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Human Resource Management

Compensation Packages That Actually Drive Performance

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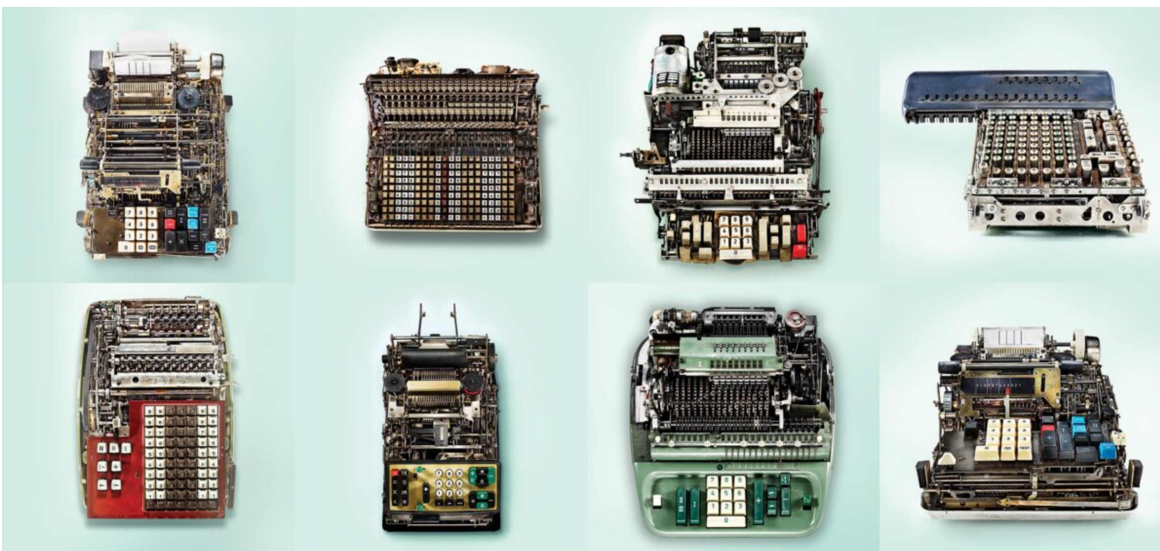

Kevin Twomey

Summary. By aligning executives' financial incentives with company strategy, a firm can inspire its management to deliver superior results. But it can be hard to get pay packages right. In this article four experts break down the key elements of compensation and explain how to... more

Decisions about executive pay can have an indelible impact on a company. When compensation is managed carefully, it aligns people's behavior with the company's strategy and generates better performance. When it's managed poorly, the effects can be devastating: the loss of key talent, demotivation, misaligned objectives, and poor shareholder returns. Given the high stakes, it's critical for boards and management teams to get compensation right.

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Many struggle with this challenge. One problem is that only a few best practices work in all situations. So it's imperative for companies to start with clear strategies and for their leaders to understand the basic elements of compensation and ways to link it to desired outcomes.

In this article we'll describe how firms approach executive compensation and how some have used it to improve performance, sharing insights from our research and experiences. Two of us (Boris and Sarah) have studied compensation for over a decade. The other two (Mike and Metin) have more than 30 years of combined experience advising a broad range of companies on executive compensation.

We'll draw on FW Cook's analysis of executive comp at companies in the Russell 3000, an index of the top 3,000 U.S. stocks by market capitalization, from its *2019 Annual Incentive Plan Report,* and from its *2018 Global Top 250 Compensation Survey.* We'll also draw on Harvard Business School's extensive research on boards of directors, including quantitative data from a survey of 5,000-plus global board members. We'll share some perspectives we gained from in-depth interviews with more than 100 directors of public and private companies from over a dozen countries. Last, we'll discuss how the recent pandemic and economic crisis will inevitably change the thinking on compensation.

How Boards Approach Executive Compensation

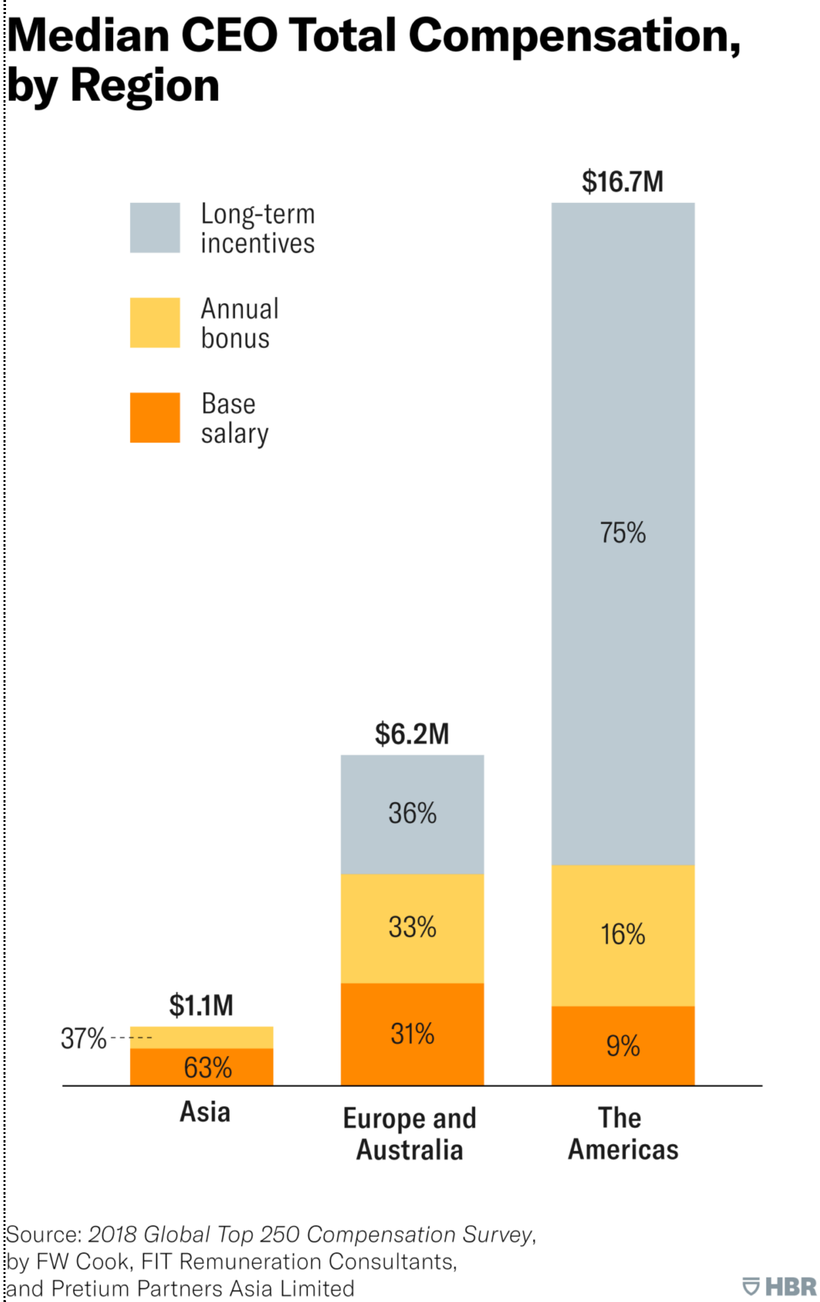
When making decisions about compensation, many directors look at the large amount of data available on executive pay. U.S. regulations require every publicly traded company to disclose the amount and type of compensation given to its CEO and CFO and other highly paid executives, as well as the criteria used in setting it.

Most companies try to keep up with what their peers are offering, but as one director told us, “Obviously, there is some balancing. If you want your CEO to stay, you’ll probably err on the side of paying more. But in a public company, we can’t go wildly off the rails because there’s enough data out there.” Another director commented, “You need to look at what other firms are doing with their incentive programs because that will set the expectations of your people. And if your people are being poached, you need to know what they’re being approached with.” Many others echoed the belief that the market determines executive compensation levels.

However, directors also argued that there are complex nuances to setting compensation. They pointed to challenges in finding suitable companies to use as benchmarks and in ensuring that that selection isn’t manipulated to achieve a certain outcome. The obstacles are even greater for smaller private companies, for which data is less available. Some directors also felt that benchmarking had created a “race to the top.” One commented, “The problem is that everyone always says, ‘We want to be just above the midpoint in this.’ And when everyone does that, then the midpoint keeps moving, right?” Other board members explained that deviations from benchmarks are often necessary to align executives with unique corporate strategies and organizational cultures.

According to FW Cook, 83% of the 250 largest S&P 500 firms use a formulaic annual incentive plan, or one that includes predefined metrics and weightings. These plans tend to incorporate multiple metrics; 76% have at least two. The most common are profits (used by 91%) and revenues (used by 49%). Seventy percent of the companies also use nonfinancial (both strategic and individual) metrics, though they’re usually weighted less heavily than financial goals.

CEO Compensation Across the Globe



Because the Russell 3000 is made up of U.S. companies, it's worth examining compensation practices in other countries. ...

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Twenty-six percent of the companies with formulaic plans include at least one environmental, social, or governance (ESG) goal. In some cases targets are attached to those goals, and in others the goals are part of an assessment of strategic performance. Among the companies using ESG measures, 43% set human capital goals (such as diversity, employee engagement, and a positive company culture); 25% set health, safety, or environmental goals; and 32% use both types. Utilities and energy companies have the highest prevalence of ESG goals (81% and 77%, respectively), typically related to health, safety, and the environment.

Thirty-three percent of companies with formulaic annual incentives incorporate a performance modifier, which provides a check on the primary metrics by adjusting payouts up or down. Some modifiers only tweak results (increasing or decreasing payouts by 5% or less) while others have a meaningful impact (altering payouts by 20% to 25%). They're commonly based on nonfinancial metrics—like safety, customer service, and employee engagement—and often incorporate elements of individual performance.

As organizations work their way through the Covid-related economic crisis, we fully expect to see changes in approach. Many companies, for instance, have cut pay for senior executives—though these cuts are largely temporary and apply just to base salary. More pressing will be how to think about the goals embedded within incentive plans. Many targets won't be achievable given the new financial realities and thus will no longer serve as effective incentives.

In light of this, companies have begun considering a range of moves: adjusting performance metrics but capping payouts, revising goals for the year, and committing to monitor the situation but not take action yet. For multiyear plans, the options being discussed include deemphasizing 2020 results in award calculations, adjusting the payout curve, shortening the performance period, instituting new awards with relative performance metrics, adding relative total shareholder returns as a modifier, and paying out awards in cash rather than shares. Discussions about whether or not to reprice options, a controversial practice, have also taken place.

> **Most companies try to keep up with what their peers are offering, but some directors felt that benchmarking had created a "race to the top."**

The silver lining here is that the crisis offers companies an important opportunity to revisit incentive programs and incorporate metrics that serve stakeholder interests in a broader and more meaningful way.

The Four Dimensions of Compensation Design

Modern compensation systems can generally be analyzed along four dimensions: fixed versus variable, short-term versus long-term, cash versus equity, and individual versus group. The factors that drive choices include the firm's strategic objectives, ability to attract and retain talent, ownership structure, culture, corporate governance, and cash flow. Within the Russell 3000 Index, companies focus on aligning pay and company performance—something stakeholders expect. But particularly outside the United States, companies may have to take into account other factors, such as seniority.

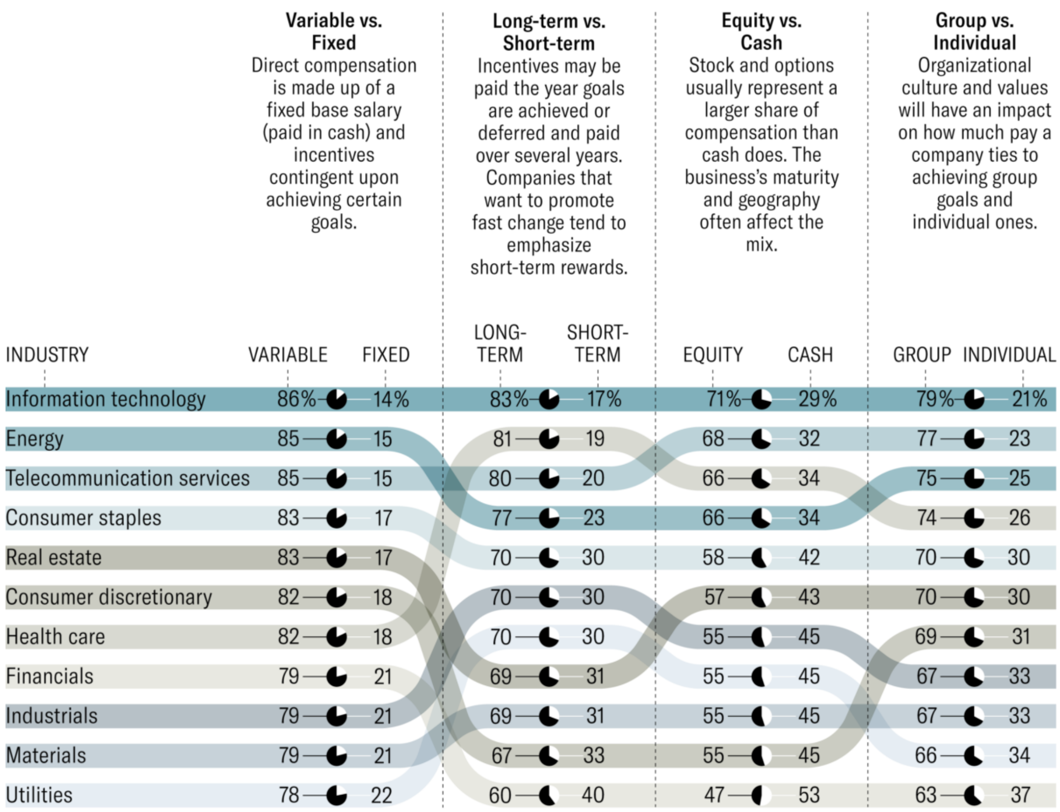
Fixed versus variable. Total direct compensation is made up of a base salary (set in advance and paid in cash) and short-term and long-term incentives. Both kinds of incentives are variable or at-risk elements and may be contingent on the achievement of certain organizational or individual goals. Awards can be based on an established formula or at the discretion of management or the board's compensation committee. Our analysis of the compensation of the five highest-paid executives at Russell 3000 companies shows that on average 82% of their compensation is variable; the rest is base salary.

The mix of fixed and variable components is driven primarily by company size and industry, and to some extent, company-specific factors like culture and risk appetite.

Click/tap image to zoom.

How Industries Compare on the Four Dimensions of Compensation Design

When setting executive pay, companies must decide how much will be variable or fixed, awarded in the short term versus the long term, delivered in the form of equity versus cash, and tied to group versus individual performance. Compensation committees often use the pay practices of their firms' peers as benchmarks. Here are the norms in selected industries.



Note: Data reflects the compensation of the five highest-paid executives at each of the companies in the Russell 3000.

Source: FW Cook proprietary research

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The breakdown between fixed and variable comp is relatively consistent across industries, although telecom, technology, and energy companies pay a slightly higher percentage of variable compensation. Financial services, materials, and utility companies pay a slightly higher percentage of fixed. The balance is also relatively consistent across U.S. and non-U.S. companies. But there are notable differences across market caps: Small-cap companies put 69% of compensation in the form of variable payments, and large-cap companies 87%.

The directors we interviewed insisted that variable pay was an important component of executive compensation. As one commented, "I'm a strong believer that CEO compensation needs to be in large part at risk. I would like to see at least 70% to 80% of the CEO's pay at risk, with less emphasis on building too high a base salary that insulates the CEO from the effect of poor performance."

Short- versus long-term. A second dimension is the extent to which variable compensation is paid out in the year it is awarded or deferred and paid over some future period. This applies to awards where the amount (a specified cash payment or a fixed number of shares) is established up front and where it's based on meeting specified future hurdles. Short-term variable compensation generally takes the form of cash; long-term generally is delivered in equity, through instruments such as stock options, restricted stock, and performance shares.

The Elements of Long-Term Compensation

Because long-term incentives make up the majority of executive compensation and have the most variations, they ...

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On average, 28% of senior executives' variable compensation is paid the year it's awarded (or immediately thereafter), and 72% is paid in future years. At the high end of the spectrum, technology companies pay 83% of variable comp in long-term awards, health care companies 81%, and telecom companies 80%. At the other end, financial firms pay only 60% of variable compensation in long-term awards.

Long-term compensation generally involves multiple overlapping cycles. Awards earned in 2018 may be payable in 2018, 2019, and 2020, but the executive receiving them may also get payments in 2018 from plans put in place in 2016 and 2017. Some companies, however, choose to make all grants up front (for example, giving three to five years of awards upon hiring or after another significant event without subsequent annual grants).

Companies undergoing a transformation usually emphasize short-term rather than long-term compensation to encourage fast change. The mix may also reflect other business practicalities. Companies with less cash, for example, may focus on long-term compensation.

Business cycles are another factor. A director we talked to described his experience with designing executive compensation at his company this way: "It's a long-cycle capital business, and most of the management team's compensation is three to five years out." He added that while executive compensation is to some extent set by market practice, the makeup of it should be determined by the company's strategy. "Is the compensation incenting sustainable long-term behavior that gets the organization where it wants to go, or is it really short-term-oriented?" he said.

Cash versus equity. Our analysis showed that on average 41% of senior executive compensation is paid in cash, and 59% in equity. The mix is often determined by business maturity. Young companies tend to rely a lot on equity to attract and retain key employees if cash is scarce. The percentage of equity compensation is notably higher for large-cap companies (63%) than for small-cap companies (48%), however. Technology, telecom, health care, and energy companies put the largest percentage of pay in the form of equity.

One director we interviewed noted that equity compensation encourages executives to think like owners. He detailed two experiences he had—one with a CEO who had a significant equity stake in the company, and one with a CEO who didn't. He recalled, "The person who owned a much more substantial stake in the company generally took the view 'We should do the right thing. We've got to grow the value of the business and the value of the equity, and that will be my compensation.'" The CEO with a smaller stake tended to have "much more of a professional-manager orientation, with an eye to cash compensation. And there was always a little bit of a tussle around whether the objectives were truly achieved or not."

Kevin Twomey

Other directors argued that while stock rewards have benefits, they're not perfect incentives. One commented, "If you gave somebody stock options in 2008, 10 years later those stock options were hugely valuable no matter what the company did, because the market came up. A rising market floats all boats. But if you gave somebody stock options in, say, 2006, no matter what the company did, no matter how well it grew or how profitable it was, by 2008, those options were significantly underwater. And it probably took almost the next seven or eight years for them to get back to where they were. So stock options are a very flawed instrument, because you really want something that gives value if your company does better than its peers." For that reason several directors we spoke with argued that stock awards should be linked, in part, to outperforming comparable firms.

Individual versus group. On average 29% of comp is based on individual performance and 71% on the performance of the organization (such as a division) or company. A firm's culture and values will have an impact on the amounts tied to the two kinds of performance. "I" companies—in which there's a high degree of personal accountability and individuals have the ability to influence results—tend to link more compensation to individual accomplishments. Such companies tend to be human-capital-centric and highly competitive—think of consulting, law, investment banking, and asset management firms, where partners are often valued for bringing in business. "We" companies tend to focus more on organizational results—typically financial goals or shareholder returns. In those companies—often manufacturing, technology, or other product-driven businesses—firm performance is more stable and predictable.

When discussing performance benchmarks in their plans, the directors we interviewed focused largely on organizational metrics, including total shareholder return, revenue growth, and profit margins. However, some also brought up individual objectives, which they believed worked well. "These personal goals include things like maintaining a detailed succession plan for yourself and the top 10 managers," one director told us, "and like attempting to choose two new specific acquisitions over the next 12 months or improving the company's public image." Directors also wrestled with the drawbacks of holding individuals responsible for metrics they can't always control—which, they argued, is frequently the case with organizational and company metrics.

Linking Compensation Design and Outcomes

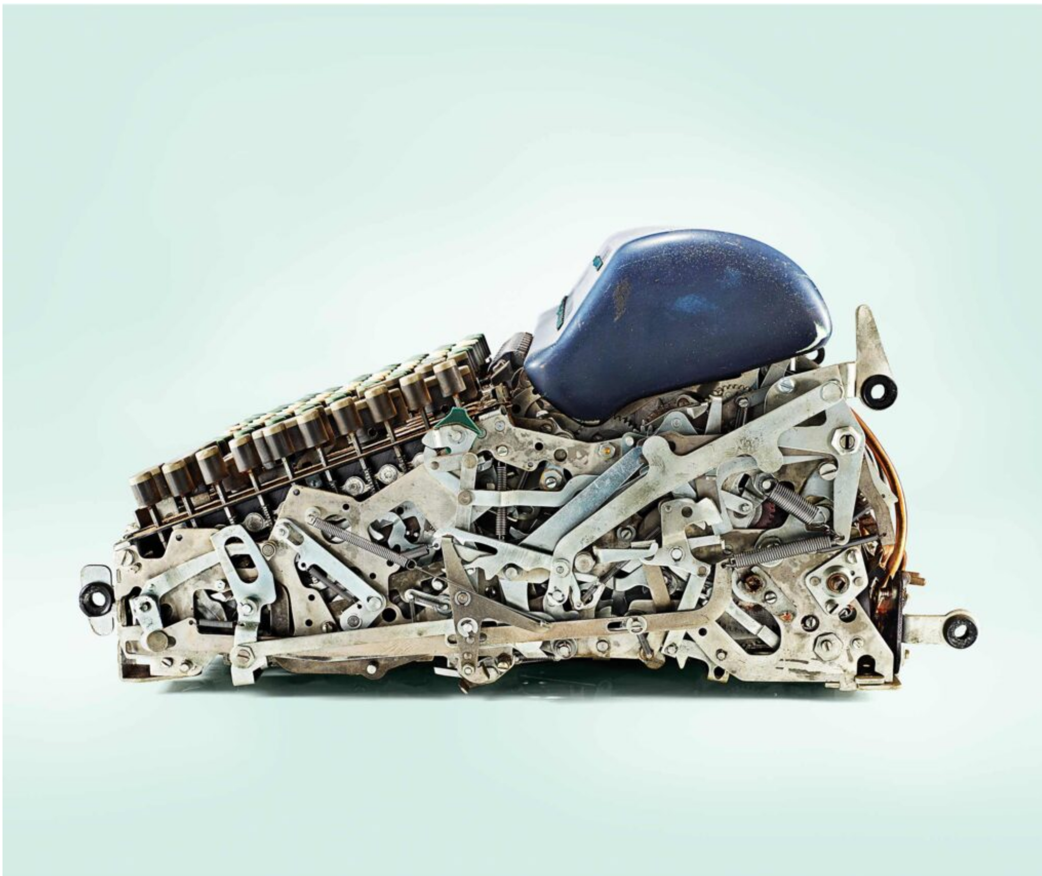
A good compensation system always begins with an organization's strategic goals. When compensation is misaligned with them, trouble ensues. Consider what happened when one company based the bonuses of its CEO and CFO entirely on growing earnings per share—because it assumed that was what investors wanted. As a director explained to us, this incentive encouraged management to make acquisitions with debt, boosting EPS growth but also the company's risk. Eventually the debt grew too expensive to service, and the company had to put itself up for sale.

Now we'll explore five common strategic objectives and how companies can put the four dimensions to use in achieving them. Note that this is not meant to be an exhaustive list of strategic goals; nor are we presenting the only or even the best ways to reach them. The examples are simply meant to suggest potential approaches. When contemplating them or other pay programs, you should answer the following questions:

- How is the business strategy reflected in the reward program?
- Are the right metrics being used given the current circumstances?
- When is it time to make adjustments to the existing program design?
- When does it make sense to deviate from the norm and tailor the solution?

Promote Profitable Growth

To achieve this goal, a large consumer-goods company adopted a plan with both short-term and long-term incentives. It rewarded increases in annual sales and gross margin equally and tied equity awards to the achievement of economic profit (profit after a capital charge) and long-term stock appreciation. Given that the firm wanted to generate growth over a period of several years, the long-term incentives were the largest component of compensation, and economic profit was the most significant metric in determining it.



Kevin Twomey photographs the complex inner workings of antique calculators, using his training in theatrical lighting to discover the objects' emotive appeal. Kevin Twomey

At the beginning of each year the company set numerical targets for all the metrics. The targets didn't function as triggers (hit them and achieve 100%; miss them and receive nothing); instead a payout curve was established for each, providing for a full range of outcomes. Executives could receive from 50% to 150% of their target bonuses.

One key aspect of this plan was that it was based on the achievement of companywide objectives. A modifier allowed the payout to be slightly adjusted according to each executive's performance for the period, but the overall size of the bonus pool was based on organizational targets.

Drive a Successful Turnaround

In a turnaround situation a company's strategic focus can shift from growth to survival. The two are often in opposition, because growth typically involves investment, which can result in cash burn, while survival requires solvency, which requires cash generation until the business's environment or operations improve.

An oil-and-gas company facing cash flow challenges after oil prices tumbled used a redesign of its compensation system to address them. Its annual incentive plan shifted its emphasis from revenue and net income growth to free cash flow generation and expense management. Similarly, its long-term incentive plan replaced annual awards of restricted stock, which were linked to three-year total shareholder return, with a front-loaded grant of options vesting over five years. The grant minimized accounting expenses and shareholder dilution while giving executives an opportunity to significantly benefit if the turnaround succeeded and the stock price hit certain targets. Thanks to the cost reductions and cash generation rewarded by the annual incentives, the company was able to hang on until oil prices rebounded. Meanwhile, the stock option plan helped it retain and engage employees in a difficult and demotivating business environment.

Note that in certain turnaround scenarios, when conditions are highly volatile or a company is in distress, it may make sense to move to semiannual and quarterly goals, to align incentives with critical short-term objectives.

Transform the Business

A public company was pursuing an aggressive new growth strategy after a recent business reorganization. But it was risky, and the firm wanted executives' incentives to reflect that. So it made a large amount of management's pay contingent on successfully executing the strategy, which included entering new product markets, changing sales channels, and expanding geographic reach. The compensation committee defined success as a significant increase in shareholder value over three years. In other words, the market would determine whether the executives had implemented the strategy well.

When setting long-term incentives, the committee decided to deviate from the norm in three key ways. First it chose to front-load three years of awards and forgo future annual awards. Second the awards were delivered only if the firm hit certain share-price targets. Third the awards were based on a scale, and the targets and vesting schedules were set so that average performance resulted in minimal awards. However, under this plan executives would be rewarded for the risks they took because they could get more compensation sooner than they would have under a traditional approach.

Compete Effectively with Public Companies as a Private Organization

Private companies are often in a war for talent with public rivals that have a powerful tool at their disposal: equity. To address this challenge, one private firm explored two potential solutions. First it considered paying above-market cash compensation (base and bonus). But that would have increased annual cash costs significantly without fostering a sense of ownership, linking compensation to better performance, or creating multiyear accountability.

Next the company considered three long-term incentives that could compete with public competitors' packages: real equity (which the company ruled out because it intended to remain private and therefore had no simple liquidity mechanism), phantom equity (ruled out because of complexities in design, administration, and communication, particularly around valuation methodology), and multiyear cash incentives, which it ultimately adopted.

The chosen plan used three-year cumulative EBITDA as a performance metric, and awards weren't vested and paid out until the end of year three. To maximize retention, the payout was back-end-weighted: 20% in year three, 30% in year four, and 50% in year five.

While a multiyear cash-incentive plan doesn't create an ownership mentality, it is a highly effective, easy-to-understand way to tie compensation to achieving agreed-upon objectives or performance superior to peers' for several years. This approach encouraged executives to remain at the company and served it well.

Foster Alignment with Owners and a Long-Term Orientation When Traditional Equity Is Unavailable

At a private family business that wanted to strengthen the alignment between employees and the owners, the existing compensation program provided base salaries and annual incentives only and no long-term incentives. That reinforced short-term thinking, which conflicted with the risk-seeking entrepreneurial focus of the company's founders. To remedy this, the compensation committee worked with management and family members to redesign the firm's approach to pay.

After considering phantom equity (which offers employees the benefits of stock ownership without giving them company stock) and long-term-performance cash bonuses, the company settled on an economic-profit-sharing program. Each year the compensation committee looked at profits, subtracted the cost of capital, and put 20% of the resulting amount into a profit-sharing pool for employees. To lengthen the time horizon, the pool was not paid out in the year it was earned but instead was put into a "banking" system. Each participating employee had his or her own bank, and the annual contribution to it was based on a formula that allowed adjustments for performance. If the economic profit in a given year was negative, the bank's balance would fall. If it was positive, the balance increased. Employees received a third of their banks every year, and two-thirds were rolled forward. The plan helped employees adopt a long view but didn't require management to set specific long-term goals.

Challenges and Opportunity

Norms for key aspects of executive compensation clearly exist, but as the data shows, they vary to some degree by industry, geography, and company size. In addition, underlying any norms are individual decisions and solutions tailored to company needs and strategies.

In the immediate future, we expect business conditions to remain uncertain and changeable, complicating the design of executive incentives. How this will all play out is anyone's guess, but we know that employee health and safety have taken on new significance to virtually all companies. Enterprisewide liquidity also has new importance. In the past liquidity concerns arose primarily when external capital became scarce. Now they spring more from internal cash-flow issues. Liquidity and employee health are just two of the areas we expect incentive plans to start tying metrics to. Indeed, the current environment offers an opportunity to revisit plans with an eye toward incorporating measures that serve stakeholder interests in a broader and more meaningful way.

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