

PAYING FOR PERFORMANCE IN A

Down Market

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When uncontrollable **external forces** hit the **bottom line**, companies should consider alternative methods for measuring **performance**.

By Yvonne Chen, Pearl Meyer & Partners

QUICK LOOK

- ⇒ Three designs for measuring performance are peer group comparison, market index adjustment and strategic focus.
- ⇒ Peer group comparison allows plan participants to be recognized for above-industry achievement of financial, operating or stock appreciation goals.
- ⇒ The market index method assumes that company results are strongly affected by market factors beyond management's control.

There's no shortage of ways to reward talented managers when times are good. The real challenge is devising effective vehicles to attract, motivate and retain high performers when the going gets tough. If incentives are based on unrealistically rosy forecasts, they are doomed. At many companies, the economic doldrums of the past few years have decimated bonus programs. Even if there are incentive payouts, defining good performance in a down market is less than straightforward when forces outside of management's control drive results.

These issues are critical in light of recent compensation scandals that have made investors even more insistent that companies only provide rewards, particularly for senior management, when shareholder value increases as a result of performance.

Measuring Performance in a Down Market

In most annual cash incentive plans, performance is defined at three levels: corporate, business unit and individual. Corporate and business unit financial goals often are tied to the annual

budget or based on improvement over the previous year's results. But such absolute benchmarks can become obsolete and de-motivating in the face of an unexpected market downturn. Three alternative designs for measuring performance may be more relevant under a range of economic conditions: peer group comparison, market index adjustment and strategic focus.

Peer Group Comparison

Performance can be measured effectively relative to a peer group of direct industry competitors that are about the same size with similar business characteristics. This comparison enables plan participants to be recognized for above-industry achievement of financial, operating or stock appreciation goals, despite the negative impact on the entire sector from an economic downturn. Figure 1 illustrates examples of earnings per share (EPS) growth goal.

The timing of incentive awards depends on the availability of peer company data (e.g., after annual reports are filed). It also is necessary to establish guidelines before the start of the performance period regarding adjustments to peer company performance data, such as excluding the impact of discontinued operations or unusual charges/income. While this method produces above-target payouts for beating the peer group's performance, the company may not be able to afford above-target payouts if the downturn is severe, as shown in Figure 1, examples D and E. To prevent this outcome, companies also may apply an earnings threshold or "gate" below which awards will be cut back or reduced to zero.

Generally, a performance peer group should include 10 or more publicly traded companies. Typically, the same peer group is used in evaluating market compensation levels. If only a few

companies dominate the industry, or if many competitors are private, market indexing or a strategic focus may be a better approach.

Market Index Adjustment

Adjusting performance goals based on a market index maintains the integrity of the existing goal-setting process, while incorporating some flexibility to recognize overall market conditions. This method assumes that company results are strongly affected by market factors beyond management's control and that management is not fully responsible for failing to anticipate or respond quickly enough to a market downturn. Market indices that affect performance can include general economic factors and/or pricing for a key underlying commodity, such as:

- Changes in the consumer price index for the leisure industry
- Interest rates for mortgage banking companies

- Weather fluctuations for the utility sector
- Oil prices for energy companies
- Grain prices for the food processing industry.

In the market index example in Figure 2, adjustments are made to reflect both market ups and downs. If adjustments are lopsided (i.e., they offer protection against market downturns only), payout levels should be reviewed carefully to avoid distorting the risk-sharing relationship between stockholders and management.

Strategic Focus

Linking incentive awards to progress toward long-term strategic goals is a way to recognize the achievement of key milestones *before* their impact is fully reflected in financial, operating or stock price results. Strategic goals can be meaningful in a restructuring situation, when business and financial

FIGURE 1: EXAMPLES OF EPS GROWTH GOALS

Example	Comparison with:	Performance Goal for Target Payout	Actual EPS Growth	Performance Rating
A	Budget	10%	-5%	Below goal
B	Last Year	8%	-5%	Below goal
C	Peer Group (Method 1)	Second quartile vs. peers (median to 75th percentile)	-5% falls in the second quartile	At goal
D	Peer Group (Method 2)	Rank No. 6 out of 11 companies	-5% ranks No. 4 out of 11 companies	Above goal
E	Peer Group (Method 3)	Peer median	-5% vs. -10% peer median	Above goal

FIGURE 2: MARKET INDEX ADJUSTMENTS

Actual Sales (in millions)	Budget Sales (in millions)	Market Index	Adjustment Factor/ Adjusted Goal	Performance Rating
Down Performance				
\$1,500	\$2,000	100%	0% or \$2,000	Below goal
\$1,500	\$2,000	90%	75% or \$1,500	At goal
\$1,500	\$2,000	80%	50% or \$1,000	Above goal
Up Performance				
\$2,500	\$2,000	110%	125% or \$2,500	At goal
\$2,500	\$2,000	120%	150% or \$3,000	Below goal

performance measures are more likely to reflect historical factors. In such cases, strategic goals could include:

- Selling under-performing business lines
- Renegotiating terms of bank financing
- Closing a long-term agreement with a key customer
- Creating new supplier relationships.

Because strategic goals can be internally focused, in contrast to the peer group or market index approaches, rewarding achievement of key milestones can motivate managers to take immediate, concrete steps within their control. Successfully reaching a quarterly product development milestone, for example, usually is a more significant achievement for a startup company than year-end net income results.

However, a predominantly strategic focus, even on a temporary basis, is not suitable for every corporate culture. In particular, not all organizations can accept the degree of discretion that may be needed to evaluate performance against strategic goals, such as how one assesses the success of a new supplier relationship that was achieved only after a significant delay and at a premium price. When incentive awards are linked to strategic goals, difficult questions may arise regarding performance evaluation and award calibration. There also is a risk of duplicating goals in annual and long-term incentive plans, thereby rewarding participants twice for the same results, such as once when a customer agreement is closed and again as sales are achieved under the agreement. Ultimately, it is critical that stockholders and employees who are not eligible for incentives do not end up perceiving payouts linked to strategic goals as entitlements for mediocre or even poor performance.

Performance Measurement Pitfalls in a Down Market

As a matter of course, annual incentive plans in cyclical businesses usually end

up providing no payouts in at least one to two years out of 10. Nevertheless, in tough times, some companies resort to distorting an established incentive plan to avoid or mitigate the perceived negative impact of a zero payout.

Familiar practices include:

- Setting low performance hurdles for award payouts
- Adjusting performance measures in hindsight
- Inflating individual performance evaluations
- Converting performance awards into the minimum guaranteed retention awards that are presumably needed to hold onto top talent.

However, there are multiple reasons that employees will choose to stay even when awards are low or inconsistent, aside from the negative of limited alternative employment opportunities. Top management may have instilled a genuinely meaningful pay-for-performance culture in which a zero payout is perceived as a potential and fair outcome for the level of performance delivered, rather than a culture focused on compensation entitlements. The company may have a well-balanced pay program that provides ongoing wealth creation opportunities through equity-based awards and deferred compensation or retirement plans even when cash incentive payouts are poor. Alternatively, managers may have confidence in the company's business prospects and future incentive opportunities.

Still, companies with below-par performance may try to mitigate or avoid a zero bonus payout, even at the most visible senior executive levels. Each year, many companies reporting a substantial net loss pay bonuses or offset zero bonuses with significantly larger stock option grants than in the previous year. Either these companies have a distorted concept of good performance, or the minimum compensation level needed to

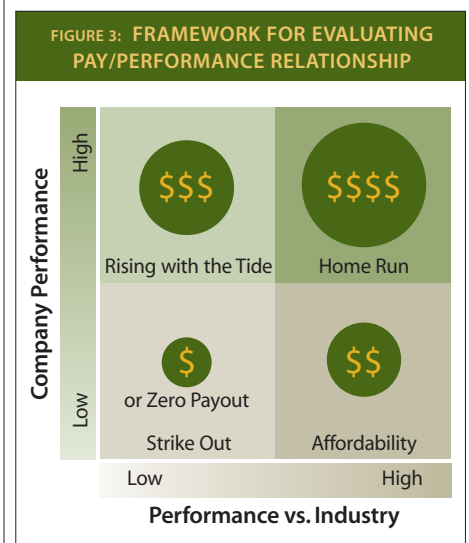
retain top talent in a down market is much more than base salary.

Payout Levels in a Down Market

The exercise of determining acceptable payout levels for target performance in a challenging economic environment is specific to each company. As a starting point, Figure 3 illustrates a conceptual framework for evaluating the pay/performance relationship.

While it might be desirable to pay more in the lower right quadrant, funding may be limited. Companies should determine whether retention is a risk factor across-the-board, or only for key individuals. Overall, payout targets in a down market need to be affordable, market competitive in the context of the company's performance relative to peers, linked to specific performance measures and not so small that they have a demoralizing effect.

On an individual basis, the compensation committee should be clear as to whether the CEO or any other executives should be held responsible for declining or stagnant performance resulting from a down market, regardless of whether the company outperforms the industry. The answer may be partial immunization only for a new management team charged with bringing about a turnaround.



Incentive Plan Design in a Down Market

Despite the performance measurement alternatives described in this article, companies still may find that formula-based incentive plans lack sufficient flexibility. A useful alternative at the opposite end of the spectrum is funding of an overall incentive pool based on company performance, from which awards to individual participants are allocated on a discretionary basis. This allows meaningful rewards to be provided for high individual contributors even when overall performance is down, but only by reducing or eliminating awards for other participants — that is,

the incentive pool is “zero sum.” The decision to reduce awards for other participants is difficult but necessary if retention risk is high for the superior performer. The incentive pool concept also could be administered at the business-unit level, with allocations made from the overall corporate pool to each business unit based on business unit performance. Figure 4 illustrates the “zero sum” incentive pool with five hypothetical participants. (In practice, there would be many more participants. Companies also can adjust the time and form of award payouts in good years to dampen the effects of a down market. A common approach

among cyclical companies in the 1960s and 1970s was to smooth payouts in bad years by “banking” 100 percent of incentive awards and paying out one-third of the “bank balance” to participants each year. Retention risk in bad years also can be mitigated if award amounts above target in good years are paid in the form of restricted stock or deferred cash. Companies will need to reconsider whether such accommodations remain appropriate when the market recovers.

Figure 5 illustrates the impact of bonus “banking” on payouts under two performance scenarios in which the “bank account” is initially credited with 200 percent of the individual’s target award.

FIGURE 4: ZERO SUM INCENTIVE POOL

Company Performance Determines Incentive Pool Size			
	Downturn	Normal	Boom
Company Cash Flow	\$18 million	\$20 million	\$25 million
Funding Percent	5%	5%	5%
Incentive Pool	\$900,000	\$1 million	\$1.25 million


Individual Performance Determines Award Allocation			
	Downturn	Normal	Boom
	One high performance participant	Satisfactory performance for all participants	One high performance participant
Participant 1	\$250,000	\$200,000	\$350,000
Participant 2	\$162,500	\$200,000	\$225,000
Participant 3	\$162,500	\$200,000	\$225,000
Participant 4	\$162,500	\$200,000	\$225,000
Participant 5	\$162,500	\$200,000	\$225,000
'Zero Sum' Pool	\$900,000	\$1,000,000	\$1,250,000

FIGURE 5: BONUS BANKING ON PAYOUTS

Scenario A	Normal	Normal	Normal	Normal
Target Award	\$100,000	\$100,000	\$100,000	\$100,000
Performance Factor	100%	100%	100%	100%
Earned Award	\$100,000	\$100,000	\$100,000	\$100,000
Starting Bonus 'Bank'	\$200,000	\$200,000	\$200,000	\$200,000
New 'Bank' Balance	\$300,000	\$300,000	\$300,000	\$300,000
Payout of 1/3	\$100,000	\$100,000	\$100,000	\$100,000
Ending Bonus 'Bank'	\$200,000	\$200,000	\$200,000	\$200,000

Scenario B	Normal	Boom	Normal	Downturn
Target Award	\$100,000	\$100,000	\$100,000	\$100,000
Performance Factor	100%	175%	100%	50%
Earned Award	\$100,000	\$175,000	\$100,000	\$50,000
Starting Bonus 'Bank'	\$200,000	\$200,000	\$250,000	\$233,333
New 'Bank' Balance	\$300,000	\$375,000	\$350,000	\$283,333
Payout of 1/3	\$100,000	\$125,000	\$116,667	\$94,444
Ending Bonus 'Bank'	\$200,000	\$250,000	\$233,333	\$188,889

Living Up to the Pay-for-Performance Ideal

Increasingly, stockholders are demanding that executives live with the consequences of performance-based pay programs in bad years as well as good. Ultimately, the best incentive plans are flexible enough to deliver fair rewards under a range of performance outcomes. For the HR professional, the challenges of realizing the pay-for-performance ideal in a down market is like an ancient Chinese curse, “May you live in interesting times.” 

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FOOTNOTES

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