

Ensuring the Executive Pay Program is on a Strong Foundation

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In the current environment with Say on Pay votes and intense media scrutiny, it can be difficult to stay centered on the foundation of the executive pay program. While it is important to be aware of external views and commentary on “best practices”, companies must ensure that their executive pay program is built on a rock-solid foundation. In terms of the building blocks of the pay program, most companies apply a “market median” compensation philosophy, but there are a wider range of practices for the peer group, performance metrics and assessing pay-for-performance alignment. Below we review key considerations in each of these three areas. As always, in designing and administering their pay program it is vital that companies start and finish with their business strategy, talent motivation and needs.

Peer Group Composition and Application

As with any benchmarking process, it is important to consider peer group information as an input, not the final answer. There is not a one-size-fits-all approach to peer group selection. Instead, a principles-based approach should be used based on consideration of relevant screening criteria. Specifically, in developing their own peer group(s), companies select peers that are in similar businesses, comparably-sized, competitors for talent and investor dollars, and fit with other relevant factors. In addition, the peer group should have a sufficient number of companies and the company’s size should be reasonable relative to the median and distribution.

There are often various potential peer companies that may not meet all the primary screening criteria initially established, but that would be reasonable to consider as peers. In this instance, the rationale for using peers outside of the primary screening criteria should be clearly articulated and disclosed.

Ensuring the Executive Pay Program is on a Strong Foundation

We have seen several examples of primary peer groups that may lead to incomplete or inappropriate conclusions:

1. *Peer group that is “too small”.* Relying on a comparator group of less than 10 companies can be challenging, particularly if the company desires to be precise in its use of external pay data.
2. *Biased peer group.* Using a peer group with too many companies that are significantly larger or smaller without balancing the distribution. While percentile rank is a common statistic, it is also important to consider the company’s size as a percent of median. For example, even though a company may be at the 55th percentile (in terms of revenue size), its actual revenues could be greater than +20% of the absolute median.
3. *Precision in considering the peer data.* Expecting that the company’s pay levels or practices will always be exactly equal to the peer median or typical practice. A competitive range should be established around the actual targeted data point to alleviate the focus of targeting a single value or amount. Market data should be one of several inputs with pay actions centered on the company’s strategy, talent needs and internal factors (individuals’ experience, etc., internal equity).
4. *Everybody does it this way (living in a vacuum).* While the company’s peer group is the most relevant external benchmarking perspective, the use of a larger secondary data set can be helpful to confirm key findings and ensure awareness of a broader perspective.
5. *Outsourcing to proxy advisory firms.* Companies need to be aware of the companies analyzed by ISS and, if relevant to the company’s shareholder base, other advisory firms. However, a company’s peer group should be self-selected to align with its business and talent markets, and other factors deemed relevant to the company. Often times there is overlap in the company’s peer group and companies used by proxy advisory firms, however, there can be significant differences in conclusions due to the specific companies analyzed and analytical approaches.

Performance Measure Selection and Goal Setting

The heart of the executive pay program is the incentive plans, particularly the performance measures and goals, which are intended to directly connect employees to the company’s business strategy. Given this criticality, it is imperative to be specific and clear in selecting incentive plan performance measures. While there are many measures that are important for a company to monitor, typically companies find the best design – to maximize motivation and line of sight to drive results – limits the number of measures to three or less in each plan. In selecting performance measures, companies consider the following perspectives:

Ensuring the Executive Pay Program is on a Strong Foundation

Perspective	Role / Key Questions to Address	Outcome
<i>1. Business Strategy</i>	<p>Starting point for measure selection</p> <ul style="list-style-type: none"> • What are the key measures of success as defined by the Board and management team? • What are the messages in the company's investor presentations? • Which measures belong in the annual and long-term incentive plans? 	<ul style="list-style-type: none"> • Ensure direct alignment of performance measures to the company's internal and external communication of performance
<i>2. Peer Group and Broader Market Practices</i>	<p>Helps refine and limit the measures used for incentives</p> <ul style="list-style-type: none"> • What are common performance measure types and weightings? • What measures (for the company and peers) have historically had the strongest correlation to value creation and which are the most volatile? 	<ul style="list-style-type: none"> • Ensure selected measures are reasonable relative to key value drivers and metrics used by companies in similar businesses
<i>3. Analysts</i>	<p>Helps finalize the selected measures for incentives</p> <ul style="list-style-type: none"> • On what areas of financial statements are key analysts focused? • What are the specific measures that are most heavily scrutinized by key analysts? 	<ul style="list-style-type: none"> • Ensure selected measures are reasonable relative to analysts' focus and appropriate in light of guidance
<i>4. Proxy Advisory Firms</i>	<p>Helps to mitigate surprises regarding the measures used by advisory firms</p> <ul style="list-style-type: none"> • What, besides TSR, are the proxy advisory firms focused on? • Have the advisory firms' views regarding measures changed recently or are they anticipated to change? 	<ul style="list-style-type: none"> • Ensure understanding of how the selected measures relate to the proxy advisory firms' likely views and provide clear proxy disclosure regarding the company's rationale and application of metrics

After the performance measures are approved, the specific performance goals (i.e., threshold, target and maximum) can be set. Since the performance goals specify the “what” for earning “how much”, it is critical for the company to be diligent in applying a consistent process that considers several inputs. In helping to finalize the incentive goals, companies often find it helpful to consider the following:

Ensuring the Executive Pay Program is on a Strong Foundation

1. *Budget / forecast for the measurement period.* In order to provide accountability to management, companies often target goals at (or within a range of) the board-approved budget. As a result, the incentive goals should be reasonable with external guidance issued by the company.
2. *Recent performance and payouts.* For both the company and peers, it is insightful to understand how the proposed goals compare to recent results, along with emerging industry and business conditions. Also it is informative to review a multi-year history of the company's incentive payouts and CEO / officer pay relative to performance to ensure the company's intended pay-for-performance alignment is being achieved.
3. *Probability of achievement.* Based on qualitative and quantitative assessments of difficulty, the company can have greater comfort in finalizing the performance goals. Many companies strive to set target goals that are "challenging, but achievable" with relatively more achievable goals at threshold and very difficult goals at maximum.
4. *Analysts' estimates.* For both the company and the peer group, understanding current projections, particularly if available prior to updated company guidance, can be helpful in approving the performance goals.
5. *Costs and other considerations.* It is also important to understand total potential costs, under a range of performance outcomes, as well as other factors that may be relevant to the company.

Collectively, based on the various perspectives that the company finds relevant, the result – at the start of the performance period – is reasonable confidence in the potential achievement of the goals, while recognizing that there is uncertainty (with higher probability of achievement below target and lower above target).

Ensuring Appropriate Outcomes – Assessing Pay and Performance Alignment

It is a necessity to analyze pay from multiple perspectives. In order to provide a competitive pay package, companies need to review pay opportunities (setting of salary and target incentive award opportunities, as well as the range of potential payouts) to ensure there is the desired alignment to the business strategy. As required by the SEC, pay for the "top five" officers needs to be presented in the Summary Compensation Table, which is a mix of actual pay and grant date values. In order to appropriately analyze pay and performance, which requires the assessment of values and outcomes of incentive awards relative to results, other perspectives are needed – specifically, Realizable Pay and Realized (Actual) Pay. These perspectives are often analyzed over 3 to 5 years (an even longer period, such as 10 years or the executive's tenure, can also be examined). These pay-performance perspectives provide the compensation committee and management an assessment of multi-year pay-performance correlations, which can help inform future decisions regarding Pay Opportunities, incentive mix and performance metrics, as well as support pay disclosures in the proxy CD&A.

Ensuring the Executive Pay Program is on a Strong Foundation

Pay Perspective	Role / Use	Appropriate Performance Comparison
1. <i>Pay Opportunities</i>	<p>Ensure market competitive total pay opportunity</p> <ul style="list-style-type: none"> Establish competitive pay opportunities and competitive incentive payout ranges 	<ul style="list-style-type: none"> Median pay for median performance is a prevalent approach; for companies wishing to have greater leverage, goal setting needs to reflect appropriate challenge
2. <i>Summary Compensation Table (SCT)</i>	<p>Mandated by SEC</p> <ul style="list-style-type: none"> Required disclosure, however, it does not clearly communicate true pay outcomes and therefore supplemental disclosure may be necessary to appropriately tell the pay for performance story 	<ul style="list-style-type: none"> Not applicable in total, since with the exception of salary and annual incentive/bonus awards, the SCT does not illustrate actual pay earned (or current value), making its use for performance comparisons irrelevant, given that the largest element of officers' pay is in long-term incentives
3. <i>Realizable Pay</i>	<p>Assess amount of salary and the value (at the end of the assessment period) of granted incentives during the analyzed period</p> <ul style="list-style-type: none"> Provide strongest "apples to apples" comparison, since all incentive pay granted during the assessment period is included 	<ul style="list-style-type: none"> Financial and TSR performance over the same time period, relative to the peer group
4. <i>Actual or Realized Pay</i>	<p>Assess amount of salary and paid annual incentives and vested / exercised equity and long-term incentives</p> <ul style="list-style-type: none"> Provide a perspective of how much the executive actually "took home" 	<ul style="list-style-type: none"> Financial and TSR performance over the same time period, relative to the peer group
5. <i>Career Pay</i>	<p>Analysis of total pay over an executive's tenure</p> <ul style="list-style-type: none"> Provide perspective of executive's total Realizable or Realized Pay, relative to value created 	<ul style="list-style-type: none"> Financial and TSR performance, including change in market capitalization, over the same time period

Ensuring the Executive Pay Program is on a Strong Foundation

Closing

There are varying external views of “market” and “best” practices, which makes it critical to remain vigilant in the design and administration of the executive pay program, particularly regarding the foundational elements. In this article we focused on three such “building blocks”, and recognize a holistic perspective needs to be applied, which includes other important elements and governance practices. In this regard, companies need to continue designing pay programs, which are clearly disclosed in the annual proxy filing, that best align to their business strategy and talent needs to create shareholder value.

Questions about this Viewpoint can be directed to John R. Sinkular or Joshua Bright by email at john.sinkular@paygovernance.com or joshua.bright@paygovernance.com.