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Escaping the Conformity Trap: Aligning Executive Pay Programs With Business and Leadership Objectives

By Pearl Meyer & Partners

The vast majority of companies in corporate America dedicate significant resources to developing and executing a business strategy that is customized to their business and focused on driving and sustaining long-term enterprise value creation. To effectively execute on their customized business strategies, companies and their boards spend ample time on selecting and developing leadership talent that exhibit the specific competencies, skills, and attributes that fit their desired organization and cultural profiles.

Yet when it comes to aligning compensation with those distinct and company-specific business objectives and leadership talent development imperatives, all too often companies default to “one-size-fits-all” executive pay programs. Such programs are predicated on external acceptance, reflecting prevailing market practice, and/or conforming to shareholder advisory firms’ standards. In doing so, they fail to leverage the power of incentives to signal the importance of key strategic imperatives internally and externally, thus imperiling their ability to deliver on their stated business and leadership strategies.

Why are companies getting caught in this conformity trap—and more importantly, how do they escape? The principal reason, of course, is the current, hyper-scrutinized environment. It is characterized by corporate governance standards defined by watchdog groups that fervently believe the U.S. executive pay model is broken and that they know best how to fix it. These groups, which include shareholder advisory firms, certain institutional investors and funds, as well as critics in academia and the media, have collectively defined a set of standards for pay levels and program design that in their view are tolerable.

In fact, external practices and viewpoints can and should inform executive pay program design. But to escape the conformity trap, companies must ensure that internal business and leadership objectives and considerations drive program design and delivery. Effective pay program design and delivery is characterized by careful customization of program elements, metrics, measurement and mix in support of key organization objectives. It also requires clear communication, both externally and internally, of the rationale underlying executive pay program design and delivery.

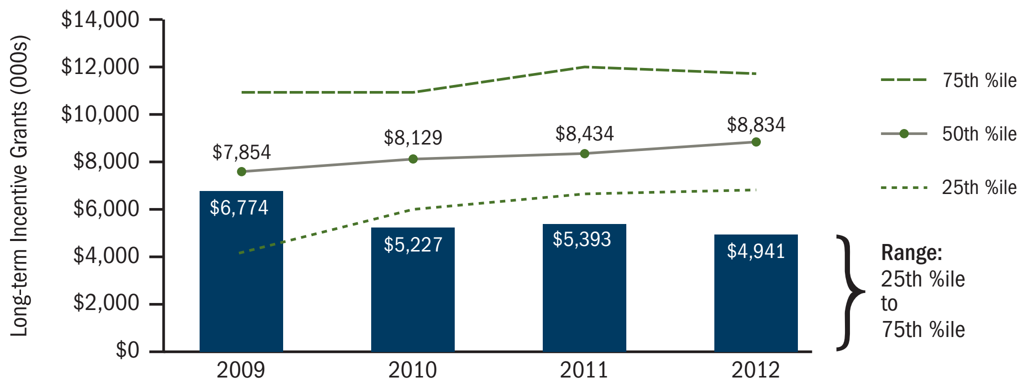
EVIDENCE OF CONFORMITY. There are two principal components of executive pay program design and delivery: how much executives are paid and what those pay levels are predicated on. Both the “how much” and “for what” components have fallen victim to the conformity trap.

In ascertaining the degree to which conformity has shaped executive pay, our firm examined CEO long-term incentives among Fortune 100 companies over the past four years. Not surprisingly, it showed that CEOs were the most highly compensated executives and that long-term incentives comprise the majority of their pay levels.

In examining CEO pay, we find that CEO long-term incentive values among Fortune 100 companies increased by approximately 12 percent between 2009 and 2012—an annual increase of approximately 3 percent over that same period, the aggregate market capitalization of the Fortune 100 increased by over 50 percent, or approximately 11 percent per year when compounded annually. The comparatively conservative expansion in CEO long-term incentive values likely reflects external scrutiny of CEO pay and companies' increasing desire not to deviate too significantly from market competitive values.

FIGURE 1:

LTI Grants: Range of Percentile Statistics for F100



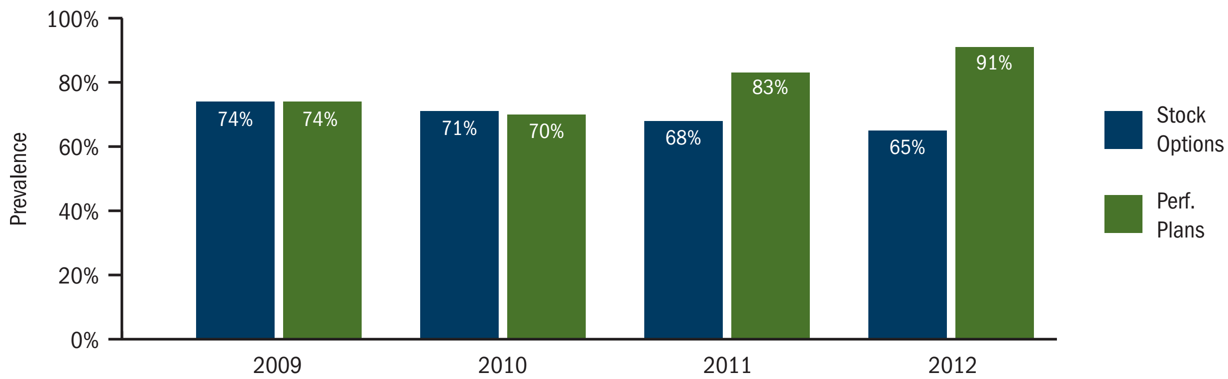
Even more notable evidence of compensation programs' "movement to the mean" is seen in the dispersion of CEO long-term incentive values. Over the same four-year period, the spread between CEO 25th percentile and 75th percentile long-term incentive values declined by nearly 30 percent—from $6.8 million in 2009 to $4.9 million in 2012. (See Figure 1.) The narrowing distribution of CEO long-term incentive values is evidence that because boards are concerned with being an outlier on executive pay, they rely heavily on prevailing market norms for establishing executive pay opportunities.

Of course, there is nothing inherently wrong with providing executives with pay opportunities that reflect market norms for comparable positions in similarly sized and oriented companies. With well-designed long-term performance metrics and goals, establishing pay opportunities at market median will help ensure that actual, realizable pay is appropriately positioned based on relative performance outcomes. Yet, as companies increasingly utilize full-value shares in place of stock options in the long-term incentive mix, there is a foregone opportunity to flex the magnitude of full-value share award values based on key performance indicators.

Further evidence of the move to conformity appears in examining the prevalence of long-term incentive vehicles and performance metrics. Once considered the ultimate vehicle for aligning the interests of executives and shareholders, stock options are now used by less than two-thirds of Fortune 100 companies. In contrast, performance shares have soared in prevalence to more than 90 percent of Fortune 100 companies. (See Figure 2.)

FIGURE 2

LTI Grants: Vehicle Prevalence for F100

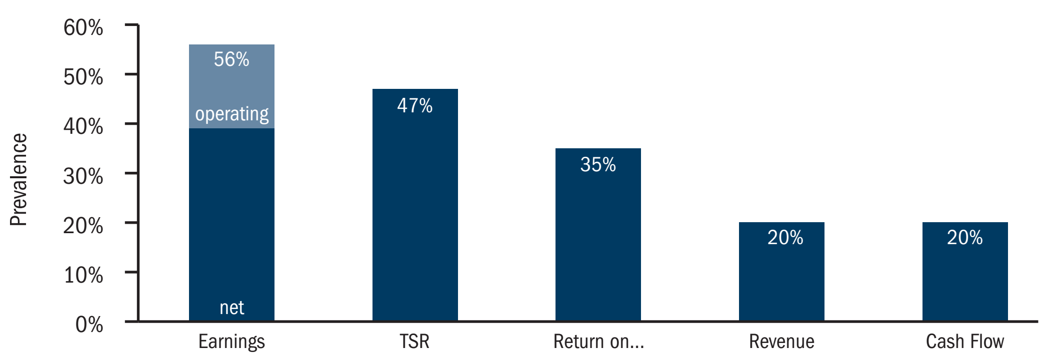


What is driving the divergence in the use of stock options and performance shares? While performance shares might be seen by companies as a superior vehicle for aligning executive incentives with desired outcomes, the more likely reason is that shareholder advisory firms do not view stock options as performance-based. One of their blanket prescriptions for fixing executive pay is to stipulate that incentive programs must reflect their own standards for what are acceptable performance-based vehicles.

This view also extends to performance metrics, reflected in the meteoric rise in the use of relative total shareholder return (TSR) as a performance metric. (See Figure 3.) Approximately half of Fortune 100 companies use relative TSR as a performance metric in their long-term incentive programs. Of course, relative TSR is often an appropriate metric and helps ensure alignment of realizable pay and performance, which is important and desirable. Relative TSR is *not*, however, an incentive metric. Rather, it is an accountability, outcome-based metric. Defaulting to relative TSR as a cornerstone metric for measuring executive performance is a missed opportunity to employ driver-based, incentive metrics that can motivate the attainment of key objectives that, in turn, lead to shareholder value creation.

FIGURE 3:

Performance Plans: Prevalence of Metrics in 2012



ESCAPING THE CONFORMITY TRAP. Understanding market practices and the views of shareholder advisory firms is important. Market practices and trends provide external context that can effectively inform executive compensation program design and delivery. Similarly, shareholder advisory firms carry significant influence with many institutional investors and it is critical that companies and their boards understand where programs and practices may deviate from the advisors' notion of what is acceptable.

In fact, that very understanding of where the company differs from prevailing market practice or prescribed program designs helps ensure that the compensation program is carefully thought-out, tailored to the specific needs of the company, and well communicated both externally and internally.

The key takeaway is that while external practices and viewpoints can and should *inform* executive pay program design, it is important that internal business and leadership objectives and considerations drive program design and delivery. The hallmark of a well-designed compensation program is that it flows from and supports the company's business and talent imperatives. As a result, program designs can change each year as the company's priorities change, or it can remain stable for many years, evolving as the company's strategy and priorities evolve.

Escaping the conformity trap and customizing program design and delivery has many potential outcomes and could potentially include the following:

- **Prioritization of lead/driver metrics over lag/outcome metrics.** Market practice with respect to performance metrics is dominated by the use of lag metrics. Financial metrics such as revenue and earnings growth, as well as relative TSR, are derivatives of business strategy execution efforts. These metrics and the underlying goals often reflect successful performance of current products and services in existing markets and applications. That is obviously very important. Over the long run, however, value will also be enhanced by successful development of a company's pipeline of new products and services, different or complementary applications and in new markets.

  These strategic initiatives are often best motivated and measured through lead or driver metrics such as revenue from new products or new markets; revenue mix; new partnerships; talent development; and succession planning. Tools that can help assess gaps between current incentive programs and business strategy, as well as customize new programs, include Strategy-Incentive Gap Analysis and Value Driver Analysis. (See Figure 4.)

Figure 4: Compensation Program Design Tools

Strategy-Incentive Gap Analysis. Assess current incentive program alignment with key strategic and organization imperatives. Short-term imperatives should lead to and foster long-term value creation. Incentives should support key driver metrics as well as desired outcomes in the short and long term.

Value Driver Analysis. A value driver tree can visually depict key drivers of enterprise value over both time and line of sight performance dimensions. Although metrics will vary across the organization based on line of sight, they should all tie to value creation metrics.

- **Use of informed and objective discretion in assessing performance and pay.** Very often, “performance” for incentive purposes cannot be sufficiently captured in a formula. Although it often has a negative connotation, discretion can be an effective tool for recognizing performance on key business strategy and leadership initiatives. A caveat with discretion is that it be applied consistently and objectively as possible. This includes establishing goals and expectations at the beginning of the year, tracking and communicating progress during the course of the year, and evaluating results at year-end in the context of the environment in which those results were attained. As a complement, it can also be helpful in evaluating relative performance on key indicators at year-end.
- **Measurement of performance over a time horizon commensurate with the company’s business cycle.** Convention in performance measurement has resulted in most companies structuring incentive programs around one-year (for annual incentive plans) and three-year (for long-term incentive programs) objectives. This is not unreasonable: it is important to ensure dynamic tension between short- and long-term objectives, one- and three-year cycles do not always coincide with a company’s business cycle or strategy execution plan. To that end, companies and their boards should not rule out measuring performance over time periods that are shorter—semi-annually for example, or longer—five years for example.
- **Greater sensitivity of pay outcomes to establish performance objectives.** Leading up to and during the meeting at which board compensation committees approve performance goals and corresponding pay opportunities most of the focus tends to be on performance metrics that are not as well linked to the underlying performance goals, with very little attention paid to the performance-award slope. “Target” performance goals often are approved at the full board level, with threshold and maximum performance goals tending to be static as a percent of target every year. This misses an opportunity to fine-tune goals and slopes to reflect changing business strategy, external environment, company maturity and expected variability of results. For example, steepening the performance-award slope can create greater sensitivity of pay to performance when results are more predictable and stable.

COMMUNICATING YOUR STORY. Moving beyond the conformity of external practices and expectations requires clear and persuasive communication, both externally and internally, of the rationale and intent underlying executive pay program design and delivery.

Externally, once-a-year boilerplate communication doesn’t work especially if your program has features/provisions that are unique to your business. Investors, proxy advisors, and the media have become experts at dissecting proxy statements and are pressuring organizations to be more clear about the links between business and leadership strategy and pay philosophy. Key messages about how your business challenges and opportunities drive the design of your program are critical to successful communication.

External stakeholders are also demanding a regular dialogue about executive pay from the companies in which they have vested interests, which means communication must go beyond the annual proxy statement. Shareholder outreach is best done proactively and regularly. Teams should include lead individuals from investor relations and human resources, as well as the CEO and compensation committee chair. Consider having the CEO attend only the portion of the meeting dealing with business strategy considerations, so that compensation-related discussions can be candid and open.

Internally, there is a tremendous opportunity to reinforce the articulated business strategy and organization imperatives, as well as increase the perceived value of your pay program, through communication of compensation program design. Ideally, incentives are vertically aligned down into the organization, based on line of sight and the sphere of influence objectives that tie to enterprise value drivers. Consistency and clarity of messaging will help foster a performance-driven culture that will deliver on desired business and leadership talent objectives.

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