

Current Trends in Executive Compensation



Michael Enos
June 8, 2007

■ Overview

- **Executive compensation and the changing landscape**
- **Top 10 Issues in executive compensation**
- **NACT survey results and executive compensation trends**
- **Long-term incentives**
- **Board of Director compensation trends**

Executive Compensation: Changing Landscape

■ Executive Compensation Changing Landscape

- **Heightened focus on executive compensation**
 - Internal – Committee and the Board
 - External – Investors and the media

■ New Rules, Regulations and Legislation

- Revisions to proxy disclosure rules (SEC)
- “Say on Pay” bill
- SFAS 123R
- Deferred compensation (IRC409A)

■ **Headlines**

- **Option backdating**
- **SEC disclosures and “Plain English”**
- **Independence of compensation consultants**
- **Home Depot**

As We See It: Top 10 Issues in Executive Pay

■ Top 10 Issues in Executive Pay

Exec Pay Issue

As We See It...

1.

2.

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■ Top 10 Issues in Executive Pay

Exec Pay Issue	<i>As We See It...</i>
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10. Fairness	<i>How much is enough?</i>

■ Top 10 Issues in Executive Pay

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■ Top 10 Issues in Executive Pay

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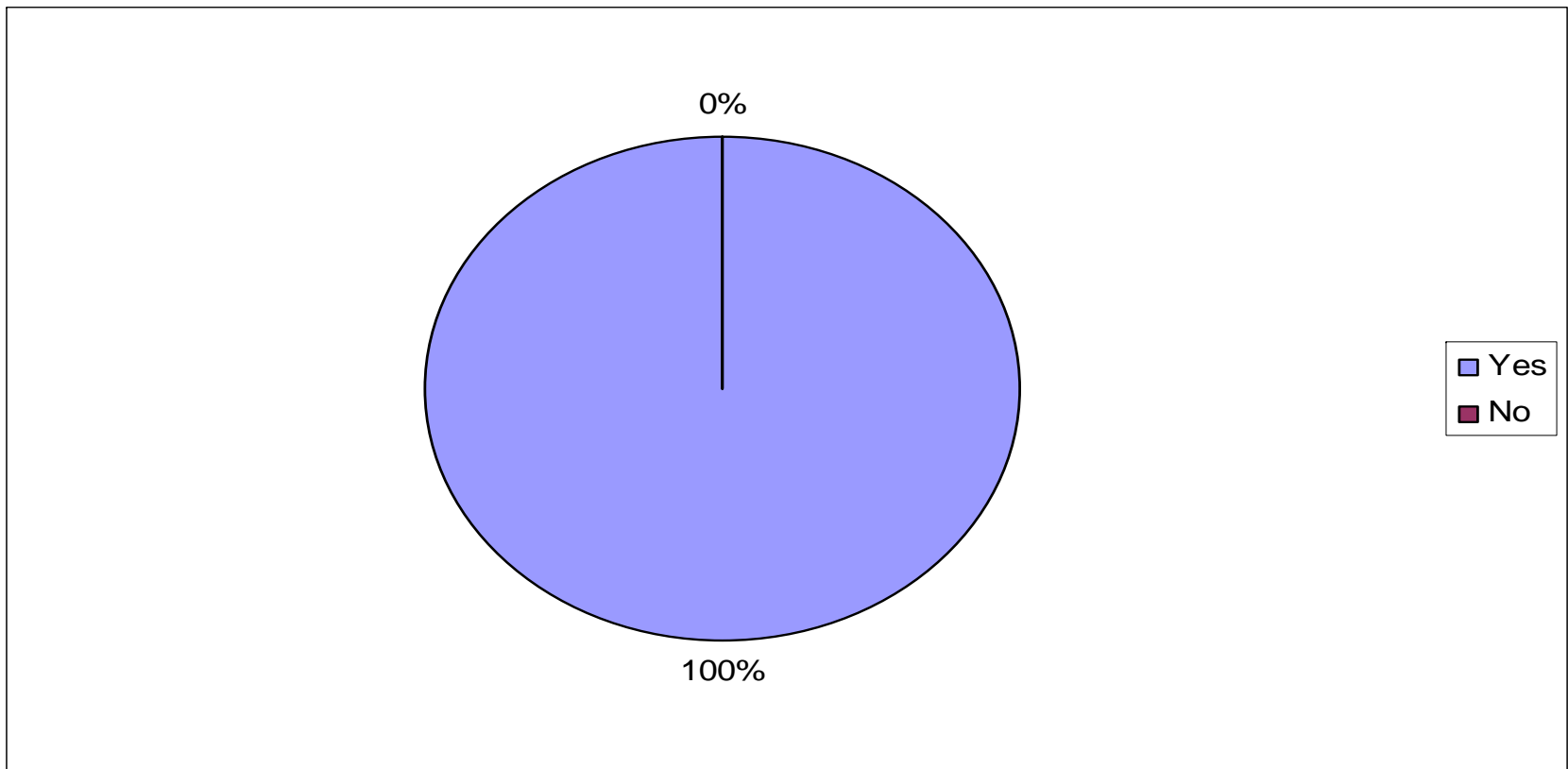
■ Top 10 Issues in Executive Pay

Exec Pay Issue	As We See It...
1. Say on Pay	<i>Every problem; simple solution; clear, neat, wrong.</i>
2. Option Backdating	<i>Where there's smoke, there's fire.</i>
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NACT Survey Executive Compensation Results

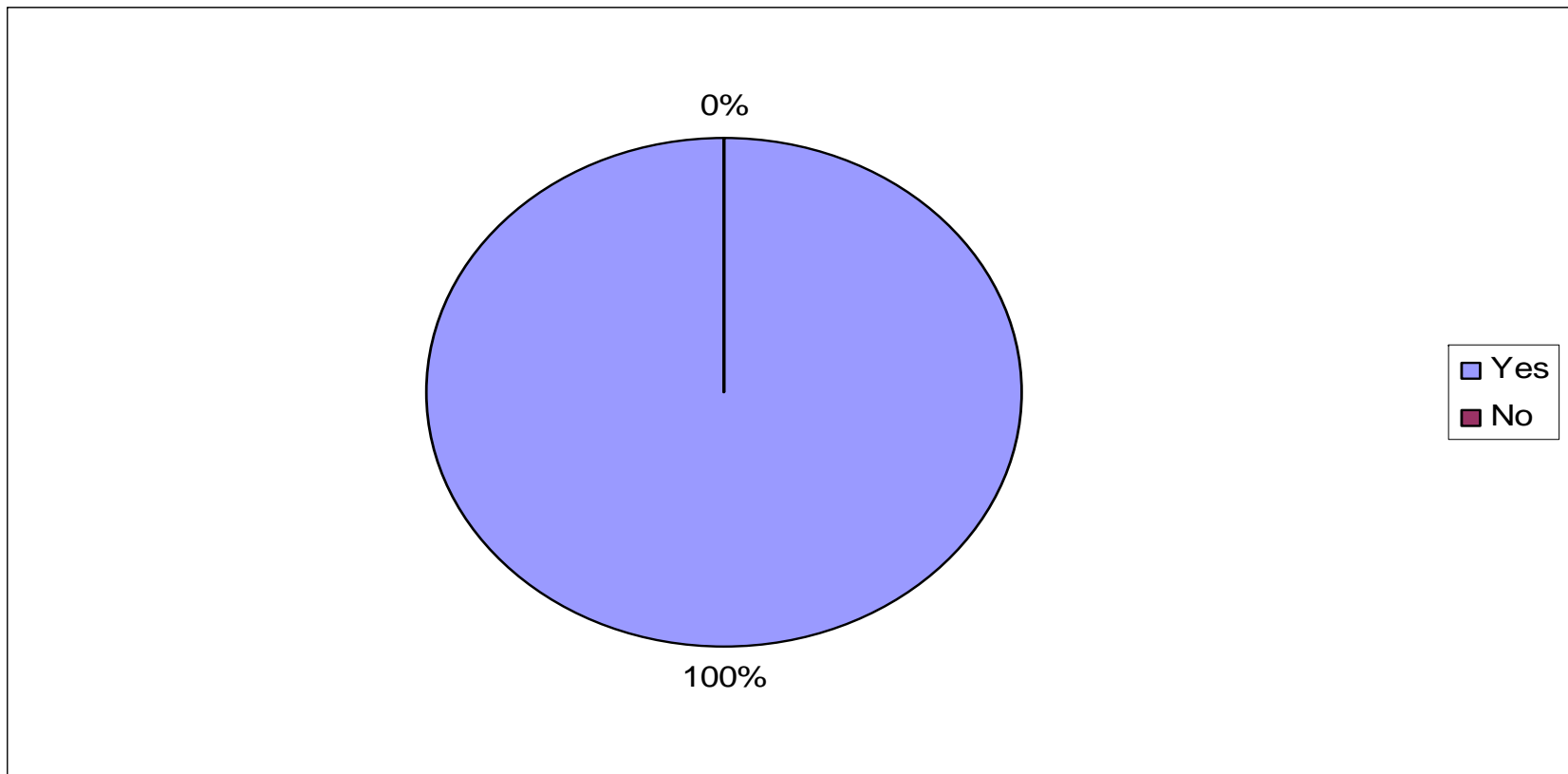
■ NACT Survey Results: STI

- Does your company have an annual short term incentive program for executives?



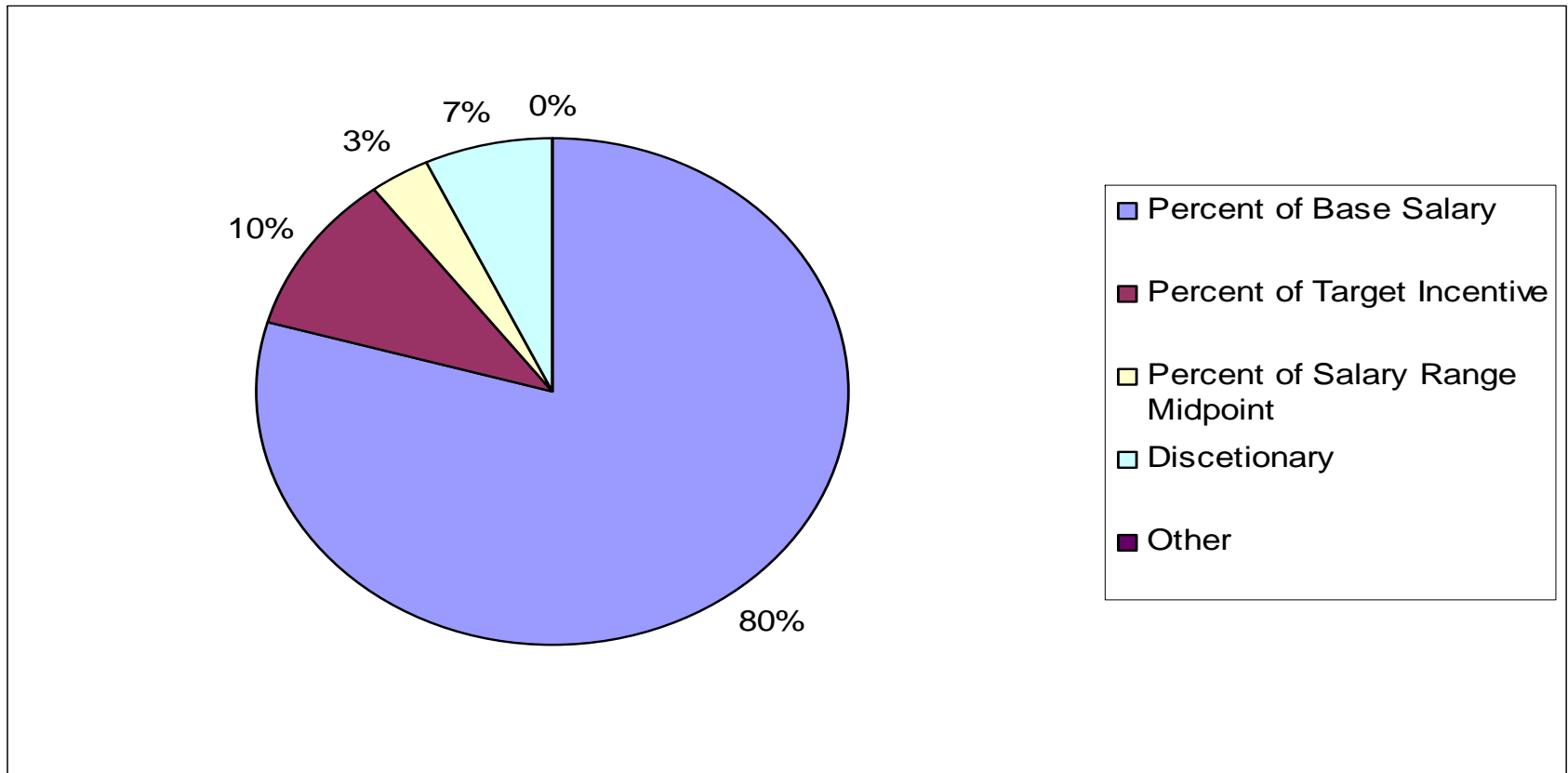
■ NACT Survey Results: STI

- **Is achievement of an organization's performance threshold required in order for awards to be paid out?**



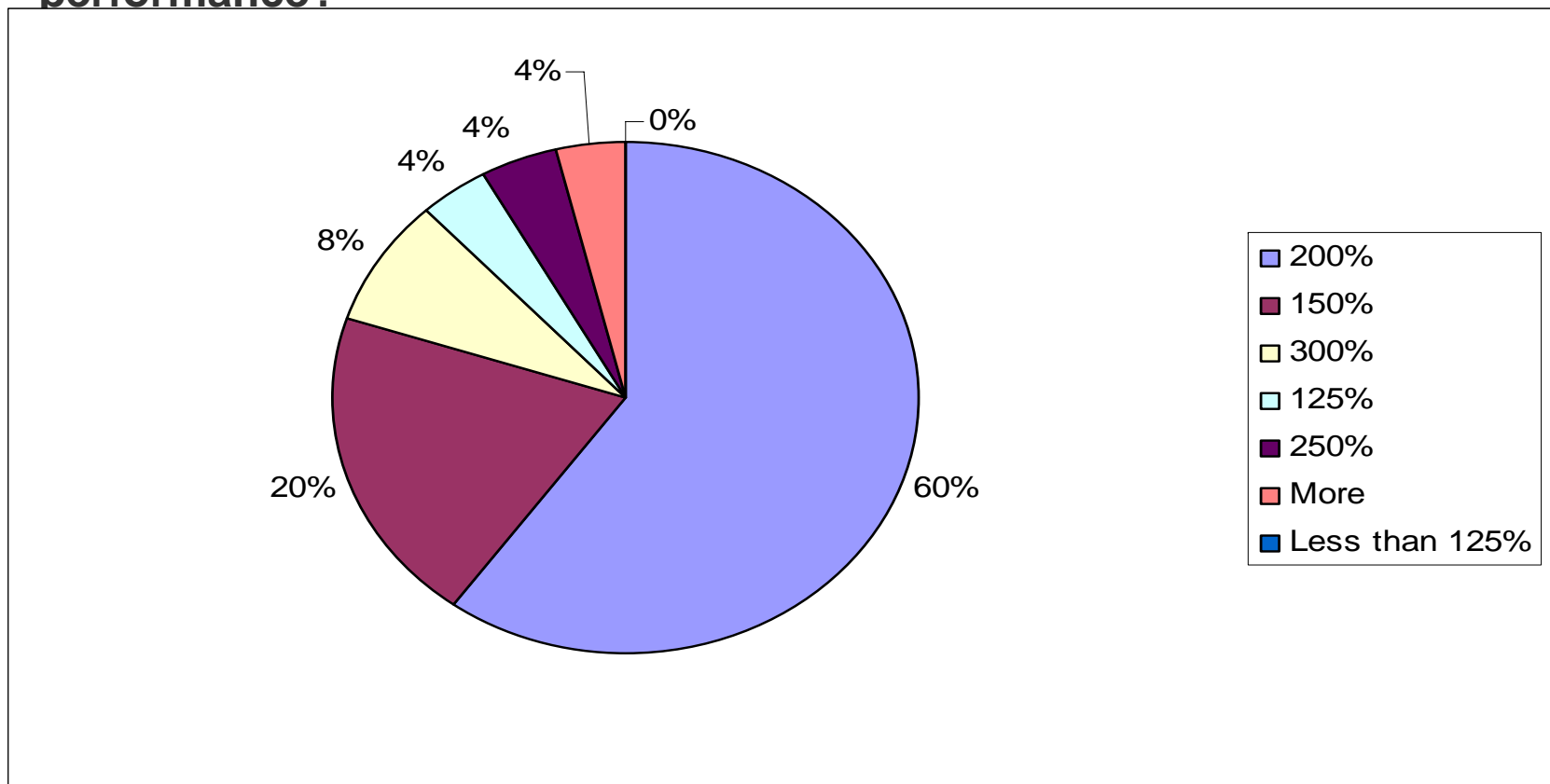
■ NACT Survey Results: STI

■ How is an individual target or award determined?



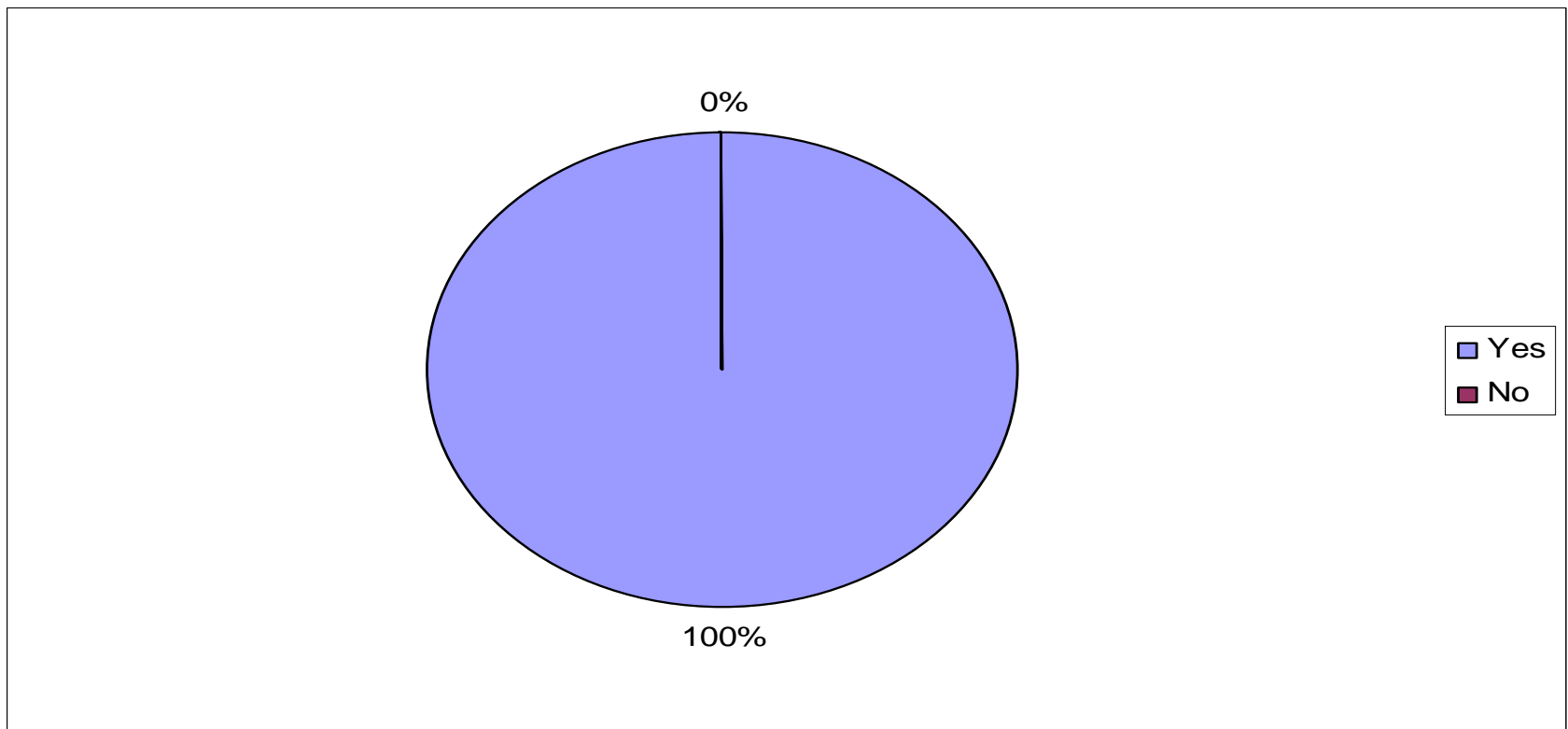
■ NACT Survey Results: STI

- In your opinion, what is the maximum percentage of target an organization should pay for short-term incentives over-plan performance?



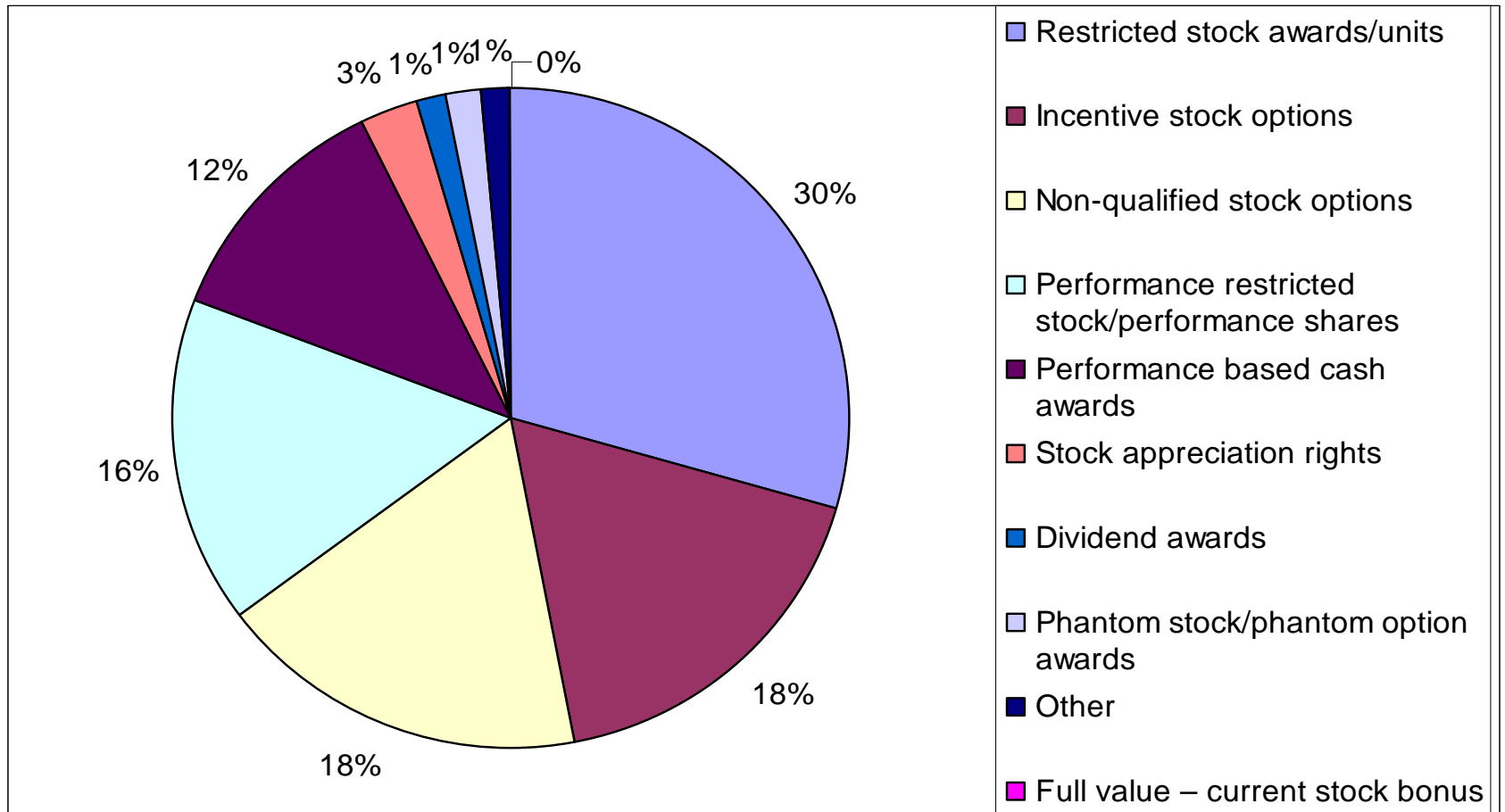
■ NACT Survey Results: LTI

- Does your company have a long term incentive program for executives?



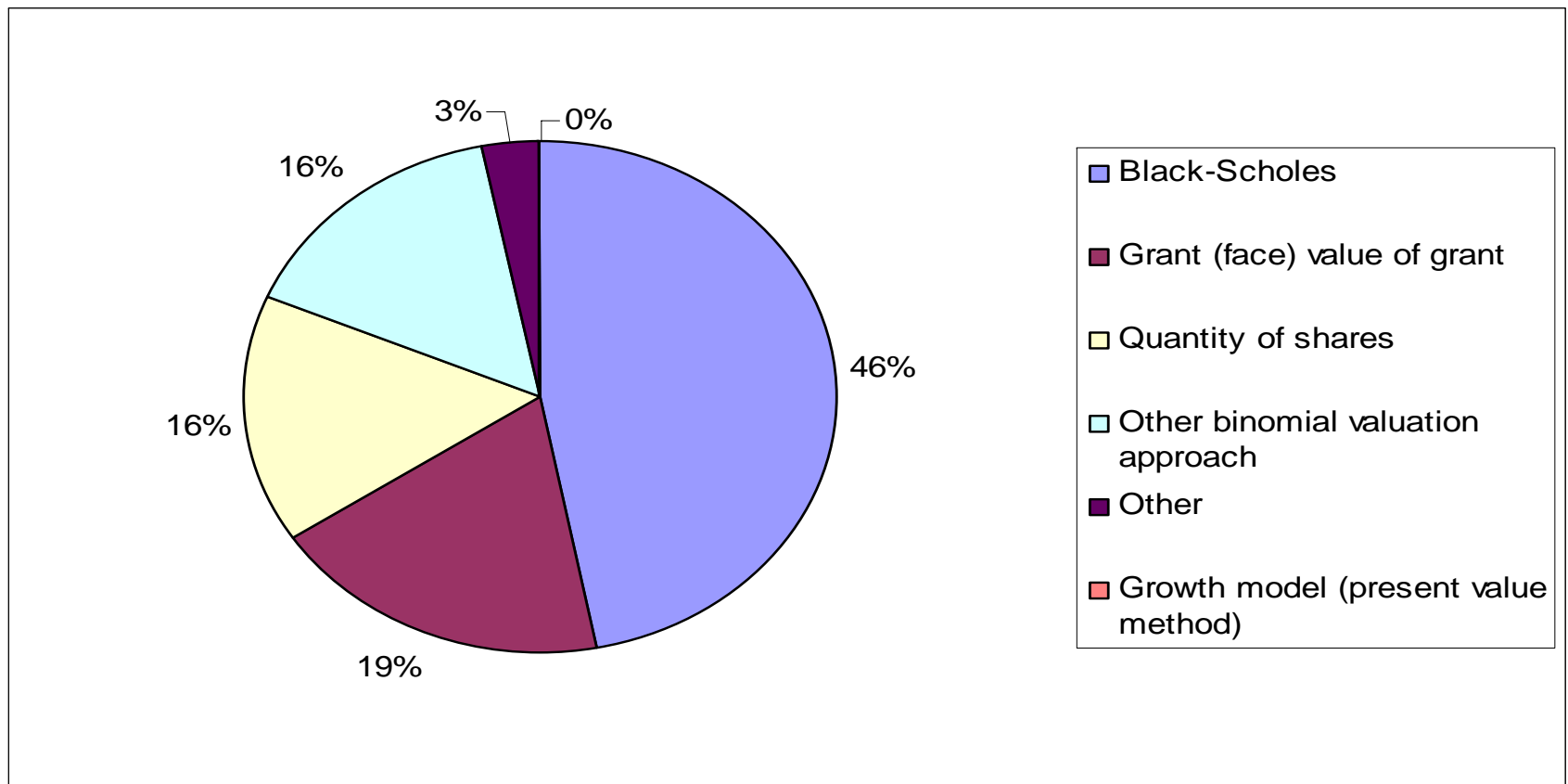
■ NACT Survey Results: LTI

■ What types of long term incentives are in use for executives?



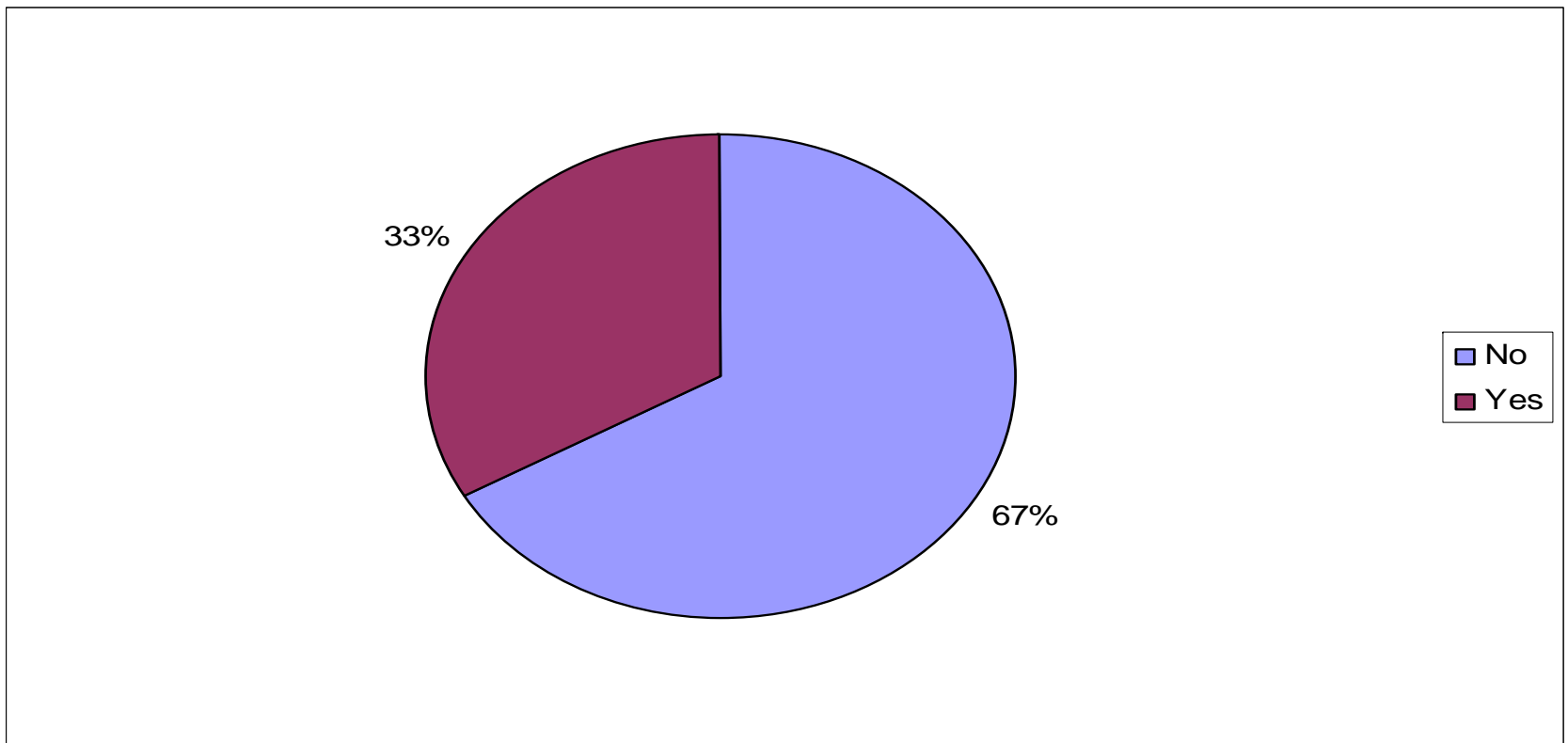
■ NACT Survey Results: LTI

- What is the primary method used for valuing long term equity incentives?



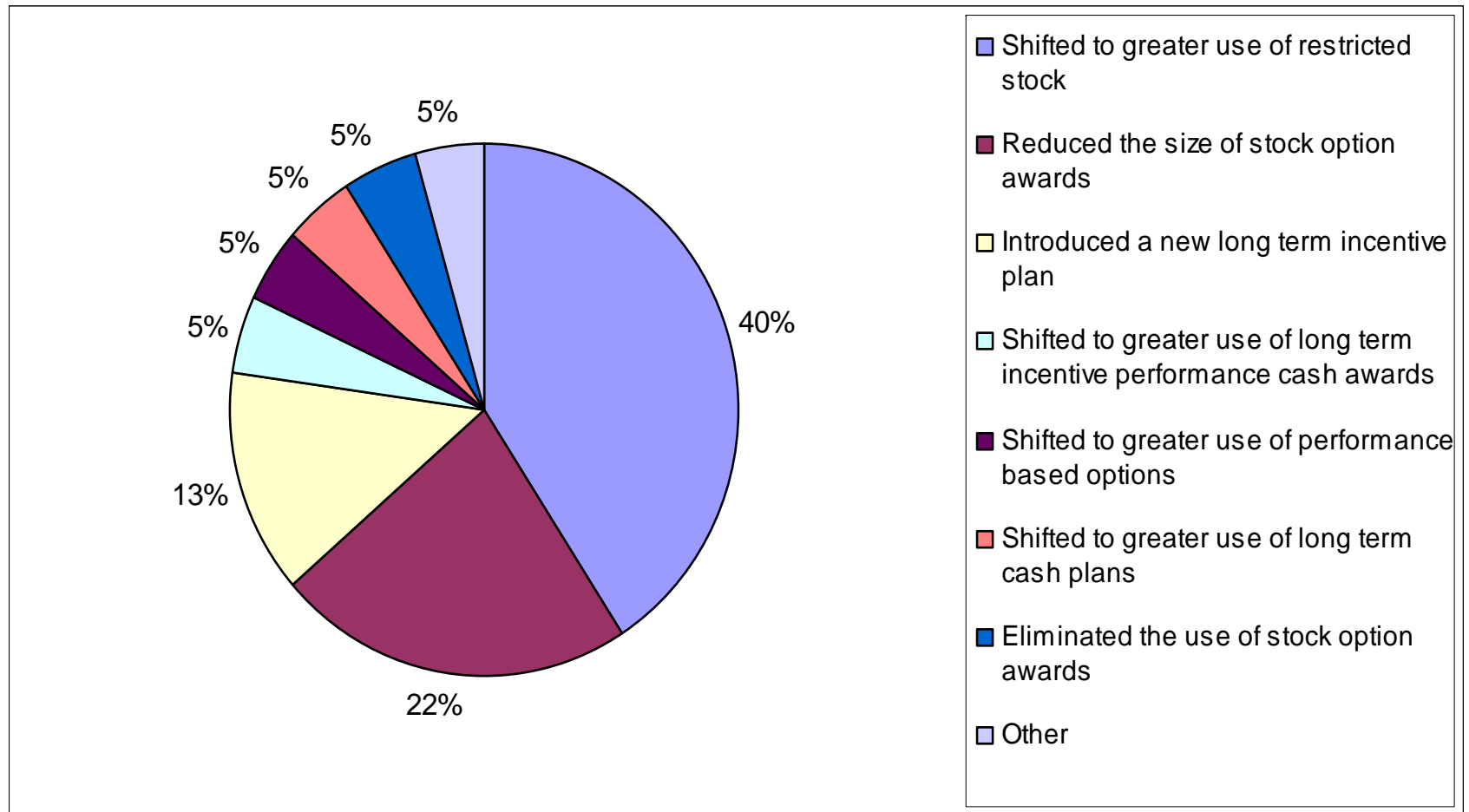
■ NACT Survey Results: LTI

- Has your company changed its long term incentive target mix (e.g., 50% options/50% performance units) for executives in the past 12 months?



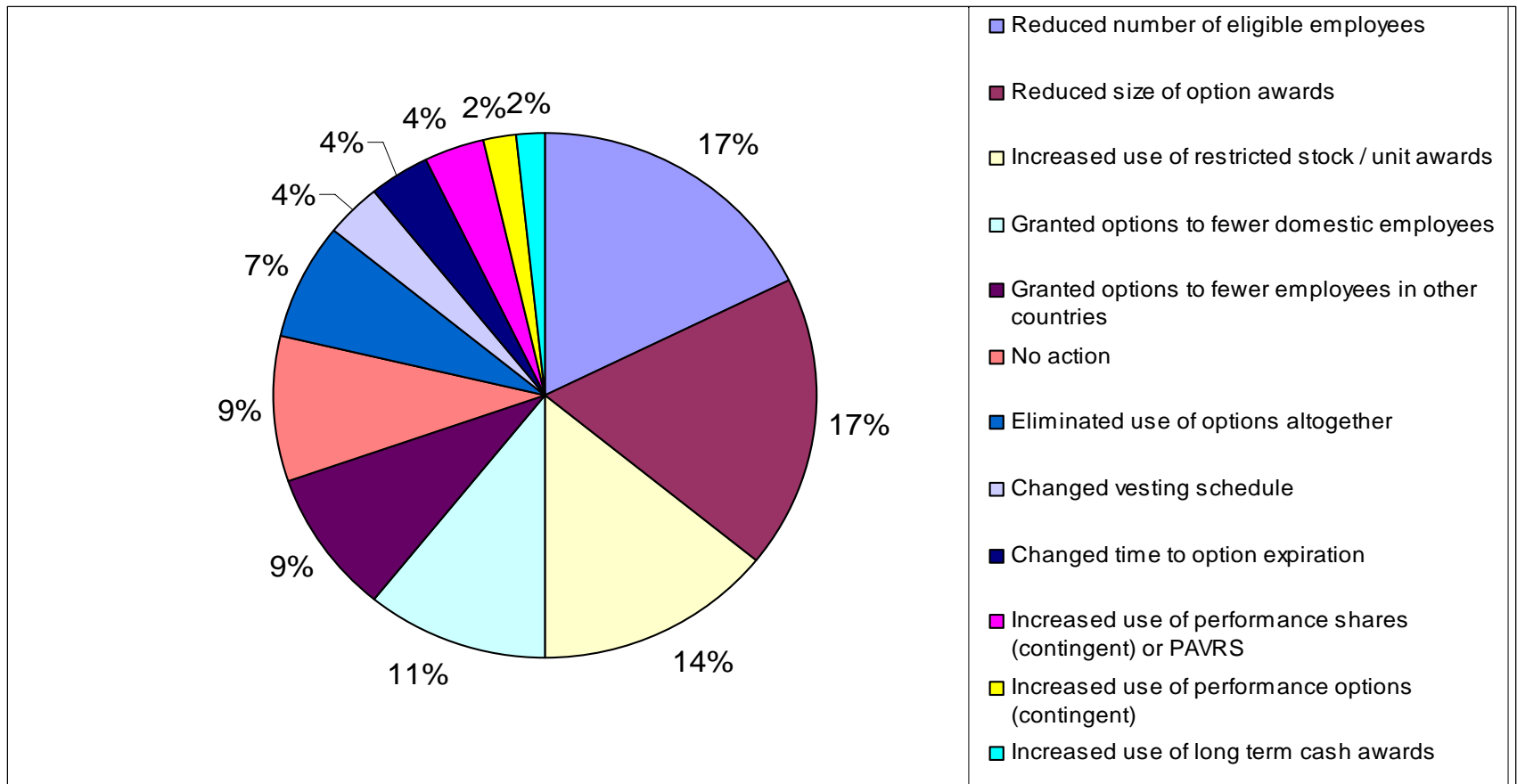
■ NACT Survey Results: LTI

■ If yes, what changes have you made?



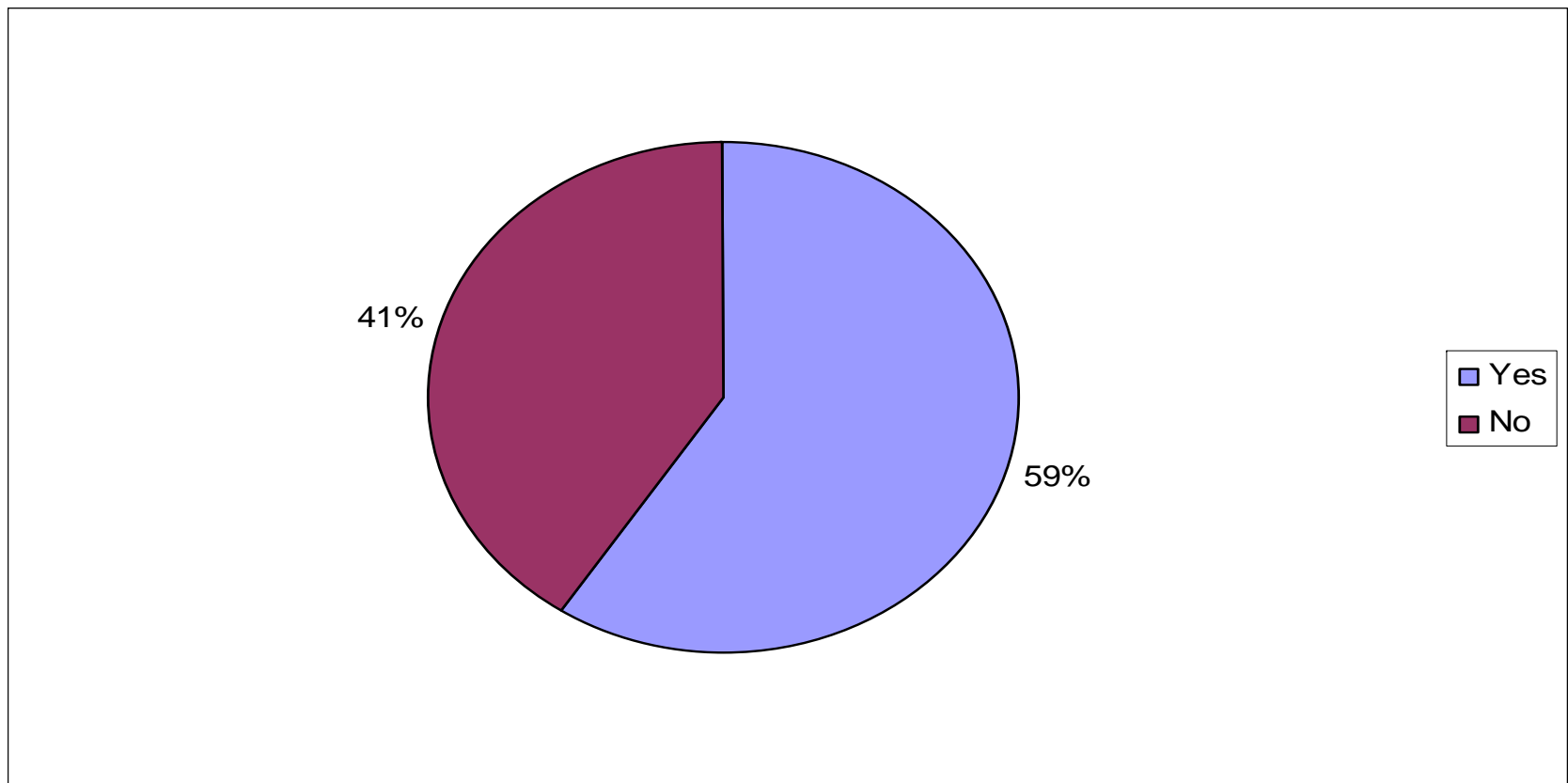
■ NACT Survey Results: LTI

- What actions, if any, has your company taken in response to FASB's option expensing requirement?



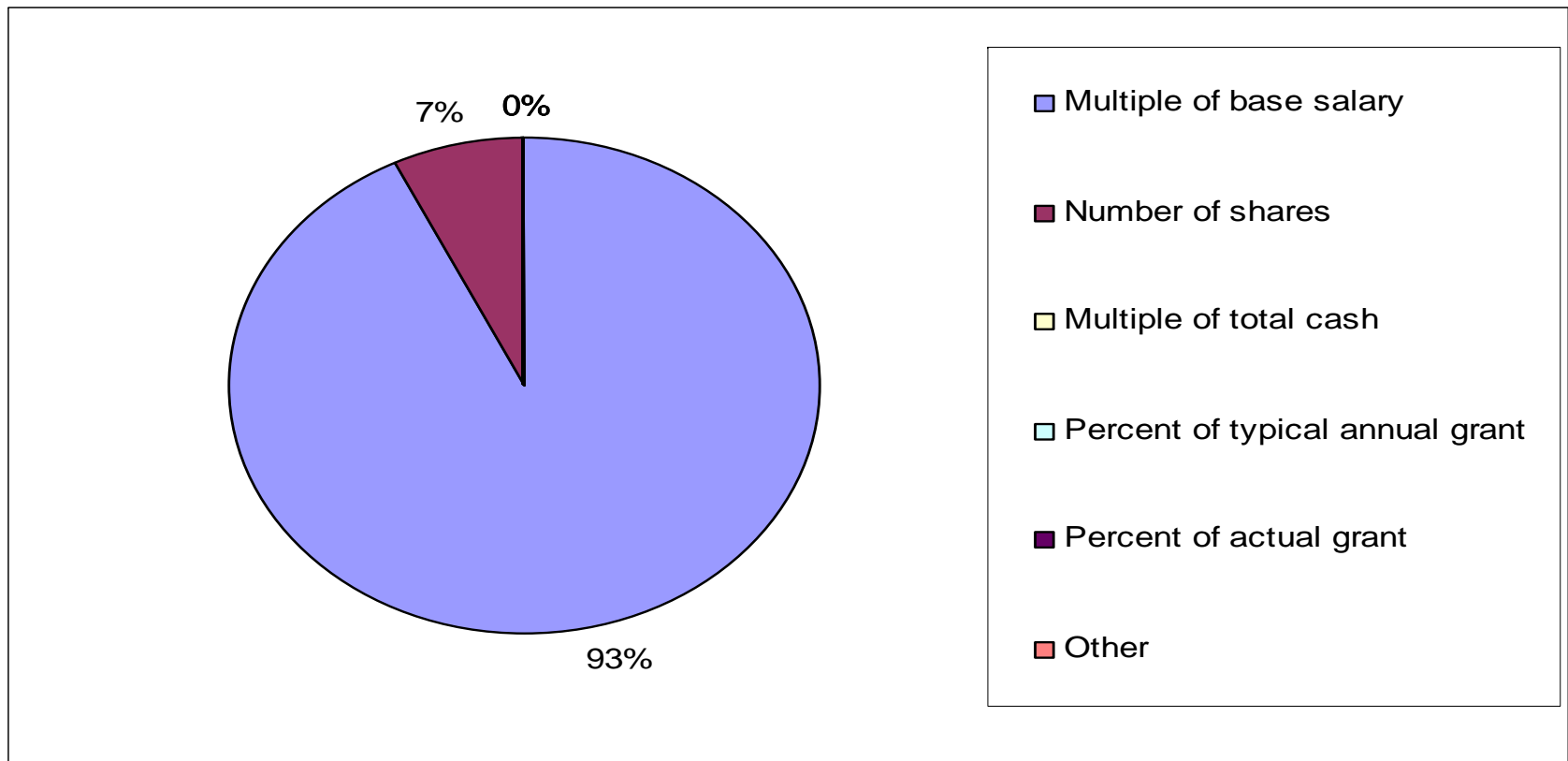
■ NACT Survey Results: Stock Ownership Guidelines

- Does your company have executive stock ownership guidelines and / or retention requirements?



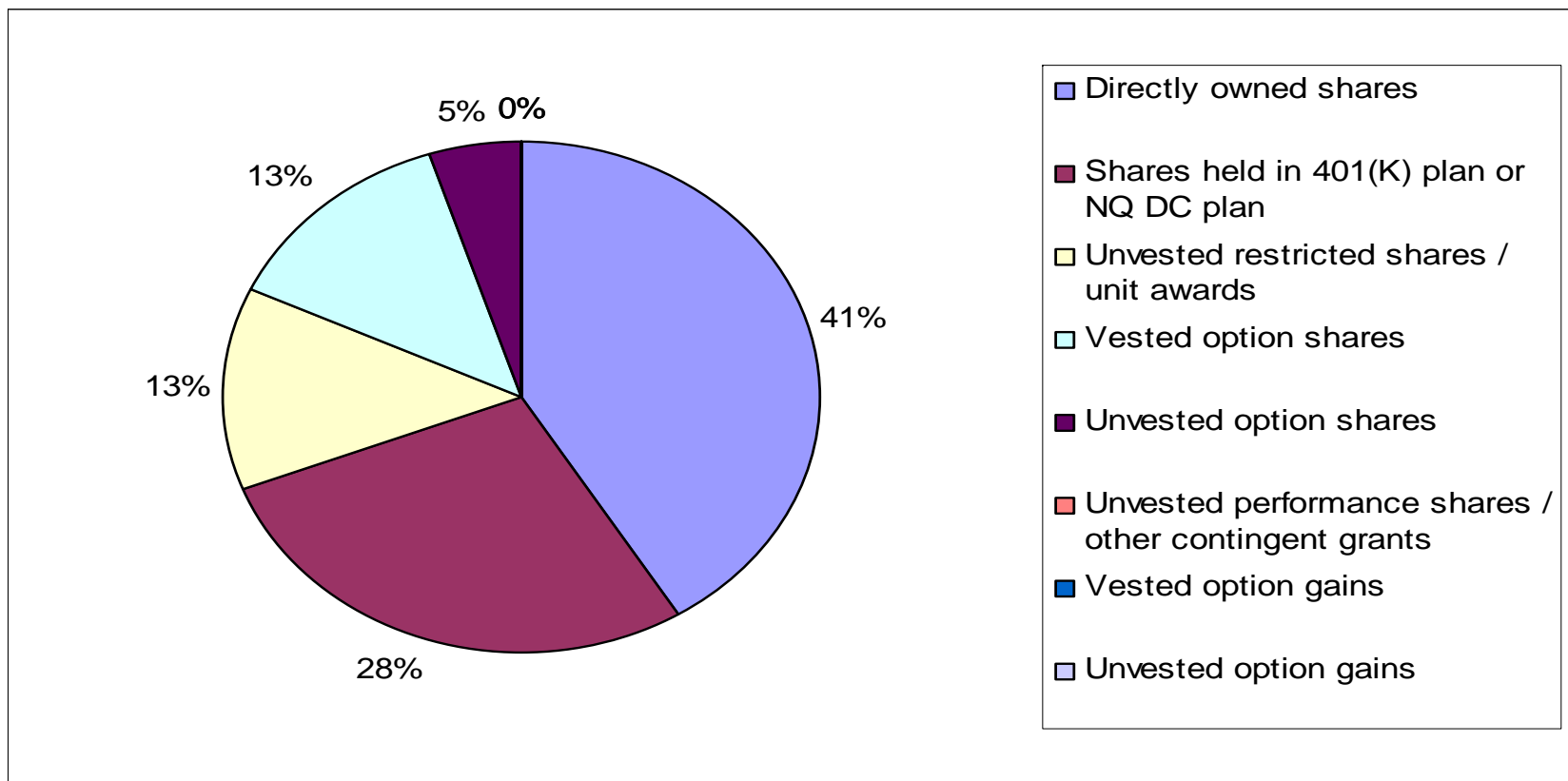
■ NACT Survey Results: Stock Ownership Guidelines

- If yes, please identify your guideline approach.



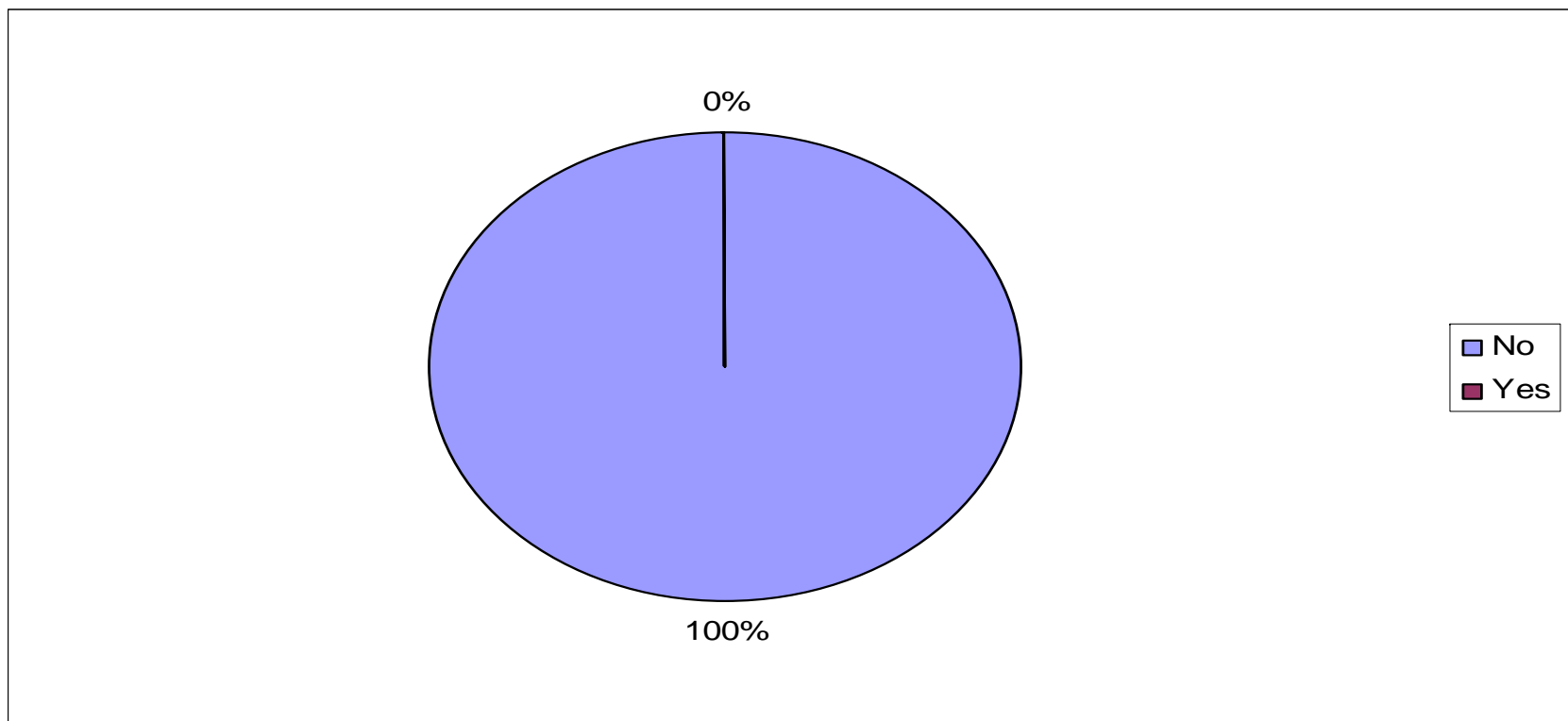
■ NACT Survey Results: Stock Ownership Guidelines

- What forms of equity count toward fulfillment of guideline / retention requirements?



NACT Survey: Changes in Light of new SEC Disclosures

- **Has your company made any significant changes to its compensation and benefits programs as a result of the new SEC disclosure requirements and / or other recent legislative regulations?**



Long Term Incentives

■ Long-Term Incentives

- **Companies will continue to rebalance their LTI pay mix**
- **More shift away from heavy stock option use**
- **Prevalence of “full value” restricted stock and performance share grants will continue to climb**

■ With that in Mind, What's the Right Ratio?

3 Ways to Think About It...

- **Cost neutral**
- **Black-Scholes breakeven ratio**
- **Risk adjusted**

■ Cost Neutral Ratio

- Assume FAS 123 option cost is about 33% of FMV
- Restricted stock cost is 100% of FMV
- Cost neutral ratio is 3 options : 1 restricted share
- 1 RS more valuable than 3 options until FMV increases 50%

Black-Scholes Breakeven/Reward Neutral Ratio

- Assume same case (option at 33% of FMV, 3:1 cost neutral ratio)
- What if assume BSV = appreciation?
- What would the breakeven ratio of options to RS be?
- At 33% appreciation, value of 4 options = value of 1 RS (4:1)
- Whatever cost neutral ratio is, the “BS breakeven” ratio is “+1”

■ Black-Scholes Breakeven Ratio

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But these analyses imply a one-time transition, when in fact the issue is more pervasive – how will we compare differing instruments and differing combinations on an on-going basis?

■ Why this is Getting More Complicated

- **Significant increase in the use of restricted stock**
- **Significant increase in the use of more than 1 instrument**
 - Options, restricted stock (various forms), cash
- **Competitive analysis focuses on estimates of value**
 - Expected value of the reward over time (e.g., cash value, Black-Scholes)

▪ 2 Other Issues to Consider

1. Instrument risk is not consistent

- Some instruments have less risk than others
- Intuitively, this is clearly recognized
- But work has not focused on quantifying the risk / reward relationship

2. Differing degrees of correlation among “returns” (rewards)

- Options and restricted stock rewards are highly correlated
- Cash – if based on goals linked to stock price – correlated w/ options, RS
- Instrument correlation likely effects overall rewards

Analysis of value without regard to risk and correlation is incomplete

Premise: Portfolio analysis concepts provide greater insight

■ Considering Risk for LTI Instruments

- **Consider Risk / Reward Index[©]**
 - Std dev of returns / (expected or historical return - risk free rate)
 - Risk indexed to the return (reward)
 - Inverse of common portfolio analysis measure (Sharpe Ratio)

- **Interpreting the Index**
 - > 1.00: expected risk greater than expected reward
 - = 1.00: risk, reward balanced
 - < 1.00: expected risk less than expected reward

- **Can be used for 1 instrument, or mix (“portfolios”)**
 - Considers impact of correlated outcomes

- **Addresses comparisons over differing periods of time**

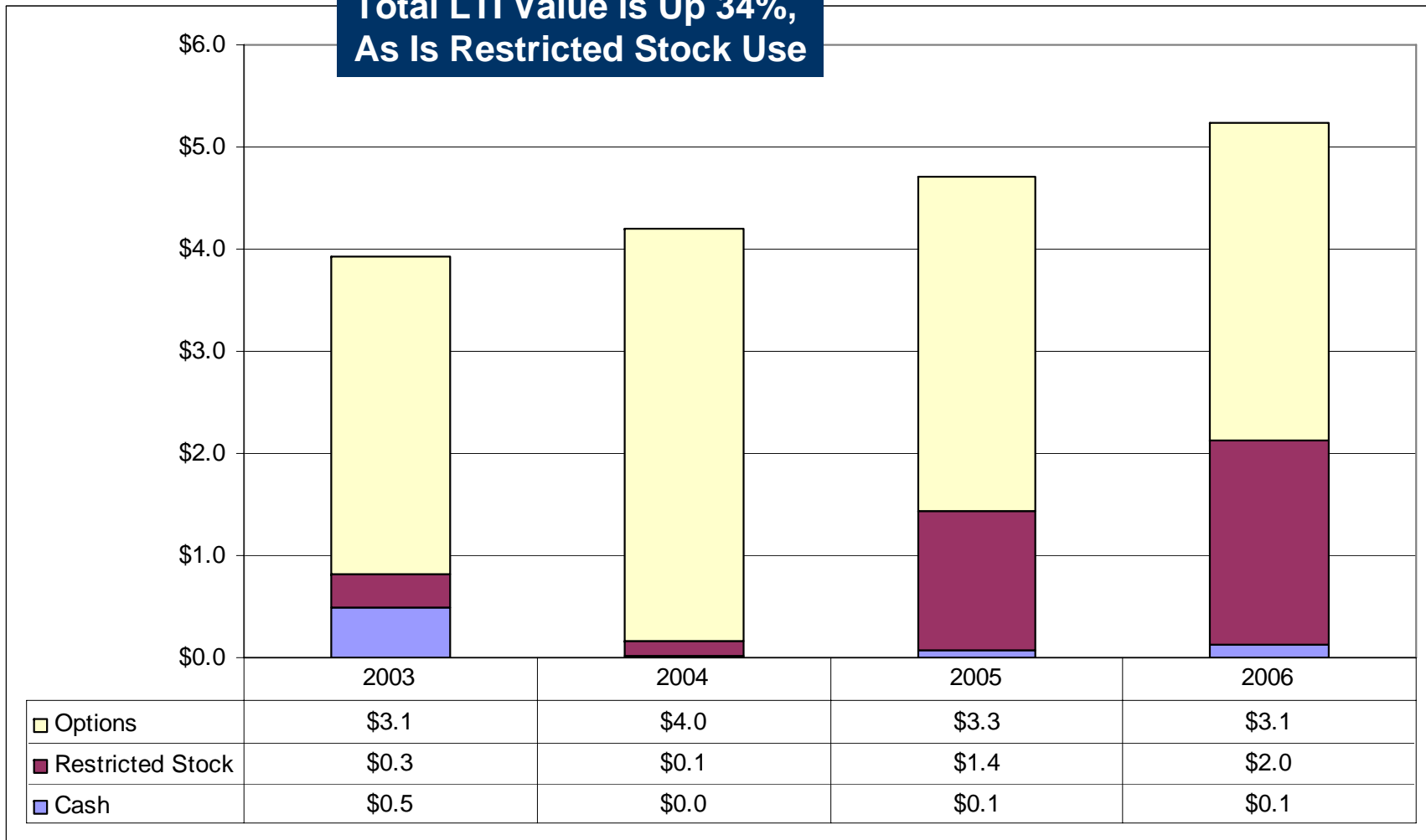
■ RRI Examples

- **Assume NASDAQ 100 is a “Stock”**

- **Over 5 year periods, past 10 years:**
 - “Option” RRI of 3.45 (high risk for reward received)
 - “RS” RRI of 0.75 (low risk for reward received)
 - RS 4.6x greater risk-adjusted return vs. options

CEO LTI Values by Instrument

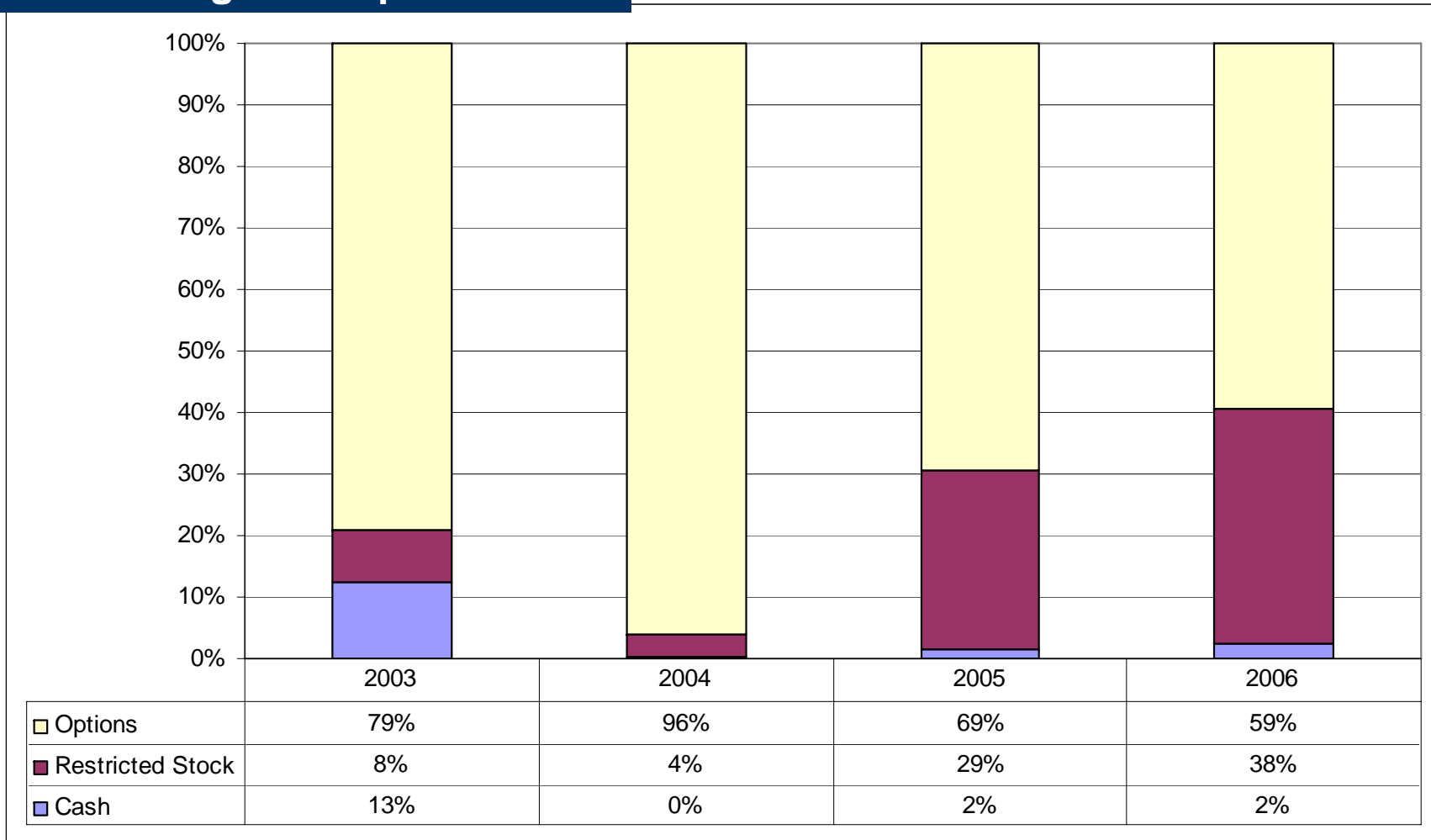
**Total LTI Value is Up 34%,
As Is Restricted Stock Use**



Source: Pearl Meyer & Partners 2003-2005 CHiPS Executive and Senior Management Compensation Survey; 2006 PM&P Projection

CEO LTI Portfolio Mix

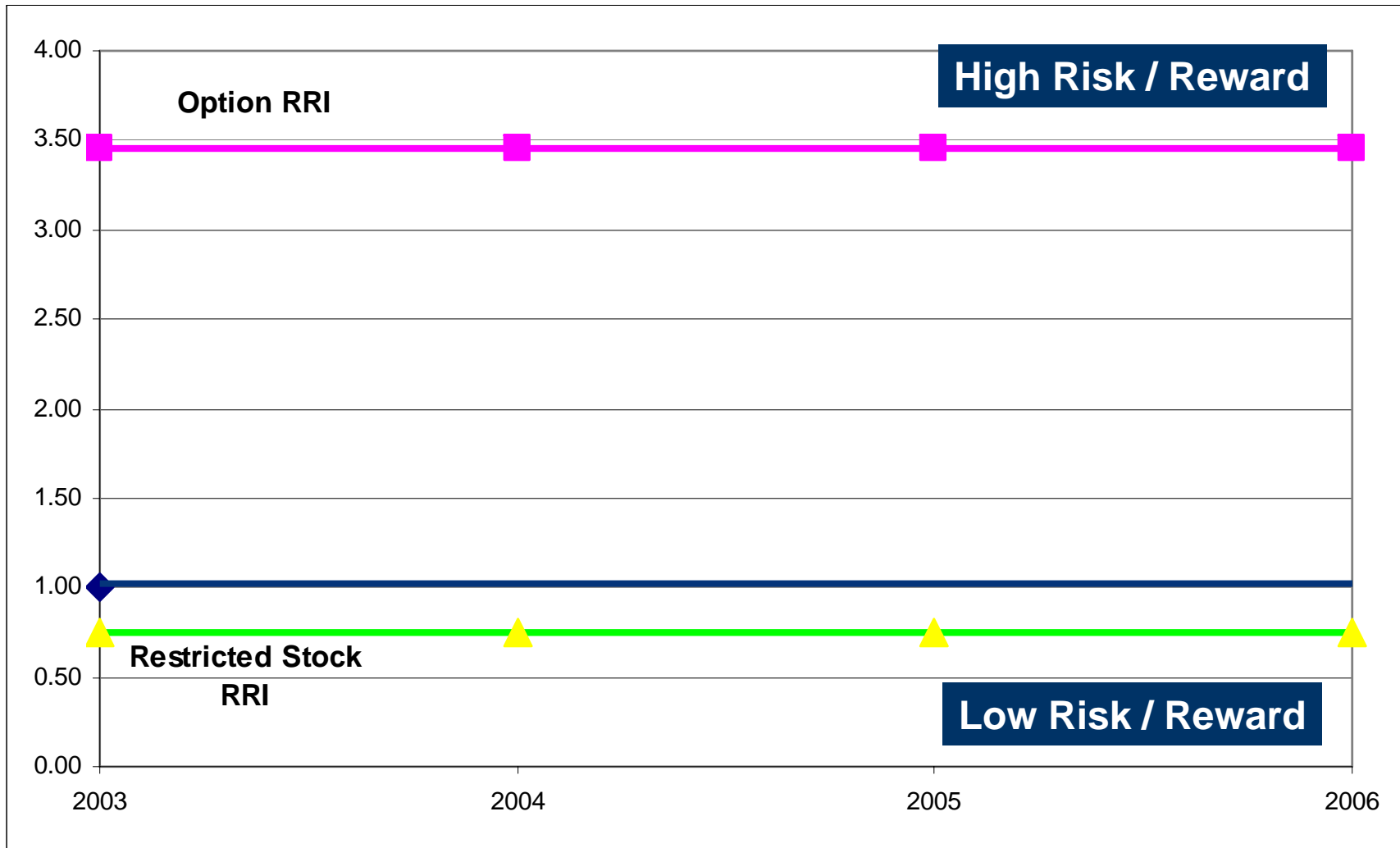
Mix Shifting from Options to RS



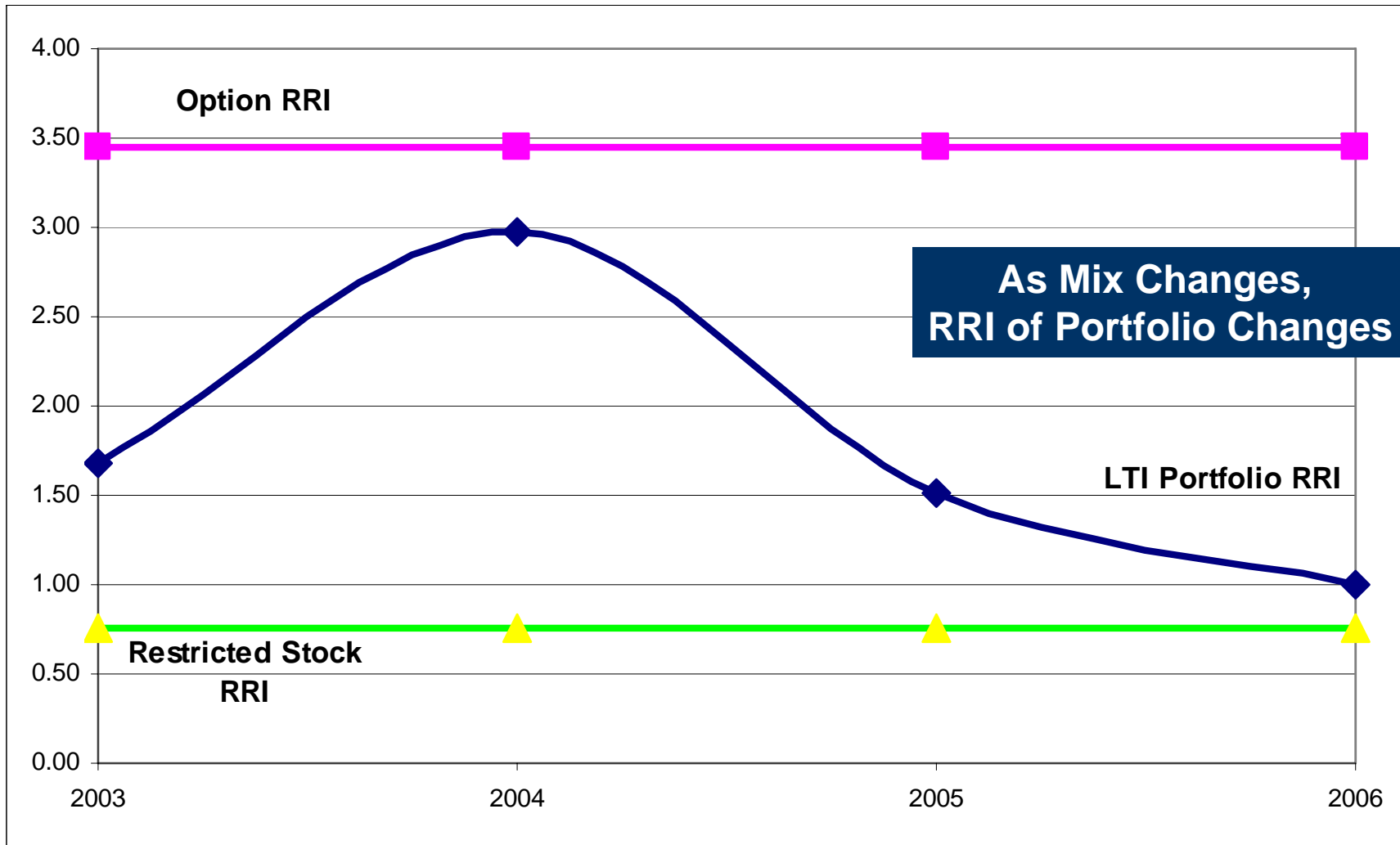
▪ Risk Ratios for CEO Packages

Year	Stock Options	Restricted Stock	Performance Cash	Risk / Reward Index [©]
2003	79%	8%	13%	1.68
2004	96%	4%	0%	2.97
2005	69%	29%	2%	1.51
2006 (Projected)	59%	38%	3%	1.00

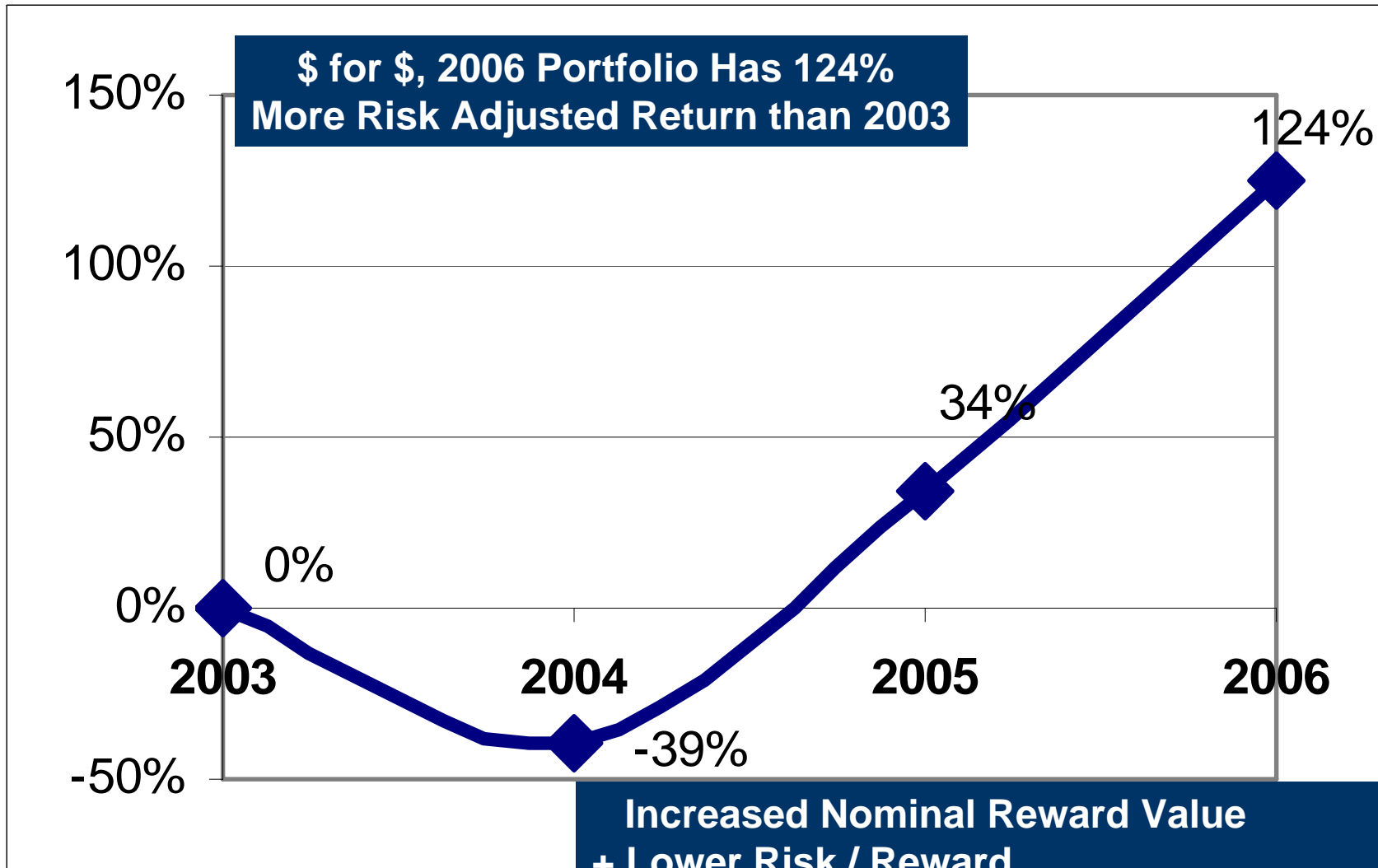
Risk / Reward Index For Options, RS



Risk / Reward Index Changes with Mix



▪ Risk Adjusted Rates Have Increased



**Increased Nominal Reward Value
+ Lower Risk / Reward
= Significantly Greater Risk Adjusted Reward**

Alternative “Balanced” Portfolios

Sample LTI Portfolio	Stock Options	Restricted Stock	Performance Cash	~ Risk / Reward Index ©
A	35.0%	65.0%	0.00%	1.00
B	55.0%	22.5%	22.5%	1.00
C	65.0%	0.00%	35.0%	1.00

Strategy:
Offer a Portfolio Where the Risk and Reward are Balanced.

Alternative “Un-Balanced” Portfolios

Sample LTI Portfolio	Stock Options	Restricted Stock	Performance Cash	~ Risk / Reward Index [©]
High Risk: Employ with More Than Competitive Target Value	80%	20%	0%	1.89
Low Risk: Employ with Less Than Competitive Target Value	20%	50%	30%	0.63

What if Market Risk Ratio is 1.10?

Assume the Market LTI Norm is a \$5M Nominal Value with a 1.10 RRI,
The risk adjusted value is \$4.55M. How Might You Compete?

Sample LTI Portfolio	Stock Options	Restricted Stock	Multi-Year Cash	RRI [®]	Nominal LTI Value	Risk Adjusted Value (Nominal / Risk)
Equal Risk, Competitive LTI Value	50%	45%	5%	1.10	\$5.00M	\$4.55M
Less Risk, Lower LTI Value	0%	87%	13%	0.67	\$2.50M	\$3.73M
More Risk, Higher LTI Value	85%	15%	0%	2.00	\$15.00M	\$7.50M

■ So What's the "Right" Ratio

Of Course, It Depends...

- Characteristics of your stock
- Instruments available
- Business, human resource objectives
- Cultural perspectives on options, restricted stock, cash
- Participant perspectives

And Maybe "The Right Ratio" Isn't the Right Question

- RRI allows you to understand and design with risk in mind

Appendix: Board of Directors' Compensation

■ Current Landscape

- **The role of the Director is going through a transformation as a result of:**
 - Sarbanes-Oxley legislation
 - SEC regulations
 - Accounting rule changes
 - Pressures from investors, pension funds, unions and governance groups
 - Media spotlight and increased litigation and enforcement
 - Recent monetary settlements relating to corporate governance and executive compensation issues

Continued Growth in Board Pay Levels

- Continued growth in board compensation, but somewhat more modest following two years of double-digit gains
- Modest growth rates suggest that many companies have already made adjustments to reflect increases in workload and potential liability resulting from Sarbanes–Oxley and other external factors

Median Total Direct Compensation (a) by Company Size

Company Size	2006	2005	2006 vs. 2005	Prior Year-to-Year Trends (b)			
				2005 vs. 2004	2004 vs. 2003	2003 vs. 2002	2002 vs. 2001
Smaller (\$50 - \$500 mil)	\$74,332	\$64,036	16 %	11 %	36 %	-10 %	1 %
Small (\$500 mil - \$1 bil)	\$110,500	\$103,605	7	15	20	11	7
Medium (\$1 - \$2.5 bil)	\$132,760	\$129,863	2	16	23	9	9
Large (\$2.5 - \$10 bil)	\$157,165	\$145,000	8	16	22	7	7
Top 200 (> \$10 bil)	\$204,975	\$182,304	12	11	14	1	1

(a) Source: 2006-2007 NACD Director Compensation Report

(b) Prior surveys reported average data rather than median. Year-to-year changes represent change in average compensation levels.

Continued Growth in Board Pay Levels (cont'd)

- Year-over-year changes in median compensation levels by pay element and by company size are:

Median Total Direct Compensation and Year-to-Year Comparison by Company Size (a)										
	Smaller		Small		Medium		Large		Top 200	
	2006	2006 vs. 2005	2006	2006 vs. 2005	2006	2006 vs. 2005	2006	2006 vs. 2005	2006	2006 vs. 2005
Cash Compensation										
Cash Retainer	\$20,000	0 %	\$25,000	0 %	\$30,000	0 %	\$40,000	0 %	\$57,500	15 %
Board Meeting Fees (b)	10,000	11	12,000	14	12,000	0	12,000	0	14,000	0
Total Committee Fees	12,167	10	18,667	12	20,000	1	23,333	6	25,000	7
Total Cash (c)	\$40,850	7 %	\$55,500	9 %	\$62,458	8 %	\$75,667	8 %	\$91,000	11 %
Stock Compensation										
Stock Options (b)	\$32,162	10 %	\$44,085	2 %	\$65,533	6 %	\$63,456	13 %	\$73,433	0 %
Full-Value Share (b)	29,308	47	40,000	17	49,948	11	60,000	4	90,000	20
Total Stock Award (c)	\$28,908	45 %	\$47,500	5 %	\$67,833	5 %	\$75,000	10 %	\$100,000	4 %
Total Direct Compensation (c)	\$74,332	16 %	\$110,500	7 %	\$132,760	2 %	\$157,165	8 %	\$204,975	12 %

(a) Year-to-year growth includes 2005 compensation adjusted for updated revenue ranges.

(b) Board meeting fees, stock options and full-value share awards reflect median of those companies using pay component (i.e., summary data exclude zeros).

(c) Median figures are non-additive.

Source: 2006-2007 NACD Director Compensation Report and the 2006 PM&P Director Compensation Report

■ Smaller Companies following the Lead of Top 200

- Top 200 companies leading the way by introducing new directions in structure and level of compensation, with changes gradually extending to other revenue groups

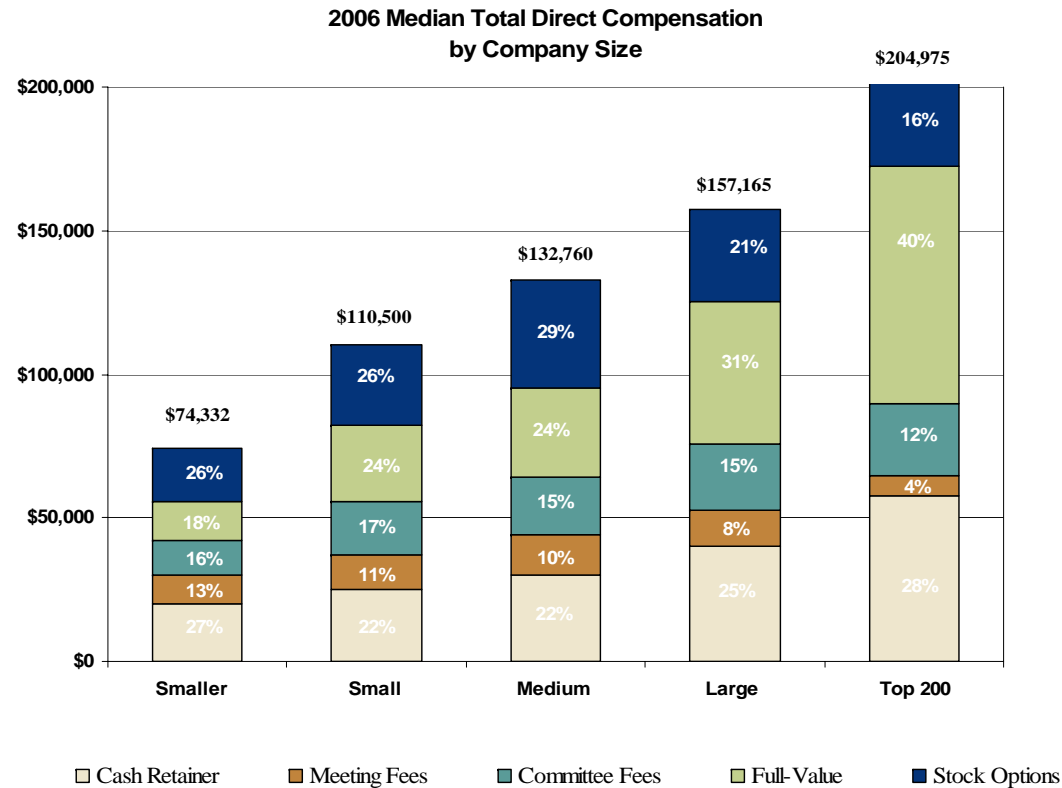
2006 Prevalence of Pay Elements by Company Size

	Smaller	Small	Medium	Large	Top 200
Cash Compensation					
Annual Cash Retainer	92%	95%	97%	97%	99%
Board Meeting Fees	73%	76%	72%	71%	54%
Committee Fees/Retainers	82%	89%	84%	87%	76%
Chair Fees/Retainers	94%	96%	96%	97%	98%
<i>Differentiate Committee Pay</i>	70%	76%	72%	76%	75%
Equity Compensation					
Full-Value Shares					
Unrestricted Stock	21%	21%	24%	36%	27%
Restricted Stock	30%	39%	40%	43%	42%
Deferred to Retire	4%	9%	12%	19%	51%
Total	49%	61%	66%	78%	90%
Stock Options	55%	54%	55%	44%	41%
All Stock Awards	86%	94%	93%	95%	99%

Source: 2006-2007 NACD Director Compensation Report and the 2006 PM&P Director Compensation Report

Board of Director Pay Mix

- Delivery of director pay programs continues to evolve in response to the increased demands of new regulatory constraints and rising shareholder expectations



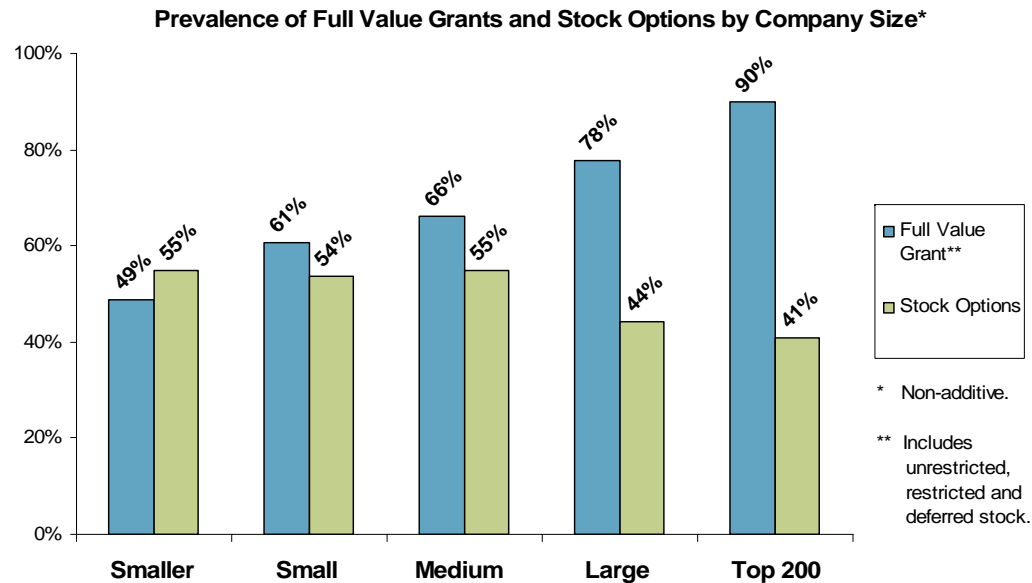
Source: 2006-2007 NACD Director Compensation Report and the 2006 PM&P Director Compensation Report

■ Annual Board Retainer / Meeting Fees

- **Annual retainer continues to be the most widely used component of board pay**
- **Overall, gradual shift away from use of Board meeting fees**
 - Ease of administration; response to critics views that “meeting attendance is part of the job”

■ Full-Value Stock Use Favored Over Options

- Responding to shareholder concerns regarding the appropriateness of option grants for directors, companies continue to curb option use in favor of full-value stock
 - Among the NACD companies, full-value equity is more prevalent than options and is used by more than 50% of the companies in all but the Smaller companies:



■ Committee Compensation

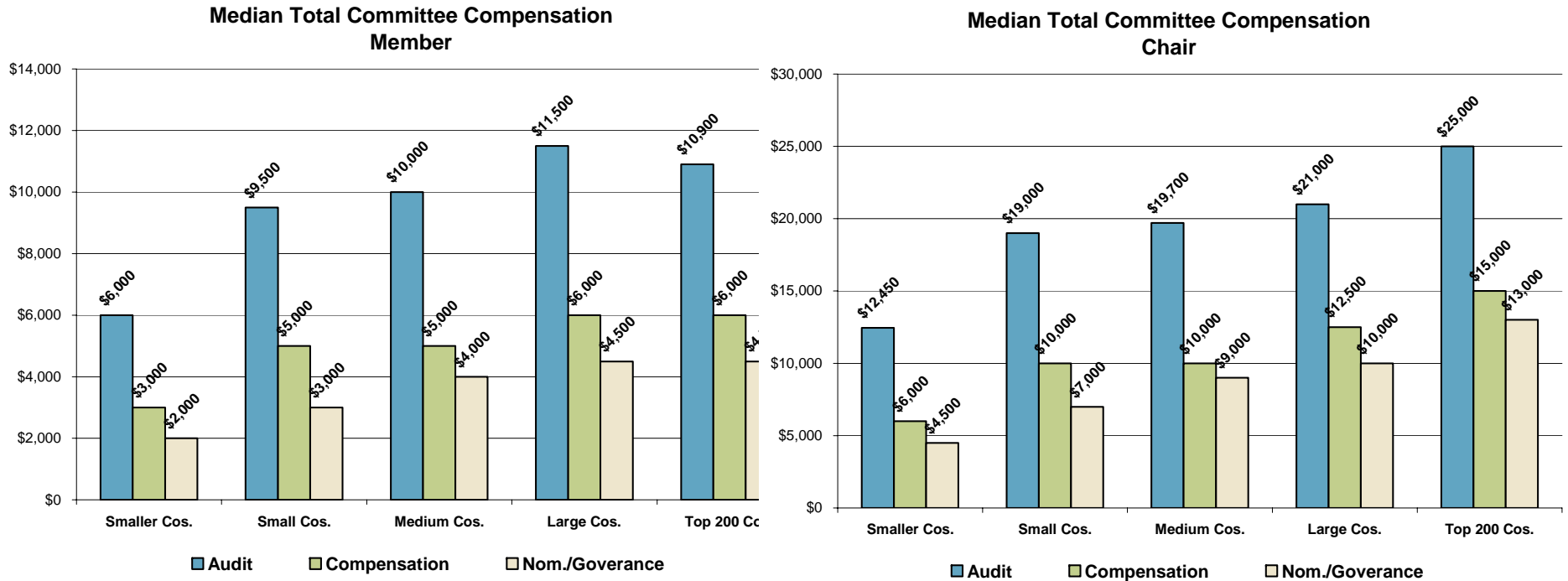
- **Number of companies electing to vary compensation for service on key board committees continues to rise**
 - Differentiation in pay is intended to address the greater workload and responsibilities of the audit, compensation and governance/nominating committees, where a significant portion of major board business takes place
 - Among Top 200 and NACD companies, differentiation of committee pay is now a significant majority practice across all companies, ranging from 70% to 76% prevalence

■ Committee Service and Compensation (cont'd)

- **Significant growing trend of paying extra compensation to committee chairs, especially committee retainers compared to meeting fees**
- **For committee chairs, committee retainers are more prevalent than meeting fees; however, for regular committee members, committee meeting attendance fees are more prevalent than committee retainers, although the prevalence of attendance fees continues to decline**

Committee Service and Compensation (cont'd)

- Audit Committee members earn a meaningful premium over other committee members, as do the Audit Committee Chairs



Source: 2006-2007 NACD Director Compensation Report and the 2006 PM&P Director Compensation Report

■ About Pearl Meyer & Partners

- **Founded in 1989, Pearl Meyer & Partners (PM&P) is a premier compensation consultancy, serving as trusted advisor to Boards and their senior management in the areas of governance, strategy and compensation program design**
- **7 locations (New York, Boston, Charlotte, Chicago, Houston, Atlanta, LA)**
- **102 employees**
- **More than 1,000 clients (serving all industries and all types of firms including not for profits, IPOs to Fortune 500)**
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