



TRENDS AND ISSUES REPORT

Executive Pay in the New Economy February 2009 Results



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Executive Summary

The Pearl Meyer & Partners online survey series “**Executive Pay in the New Economy**” asks board members, executives and human resources professionals about the likely impact of recent financial turmoil on executive pay programs. The first edition (in early November 2008) received 410 responses, while the latest edition closed on February 6, 2009 and received 436 responses.

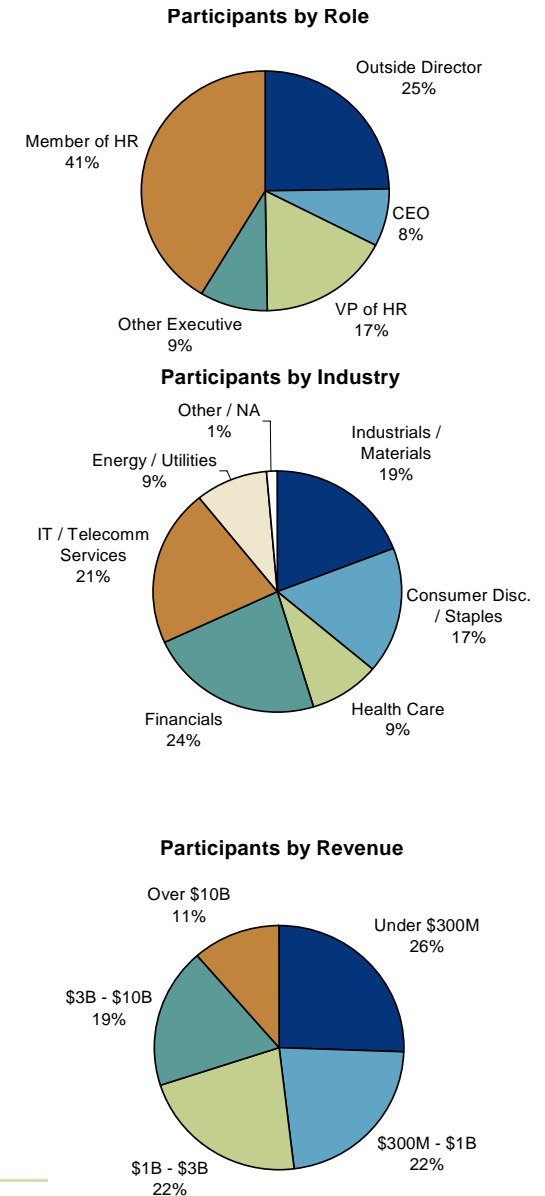
- In addition to this *Trends and Issues* report, you may also replay our February 11th webcast, “Executive Pay in the New Economy – Updated Data and Guidance” by going to pearlmeyer.com.
- For questions regarding the data, contact Jim Heim, Managing Director, jim.heim@pearlmeyer.com or 508-630-1502.

Approach and Methodology

The latest edition of the survey was conducted from January 15 through February 6, 2009. The 436 respondents represent organizations from a broad variety of industries and ownership structures, and include 108 “outside directors” and 328 “employees of the firm.”

Topics addressed included:

- Base Salaries.
- Bonus Payouts.
- Long Term Incentives and Equity Awards.
- Severance and Security Arrangements.

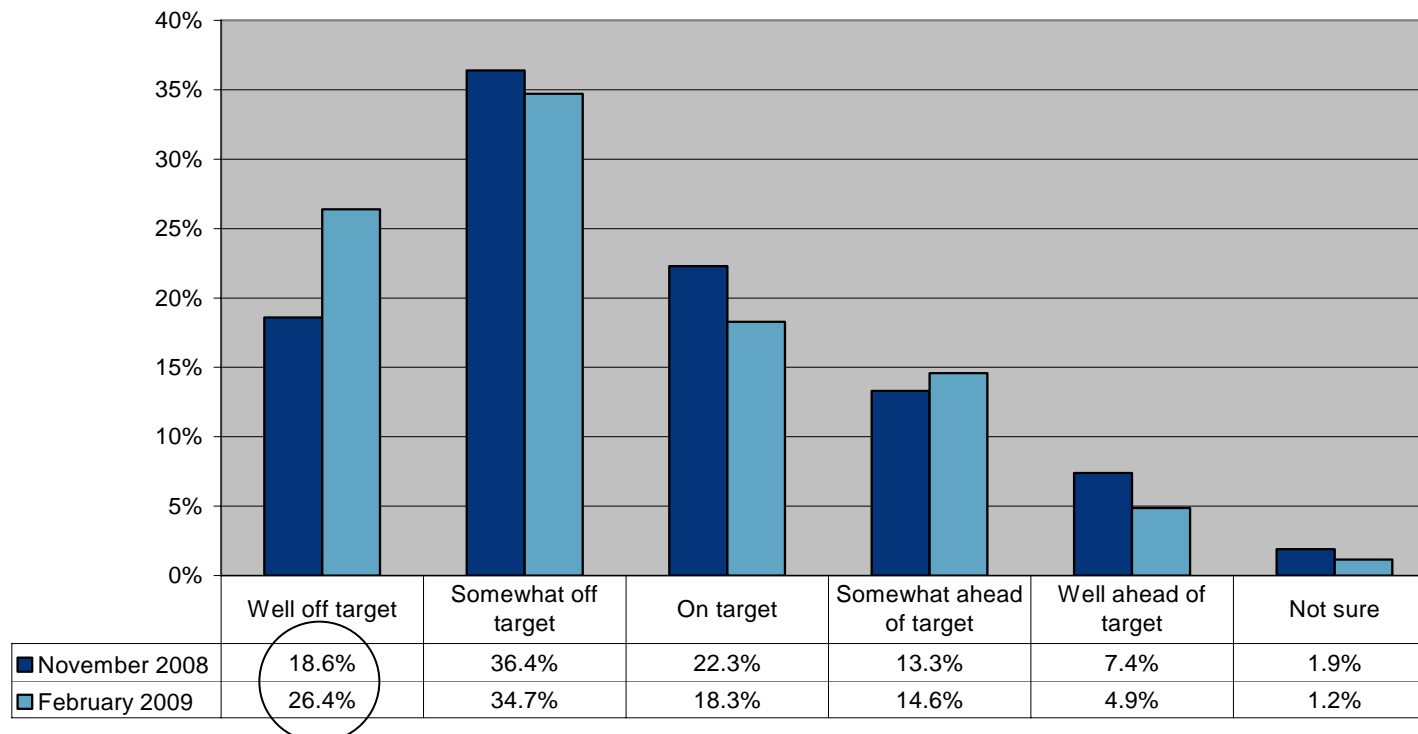


Key Findings

Assessment of Performance vs. Plan or Budget

We observed a marked increase in the number of companies that reported 2008 company performance was “well off target” as compared to the November responses. Interestingly, there was a fairly broad distribution of performance given that the S&P 500 was down more than 34% in 2008. While 61% of respondents indicated that performance was “well off” or “somewhat off” target, 18% reported that results were “on target”...and 20% actually beat their internal benchmarks in this challenging environment.

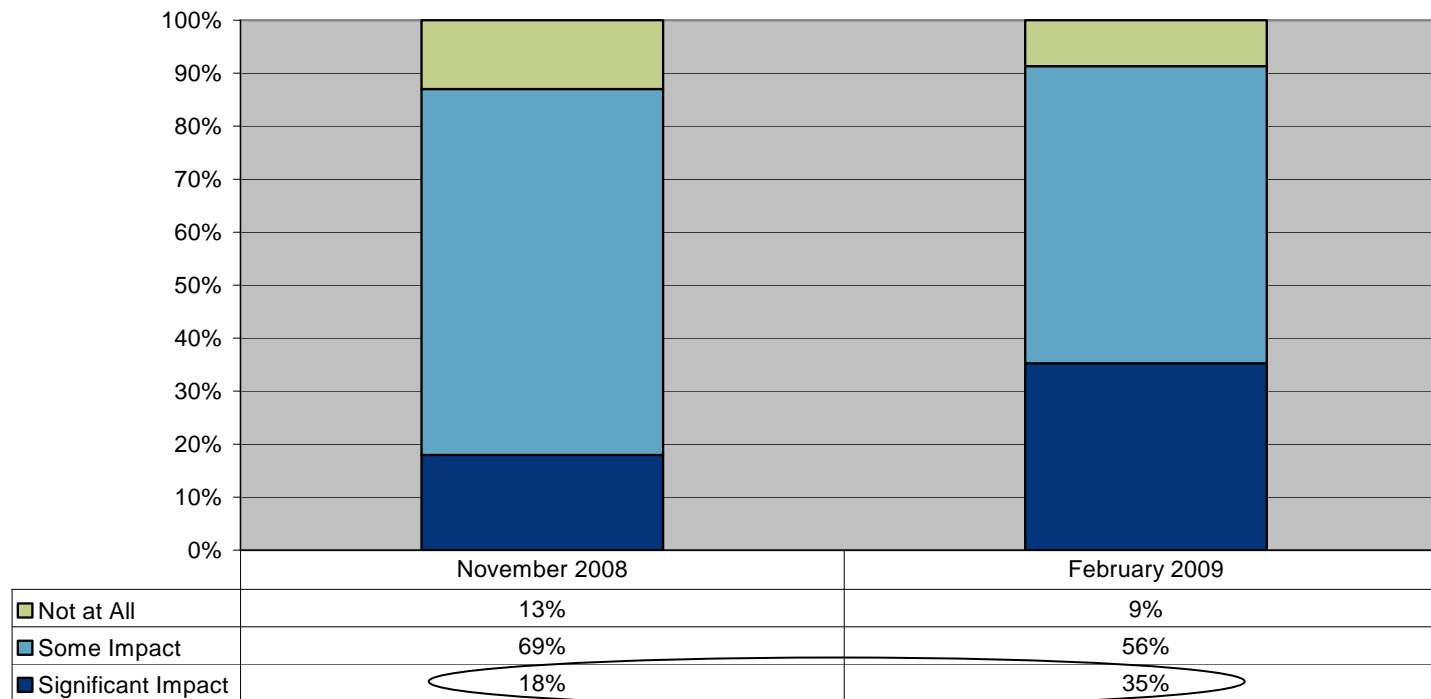
Assessment of 2008 Performance vs. Plan or Budget



Impact of Financial Market Turmoil on Pay Decision Making

The number of respondents indicating that recent financial market turmoil would “significantly” impact their pay decision making process nearly doubled between November and February. Those responding that financial market turmoil will either impact their process “some” or “not at all” may be indicating that they are generally comfortable with the processes that lead to their pay decisions (e.g., what external market data is considered, how internal performance targets are set, how pay is intended to scale up and down in line with performance, etc.) even if outputs (the pay decisions themselves) may differ significantly this year.

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



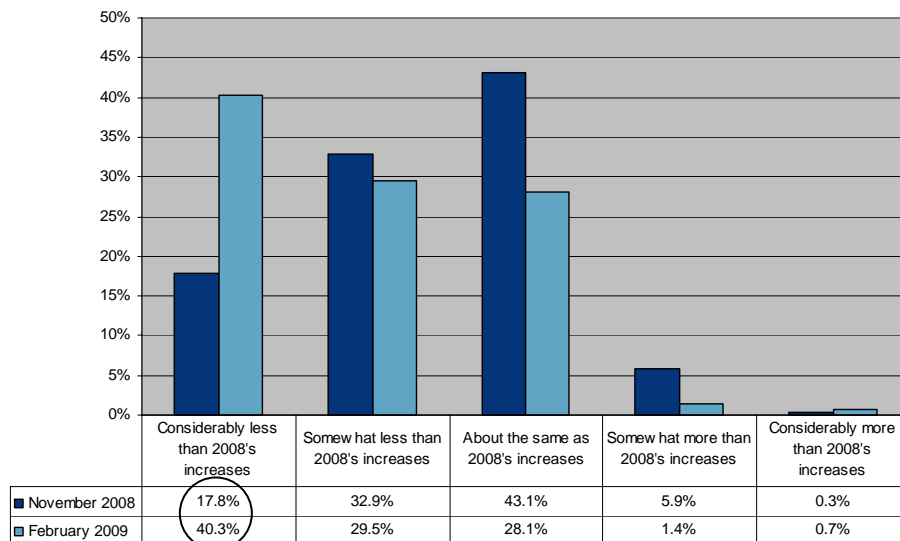
Base Salaries

We observed a significant shift in anticipated 2009 executive base salary increases over the past three months (with 40% of February respondents anticipating an increase “significantly less” than in 2008), as well as in the number of respondents who are “strongly” considering or have already implemented an executive base salary freeze for 2009.

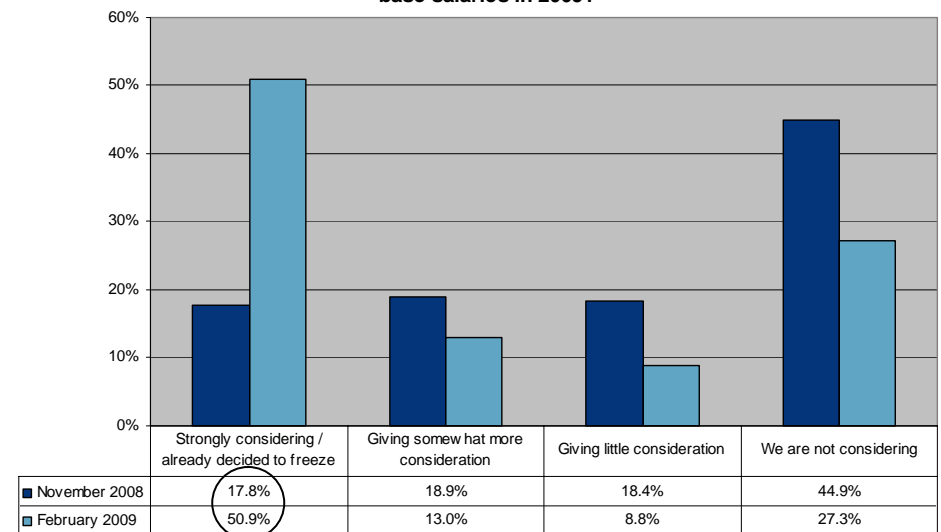
One possible explanation is that Compensation Committees had been holding off on any “pre-conceived” freeze until reviewing the outcome of their usual compensation setting process. These reviews are now complete, and many companies have evidently concluded that a freeze is in fact appropriate.

Given that base salaries are such a transparent component of pay (easily relatable to employees, media and shareholders), it’s clear that any increases will receive more attention than in the past. With this as a backdrop, and considering that base salary continues to be a relatively small portion of the typical executive’s total pay package, it’s quite possible that many Compensation Committees concluded that a 0% increase is a better disclosure and not particularly punitive from the executive’s perspective as compared to a 1%, 2%, or 3% bump.

Anticipated Executive Team Base Salary Increases for 2009



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



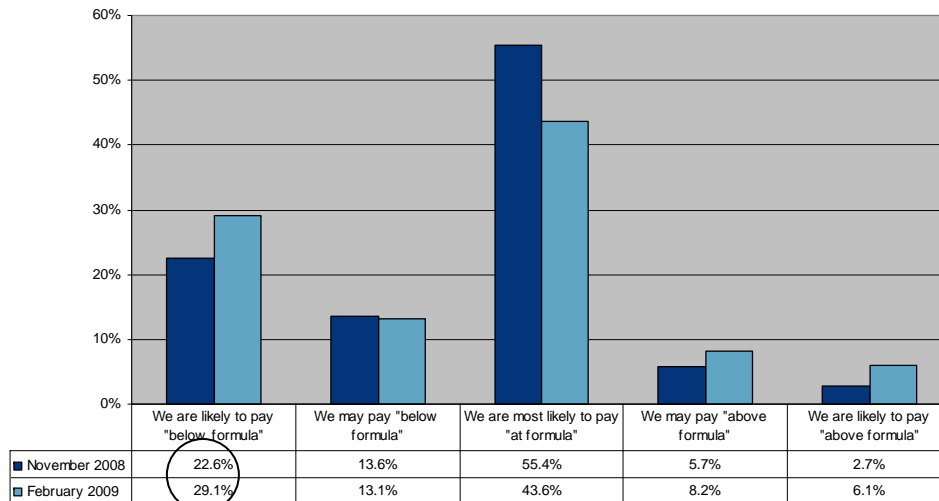
Bonus Payouts

Only 44% of respondents said they expect to pay this year's incentive payout "at formula." More than 42% said they may exercise discretion to pay a bonus that is "below formula" – that is, less than what executives "earned" based on achievement against the plan's stated objectives. This suggests that many companies believe they may need to correct a disconnect in their goal-setting process in order to better align their executive rewards with market performance.

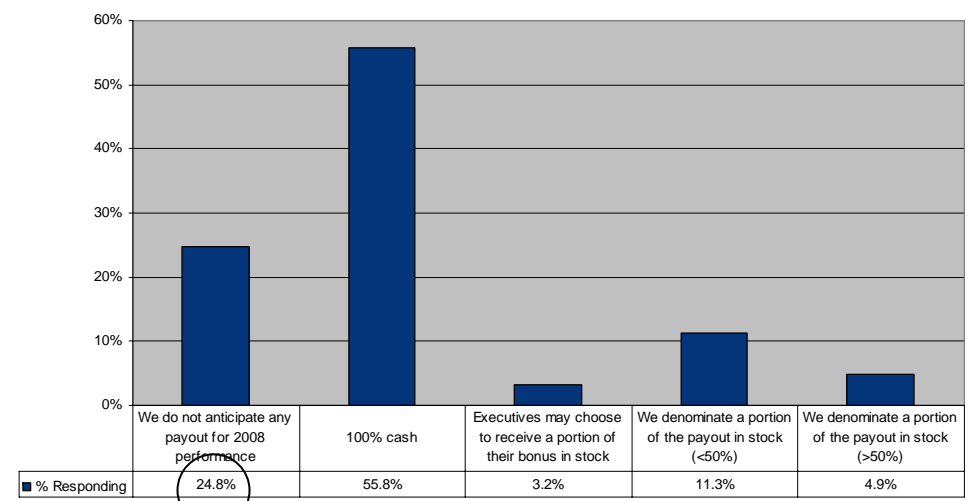
Interestingly, nearly 25% of respondents indicate that there will be no bonus award for 2008 performance at all.

A number of firms are denominating their 2008 bonus awards at least partially in stock rather than cash. In an environment where cash flow is less than stellar, this approach can become particularly attractive and the award may be structured to include time-based vesting restrictions that provide retention "glue" (e.g., the stock may not vest for one, two, or three years). In these scenarios, accounting expense may also be spread out over the vesting period. The challenge from the company's perspective is that it may take some inducement to convince executives to forgo the liquidity of cash. Companies denominating payouts in the form of stock may have to add an extra 10% to 25% value relative to cash to keep executives' "perceived value" constant.

Which statement best describes whether you may exercise discretion in 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?

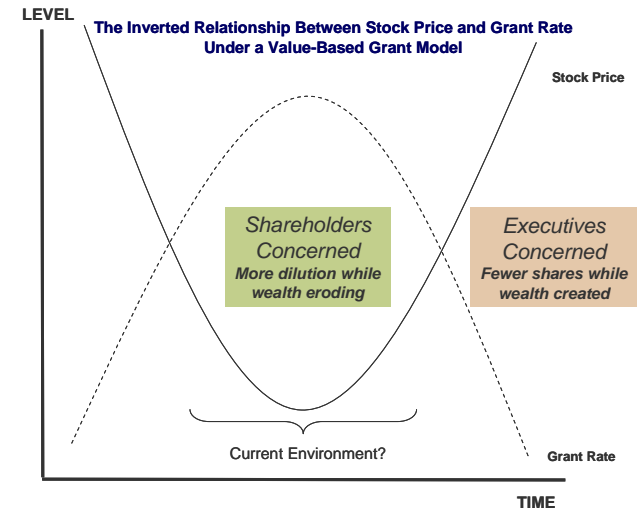


Long-term Incentives: Setting Equity Award Grant Levels

Historically, many firms have used a value-based grant model to determine how many shares to grant to executives on an annual basis. In other words, a competitive value is derived from external market data, and the number of shares to grant is calculated by dividing the competitive value by the accounting cost (as proxy for economic value) of a single option or restricted share. This approach begins to break down when stock prices fall steeply, as (a) the number of shares that must be granted to match “competitive value” increases significantly, and (b) it is difficult to determine “competitive value” since external market data likely reflect grants that were made when the economic outlook was rosier. The chart to the right illustrates these challenges.

When we asked survey respondents to describe their company’s approach to determining the number of shares to grant (for awards made to executives at the end of 2008 or beginning of 2009), a plurality indicated that they continue to reference market data and attempt to match the economic value. However, other approaches are being explored.

Our client experience suggests that many companies are refining market data in some manner in recognition that share prices have fallen substantially since the data were collected.



“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%

Long-term Incentives: Award Values and Burn Rates

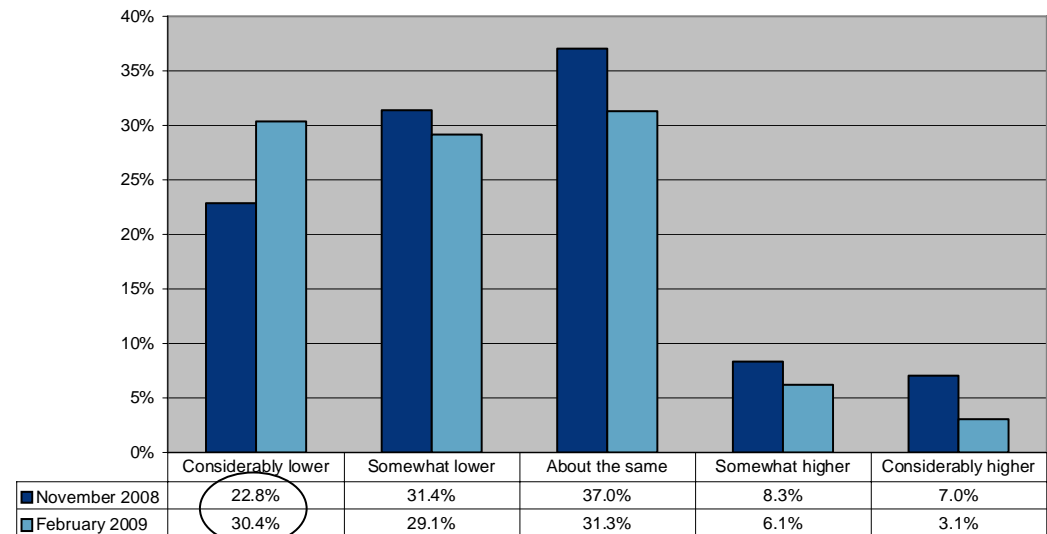
Relative to November, our February results indicate a greater proportion of respondents will set executive award levels at a level that is considerably lower than the prior year. What remains unclear is whether these results reflect a general sense that performance is down and therefore award levels should be cut accordingly, or if the lower grant levels are a result of a more sophisticated data-driven analysis of the issue.

Interestingly, we did not find clear evidence that overall burn rates would rise. Our sense is that the total number of shares that will be granted to executives will increase year-over-year. Although the economic value of awards will fall, we don't believe the drop will be in line with the drop in share price – for example, if 10,000 shares were granted at \$10 in the prior year, 12,500 shares may be granted at \$6 in the current grant cycle.

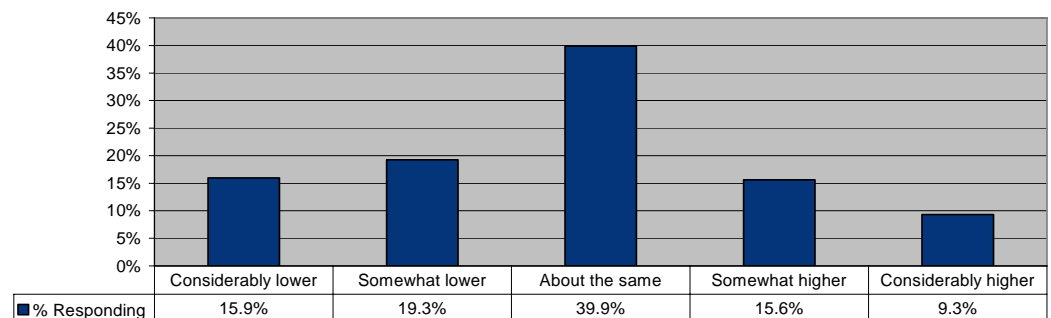
Why are respondents not indicating that overall burn rates will increase in line with executive burn rates? It's likely that non-executive populations will be receiving fewer shares.

- Increased layoffs mean that there are fewer eligible employees in general.
- Less hiring activity translates into fewer new hire grants.
- Grant eligibility below the executive level may be reduced.

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



"Relative to the prior year's burn rate, do you anticipate that this year's burn rate will be..."



Long-term Incentives: Addressing Underwater Stock Options

Broadly speaking, alternatives for addressing underwater stock options include:

- 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.

5.8% of respondents indicated that they would in fact likely institute some manner of exchange in the next 6 months, while an additional 1.6% indicated that they had either just completed or were in the midst of an exchange.

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

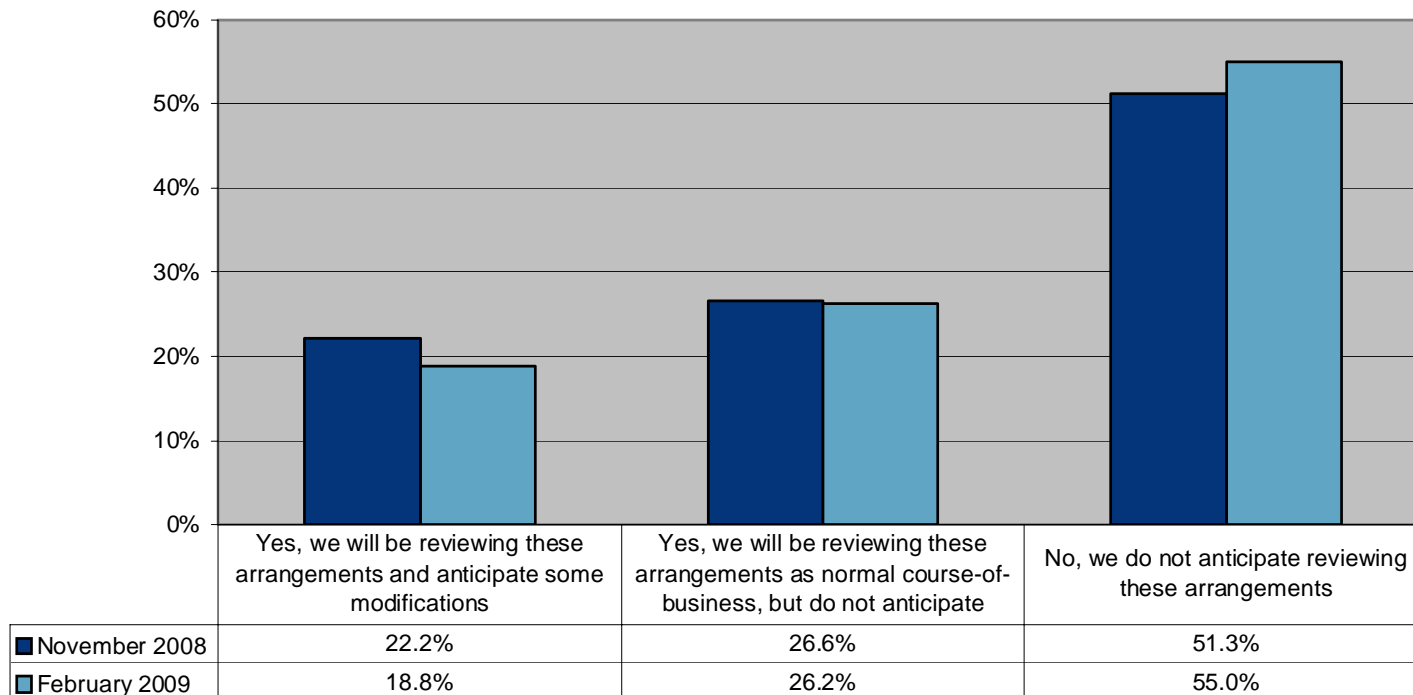
Reason for not pursuing an underwater stock option exchange program	% Responding
Anticipated difficulty in garnering support from shareholders	43%
A repricing / restructuring /exchange would run counter to overall compensation philosophy	34%
Decided to preclude action until it is confirmed that share 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 their decision (in other words, reconsider an exchange program) in the next 12 months.

Severance

No clear trends emerged from questions relating to severance and security arrangements. It may be safe to conclude that these arrangements are reviewed on their own schedule regardless of economic swings. (Unless, of course, your company is receiving TARP money or other bailout funds, in which case an intensive review of severance programs is likely underway.) A wide variety of severance pay restrictions are being contemplated under the various government bailout programs, and it's likely that institutional investors and proxy vote advisors such as RiskMetrics Group will continue to consider severance and security arrangements when deciding whether to withhold votes from Compensation Committee members who come up for re-election.

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



Variations by Industry

While responses were generally consistent across industries, a few differences did emerge. For example:

- Consumer Discretionary / Staples firms (e.g., the Retail sector) had a high response rate with regard to anticipated base salary freezes. It's not surprising that this hard hit sector which closely monitors margins would carefully examine base salary levels.
- Only 3% of Energy / Utilities firms are anticipating a \$0 annual incentive payout for 2008 performance. The Utilities industry is highly regulated and in some sense insulated from short-term market downturns, while Energy firms tend to have incentive programs designed to accommodate price volatility, so even a very low performance level will trigger some form of payment (although the payment will likely be lower than the prior year).
- Interestingly, Industrials / Materials firms are most likely provide an equity award that is significantly lower year-over-year. These sectors are generally not as equity-focused in their pay programs as, for example, technology firms may be. They also tend to embrace defined benefit pension programs and SERPs to a greater extent than other sectors. Consequently, lowering equity award values for executives at these firms may not be as painful as it would be in sectors where equity awards dominate pay discussions.

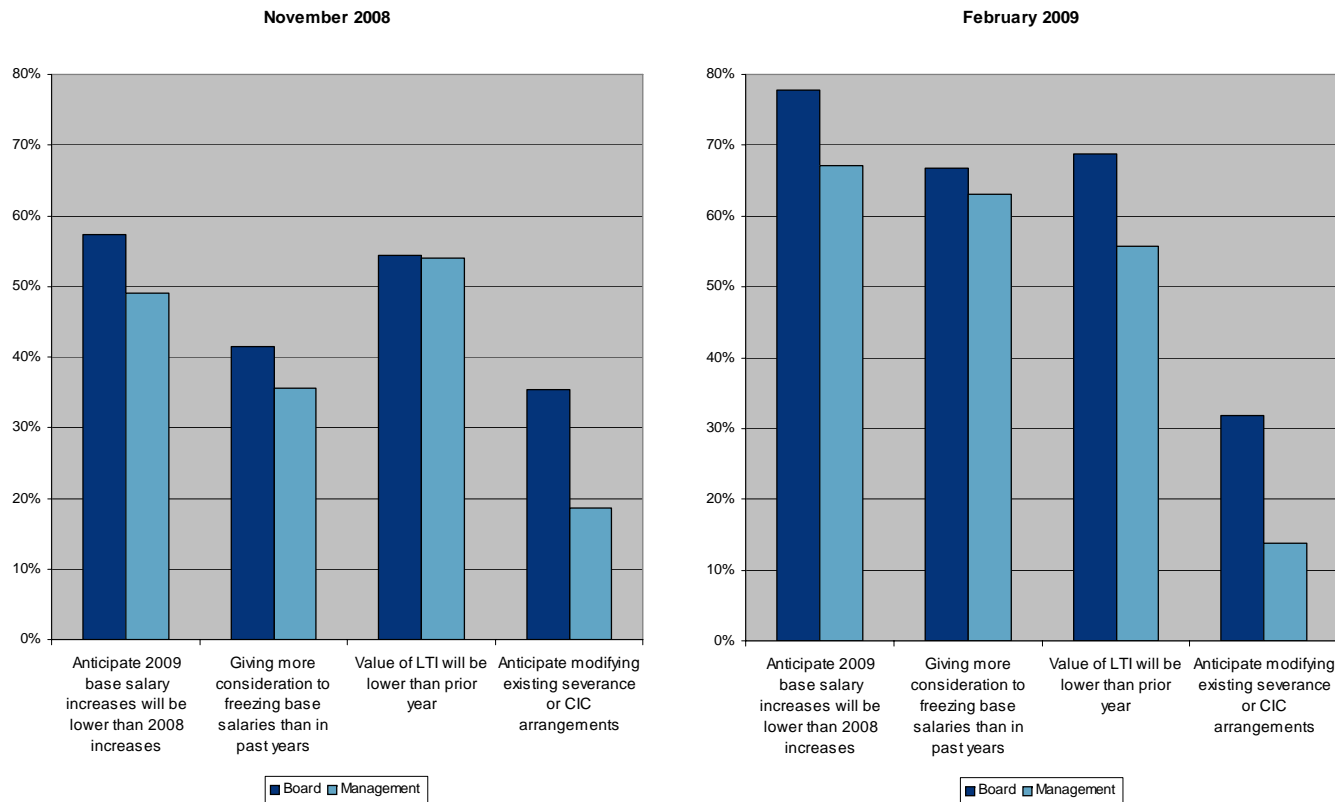
% Agreeing with the Following Statements	Industry					
	Industrials / Materials	Consumer Disc. / Staples	Health Care	Financials	Info Tech / Telecomm Services	Energy / Utilities
We have decided to freeze or are strongly considering freezing base salaries for 2009	51%	62%	40%	43%	59%	47%
We do not anticipate (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

When comparing responses from employees of the firm to those of outside directors, what was most notable was that February responses were much more “negative” than November responses (with the exception of the topic of severance arrangements, where attitudes held steady). The second theme that emerged in February was that management and board members were generally of like minds on topics such as base salaries and the value of long-term incentive grants, with board members perhaps a little more aggressive in anticipating lower pay.

This suggests that management and board members are generally on the same page in terms of anticipating change, which should allow for an environment that’s conducive to productive discussion (rather than contentious negotiation) when setting 2009 pay levels.





About Pearl Meyer & Partners

For twenty years Pearl Meyer & Partners (www.pearlmeyer.com) has served as a trusted independent advisor to Boards and their senior management in the areas of compensation strategy and program design, compliance and reporting, and committee structure, policies and procedures. The firm provides comprehensive solutions to complex compensation challenges for companies across all industries ranging from the Fortune 500 to smaller private companies and not-for-profits, as well as emerging high-growth companies. These organizations rely on Pearl Meyer & Partners to develop programs that align rewards with long-term business goals to create value for all stakeholders: shareholders, executives, and employees. The firm maintains offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston and Los Angeles.

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