Executive Compensation: Staying Focused on the Essentials

We live in tumultuous times. The current political environment is heavily shaped by populism—from all corners of the political spectrum. In addition, business and social media can often be similarly fueled by hyperbole and hype. In this environment it can be difficult to separate facts from inflammatory rhetoric. This uncertainty can lead to confusion for investors, board members, executives and the public at large regarding executive compensation. The purpose of this piece is not to take a political stand—each person can decide that for themselves—but to bring facts and analysis to some basic topics in executive compensation.

Why is executive pay so high?

Executive pay tends to be high due to basic supply and demand. C-level executives are in high demand but comparatively low supply.

In terms of demand, there are at least 5,500 public companies in the United States alone. When private companies are included it becomes clear that the demand for executive talent is very high. In addition, the value of intellectual capital (knowledge!) has grown dramatically over the last 50 years. So the value associated with effective, expert leadership is critical. Finally, there are no substitutes—leadership requires people; those that can credibly execute on strategy *and* convey the confidence of necessary for success to both internal and external constituencies.

On the supply side, talent that can excel at the executive level usually requires decades of experience and a variety of specialized skills. C-suite roles most often are occupied by people that have *at least* 15 to 20 years of experience and sometimes more. Moreover, it is not just years of service that matter. There are many that have the *number* of years but have not honed the expertise or simply do not demonstrate the desire for these roles and the associated pressures. C-suite roles require a unique blend of skills and broad business acumen honed over many years of relevant business experience. Consequently, the supply of talent is comparatively limited.

Can Companies Overpay for Executives

Yes. Human capital in some ways is no different than any other product or service we as individuals or organizations might buy. A product that does not perform; a service where we did not get our money's worth; or outcomes that simply did not live up to expectations. The marketplace for talent does not ensure the "perfect' or "ideal outcome" only the prevailing *price*.

However, this risk is the reason companies go to extensive lengths to tying a substantial fraction of compensation opportunities to performance.

How do Companies Lower the Risk of Overpaying?

There are four key strategies and policies that companies commonly undertake:

1. Understand the market you are competing in—which players, what size etc.
2. Deliver majority of pay as "performance-based" (for CEOs this is usually >70%)

3. Create a balance of short- and long-term incentives (for short and long-term results

4. Measure the right things (varies by company) it is essential to either pay for value creation (i.e., share price appreciation or those measures most associated with creating value)

Isn't There Widespread Dissatisfaction with Executive Compensation?

No. Certainly not from those who pay the compensation—owners/shareholders. Shareholder "say on pay" votes are a strong indication in this regard. Over the last decade only about 1%-2% of companies fail to "pass" with a majority of FOR votes. Indeed 80% of companies get >90% support "FOR" votes. The primary predictor of a failed Say on Pay vote is not the level of pay but *performance*.

Most of the outcry about executive compensation tends to be from the media and politicians—which tend to have particular philosophical angles. Again, each person can decide for themselves philosophically but these are not parties who are involved in the "transaction" of what one company pays its management team. Rather, these are perceptions from afar which tend to be driven by sentiment and emotion rather than sound business judgment.

Shareholders tend to focus on performance rather than pay. Ultimately, shareholders will force a change to pay (or incumbents) when they are not satisfied with company performance. Alternatively, if performance is in line with goals/expectations, shareholders will keep executive pay as high as it needs to be.

Optimal Executive Compensation Outcomes

Every economic decision ultimately hinges on two things—what's the cost and compared to what? Companies make decisions based on the totality of costs and benefits.

As with most endeavors the achieving the best outcomes starts with preparation. Research, from the beginning, will ensure that the compensation program is on par with the market **but** also makes sense from a business perspective.

In general, shareholders are paying for outcomes, pay *opportunities* (not certainty) are predominantly based on performance. Companies need to determine how much of their program depends on performance and then designate *what kind* of performance.

- Stock price growth
- Profitability/efficiency
- Growth efficiency
- Other factors

Similarly, preparation also means specifying performance ranges and vesting terms. Just as importantly, limiting costs when changes in the executive team have to be made at the *front end*…

- What amount of severance?

- Under what circumstances?
- What happens to unvested awards?

Executive Compensation in the Future

Executive compensation is high because talented people dedicated to organizations are vital to company success and shareholder value.

Most likely, executive compensation will remain controversial. Politicians and the media remain critical of many executive compensation schemes, and they will continue to do so as they find the opportunity. However, their insistence on “transparency” will most likely backfire as it has in the past. Ever greater disclosure and detail only makes the market more “efficient” and informed allowing for executives to negotiate even higher compensation.

Companies are increasingly attentive to diversity while continuing to ensure that hiring is based on capabilities and merit. They will continue to require that all candidates have demonstrated their ability to fill the role of the executive.

ESG metrics may become more prominent in executive compensation packages. Although not generally dominant metrics in the incentive structure, there are some shareholders as well as other constituencies many companies want to communicate with and convey their values.

Conclusion

Companies choose executives based on who can fulfill the required duties most effectively based on both skills and demonstrated results. This talent often comes with a high price tag. Executives generally have decades of experience and can demonstrate confidence necessary for effective leadership.

Despite near-term uncertainty generated by COVID-19 and our periodic political controversies companies are focused on their task at hand—competing in their markets, creating value for shareholders and to do this requires dedicated, effective leadership. Meridian helps its clients sift through the noise to see the situation as it really is so they can maintain the right balance of performance and a sustained leadership team.

Get in touch with Meridian Compensation Partners to understand the best way to develop your organization’s executive compensation package. Each organization should consider its options and metrics specific to them. We can help you determine what makes sense to incorporate into your company’s plan.