

# a new day for executive compensation

the

new SEC disclosure requirements will compel companies to share more information about their executive compensation plans, including the rationale behind plan designs and their link to the business strategy.

Some may view the requirements as intrusive and burdensome. Yet they provide an opportunity to hold a mirror up to the structure and reasoning behind the executive compensation program and articulate how the program helps the business. In these turbulent times, a company needs a firm grasp on that mirror, rather than await the image reflected by the media or institutional shareholder groups.

Unfortunately, too many companies may miss the chance to scrutinize executive pay and shore up its connection to business strategy. When it comes to compensation design, companies often prefer the “known” to the unknown. Change can be threatening, and executive compensation design is complex. Consequently, if the current plan poses no risk to the company, the safe decision is to stick with the status quo, rather than shake things up. When companies decide to make a change, they prematurely may adopt

## QUICK LOOK

- ➔ “One size fits all” has never been the right answer to executive pay. Different business models dictate different approaches.
- ➔ Consider three areas in compensation design: The company’s business situation and market characteristics, talent requirements and desired performance and rewards strategy.
- ➔ As the face of the company evolves, so should the compensation approach.

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popular plan designs, citing “competitive reasons,” rather than decipher their true needs and construct a plan that acts as a strategic business tool to reinforce desired performance. Consider the following:

- A company relies on a plan that worked in the past, even though the plan is beyond its prime given changes in business strategy and structure.
- A “corporate” plan applies to all business units even though the businesses operate differently and have different strategies.
- Attention focuses solely on long-term incentives (LTI), forgetting long- and short-term plans must harmonize—driving annual operational performance that ultimately will create longer-term financial success.

Companies should take the new SEC disclosure as an opportunity to eschew indistinguishable plan design, overused measures and safe pay-delivery choices. Instead, view the requirements as a chance to reassess the link between compensation design and business strategy, and do what is right for the organization. The feared unknowns will become less intimidating when a company asks the right questions,

considers its business model and uses compensation to advance strategy.

### Ask the Right Questions

What’s the *right* compensation design? A strategic approach to executive compensation considers the following three areas:

1. The company’s business situation and market characteristics
2. Talent requirements
3. Desired performance and rewards strategy.

Answering some pointed questions about each can lay the groundwork for discovering the right direction and building pay and performance alignment. Figure 1 on page 17 identifies many of the questions to ask and explains how the answers will influence plan design. The answers can shape all aspects of program design, from objectives to measures to incentive vehicles.

### Consider the Business Model

“One size fits all” has never been the right answer to executive pay. Different business models dictate different approaches. Companies that overlook or minimize

this link by viewing compensation as a neutral influence at best, or as a distraction at worst, take a dangerously shortsighted outlook. Similarly, companies swayed by “best practices” to adopt the plan “du jour” and stay under the radar miss the opportunity to advance the achievement of business goals.

Take for example companies “X” and “Y.” While they have extremely different business situations, both employ the same compensation approach—time-vested restricted stock. By clinging to easy solutions, these two companies miss the opportunity to use compensation strategically.

Company X, a reasonably mature company in the hospitality industry, follows a strategy of “stay the course.” The strategy is clearly working, as the company has experienced steady stock price growth through recent up and down markets. The company returns value to shareholders through buybacks rather than dividends. Management is stable, with no history or expected risk of executive turnover. Pay prominence is moderate, indicating no need for a behavioral shift. Executive stock ownership guidelines require executives to hold meaningful amounts of stock, thus linking them tightly to business success.

Given this profile, time-vested restricted stock is at best a neutral solution, or, when coupled with significant ownership guidelines, possibly inches toward positive. A *better* approach for a growth company like this is an equity vehicle focused on stock-price appreciation, such as stock options. Time-vested restricted stock does reward retention. But these executives are not intent on leaving. Stock options, on the other hand, spur continual motivation to build on past success. By providing executives the opportunity to share directly in the incremental wealth generated, stock options drive the creation of even more value.

FIGURE 1: CONSIDERATIONS IN DESIGNING EXECUTIVE COMPENSATION

Business and Market Characteristic	Impact on Program Design
1. What are the company's business stage (start up, mature, decline), performance and prospects (industry leader, solid performer, distressed/turnaround)?	Influences the degree of leverage (i.e., how much pay varies with performance) that needs to be built into the program.
2. Are major shifts in strategy ahead?	Determines how specific the messages need to be to guide new behaviors.
3. Is the company and/or its sector volatile and/or cyclical?	Suggests the potential need for indexing or other mechanisms to control for factors beyond management's influence.
4. What is the company's strategy for delivering returns to shareholders (i.e., the relative emphasis on stock price appreciation and dividends)?	Helps to determine the appropriate focus of equity-based vehicles, i.e., stock price appreciation alone, or whether dividends should also be included.
5. What is the organization structure and decision rights (e.g., centralized, single business versus several autonomous business units)?	Helps determine the level of performance measurement, i.e., for the overall company or individual business units, or some combination.

Talent Requirements	Impact on Program Design
<ol style="list-style-type: none"> <li>Does the company need to attract outside talent to replace or support the current leadership team?</li> <li>Does it need to retain existing talent, because either the current executive value proposition is deteriorating, or outside competitors are targeting the company?</li> <li>Does it risk turnover of executives in critical, strategic positions?</li> <li>What degree of behavioral change is needed?</li> </ol>	<p>All influence:</p> <ol style="list-style-type: none"> <li>Types of vehicles chosen, e.g., full-value shares may be more important to include when retention is key or compensation packages from another employer need to be bought out to attract top outside talent; stock options may be more attractive when attracting talent to help with a turnaround or in an entrepreneurial culture.</li> <li>Vesting/performance provisions, e.g., vesting should be longer if the purpose of a vehicle is retention; performance requirements may be structured differently depending on the situation.</li> </ol>

Performance and Rewards Strategy	Impact on Program Design
1. What is the desired role of pay in influencing behavior, especially if material changes in behavior and decision-making are required?	Influences the amount of leverage and performance orientation.
2. What level of alignment is desired between executive and shareholder gains?	Influences the relative weighting of the equity portion of the program and the inclusion of elements that ensure executive net worth at risk (e.g., executive stock ownership or holding requirements).

Time-vested restricted stock alone is a suboptimal answer for Company Y, a diversified manufacturer with a lagging stock price and uncertain future. The company experienced a fundamental strategic shift when it repositioned itself as a services and solution provider. This new direction demands demonstrable growth and some new talent to achieve it. The stakes are high, and the contributions of executives are critical. Performance-vested restricted stock—tied to metrics that reflect the company’s repositioning—plus some stock options provides a better answer. The combination creates the urgency to achieve key milestones and realize the longer-term benefits for the repositioning effort. A small portion of pay (e.g., 20 percent) delivered in time-vested restricted stock could be appropriate to reward executives for sticking with the company during the repositioning while they drive performance forward.

Never assume the old model fits today’s challenges. As the face of the company evolves, so should the compensation approach.

## Using Compensation to Advance Strategy

The following examples show how the right compensation strategy can advance business strategy. In each scenario, the company specifically chose vehicles and metrics to send a message critical to its business and talent needs at the time.

### Same Industry; Different Performance

Companies often look to successful industry competitors for hints on incentive plan design. Yet plans are not interchangeable. As the following examples demonstrate, company strategy and situation, not the competition, should dictate compensation approach.

An established “Grande Dame” retail conglomerate had a historical record of aggressive and profitable growth,

generating significant wealth for shareholders. The company acquired and successfully operated new locations ... for awhile. Then consumers discovered outlets and discounters. The big-store market flattened and then dived. The company suffered mightily from consumer defection—same-store sales soon lagged the competition.

Turning around the company required a high degree of behavioral change. Management style needed to shift from a pattern of strict operational control to one promoting innovation and customer responsiveness. Yet, old habits are hard to break, and the veteran executive team initially resisted the new focus. The reward strategy, which had catered to the needs and desires of individual executives, had long since splintered as company strategy disintegrated and results faltered. So a new rewards strategy was defined to promote unity and drive key company metrics, with an emphasis on profitable same-store sales growth. The company began to combat discounters by stressing superior service and simplified quality merchandise assortments. The annual plan directly and aggressively rewarded same-store sales growth. As a counterbalance, and to motivate profitable growth, LTIs rewarded sustained earnings growth and returns. Stock option grants complemented these metrics by reinforcing the new behavior that contributed to an improved financial outcome.

In a contrasting example, another retailer has enjoyed continual profitable sales (experiencing a brief dip in the late 1990s). The company relies on its hallmark strategy, yet desires a firmer position as an industry leader. Leadership is committed to a more aggressive pursuit of strategy, and turnover is not an issue. The company wants to continue its attractive value proposition, not change behavior. Salaries graze the market median or fall just below,

depending on a job’s strategic importance. Real rewards come from incentives. The annual incentive plan is highly leveraged, paying out superior rewards for earnings and return on capital targets, which are set above industry medians. The executive LTI is also highly leveraged, consisting predominately of stock options, which focus on continued growth in total return to shareholders and relative performance that consistently exceeds peers. Metrics for the next management layer include complementary financial and nonfinancial measures that will drive bottom-line profitability. The two plans work in concert to reinforce the strategy.

As these examples demonstrate, if the goal is to change strategy or improve performance, the annual and LTI metrics must explicitly define the desired outcomes. If the company wants to sustain superior performance, it should set goals high and provide high rewards for meeting them. The department store conglomerate is holding its own against discounters; the upscale retailer continues to step ahead of its competition. The custom compensation plans are not neutral influencers of change, but true drivers of behavior change and performance results.

### Same Company;

#### Different Circumstances Over Time

As the retailers recognized, a shift in strategy should trigger a reassessment of the executive compensation plan. Yet what if the strategy remains viable while other circumstances change? The next example shows that even a successful plan design requires rethinking to keep pace with talent demands and business realities.

A health-care company had a record of dramatic growth until an accounting scandal depressed its stock and reduced morale. A new pay program was in order: one that would meet the needs

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of stakeholders—from disillusioned executives to angry shareholders—and pass muster with regulators. In this time of turmoil, the company had to hold onto key talent to lead the turnaround, restore trust, and rebuild the business and its reputation. To strengthen retention, the company de-emphasized the annual plan and delivered LTI rewards through performance-restricted stock and options. The LTI combined controllable metrics with key shareholder outcomes, leading to a handsome payoff if the turnaround succeeded. Measures for performance-restricted stock included a balanced mix of hard financials with operational and stakeholder metrics geared toward ensuring operational excellence and constituent satisfaction—returning the company to its mission of providing economical quality care.


Once in place, the compensation plan performed as designed. The company rose like a phoenix to deliver improved financials. Flash forward several years: Growth has moderated and the company is now more a value versus growth investment. Competitors are looking over the company’s talented

leaders, intent on luring them away. The company has updated its executive compensation plan to match current circumstances and demands. Today’s focus is on sustained value creation through continuous improvements in productivity, optimized performance in select facilities and a strong bottom line that allows for continued stock price growth but also strong dividend yields for shareholders. A new annual incentive plan drives these results through financial and nonfinancial measures. In the new LTI, options are less prominent now that the turnaround has succeeded. A larger portion of equity comes from performance-vested restricted stock focused on a balance of earnings growth and overall returns. Selected leaders in key strategic roles also receive grants of time-restricted stock.

Even if a plan appears to be delivering results, it is important to keep an eye on changes in business and talent requirements and the implications they hold for incentive design. A reassessment every three years would not be unusual in these fast-moving times.

## Dust Off the Compensation Philosophy

This is a time of opportunity. The SEC disclosure requirements coming on the heels of recent accounting changes under FAS123R create a clear impetus for re-examining executive pay. Companies that missed the earlier opportunity now get a second chance to make sure their incentive plans are designed to make a difference.

The strongest message a company can deliver in its proxy is to show how the executive compensation program deliberately supports the business goals. Making that cause and effect evident speaks volumes to employees and to shareholders. Jump on their bandwagon; do not let this opportunity pass by. 

### EDITOR'S NOTE:

More information about the new day for executive compensation will be published in part two of this article in the February issue of *workspan*.

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