Executive Compensation:
How Well Do You Know Your Performance Range?

Marc Ullman and Jamie McGough

Think about a dart board. Immediately, the bulls-eye comes to mind. All you need to do is aim and throw the dart at the middle of the board to win, right? For the most part, the answer is yes. But, there is a little more to it than that. The points on the board are strategically arranged to drive accuracy. This means that knowing how to use the range around the bulls-eye—not just aiming for target—can work to your advantage.

Like a dart board, the performance range that surrounds the goal in an incentive plan has a distinct purpose—to drive the appropriate focus for optimal results for both shareholders and executives. Today, with increased attention on executive pay, shareholders want to know more about the performance required in those pay packages. Specifically beyond target:

- Is threshold performance sufficiently rigorous?
- What performance is required to earn the “maximum” award?

Right Sizing Performance Ranges

First, consider how *targets* are set versus how *ranges* are set. Performance targets are generally easier to defend because they are often rooted in the annual budget. But the practices that have evolved in setting ranges that surround targets aren’t as precise. In their least favorable form, ranges have become driven by so-called “best practices” (e.g., the symmetrical 80%/120% rule) that set threshold and maximum goals at 80% and 120% of the target, respectively. These sorts of predetermined factors, while reflective of broad averages and “rules of thumb,” are subject to wide variation by company and by measure. Therefore, this is not a reliable approach in calibrating goals. When it comes to performance ranges, one size does not fit all.

Performance goals must be tailored—they must take into account the likely range of outcomes from a given measure at a given time for that business model, or run the risk of having a poorly calibrated incentive plan. The only rule of thumb we can feel comfortable with is: *the more uncertain or volatile the measure, the wider the range.* For example, a very large company with predictable top-line revenue may only need a range from 97% to 103% around its target (i.e., 100%), versus EPS growth for a smaller company in a more volatile industry, where a 70% to 130% range around target may be needed, or perhaps a nonlinear and/or non-symmetrical relationship might be necessary. Simply put, there is not a “normal” that can be used to shortcut the process, rather, each measure and business circumstance needs to be considered separately for the pay-performance relationship to be properly structured.

The objective is for the performance range to be “operational,” meaning there is a low probability that actual outcomes will fall outside the ranges (either below the threshold or above the maximum). This is important because incentive plans must operate so *incremental* performance (negative or positive) has a financial impact on participants. When actual results routinely go far beyond, or fall notably below the incentive plan performance ranges, neither of these outcomes will motivate improvement since either the payout has already “maxed-out” because the goals were too easy, or the payout was zeroed-out because the goals were too difficult.

Trust but Verify

With the governance climate and heightened demand on Directors to explain their decisions around executive pay, it is becoming an expectation for compensation committees to demonstrate their "duty of care" by validating incentive plan targets *and* ranges from various perspectives. Here are five perspectives that can be helpful in the validation process:

I. Recent company performance;

II. Strategic aspirations and imperatives;

III. Performance of a relevant group of peers;

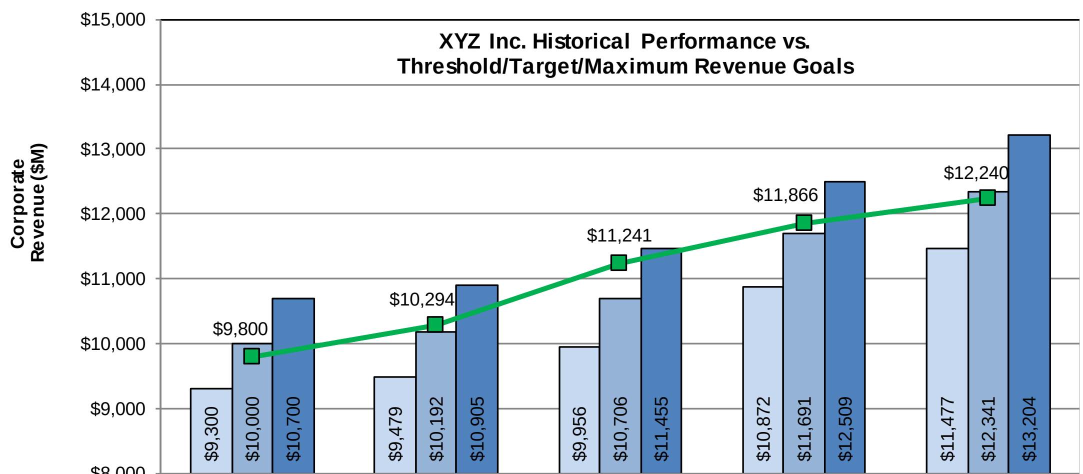
IV. Analyst/shareholder expectations; and

V. Sharing ratio between participants and shareholders.

Let's briefly consider each.

I. Recent company performance—Most companies compare proposed targets and ranges with their own historical financial performance; where has the company been and what is a plausible trend line of improvement.

In the exhibit below, we see an example of a company that has consistently performed near its annual target revenue goal of 4.0% growth. Based on historical performance, 4.0% might then seem like the appropriate "starting place" when setting goals for 2014, though other factors should be considered. For example, does current market demand suggest a plateau or do current economic prospects suggest higher growth is "expected" over the near future?



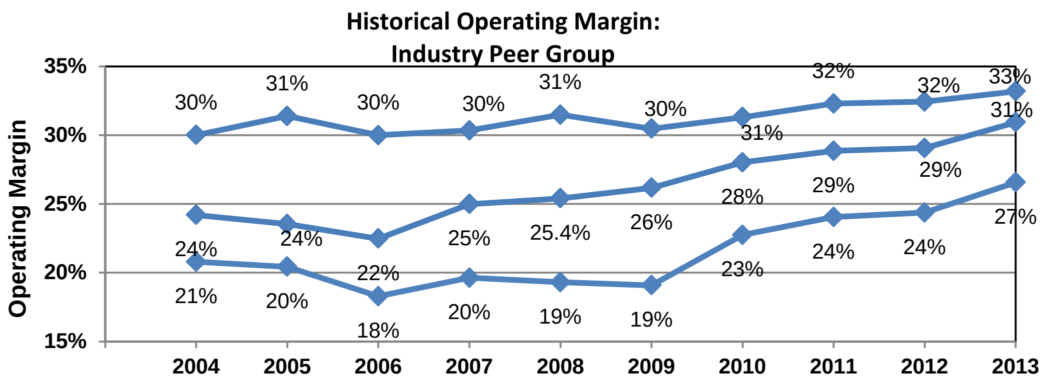
	FY 2009	FY 2010	FY2011	FY 2012	FY 2013
Target Revenue Growth	4.0%	4.0%	4.0%	4.0%	4.0%
Actual Revenue Growth	1.9%	5.0%	9.2%	5.6%	3.2%
Payout (% of target)	86%	114%	171%	121%	94%

II. Strategic aspirations and imperatives—Goals must be aligned with, and make meaningful progress towards, achieving long-term strategic objectives. Examining proposed targets and ranges for each measure against the company's longer-term strategic plan is essential if the long-term vision is to be more than a pipe dream. Below are examples of strategic goals that can be used as incentive plan measures.

III. Performance of a relevant group of peers—Examining performance across a relevant group of companies, over an extended period of time, provides valuable perspective for the level and range of expected performance outcomes. Although a deep topic on its own, the peer group for this purpose should represent industry competitors and/or those broadly influenced by similar macroeconomic phenomena in the case of classically cyclical industrial companies.

The graph below is an example of understanding the long-term profitability for an industry group. By plotting long-term profit margins (median) and correspondingly stratifying the comparator group into the 25th percentile and the 75th percentile several insights are possible:

- Long-term average, median or "expected" performance.
- Typical *range* of results around median that can serve as a potential guide to set threshold and maximum goals around target.



IV. Analyst/shareholder expectations—Goals should generally be consistent with investors' expectations and with what their advisors expect; it is especially important to avoid a target that is set too conservatively, as this can result in above-target payouts and a declining stock price.

V. Sharing Ratio between Participants and Shareholders—Any incentive plan needs to embed a balanced sharing of the fruits of success between the participants and the shareholders. For an executive incentive plan, among the more effective ways to assess the proportionate sharing in any set of goals is to examine two ratios:

1. $$\frac{\text{Target Incentives}}{\text{Pre-Incentive Operating Income}}$$

2. $$\frac{[(\text{Incentives at Maximum} - \text{Target Incentives})}{(\text{Pre-Incentive Operating Income at Maximum Performance} - \text{Pre-Incentive Operating Income at Target Performance})]}$$

The first formula computes the sharing between participants and shareholders based on target performance. The second formula computes the sharing in the *incremental* sharing of profitability between target and maximum performance. This is important because, while it would be common to see the sharing percentage rise for above-target performance, it nevertheless needs to remain balanced.

Both are important reference points in evaluating the proportionate sharing in the annual (or long term) profits and improvement in company results. There are no "right" answers or consistent market standards of what are "typical" or "normal" sharing relationships. Sharing ratios can, and do, vary considerably depending on the pay philosophy, number of plan participants and industry. Nevertheless, most companies are able to judge if the sharing relationships seem appropriate given all the facts and circumstances, and an outside advisor often can also provide context for what their professional experience would suggest for any given circumstances.

Moreover, while their might not be “an” answer (any more than there is an answer to the goal-setting process generally), this sort of stress testing frequently does reveal when the answer (i.e., the implied level of sharing) is wrong. The collective judgment of directors can usually determine if the sharing is too great for a level of performance being considered and therefore when goals need to be higher.

Hitting the Bull’s-Eye

Companies that are getting it right have committees and management teams that are using these perspectives and analytics as a part of their annual goal-setting process. The process is a rigorous blend of quantitative and qualitative assessments that ultimately yields goals which reflect an informed business judgment.

When companies take all of these steps, there is much to gain. Management can make sound recommendations; committees can confidently approve incentive plan targets and ranges; and shareholders can support the pay practices of the companies in which they invest. *Bull’s-Eye!*

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Jamie McGough is a Partner in Meridian’s Chicago office. Marc Ullman is the Lead Consultant in Meridian’s New York office. Additional information about Meridian can be found at www.meridiancp.com

Biographies

Marc R. Ullman

Marc Ullman leads the New York office for Meridian Compensation Partners, LLC, having recently joined the firm after 15 years with the Towers Perrin/Towers Watson executive compensation practice. With nearly 20 years of executive compensation consulting experience—and with the last seven years as the leader of the Toronto and then the Metro New York executive compensation practices for Towers—Marc has established many long-standing relationships as a trusted advisor to both boards and management teams.

Marc consults with public and private organizations, and has experience in various industries, including advertising, computer software, consumer products, financial services, manufacturing, media, professional services, retail, telecommunications and transportation. Marc consults in the areas of executive new hires & terminations, shareholder engagement, share reserve requests, transaction-related compensation programs, such as in initial public offerings, mergers & acquisitions & spin-offs, as well as in all phases of the annual executive compensation cycle.

Marc has been a popular speaker at the Conference Board of Canada and has presented at the national conferences for World@Work, Conference Board and National Association of Stock Plan Professionals (NASPP).

Marc started his career with the Segal Company in 1997 where he advised clients on compensation and benefit programs. Marc received his Bachelor's degree in Psychology from Roger Williams University and his Master's degree in Organizational Behavior from Columbia University.

Contact Information

Marc R. Ullman
Meridian Compensation Partners, LLC
mullman@meridiancp.com
646-737-1642

Jamie McGough

Jamie is a partner of Meridian. Jamie has been consulting in the areas related to executive compensation and corporate governance for over 20 years. His work includes the design and structuring of all aspects of executive and outside director compensation arrangements including equity- and other wealth-sharing programs, short- and long-term incentive design, supplemental retirement programs, and change-in-control arrangements. Jamie is the firm's leader on our *Performance Measurement Team* which examines the range of issues related to performance measurement, how financial measures relate to shareholder value, aligning pay and performance and other similar subjects. In addition to his client responsibilities, Jamie is a member of our Executive Committee overseeing the governance of our firm.

His work has encompassed a wide range of small and large, public and private, consumer products, industrial, service, and technology firms. Most of the clients listed below include regular consultations with their board of directors.

He received a B.S. in Accountancy from DePaul University, and an MBA in Finance and Economics from the University of Chicago, and is a Certified Public Accountant.

Contact Information

James C. McGough
Meridian Compensation Partners
jmcgough@meridiancp.com
847-235-3608