



Executive Remuneration Perspective

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What is the best method of determining incentive plan measures that align performance with results?

When setting performance targets, what analytical tools are available to evaluate the difficulty of those targets?

How can companies assess whether a plan achieved its desired results?

Tackling the challenge of aligning pay with results

In light of the current recession, the credit crisis and significant shareholder losses, there has been increased scrutiny of executive compensation, particularly regarding issues related to how companies should align executive pay with business results. Consequently, various shareholder organizations have rethought their pay-for-performance “guiding principles,” adopting more prescriptive views of what’s expected when it comes to measuring and rewarding performance.

While the focus and influencing tactics have changed over time, the most critical question remains: How should companies align executive pay with business results?

Until recently, share price appreciation was the definitive guide for the “right” results, which explains the heavy reliance on stock options. However, given the recent turmoil in the markets, stock options in many companies have fallen out of favor. While many companies are continuing to use stock options as a component of their long-term incentive strategies, most are incorporating other vehicles as well, including performance shares and cash plans. One of the biggest challenges with these programs is selecting the right metrics and setting targets with an appropriate degree of difficulty.





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While there is no silver bullet strategy for selecting measures and performance targets, a comprehensive and rigorous approach can create a rational and defensible link between pay and results. This *Perspective* describes the tools and processes that companies can use to answer the following questions:

- How should we define results?
- What targets are appropriately difficult?
- How do we calibrate pay to results?

Ingredients for a robust pay-for-results discussion

There are a number of analytical tools that can provide companies with information to help them evaluate various performance metrics and levels and strengthen the link between executive pay (cash and equity) and corporate results. These tools do not replace management’s input or directors’ judgment; rather, they help increase understanding and foster greater insight. We believe the best approach is collaborative, in which committee members, the committee’s independent adviser, senior management and executives from the company’s human resource and finance functions get together to share their views.

Healthy debate over the issues identified by analytical tools provides the basis for:

- Compensation committees to meet the test of reasonableness and the demands of effective governance; and for
- Senior management to motivate and direct the company’s workforce.

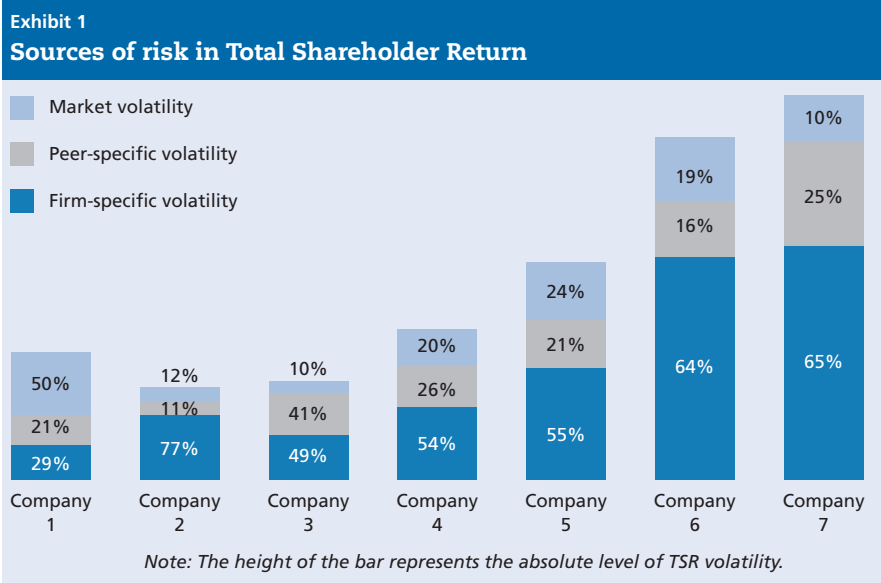
Identifying the right performance measures

The primary objective of most incentive plans is to drive business results that will ultimately translate into increased shareholder value. Selecting the right performance measures is one of the most important aspects of establishing the appropriate link between pay and results. But determining what defines “good” results and deciding where an organization should focus its attention are not always so obvious.

There are two broad categories of measures – internal and external. Internal measures, such as financial results or operational objectives, are different from stock price or total shareholder return (TSR) measures, which are external. Stock performance has long been favored, but for many organizations it *alone* is rarely the best judge of an executive’s contribution to results. Stock price is influenced by market factors outside of management’s control and does not reflect day-to-day decision making, thereby limiting the line-of-sight. So, what role should equity and stock price have in executive compensation programs?

Performance Sensitivity Analysis® (PSA) can help companies answer this question. Each company faces a unique risk environment in the capital markets. PSA analyzes the source of volatility in a given company’s stock compared to a peer group of companies with similar industry or business profiles. This analysis gives new insights into how firm-specific behaviors contribute to TSR as compared to industry and general market factors. PSA thus provides a quantitative basis for setting the degree to which equity performance – and the related risk – should be part of incentive compensation design.

Exhibit 1 shows the risk profiles of a group of industry peers and the influence of market-, industry- and firm-specific factors on TSR volatility. Compared to its peers, Company 1 has low TSR volatility, and most of it was the result of external – industry and market – risks. This information played a significant role in the company’s decision to reduce its emphasis on equity compensation and to add relative performance metrics to its long-term incentive plan.



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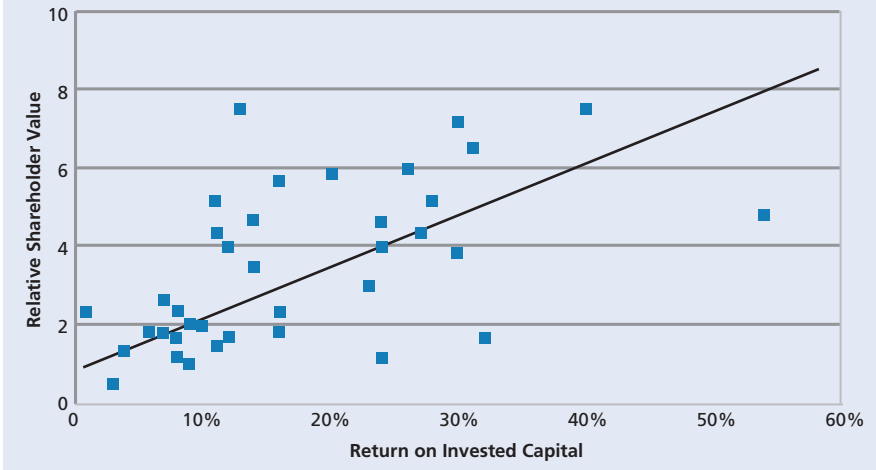
After a company has addressed the role and importance of equity and share price, the next decision requires an assessment of how to measure success from an internal perspective and ensure that performance measures are aligned with creating shareholder value.

Shareholder Value Analysis provides a basis for understanding how financial results on selected internal metrics relate to shareholder value creation. There is extensive historical data available on the results of US companies and the market, often at a level granular enough to identify the key drivers of shareholder value. Through regression analysis, it is possible to identify how results on a given measure or on multiple measures link to shareholder value creation over the short, medium and long term.

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Exhibit 2 shows why one company decided to incorporate return-on-invested capital (ROIC) in its executive incentive plan. In analyzing historical data, the company found a very high correlation between ROIC and shareholder value among its peer group.

Exhibit 2
Return on Invested Capital vs. Relative Shareholder Value
FYE 1998 – 2008



Of course, identifying appropriate performance measures goes beyond strong correlations and financial analysis of potential outcomes. Each company has a different business strategy, its own point on the maturity curve and a unique culture. These factors, as well as common sense considerations about the measures – accuracy, reliability, simplicity, ease of implementation, consistency across plans and transparency – should influence the final selection of measures. But initiating the discussion with factual information about which measures drive shareholder value is often a valuable approach.



Setting targets

Setting appropriate performance targets that link performance measures to pay can be challenging, especially when incentive programs are expected to reward results over multiple years. Management budgets and long-range forecasts are useful starting points for the discussion, but, given the difficulty of forecasting, they should not be relied upon as the only inputs into the target-setting process. The key questions include:

- Are the performance targets meaningful (that is – *If we deliver these results, should it increase shareholder value over the long term?*)?
- Are they reasonably achievable (that is – *Is there a sufficient degree of stretch?*)?

As with measure selection, a number of analytical tools can help evaluate the difficulty of performance targets.

Relative Performance comparisons are often an important component of performance target setting. Although not necessarily a predictor of the future, the company's historical results compared to its peers and the broader market can help inform whether targets are achievable and meaningful. Goals are often set within a range of historical peer results, for example, at the 50th or 60th percentile for target payouts and at the 70th to 80th percentile for upside performance.

Beyond peer comparisons, **External Expectations Analysis** can be used to determine whether the selected performance goals are sufficient to meet expectations built into the company's current market value. Stock analysts' reports are an important external source for these insights. Their research often focuses on specific industry metrics and expectations that they consider indicative of success and provides some input into the target-setting process. Performance targets can easily be derived that are directly comparable to analysts' projections of earnings per share (EPS) or cash flow.

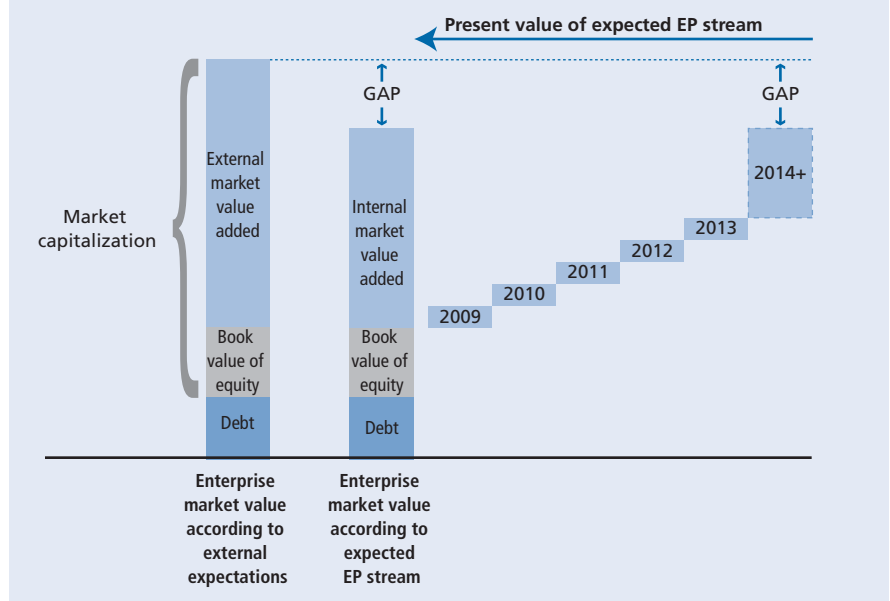
Beyond analysts' reports, the performance-improvement expectations built into stock price can be directly analyzed. The value of current results can usually be quantified with reasonable assumptions. Looking at the gap between the current value of operations and market value, future growth expectations can be identified and should be considered in evaluating targets. See Exhibit 3 for an illustration of a "Gap Analysis" whereby the company's projected economic profit (EP) stream, according to its business plan, does not deliver on the market's expectations. In other words, the market is expecting better results than the company currently has built into its business plan.

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Exhibit 3
Illustration of gap between current value of operations and market value



In these unprecedented times, companies must be willing to invest more energy in setting credible performance goals to ensure that incentive plans continue to be motivational as the economic landscape changes. This is achieved by incorporating a range of perspectives – forward looking and historical, internal and external, relative and absolute – into the target-setting process.

Calibrating pay to results

The final requirement in aligning pay with results is putting the pieces together and making sure that the designated “how much” is reasonable, given the measures and performance targets.

Neither boards nor shareholders like surprises. From a governance standpoint, boards have an obligation to understand how the incentive plan will operate at both anticipated and unanticipated performance levels. This is particularly the case if plan payouts are not capped.

Scenario Testing provides a basis for companies to understand the implications of actual payouts relative to results. Payout levels should always be evaluated under a variety of potential performance scenarios. This testing often leads to discussions about the payout curve. A straight-line payout between threshold, target and maximum is common but may not be appropriate in all cases. The question is: do results that are halfway

between threshold and target goals warrant half the payout? The answer is at the heart of the calibration discussion. In some cases, the answer is “yes,” and the straight line is appropriate. In others, it is a decided “no,” and the payout curve between threshold and target may look like a hockey stick with minimal payouts until performance nears target. Not only is it important to consider the financial outcome scenarios, but also the behaviors and decisions that can drive those results. For example, key questions companies need to consider include:

- Does the payout curve encourage excessive risk taking?
- Are there decisions and actions that can be taken for short-term gain that may have negative long-term implications?
- Are sufficient balancing factors in place that control for the quality of results and for managing risks (for example, board oversight, qualitative assessments, etc.)?

Cost-Benefit Analysis helps to quantify the relationship between aggregate payouts and the underlying value delivered to shareholders. Two common approaches are to measure incentive plan payouts (1) as a percentage of net income or other returns and (2) as a percentage of incremental performance improvement (for example, year-over-year net income growth). Regardless of approach, it is incumbent that the company understands whether the costs of the program are commensurate with the results for shareholders.

A note of caution: accurately benchmarking the cost-benefit analysis relative to other companies is very difficult, as there are significant differences between companies – even those in the same industry – in terms of organizational structure, staffing levels, pay mix and incentive participation. Therefore, evaluating the cost-benefit is often a test of “reasonableness” rather than an exercise in explicit benchmarking.

A word about transparency

Transparency is one of the guiding principles for improving governance of executive compensation. This implies simplicity in design as well as comprehensive disclosure. Simplicity in design is a laudable goal, but it is very challenging where the incentive plan is supporting complex business structures and strategies. A good test for whether a design is simple enough is if it can be communicated effectively – both internally and externally. Over the last few years, a good way to determine whether a plan is too complex has been to ask “how will we describe this program in the Compensation Discussion & Analysis section of the proxy?” While disclosures have become more robust and detailed, over-complicated plans can leave shareholders confused about how incentives are linked to performance.

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A simple plan design demands rigorous analysis

Performance measurement need not become so overly complicated that it cannot be understood by stakeholders. However, delivering a relatively simple plan design with pay and results appropriately aligned requires rigorous factual analysis supported by appropriate tools and healthy debate. Ultimately, this approach enables both a committee to meet governance standards and senior management to use performance measures as a more effective management tool.

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