

Executive Pay in the New Economy: Updated Data and Guidance

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■ Our Speakers

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Theo Sharp specializes in incentive plan design, deferred compensation, benchmarking, golden parachute design and evaluation, and the tax and accounting treatment of equity compensation.

Jim and Theo both operate out of our Boston office.

■ Agenda

- What a Difference Three Months can Make
- Methodologies & Research
- Findings – Company Performance & Impact on Pay Decisions
- Findings – Components of Pay
 - Base Salaries
 - Bonus Decisions
 - Long-term Incentives
 - Severance & Security Arrangements
- Findings – Variations and Similarities
 - Across Industries
 - Management vs. Board Perspectives
- Closing Remarks

Over the Past Three Months...

Pay practitioners have observed:

- **No sign of market recovery (S&P 500 down 14.7% from November 1, 2008 to February 1, 2009).**
- **Relatively few firms implementing option exchanges—but those that do receive great deal of attention.**
- **“Alphabet soup” of assistance programs, each with related executive pay restrictions.**
 - EESA, CPP, GACAP, EFRAP.
 - Obama administration makes its move.
- **Widespread outrage over New York State Comptroller’s report that 2008 Wall Street bonus pool totaled \$18.4B.**

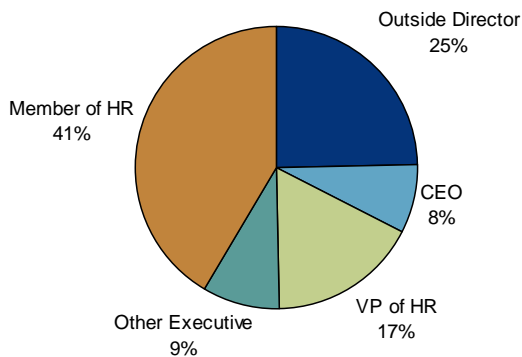
And pay decision makers have responded:

- **Pace of change is accelerating.**
- **Distinct, more negative outlook in Board & executive expectations for both company performance and executive pay.**
- **Executive expectations are now more in line with director expectations.**
- **Move to redesign executive pay, find a pay model that works (before government imposes a pay model that may not).**

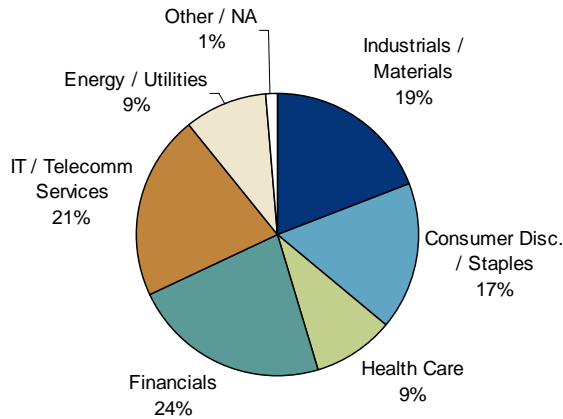
Methodologies & Research

- **This is round two of the PM&P Quick Poll on “Executive Pay in the New Economy”.**
 - Round one in early November 2008 received 410 responses.
 - Round two closed February 6 with 436 responses.

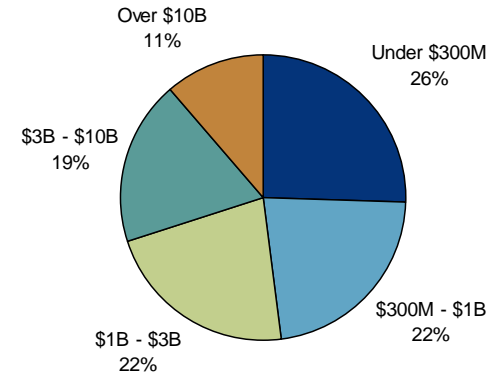
Participants by Role



Participants by Industry



Participants by Revenue



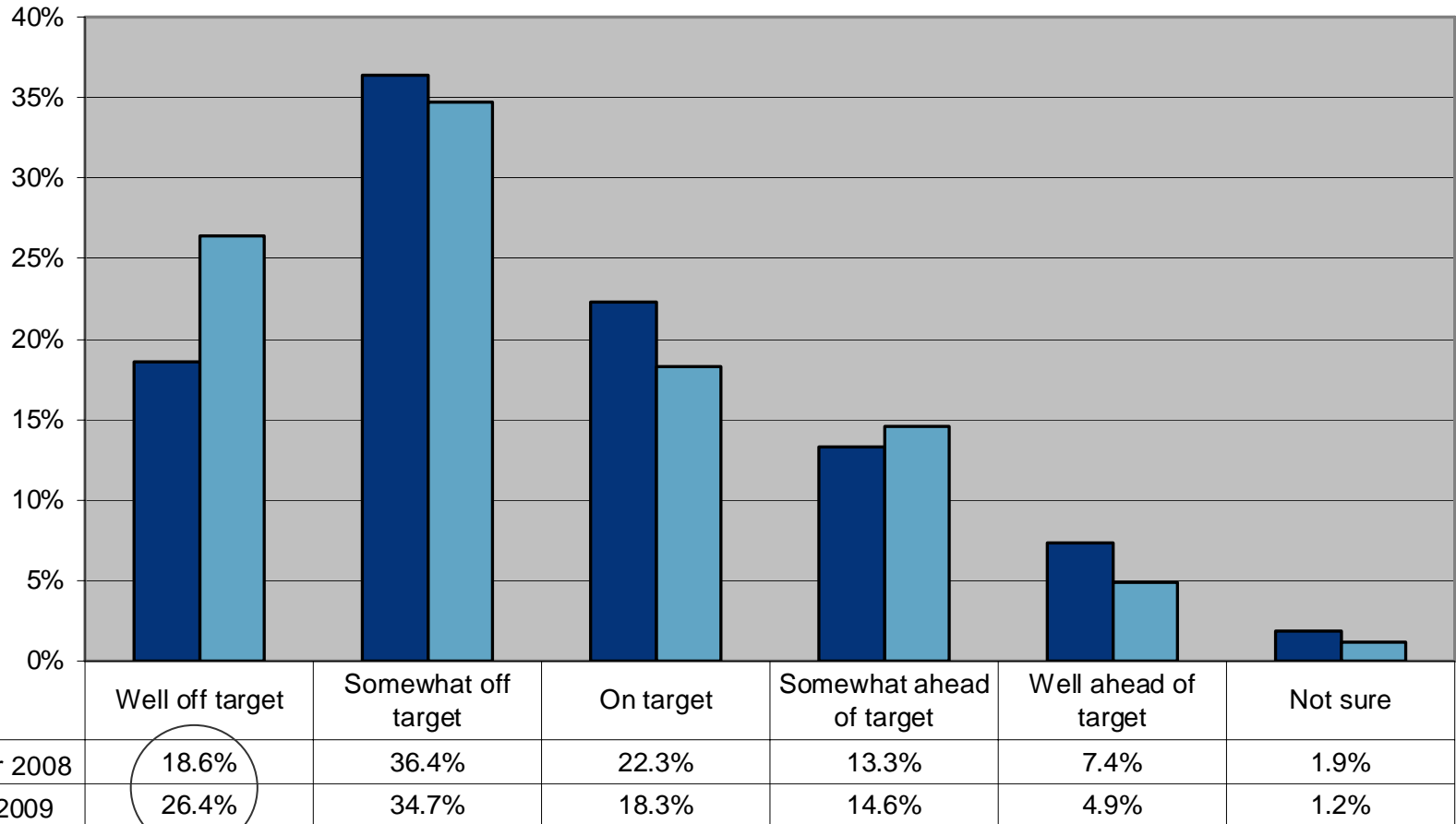
Topics addressed included:

- Company performance & impact on decision making.
- Executive base salary and bonus changes.
- Long-term incentives and equity awards.
- Severance and security arrangements.

What modifications to pay programs are being contemplated in the wake of financial turmoil?

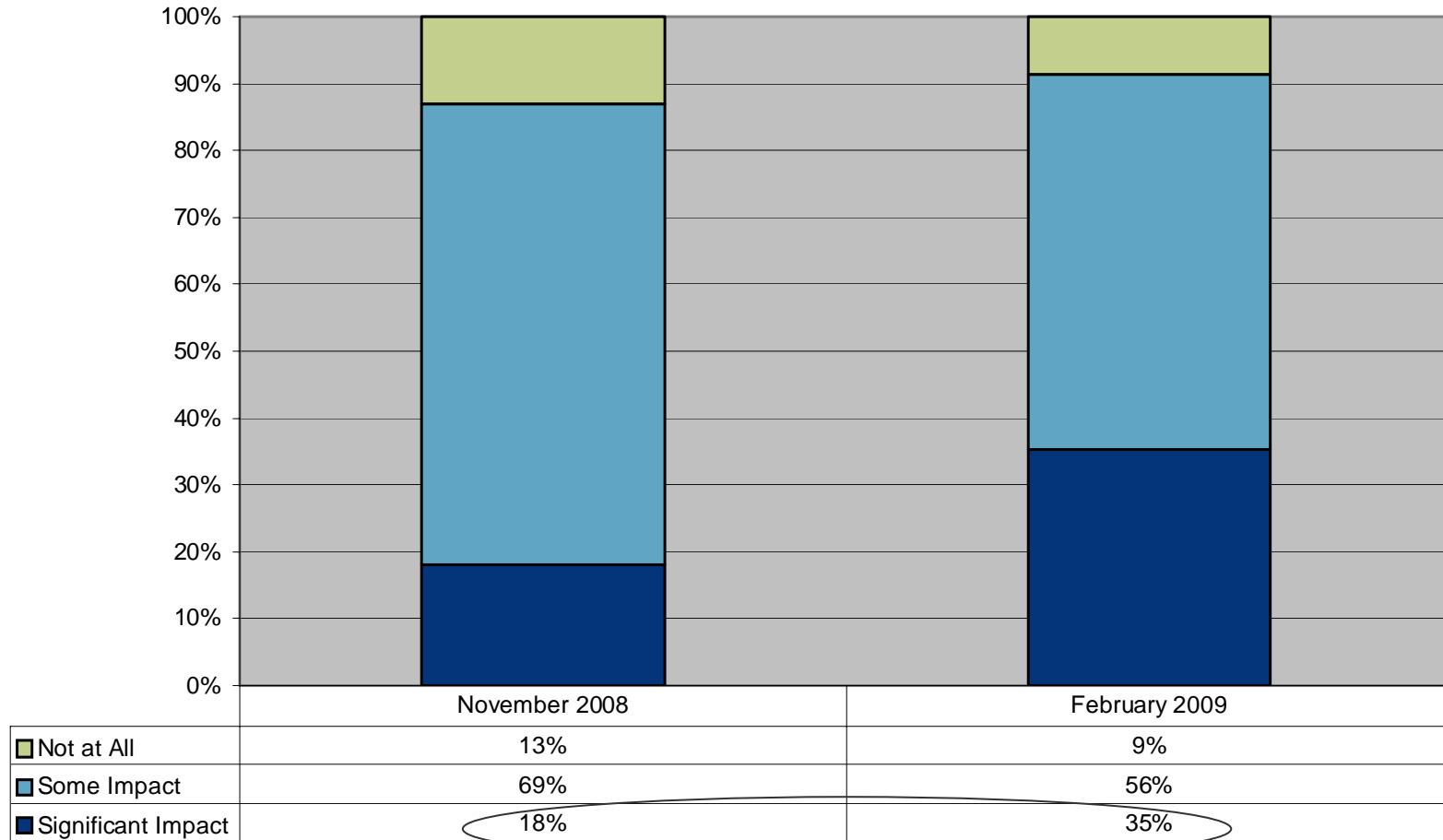
Performance vs. Plan

Assessment of 2008 Performance vs. Plan or Budget



Impact of Financial Market Turmoil on Pay Decision Making

“To what extent will recent financial market turmoil impact your pay decision making process over the next 6 months?”



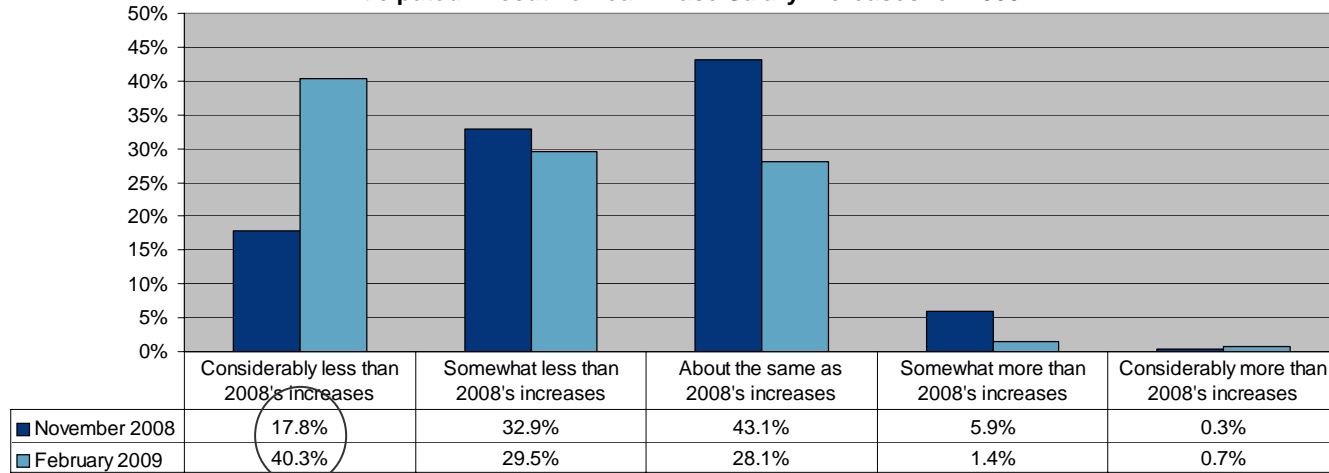
Impact of Financial Market Turmoil on Pay Decision Making

Anticipated impact varies with performance...

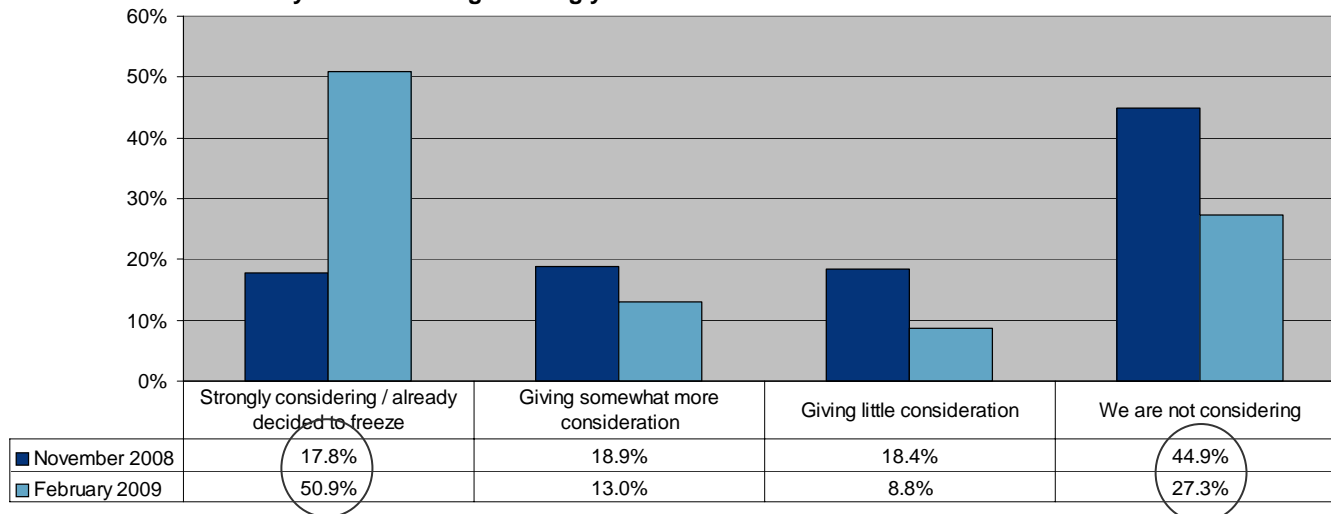
All Firms		To what extent will recent financial market turmoil impact your executive pay decision making process for 2009?			
		Not at all	Some Impact	Significant Impact	Total
Please indicate your assessment of your company's performance for the year as compared to plan or budget.	Well off target	4.5%	28.6%	67.0%	100.0%
	Somewhat off target	4.7%	62.8%	32.4%	100.0%
	On target	12.8%	75.6%	11.5%	100.0%
	Somewhat ahead of target	17.7%	64.5%	17.7%	100.0%
	Well ahead of target	14.3%	66.7%	19.0%	100.0%
	Not sure	20.0%	20.0%	60.0%	100.0%

Base Salaries: Findings

Anticipated Executive Team Base Salary Increases for 2009



Are you considering freezing your executive team's base salaries in 2009?

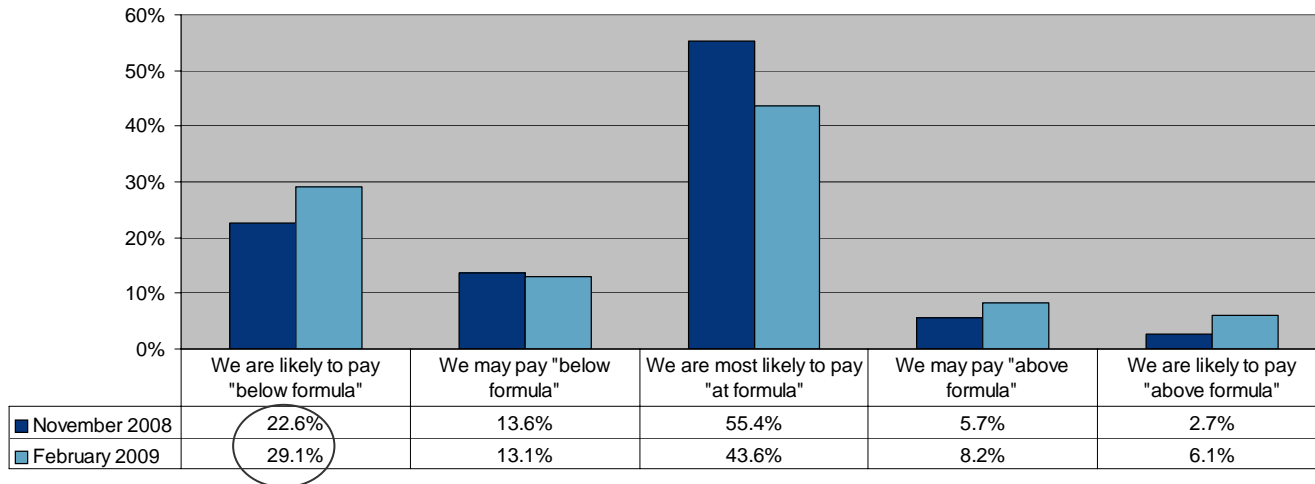


■ Base Salaries: Considerations

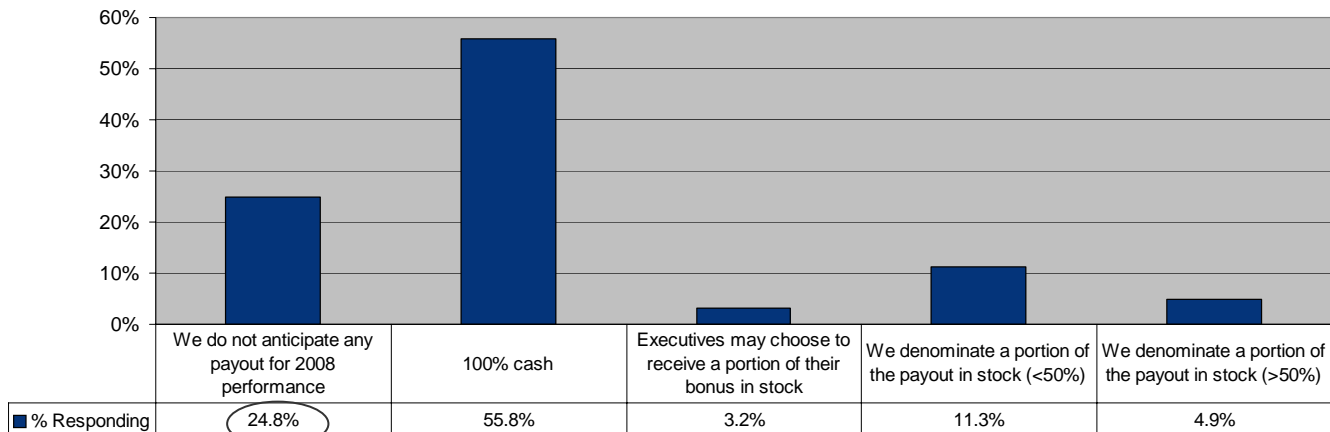
- **Seems that many firms decided to “stick to the process”, and the process determined that a lower increase or a freeze was in order.**
- **This is most transparent component of pay, and marginal increases may simply not be worth the pain.**

Bonus Decisions: Findings

Which statement best describes whether you may exercise discretion in determining determining your incentive payout for 2008 performance?



To what extent will your incentive payout for 2008 performance be paid in the form of stock denominated vehicles?

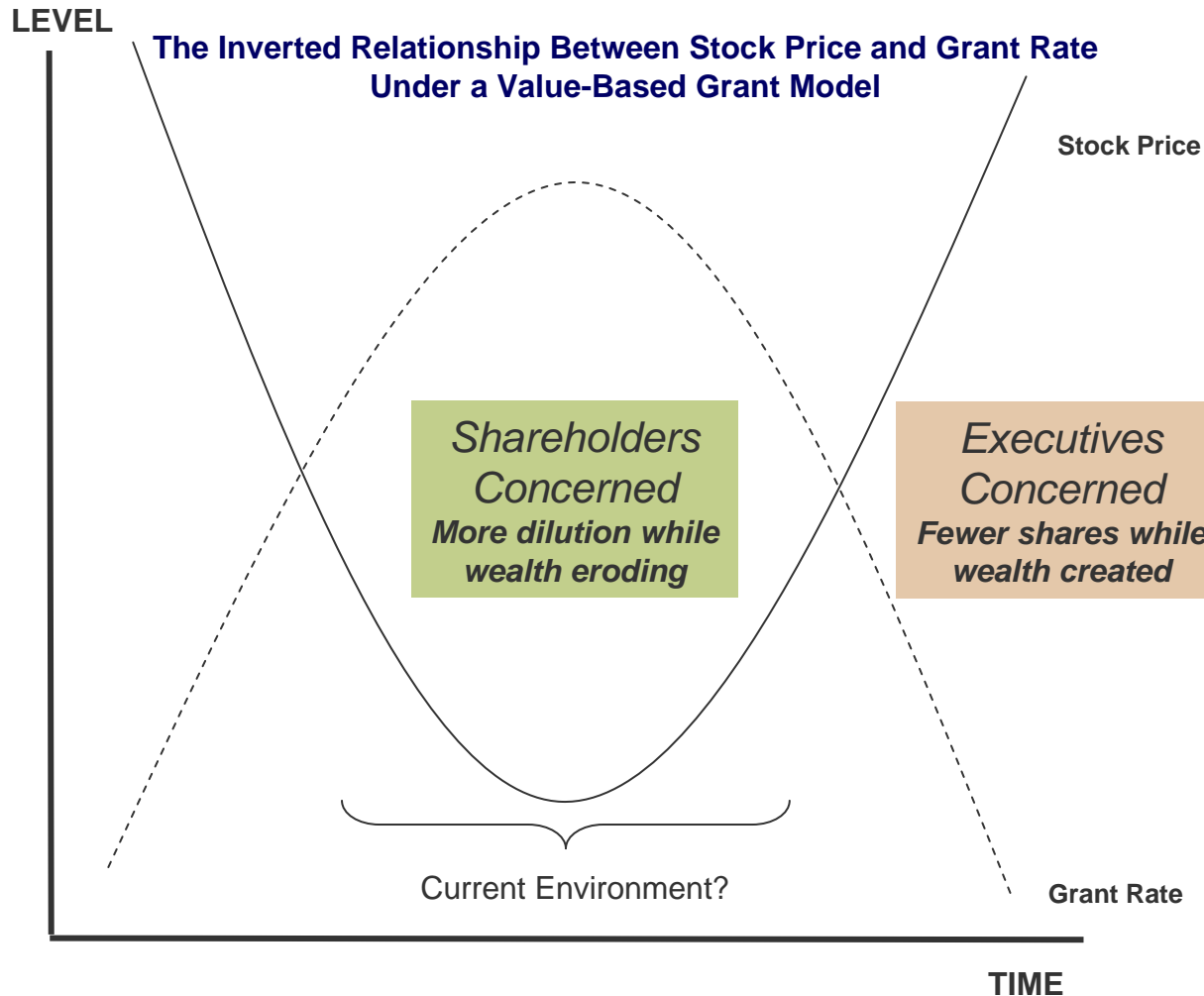


■ Bonus Decisions: Considerations

- **In designing programs that drive performance, metric selection and scaling are at least as important as actual pay levels.**

- **Does the plan meet company goals and objectives?**
 - Appropriateness of performance metrics.
 - Measurement standards.
 - Degree of aggregation for incentive award determination.
 - Relationship between retention and performance.
 - Relationship between risk and reward.
 - Desired degree of similarity or differentiation.

Long-term Incentives: Setting Equity Award Grant Levels



How to address challenges?

- Simply grant more shares (match “competitive value”)?
- Match past participation (grant same # of shares as past year)?
- Hybrid approach?

Still need to motivate and retain management!!

Long-term Incentives: Setting Equity Award Grant Levels (Alternatives to Consider)

This list is not exhaustive, but represents alternatives from which survey respondents were asked to choose...

Alternative	Advantages	Challenges
Reference market data and attempt to match the economic value at a targeted market percentile	<ul style="list-style-type: none"> - Market-based approach - Total pay concept - Disclosure 	<ul style="list-style-type: none"> - Assessing “current” market - Share usage - Grant timing
Set number of shares based on an assumed share price growth rate and a targeted “future value” at that growth rate	<ul style="list-style-type: none"> - Emphasis on value creation 	<ul style="list-style-type: none"> - Goal setting and buy-in - Determination of target future value
Grant a similar number of shares as in the prior year (consistent burn rate)	<ul style="list-style-type: none"> - Maintain burn rates - Mirror participation rates 	<ul style="list-style-type: none"> - May be out of step with competitive grant levels
Determine number of shares based on achievement relative to performance goals established at beginning of year (formula based)	<ul style="list-style-type: none"> - Performance orientation 	<ul style="list-style-type: none"> - Goal setting - “Multiplier effect”
<i>Value-based hybrid approaches are likely to evolve</i>		

Long-term Incentives: Setting Equity Award Grant Levels (Findings)

“What best describes your company’s approach to determining the number of shares to grant to each executive (for awards made at the end of 2008 or beginning of 2009)?”

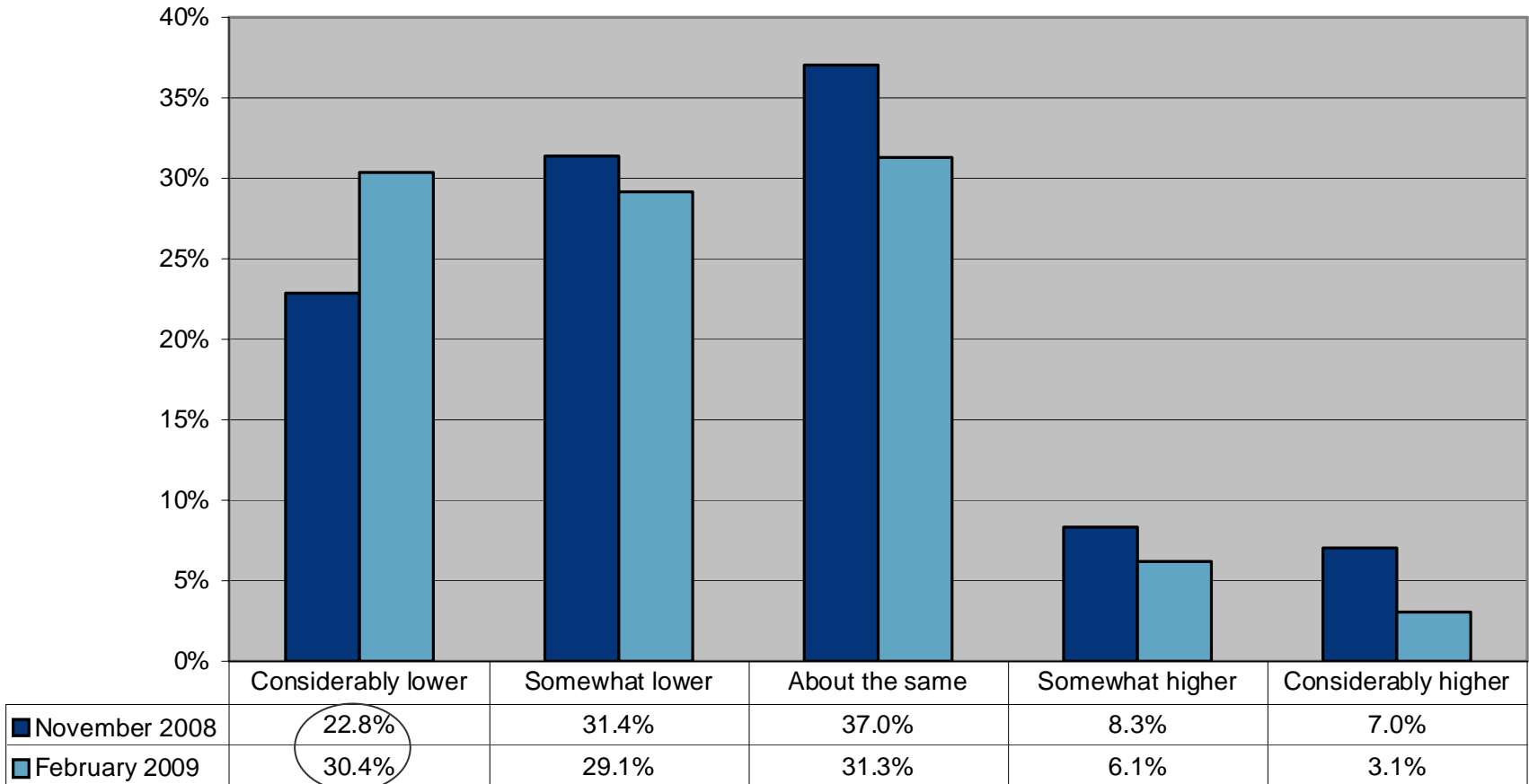
Alternative	% Responding
Reference market data and attempt to match the economic value at a targeted market percentile	40%
Set number of shares based on an assumed share price growth rate and a targeted “future value” at that growth rate	5%
Grant a similar number of shares as in the prior year (consistent burn rate)	20%
Determine number of shares based on achievement relative to performance goals established at beginning of year (formula based)	11%
We used an alternative approach not described above	24%

Our experience with clients suggests:

- ***Refine benchmark data for greater comparability***
- ***Anticipate a decline in competitive market grant values***
- ***Consider increasing grant frequency (multiple times per year)***
- ***Incremental awards over prior year may include tougher holding requirements***

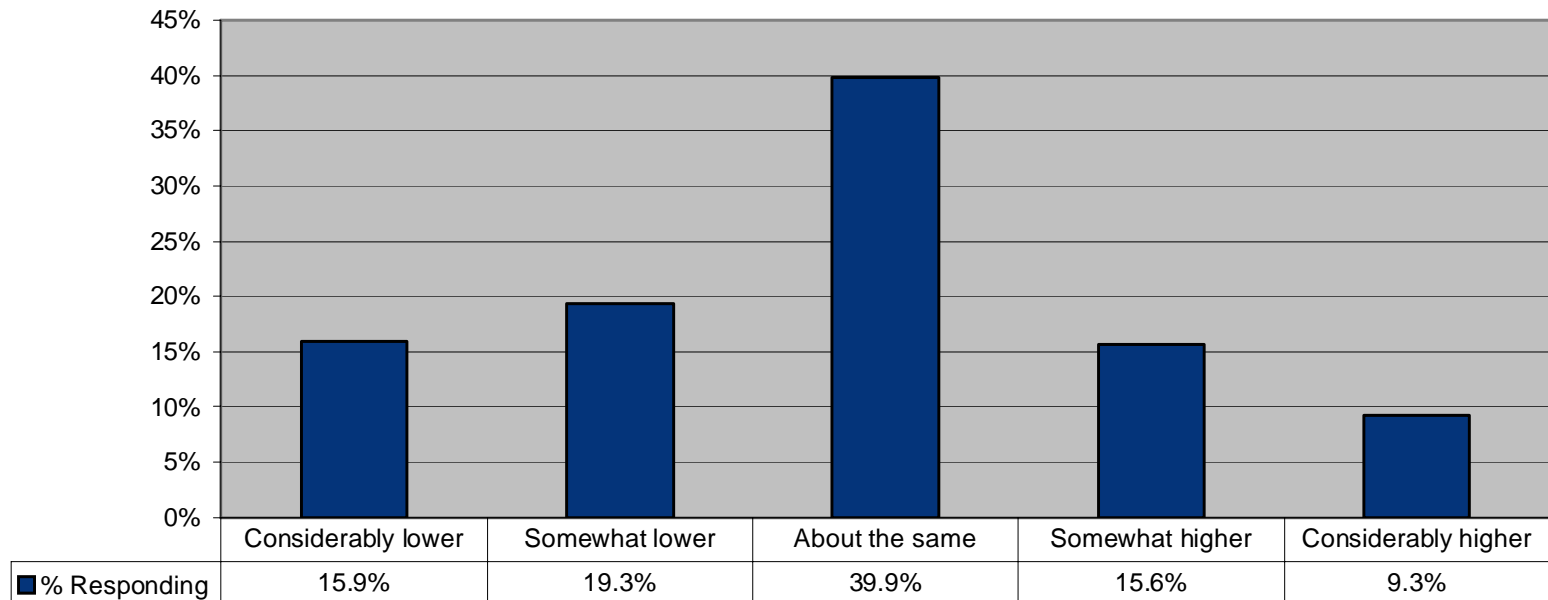
Long-term Incentives: Values Drop

Economic Value of this Year's Award, Relative to Last Year's



Long-term Incentives: Equity Share Usage (Findings)

“Relative to the prior year’s burn rate (total shares granted on an annual basis as a percent of common shares outstanding), do you anticipate that this year’s burn rate will be...”



Client experience suggests somewhat higher burn rates for **executive** population.

Overall burn rates may hold steady due to:

- Layoffs within industries that are significant equity users
- Fewer shares allocated to new hires
- Reduced eligibility below executive level

Long-term Incentives: Equity Share Usage (Background)

According to data provided by RiskMetrics Group in December, while there was a clear downward trend in three-year average burn rates from 2005 to 2007, 2008 demonstrated a slight uptick.

All Firms

BurnRate at Each Percentile				
PercentRank	2005	2006	2007	2008 YTD
90%	6.25%	5.79%	4.88%	4.86%
80%	4.04%	3.62%	3.01%	3.09%
70%	2.90%	2.59%	2.09%	2.12%
60%	2.08%	1.92%	1.54%	1.57%
50%	1.51%	1.38%	1.12%	1.18%
40%	1.06%	0.96%	0.78%	0.83%
30%	0.65%	0.61%	0.49%	0.54%
20%	0.25%	0.27%	0.21%	0.25%
10%	0.00%	0.00%	0.00%	0.00%

Russell 3000 Firms

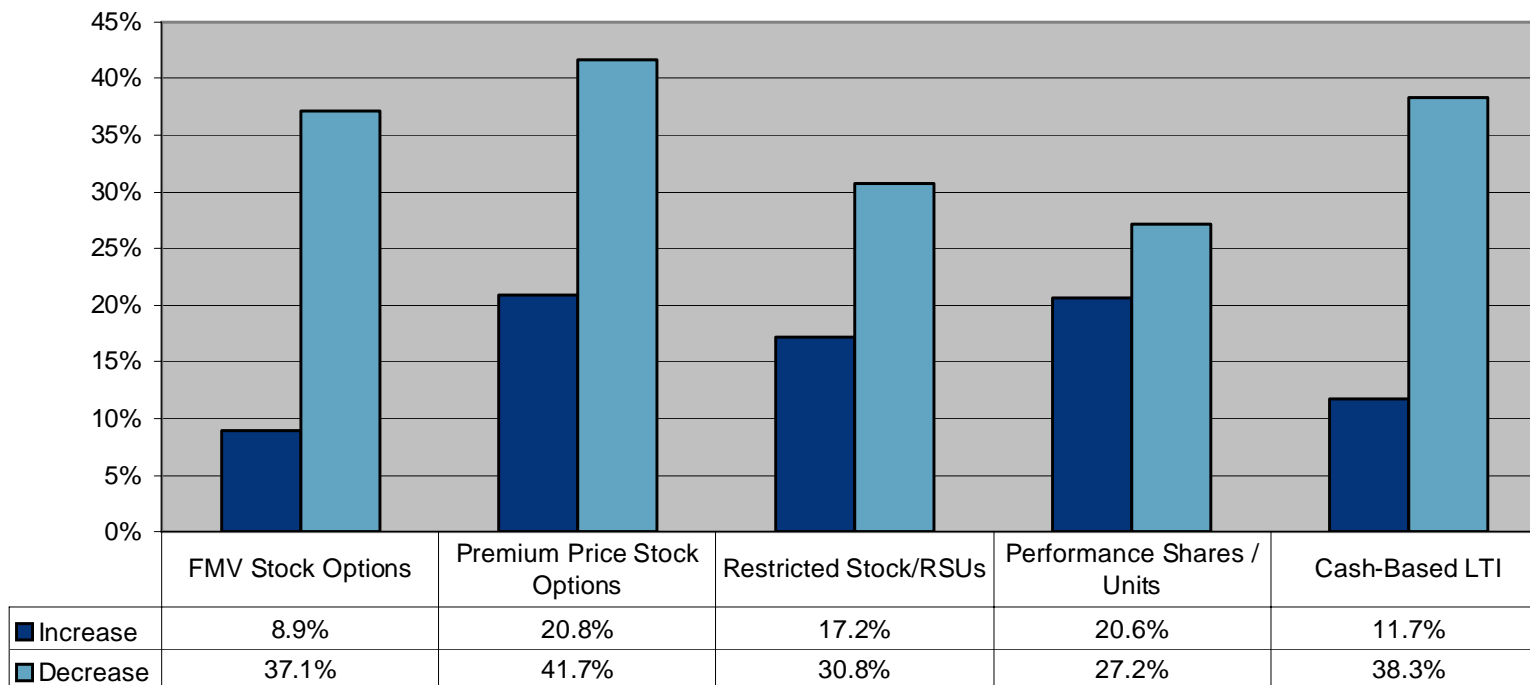
BurnRate at Each Percentile				
PercentRank	2005	2006	2007	2008 YTD
90%	5.19%	4.35%	3.52%	3.79%
80%	3.44%	2.95%	2.30%	2.45%
70%	2.44%	2.10%	1.71%	1.79%
60%	1.80%	1.59%	1.34%	1.41%
50%	1.42%	1.21%	1.05%	1.13%
40%	1.06%	0.93%	0.79%	0.85%
30%	0.71%	0.65%	0.57%	0.63%
20%	0.38%	0.36%	0.33%	0.37%
10%	0.06%	0.09%	0.11%	0.14%

The tables show levels of 3-year average burn rate at each decile of all proposals reviewed by RMG for a given year. A company sample at the X percentile means that X% of all samples for a given year were lower.

2009 burn rates will depend on how firms reconcile pressure from institutional shareholders to manage overall dilution levels with the need to continue to incent and motivate executives (and broad-based populations!) at lower share prices.

Long-Term Incentives: Instrument Mix will be Circumstance-Based

“Please indicate whether you anticipate the following LTI / equity award types will account for an increased or decreased percentage of executive award value as compared to the prior year”



Surprising Results!

- How is it possible for every award type to decrease in prevalence? Does nothing work?
- Client experience suggests that (a) companies remain committed to a portfolio approach, (b) while there is a desire to explore performance shares or units, there is a great deal of concern related to goal setting, and (c) there will be considerable difference in equity instrument use across different industries.

Long-term Incentives: Alternatives for Addressing Underwater Options

- **Wait...gather additional data and monitor market to determine if share prices begin recovery and whether industry or circumstance-specific “best practices” develop.**
- **Do nothing...continue annual grant practice assuming that share price will eventually recover (and underwater options are again “in-the-money), and in the interim tolerate the continued expense and overhang associated with underwater options.**
- **Accelerate annual award schedule...in order to immediately address retention and incentive concerns.**
- **Shift LTI strategy to insulate against market downturn...by including more full value shares, while not addressing outstanding grants that are underwater.**
- **Institute some manner of underwater option repricing / restructuring / exchange.**

Long-term Incentives: Addressing Underwater Options (Findings)

- **5.8% of respondents indicated that they “would likely attempt an exchange in the next 6 months”, while an additional 1.6% indicated that they had either just completed an exchange or are in the midst of completing an exchange.**
 - In all, 32 of the 436 respondents have either just completed, are in the midst of, or are about to attempt an exchange.

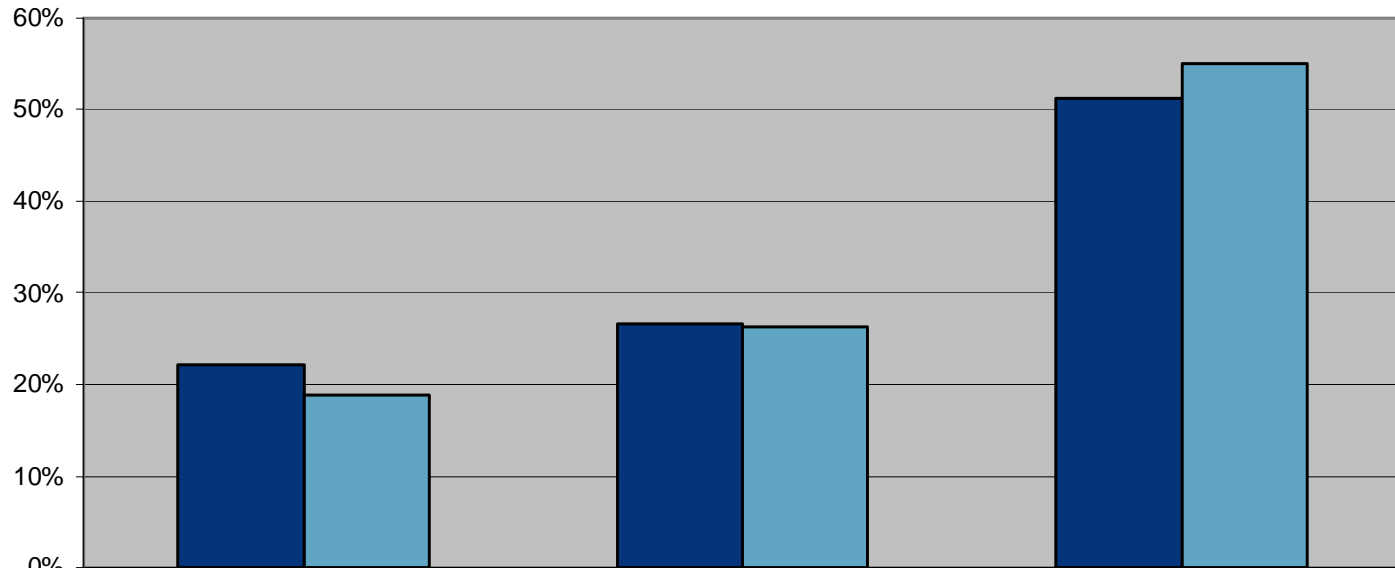
- **An additional 92 firms indicated that they had considered, but ultimately decided not to pursue, an exchange. Reasons cited:**

Anticipated difficulty in garnering support from shareholders	43%
A repricing / restructuring /exchange would run counter to overall compensation philosophy	34%
Decided to preclude action until it is confirmed that share price drop is long-term (not an isolated event)	29%
Logistical difficulties in developing and implementing a program within this limited time frame	17%
Additional expense associated with tender offer, filings, etc. (i.e., administrative expense)	14%
Equity plan document language precludes a repricing / restructuring / exchange	9%

- **Interestingly, 29% of these firms indicated that they planned to revisit the decision within the next 12 months.**

Severance & Security Arrangements: Under Review

Do you anticipate reviewing your executive severance or change-in-control arrangements during the next 12 months?





	Yes, we will be reviewing these arrangements and anticipate some modifications	Yes, we will be reviewing these arrangements as normal course-of-business, but do not anticipate	No, we do not anticipate reviewing these arrangements
■ November 2008	22.2%	26.6%	51.3%
■ February 2009	18.8%	26.2%	55.0%

Severance and Security Arrangements: Considerations

- **Overall severance benefit levels.**
- **Provisions for excise tax following CiC.**
- **Migration from single-trigger to double-trigger acceleration of vesting upon CiC.**

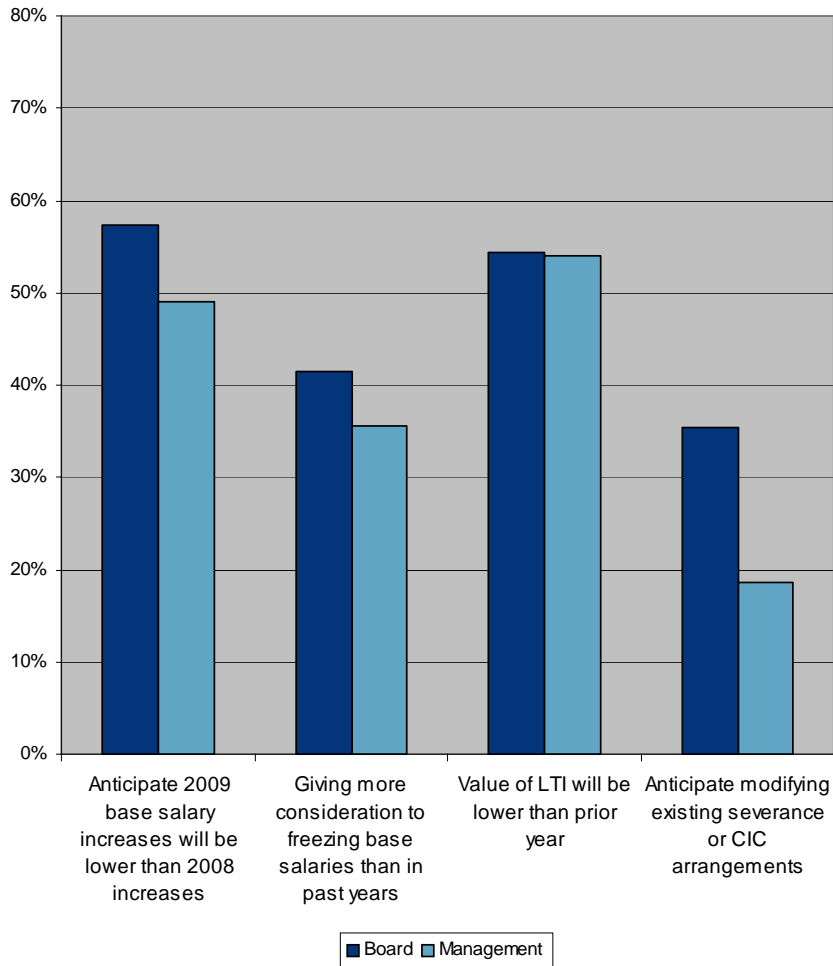
Variations by Industry: Findings

% Agreeing with the Following Statements	Industry					
	Industrials / Materials	Consumer Disc. / Staples	Health Care	Financials	Info Tech / Telecomm Services	Energy / Utilities
We have decided to freeze or are strongly considering freezing base salaries for 2009	51%	62%	40%	43%	59%	47%
We do not anticipate (or have not made) any annual incentive payout for 2008 performance	24%	26%	14%	33%	26%	3%
Relative to the prior year's equity award, the value of awards made at the end of 2008 or beginning of 2009 will be <u>considerably</u> lower	41%	33%	19%	29%	28%	23%

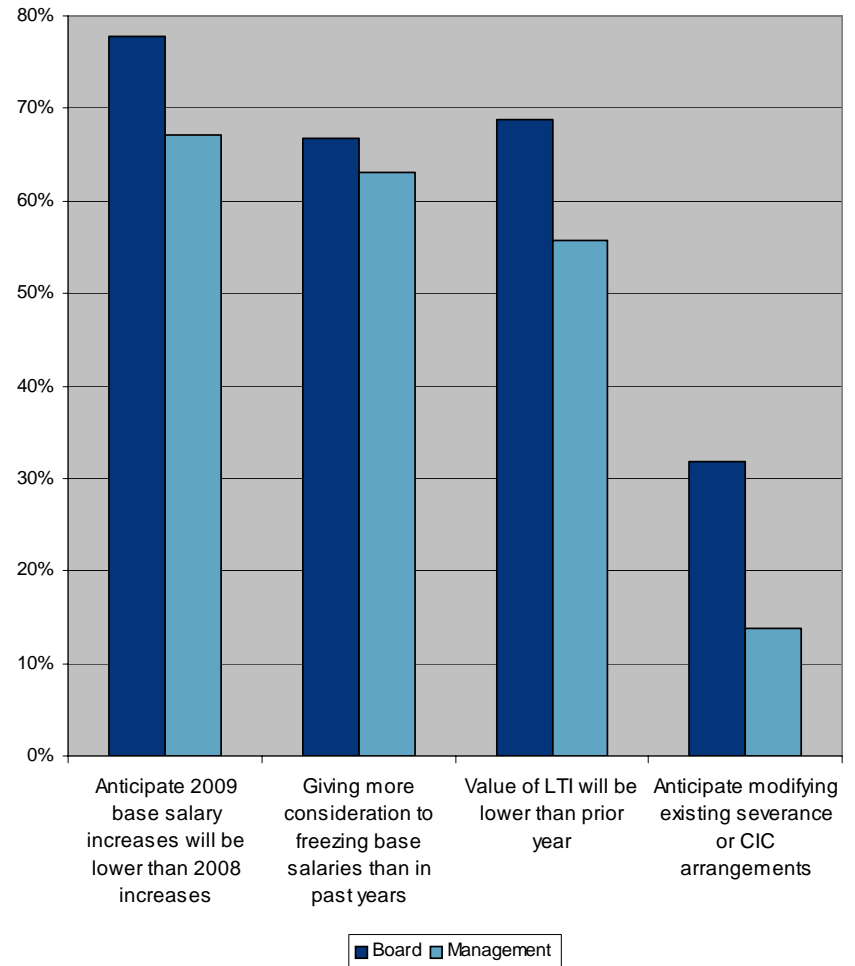
Key		= highest response rate for question
		= lowest response rate for question

Management vs. Board Perspectives

November 2008



February 2009



■ Closing Remarks: Top Ten Trends

- 1) Pay programs in a down economy**
- 2) Appearance / optics**
- 3) Shareholder communication and preparing for Say on Pay**
- 4) TARP and prospective impact on other industries**
- 5) Addressing underwater options**

- 6) Stock ownership guidelines**
- 7) Corporate governance**
- 8) Performance management and goal setting**
- 9) Managing career compensation**
- 10) Peer Group Selection**