



# Pearl Meyer

## NACD Board Committee Forum

### Three-Dimensional Pay Analysis: A Data-Driven Approach to Compensation Design

September 30, 2018



## What we will cover

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- What is three-dimensional pay analysis?
- How can it help Compensation Committees make better decisions?
- Example
- Discussion



# What is three-dimensional pay analysis?

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- A thorough examination of senior executive compensation that relies on three distinct types of analysis
  1. Target pay analysis
  2. Realizable pay-for-performance analysis
  3. Opportunity analysis

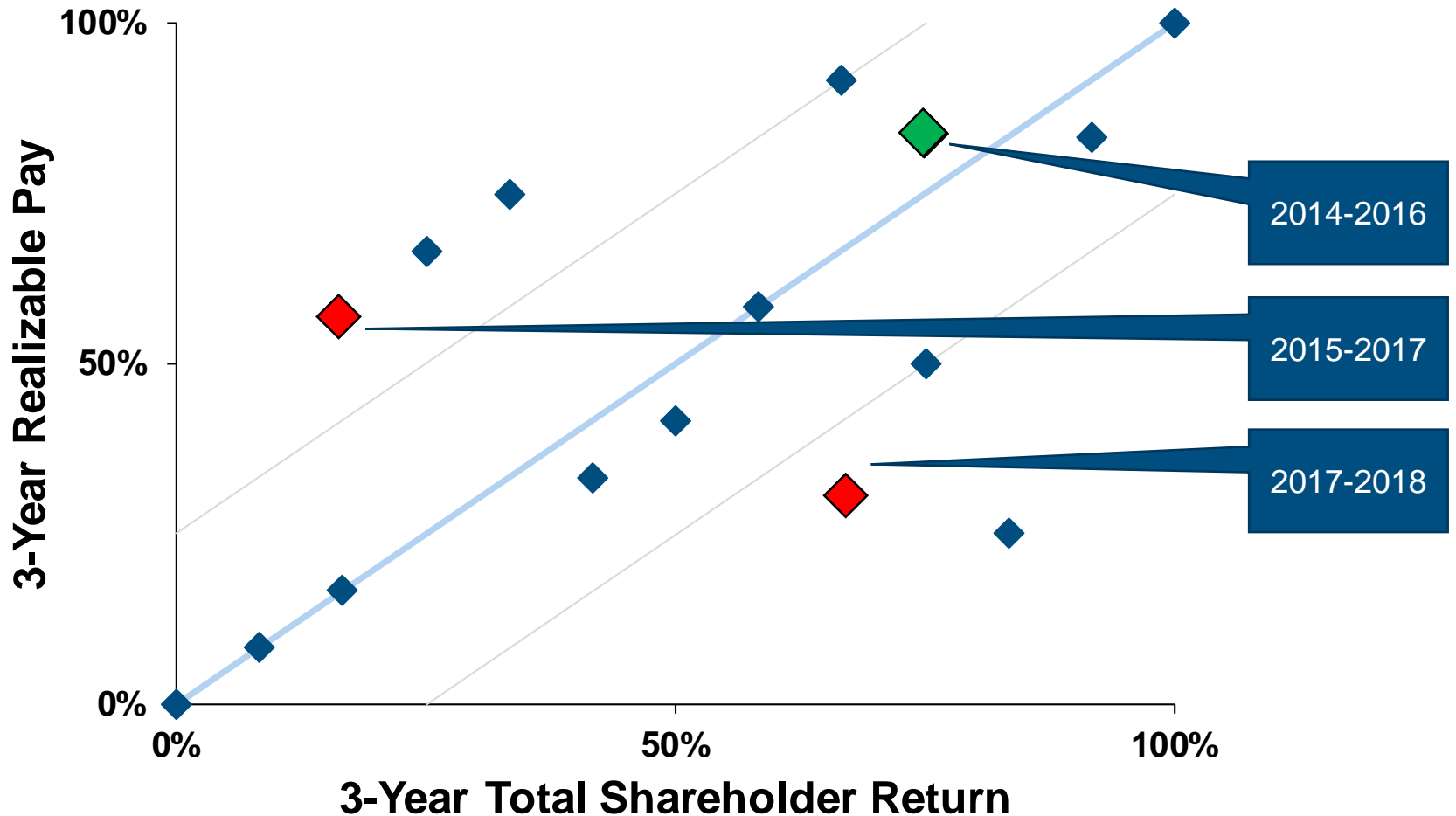


## How can it help?

- Provides a more comprehensive picture of your executive compensation program than one or two analyses can provide
  
- Allows the Compensation Committee to better choose among multiple levers to better ensure pay-for-performance alignment across a broad range of performance outcomes
  - *Base pay increases (pay levels)*
  - *Changes to incentive targets or grant values (pay mix)*
  - *Change to long-term incentive mix vehicles*
  - *Incentive plan design features/mechanics*
  - *Thresholds and caps*
  - *Performance goals (targets)*
  - *Performance ranges (threshold – maximum ranges)*

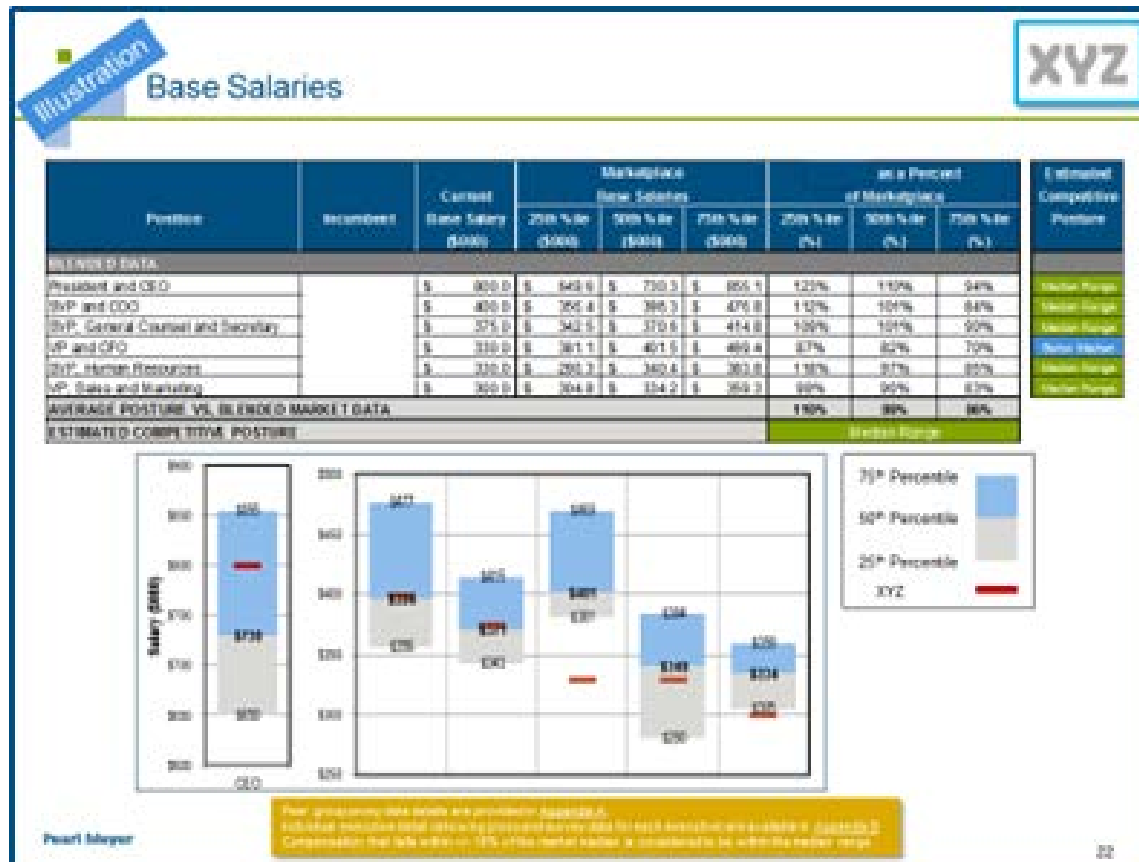
The objective is to land in the fairway, every time!

### CEO ABC Co. 3-Year Pay for Performance Realizable Pay vs. Total Shareholder Return



# Target pay analysis

- Traditional total direct compensation benchmarking
  - Salaries, target incentives, the grant value of long-term/equity awards
  - Useful to calibrate executive pay to a desired pay positioning goal
  - Widely understood; basis upon which pay increases are determined each year





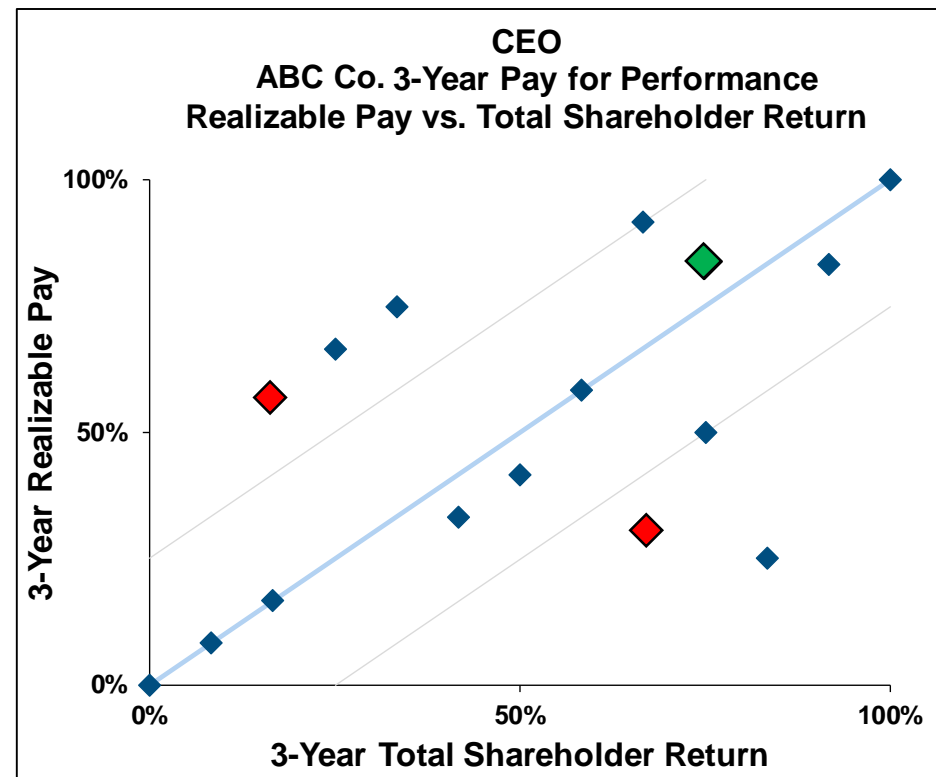
## Target pay analysis is necessary, but not sufficient

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- Do market median pay levels and pay mix inevitably lead to fair pay outcomes and pay-for-performance?
- When was the last time your company produced exactly on target financial results and the realized value of equity awards equaled the grant value?
- Different outcomes vs. peers will be driven not just by different performance, but by different
  - Incentive plan design
  - Pay mix
  - Difficulty of goals
- So, how can we know if the pay program will lead to the desired outcomes?

# Realizable pay-for-performance analysis

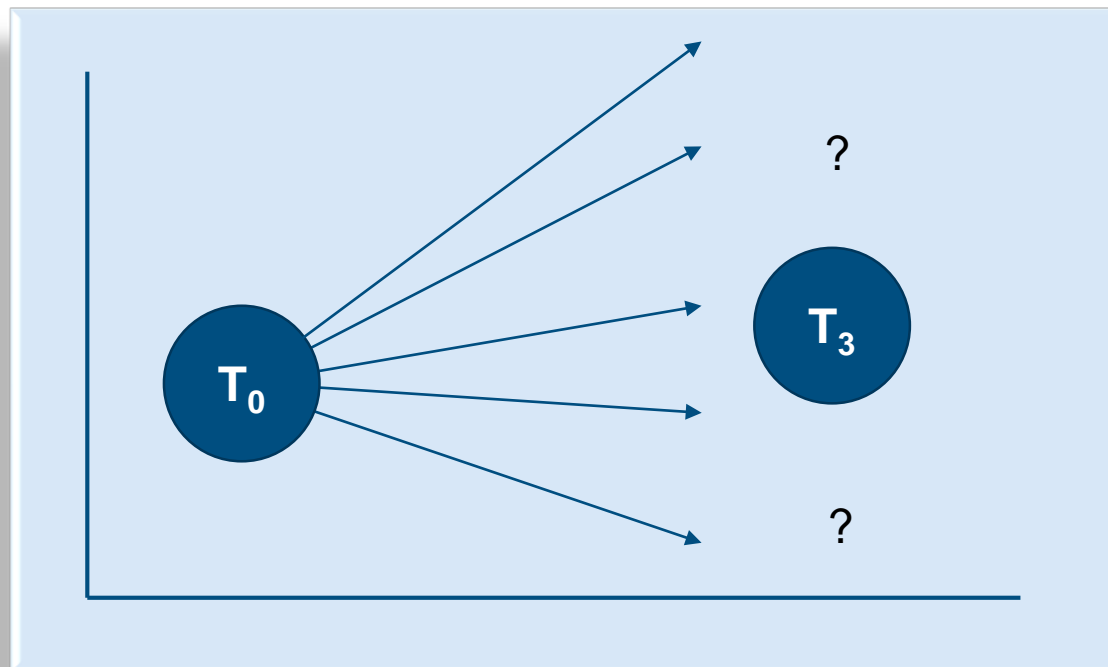
- Similar to the ISS relative degree of alignment test, but with important differences
  - Company peers v. ISS peers
  - “Carried value” of equity incentives at the end of the performance period
- Actual pay and performance outcomes
- Not concerned with target pay levels, pay mix, plan design, or goal-setting difficulty
- ***However, this is a snapshot in time***





# Opportunity analysis

- Takes into account a wide range of potential performance outcomes, for both incentive plans and share price
- Highlights the impact of pay mix and plan design features
  - Two executives at different companies with exactly the same target pay can have very different pay opportunities
  - Helps determine the relative sensitivity of your program to financial versus stock price performance variations



## Opportunity analysis – step one

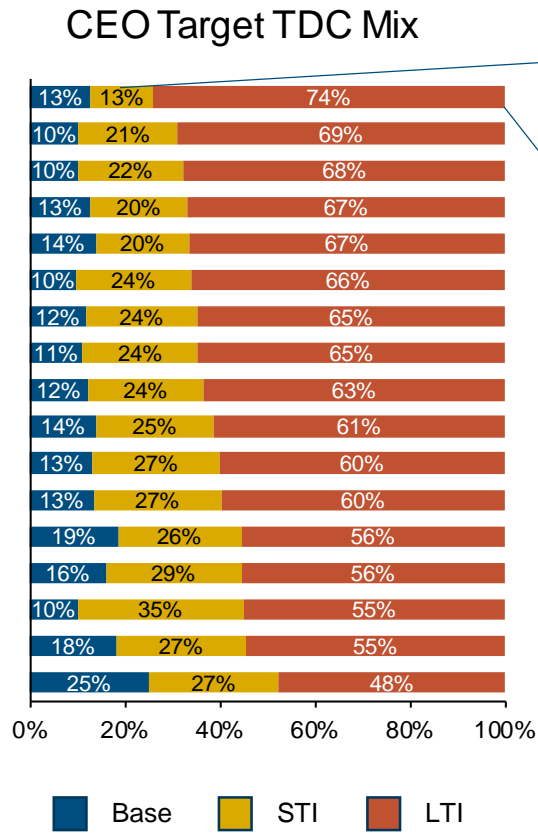
- Define a broad set of performance outcomes for both incentive plan and share price performance
  - Stock price performance points based on the observed variance of S&P returns over the past twenty years, centered upon a reasonable forward looking expected return
  - Incentive plan payout factors are the specific scale used by each company in the peer group – typically with a 25% or 50% threshold and a 2x target maximum, *but not always*
  - ***Simplifying assumption: performance moves in lock-step***

### Seven Performance Levels

	Below Threshold	Threshold	Midpoint	Target	Midpoint	Max	Above Max
3-yr. TSR	-5%	1%	4%	7.5%	11%	14%	21%
Incentive Plan Factor	0.0x	<i>Company Indicated</i>	← Avg. →	1.0x	← Avg. →	<i>Company Indicated</i>	Max, or ?

# Opportunity analysis – step two

- Determine the pay mix, vehicle mix and plan features for each company



**STI** →

**Company specific:**

- ✓ Threshold as % of target
- ✓ Maximum; uncapped?

**LTI** →

**Company specific:**

- ✓ Mix of stock options, RSUs, performance shares, cash LTI
- ✓ Threshold/maximum as % of target for PSUs
- ✓ Other features



## Opportunity analysis – step three

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- Map each company's pay mix and plan features to the seven performance scenarios. Two approaches:
  - 1) Use each company's specific target total direct compensation
    - *Gives a clearer picture of the actual opportunity for your executive(s) and across peers*
  - 2) Set each company target total direct compensation equal to the peer group median
    - *Allows for better isolation of differences in pay opportunity not due to differences in target pay levels*

## Opportunity analysis – step three

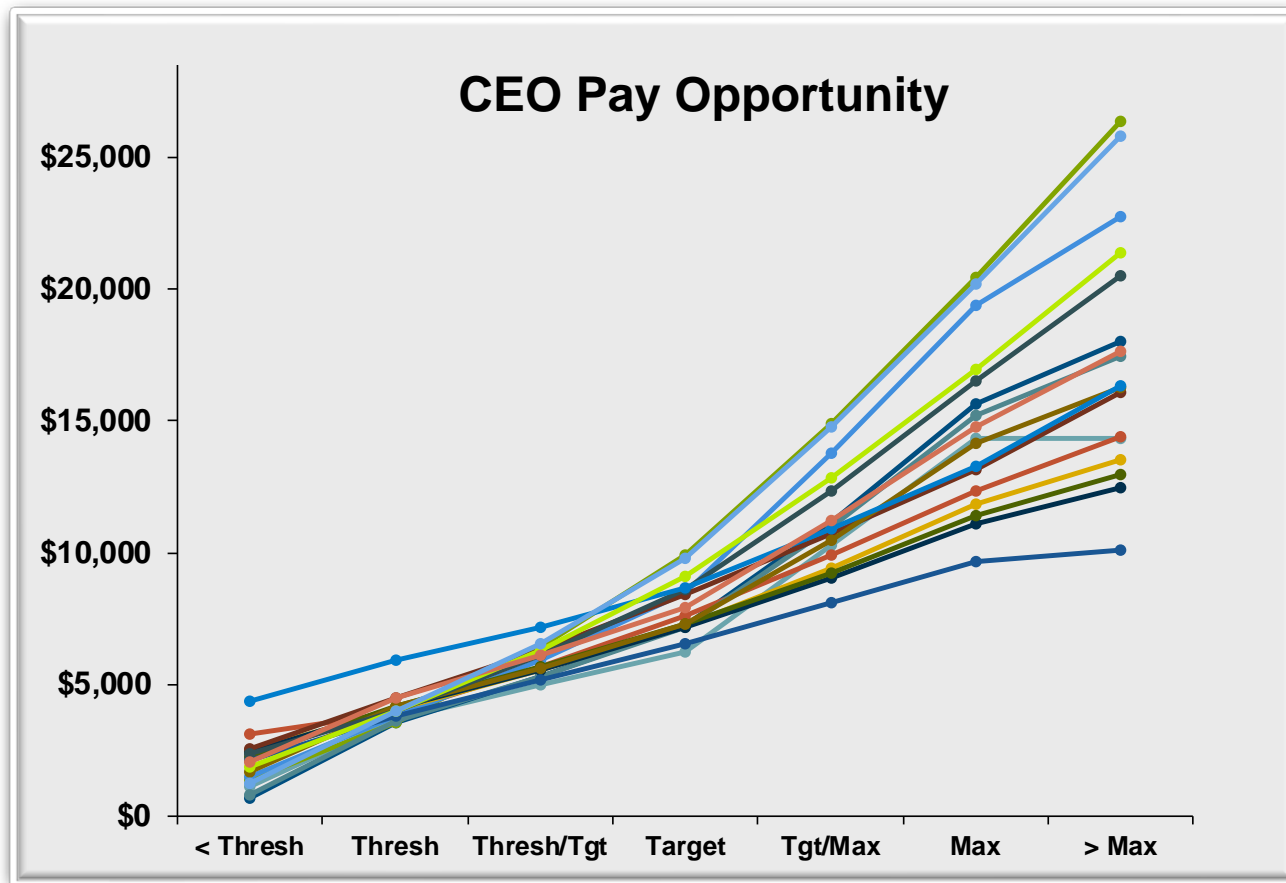
- Example – CEO with \$1000 salary, 125% target STI, 300% LTI
  - STI range is 0 to 250% with a 25% threshold cut-in
  - LTI is equal parts PSUs, RSUs, and stock options
  - PSU pays out 50% at threshold, 200% at maximum

### Pay at Each Performance Scenario

	Below Threshold	Threshold	Midpoint	Target	Midpoint	Max	Above Max
Salary	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
Ann. Incentive	0%	31.25%	78.13%	125.00%	218.75%	312.50%	312.50%
	0.0x	0.25x	0.625x	1.0x	1.75x	2.5x	2.5x
TSR →	-5%	1%	4%	7.5%	11%	14%	21%
PSUs	\$0	\$515	\$844	\$1,242	\$2,051	\$2,963	\$3,543
	0.0x	0.50x	0.75x	1.0x	1.5x	2.0x	2.0x
RSUs	\$857	\$1,030	\$1,125	\$1,242	\$1,368	\$1,482	\$1,772
Stock Options	\$780	\$940	\$1,120	\$1,330	\$1,620	\$1,940	\$2,300
<b>Total</b>	<b>\$2,637</b>	<b>\$3,798</b>	<b>\$4,870</b>	<b>\$6,065</b>	<b>\$8,227</b>	<b>\$10,510</b>	<b>\$11,740</b>

## Opportunity analysis – the results

- The analysis shows the relative competitiveness of each company's pay opportunity at each of seven performance levels



# With “three-dimensional” insights, executive pay decisions can be improved

	Target Pay Analysis	Realizable Pay-for-Perf.	Opportunity Analysis	Decisions/ Insights
A	<ul style="list-style-type: none"> <li>TDC below median due mainly to low LTI</li> </ul>	<ul style="list-style-type: none"> <li>Near median performance; pay still in the fairway</li> </ul>	<ul style="list-style-type: none"> <li>Competitive at and below target</li> <li>Lowest among peers at high performance</li> </ul>	<ul style="list-style-type: none"> <li>Focus on LTI grant</li> <li>Ensure PSU portion is meaningful</li> </ul>
B	<ul style="list-style-type: none"> <li>TDC at median</li> <li>Pay mix similar to peers</li> </ul>	<ul style="list-style-type: none"> <li>Above median performance</li> <li>Pay outside/above the fairway (aggressive)</li> </ul>	<ul style="list-style-type: none"> <li>Competitive across the performance spectrum</li> </ul>	<ul style="list-style-type: none"> <li>Performance goals may be too easy</li> </ul>
C	<ul style="list-style-type: none"> <li>TDC below median</li> <li>Pay mix similar to peers</li> <li>LTI mix heavier to RSUs</li> </ul>	<ul style="list-style-type: none"> <li>Below median performance</li> <li>Pay in the fairway, but somewhat aggressive</li> </ul>	<ul style="list-style-type: none"> <li>“Flatter” pay line than peers</li> <li>Strongest for poor performance</li> </ul>	<ul style="list-style-type: none"> <li>Shift LTI mix toward PSUs or stock options</li> <li>Pay increases should be in AIP target and PSUs</li> </ul>
D	<ul style="list-style-type: none"> <li>TDC at median</li> <li>Pay mix similar to peers</li> <li>Heavy PSU in LTI mix</li> </ul>	<ul style="list-style-type: none"> <li>Top quartile performance</li> <li>Pay outside/below the fairway (conservative to performance)</li> </ul>	<ul style="list-style-type: none"> <li>“Steeper” pay line than peers</li> <li>Top performance should be rewarded well</li> </ul>	<ul style="list-style-type: none"> <li>Performance goals appear too aggressive</li> <li>Review plan caps and mechanics</li> </ul>



## Some qualifiers...

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- Three-dimensional analysis is not a “unified theory” of executive compensation; doesn’t tell us everything
- Best for determining overall competitiveness and balance of program, as well as likelihood of landing “in the fairway” consistently
- Other important analyses:
  - Pressure testing the program for extreme and mixed performance scenarios (e.g., poor share price performance and strong financial performance against goals; extreme divergence of absolute and relative share price performance)
  - Validation of the financial performance measures to ensure they are truly aligned with share price performance over the long-term
  - Risks of unintended incentives in the structure and balance of performance focus





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