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How to Conduct a Pay-for-Performance Analysis of your Executive Compensation Program

October 22, 2019

Welcome

Ron Michalak, Senior Director, Sponsorship



Illinois Health
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How to Conduct a Pay-for-Performance Analysis of your Executive Compensation Program

October 17, 2019

Steve Sullivan

Ed Steinhoff



Agenda

- Introduction
- The Basis for Defining Performance
- Pay Program Alignment is Key
- Measuring the Competitiveness of Target Pay
- Incentive Plan Results
- Compensation Cost
- Incentive Plan Target-setting
- Incentive Plan Leverage Models
- Next Steps for Aligning Pay and Performance
- Questions



Introduction

- Healthcare organizations are adopting sophisticated approaches to variable compensation to align executive performance, business strategy and pay
- These more complex incentive programs are relatively new to healthcare and typically have more moving pieces than the industry's traditional "salary and bonus" approach
- Newer programs often include both annual and long-term incentive plans, in addition to base salary, and represent new challenges in calibrating performance, total direct compensation levels, market positioning, and cost
- A carefully designed executive compensation program can be a powerful connection between the executive team and the board's vision, but only if it is properly evaluated and maintained
- As an organization completes its fiscal year, the compensation committee can utilize pay-for-performance analytics to evaluate the effectiveness of the variable compensation program



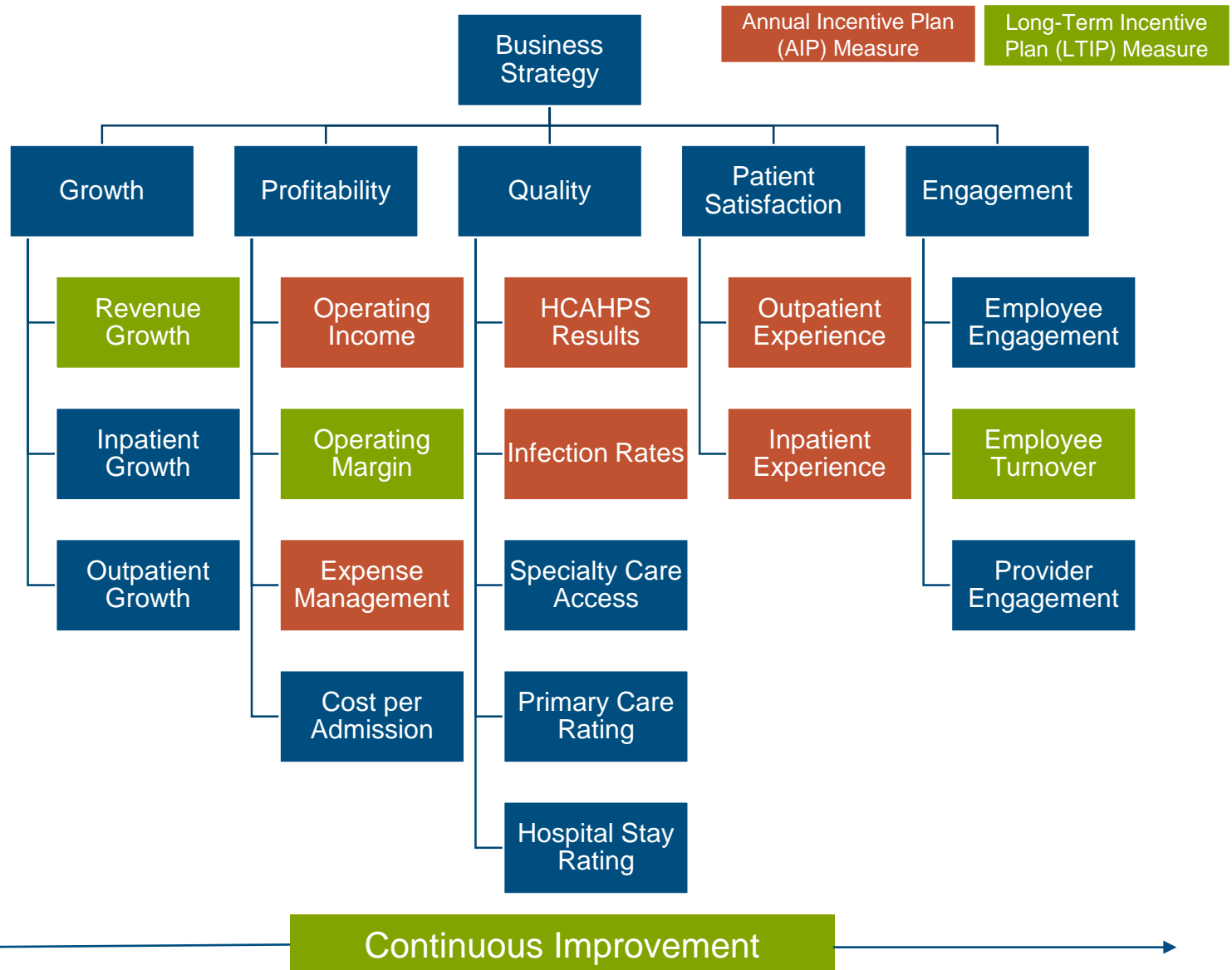
Introduction

- While every organization is different, most pay-for-performance analyses will include some or all of the following:

The organization's performance against its overall performance scorecard:	<ul style="list-style-type: none">Performance results and payouts for each measureOverall performance result and payout
The executive team's performance against:	<ul style="list-style-type: none">Each individual annual incentive metricThe overall annual incentive planEach individual long-term incentive metricThe overall long-term incentive plan
Overall amount of annual and long-term incentive awards earned, expressed in dollars and as a percent of base salary:	<ul style="list-style-type: none">Across all participating executivesWithin each executive level or tierBy each executive
Base salary, total cash compensation, and total direct compensation market compa-ratios for:	<ul style="list-style-type: none">All participating executivesEach executive level or tier
Total cost of variable compensation:	<ul style="list-style-type: none">Alignment of overall executive pay with business strategy and results

The Basis for Defining Performance – Incentive Plan Map to Business Strategy

- A critical starting point for assessing the alignment of executive pay with performance is defining “performance”
- Companies define “performance” in different ways; incentive plan metrics should incorporate those measures on which the business plan focuses and which the executive team can control
- Measures may be outcome-based or process-based; your incentive plans may incorporate both



Pay Program Alignment is Key

- Well designed incentive plans align executive pay with organization performance and ensure that pay levels are reasonable and appropriate relative to competitor organizations within a pay for performance context

Perception of Overall Institutional Performance

- What is the Board's perception about the institution's overall performance?
- What is the experience of patients?
- What is the public's perception?

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Current Performance Against AIP and LTIP Metrics

- What is overall AIP and LTIP performance as a percent of target?
- Does it seem reasonable given Board/public perception?
- Is the plan measuring the right things?

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Annual and Long-Term Incentive Amounts

- Do the projected annual and long-term award amounts seem reasonable given perception and performance?
- Overall?
- Against individual metrics?
- By tier?
- By individual executive?

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Overall Cost of AIP and LTIP

- Is the overall variable compensation program cost appropriate given current performance?
- As a percent of earnings?
- As a percent of leadership payroll?

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Total Direct Compensation Market Positioning

- Are projected compa-ratios appropriate based on:
- The executive compensation philosophy
- Overall performance against AIP and LTIP metrics?
- Perceived institutional performance?

**ALIGNING THESE IS ONE OF THE
COMPENSATION COMMITTEE'S
PRIMARY RESPONSIBILITIES**

Measuring the Competitiveness of Target Pay

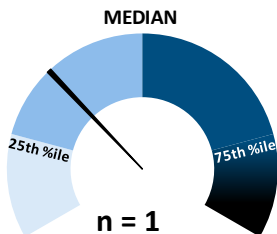
- The table below shows a comparison of market actual compensation values to an organization's projected total direct compensation (TDC) by tier. Values have been averaged by tier.

Incentive Level	Average TDC	Market Comparison			Ratio to Median	Estimated Percentile
		25th	Median	75th		
Tier 1	\$1,175.7	\$1,082.2	\$1,337.9	\$1,661.9	87.9%	37th
Tier 2	\$710.9	\$564.9	\$670.2	\$806.9	106.1%	58th
Tier 3	\$403.7	\$307.3	\$393.8	\$494.4	102.5%	53rd
Tier 4	\$330.6	\$269.6	\$337.6	\$435.1	97.9%	48th
Overall	\$426.8	\$345.4	\$431.2	\$543.6	99.0%	49th

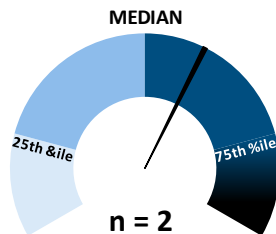
NOTE:

- (a) TDC = base salary + annual incentive amount + long-term incentive amount
 (b) Market data has been trended to 4/1/2019 at an annual rate of 3%
 (c) Tier 1 n=1; Tier 2 n=2; Tier 3 n= 7; Tier 4 n= 12

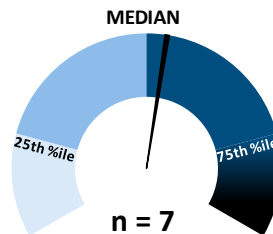
Tier 1 TDC - 2019



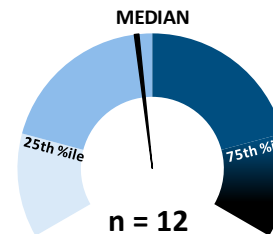
Tier 2 TDC - 2019



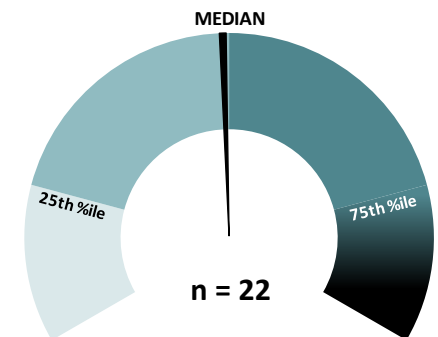
Tier 3 TDC - 2019



Tier 4 TDC - 2019



All Executives TDC – 2019



- “Speedometers” reflect 25th, 50th (median) and 75th percentiles of market pay
- The organization is trying to calibrate “target” performance with TDC positioning at market median

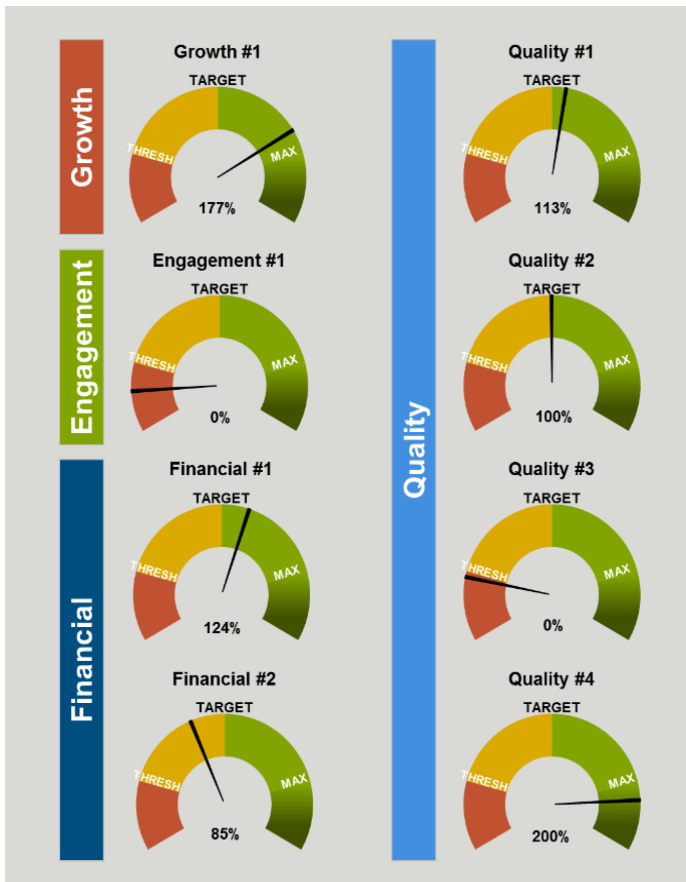


Incentive Plan Results

- The slides that follow show how a compensation committee can:
 - Review performance-pay alignment
 - Evaluate the ongoing use of current measures and metrics
 - Modify award opportunity levels
 - Change measure weighting
 - Reassess the likelihood of achievement of targeted performance
 - Ensure that total direct compensation levels are positioned appropriately against market competitors based on performance

Short-Term Incentive Plan Results

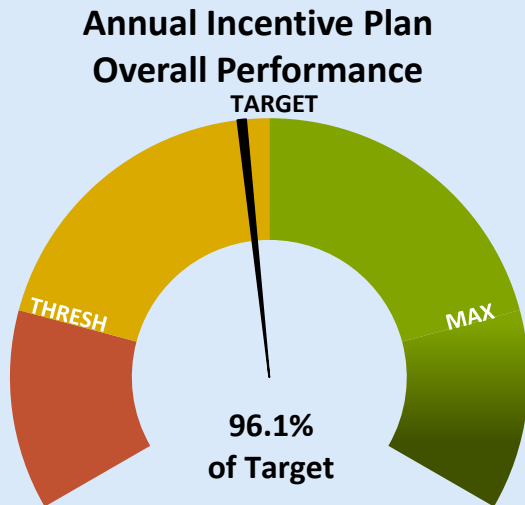
- The committee can evaluate data which outlines an organization's performance against the eight metrics that comprise its annual incentive plan



- The compensation committee can clearly see how well the executive team performed against each metric, and the analysis can drive a robust conversation between the committee and the CEO regarding:
 - The team's successes that year
 - Specific business challenges
 - Likelihood of achievement
 - Annual goal setting for the following year and beyond

Short-Term Incentive Plan Results

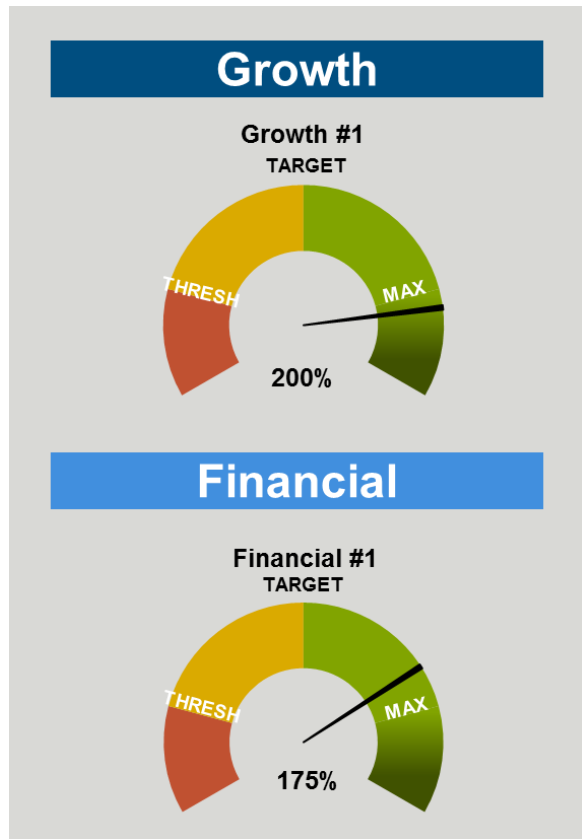
- The committee can then evaluate the executive team's performance on the annual incentive plan in aggregate



- The committee and CEO can discuss whether the overall AIP performance level achieved accurately reflects the organization's performance in general
- This conversation is most useful if held on an annual basis over the course of multiple consecutive years:
 - Some of the individual plan metrics may no longer align with the organization's evolving strategy
 - Metrics may need to be adjusted, eliminated or replaced
 - The relative weighting of the individual metrics may also be assessed

Long-Term Incentive Plan Results

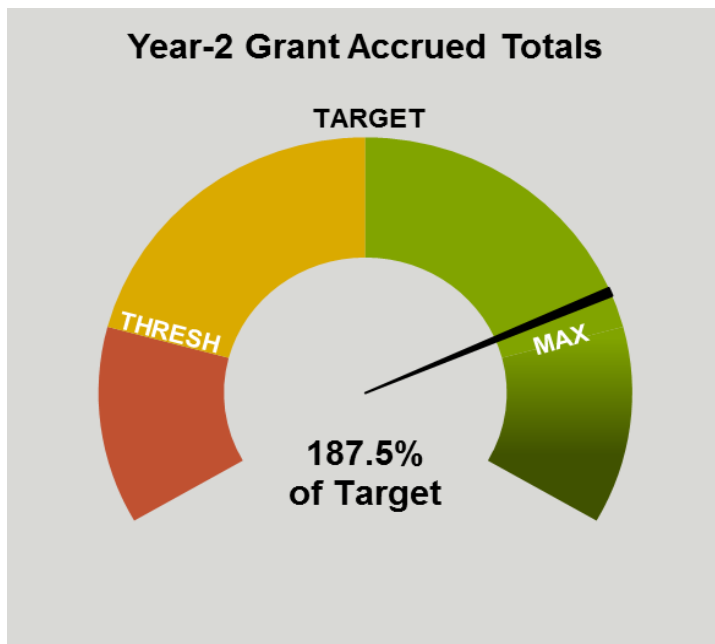
- The committee can then assess the metrics that comprise the organization's long-term incentive plan during the first period of that plan



- The LTIP performance data provides an opportunity for the committee and CEO to discuss:
 - The factors influencing performance
 - The rigor of goal setting
 - LTIP performance versus the organization's overall progress towards its long-term goals

Long-Term Incentive Plan Results

- The committee can evaluate the executive team's performance on the long-term incentive plan in aggregate
 - A holistic review of the long-term incentive plan can generate a strategic conversation regarding the alignment between the team's performance against the plan and the organization's progress moving towards the future version of itself



- Long-term incentive metrics should generally be maintained for periods of at least three to five years, if possible, and have fewer changes to metrics than the short-term plans
- This annual conversation is important in making sure that the long-term plan still has integrity for the executive team and board, and continues to reflect movement towards the board's strategic vision

Size of Incentives Earned

- The committee can evaluate the size of annual and long-term incentives earned at the conclusion of each performance period
- Award levels should be expressed as a dollar value and as a percent of base salary
- This information is important to the committee so they can determine whether the level of performance attained is calibrated properly with the amount of compensation being delivered via each compensation component, namely the desired mix of base salary, annual incentives, and long-term incentives

	Base Salary		Annual Incentive		Total Cash	
	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2
Tier 1	\$650,000	\$675,000	\$195,000	\$129,766	\$845,000	\$804,766
Tier 2	\$650,000	\$800,000	\$195,000	\$153,796	\$845,000	\$953,796
Tier 3	\$1,800,000	\$1,900,000	\$405,000	\$273,949	\$2,205,000	\$2,173,949

Percent Mix of Total Cash by Year

Tier 1	77%	84%	23%	16%		
Tier 2	77%	84%	23%	16%		
Tier 3	82%	87%	18%	13%		
Totals	\$3,100,000	\$3,375,000	\$795,000	\$557,511	\$3,895,000	\$3,932,511

Note: Tier levels above include: one participant in Tier 1, two participants in Tier 2, and eight participants in Tier 3.

	Base Salary		Long-Term Incentive Year 1 Grant ⁽¹⁾			Grant ⁽²⁾	
	Year 1	Year 2	Period-1	Period-2	Aggregate Total	Period-1	Aggregate Total
Tier 1	\$650,000	\$675,000	\$185,250	\$365,625	\$275,438	\$379,688	\$379,688
Tier 2	\$650,000	\$800,000	\$123,500	\$243,750	\$183,625	\$300,000	\$300,000
Tier 3	\$1,800,000	\$1,900,000	\$256,500	\$506,250	\$381,375	\$534,375	\$534,375

Percent of Base Salary

Tier 1			29%	56%	42%	56%	56%
Tier 2			19%	38%	28%	38%	38%
Tier 3			14%	28%	21%	28%	28%
Totals	\$3,100,000	\$3,375,000	\$565,250	\$1,115,625	\$840,438		\$1,214,063

Note: Tier levels above include: one participant in Tier 1, two participants in Tier 2, and eight participants in Tier 3.

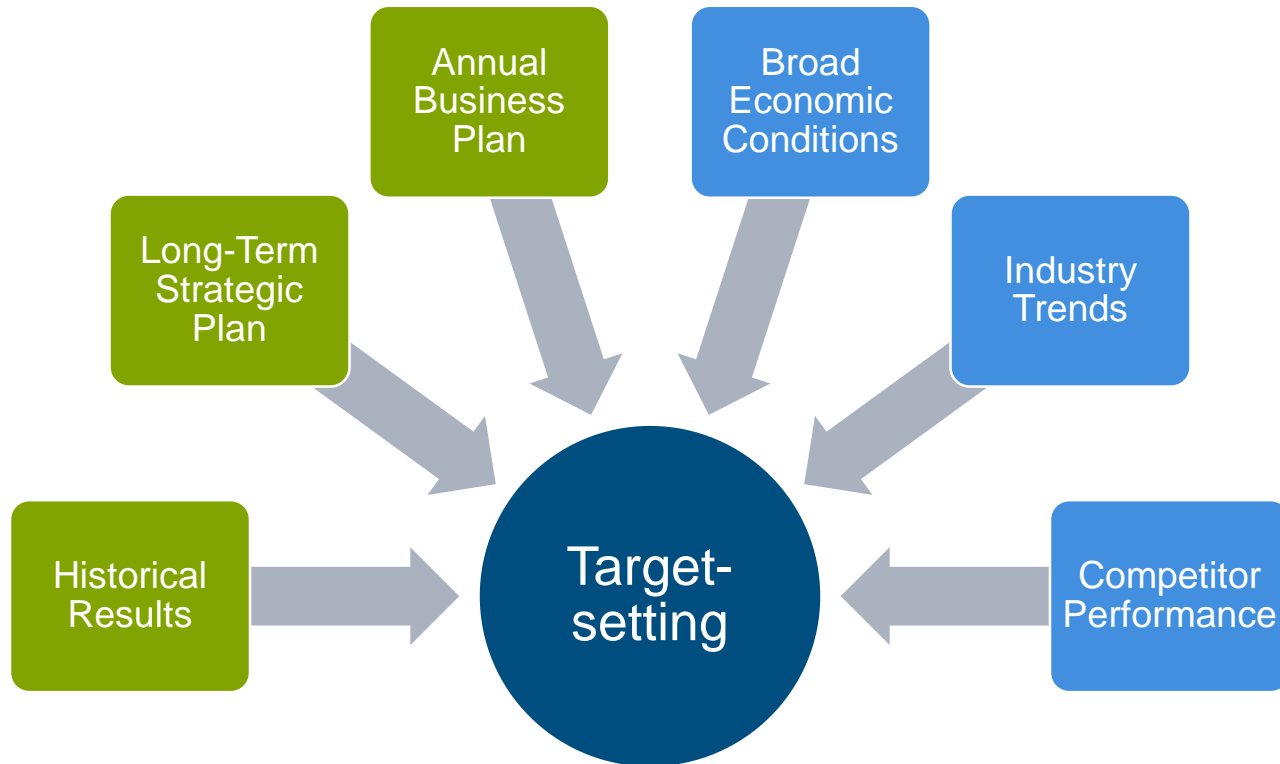
Size of Long-Term Incentives Earned

- The committee can evaluate the size of long-term incentives earned at the conclusion of each performance period for each executive
- The committee can evaluate internal equity across tiers and individual executives to determine whether the current grant strategy is appropriate
- It is also helpful for committee members to actually see the amounts of long-term incentives being granted and currently vesting for each executive:
 - Is it appropriate based on individual contribution to the organization?
 - Does it reflect the current succession plan?
 - Should additional program tiers be added?

Tier	Executive	Position	LTI Target % of Base	Base Salary		Long-Term Incentive Year 1 Grant ⁽¹⁾			Grant ⁽²⁾	
				Year 1	Year 2	Period-1	Period-2	Aggregate Total	Period-1	Aggregate Total
Tier 1	Exec #1	Chief Executive Officer	30%	\$650,000	\$675,000	\$185,250	\$365,625	\$275,438	\$379,688	\$379,688
Tier 2	Exec #2	Chief Operating Officer	20%	\$325,000	\$400,000	\$61,750	\$121,875	\$91,813	\$150,000	\$150,000
	Exec #3	Chief Financial Officer	20%	\$325,000	\$400,000	\$61,750	\$121,875	\$91,813	\$150,000	\$150,000
Tier 3	Exec #4	Chief Legal Officer	15%	\$225,000	\$237,500	\$32,063	\$63,281	\$47,672	\$66,797	\$66,797
	Exec #5	Chief Information Officer	15%	\$225,000	\$237,500	\$32,063	\$63,281	\$47,672	\$66,797	\$66,797
	Exec #6	Chief Human Resources Officer	15%	\$225,000	\$237,500	\$32,063	\$63,281	\$47,672	\$66,797	\$66,797
	Exec #7	Chief Marketing Officer	15%	\$225,000	\$237,500	\$32,063	\$63,281	\$47,672	\$66,797	\$66,797
	Exec #8	Chief Medical Officer	15%	\$225,000	\$237,500	\$32,063	\$63,281	\$47,672	\$66,797	\$66,797
	Exec #9	Chief Ambulatory Services Officer	15%	\$225,000	\$237,500	\$32,063	\$63,281	\$47,672	\$66,797	\$66,797
	Exec #10	Chief Performance Officer	15%	\$225,000	\$237,500	\$32,063	\$63,281	\$47,672	\$66,797	\$66,797
	Exec #11	Chief Inpatient Services Officer	15%	\$225,000	\$237,500	\$32,063	\$63,281	\$47,672	\$66,797	\$66,797

Incentive Plan Target-setting

- Target-setting should incorporate multiple internal and external perspectives:





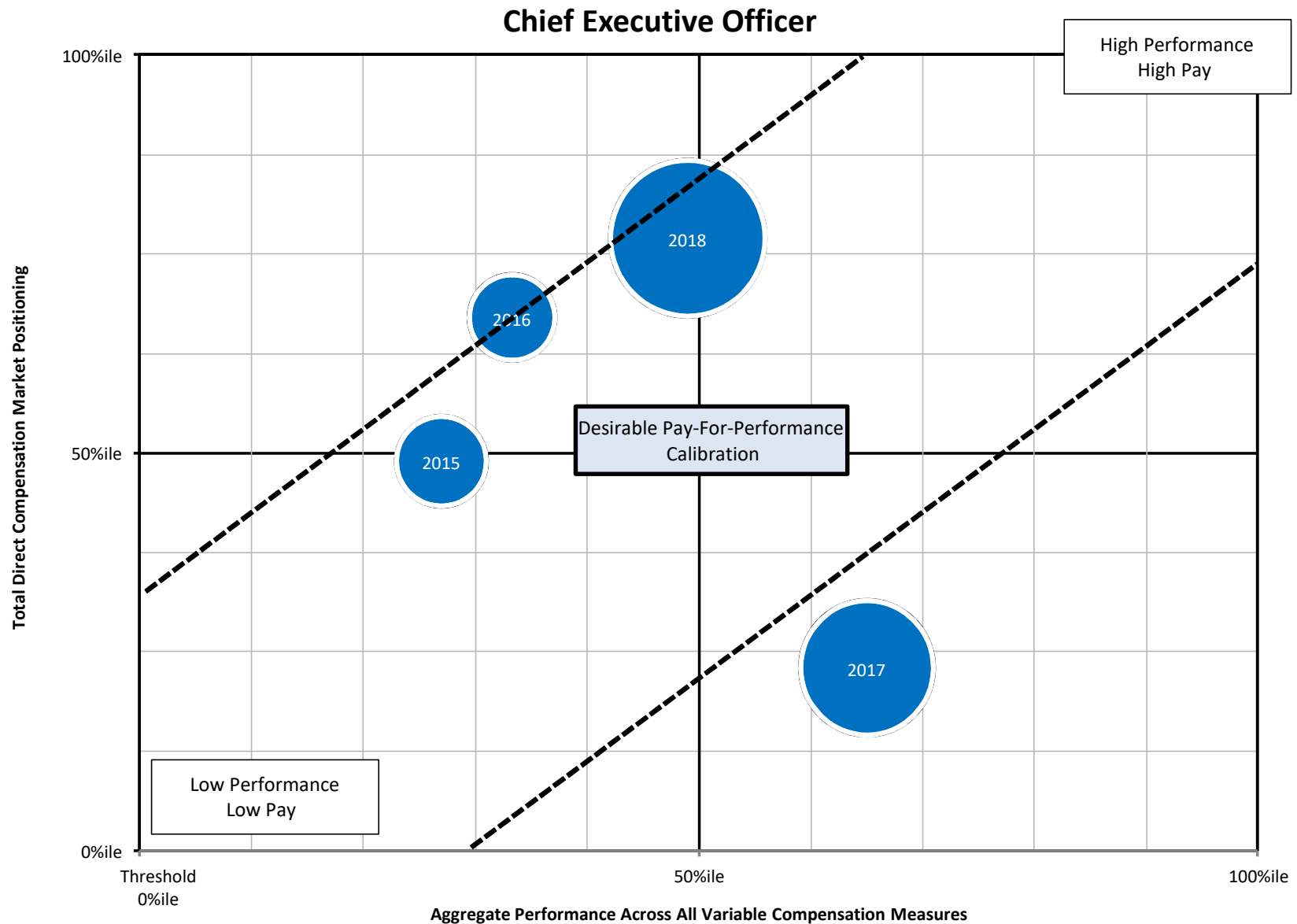
Incentive Plan Target-setting

- Target-setting involves setting not only “target” performance levels which result in “target” payout levels, but also threshold and maximum/superior performance levels
- Typical market practice incorporates the following structure:

Performance Level	Payout Level	Likelihood	TDC Market Position
Threshold	0 to 50% of target	9-10 times over 10 years	25 th to 40 th percentile
Target	100% of target	4-6 times over 10 years	50 th percentile
Maximum	150% to 200% of target	1-2 times over 10 years	75 th percentile and above

- Payouts are typically interpolated for performance between threshold and target and between target and maximum

Performance-Based Market Positioning need to be Carefully Calibrated



Incentive Plan Target-Setting

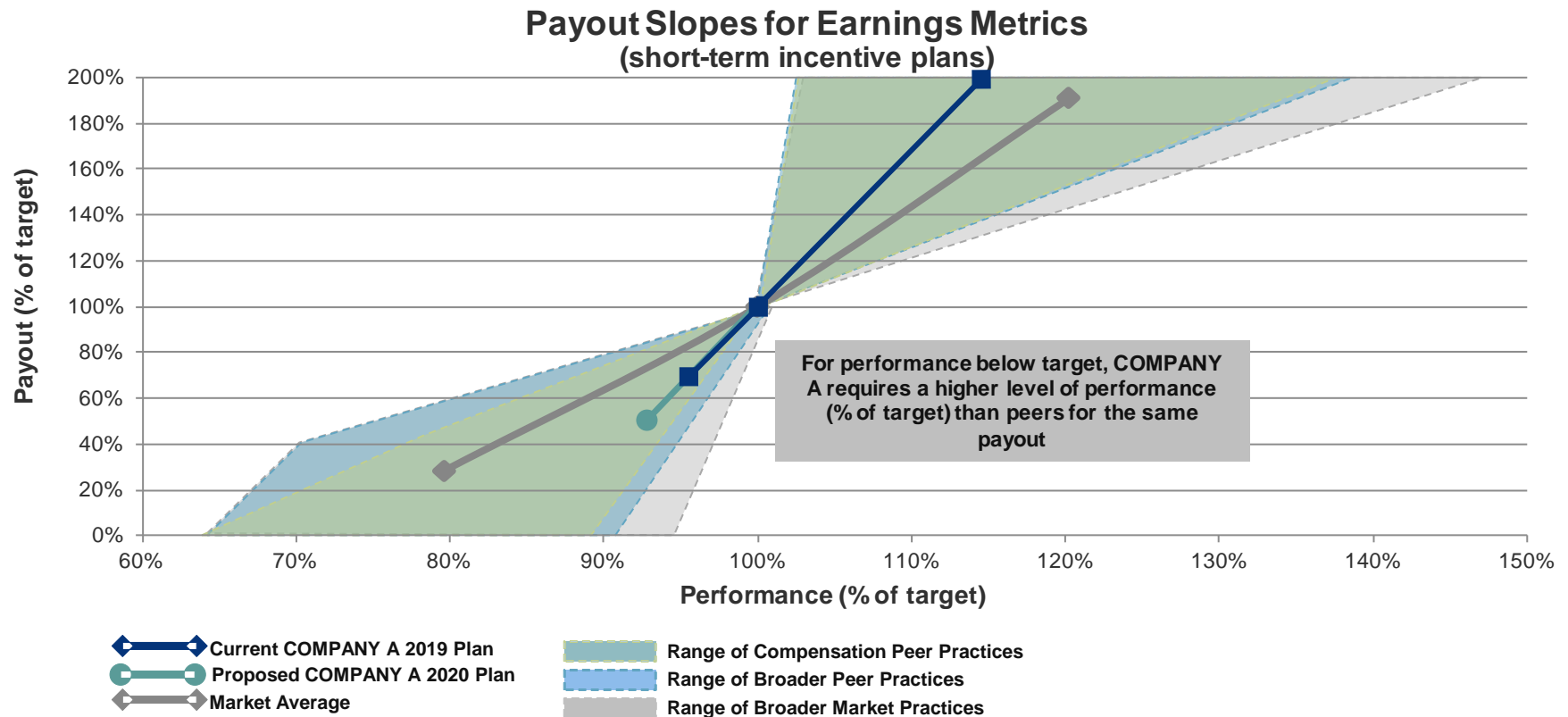
- Looking at payouts over a multi-year time period in conjunction with the board's judgement about the company's performance over that same time period can help assess the effectiveness of the target-setting process

Goal	2011			2012			2013			2014			2015			2016			2017			2018		
	Weight	Actual vs. Target	Payout vs Target	Weight	Actual vs. Target	Payout vs Target	Weight	Actual vs. Target	Payout vs Target	Weight	Actual vs. Target	Payout vs Target	Weight	Actual vs. Target	Payout vs Target	Weight	Actual vs. Target	Payout vs Target	Weight	Actual vs. Target	Payout vs Target	Weight	Actual vs. Target	Payout vs Target
Measure 1	40%	68%	80%	30%	143%	150%	30%	143%	150%	25%	320%	150%	25%	40%	46%	20%	0%	0%	20%	100%	100%	20%	99%	99%
Measure 2	25%	0%	0%	25%	200%	150%	25%	200%	150%	25%	147%	147%	20%	84%	84%	25%	200%	150%	50%	112%	112%	50%	55%	55%
Measure 3	25%	-	105%	25%	-	150%	15%	-	135%	20%	-	125%	20%	-	106%	20%		125%	15%		133%	15%		133%
Measure 4	10%	-	100%	20%	-	100%	30%	-	150%	30%	-	100%	35%	-	85%	35%		100%	15%		103%	15%		73%
Total	100%		68%	100%		140%	100%		148%	100%		129%	100%		79%	100%		98%	100%		111%	100%		78%

Goal	2011 - 2018 Averages			2011 - 2018 Payout Occurrence			
	Weight	Actual vs. Target	Payout vs Target	No Payout	Below Target	Target or Above	Max
Measure 1	26%	114%	97%	1	4	4	3
Measure 2	31%	125%	106%	1	3	5	3
Measure 3	19%	-	127%	0	0	8	1
Measure 4	24%	-	101%	0	2	6	1
Total	100%	-	106%	0	4	4	0

Incentive Plan Leverage Models

- Various leverage approaches can be modeled to arrive at one that the board and senior management are most comfortable with – and one that rewards appropriately for higher performance levels without encouraging excessive risk-taking





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