Pearl Meyer & Partners
Comprehensive Compensation®

# 2014 Compensation Committee Agenda:  Raising the Bar

In this business, we have countless discussions and debates about executive pay — in Boardrooms, at industry conferences and in management meetings.  But we are not the only ones. Executive pay has become a mainstream topic, fueling year-round conversations from Capitol Hill to the Twitter-sphere.  This has put an even brighter spotlight on Compensation Committees that are already working harder than ever to ensure that the pay programs they oversee are designed in the best interests of their companies, executives and, of course, shareholders.

At the same time, external pressure from proxy advisors to conform to "one-size-fits-all" pay practices and methodologies has made many Compensation Committees uncomfortable adopting program designs that deviate from what's considered "the norm."  Last year, our annual Pearl Meyer & Partners' "Top 5" 2013 Compensation Committee Agenda report encouraged companies to "Go Beyond" — beyond best practices, beyond check-the-box compliance, and beyond the obvious.  This year, our advice centers on practical recommendations for exactly how to accomplish that objective.

An executive pay program that will successfully attract, retain and motivate high-performing executives to drive business results and create long-term shareholder value must be built around five fundamentals:

1. **Business Strategy**
2. **People Strategy**
3. **Performance Measurement**
4. **Good Governance**
5. **Clear Communication**

By taking a closer look at each of these fundamentals, their roles and the interplay between them, you can ask strategic questions and identify the key issues to consider when making decisions about executive pay throughout the year.

## 1. Business Strategy
### *Does your pay program align with your business value drivers?*

"You get what you pay for."  We hear the old adage when we talk about pay program design. Unfortunately, it's often followed quickly by another adage: "be careful what you wish for."  The concept of pay-for-performance is seemingly simple: executives are rewarded with high pay for exceptional performance and correspondingly lower pay for poor performance.  Yes, you get what you pay for, but do you know what you want?

A primary driver of the increasing complexity of executive pay is the myriad and disparate perspectives as to what constitutes exceptional, or even acceptable, performance.  Significant time and money are spent on compensation studies to determine appropriate pay levels, but comparatively little energy is expended on defining performance objectives and measures specific to the organization.

All too often, companies default to “one-size-fits-all” executive pay programs that are predicated on external acceptance. They reflect prevailing market practices and/or conform 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 strategies.

Here are some suggested approaches, tools and tactics to consider:

- ***Understand what drives value creation at your organization.*** A simple and effective tool for understanding which internal metrics contribute to value creation is an enterprise value driver tree. For most organizations, some combination of growth and returns drives value creation. Indeed, statistical analysis shows that those companies with the highest levels of performance on both top line revenue growth and return on invested capital have the highest shareholder return over ten-year periods. However, it is important to disaggregate growth and returns into multiple tree branches identifying the sub-drivers of performance. This enables vertical alignment of incentives throughout the organization using line of sight metrics that are aligned with long-term value creation.

- ***Develop a strategy-incentive map.*** Map the company’s current short- and long-term incentive framework against the business strategy. Critical questions to be answered as part of this gap analysis include: Are the organization’s strategic imperatives adequately reinforced through incentive measurement and rewards? Does the organization currently use incentive metrics that are not woven into the fabric of how the business is managed?

- ***Give equal weight to lead/driver metrics in relation to lag/outcome metrics.*** Market practice with respect to performance metrics is dominated by the use of lag metrics. Financial measures such as revenue, earnings growth and relative TSR are derivatives of business strategy execution efforts and often reflect the performance of current products and services in existing markets and applications. While this current baseline is obviously very important, long-term enterprise value will also likely be driven by development of new products and services, different or complementary applications, and growth into new markets.

**Diagnostic Tools:**

- Value driver trees disaggregate results and identify areas where incremental organizational attention may generate the greatest rewards.

- Strategy-incentive maps can highlight gaps between the company’s strategic priorities and the measures used in the incentive plans

Linking the company’s pay programs to your business strategy can transform compensation costs — often one of the largest line-item expenses a company has — from just another “cost of doing business” into a powerful competitive advantage that drives business results and long-term value creation.

## 2. People Strategy
### *Does your pay program support your talent management strategy?*

The topic of talent management is of growing interest and concern not only among management teams, but also in the Boardroom — everyone recognizes that executive talent is critical to long-term organizational success. Virtually all Boards receive an annual talent overview as part of their succession planning and development oversight responsibilities, and many Compensation Committees have ongoing responsibility for input to management on this subject. However, we find that the topics of talent management and compensation strategy are often considered separately, without integration.

Compensation is a powerful communication tool, since we usually pay for what we truly value. Promotion and career advancement are also powerful signals of the types of people we value. If these systems work together, the organization will have a clear direction from a talent perspective. If they conflict, it will be impossible to build and maintain a great management team. Following are some key questions and actions we suggest you consider:

| **Key Questions** | | **Action Steps** |
|---|---|---|
| ***Leadership Talent Strategy*** | ***Pay Program Alignment*** | |
| • What competencies and experience do you want? | • Are incentives 100% formulaic?<br>• Do you also reward individual development goals? | • Focus on the team, not just the CEO<br>• Think broadly about current and future leadership needs<br>• Ensure target pay levels are sufficient to attract and retain experienced talent |
| • How will managers acquire the experience they need to become future leaders?<br>• Do current unit heads have full P&L responsibility? | • Do pay levels and practices enable moves across the organization?<br>• Do your relocation and expatriate programs support global leadership?<br>• Do you reward corporate <u>and</u> business unit results? | • Test your organizational ladder to see what "steps" are available to future leaders<br>• Consider whether some "steps" are too big a jump in scope or if there are "blockers" in key jobs<br>• Assess pay decisions relative to both market levels and internal equity |
| • What opportunities will managers have to "practice" their leadership skills? | • Do your programs penalize failure to the point of discouraging risk-taking?<br>• Are payout curves so narrow that managers become overly conservative? | • Build a management style that aligns accountability and control<br>• Provide opportunities for Board visibility or coaching<br>• Be willing to exercise pay discretion to reward leadership growth |
| • What are the key attributes of the culture you want to create and maintain across the organization?<br>• What unique attributes are integral to your business strategy? | • Do you reward results <u>and</u> behaviors?<br>• Do your incentive pools and performance metrics encourage company-wide teamwork or silos?<br>• Do your long-term incentives encourage risk-taking (stock options) or stability (time-vested shares)? | • Expect typical attributes: personal integrity; business ethics; pragmatism<br>• Define and reinforce unique attributes: team vs. individual; risk-taking vs. cautious; fluid vs. systematic; patient vs. aggressive; nurturing vs. survival of the fittest |

The answers to these questions are not found in management reports. You need first-hand exposure to future leaders throughout the organization, observing them in action on their home turf, at trade shows, in the plants, etc. In addition, you should look to two resources for help with the challenge of integrating talent and pay strategies: a strong human resources leader with good people development skills, and your independent compensation consultant. The more your managers and outside advisors understand about your culture and leadership team, the more they can contribute as partners in developing pay programs that support your unique talent management strategy.

## 3. Performance Measurement
### *Does your pay program reward the right performance?*

The key link between business strategy and executive pay is performance measurement. As we note in the Business Strategy section, effective linkage involves translating strategy into measures and goals that provide the right signals and incentives to management to enable successful execution. How can you feel confident that measures are truly linked to the business strategy, and that performance against incentive plan goals will translate into shareholder value creation?

With all eyes on external pay-for-performance tests that focus on relative TSR, you must rigorously and periodically ensure that the measures and goals in executive incentive plans foster strong alignment with shareholder value. Here's how:

- ***Validate the measures.*** Most Directors and executives have a good idea of the performance measures that matter for value creation in their business. However, periodic review and testing of those measures can improve the system. Subtle changes in business conditions, shifts in business strategy, acquisitions and divestitures, even changes in sustained levels of performance can make refinements to the performance measurement framework appropriate. Periodic testing of the measures, using regression techniques (against market valuation multiples and total shareholder return), can reinforce your intuition with analytic proof and help refine the measures. The review can also help to better balance the performance focus. Growth and returns, in some form, almost always matter. But sometimes the balance between the two centerpiece financial measures should be tipped, e.g., to focus on capturing market share (emphasis on growth), or when pricing conditions in a mature market become unfavorable (emphasis on returns).

**Diagnostic Tools:**
- Regression analytics test correlation of performance measures with market valuation multiples and TSR
- Stress-test balance of measures as compared to short-term strategic priorities (e.g., emphasis on growth to reinforce market share as a priority)

- ***Calibrate the goals.*** Knowing which performance measures matter is necessary—but not sufficient. Successful performance measurement also requires understanding what level of performance against those measures will produce desired changes in shareholder value. Again, regression analysis can be helpful. For example, once we understand that ROIC is strongly correlated with market-to-book in an industry, we can analyze how changes in sustainable ROIC performance will translate into shareholder value. We can use scenario modeling of enterprise value to infer shareholder expectations of future company performance (i.e., how much growth and what sort of returns are baked into the prevailing company share price), and to test the expected impact of the company's long-range plan on shareholder value. Holding external factors constant, a plan that delivers better (or worse) performance than shareholders expect will result in TSR in excess of (or below) the company's cost of equity.

**Diagnostic Tools:**
- Regression analytics test sensitivity of market valuation multiples and total shareholder return to different levels of performance
- Model enterprise value to infer shareholder expectations of future company performance

- ***Analyze the actual results.*** A rigorous approach to performance metric selection and calibration should lead to rational, business-based pay-for-performance results. In addition to conducting analyses at the beginning of the year to develop a thoughtful incentive structure, it is important to test the actual results at year-end. We advocate a pay-for-performance review that goes well beyond the cursory

**Diagnostic Tools:**
- Pay-for-performance analyses should go beyond the external ISS model to look at other definitions of pay (i.e., realizable pay) and performance, financial measures in addition to TSR)

 

analysis used by ISS. We suggest including the full NEO group, as CEO pay may not be representative of "normal" company programs. Further, we believe realizable pay is a better match to actual performance than the values in the proxy's Summary Compensation Table. We also recommend using financial performance measures in addition to standard TSR.

Armed with a performance measurement framework that has been validated, and a set of performance goals that are calibrated against shareholder value objectives, you will be in a much better position to feel confident about pay-for-performance outcomes.

## 4. Good Governance
### *Is your pay program informed or dictated by external pressures?*

Say on Pay votes were intended to give shareholders a voice on executive pay practices that were perceived as running amok and the process has worked to rein in the most egregious practices and outliers. However, positive Say on Pay votes — and even the level of shareholder approval — have become viewed as the exclusive measure of good pay programs and, by extension, governance. We believe this is a flawed standard of good compensation governance.

Today, we still see many organizations defaulting to generic program designs that mimic the marketplace (e.g., the proliferation of relative TSR plans) and safely meet proxy advisory firm standards. Such conformity suggests uncertainty that customized pay programs can influence executive behaviors that support the unique business strategy of a company. Our experience shows that nothing is further from the truth: a well-tailored pay program, supported by a robust governance process, is the best way to drive exceptional performance on key initiatives:

- ***Allow external viewpoints and market practices to inform, not drive, pay program design.*** You are right to gather and review market intelligence so you can make informed decisions. But "good governance" should ensure that your pay program is characterized by careful customization of program elements, metrics, measurement and mix in support of key organization objectives. The hallmark of a well-designed program is that it flows from and supports the company's business and talent imperatives and it changes over time as the company's strategies and priorities evolve.

- ***Recognize that good pay programs often bear management's imprint.*** Before the proliferation of survey data, increased transparency and a slavish focus on market practices, there was recognition that management should be integrally involved in the design process because they best understood what was needed to drive and sustain long-term value creation for the company. The Board would review and recommend changes when needed; however, ownership of the initial design rested in management's hands. While we applaud the governance advances that have created more active and engaged Compensation Committees, it is critical that management's voice not be lost.

- ***Exercise business judgment.*** Very often, "performance" for incentive purposes cannot be sufficiently captured in a formula. Although often carrying 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 as consistently and objectively as possible. Importantly, the key to widespread acceptance of discretionary actions is having previously established a solid foundation of good governance.

- ***Be transparent.*** The ultimate goal of a strong governance process is to provide shareholders with a high degree of confidence that you are working in the best interests of the company. As we explain in the next section, clear, consistent communication of the process and outcomes of decision-making is essential to building that trust and a critical component of good governance.

In short, a pay program aligned with and based on the company's business strategy and objectives, rather than hewn to external views of what is "acceptable", is the new best governance practice.

## 5. Clear Communication
### *Does your pay program resonate with executives and shareholders?*

It's no longer just major investors and proxy advisors who pay attention to the details of pay-for-performance programs. Employees scour their company's proxy statement and executive pay issues regularly make headlines in the mainstream press and trend on social media. Everyone wants to know who is getting paid what and why… and Directors are feeling the pressure. Effectively managing messages about executive pay to this expanding and diverse audience is daunting. Not only is compensation a complex and sensitive topic to begin with, but the number of internal constituents involved in crafting messages has grown exponentially (e.g., legal, human resources, corporate communications, finance, investor relations), making the development and delivery of executive pay communication a more complex process.

As a result, having a plan of action for how messages about executive pay will be managed on an ongoing basis must be a shared responsibility between Compensation Committees and company management. Following are some issues to consider and steps to help ensure that messages about executive pay are being effectively managed inside and outside of your organization:

| Communication Issues | Action Steps |
|---|---|
| There is a growing demand for Directors to be more involved in direct dialogues with investors on a year-round basis — even if past Say on Pay votes have been positive. | • Identify who within your organization is qualified (or should be trained) to discuss executive pay issues.<br>• Do regular outreach and conduct town hall meetings (e.g., shareholder webinars).<br>• Prepare talking points and/or anticipated questions and answers.<br>• Develop a playbook for responding to different constituencies (e.g., activist investors, the media, proxy advisers, executives). |
| The Compensation Committee's role has grown beyond a cursory review before the proxy is filed. Today there is pressure to produce a clearly written, understandable CD&A that explains exactly how business performance is linked to pay outcomes. | • Be clear from the beginning about your expectations for the narrative, including tone, style and perspectives on the primary storyline and key performance themes.<br>• Determine who should lead the drafting and review process to promote efficiency and minimize conflicts. |
| Poor explanations are liable to be misunderstood. If not carefully positioned, a program change can be interpreted as a takeaway, resulting in decreased engagement and unwanted turnover. Or, if executives are unclear about how and why their pay is linked to specific metrics, they cannot see the line of sight to what they can do on a day-to-day basis to influence results. | • Make sure your management team is expending the same time and energy on planning for communication as it does on plan design.<br>• Challenge management on its tactics for communication, just as you would with any plan design recommendations.<br>• Ask for a strategy and implementation plan that outlines key messages, audiences, and the frequency and timing of communication when plan design changes are approved. |

In today's highly visible executive pay environment, it is critical to be able to articulate the rationale for the program design:  i.e., how it supports the company's strategy and business imperatives, and where and why it deviates from prevailing external practices.  Understanding where your program differs from prevailing practices or proscribed program designs, and crafting messages about how your business challenges and opportunities drive the design of your programs, is critical to making a compelling case for why it makes sense to do something different.  These messages should serve as the foundation for communicating about your pay program, not just in the proxy but as part of an ongoing, year-round outreach effort to shareholders and executives.

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**Break the Mold. Raise the Bar. Now's the Time.**

We continue to strongly believe that putting your company's business and leadership strategies ahead of generic approaches in your pay program is the most effective way to properly motivate your executives to implement the strategies that will create real long-term value for shareholders. Not only do you need to go beyond compliance and conformity in your program design, you need to raise the bar to ensure that everyone with vested interests in your organization fully supports your decisions — they understand the goals you are striving to achieve *and* believe your process is sound, responsible and essential to fueling long-term growth and success.

## About Pearl Meyer & Partners

*For 25 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 governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges for multinational companies ranging from the Fortune 500 to not-for-profits as well as emerging high-growth companies. These organizations rely on Pearl Meyer & Partners to develop global programs that align rewards with long-term business goals to create value for all stakeholders: shareholders, executives, and employees. Pearl Meyer & Partners maintains U.S. offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles, San Francisco and San Jose, as well as an office in London.*

Pearl Meyer & Partners

*Comprehensive Compensation®*

www.pearlmeyer.com


**NEW YORK**
570 Lexington Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

**ATLANTA**
One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

**BOSTON**
132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

**CHARLOTTE**
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

**CHICAGO**
123 N. Wacker Drive, Suite 860
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

**HOUSTON**
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

**LONDON**
Clifford House
15 Clifford Street
London W1S 4JY
+44 (0)20 3384 6711
london@pearlmeyer.com

**LOS ANGELES**
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

**SAN FRANCISCO**
455 Market Street, Suite 2000
San Francisco, CA 94105
(415) 651-4560
sanfrancisco@pearlmeyer.com

**SAN JOSE**
2880 Zanker Road, Suite 203
San Jose, CA 95134
(408) 954-7399
sanjose@pearlmeyer.com