EXECUTIVE COMPENSATION

Lessons Learned from an Index Tool in the UK Market

By Simon Patterson, Pearl Meyer
Executive compensation is a challenge facing domestic and global companies alike. While the practical or cultural hurdles may be different, the headlines are not. Simply put, pay must not be excessive and it must be carefully calibrated in relation to performance.

In the United Kingdom, there appears to be a post Shareholder Spring where anti-elite sentiment is affecting politics as well as corporate governance. This is an investor tendency happening among businesses around the world. Because of this broad outlook, it has affected how regulators and shareholders treat executive pay, which is driving more aggressive shareholder activism.

A new approach seeks to bring clarity on executive pay for performance.
activism and turning executive compensation into a priority issue for public companies.

Earlier this year 14 companies with a combined market cap of approximately 1.1 trillion pounds met at an event in Geneva to discuss the challenges of managing compensation globally. A few current core issues were identified: public opinion on pay inequality, managing Millennial talent, and how to move from the traditional model of static role descriptions to one where goals and performance expectations shift constantly and assessment is often team — or project-based.

Over time, these more nuanced issues may come and go, but the overarching theme of aligning executive compensation to performance — or not — persists. While investors are pressuring boards to “fix” programs so that overall compensation levels are more acceptable, many executives see their incentive design becoming increasingly “off-the-shelf” to suit regulators, proxy agencies. In addition, there’s also a desire to reduce the risk for independent directors governing compensation programs. How pay ties to the strategies that management teams are tasked to execute isn’t always clear.

The UK CEO Value Index, developed by Pearl Meyer, is an annual proxy research endeavor that measures how much shareholders receive in value for every pound a CEO is paid. This offers a look at the effectiveness of compensation committee decisions and the way in which the shareholders’ investment in incentive pay leads to incremental value, or not. It also provides companies with insights into how executives could deliver more value when incentives are linked to those broad measures that drive value. Published annually since 2012, this data has become increasingly relevant and is driving refined discoveries of the kinds of incentive design that work and how much is enough.

The outcomes of the investigation are remarkably consistent year over year. Knowing the top quartile index value, compensation committees can set value creation goals that link to the appropriate market pay levels. For example, the CEO of a FTSE 350 company, that would typically earn 2.2 million pounds a year, may be reasonably expected to deliver 3.5 billion pounds in incremental value to shareholders during a four-year period. While that might not necessarily be the exact goal set, it gives the board a handy guide to judge and calibrate “success” without having to estimate or take the CEO’s guidance.

Based on the index, there are five consistent findings that lead to certain incentive design characteristics associated with out performance. Additionally, these findings may provide some interesting context and food for thought as HR teams and boards contemplate other hot compensation issues around the globe related to pay inequity, managing upcoming talent and constructing effective goals and metrics.

1 Winners Pay More

The eight companies in the index’s top 30 — four years running — deliver the most value to their shareholders, but they also pay the most to their CEOs. On average, these companies have added 100% more value to shareholders and earned 44% more in total earnings during the research period, compared to other companies.

How does this finding square with the identified global issue of pay inequity and stagnant wages? The problem is obviously much larger than the purview of compensation professionals. However, because high pay can equal high performance at the executive level, we can consider
the implications for broad-based pay. When companies who pay more perform better, it makes sense to focus on the value of the talent and not cost throughout the organization.

2 The “Goldilocks Factor” Is Real
We looked at the use of strategic measures, defined as measures directly attributable to company-specific goals and objectives, in both short- and long-term incentive plans. The results show that insufficient emphasis on strategic measurement, or too much emphasis, can be detrimental. But just enough focus — between 50% and 70% — delivers excellent results. Companies that use strategic measures appropriately in their long-term incentives add almost double the value to their shareholders than companies that don’t. These organizations outperform on index rankings, despite paying 30% more at median.

What might this mean for those experiencing difficulty in managing or shifting performance expectations year over year? From the management team down through the ranks, it can be difficult to pinpoint and then communicate intertwined goals and priorities. While using strategic measures in a compensation plan can likewise be complicated, they do signal importance to the overall business strategy and drive the right behavior.

3 A License to Operate May Not Be Enough
Of the UK CEOs studied, one-third have shareholdings worth 5 million pounds or more, and they deliver more than double the value compared with CEOs where shareholdings are under 5 million pounds. The CEOs who have more at stake — that is, who own more of the company — add approximately four times more value than those with less ownership. They are paid more, deliver more and as a result are better value for shareholders overall.

Is this a broader engagement statement that may apply to up-and-coming Millennial talent? We generally understand that a sense of investment among a workforce is a critical component of a successful corporate culture, perhaps increasing actual long-term investment among high potentials.

4 Uncertainty Could Be Expensive
According to the index, pay packages for the best-value CEOs in the FTSE 100 are less leveraged than those for the rest of the FTSE 100 CEOs. At median, the top 30 companies pay
How It Works

The UK CEO Value Index is a rule of thumb to guide compensation decision-making. It measures how much value a CEO adds to his/her company for every pound he/she is paid. Examined is value added to shareholders during a period of four years, which captures change in market cap, dividends and share buybacks. We divide that by the total realized pay for the CEO over the same period.

The findings offer shareholders, compensation committees, total rewards professionals, regulators and commentators the opportunity to calibrate and evaluate pay programs in important ways.

For shareholders, there is clear and immediate evidence about whether leadership is delivering value, relative to the total pay opportunity being offered. Also a simple comparison can be seen across sectors by company size and over time.

For boards and HR teams there is the ability to review the results of incentive compensation design; an opportunity to ask how well pay aligns with performance and how that pay-to-performance alignment compares with other relevant comparators; and the ability to calibrate future performance requirements, given benchmark pay.

For regulators and commentators, there is a comprehensive view of pay and performance over time, across sectors and across geographies; and a snapshot of pay-to-performance alignment, providing an objective commentary on the impact (or lack of impact) of regulatory changes.

Simon Patterson is managing director for Pearl Meyer in London, UK. Contact him at simon.patterson@pearlmeyer.com.

resources plus
For more information, books and education related to this topic, log on to worldatwork.org and use any or all of these keywords:
- Executive compensation
- Pay programs
- Pay for performance.