

# BEST BUY uses flexibility and choice to improve long-term incentive design

Recent trends in long-term incentive (LTI) plans show growing emphasis on linking these incentives to performance to better align employees with shareholders' interest. In addition, new Securities and Exchange Commission (SEC) requirements for equity-based rewards has created an increased sense of urgency among publicly traded companies to improve the overall return on investment (ROI) from these programs.

Long-term incentive vehicles can be structured to be more effective in delivering long-term wealth creation potential for employees while increasing retention. In addition, incorporating multiple performance measures adds flexibility to plan design and enables the achievement of a broader set of business goals. In the end, this flexibility may

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## QUICK LOOK

- ➔ For many years, stock options have been the prevailing vehicle for delivering LTI plans.
- ➔ In a drastic departure from traditional LTI plan designs, Best Buy redesigned its plan by introducing four different delivery vehicles.
- ➔ To support the rollout of the new plan, Best Buy made a significant investment in employee education, including instructor-based seminars, online seminars and printed materials.



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help increase the alignment of the LTI program with a continually evolving business strategy.

Best Buy, one of the largest electronics retailers in the United States, is attempting to improve the perceived value of its LTI program by using employee input to create a menu of choices. As Best Buy discovered, treating its employees in the same manner it treats its customers proved to be a competitive advantage to attract and retain talent.

### Best Buy's Challenge

Very few companies have ventured outside of the traditional single LTI delivery vehicle and performance measure because of the challenge of communicating these plans to employees as well as the added difficulty of plan administration. Best Buy was not an exception. During the bull market of the '90s, stock options were in the money most of the time as a result of stock-price appreciation. Employees were quick to exercise their options as soon as

they vested. John Moynihan, vice president of rewards at Best Buy, summarized the situation: "The company was expensing options over a seven-year period, but employees were exercising them in three to four years through cashless exercise. They were leaving too much value on the table that the company was recognizing as an expense."

In a drastic departure from traditional LTI plan designs, Best Buy redesigned its plan by introducing four different delivery vehicles. It also used internal and external performance measures in the plan design while allowing employees to choose their own packages. (See Figure 1).

### Why Offer Choices?

Best Buy offered these choices to address the range of employee preferences and to improve perception of its LTI compensation's value. In addition, offering choices is consistent with Best Buy's total rewards philosophy, which is anchored to the following four pillars:

- Give employees more choice of rewards that are most valued to them.
- Differentiate rewards based on contributions.
- Encourage experimentation and recognize innovation.
- Reward employees for achieving business results.

**FIGURE 1: LTI PACKAGE MIX AND THE UPSIDE POTENTIAL GAIN**

Choice	Employee Preference	Employee Segment	Vehicle's Mix			
			Stock Options	Performance Shares	Restricted Stock	Cash Performance Units
A	Maximum Leverage	Bullish on stock, all employees	50%	50%	0%	0%
B	Stock Options	Officers and Middle Management	100%	0%	0%	0%
C	Balanced Risk	Middle Management	50%	0%	50%	0%
D	Most Conservative	Middle Management	0%	0%	50%	50%
Upside Potential as % of Award			No Limit	150% of award	125% of award	125% of award

Choice also provides employees with various wealth-accumulation vehicles tailored to their level of tolerance for risk; offers flexibility in the timing of realization of income from LTI compensation; and contributes to better investment-portfolio diversification. Furthermore, choice gives employees an opportunity to select the package with the delivery vehicles and performance measures that they feel they can influence the most. Eventually, this should lead to improvement in the motivational impact of LTI and better engagement of employees in serving customers. In the words of Shari Ballard, Best Buy's executive vice president of human resources and leadership: "If our employees feel rewarded as individuals, they become more engaged, and that gives them the incentive to take ownership of the solution to our customer problems. To make them feel rewarded, we must give them a choice of rewards."

### Employee Input in Program Design

A comprehensive employee survey was conducted using conjoint and nonconjoint questions. The conjoint questions asked employees to make trade-off decisions between alternative rewards with a cost-neutral outcome. For example: Would you give up a certain number of stock options in return for receiving a certain number of restricted stocks? The nonconjoint questions focused on pay-mix preferences between base pay, short-term incentives and LTI rewards.

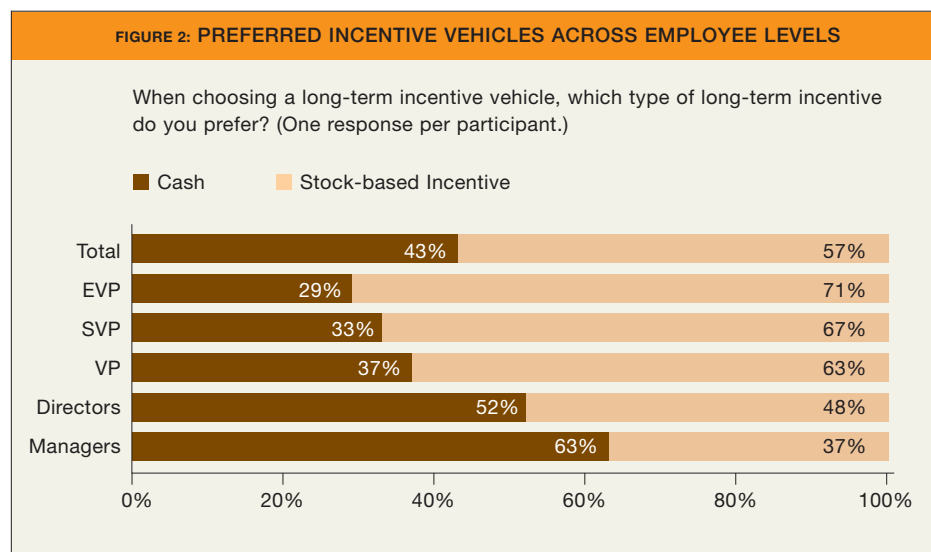
Employee input revealed that changes can be made in the LTI program design to reduce cost while increasing employee-perceived value of the LTI award. This was evident from the willingness of employees to trade off stock options for restricted stock on a cost-reducing basis. The survey results also showed that middle-management

employees tend to prefer different LTI vehicles than executive-level employees. (See Figure 2.) Lower-level employees preferred cash-based vehicles while upper-level employees chose incentives tied to external measures. Predominantly, employees showed great interest in having a choice if they are given appropriate financial counseling. (See Figure 3.) Based on this employee feedback, as shown in Figure 1, a menu of limited choices was offered to employees eligible for LTI.

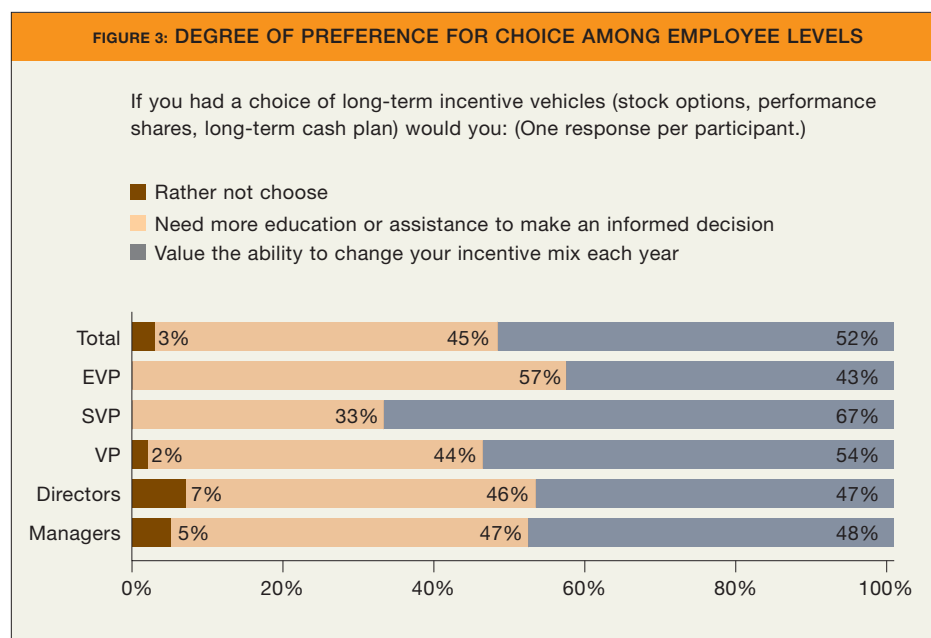
### New Plan Design

Choices under the new LTI program were created based on the results of optimization analysis among various levels of equity and cash-based long-term incentives. The main features of the new plan design include:

1. Four LTI choices are offered to employees based on a carefully constructed mix within each choice.
2. Initial awards are made in 100 percent stock options.
3. A combination of external and internal performance measures



Source: Best Buy.



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are selected for each package mix. (See Figure 4.)

4. There is a preset exchange rate to convert the initial award into other vehicle combinations. (See Figure 4.)
5. Common performance measures between short-term and long-term incentives help better align these rewards (economic profit.)
6. Incentives qualify for 162(m) treatment (tax deductibility of expenses).
7. Participants default to an award mix of 50 percent stock options and 50 percent performance shares if they do not make an active election.

To support the rollout of the new plan, Best Buy made a significant investment in employee education, including instructor-based seminars, online seminars and printed materials. Also, an external firm was retained to provide employees with one-on-one

phone counseling sessions to help them make the best choice for their situation. In addition to education, an online modeling tool was provided so employees could better understand the risk-reward balance associated with their choice based on how they felt about the future of the company and its stock price.

### Employee Reaction to LTI Choice

The majority (88 percent) of surveyed employees stated that their opinions of the Best Buy long-term incentives programs have improved as a result of their ability to choose. About 85 percent of these employees said they understood the LTI program better. The program positively affected their desire to remain with Best Buy. Other employees need more education, more historical data on Best Buy stock

performance and internal financial measures, simpler choices and more timely communication. One employee summed it up by saying: “I truly appreciate the efforts of the leadership to continually look for ways to upgrade our compensation; this definitely impacts my desire to stay with our company long term. The Webinar was a particularly helpful and user-friendly tool. Thanks!” Another employee emphasized the desire to have more historical data on performance measures: “I love the fact that I have a choice to make. The only concern I have is the little line of sight to how we have done on total shareholder return and economic profit.”

### Lessons Learned

When Best Buy decided to experiment with innovative rewards offerings, it expected several refinements going forward. The glaring needs surfaced around the fact that implementing choice should be accompanied by a high level of investment in training and education. Other lessons learned include:

1. Promotion and education are keys to successful plan implementation.
2. It’s important to provide multiple educational and communication

**FIGURE 4: EXCHANGE RATES, VESTING SCHEDULES AND PERFORMANCE STANDARDS BY DELIVERY VEHICLE**

Feature	Delivery Vehicle			
	Stock Option	Performance Share	Restricted Stock	Performance Unit
Exchange Rate	Common Currency	2 options for 1 performance share	2.5 options for 1 restricted stock	1 option for 18 performance units
Vesting Period	25%/year	Three years	Three years	Three years
Performance Standard	Stock Price (external)	TSR (external)	Economic Profit (internal)	Economic Profit (internal)

## Attributes of Best Buy LTI Program Choices


Choice	Employee Segment	Key Characteristics
A	“Stock Options Forever” Primarily officers and some directors	Simplest choice for those who believe in the long-term growth of the company and its stock price
B	“Maximum Leverage” Risk takers from all levels	Potential to earn 0%-150% of performance shares based on how company stock performs against the S&P 500 Index
C	“Balanced Risk” Some directors and some managers	Potential to earn 0%-125% of restricted shares based on company’s economic profit-attainment performance
D	“Show Me the Money” Some directors and managers	More conservative, provides the opportunity to diversify portfolio; own company stock without putting money on the line

vehicles to accommodate the various learning styles and to reach participants in dispersed geographical locations.

3. Individual investment counseling becomes especially important when program eligibility extends across multiple employee levels.
4. Introducing a variety of LTI vehicles for delivery and performance measures adds complexity to the program. This complexity multiplies over time as employees make choices year after year.
5. Participants have high requirements for ongoing communication about their LTI awards and how well they are performing against goals.

## Conclusions

Offering choice is not a best practice that can be duplicated in every company. Organizations with a total rewards

philosophy which aims at providing rewards to meet employee preferences as a strategy to compete for talent would be good candidates for considering the choice program. At Best Buy, LTI choice has been credited with improving employee perception of rewards and a desire to stay with the company. It became obvious, based on employee feedback, that some employees had difficulty understanding their choices, while others quickly embraced the concept. For Best Buy, choice appears to be a more efficient use of company equity. If managed well, it could be a great rewards differentiator, and may result in less share dilution when compared to traditional LTI plans that feature stock options as the main delivery vehicle. 

## ABOUT THE AUTHOR

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