Pearl Meyer

ADVISOR BLOG

Getting CEO Performance Metrics Right

AUTHOR

Matt Turner
Managing Director

We ran across an interesting piece in the Wall Street Journal last week asking how well firms measure and reward for CEO performance. The consensus seemed to be that firms have been responsive to investor demands, but that performance hurdles may still be questioned in too many instances. Pearl Meyer's experience is that, while the process of choosing measures and setting goals has improved in recent years, there is room for more improvement by compensation committees, management, and their advisors.

Most companies have what can be referred to as "centerpiece" financial measures, which capture growth, profitability, and returns of the company to one extent or another. These are the measures that pose the greatest difficulty in goal-setting and are most often the subject of external scrutiny like that in the referenced article. Total Shareholder Return (TSR) takes care of itself, as TSR performance relative to an external benchmark is actually the yardstick against which financial goals are most often evaluated. And operational measures, like working capital management, customer satisfaction, quality, etc., should be outcomes of the company's long-range plans and somewhat dependent upon the financial goals. So, it is the centerpiece financial goals that most bedevil compensation committees.

The objective of the goal-setting exercise should be to attain the desired alignment between pay and performance. As a board member, you don't want to arrive at the end of a performance period and feel that you have overpaid, or underpaid, for the performance result. So, what can compensation committees do to better avoid these errors? Here are three things to keep in mind:

1. **Get the measures right.** It is critical to select and define the centerpiece financial measures in a way that is aligned with long-term value creation. It is not enough to simply use the measures most commonly found among peers or within your industry. Take the time to examine the link between value creation and financial performance. This may involve statistical analysis and financial modeling. Financial and stock price performance will not always align nicely in a given three-year period.

But grounding your measures in fact-based analysis will help you to be reasonably certain that they will align over the long term.

2. **Understand performance expectations.** Once you have defined your financial measures, it is important to understand what levels of performance are acceptable, and what levels are exceptional with respect to value creation. It is not enough to compare your company's performance to peers (i.e., 75th percentile performance is exceptional and should deliver a maximum bonus). Shareholders may have very different expectations of performance for your company than the peers. These differing expectations will reflect your company's unique (dis)advantages and economic context. Take the time to understand these company-specific expectations. Gear your incentive targets toward at least meeting them, with superior levels of incentives geared toward materially exceeding those expectations. Analyst earnings forecasts can be helpful. But more direct and specific modeling of your incentive plan metrics will provide the best insight. Such analysis, together with peer and company-historic performance perspectives, help you to be in a better position to set threshold, target, and maximum performance levels for incentives.

3. **Start early and take your time.** Gone are the days when the compensation committee reviews management recommended goals based on the budget early in the first quarter, and approves them in the same meeting. Given the heightened attention on incentive goals and the pay-to-performance relationship, compensation committees are well-advised to begin the goal-setting process early in the fourth quarter, with initial modeling of shareholder expectations and review of competitive performance. Moreover, the work should focus not just on targets, but the performance range, from threshold to maximum. Committees should have two or even three bites at the goal-setting apple before finally approving incentive bogies for new performance cycles of the annual and long-term plans.

The process of choosing performance measures and setting performance goals has improved in recent years. However, there remains room for improvement. The best way to ensure robust pay-for-performance, and fend off external criticism of your executive compensation program, is to get the measures right, understand shareholder expectations, and take your time setting the performance ranges for incentives.

About the Author

Matt Turner is a managing director in the Chicago office of Pearl Meyer. He specializes in advising company boards and senior management on executive compensation strategy, incentive plan design, tailoring of performance measures, and the setting of shareholder-focused performance objectives. With nearly 25 years of experience, Mr. Turner has worked with public and private companies in a range of industries including insurance, manufacturing, technology, real estate, transportation, and retail.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Jose.

Pearl Meyer

NEW YORK
461 Fifth Avenue, 19th Floor
New York, NY 10017
(212) 644-2300
newyork@pearlmeyer.com

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

BOSTON
93 Worcester Street, Suite 100
Wellesley, MA 02481
(508) 460-9600
boston@pearlmeyer.com

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

CHICAGO
151 North Franklin Street, Suite 450
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

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

LONDON
Collegiate House
9 St. Thomas Street
London SE1 9RY
+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 JOSE
333 West San Carlos Street
San Jose, CA 95110
(669) 800-5074
sanjose@pearlmeyer.com

For more information on Pearl Meyer, visit us at www.pearlmeyer.com or contact us at (212) 644-2300.