



Pay-for-Performance: Bridging the Gap between Board and Management

Compensation Series

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Pearl Meyer & Partners
Comprehensive Compensation[®]



ADVANCING EXEMPLARY BOARD LEADERSHIP



Meet the Presenters



Richard Goeglein (moderator), Chairman, Pinnacle Entertainment; Member, Advisory Board of The Board of Veteran CEOs; Trustee, Board of Volunteers in Medicine of Southern Nevada



Don Lindner, executive compensation practice leader for WorldatWork



Matt Turner, managing director in the Chicago office of Pearl Meyer & Partners





About the Survey and this discussion document



- As a result of recent economic turmoil and increased scrutiny of executive compensation practices, more pointed questions are being asked by investors, legislators and the media as to whether pay and performance are truly aligned.
- As Management and Boards of Directors engage in such discussions, they need to agree upfront on specifically how “pay-for-performance” (PfP) should be defined. They also need to agree on how PfP is periodically reviewed and the respective roles of the Board, management and others.
- The ***PM&P On Point: 2011 Executive Pay-for-Performance Survey*** provides a unique look at the views held by board members and management regarding multiple aspects of pay-for-performance. Among the topics covered:
 - What specific performance is relevant in the pay-for-performance equation?
 - Which types of measures are important incentive plans?
 - How much discretionary adjustment of incentives is appropriate and under what circumstances?
 - Who is involved in performance measure selection and goal-setting?
 - What kind of data and analysis is being used to determine performance measures and goals?



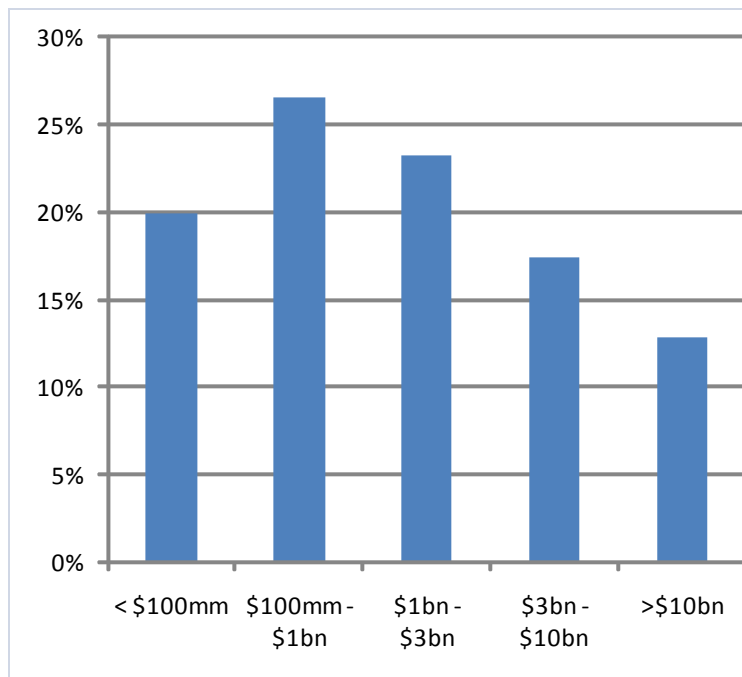


Participants in the survey represent companies of all sizes and industry

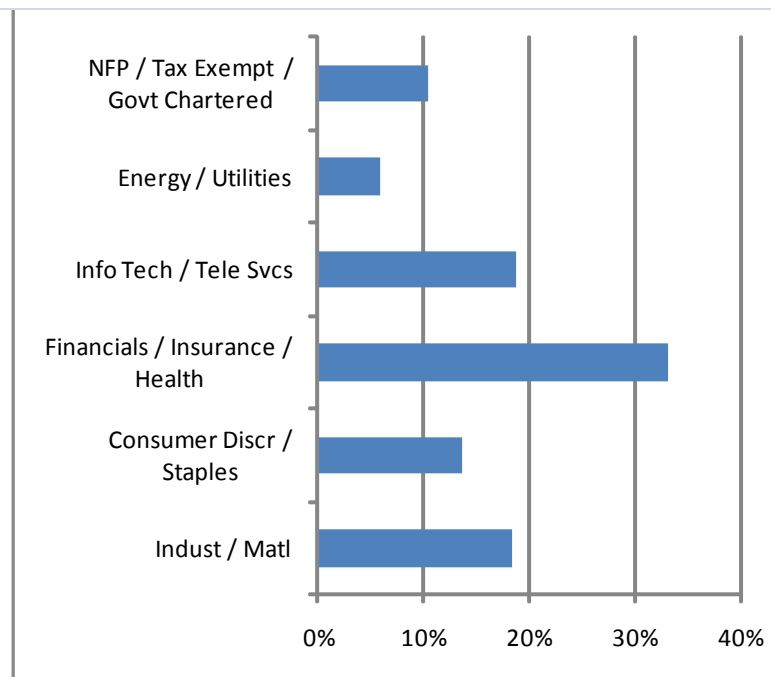


- The survey is based on 241 participants, with 179 who responded as company managers and 62 who responded as board members of their company.
- 61% of participants represent publicly traded companies, while 29% represent private, membership and mutual organizations. 10% of respondents are from not-for-profit or government entities.

Company Size by Revenue



Company Industry



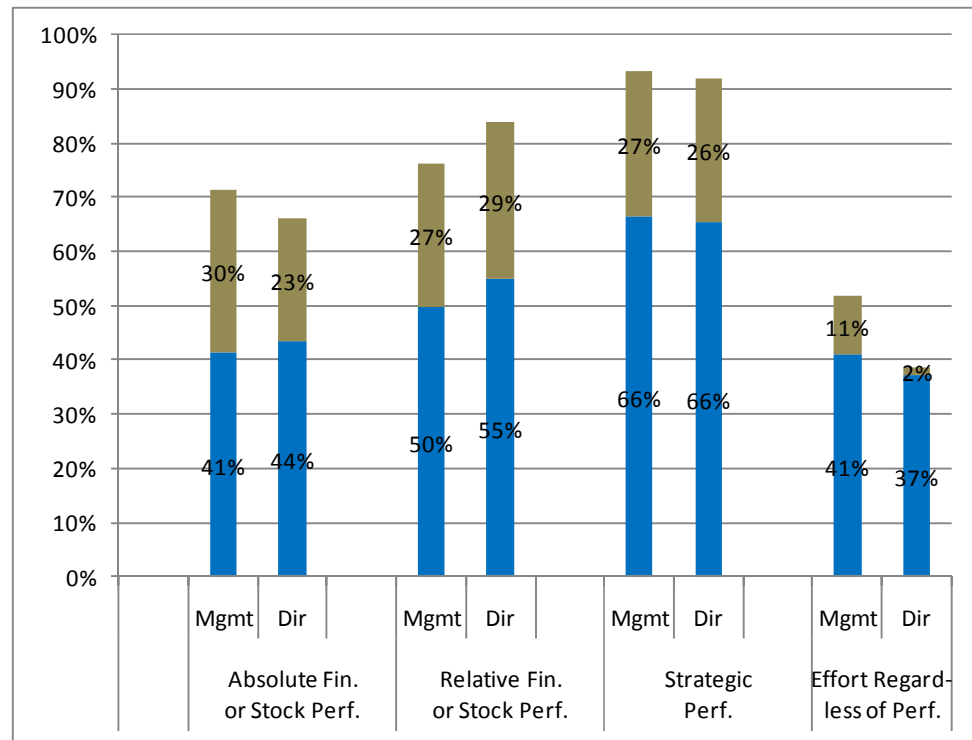


What aspects of “performance” should be reflected in a “pay-for-performance” philosophy?



- Strategic performance assessment belongs in an organization’s overall definition of “pay-for-performance”
- Relative performance (stock or financial) is considered more important by directors than by management
- Individual effort is not likely to be considered part of the “pay-for-performance” definition, especially by directors

Pay-for-Performance Should Reflect...



Percentage of management and director responses that “agree” (blue) and “strongly agree” (beige) with the form of measurement

Polling question up next...

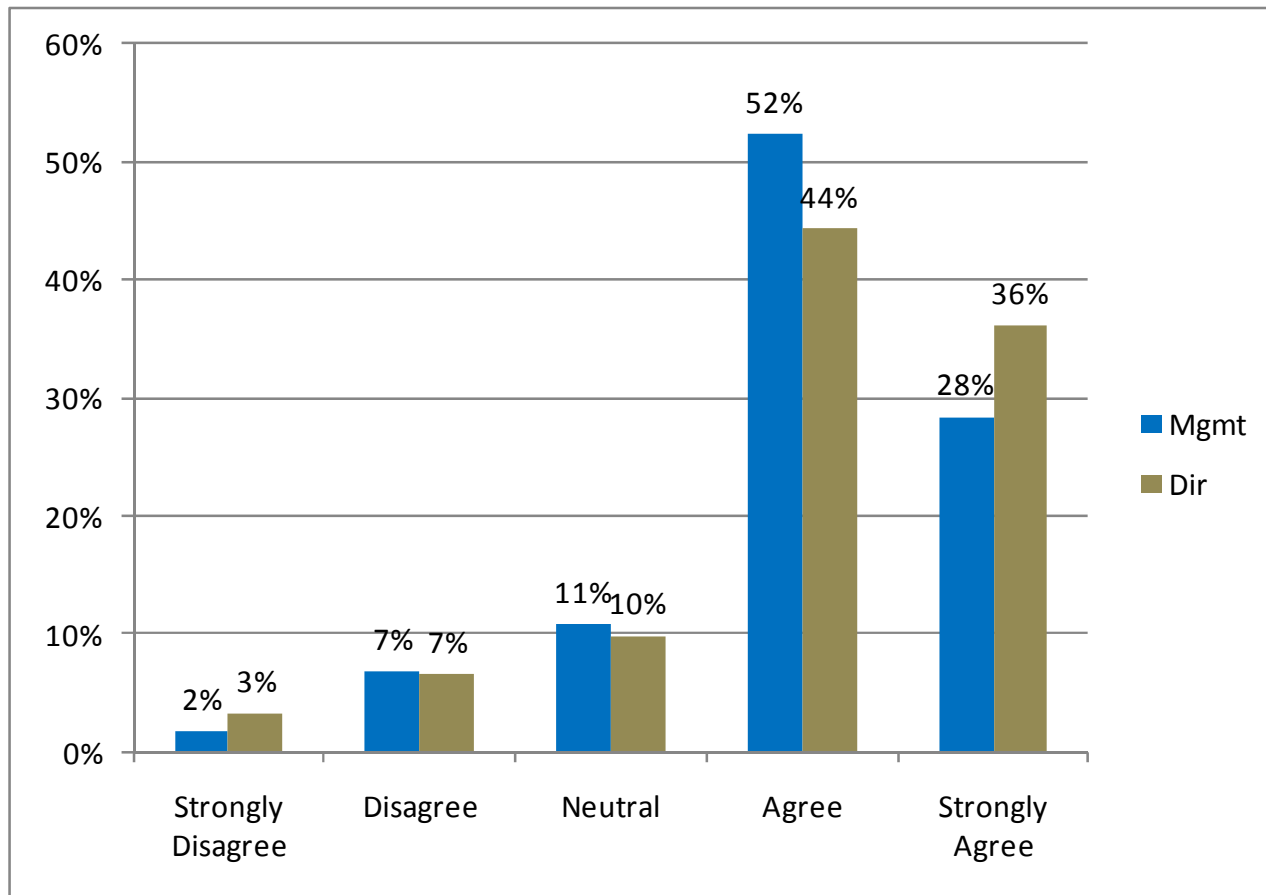




Both management and directors agree that there are reasonable limits on executive compensation



There are Limits to Executive Compensation, Even with Exceptional Results



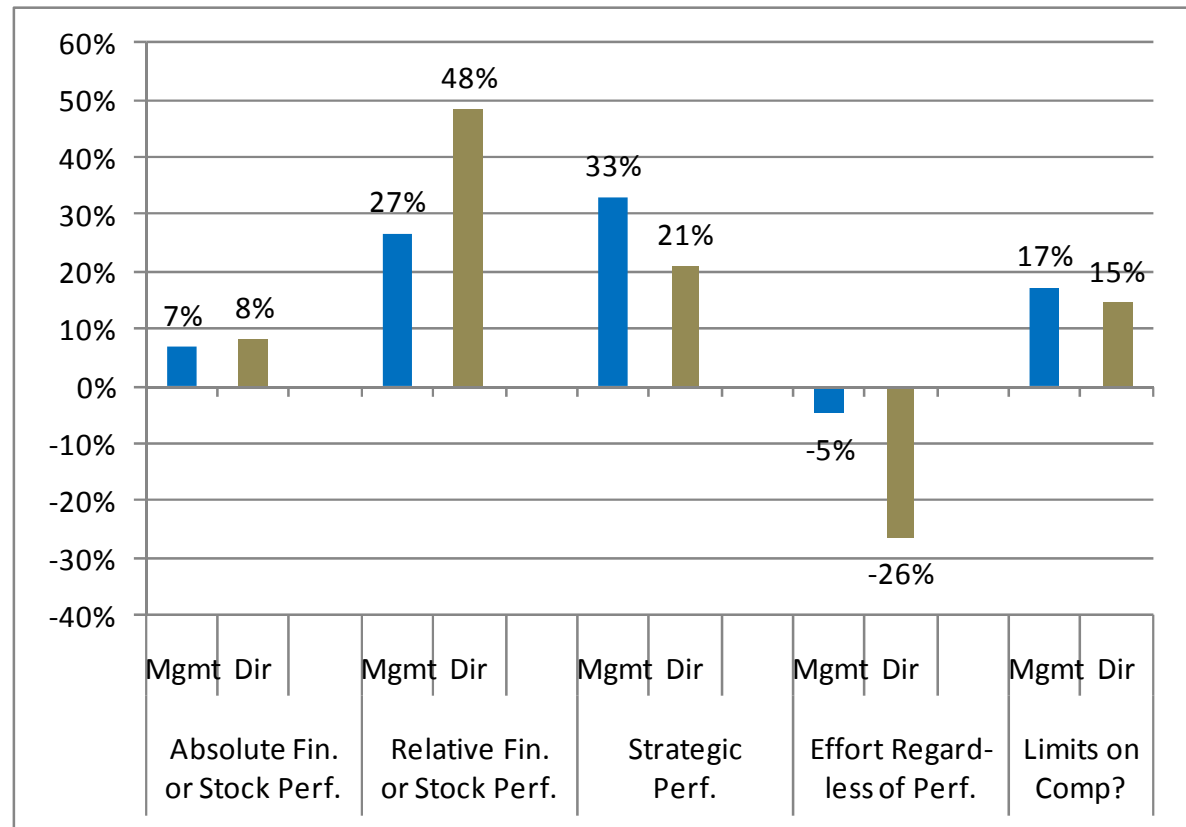


Views have shifted over the years with respect to pay-for-performance



- The focus on absolute stock price and financial performance has remained relatively the same
- Directors have shifted strongly in favor of increased focus on relative performance
- Management has increased focus on strategic performance
- Directors have shifted strongly against focus on individual effort

How have your views changed in recent years?



Bars represent the difference between “more emphasis” versus “less emphasis” responses for each aspect of performance and respondent type



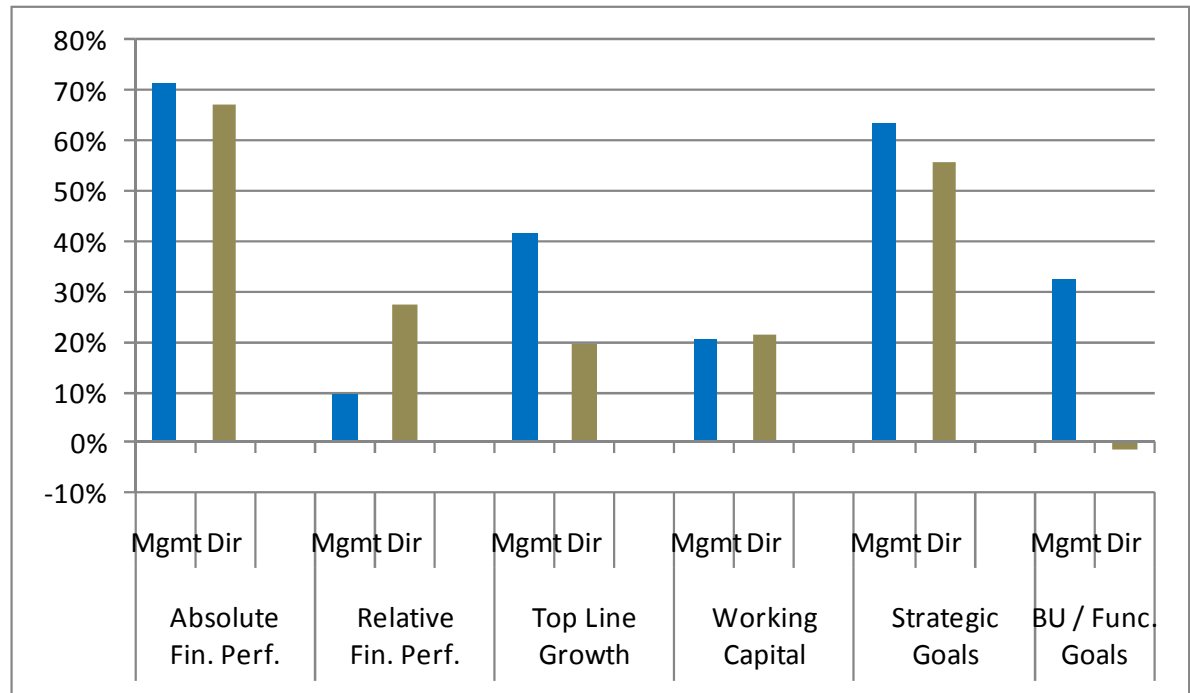


Views differ regarding annual and long-term incentive plan performance focus



- Financial performance is the “centerpiece” of an annual incentive plan.
- Management also places greater importance on growth than directors
- Management is more inclined than directors to believe unit and functional goal emphasis is important

ANNUAL incentive plans should focus on...



Bars represent the difference between “critical” versus “less important” responses for each aspect of performance and respondent type. The middle response (“somewhat important”) is not reflected above



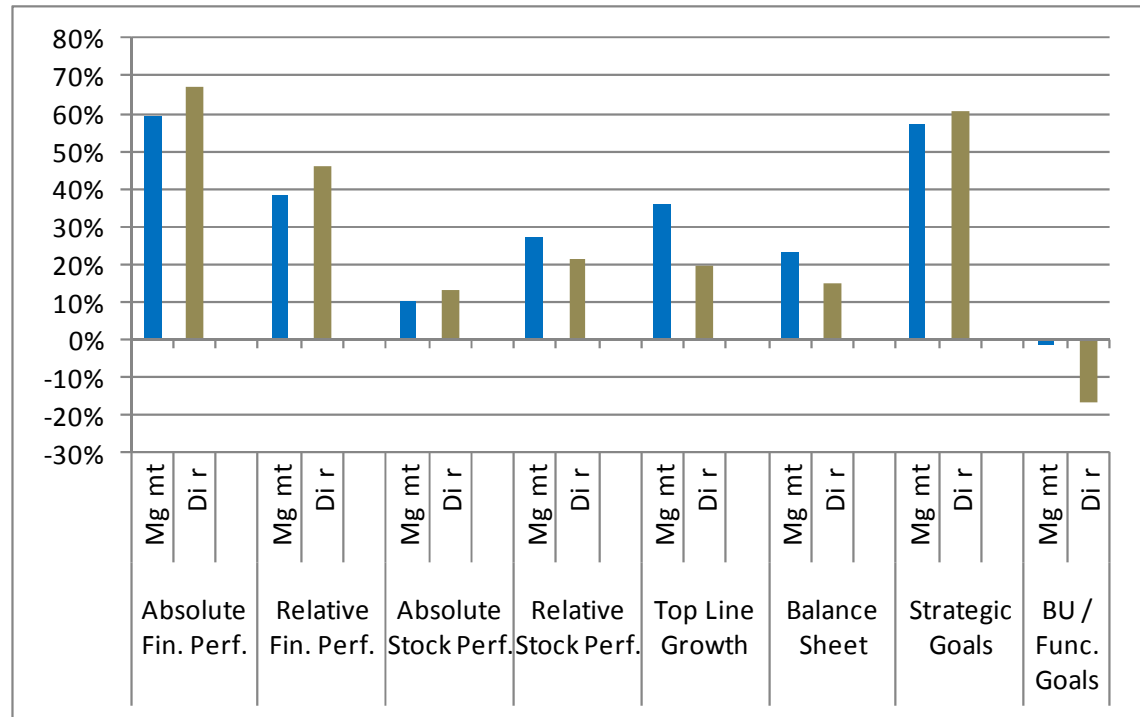


Views differ regarding annual and long-term incentive plan performance focus



- Financial and strategic goals are the preferred measurement focus for long-term incentive plans
- Relative total shareholder return tends to evoke strong positive and negative responses, especially from management
- BU and functional goals don't tend to fit into LTIP

LONG-TERM incentive plans should focus on...



Bars represent the difference between “critical” versus “less important” responses for each aspect of performance and respondent type. The middle response (“somewhat important”) is not reflected above

Polling question up next...



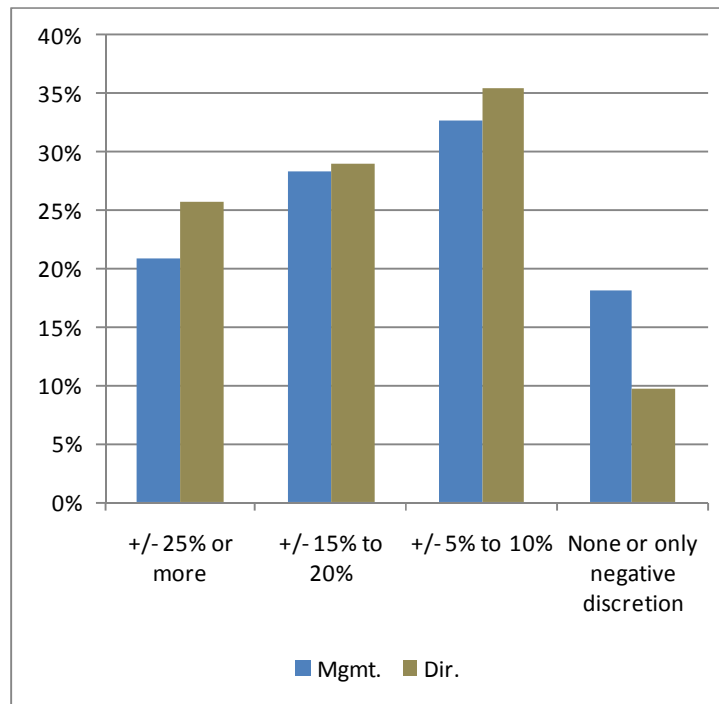


Discretion is generally viewed as a necessary part of executive incentive design, especially for annual plans

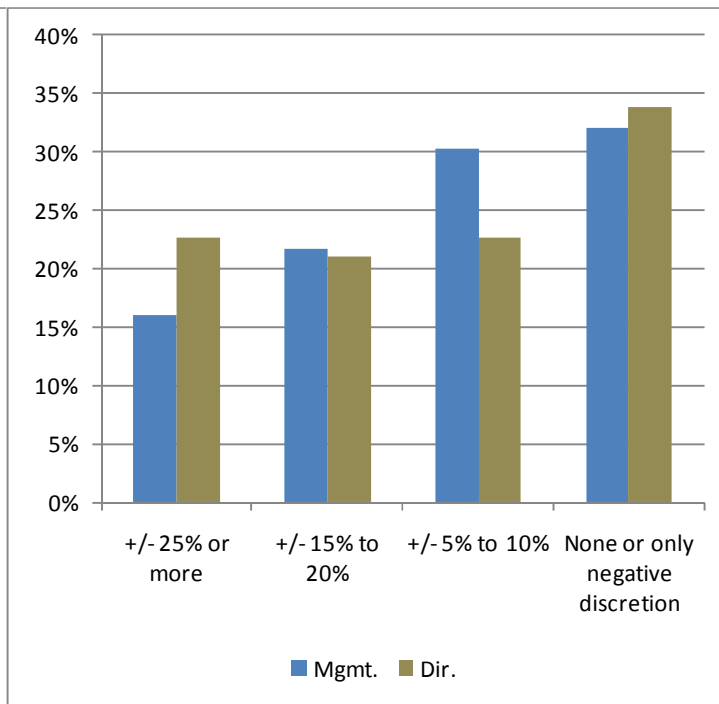


- Directors, in particular, are comfortable allowing for a reasonable level of discretionary adjustment (positive or negative) for annual incentive awards
- They are much less likely to tolerate discretion for long-term incentives

Annual Incentive Plan Discretion



LTI Plan Discretion



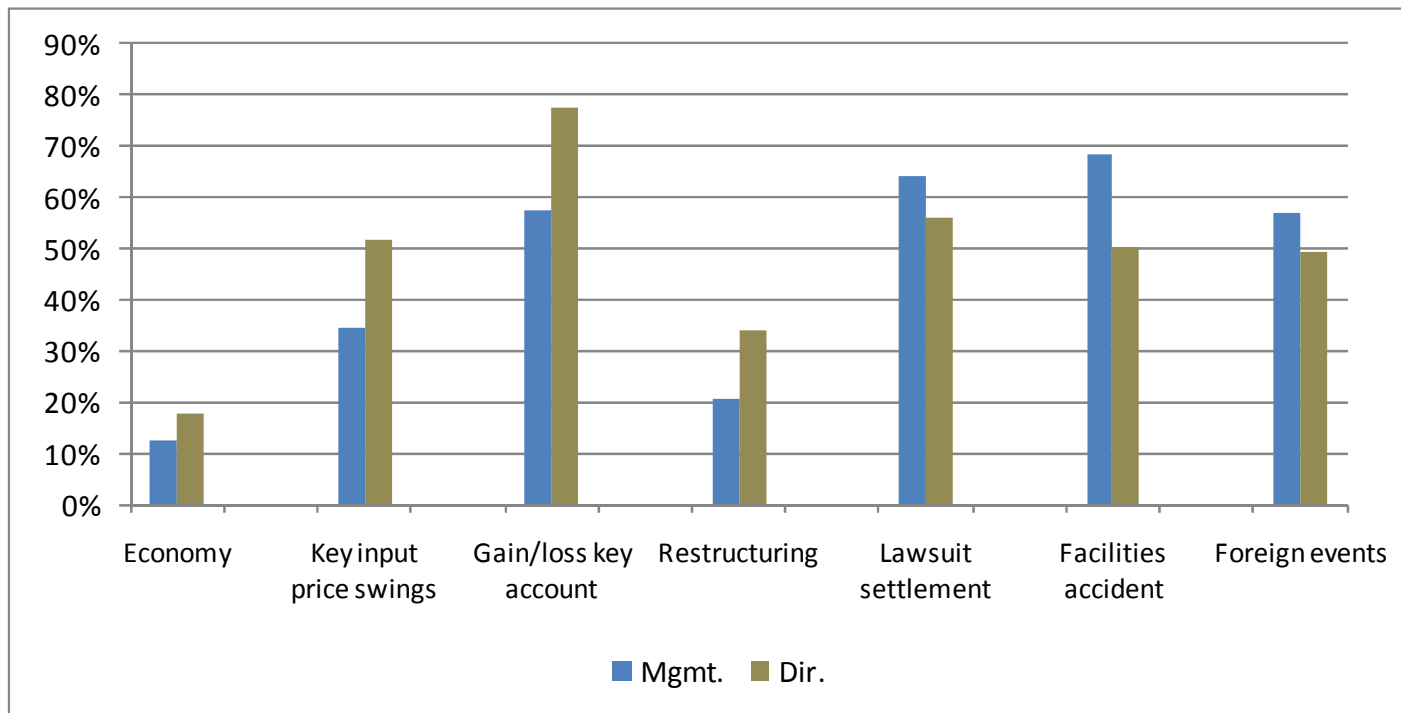


General economic conditions and restructuring are viewed as appropriate for discretionary adjustment



- Directors are less likely than management to consider key input price swings or changes in key accounts as grounds for discretionary adjustment. Even restructuring events will garner greater director scrutiny
- Management is less forgiving of facilities accidents and legal settlement

Situations Viewed as LESS Appropriate for Discretionary Adjustment

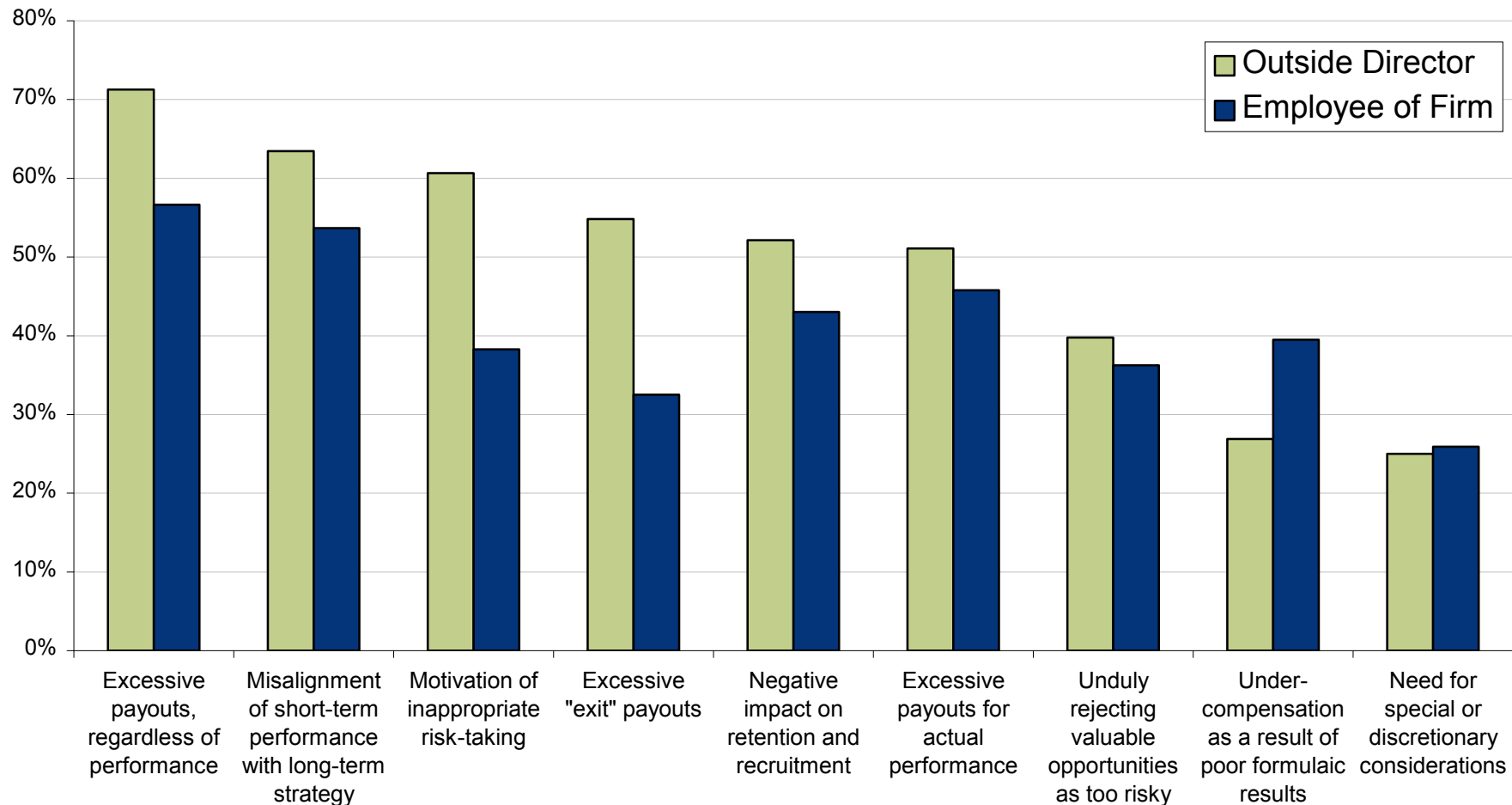




Another area where management and directors have different concerns is with respect to “risk”



Importance of Compensation-Related Risks
% of Responses that were a “4” or “5”
(5 = Most Critical; 1 = Least Critical)





Who should be involved in measurement selection and goal-setting?



- Directors are less inclined to have non-CEO executive involvement on a routine basis
- Management is less inclined to have the full Board involved in the measurement selection process
- Both management and directors see a “sometimes” role for outside advisors

Who Should be Involved in Measurement Selection?

		Mgmt.	Directors
CEO	Never	1%	-
	Sometimes	11%	11%
	Always	89%	89%
CFO	Never	6%	5%
	Sometimes	20%	43%
	Always	74%	52%
HR	Never	7%	10%
	Sometimes	18%	41%
	Always	75%	49%
Other senior executives	Never	17%	38%
	Sometimes	67%	48%
	Always	16%	14%
The Compensation Committee	Never	-	-
	Sometimes	11%	3%
	Always	89%	97%
The Board of Directors	Never	5%	-
	Sometimes	50%	39%
	Always	45%	61%
Outside advisors	Never	16%	10%
	Sometimes	50%	54%
	Always	34%	36%



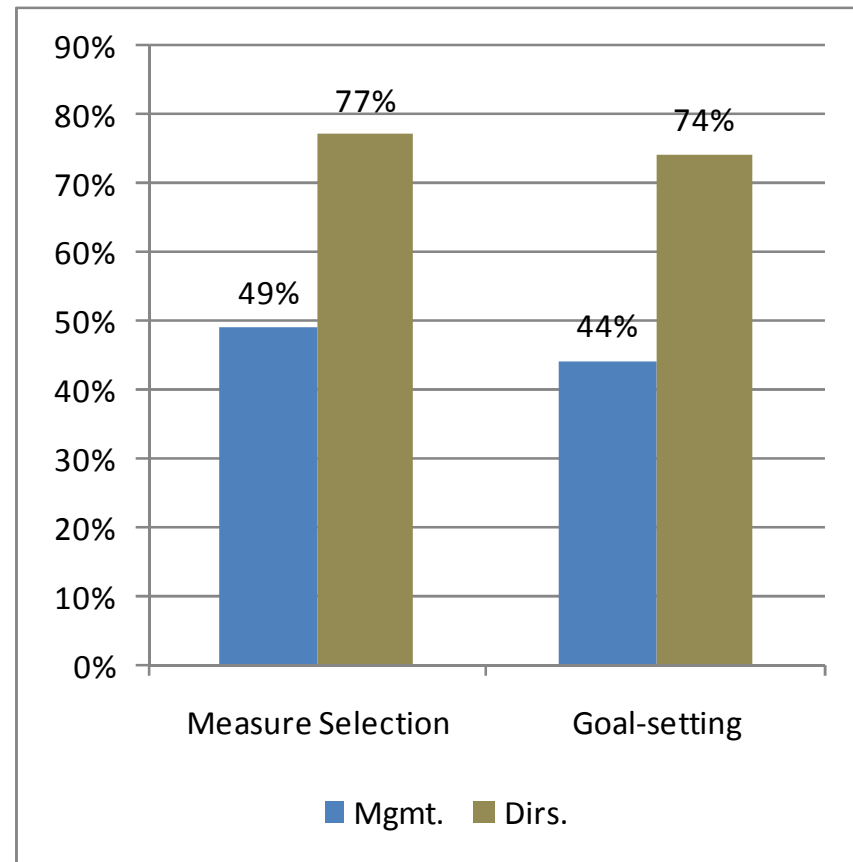


Directors are more involved with the measure selection and goal-setting processes than in prior years



- While both management and directors agree, directors seem to have a more acute sense of their increased involvement in the measure selection and goal setting processes

% Indicating Board is MORE Involved in Each Process





Some other findings from the survey include...

- **Key inputs in the review and selection of performance measures include:**
 - “Always” – Company strategic plan, review of peer and industry practices, review of company performance against peers
 - “Sometimes” – Statistical analysis of the link between measures and shareholder value; tailored measured and/or adjustments to GAAP

- **Key inputs in setting performance goals include:**
 - “Always” – Annual budget and long-range plan
 - “Rarely” – Analyst expectations (directors are especially averse)

- **Pay-for-performance assessments are conducted at companies represented by most respondents, though annual looks are more common than multi-year looks**

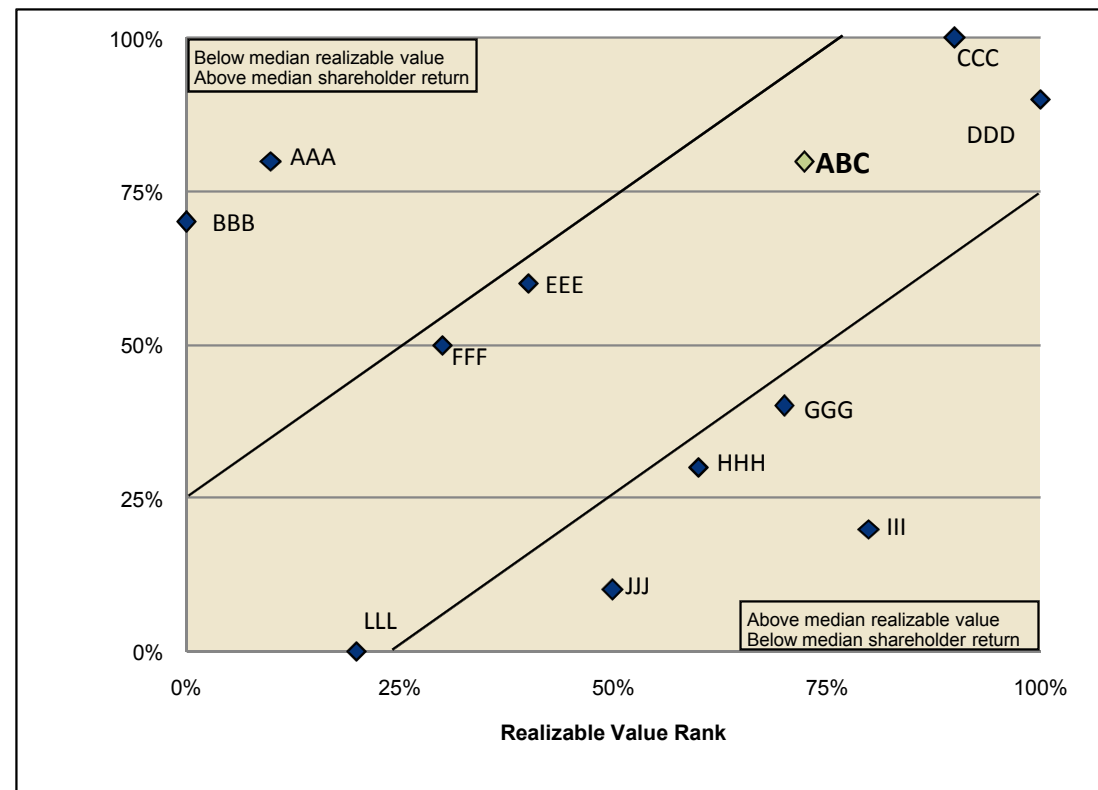




Example: Pay-for-Performance Analysis

- **Key Finding:** ABC Co. cumulative realizable compensation is roughly aligned with total shareholder return performance over a three year period
- **Additional Commentary:** Board assessment of CEO and senior executive performance should focus in on performance factors not directly captured by share price, and/or acknowledge unusual firm-specific events that might have influenced TSR unrelated to executive performance

Peer Percentiles	TSR Performance	CEO Cumulative Realizable Compensation
Peer 75 th Percentile	12.1%	\$9,273
Peer Median	-1.6%	\$4,947
Peer 25 th Percentile	-7.0%	\$4,167
ABC Co.	15.0%	\$8,722
ABC Co. Percentile Rank	80th	73rd



* Time period is 12/31/2008 to 12/31/2010





Top priorities for “bridging the gap” and having an effective pay-for-performance culture



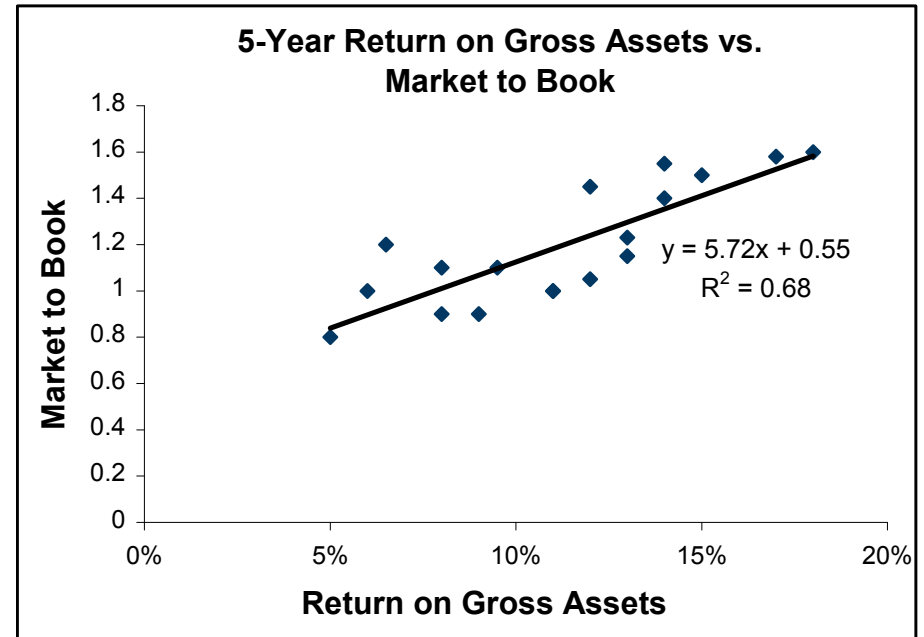
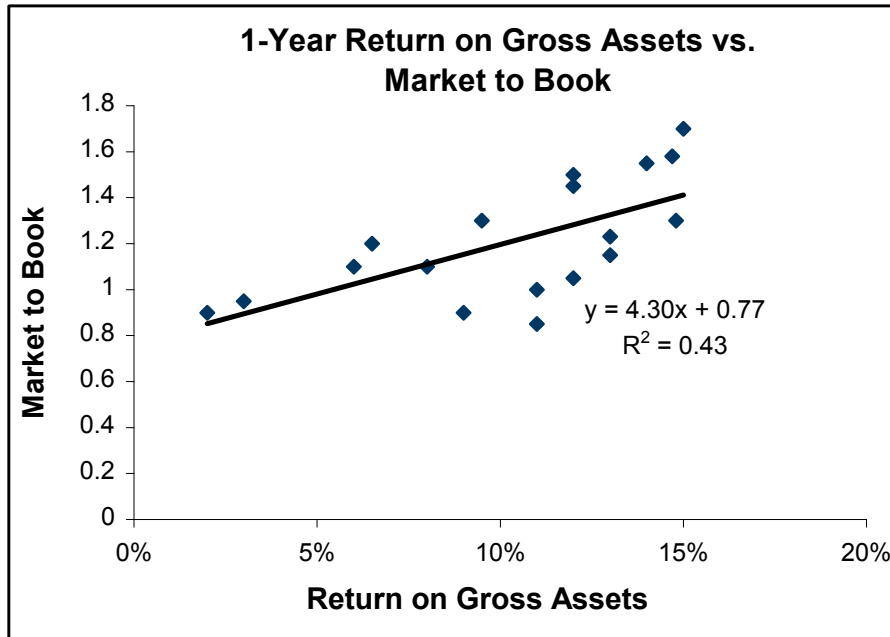
1. Agree on a working definition of “pay-for-performance”
2. Validate the measures you are using in incentive compensation
3. Allow sufficient time and process to gain agreement between management and directors on the sticky points
4. “Pressure test” incentive plans; understand potential outcomes and ensure they produce “rough justice” in pay-for-performance
5. Communicate, quantitative and qualitative





Analysis of performance measures and their link to value can reinforce existing views, or challenge current thinking

- **View that return measures drive company valuations is reinforced. However:**
 - ROGA is correlated to shareholder value better than RONA or ROIC (not pictured); “Net Asset” returns may be distorted by differences in book value of PP&E versus economic value
 - There is a better/tighter relationship to value for longer periods of time; Return measures are most meaningful in a long-term plan versus an annual plan



Graphs are regression analysis of a specific industry peer group. Each point represents a specific company's ROGA and Market to Book ratio. In general, the graphs show that ROGA provides meaningful explanation of a company's market valuation, with the longer time period providing better explanation than the shorter period
Remember: correlation does not necessarily mean causation





Thank You

