Pearl Meyer

NACD | ELEVATE BOARD PERFORMANCE

The "Seven Deadly Sins" of Executive Pay Analysis

Compensation Committee Series Webinar
Presented by Pearl Meyer

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Meet the Presenters

Mary Beth Vitale is a director of CoBiz Financial Inc. and GEHA. Vitale chairs CoBiz' nominating and governance committee and also oversees the organization's IT and cyber-security processes and policies. She also chairs GEHA's risk and technology committee and serves on the executive committee. Previously, Vitale was lead director for Eye-Ris Inc. and on the board of Zynex Inc. She chaired Zynex' compensation committee and served on its audit committee. Vitale is a former chair and CEO of Westwind Media Inc. and a past director of both Intrado Inc. and RMI. She is a faculty member for NACD's Board Advisory Services.

David Seitz is a managing director with Pearl Meyer. He has over 30 years of experience in executive compensation consulting and has conducted and reviewed more than a thousand executive pay studies. He has consulted with companies in a wide range of industries from start-up to Fortune 100 and is an expert on total executive compensation with a special emphasis on long-term incentives. David has extensive experience with private companies including family and private equity and has assisted companies based in the U.S., Latin America, and EMEA.

Tim Dupuis is a vice president in Pearl Meyer's Chicago office, where he specializes in executive and director compensation and works closely with boards and senior management teams to design programs that are aligned with the organization's business strategy, aid in the attraction and retention of key executive talent, and withstand external scrutiny.

Housekeeping

Submit a question and receive your answer directly from Pearl Meyer, either during today's webinar or as a follow-up. You will also be opted-in to receive future executive compensation thought leadership from Pearl Meyer.

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Housekeeping

- You will automatically receive 1 NACD credit for your participation (live program only).
- Credit may be applied to NACD Fellowship programs. Contact Fellowships@NACDonline.org for more details.
- Presentation slides are available today at www.pearlmeyer.com/seven-deadly-sins and within the webinar console.
- The replay will be available early next week at www.NACDonline.org and www.pearlmeyer.com/seven-deadly-sins.

The Role of Executive Pay Data

"Garbage in, garbage out." Like all business decisions, executive pay decisions depend on the quality of the information used for those decisions.

- Executive pay data is fundamental to effective compensation committee governance and pay decision-making
- Compensation committees are often inundated with mountains of pay analysis
- Unfortunately, there are common issues with this analysis which can cause:
  - Confusion and lack of understanding
  - Poor decisions based on inaccurate or misleading information

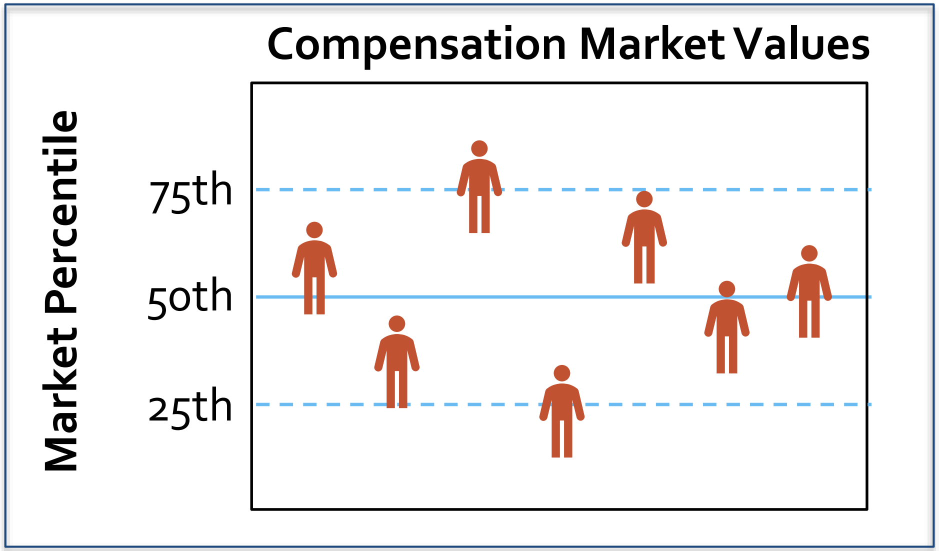
Today's Agenda

Goals of this Session

- Outline the most common issues with executive pay analysis: **"The Seven Deadly Sins"**
- Provide questions to stress test the quality of executive pay analysis
- Improve governance and decision-making

Caveat: The Important Role of Market Data

Market data is a critical starting point for compensation decision-making.



Key Considerations:

- Company philosophy
- Performance:
  - *Individual (certainly)*
  - *Company (maybe)*
- Individual experience
- Strategic importance of role

Some jobs should be paid above market; some jobs should be paid below market.

The Seven Deadly Sins of Executive Compensation

Compensation Issues	The Deadly Sin
1. Market definition	• The market is not clearly defined (or inconsistent)
2. Business size and market values	• The market values are not properly size-adjusted (or are inconsistent)
3. Executive position matching	• The executive position matching is not transparent
4. Market statistics	• The market statistics are distorted or unclear
5. Long-term incentive (LTI) values	• LTI values and methodology are inconsistent and unclear
6. Annual incentive awards	• Analysis uses actual incentive payouts rather than target opportunity
7. Compensation report	• The report makes my head spin!

Root Causes of The Seven Deadly Sins

Why do we have these executive pay analysis problems?

- Imperfect information
  - Public proxy data: good (proxy rules revised in 1992 and 2007)
  - Private data: has not improved in 30 years (small samples, inconsistent quality, and different survey methodology)

- Analysis: complex pay information requires rigorous analysis
  - Significant business judgement is required
  - Takes considerable time and experience

- Writing: requires critical thinking skills and ability to identify and convey relevant information for the committee

Poll Question #1

What is the organization's form of ownership for your primary board?

A. Public

B. Private, for-profit

C. Not-for-profit

One: Market Definition
The market is not clearly defined

The purpose of a competitive analysis is to assess how a company is paying relative to a specified market, therefore the committee and management must define the market.

Key Considerations for Market Definition

1. Company Size
- Company size and growth rate
- Size and pay correlation

2. Industry
- Same or related industries
- Similar economics
- Competitors

3. Executive Labor Market
- Broad marketplace
- Usually national

One: Market Definition
The market is not clearly defined

There are two primary sources of market data used for pay analysis:

1. Public Peer Group

- Since 2007, CD&A requires disclosure of a peer group
- Named Executive Officer (NEO) pay levels
- Plan design and director pay

2. Private Survey Data

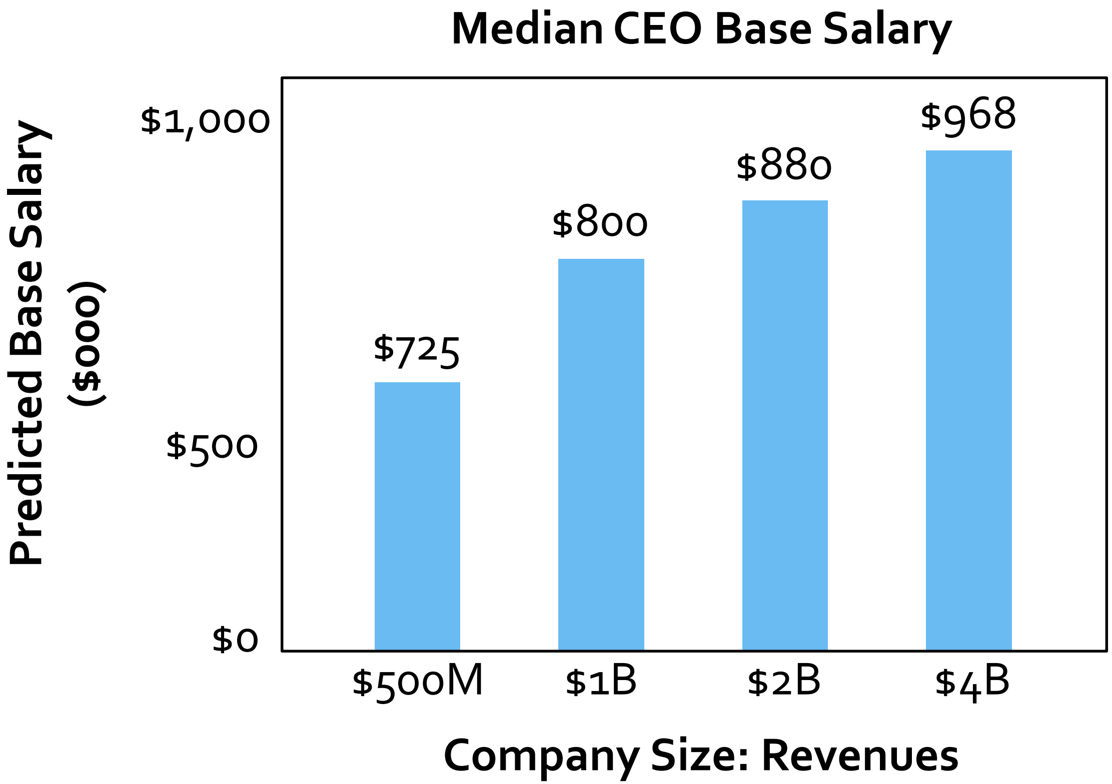
- Must be used for all other executives
- Issues: different sizes, different industries, inconsistent quality

Companies must also utilize broader sources of compensation market data to manage pay. The "public peer group" is not everything!

Two: Business Size

The market values are not properly and consistently size-adjusted

Rule #1 of exec pay analysis: all executive compensation market values must be size-adjusted!



Two: Business Size

The market values are not properly and consistently size-adjusted

Which financial metrics are used to size-adjust market data?

- **Revenues** provide most consistent correlations with executive pay levels
  - Market cap can be too volatile for pay correlations
  - For very larges sample sizes, earnings metrics may provide decent correlations (e.g., EBITDA, net income)

- Many private surveys do not have consistent size-adjusted data
  - Two ways to adjust: regression analysis and tabular data (revenue sizes)
  - But, survey data is often very small samples
    - No regressions and inconsistent tabular data with revenue

Bottom-line: the compensation committee must understand the median size of companies in market and how market values were size-adjusted.

Three: Executive Position Matching

The executive position matching is poor and is not transparent

The essence of external market pricing is to match like-for-like jobs in the market.

- In compensation parlance, this is called "external equity"
    - External equity is about external market competitiveness
    - Internal equity is job-slotting/leveling-based job evaluation systems
        - Sometimes these point systems are a "black box" and/or a mix of jobs

- Market pricing basics:
    - Match jobs by responsibility and reporting relationship (not pay)
    - Executive should have at least 80% of market benchmark responsibility
    - Not all company executives have an external benchmark

Three: Executive Position Matching

The executive position matching is poor and is not transparent

All compensation analysis must have a transparent summary of positon matches.

Company	External Benchmark
President and CEO	Chief Executive Officer
EVP and CFO	Chief Financial Officer (+15% for IT function)
Chief Accounting Officer	Controller
Head of Human Resources	Top HR Executive

Guiding Principles for Adjustments

- Infrequent: adjustments should be exception rather than norm
  - The reason for adjustment is obvious to all stakeholders
- Transparent: all adjustments (amount and reason) should be transparent

Four: Market Statistics

The market statistics are distorted and/or unclear

Market statistics used in analysis should be appropriate and understood.

1) Compensation studies should work medians, not averages.

- Averages are *almost never* an appropriate reference point for executive compensation analysis
- Why? Averages are distorted by outliers
  - Small sample size: public pay groups are small (e.g., 15 companies) and private survey data is often small sample sizes
  - Long-term incentive values have a wide distribution
    - Most volatile component of pay with a wide distribution
    - Average LTI values for small samples are *almost always* distorted

Note: there is some standard error around the estimated market value.

Four: Market Statistics
The market statistics are distorted and/or unclear

2) The term "market value" should be clearly defined in the report.

- Many reports do not define the market value
- One would assume that the market is the median

Example: Unclear and Misleading Summary

Component of Pay	Company vs "Market"
Base salary	+ 10%
Total annual cash	+ 10%
Total direct compensation	***-10%***

Four: Market Statistics

The market statistics are distorted and/or unclear

Example: Same Company But a Much Clearer Summary

Component of Pay	Company Target Percentile	Actual Percentile
Base salary	40th	43rd
Annual incentive	60th	50th
Total annual cash	45th	45th
Long-term incentive	Implied 90th	85th
Total direct compensation	***75th***	***73rd***

Five: Long-Term Incentive Values

The LTI values represented in the analysis are unclear

Long-term incentive market values should be grant-date values .

- Best practice in 2018: ***accounting values for equity awards*** and the target value for cash awards
- Proxy NEOs: grant-date market values are now clearly disclosed in proxy

What is the problem with "survey" LTI values?

- Unfortunately, for published survey data, the LTI values are often poor
- Under-reporting of LTI data to surveys
- Inconsistent methodologies used by survey providers ("apples and oranges")

Five: Long-Term Incentive Values

The LTI values represented in the analysis are unclear

Grant-Date LTI Valuations: Ideal Methodology

Type of LTI Award	Valuation	Comment
Stock options/SARs	ASC 718 value	• Option pricing model
Restricted stock/units	ASC 718 value	• Stock price at grant (usually)
Performance stock/units	ASC 718 value	• TSR plans: valued using Monte Carlo model (e.g., 120% stock price) • Operating plans: stock price at grant
Long-term cash	Target $ award	• Assumes average target payout over time

ASC 718 values are the grant-date accounting values per share as calculated by the company, not the survey provider.

Six: Annual Incentive Awards

Analysis is predicated on actual annual incentive, rather than target annual incentive

The assessment of competitive opportunity should focus on target annual incentive.

- Goal: provide a market-competitive target opportunity
  - Actual payouts are volatile and based on performance
- Target: the amount that the company pays if it meets target performance goals
- Assumptions:
  - Reasonable stretch: the underlying assumption is that there is reasonable stretch in the target (and that the company will average target over time)
  - History: if a company has a "consistent" history of paying out well below or well above target, then that point should be discussed
  - No targets: in cases where a company has no formal target, then the de-facto target is the recent average

Six: Annual Incentive Awards

Analysis is predicated on actual annual incentive, rather than target annual incentive

Estimating Market Annual Incentive Targets

- Public peer group: proxy disclosure is very good for public peer groups
- Private survey data: there are often problems with targets in published surveys
  - For years, most published surveys did not have targets
  - Even today, the quality of the published targets is inconsistent
  - This can result in distorted views of annual incentive competitiveness

Seven: Compensation Report

The compensation report makes my head spin!

"It is much harder to write a two minute speech than a two hour speech." *–Abraham Lincoln*

- Data dump: some reports are mind-numbing mountains of numbers
  - The reader should not have to study to figure out the point
- Quality of writing: reflects the quality of the thinking
- Study methodology: all key methodology points should be very clear in the report

Poll Question #2

Which of the seven deadly sins do you find most concerning?

A. Market definition

B. Business size and market values

C. Executive position matching

D. Market statistics

E. Long-term incentive (LTI) values

F. Annual incentive awards

G. Compensation report

Compensation Committee Questions

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Questions Compensation Committees Must Ask

Compensation Issues	Governance Questions
1. Market definition	• Per pay philosophy, what is our market? • What is the market in this analysis? • What is the market for non-NEOs?
2. Business size and market values	• What is median size of companies in this analysis? • How were the market values size-adjusted?
3. Executive position matching	• What is the external benchmark for each job? • Were there any adjustments? If so, why and how much?
4. Market statistics	• What statistic is the market value in analysis?
5. Long-term incentive (LTI) values	• What do the LTI values in the analysis represent?
6. Annual incentive awards	• Does the annual incentive reflect target or actual?
7. Compensation report	• What are the key findings and issues from this analysis? • Are all methodology issues transparent in report?

Questions

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