Staying Ahead of Pay Practices

Compensation experts address TSR, incentives, and how to manage bad news.

Public conversations about executive compensation tend to be spurred by the media and other entities that don't have direct involvement in the creation and implementation of payment programs. The National Association of Corporate Directors' (NACD) annual Leading Minds of Compensation event sought to hand directors the reins to guide and shape a smart dialogue on sensitive compensation questions. The Grand Hyatt Hotel in New York City was the setting on March 3 for a slate of experts to speak to and answer questions about the latest compensation trends.

Panelists included **Steven Hall**, managing director of Steven Hall & Partners; **Dayna Harris**, vice president of Farient Advisors; **Jeffrey Joyce**, partner at Pay Governance; **Jannice Koors**, managing director of Pearl Meyer & Partners; **Rose Marie Orens**, senior partner at Compensation Advisory Partners; and **Barry Sullivan**, managing director at Semler Brossy Consulting Group.

What follows are some of the most germane answers to questions asked of the panelists by *NACD Directorship* Publisher Christopher Y. Clark. At the conclusion of the moderated portion, the panelists fielded questions from the audience of some 150 directors.

What are the pros and cons of using total shareholder return (TSR) as a performance metric?

Jannice Koors: I am not a fan of TSR as an incentive metric, but it does have some benefits. It clearly is one of the most directly aligned metrics between shareholders and executives. But it also has a lot of downsides. If you think about the purpose of an incentive plan, which is to incent behaviors and decision making, you don't have behaviors that directly create stock price. You have behaviors that create profits, sales, and operational excellence. I view TSR as a reward plan rather than incentive plan.

Beyond that, a lot of companies have been hasty in adopting TSR because they think everybody else uses it. There aren't many companies that can create a relevant peer group with which to measure TSR, and relative TSR falls apart when you're not doing an apples-to-apples comparison within your peer group. Furthermore, because it is a point-to-point measure—you're measuring movement across a fixed period of time—TSR creates some natural spikes. What goes up must come down—if you're in the top quartile at the end of three years, you have vastly improved the probability that you will be in the bottom quartile by the end of your sixth.

TSR really values being a steady eddy in the middle of the pack, and one of the downfalls is you'll get a lot of spikes in your payouts. As a management team, are you prepared for the ups and downs of those inevitable spikes? My preference is for companies to look at which internal measures are within the control of management that really drive shareholder value. Reward people for what they do, and if you do that right, payouts will be correlated to value creation.

Looking ahead, what can we expect with regard to changes to annual incentives?

Rose Marie Orens: Annual incentives probably are our strongest motivator in terms of the elements of pay we have available to us, and about 40 percent of companies make changes to their annual incentive plan every year. That might sound horrifying, but most of it is tweaking on the metrics side. Most companies are continuing to look at refining what their performance metrics are, how they align with pay for performance, and how they can create greater line of sight with executives. We're noticing that most of the metric changes impact how incentive plans are funded. We are seeing a trend in plans being more structured, rather than discretionary, as the economy is becoming a bit more predictable.

What we see in terms of the metrics is a continuing focus on profitability. The second most common metric is revenue, which is interesting because, after many years of companies finding it extremely difficult to grow, we are seeing a resurgence in growth in revenue. Returns, which you see used a lot in long-term plans, are not common in annual plans because improving your return is not typically a one-year event. Companies are using more creative, strategic objectives in their compensation plans, such as including pipeline performance for a pharma company and international revenues for a firm expanding overseas.

Keep metrics simple. Keep them consistent year over year so you can do back-testing to see how your plans are working over time. Assume plans need a couple of years to ferment. Lastly, when you change short-term metrics, look at long-term metrics. Do you have the right balance? In some cases, it's OK to use the same metrics in both plans, but ideally you want them to comple-

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ment each other, e.g., net income in the annual plan, return on equity in the long term.

Is there a way to stay ahead of activists?

Barry Sullivan: If the activists are at your door, think of the two profiles: there are those that are very interested in executive compensation as a tool to enact strategic change, and there are others that are interested in executive compensation less as a tool and more as a means of discrediting the sitting management and board.

You need to make those distinctions. If your activist is more in the first camp, chances are you want to listen and engage—and there are high-profile examples where a board seat or two was "given up" with really terrific outcomes for the company and its shareholders. If the activist at your door is more about a loud and public fight, your "prevent defense" needs to be very strong.

"Prevent defense" is about having a clear strategic course. And then you need strong linkages from your pay programs to the business strategy. You want to have a heavy incentive compensation piece where the majority is equity. You want to make sure you are taking care of the equity side of the equation to drive the alignment with investors. You also don't want to have too many hot-button issues that are easy targets from an activist perspective, such as high severance multiples. Finally, you want to make sure your Compensation Discussion & Analysis (CD&A) looks more like an investor presentation than a textbook, with very clear headlines that say we pay for performance, our executives hold stock, our board is very engaged, and we have an open dialogue with shareholders around pay.

PHOTOS BY DAVID NICHOLAS/LONGVIEW

In view of this proxy season, what would you identify as key issues for compensation committees?

Jeffrey Joyce: Boards need to be aware of key shareholder concerns, and be well versed in the proxy advisor rule changes and the implications for their companies.

This year, Institutional Shareholder Services (ISS) changed its equity plan scorecard, moving from its previous quantitative ap-

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proach to a more holistic, scorecard approach. It's also important for companies to understand if ISS will have any pay-for-performance concerns so that the company can review other aspects of its programs and determine if any changes are required. Equally important is to understand key shareholder perspectives regarding the company's executive compensation and governance practices to ensure there are no surprises come time for the say-on-pay vote. Good relations and an ongoing dialogue with key shareholders can go a long way in securing a supportive say-on-pay vote, especially if proxy advisors have some concerns.

Finally, committees should not neglect to ask themselves if the programs are continuing to support the company's business and compensation objectives. Programs are often designed and not revisited for a long time, as compliance and securing a favorable shareholder vote for the executive compensation program may sometimes usurp the more basic question: Are our programs supporting our objectives? Committees should take the time after the annual meeting to ask, "Are our programs still doing what we want them to do?" If not, then it's time to revisit the programs.

How should a company go about setting goals and payouts when the outlook is in a declining mode?

Dayna Harris: This proxy season, we expect there to be a lot more focus on goals than we've seen in the past. But what do you do when the goals you are setting for the new fiscal year are lower than what you had last year? First, analyze the situation and determine how much lower your goals are and why. Is this a function of an industry or economic turndown? Is it a company-specific problem?

Once you have a general framework, there are four ways to address those goals. You can decrease target payout as a percentage of salary on a temporary basis. You may leave the target where it is, but increase threshold and maximum goals so before you pay any award at threshold, you need to have higher performance that you might otherwise have had in relationship to target. You might decrease threshold and maximum payouts as a percentage of the target, leaving the goals in proportion to how you normally would. Finally, you may use compensation committee downward discretion at the end of the year.

Whatever the company decides to do, it needs to do that in the

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context of what is fare and balanced for shareholders, who may be receiving lower value in stock prices that year, and to executives, who need to be focused and motivated.

Assess say on pay four years later: what's happened and what hasn't happened?

Steven Hall: On an overall basis, I think say on pay has worked out OK. The voting has been fairly consistent over the past four years. We generally found about 90 percent of votes were in favor, 8 percent against. But if you look at the number of companies that failed in a particular year, you'll find that 25 to 30 percent of them had passed the year before with a 90 percent or greater vote.

What does that mean? One would think that it means they drastically altered their compensation programs, but that's not it. Instead, they had poor stock price performance or there were changes in pay levels or some other component that irritated shareholders. This creates a problem for us in terms of understanding what people are really voting on. Is it that shareholders truly like the program or the product that comes out of that program? Or do they only focus on the program when stock price falters? Are they voting for or against the program or the performance? The strongest thing we can be doing all along to assess the answer to this question is to stay in touch with shareholders.

We also have to look and see where say on pay could be going. We know some of the pension funds have made comments to ISS asking, "How could you be recommending 'no' only 12 or 13 percent of the time?" In addition, look to the east and see what's happening in Europe. Mandatory say on pay is gaining ground, and I think we're only one mess away from seeing those discussions happen here.

One of the challenges that we have in how compensation is administered is that at the beginning of each year, most companies make salary increases, set annual incentive goals and payout targets, and award long-term equity grants. Thus, with annual incentives representing a relatively small slice of the total compensation pie, it would not seem that there is the ability to adjust compensation down sufficiently to respond to TSR-focused reviews when stock price falls.