PAY FOR PERFORMANCE

Where We Veered Off the Road

In our last article, we noted that somewhere along the way, executive compensation veered off the road. It became too complex, isolated from true performance and downside risk, and in many cases, too high. While there is no shortage of blame to go around, we find one obvious flaw is the prevailing practice of treating executive equity as annual compensation.

Assume that you had money to invest in a business, and I was going to run it for you. I'd get a salary and bonus for my labor. You might also give me shares of the company to align our interests and ensure I was fully "bought in" to the venture. It would be clear between us that the stock was my "share of the deal" and would remain invested with the company until we parted ways.

As an unintended consequence of the 30-year effort by the SEC to improve the oversight of executive pay, we have effectively created a bias against the "share of the deal" approach to equity. To provide greater transparency and comparability, the SEC requires companies to report all remuneration in annual terms—even if it is not an annual event. Consequently, we stopped thinking about executive equity as a "share of the deal," and we fell into the mindset that it was all annual compensation.

Obviously, equity awards have a compensatory effect and are a key part of an executive's total pay. The best talent will seek opportunities where they can share in the value they help create. However, by seeing executive equity as a piecemeal annual reward rather than as one's share of the deal, we have created the perception that the equity is indeed a cash equivalent, to be exchanged for cash when needed.

From an owner's perspective, the critical issue should not be the annual increment of equity, but the total equity commitment necessary for each key executive role to achieve the following investor objectives:

- providing an attractive package to recruit and retain the management talent needed;
- matching executive performance and wealth more closely to the company risk horizon; and
- aligning executive wealth proportional to investor gains or losses.

Unfortunately, in the current "tail wagging the dog" scenario, we find companies think about equity in annual terms because we report it and compare it on annual terms. This has the perverse impact of

- delaying the formation of a substantial equity position for several years in order to comply with annual compensation practices;
- rewarding volatility by granting more equity (as a percent of outstanding stock) when the company does poorly and fewer shares when the company is highly successful; and
- thinking of equity as a cash equivalent that can be sold during the term of employment.

It makes far more sense to manage equity decisions using established target equity levels for each of the key executive roles. Achieving the target ownership may be accomplished in one step (e.g., in a turnaround), or parsed out over time. The key difference, however, is that executives and investors know the annual grant is not a bottomless pit of investor dilution. Periodic grants would represent the execution of a strategy rather than an attempt to chase some market median practice.

With this approach, companies, executives, and investors benefit three key ways:

- We answer the question "How much is enough?"—the elephant in the room nobody currently wants to talk about;
- We simplify pay by distinguishing an illiquid career investment from annual cash pay. This change in perspective removes much of the concern driving the Dodd-Frank pay-ratio debate; and
- We assure all parties that executive management is a long-term investor in the company, with upside and downside risk, and full accountability for the economic consequences of risks through a sizeable stake held throughout their career.

It is time we begin to think and act like owners and treat equity as if we were making partners out of management—by granting them a piece of the enhanced value of the business over time, not doling out shares simply to reach a "competitive" amount of annual compensation.

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