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01 | 2016 workspan
The Magazine of WorldatWork©

Executive Pay: Creating Real Alignment With Shareholders

Nobody really likes total shareholder return (TSR) as an incentive plan metric.

Nobody, that is, except the major shareholders of publicly traded companies. Boards feel pressured to adopt TSR as a metric because it is easy to explain to shareholders, but they don't really embrace TSR due to the lack of transparency and understanding among executives. Shareholders, on the other hand, have strongly supported TSR as a key metric of success. This is the new reality to which board members and executives need to be sensitive when designing incentive plans.

We recently attended a Nasdaq compensation committee forum attended by board members, top HR executives and representatives from a number of institutional investors where the major topic of discussion was about the growing prevalence of TSR and relative TSR (rTSR) metrics in executive compensation. There was broad and general agreement that linking compensation to TSR does not make a very good "incentive" plan. Executives cannot control TSR directly, and it generally makes more sense to link pay to the strategic priorities of the business that executives can control, like revenue growth, innovation, margin management and returns on investments. This idea of strategic alignment has been the core principle for designing effective incentive plans for more than 30 years, and it continues to be relevant today.

At the same time, while shareholders acknowledge the benefits of aligning executive pay with strategic priorities, they also have been consistently clear for the past several years — they like to see a meaningful portion of executive pay aligned with their results. Despite the limitations from an incentive plan standpoint, shareholders like total shareholder return as a measure of success. This is not just

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a fad to be dismissed or an arbitrary rule developed by governance advocates — it is a strong perspective shared by many shareholders and a new paradigm for executive pay practices that should be incorporated into thinking on effective design. The key is to have balance between incentives for performance and rewards aligned with shareholders.

This evolving paradigm for thinking about executive pay is the basis of new research being conducted by Semler Brossy Consulting Group on shareholder sensitivity in compensation plan design. In our research, we explicitly challenge the notion that by granting a significant amount of executive compensation in the form of equity, companies have by definition created alignment with shareholders. The reality is more complicated than that. Our research shows that companies and industries that grant a lot of time-based restricted stock, for example, have fairly limited alignment between rewards actually realized by executives and stock performance for shareholders. Ironically, our research also demonstrates that the movement away from stock options has significantly reduced the sensitivity to shareholder returns in executive compensation, as compensation programs that continue to use options are much more highly aligned with shareholder results.

Our approach to the research was to upend the traditional framework of assessing total compensation for executives as a combination of base salary, annual cash incentives and long-term or equity incentives — the classic "total direct compensation" approach. Instead, we disaggregate this number and reallocate into three new categories as shown in Figure 1.

Note that we explicitly separate out the value of equity awards granted (time-based and performance-based shares) from the change in their value based on actual share price results. This allows us to measure the shareholder-sensitivity of these vehicles independently of their underlying award value.

Once we reallocated total compensation into these new categories, we then measured the impact of actual shareholder returns on the realizable value of these pay elements

Figure 1 | **Reallocated Total Compensation Categories**

Category	Definition	Pay Elements
Pay Delivery	More or less guaranteed elements of pay; expected value for doing the job	• Base salary • The original grant value of time-based restricted shares
Pay for Performance	Classic "incentive" compensation elements; pay linked to explicit but controllable elements of performance, such as financial results	• Annual cash incentives • Cash long-term incentives • The grant value of performance-based shares tied to financial results or other controllable factors
Pay for Results	Amount of pay tied to shareholder returns, whether explicitly tied to TSR metrics or implicitly linked through share price changes	• The grant value of performance-based shares explicitly linked to TSR or share price goals • Stock options • The impact of share price changes on other equity vehicles

for executives. We completed this assessment for the CEOs across three groups of companies in industrial, health care and technology industries — with a total sample size of more than 60 companies — to understand the implications of this model in different markets. Some of the results were surprising:

- The average CEO has more than 40 percent of total compensation tied to results for shareholders, which appears to be in reasonable balance with the other elements of compensation.
- Industrials have the highest degree of alignment with shareholders, while technology companies have the lowest degree of alignment.
- Technology companies also have the highest proportion of "fixed" pay elements, with 30 percent of the average CEO's pay categorized as "pay delivery."

These findings appear counter-intuitive — CEOs of industrial companies have more pay "at-risk" and stronger shareholder alignment than CEOs of high-flying, risk-oriented technology firms? But dig a little deeper and the results begin to make more sense. (See Figure 2).

Due to high-historical levels of dilution, many technology firms have significantly reduced or eliminated stock options from their incentive plan mix. As a result, the average technology-company CEO now receives less than 20 percent of his/her long-term incentive awards in the form of stock options. Although many of these companies have adopted performance-based shares tied to TSR, this is still a minority portion of total compensation. Also, most of the opportunity from options has been shifted into time-based and performance-based equity linked to financial performance results.

Industrial companies, on the other hand, have been slower to adopt to the movement away from options, and the average industrial-company CEO still receives more than 50 percent of long-term incentive awards in the form of stock options. As a result, pay packages for industrial-company CEOs are more sensitive to changes in share prices than the equivalent technology CEOs. This counterintuitive result demonstrates the unintended consequences of the strong shareholder pressure to reduce the use of stock options — fewer stock options reduces the sensitivity of executive pay to shareholder results overall.

We also see another unintended consequence of compensation plan design in these results, and that is the impact of time-based restricted stock on total compensation results for executives. Although time-based restricted stock is indeed variable with share price over time, the relative impact of share price changes is generally muted for this vehicle relative to other forms of compensation — most boards and HR professionals think of restricted stock as primarily a retention incentive. We have accounted for this in our model by allocating the grant date value to "pay delivery" and showing the impact of increased share prices in "pay for results."

As a result, we see that the technology industry companies are again different than the overall market, with nearly 30 percent of total compensation in the pay delivery category rather than pay at risk. This is despite the fact that technology companies have the lowest average mix of salaries among the companies tested (10 percent vs. 15 percent for the other two industry groups) and the highest proportion of long-term incentive pay (76 percent of total compensation vs. 67 percent on average). This highlights another key finding from our

Figure 2 | Degree of Shareholder Alignment at 10% Annual TSR

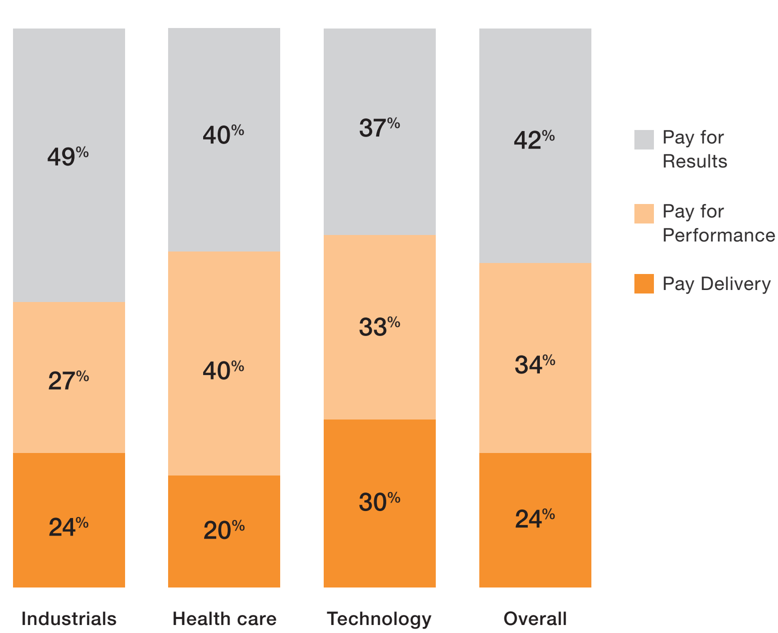
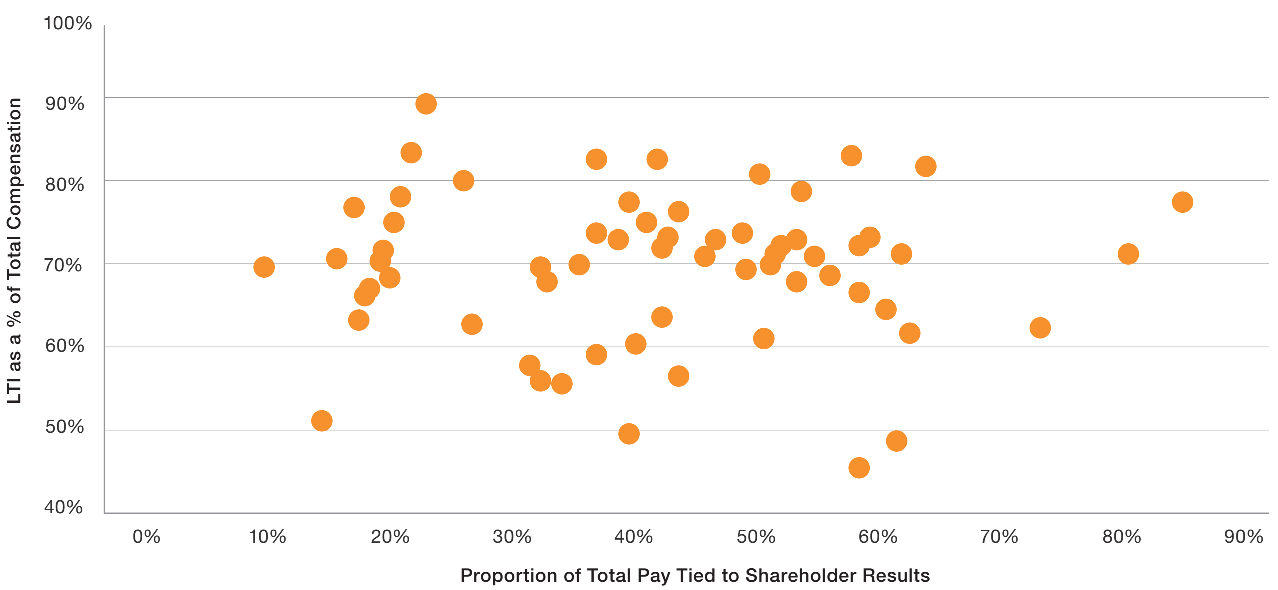


Figure 3 | LTI as a % of Total Comp vs. Pay for Results



analysis — the proportion of total compensation delivered in long-term incentives has no meaningful relationship to the degree of shareholder alignment. (See Figure 3.)

This is persistent across companies and industries. In the case of technology companies, the effect of delivering more pay in equity is overwhelmed by the higher relative use of time-based restricted stock in the industry — pay delivery undermines pay for results.

So does all this mean that you should scrap your current incentive-based compensation and go back to using 100 percent stock options or making all of your compensation contingent on total shareholder returns? Absolutely not! Any compensation plan design needs to be a balance between incentives for clear and controllable results aligned with business strategy and alignment with shareholder interests in order to be effective.

However, our perspective is that the relative degree of alignment with shareholders is not always well understood and not well benchmarked. The concept that all compensation delivered in equity is by definition aligned with shareholders is likely overstated and should be assessed in more detail. This new analytical model is just a first step in developing another lens for evaluating executive pay and the underlying drivers of pay results.

As our engagement with shareholders has taught us over the last several years, in an era of increasing shareholder involvement with executive pay, it is more and more critical that boards understand how their pay practices compare to the norm. Boards need to understand and be able to articulate — and defend — how well their executive compensation design aligns with shareholder interests. This understanding helps ensure that companies continue to have a balanced perspective on executive pay and meet the needs of all constituencies — both the incentive and performance needs of the company and the alignment of rewards with the actual results for shareholders. ws

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