Age of Alignment: Linking Compensation & Business Strategy

Compensation Series

December 16, 2014
Meet The Presenters

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Submit questions and comments anytime during the webinar.

Click the buttons below to access additional resources.
Housekeeping

Click below for a copy of the slides.

Slides are also available at pearlmeyer.com/ageofalignment
You will automatically receive 1 NACD skill-specific credit for your participation.

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The replay and slides will also be available early next week at NACDonline.org/webinars and pearlmeyer.com
Today’s Discussion

• What should be the role of the Board as it relates to corporate strategy?
• Why is it important to link pay and strategy?
• What are the hallmarks of a strategically-aligned pay program?
• What are some approaches for developing strategically-aligned pay programs?
• What methods can a Board use to evaluate the degree to which current or proposed pay programs are aligned with strategy?
• How does the Board ensure ongoing alignment of pay and strategy?
If Directors are too hands-off they may fail to fully understand the options and risks the company faces, and they may miss the opportunity to influence strategy in positive ways.

Too far on the other side of the spectrum, Directors risk crossing the line from oversight into management, which can undermine the board’s ability to hold management accountable for the strategy.

*Source: NACD Blue Ribbon Commission on Strategy Development*
Ten Recommendations for Strategy Engagement

NACD Blue Ribbon Commission on Strategy Development

1. Expect change and understand how it may affect the company’s current strategic course
2. Engage with management on strategy issues on an ongoing basis, including early involvement
3. Evaluate strategy options and underlying assumptions in good times, as well as in times of change or crisis
4. Divide the strategy into elements that are tied to performance drivers and critical assumptions, and revisit throughout the year
5. Communicate to management the expectation that strategies are brought to the Board in the early stages to allow for open discussion
6. Establish an effective and collaborative relationship between the Board and CEO via the chair or lead Director
7. Consider Director experience and expertise in relation to the strategic role of the Board as part of nomination decisions
8. Develop consensus with management on forward-looking metrics that will be indicators of the success/failure of a chosen strategy
9. Hold executive sessions at the beginning and end of each Board meeting to allow directors to freely discuss strategy
10. Establish a relationship with key investors when performance is good to ease conversations that may arise during more challenging times.

NACD Blue Ribbon Commission on Strategy Development Recognizes the effect disruptive market forces have on strategy

- Raises the bar in frequency and degree of Board involvement
- leverages Board experience and expertise
- Fosters and open and candid relationship with management
- Recognizes the importance of aligning compensation with business strategy
Importance of Aligning Pay and Strategy

Linking strategy and pay is a primary concern in 2015*:

- External pressures create challenges
- Recognition of the importance of getting pay “right”
- Opportunity to use pay design as a competitive advantage
- Strategy is only as good as employees’ ability to execute

*Pearl Meyer On Point Survey: Looking Ahead to Pay Practices in 2015; approximately 300 Director and management respondents

Greatest Challenges for Executive Compensation in 2015*

- Aligning executive incentives with business strategy and objectives: 70%
- Attracting/retaining executives: 60%
- Aligning executive pay and performance: 50%
- Significantly improving performance: 40%
- Preparing for or responding to legislation: 30%
- Managing dilution and overhang: 20%
- Preparing for Say-on-Pay: 10%

* % Responding “To a moderate extent” or “To a great extent”
Importance of Aligning Pay and Strategy

• Signals to employees the importance of the chosen strategy

• Reinforces employee understanding and acceptance of the strategy

• Creates a virtuous cycle where increased understanding drives aligned actions which helps accomplish the chosen strategy
Importance of Aligning Pay and Strategy

- Developing a business strategy inherently involves prioritization.
- A value driver analysis can reveal the key drivers of enterprise value.
- A value driver analysis can highlight key determinants of success.
- It can also be used to vertically cascade performance metrics and goals into the organization.
1. **Balances Driver and Outcome metrics**
   - Driver ("Lead"): strategic imperatives
   - Outcome ("Lag"): financial results

2. **Balances Alignment and Accountability**
   - Alignment: line of sight; ability to influence
   - Accountability: absolute; relative

3. **Considers both “What” and “How”**
   - What are the results (measurable)
   - How the results were attained (discretion)
Developing Strategically Aligned Pay Programs

✓ Business and Leadership strategy drive program design

✓ External practices and views inform program design

Understand Key Drivers

Business Strategy

Leadership Strategy

Review/Design Programs

Compensation Philosophy & Strategy

Compensation Program Design

Implementation and Communication

Business Results

Concept in Practice #1
Conscious Deviation from Market Norms
• Drive competitive advantage
• Create value proposition differentiation
**Concept in Practice #2**
Incorporating Value Drivers into a Balanced Scorecard

Value drivers are comprised of lead metrics that drive value creation.

A scorecard can be used for merit or bonus determination.

Weight is given to metrics of key strategic priority and line of sight.

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</tr>
</thead>
<tbody>
<tr>
<td>Financial</td>
<td>40%</td>
<td>Year over year sales growth</td>
<td>5%-10% YoY growth</td>
<td>4%</td>
<td>7%</td>
<td>--</td>
<td>--</td>
<td>1.0</td>
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<td></td>
<td></td>
<td>New business from customers in the mid-Atlantic region</td>
<td>6-8 new or returning customers</td>
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<td></td>
<td></td>
<td>Booked business for FY2015</td>
<td>$1.0-$1.5M</td>
<td>$1.3M</td>
<td>$1.4M</td>
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<tr>
<td>Customer</td>
<td>40%</td>
<td>Third-party customer survey satisfaction scores</td>
<td>80% or greater “very satisfied”</td>
<td>86%</td>
<td>88%</td>
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<td></td>
<td></td>
<td>Proportion of returning customers</td>
<td>95%</td>
<td>95%</td>
<td>90%</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Customer referrals</td>
<td>10% or greater new customers referred</td>
<td>8%</td>
<td>3%</td>
<td>--</td>
<td>--</td>
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<tr>
<td>Process</td>
<td>10%</td>
<td>New product development, enhancement or improvement</td>
<td>New products developed in consultation with BD</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
<td></td>
<td>1.0</td>
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<tr>
<td></td>
<td></td>
<td>New sales logged in Salesforce tracking system</td>
<td>95% of above of sales logged within 24 hrs</td>
<td>100%</td>
<td>100%</td>
<td></td>
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<tr>
<td>Talent &amp; Technology</td>
<td>10%</td>
<td>Cross-sales with other Business Development staff</td>
<td>5% of sales arise from regional cross-sell opportunities</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
<td></td>
<td>1.0</td>
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<tr>
<td></td>
<td></td>
<td>Involvement in recruitment and training of new BD staff</td>
<td>Hiring, Hiring, Training</td>
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*Weight will vary by role and level

2014 Scorecard Factor: 88
Developing Strategically Aligned Pay Programs

**Concept in Practice #3**
Balancing Line of Sight and Accountability in an LTI Program

- Organization employed three LTI vehicles to achieve specific goals
- Vehicle eligibility varies based on ability to influence results

<table>
<thead>
<tr>
<th>Program Participants by Vehicle</th>
<th>Key Objectives Realized</th>
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<tbody>
<tr>
<td><strong>Stock Options</strong></td>
<td>Shareholder Alignment</td>
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<tr>
<td>Senior Leadership</td>
<td></td>
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<tr>
<td>Management</td>
<td></td>
</tr>
<tr>
<td>Other Participants</td>
<td></td>
</tr>
<tr>
<td><strong>Performance Shares</strong></td>
<td>Accountability for Results</td>
</tr>
<tr>
<td>Senior Leadership</td>
<td></td>
</tr>
<tr>
<td>Management</td>
<td></td>
</tr>
<tr>
<td>Other Participants</td>
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<tr>
<td><strong>Restricted Stock</strong></td>
<td>Line of Sight</td>
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<tr>
<td>Senior Leadership</td>
<td></td>
</tr>
<tr>
<td>Management</td>
<td></td>
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<tr>
<td>Other Participants</td>
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</tbody>
</table>

- **Performance Shares** based on Lag Metrics: EPS growth and Relative TSR
- # of **Restricted Shares** contingent on attainment of Lead Metrics based on level (e.g., succession planning and foreign market sales for CEO)
Evaluating Current Pay and Strategy Alignment

Understanding and Gauging the Level of Alignment

There are many ways to measure the link between business strategy and compensation.

Analysis does not have to be conceptual or abstract.

Examination can be done methodically and quantitatively.

Tools and models provide solid frameworks for analysis.

1. Metrics Correlation Analysis
2. Probability of Achievement Analysis
3. Pay for Performance Analysis
**Evaluating Current Pay and Strategy Alignment**

**Sample Analysis: Metrics Correlation Analysis**

- **Metrics Correlation Analysis** helps illustrate the strength of the link between various company and/or departmental metrics and outcome; when done correctly, companies create strong line of sight and influence.

Various metrics can be examined

Output can include various growth or static measures that “drive value”

Correlation is determined based on regression

Analysis may call into question use of mediocre or ineffective metrics

Metrics with the highest correlation are highlighted

Sometimes more than one metric is appropriate
Evaluating Current Pay and Strategy Alignment

Sample Analysis: Probability of Achievement Analysis

- **Probability of Achievement Analysis** is designed to take a deeper look at financial metrics, goal achievement, company and peer performance, and implications on the shape of payout curves for STI and/or LTI programs.

-Historic achievement of goals is examined.

-Peer group data is used to help calibrate difficulty.

-Threshold, target and maximum performance levels are determined.

-Analysis can inform actual pay decisions.

-Historic company performance is displayed relative to peers.

-Analysis can be repeated to arrive at an optimal design.
Pay for Performance Analysis examines the link between corporate performance and pay, and is another way to evaluate the link between compensation and business strategy.

Sample Analysis: Pay for Performance Analysis

- Pay and performance misalignment and shareholder concerns
- Pay and performance are aligned
- Pay and performance misalignment and executive concerns

Diagram:
- Low Performance – High Pay
- Low Performance – Low Pay
- High Performance – High Pay
- High Performance – Low Pay

Alignment Corridor:
- Compensation Earned Versus Peers
- Performance Ranking Versus Peers
Post-Design Feedback

Creating an enduring link between business strategy and compensation requires regular review and maintenance.

1. Review and Re-assess
   - How are the plans working out?
   - Are they still aligned with strategy?
   - Do we need to make changes?

2. Re-confirm / repeat
   - If no concerns, maintain business as usual; but keep asking tough questions

2a. Revise or replace
   - Has business strategy changed?
   - How do we adjust our plans?
   - To what extent do they need revision?

3. Re-evaluate
   - Conduct analyses
   - Compile research
   - Synthesize input and inform the review process

Regular cadence is annual, but should be an on-going process.
Questions
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“Board Preview: What’s Next for Director Compensation”
January 29, 2015

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