Incentive Plans

Dare to Be Different: Strategic Compensation Plan Design

By Robin Ferracone

The criticism of executive compensation plans these days is that they are too homogenized. Our post–Dodd-Frank governance landscape, proxy advisor policies, and even investor guidelines have conspired to create a rules-based environment for executive compensation design, pushing most companies to a new, formulaic normal. Take a short-term incentive plan with two financial measures and perhaps an individual component, mix them with a long-term incentive plan comprised of two vehicles with three-year overlapping performance/vesting. Repeat every year, and presto, you have the typical program. Such homogeneous plans have been useful in that they have helped companies stay under the radar with respect to proxy advisor criticism and say-on-pay votes.

The good news is that the tide is changing. Investors are now asking for compensation programs that more strongly reflect a company's strategy and even social objectives without, of course, sacrificing returns.

At a recent roundtable organized by the Council of Institutional Investors, one investor commented, "All companies are different, and yet we've seen homogeneity in the way they're structuring their [compensation] packages...I would like to see programs designed individually by companies."

Pursuant to the Tax Cuts and Jobs Act, we've also seen the repeal of the exemption under Internal Revenue Service Code Section 162(m). This exemption allowed performance-based compensation over $1 million to be tax deductible by corporations for certain top executives. Now, compensation over $1 million for certain executives is not tax deductible under any circumstance, so there is less pressure to meet the very specific design requirements prescribed by 162(m).

These changes are not a license for excessive compensation or an "anything goes" design, but they do invite different and more strategically aligned executive compensation programs. In addition, companies are starting to recognize that customized pay plans offer them an opportunity to communicate key strategic and cultural priorities. While strategically differentiated compensation programs are not yet the norm, examples of these types of programs exist, and they make creative use of the following elements:

- Performance measures;
- Time horizon; and
- Ownership.

Performance Measures

Most companies use two or three financial measures that are believed to drive shareholder value in their incentive plans. This approach makes sense. However, it also makes sense to use nontraditional financial and nonfinancial measures that are uniquely indicative of the company's strategic imperatives. Examples of unique financial measures include:

- Intrinsic value growth, which reflects the way in which the business is managed and how value-creating decisions are made.
- Economic value added, which reflects the way in which the business is managed, including the language of the business.
- Long-term cumulative, rather than point-to-point, measures to mitigate the impact of external economic conditions at any given point in time.

Strategic measures help communicate key strategic themes. Plan participants can either rise or fall together with such measures, or the strategic themes can be baked into each participant's objectives. While we now see strategic objectives emerging in short-term incentive plans, we have not yet seen their advent in long-term plans. This is because goal setting for long-term plans can be difficult, particularly for strategic objectives. Notwithstanding this challenge, strategic change is often a long-term endeavor, and long-term strategic measures warrant consideration. Examples of strategic measures include:

- Customer retention, which reflects the need to focus on customers by measuring improvement in four categories: people, products, shopping experience, and price.
- Customer experience, which is gauged by measuring the likelihood that a customer would recommend doing business with the company to others.
- Diversity, which reflects the need for a balanced and inclusive workforce.

Time Horizon

An overwhelming majority of companies gear their long-term incentives to three-year overlapping performance and vesting cycles. Two factors have caused this phenomenon. First, there has been a precipitous drop in the use of stock options. This change has all but shut down an incentive vehicle that generally offered 10-year terms. Second, there has been a tremendous rise in the use of performance shares. Performance shares almost always default to a three-year term, primarily because companies find it difficult to set goals extending beyond three years. Further, they find it difficult to ask executives to wait more than three years for an uncertain payout. Now that three-year cycles are the norm, it is very difficult to compete in a hot talent market with incentives that mature over a longer period of time.

While incentive plan time horizons have devolved to three years, business time horizons have not materially changed. For example, an investment time horizon (i.e., starting from the point at which an investment decision is made and ending when the investment is paying off) often is longer than three years, particularly in capital-intensive businesses. Further, economic cycles are generally five to seven years, making it more difficult to measure real sustainable performance versus performance caused by cyclical effects. As a result, many companies would like to establish incentives with longer-term cycles, but are stymied by the competitive pressure for talent.

Despite these obstacles, some companies have managed to break away from the three-year mold in their fundamental pay programs, not just with special awards that sit on top of the basic plans. Examples include:

- Amazon.com, where long-term restricted stock units are granted when there is a project need, not every year. Grants tend to vest over five or six years and are matched to the time horizon of the investment.
- Ball Corp., where any bonus over the 200 percent maximum payout level is banked and paid out in one-third increments in years where the maximum is not achieved.
- Tesla, where the CEO has 10 years to vest in 12 tranches of stock options, which can be earned over successive increases in market capitalization and either revenue or EBITA.

Ownership

The concept of wealth leverage—i.e., the sensitivity of management's wealth to the company's stock price—has proven to be powerful. Companies with high wealth leverage tend to outperform those with low leverage.

Most companies achieve real ownership and wealth leverage by implementing ownership guidelines, usually five or six times salary for the CEO and two to three times salary for other executives, or by requiring that stock earned through incentive plans be held until the guidelines are met. However, some companies are daring to be different by treating ownership as a carrot instead of a stick. These companies incentivize ownership by offering a premium or upside potential for voluntarily taking equity in lieu of cash. For example:

- AT&T uses deferral with match. Here, managers and executives can elect to defer short-term compensation into deferred share units. AT&T grants plan participants a 20 percent match on deferred shares. This match for officers is capped at the target value of the annual incentive award.
- Exxon Mobil Corp. uses long-term incentive deferral. Executive incentives are structured to provide additional ownership and focus on long-term success. Long-term incentive awards are also deferred, with 50 percent being paid out at the end of five years, and the remaining 50 percent held for 10 years or until retirement, whichever is later.
- Siemens AG uses broad-based match, where senior managers can invest a portion of their variable compensation in stock and receive one matching share for every three shares invested and held for three years. Employees can invest a portion of their monthly compensation in stock and can receive the same match as senior managers if they hold the shares for two years.

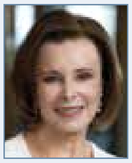
Companies that use ownership as a carrot rather than a stick implore employees not only to think and act like owners, but also to regard ownership as an opportunity as opposed to an obligation.

The Path Ahead

The pressure to "conform to the norm" in executive compensation seems to have hit its peak. There is increasing room and even a growing call to action for designing executive compensation plans that encourage and support unique aspects of a company's strategy and culture. Companies need to shake the notion that nonconformance is somehow a dangerous or dirty word. In fact, differentiated compensation plans and good corporate governance can happily coexist as long as there is strong alignment with pay and performance, particularly for the CEO, and there is a compelling rationale disclosed in the proxy. If a company clearly communicates how the incentive program is linked to its strategy, culture, and shareholder value, investors will be more willing to support a plan sporting nontraditional features, and participants are likely to be motivated by such a plan.

So go ahead. Dare to be different. Design a compensation program that your company truly owns.

Robin Ferracone is the CEO of Farient Advisors LLC, an executive compensation, performance, and governance advisory firm.



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