Pearl Meyer

TRENDS & ISSUES

Compensation as a Catalyst

Value Creation and Executive Compensation

AUTHOR

David Swinford
President & CEO

Pearl Meyer is a strategic content partner for the National Association of Corporate Directors (NACD). Pearl Meyer is an active participant each year on the NACD Blue Ribbon Commission (BRC) and contributor to its annual BRC reports—signature publications that propose new principles and practices to address the most critical boardroom issues. The following article was published as an appendix in the 2015 BRC report The Board and Long-Term Value Creation.

The Board's discussion of value creation is usually connected to its deliberations on strategy; although in some cases where a company is struggling to survive, the discussion may be more about value preservation. However, both situations seek to answer the question, "What are we going to do differently?" The next question is "How do we ensure that we get those things done and how can we use compensation to drive the right behaviors at the right time?"

In the first case—building value—the focus of the discussion will move quickly to the use of long-term incentives. In the case of survival, short-term actions and short-term incentives dominate the conversation. This certainly makes intuitive sense, but for the reasons explained below, we believe that the most effective approach for both scenarios is a balance of both short- and long-term incentives. The strongest results can be achieved when these compensation plans are designed and implemented after determining the right business plan is in place and taking into account differences in perspective among the levels of leadership.

> *"TSR evaluates the actions that have already occurred, rather than spurring new and better things to happen in the future."*

Assessing the Annual Business Plan

Broadly speaking, there are two ways of creating value over the long term. The first is executing an approach that is already in place and refining it over time, for example making incremental improvements in current operations. The second is developing and executing a new idea—creating the strategy and its integration and implementation plans. With rare exceptions (such as a necessity to cannibalize one technology or business to the benefit of a new one with greater future value creation potential), the Board wants to ensure that both approaches are being used on a continuing basis. The best time for directors to satisfy themselves that both forms of value creation are being properly addressed is at the annual review of the upcoming year's business plan, which is a different exercise and normally separate from a review of proposed incentive plan goals. Some questions to ask at this time include:

Assess the Plan:	*Consider:*
What specific operating improvements and targets are reflected in the proposed business plan?	*These may or may not be similar to incentive plan goals.*
If management performs just as effectively next year as it did this year, what operating and financial results can we expect to achieve?	*The goal here is to understand how projected changes in the external environment are expected to impact results, in other words, "If we don't do anything better than this year, what do we expect the results to be?"*
How is our longer-term strategic plan reflected in this proposed annual business plan?	*The goal here is two-fold: to understand what is broader than "business as usual" in terms of sales/revenue, expense, and capital expenditures; and to ensure that the implementation of agreed-upon strategies is happening at a pace sufficient to achieve those objectives on time and on budget.*
What does the management team have to do differently next year to move our various strategic objectives toward completion?	*Business plan discussions tend to be very specific about financials and very general about behaviors and specific actions, but the crux of value creation is encouraging both incremental improvement and innovation—the creativity and openness to new ways of doing things.* *These adaptation and innovation elements don't always get the attention they need or deserve, and are often a source of concern for directors who don't regularly see what is happening below the very top executive level and beyond the numbers.*
For public companies, how will the markets view these business plan goals—and the results if achieved—in light of the economy and competitors' performance and plans?	*Get a sense of whether investors will see the goals as justifying a higher stock price—a key indicator of incremental value.*

Account for Multiple Viewpoints

Once satisfied that annual and longer-term strategic plans are in sync, the next step often turns to the use of compensation to reinforce value creation objectives. Directors should look at both short- and long-term incentive plans and begin the process by considering differences in perspective among the various levels of incentive plan participants.

It is critical to recognize that one size does not fit all, as the needs and outlook of the CEO and most senior leaders of the organization are different from the managers reporting to them, especially those in the business units as opposed to the corporate office. To understand the differences that impact incentive plan design for value creation, directors should ask questions like:

Evaluate:	*Consider:*
How are the need for and plans to achieve value creation communicated at each level of the organization?	*In general, the lower the level of the manager, the greater the focus on day-to-day operations, and the greater the potential need to provide specific incentives to change how things get done.*
What is the mix of pay in terms of fixed salary, short- and long-term incentives; and between cash and equity?	*Compensation at risk and upside opportunity should be proportional to the degree of change needed to accomplish value creation objectives.*
Do our incentive plan measures properly balance line of sight—things the participant substantially influences—with accountability for bottom line results, which may be affected by circumstances well beyond their control?	*Final results truly matter and they align participants with shareholders in the long run, but line of sight goals influence decision-making and behavior.*
How confident are we that the goals we approve are fair and appropriate?	*To be effective, incentive plans must require a comfortable stretch—goals cannot be layups, but they must be achievable, lest they lose impact on performance altogether. Conversely, consistently unachievable goals negatively influence behavior over the long term.*
How well do the participants understand how they personally can contribute to maximum performance on the goals that affect them?	*Communication is critical—not just in explaining the incentive plan, but in all aspects of company and individual performance.*

Create a Catalyst with the Incentive Plan

After the Board reaches a level of satisfaction with the annual business plan's short- and long-range goals and has made assessments on the lines of sight and appropriate levers for the various business leaders, it's time to design the compensation strategy. When it comes to incentive plan design as a catalyst for achieving value creation, as with the business plan, the right mix of near-term and future goals is a requirement for success. However, there are some nuanced and often overlooked challenges Boards can encounter as they seek to achieve this optimally effective balance. The essential evaluations below can further strengthen compensation's stimulus for creating value.

Short-term incentive plans are more important to long-term results than many compensation theorists appreciate. Typically, in most organizations as the year progresses, achieving annual business plan goals becomes increasingly important to company leadership for two reasons: the CEO has committed to delivering the plan to the Board, and all parties want to achieve the best bonus possible for the year. Certain actions that need to get done now to realize a strategic objective later may get lost in the drive to deliver the annual plan. Therefore, consider incorporating key milestones for long-term success into the annual plan as a way to balance both current and future needs of the business. To address this, directors can ask:

- What steps do we need to take now to ensure that our long-term goals are fully achieved by their targeted dates?
- Where and in what degree should these steps or milestones be incorporated in the incentive plan structure? (We are not suggesting that the Board micro-manage goal-setting below the top leadership team, but rather that directors satisfy themselves that these issues are being adequately addressed.)

With respect to long-term incentives, a current and significant challenge is determining whether goals that operate independently of stock price are necessary for creating true value over the long term. If that is the case, can these goals be reasonably established and effectively communicated?

While total shareholder return (TSR) is the ultimate long-term measure of success and provides strong alignment with shareholder interests, it lacks two desirable aspects of an incentive: line of sight from the participants' actions to the ultimate result and specific information on what it takes to successfully influence the end result. It evaluates the actions that have already occurred, rather than spurring new and better things to happen in the future.

Since most long-term performance plan cycles are three years in length, even relative TSR is lacking, as market conditions and stock price volatility among peer group companies often have a bigger influence on the result than value-creating actions implemented during the performance period. In many if not most industries, such performance periods are shorter than business or investment cycles, making it difficult to determine whether the results achieved are simply due to cyclical phenomena or actual successful long-term value creation efforts.

This issue may sort out over a period of several three-year cycles for the company, but over-reliance on the metric can present other issues that may not resolve naturally. Executives approaching retirement or those moving into different positions over the course of time can be driven to decisions and behaviors that are too focused on the near-term, while influential forces outside the company can likewise focus on short-term gains at the expense of a long-range, high-value vision. Here we encounter the limits of even well-designed incentive plans and the need for the directors' collective judgment regarding the overall health of the enterprise and the ability of the leadership team to navigate the turbulent waters of an ever-changing business environment. Some questions to ask:

- Is the length of our incentive plan performance cycle appropriate to our particular investment time frames and our true and unique business cycle?
- How are we evaluating our success and developing and implementing value creation strategies over the long haul?
- Do our senior leaders have sufficient long-term equity interests to counter-balance all of the existing pressures in the system to deliver short-term results, which are potentially counter to long-term success?
- Are we comfortable that we have a solid long-term vision for the business, and that we are doing all that we can to create long-term success for the organization and its shareholders?

Conclusion

As Boards search for new and better ways to enact long-term value creation for the companies and shareholders they serve, the deployment of carefully calibrated compensation plans can play a significant role. In designing these incentives, the ability of directors to achieve balance in numerous areas is key:

- Design your incentive plan after determining the annual business plan has the right mix of short- and long-term vision;
- Account for unique perspectives among management levels to ensure incentive plans align to appropriate and achievable results;
- Develop a combination of short-term incentives that align to expected annual results, as well as drive the incremental milestones necessary for long-term strategy execution;
- Create long-term incentives that support shareholder interests, but do so in line with your company's business cycle; and
- Communicate each element and its rationale with all stakeholders.

About the Author

David Swinford, President and Chief Executive Officer, joined Pearl Meyer in 1998. For the last 35 years, he has worked closely with compensation and governance committees of Boards, as well as management teams, to link compensation with business and executive leadership development strategies. Mr. Swinford has considerable experience in contractual arrangements and incentive plan design, including the development of meaningful performance standards. He provides a strong focus on issues related to Board independence and oversight, talent development and succession planning.

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 Francisco.

Pearl Meyer

NEW YORK
570 Lexington Avenue, 7th Floor
New York, NY 10022
(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
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
3rd Floor
58 Grosvenor Street
London W1K 3JA
+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
595 Market Street, Suite 1340
San Francisco, CA 94105
(415) 651-4560
sanfrancisco@pearlmeyer.com