EXECUTIVE PAY

PAY FOR PERFORMANCE MADE SIMPLE

With the introduction of shareholder say-on-pay votes, an entire industry formed to demonstrate the degree of alignment between executive pay and corporate performance or to challenge the result. The underlying assumption being that the two should be directly, causally, related. However, few compensation committees really consider the definitions of what constitutes "pay" and "performance."

Moreover, even assuming a perfect graphical relationship between, for instance, SEC-reported total pay and total shareholder return, where your company's pay is dead on with performance, you still don't know if that pay is appropriate or if any causality exits. At best, all you can say is that you are no worse than anyone else. What is missing in this analysis is whether shareholders are getting a fair return on the value of the equity they have granted to employees.

Our analysis of Fortune 1500 companies indicates that salaries and target cash incentives are generally predictable, based on company size. The level of salary is strongly linked to size, and the amount of the annual incentive (usually as a percent of salary, with notable exceptions in certain industry sectors) is tied to annual financial performance.

Most of the disparity in the relationship between pay and performance arises from equity. Equity is powerful; it constitutes 60%-70% or more of the pay package in the largest companies. Because it takes many forms, it is difficult to compare types of equity in terms of the value delivered to management and in direct comparison to any market standard. The matter is further complicated by governance programs and the regulatory/reporting framework.

For compensation committees and executives, it is beneficial to stand back from the process and think in more broad terms about what incentive equity should achieve. In a start-up, it represents a tradeoff for current compensation and a shared risk in the venture, with first hires (higher risk takers) generally receiving the more lucrative terms. As the existential threat declines, the relative ownership stake awarded to management as a percent of the company usually declines through successive capital raises, IPOs, etc. In private equity situations, an upfront sharing of 10%-12% of the company in the form of an option is intended to align management to an expected time horizon and a new, focused strategy. This dilution is explicitly built into investors' expectations, and management's potential gain is calculated based on the expected returns of the specific investment thesis.

However, in most public companies in corporate America, we see a different practice. Executives are awarded long-term equity on an annual basis, which is valued, reported, and viewed by executives as part of their annual compensation. We effectively shift from a value-sharing arrangement to a competitive annual pay arrangement, where in most instances, the competitive pay target is hypothetical and only loosely related to value sharing.

We think it is a better approach to think in terms of a competitive level of value to be shared with management based on the relative importance of capital and labor (knowledge) in the creation of that value. Industries or situations where capital is the primary driver require less value shared. Industries where intellectual capital is paramount warrant proportionally larger ownership interest to attract the necessary talent. Once a competitive ownership level is defined, boards and their compensation committees should think about how quickly to allocate the equity. If it is a potential breakthrough situation or a turnaround, a frontloaded award of equity makes sense. If the strategy is more akin to hitting lots of singles and doubles (to use a baseball analogy), annual awards tied to incremental achievement might make more sense. In either instance, the level of sharing is not in question, only the time required to realize the full allocation.

A shared value approach to equity also addresses the "elephant in the room"—how much equity is enough? By operating

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with a value-sharing target, the conversation shifts to how quickly the target can be allocated. Long-term vesting, distinct from the award, remains the key to retention and liquidity and limits the company's exposure from a premature executive exit. More important, the value-sharing approach automatically aligns executive and shareholder interests through shared expectations, without the need for elaborate charts and graphs.

At the end of the day, it's about value sharing—the more value you create, the more wealth you get. Committees need to avoid distractions from excessive peer comparisons, proxy adviser edicts, and SEC and accounting rules. It is only through a shared, mature view of the executive relationship that we can quell the critics and clear the air on executive pay.

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