Survey Says: Incentives Matter, But the Devil is in the Details

Compensation Series

November 10, 2016
Meet The Presenters

Howard Brod Brownstein is president and founder of The Brownstein Corp., a nationally-known turnaround management firm. Brownstein is an NACD Board Leadership Fellow and is President of the NACD Philadelphia Chapter. He regularly serves as an independent director and currently serves on the board of A.M. Castle & Co., chairs the audit committee of PICO Holdings Inc., and also chairs the nominating and governance and the strategic planning and risk assessment committees of P&F Industries Inc. Previously, he was the sole board member of Betsey Johnson LLC, chaired the audit committees of LMG2 LLC and Special Metals Corp., and served on the board of Magnatrac Corp. He has also chaired the boards of the National Philanthropic Trust and of a United Way agency, and served on the boards of a regional bank and a retail department store. He has published more than 80 articles, books, and chapters on turnaround management and corporate governance.

David Seitz is a managing director with Pearl Meyer, located in Dallas and affiliated with the firm’s Houston office. He has nearly 30 years’ experience in compensation consulting and particular expertise in long-term incentive plan design. Additional areas of concentration include director compensation, performance metrics, and total compensation strategy, among others. Mr. Seitz has worked with companies across all industries, with specific focus on financial services, manufacturing, retail, healthcare, and energy. He has helped develop the executive compensation strategy for numerous types of significant business change, such as reorganizations, turnarounds, IPOs, and mergers and acquisitions.
Submit a question and receive your answer directly from Pearl Meyer. You will also be opted-in to receive future executive compensation thought leadership from Pearl Meyer.

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The presentation slides are available for download at https://www.pearlmeyer.com/incentives-matter within the webinar console.
You will automatically receive 1 NACD credit for your participation. Credit may be applied to NACD Fellowship programs. Contact Fellowships@NACDonline.org for more details.

The replay and slides will be available early next week at www.NACDonline.org and www.pearlmeyer.com.
Today’s Discussion

Highlights from Pearl Meyer’s annual planning survey—what is on the minds of directors and management, and what it means for compensation in 2017.

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2017 Executive Pay Projections
Projected 2017 Base Salary Increases

On Point Survey: most companies are projecting executive salary increases of 3% for the CEO and direct reports.
Projected 2017 Annual Incentive Payments

On Point Survey: projected 2016 annual incentive payouts (to be distributed in early 2017) are expected to be comparable to 2015 payouts.

Projected Payouts: 2016 vs. 2015

- Lower: 24%
- About the Same: 47%
- Higher: 29%
Projected LTI Grant Values

On Point Survey: most companies (69%) project the value of 2017 LTI awards to be about the same as 2016 and 25% are projecting higher awards.

Expected LTI Grant Values - 2017 vs. 2016

- Lower: 7%
- About the Same: 69%
- Higher: 25%
Performance-Based Long-Term Incentives (LTI)
Executive Incentive Plans Can be a Catalyst for Driving Business Strategy

We believe executive incentive plans have the power to:

- Drive Participant Behavior
- Focus Executive on Specific Goals
- Reinforce a Business Strategy
- Communicate Business Priorities
- Motivate Executives to Achieve Business Goals
- Align Compensation with Business Results
Polling Question #1

*To what extent do you believe that executive incentive plans impact behavior and focus?*

A. Significant impact  
B. Some impact  
C. Little impact  
D. No impact  
E. Unsure
Performance-Based LTI: Four Key Levers

1. Metrics
   What are the right performance measures?

2. Targets
   What are the appropriate goals for this metric?

3. Incentive Scale
   What should the incentive curve or “leverage” look like?

4. Communication
   What do we tell participants about the plan?
Performance-Based LTI: Selecting Performance Metrics

On Point Survey: most companies cited committee/board preference (54%) as “very important” when selecting incentive metrics.

"Very Important" Considerations:
- Committee/Board Preference: 54%
- Shareholder Value Correlation: 39%
- Management Preference: 29%
- Industry and Peer Practices: 24%
- Proxy Advisory Perspective: 11%
1. Metrics: Select Metrics by Considering a Number of Issues

Key Considerations for Selecting Incentive Metrics

- Company Culture
- Business Strategy
- Financial Reporting
- Correlation to Value
- Industry/Peers
- Complexity/Accuracy

Desired Behaviors and Focus
2. Performance-Based LTI: Setting Targets

On Point Survey: most companies (64%) find it either “difficult” (18%) or “somewhat difficult” (46%) to agree on financial targets.
2. Targets: Set Appropriate Stretch Targets by Utilizing Multiple Perspectives

- **Historical Perspectives**
  - Company
  - Company vs. Plan
  - Industry/Peers

- **Forward-Looking Perspectives**
  - Company Plan
  - Analyst Estimates
  - Stock Price Implied
3. Incentive Scale: Setting the Incentive Scale

On Point Survey: most companies (73%) set the incentive scale using simple formulas (e.g., threshold = 80% of target; maximum = 120% of target).
## 3. Incentive Scale: Think more Incentive Scale/Curve

Incentive curves must be customized based on key considerations:

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<th>Consideration?</th>
<th>Comments</th>
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<td>Metric: What is the metric?</td>
<td>• What is impact on firm value?</td>
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<td>• How volatile is metric?</td>
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<td>• What is strategic priority?</td>
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<td>Target: How much stretch is in target?</td>
<td>• Should be willing to pay more for a stretch goal (and vice-versa)</td>
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<td>Risk: What is the desired incentive risk?</td>
<td>• What is philosophy and total package?</td>
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4. Communicate: Companies Can Improve Incentive Plan Effectiveness & ROI via Better Communication

Communication “touch points” in the performance period:

**Grant/Award**
- $/Shares
- Legal terms
- Objectives (why?)
- Value drivers/behaviors (how to influence?)

**Progress Report**
- Current score
- Why?
- How to adjust?

**Final Payout**
- Payout amount
- Why?
Polling Question #2

In which incentive area do you believe your company could do a better job with execution?

A. Selecting performance metrics
B. Setting target goals for each metric
C. Establishing incentive curve
D. Improving incentive communication
E. All of the above
Relative TSR Plans – “Hot Topics”

What happens when relative TSR is strong but absolute TSR is negative? Most companies (51%) have no provision for negative TSR in their incentive plan.

How do you treat acquired peers? Most companies (42%) exclude peer companies that have been acquired when assessing relative TSR.
Annual Incentive: Basis for Targets and “Stretch”

Annual incentive targets are anchored to budget (71%) and are usually identical (38%).

Most companies (60%) believe that annual targets typically have a fair stretch, but that the stretch is viewed by some (24%) as a bit inconsistent from year-to-year.
Most companies (71%) make adjustments for unusual events on an ad-hoc, discretionary basis.

**Most Common Formally Identified Adjustments**

- Non-recurring/Restructuring: 91%
- Asset Write-downs: 49%
- Extraordinary Foreign Exchange Rate Changes: 25%
- Share Buy-backs: 18%
Dodd-Frank Compliance Planning
Most companies (86%) are more concerned about employees comparing their pay to the “median employee” rather than to the CEO. Furthermore, most companies are either not confident (33%) or unsure (28%) about HR/line managers answering employee questions on “median employee” pay.
Pending Disclosures: Pay vs. Performance and Clawbacks

Most companies are not taking action until the proposed pay-versus-performance and clawback rules are final.

What are you doing to prepare for the proposed pay-versus-performance disclosures?

- No actions taken, waiting for the final rules: 56%
- Discussed proposed rules with the compensation committee: 32%
- Started modeling pro-forma examples of what disclosure would look like: 12%

What are you doing to prepare for the proposed clawback rules and disclosures?

- No actions taken, waiting for the final rules: 47%
- Discussed proposed rules with the compensation committee: 33%
- Modified clawback policy to mirror provisions of proposed rules: 20%
Key Takeaways

- Incentive plans can drive executive behavior and focus but the “devil is in the details”.

- We must do a better job of execution in order to maximize the incentive value of any compensation program; all four levers are critically important to a successful plan.

- Incentive plan participants may not understand as much about the plans as the board believes; there is opportunity for better communication and subsequent execution.

- Workforce communication about the median employee’s pay will be critical after CEO pay ratio disclosure. It’s in the early days but plan ahead!

- Review proposed Dodd-Frank clawback requirements against your current provisions and model pay-versus-performance disclosure so the results aren’t a surprise.
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December 1
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