation of how other factors can significantly impact share price performance, allowing for fine-tuning of incentive programs. Shareholder expectations, along with the other target-setting perspectives, should be examined each year as part of the analytic support offered to the Compensation Committee.

### **Involve All of the Relevant Stakeholders**

Even if the process seems to produce reasonable targets for reasonable measures, a process that does not fully engage the appropriate parties may create problems later. In today’s governance environment, Compensation Committees are accountable for the pay-for-performance philosophy and for its actual attainment. As a result, members are devoting much more time to discussing performance measures and performance targets.

However, too often Compensation Committees ask good questions at meetings in February that should have been posed back in November. Committee meetings can seem very long in these instances, and even longer when there are no ready answers available. Often, this reflects a historic lack of coordination between the finance and human resource functions, the committee and the outside advisors. While understandable under the old paradigm, in the new pay-for-performance environment, such disconnects must be addressed.

Constructing effective and shareholder-focused incentive arrangements requires continuous cooperation and communication between finance, HR, the Committee and outside advisors. Prior discussions with committee members regarding the level of analytic support it needs promote an orderly target-setting process and minimize unnecessary delays in gaining agreement. Identifying disconnects between bottom-up planning

figures and shareholder expectations early can allow HR, the committee and its advisors to provide appropriate accommodations, while remaining shareholder-focused.

For example, a print publisher discovered that near-term financial performance could in no reasonable way justify current share price levels. In addition to prompting an appropriate investor relations response, the insight allowed the company to proactively deal with a future retention issue, rather than having to enter into an incentive arrangement doomed to failure.

Gaining and sharing the insights of a rigorous performance measure selection and target-setting process can help remove the emotions and politics and result in more effective and shareholder-focused incentive arrangements. Companies that engage in a truly in-depth analysis of the type and level of performance targets will better ensure the involvement of all relevant stakeholders and avoid unpleasant surprises down the road for both management and directors.

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### **TAKEAWAYS**

- >> A systematic and thoughtful approach to setting executive pay involves validating performance measures, grounding the target-setting process and involving all the relevant stakeholders.
- >> Validating performance measures should involve at least some statistical analysis that starts with a strong understanding of the economics of the industry and the specific company’s business strategy and value chain.
- >> Even if the process seems to produce reasonable targets for reasonable measures, a process that does not fully engage appropriate parties may create problems later.