

## WHITE PAPER

# Dynamic Pay Modeling – A Holistic Approach to Executive Pay

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Growing public scrutiny of executive compensation means that for many companies today, it's a matter of when – and not if – they will eventually be required to defend the design and administration of executive compensation programs. Directors, human resource leaders and executives need to be able to tell a compelling story about the thinking behind decisions and outcomes, supported by evidence of a solid, far-reaching framework underlying the full complement of pay elements. Moreover, without a detailed understanding of how a confluence of individual factors in various scenarios could affect compensation levels, Boards may find themselves surprised by controversy over unexpectedly large payouts.

The most commonly used tools for compensation analysis bring important information to the decision-making process. A competitive analysis allows companies to compare the overall structure and expected payout of a compensation package against peer companies at target or actual performance achievement levels. A tally sheet calculates an executive's total earnings as of a single point in time for all elements of compensation, from salary and bonus to deferred compensation, pension and severance arrangements, assuming target or actual performance achievement levels.

#### About Pearl Meyer & Partners

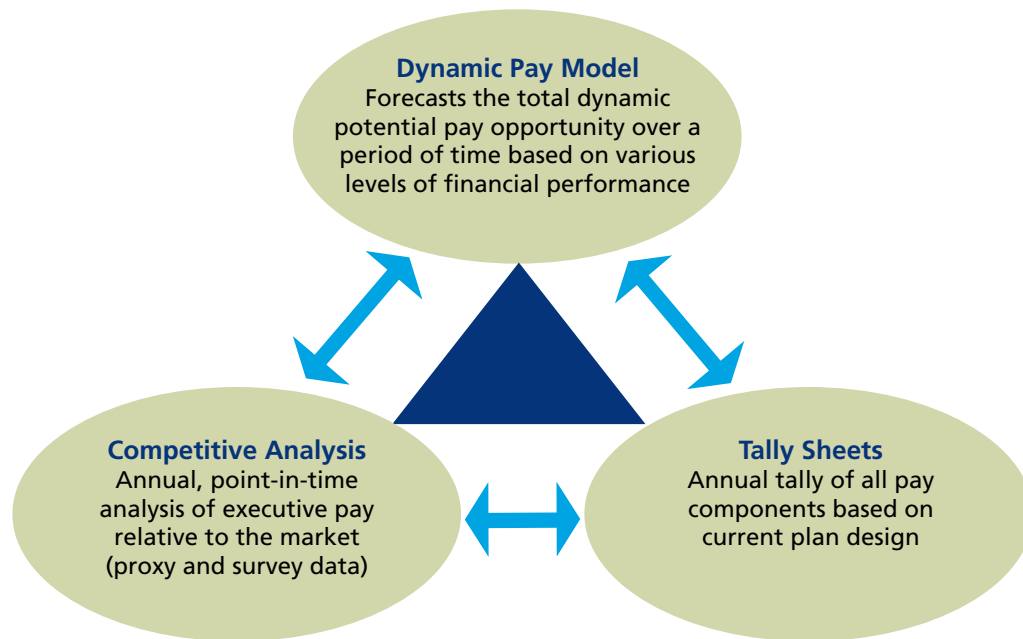
Since 1989, Pearl Meyer & Partners ([www.pearlmeyer.com](http://www.pearlmeyer.com)) has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. PM&P provides comprehensive solutions to complex compensation challenges for companies ranging from the Fortune 500 to not-for-profits as well as emerging high-growth companies. These organizations rely on PM&P to develop programs that align rewards with long-term business goals to create value for all stakeholders: shareholders, executives, and employees. Pearl Meyer & Partners has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston and Los Angeles.

What has been missing from the oversight tool kit is a more dynamic analysis of how the individual elements of complex executive compensation programs will behave singly and cumulatively, now and over the long-term, under a full range of possible performance outcomes. One way to bridge the gap between the data available today and a forward-looking, more in-depth analysis is the Dynamic Pay Model. This proprietary analysis developed by Pearl Meyer & Partners, used in conjunction with competitive analyses and tally sheets, gives company leaders and Directors a deeper understanding of the full range of potential compensation outcomes, while helping companies make better decisions about executive pay.

The Dynamic Pay Model breaks free of the static, "point-in-time" constraints of current pay analysis tools to provide a more far-reaching line of sight into specifically what an executive could earn under varying scenarios. It projects payouts for individual elements of compensation such as base pay, short-term incentives and long-term incentives, for a wide range of stock and financial performance levels over time. Additionally, it enables a calculation of the

complete, combined value of the individual pay elements for various levels of performance. By more clearly illustrating the direct relationship between pay and performance, the Dynamic Pay Model generally enables Compensation Committees and company leaders to determine if pay is appropriately aligned with the company's compensation philosophy and with shareholder expectations.

### A Complete Picture of Executive Compensation



The Dynamic Pay Model allows companies to analyze critical compensation issues such as:

- Whether the program has the appropriate performance-orientation
- If the focus on company performance and stock price performance is balanced or weighted more heavily in one direction or the other
- If incentive opportunities for payouts are appropriately aligned to the right performance achievement levels
- The appropriateness of the current compensation mix
- Whether the emphasis on time-based awards is too heavy
- How the current design of the incentive program supports or doesn't support the business strategy and timeline
- Whether total payouts for executives are aligned with incremental shareholder returns

## The Picture(s) Tell the Story

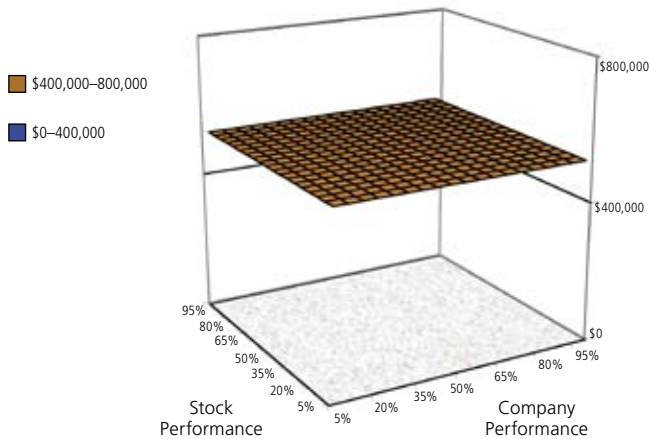
Unlike most pay analyses, a Dynamic Pay Model is not represented by a one-dimensional graph. Rather, the results are illustrated by a fluid, undulating set of three-dimensional charts that reveal the extent to which incremental changes in stock or company performance may or may not trigger straight or steady changes in pay. The impact of performance differences is less like a row of dominoes falling in a predictable and static pattern, and more like a water balloon being squeezed: the balloon can bulge to accommodate changes in pressure or, in this case, performance.

### Individual Components of Executive Compensation

The color in the graphs reflect the range of payout opportunities for each element of the compensation program.

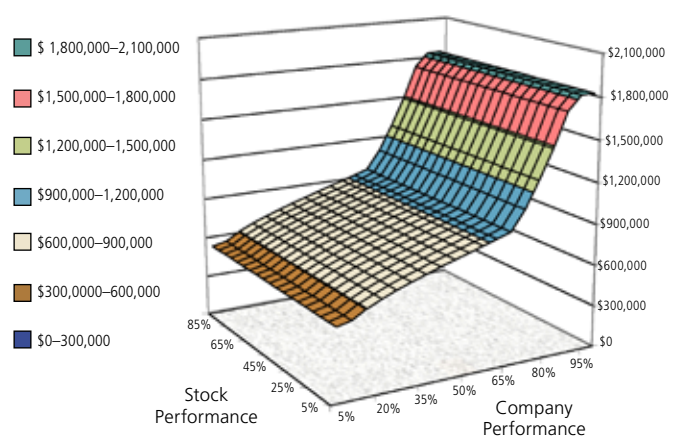
**Figure 1**

**Base Salary**



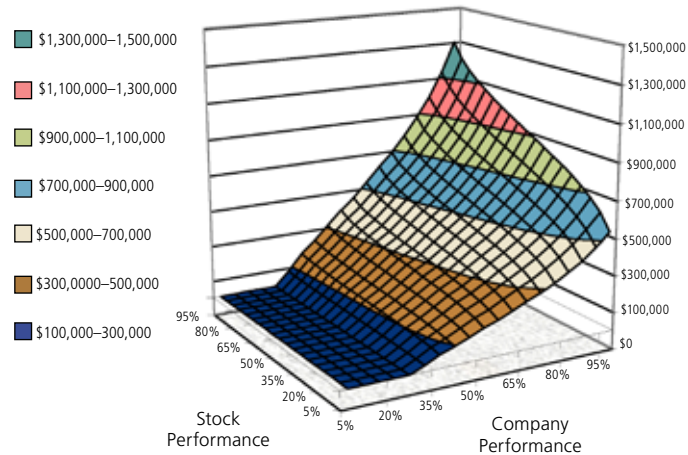
**Figure 2**

**Total Cash (Base plus Annual Incentive)**



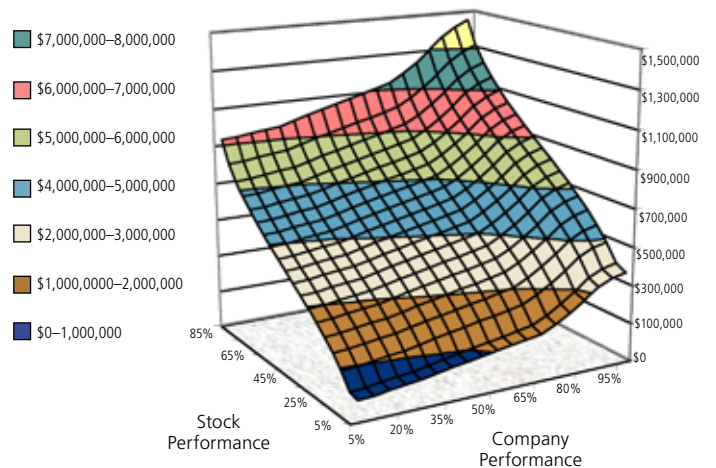
**Figure 3**

**Performance-Based Restricted Stock**



**Figure 4**

**Total Potential TDC**



To understand how this crucial analysis takes shape from a graphical perspective, it's helpful to look at the individual elements that feed into the analysis. Base salary as shown remains fairly static (see figure 1); total cash encompasses base salary plus annual incentives, which change with company performance (see figure 2); and long term incentives, including instruments such as stock options and performance-based restricted stock, also change in different directions, based on company and stock price performance (see figure 3). Taken together, the graph provides a view of total potential compensation that includes the opportunity for each individual component over a period of time (see figure 4).

## Assumptions at the Heart of the Analysis

Data about the current and future state of the business and the range of possibilities in terms of company performance and stock price performance is used to make reasonable predictions about future outcomes-providing a benchmark from which potential payout scenarios unfold. The assumptions and recommendations for company and stock price performance are unique to each company.

Generally, assumptions are based on a range of data points and research focused in the following areas:

- **A Look Back** - The company's historic performance over a specific period of time.
- **Look Around** - The historic performance of similar companies, such as a peer group or an industry or financial index.
- **Look Forward** - External forecasts for company performance, culled from sources such as Value Line and Analyst reports.
- **Management Outlook** - Internal performance projections.
- **Expected Value (for stock price performance only)** - The company's annualized expected return using the Black-Scholes model.

The assumptions' analysis also helps in assessing the company's overall financial performance compared to its peers or a general index. The analysis also determines whether there is an appropriate degree of stretch/challenge built into financial performance objectives for the short- and long-term incentive plans. In addition, the analysis also provides key information needed to assess the total potential incremental return to shareholders, relative to the total potential payout for executives.

Before beginning the Dynamic Pay Model analysis, these inputs should be carefully vetted with the company. If not, the Compensation Committee later may find itself diverted by a debate over the validity of the initial information on which the analysis is based. Ensuring that management understands the assumptions and the model at the beginning of the process can stave off potential push-back later, when company leaders see how their pay stands up.

## Dynamic Pay Model Findings Spark Robust Discussion

In addition to financial and competitive issues, the robust, fact-focused discussions typically spurred by reviewing a Dynamic Pay Model can promote meaningful conversations about the broader economic ramifications and appropriateness of existing compensation programs.

### Key Discussion Topics

Percentiles		Company Performance				
		10%	30%	50%	70%	90%
Stock Performance	10%	\$3,267,271	\$2,668,954	\$2,947,203	\$4,364,576	\$4,967,100
	30%	\$6,746,835	\$7,148,518	\$7,426,767	\$7,844,140	\$8,446,664
	50%	\$9,156,771	\$9,558,454	\$9,836,702	\$10,254,075	\$10,856,600
	70%	\$11,566,706	\$11,968,389	\$12,246,638	\$12,664,011	\$13,266,536
	90%	\$15,046,270	\$15,447,954	\$15,726,202	\$16,127,886	\$16,746,100

- (1) is CEO compensation appropriate for company and stock price performance between the 10th - 20th percentile?
- (2) is CEO compensation appropriate for company and stock price performance in the 50th percentile?
- (3) is CEO compensation appropriate for company and stock price performance in the 80th - 90th percentile?
- (4) In an incremental change in TDC of 67% (30th to 70th percentile for company performance only) sufficient to drive desired behaviors?
- (5) Is enough of the TDC package driven by company performance?
- (6) Is an incremental change in TDC of 67% (30th to 70th percentile for stock performance only) appropriate for the results generated?
- (7) Is an appropriate amount of the TDC package driven by stock price performance?
- (8) Is the mix between company and stock price performance appropriate?
- (9) Does this compensation program have a true pay for performance orientation?
- (10) What behaviors does this type of compensation program drive?

Such a discussion might include questions such as:

- Are potential CEO payouts appropriate for all levels of performance, including results at the upper and lower range of financial and stock price results?
- Are incremental changes in total potential compensation in company and/or stock price performance sufficient to drive desired behaviors?

The Dynamic Pay Model also provides a means for compensation decision-makers to address broader questions such as:

- Is there a clear understanding of the range of potential payouts associated with the current compensation program?
- Is the program paying for truly meaningful performance?
- Is there an appropriate degree of focus on company versus stock price performance?
- Is the program too weighted toward time-based rewards?
- How well does the plan adhere to the firm's compensation strategy and philosophy?
- Does the current compensation program align with shareholder expectations?

The Dynamic Pay Model results can trigger a number of responses, including changes to the level or mix of total compensation; a reexamination of performance metrics and goal-setting; restructuring of incentive programs and payouts; or an entirely fresh look at the compensation philosophy.

At one company, Rogers Corporation, the Dynamic Pay Model served as a means of testing its compensation programs' alignment to, and support of, the company's business strategy. It provided empirical data that showed the current compensation plans were working as intended and highlighted where the company could change part of the plan without undermining the rest of the pay mix. At another company, Charles River Laboratories, the Dynamic Pay Model provided data that supported earlier decisions to implement certain compensation programs to address potential retention concerns, by providing empirical data for pay elements that gave executives the opportunity to share in the company's future potential.

#### **Case Study: Rogers Corporation**

Planning for and designing compensation programs in a volatile performance environment that can range from "feast to famine" can be tough. Connecticut-based Rogers Corporation turned to the Dynamic Pay Model as a source of empirical data that would indicate whether the company's compensation plans were working as intended and where improvements could be made without compromising the compensation mix. "Most companies in this situation are not comfortable with payouts ranging between 0 and 300% and try to minimize the volatility," said Vice President of Human Resources Jack Richie, "However, we don't try to cushion the compensation impact. Our basic philosophy has been that only when shareholders win, we win."

Rogers Corporation manufactures high-performance specialty materials used in a variety of products, including portable communication devices, communication infrastructure, consumer products, computers and office equipment. At the time of the study, it had approximately 2,500 employees, revenues of approximately \$500 million and a market cap of around \$800 million.

#### **The Analysis**

Pearl Meyer & Partners approached the Dynamic Pay Model at Rogers Corporation by separately reviewing each element of its pay program: base salary along with annual short-term incentives, performance-based restricted stock, and stock options. Next, various assumptions related to financial and stock price performance were applied to build a complete picture of the executive compensation package.

The Dynamic Pay Model provided detailed payout ranges for every element of pay based on a variety of financial and stock results. The data included base pay (which is not affected by company or stock performance), total cash (affected by company performance only), performance-based restricted stock (affected by both company and stock performance), and stock options (affected by stock performance only), combining all elements to assess total direct compensation.

#### **The Discussion**

The modeling results presented by Pearl Meyer & Partners included a multi-year view, comparing incremental pay and company performance that revealed how executive pay would track against the company's potential market value over the long-term. That served as a catalyst for a new kind of conversation among Rogers' Compensation Committee members. "A lot of 'aha' lights came on," said Richie, noting that the model appealed to members who prefer a qualitative approach to data as well as those more comfortable with a visual approach. Members were especially interested in data regarding the lowest levels of compensation. Richie said when top management was asked if they were willing to potentially have payouts at or near zero, the answer was a resounding "yes."

#### **The Result**

Following the analysis, Rogers Corporation decided that changes were not needed to its executive compensation program. The analysis confirmed that the program fit the company's compensation philosophy: there would be zero payouts if the company under-performed, target payouts when performance reached expected levels and maximum payouts when performance exceeded expectations. Richie said the Dynamic Pay Model analysis allowed members to get beyond just a "gut feeling" about whether its programs were working as intended and helped the company more clearly communicate with executives about how its programs operate.

### **Case Study: Charles River Laboratories International Inc.**

Charles River Laboratories was looking for a more in-depth analysis of its executive compensation programs when it embarked on a Dynamic Pay Model assessment. Like many companies, pay plans at the life sciences firm typically were driven by individual, stock and company financial performance, with the three metrics generally considered separately. The company was concerned that the more traditional industry and peer group data models on which it usually relied to analyze the effectiveness of its executive compensation designs were not complete.

“We wanted a broader, more far-reaching look at our compensation practices,” said David Johst, Corporate Executive Vice President of Human Resources and Chief Administrative Officer. The Dynamic Pay Model, he said, provided a much more precise picture of the interplay of various pay elements under different performance scenarios and their impact on actual payouts. That in turn helped the company understand the interplay of the various elements of their compensation program and to determine if the program was driving the intended results and behaviors.

At the time, Charles River Laboratories had revenues in the \$1 billion range, a market cap of approximately \$3 billion and approximately 8,000 employees. Headquartered in Wilmington, Mass., the firm provides research models and laboratory animal support services, preclinical services, and clinical services to the biomedical market.

#### **The Analysis**

In building the Dynamic Pay Model, Pearl Meyer & Partners began by looking at the basic elements of the compensation program at Charles River Laboratories: base salary; short-term incentives based on earnings per share, corporate operating income, sales and return on assets, and long-term incentives in the form of stock options and time-based restricted stock. A series of assumptions were then used to project future outcomes for each element of pay. These assumptions included a “look back” at one-year total shareholder returns over the previous six years, the period during which Charles River Laboratories had been a public company, and a “look around” at one-year average total shareholder returns over the past 10 years for the Dow Jones and S&P indexes.

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#### **The Discussion**

The Dynamic Pay Model gave Charles River Laboratories an in-depth look at potential payouts over time for base salary, total cash compensation, time-based restricted stock, stock options and total direct compensation. It also provided an understanding of the relative value of the different elements of pay to the total package; a comparison of incremental pay to incremental changes in company and stock price performance; and a comparison of incremental pay to incremental total shareholder return.

While thorough, the resulting analysis was not always intuitive. Johst noted that management and Compensation Committee members needed some time to fully grasp the model’s broader, multi-dimensional view of performance metrics and the impact on compensation levels. Once the Compensation Committee had walked through and digested the data, however, he said the Dynamic Pay Model sparked insightful and meaningful discussions about the ramifications of the firm’s pay structure. “We had a great deal of debate and discussion that led us to the question, ‘Is this really what we want to reward?’” said Johst. “Ultimately, we had a straightforward, easily understood and thoughtful discussion regarding the alignment between the desired behaviors and our broad-based compensation strategy”.

#### **The Result**

Based on the detailed analytics in the Dynamic Pay Model, Charles River Laboratories decided to tweak some executive pay elements with the goal of better promoting performance outcomes beyond its one-year bonus opportunities. Among the changes were adjustments made to threshold and maximum performance levels in the firm’s short-term incentive plan and the introduction of a new performance-based long-term incentive plan. The Committee continues to use the Dynamic Pay Model as a valued reference point. The analysis has become “an integral part of the compensation conversation,” Johst said. The ultimate end result of the Dynamic Pay Model for Charles River Laboratories was more clarity and a better understanding about how its executive compensation program worked.

## Useful Beyond the Compensation Committee

In some cases, the Dynamic Pay Model can be used to help Boards communicate with executives about their total compensation package, including the link between payouts and performance. This is especially useful when market downturns impact performance and limit bonus potential; a common scenario for cyclical businesses. When it became clear in the middle of one year that Rogers Corporation would not be providing bonuses, the company utilized data from the Dynamic Pay Model to remind executives that by continuing to do as well as possible, they could bank future results in the restricted stock portion of the plan and enhance future payouts.

## Looking Ahead

The Security & Exchange Commission's drive for expanded reporting of data on compensation programs eventually could make the Dynamic Pay Model an even more powerful and effective tool. Ideally, the analysis should incorporate data that compares the total potential compensation for an executive with comparable data from the external market. While such detailed information currently is not subject to disclosure, the Security & Exchange Commission is continuing to fine-tune and, in some cases, heighten its disclosure requirements.

## Conclusion

The tools on which compensation decision-makers typically rely, including tally sheets and competitive analyses, provide a solid set of data. But they offer a limited and static view of the complete compensation picture. Augmenting that perspective with a Dynamic Pay Model analysis provides a significantly more in-depth method of analyzing the appropriateness and effectiveness of compensation plans and outcomes that can help companies make more thoughtful, well-reasoned, decisions.