Setting Appropriate Performance Metrics and Goals

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In an environment of significant public and media scrutiny, executive compensation's evolution over the last decade has been dramatic and very visible. Executive pay has become more transparent, responsible, and aligned to performance than ever before.

But in this Say-on-Pay world where proxy advisors, activist investors, and other third parties hold significant sway, the parameters for "acceptable" executive pay practices have now been drawn more narrowly. There is a charge—one with some basis in available data—that executive pay programs have become "homogenized" at many public companies, designed mainly to be as inoffensive as possible to external observers and stakeholders.

The most obvious examples of this phenomenon include: 1) the rapid increase in use of relative Total Shareholder Return (TSR) performance plans as a core vehicle for long-term incentive compensation, and 2) the parallel decline in the use of stock options as a form of long-term executive pay. Meridian's 2014 Trends & Developments in Executive Compensation survey indicates that use of relative TSR increased by 7 points, since 2012, to 57% prevalence[1]. The decline in stock option usage has been both a longer-term trend and ultimately one with more dramatic results. Stock option-only long-term incentive (LTI) plan prevalence is now in single digits and when combined with other long-term vehicles, stock options represent only 18% of the total LTI value on average. It is now practically accepted wisdom at many companies that stock options should not form a significant portion of long-term incentive compensation.

Our purpose in citing these examples is not to start a debate on the merits and demerits of each. Nor are we seeking to paint with an overbroad brush the observed "narrowing" of acceptable pay parameters in recent years as a problematic development. Some of the pay practices that are now either going or gone would be very hard to justify in the current environment (e.g., tax-free loans), where shareholders care more than ever about the pay-for-performance linkage. Moreover, some of these practices (e.g., excise tax gross-ups on golden parachutes) are simply economically very inefficient.

But we argue that there should be a wider set of recognized executive pay boundaries when the subject is incentive compensation design. "Plain vanilla" incentive compensation plans that are designed principally to avoid criticism run a significant risk of missing many important linkages that should be created between a company's unique business opportunities and challenges, and its incentive pay arrangements. These linkages are created by the selection of incentive compensation **vehicles**, by the **performance measures** selected for incentive compensation designs, and by the way performance **goals** and **ranges** are set.

Why does this matter? The selection of vehicles, measures, and goals creates the bridge between the creation of short- and long-term shareholder value, and the executive compensation program. If that were not enough, this is also an area where we expect significant attention from third-party observers in the near future. In recent years, third parties have tended to focus on the existence (or non-existence) of various pay *practices*, primarily from outside the incentive compensation arena. Thus far there has been some commentary on performance *vehicles*, somewhat less on performance *measures*, and very little on performance *goals*. We believe this is changing. It will be difficult to evaluate goals fairly or well, but that will not stop many third parties from trying. Compensation committees should be prepared to answer this challenge by analyzing their incentive plan goals rigorously and explaining them thoroughly.

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[1] From a survey sample of major public companies with median revenues of $4 Billion, covering a range of industrial sectors.

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With that backdrop in place, we offer the following "Top 10 Pitfalls" to avoid when considering incentive compensation at the executive level:

Top 10 Pitfalls for Performance Measures and Goals:

Basing plan design purely on prevalent market practice*.* There is comfort and a certain amount of benefit derived from staying with what is known or popular. A related issue is the tendency to assume that common practice equals best practice. In some industries, the formula for value creation *is* so well-understood that only a narrow array of performance vehicles or measures makes sense. We think that this is the minority case, however. Most of the time, there will be multiple potential pathways to value creation. A company seeking to create value via a strategy of differentiation might also need to build their incentive pay program around designs that are *not* prevalent.

Giving too much deference to third parties. It is no secret that proxy advisory firms and large institutional shareholders wield significant influence over pay design, notably by publishing lists of pay practices that they deem to be undesirable. But getting a "smooth ride" from proxy advisors can sometimes be at odds with putting the right compensation structures in place, particularly over the long run. For instance, consider the following set of circumstances:

- Industry undergoing disruptive change (from new technologies, new regulatory framework, new international competitors)
- The leadership at an established company perceives opportunities to capitalize on these changes, but to do this will require sacrificing some of the current "annuity" business
- The time frame for accomplishment is uncertain but potentially lengthy—longer than the typical three-year performance cycle incorporated in most performance plan designs
- There are above-average risks and rewards

Other things equal, many observers would consider this situation and conclude that leveraged compensation vehicles like stock options should at least be part of the pay opportunity, despite their unpopularity with proxy advisors and certain institutional investors. Such third-party opinions should be considered but should not be allowed to foreclose the conversation.

Ignoring business imperatives and the cost of capital. A simple but often ignored theory of value creation holds that companies create value when they find a way to grow—so long as that growth is profitable. More specifically, companies create value when they grow while earning a return on capital in excess of that capital's cost—an *economic* profit. Neither debt nor equity capital comes for free; the cost of debt financing—its interest rate—is more obvious, but equity financing also carries an implied cost.

It is well-understood in the theory of finance that a company that is not earning an economic profit will create more value by focusing primarily on becoming more profitable. By contrast, a company that is earning extremely high excess returns on capital will create more value by seeking to grow, even at lower marginal returns on capital—to the point where the marginal return on capital *just* offsets its cost.

There is a lesson for incentive plan compensation here. While a return-based measure of profitability may not be ideal for all companies, in many industries (e.g., those with relatively high tangible capital intensity), a return on capital-type incentive measure could be very useful. But the performance goals associated with such a measure should be set with an estimate of the cost of capital used at least as a reference point.

Destroying line-of-sight by over-engineering the incentive plan, by using too many measures, or by using the wrong measures. A very common phenomenon—particularly with annual incentive programs—is the tendency to design them to such a fine level of detail that their incentive properties are washed away.

Having too many performance measures is the most common error we see in this respect. It is hard to believe that a plan participant's behavior will change in any meaningful way if their annual bonus depends on their performance on eight to ten or more measures, none of which is worth more than several percentage points of the total. Overcomplicating the way that performance is measured, and the interaction of the different measures, are other common issues. We believe that more successful incentive plans measure fewer critical priorities, as transparently and openly as possible.

Relying solely on own historical performance and/or current-year budget to set incentive plan targets and ranges. Most companies base their incentive plan goals on the current-year, and board-approved budget or strategic plan. Sometimes goal setting is informed by the company's own recent history (depending on whether the company generally seeks continuous improvement, or alternately sets goals each cycle based on an updated understanding of business conditions). But, that is often where it stops. The quality of decision making as it pertains to performance goals depends on the quality of the budget or strategy document, and the compensation committee's understanding of embedded assumptions.

We believe that the goal-setting process would be improved if companies made regular use of expanded methods of analyzing their incentive plan performance goals. Three examples include: 1) examination of peer or industry results over a long-run historical period, which aids both in understanding any cyclicality in performance over time, and in understanding how much improvement is plausible over a given time interval; 2) understanding external market expectations in detail; 3) modeling potential impacts to value (or even to earnings) if goals are attained at various levels. This latter approach can be especially useful if the company also considers how much of the value created is to be shared with incentive plan participants.

Applying performance ranges based on rules/mechanics (e.g., symmetrical 80%/120% with linear apportionment), and disregarding the shape of the performance/payout relationship. Performance plan targets (i.e., achievement required to earn a payout at 100%) are often derived from the strategic plan or budget, as noted. For companies with leverage in their performance plans (i.e., payouts at more or less than 100% are possible, by formula), much less attention is given to performance at these boundaries on either end. There is sometimes a tendency to apply "rules of thumb" as a substitute for judgment or analysis in setting the boundary performance conditions—most iconically the "80/120" rule, where performance at 80% of the target goal justifies a minimum or "threshold" payout (often 50% of target), and performance at 120% of the target goal earns a maximum payout (often 200% of target).

Such a mechanical approach ignores entirely the prospect that performance at target may incorporate significant stretch or significant slack, either deliberately or otherwise. It also assumes that the performance/payout relationship is effectively straight-line between minimum and target, and then again between target and maximum, and that the same performance range is appropriate for all performance measures.

There could be very valid reasons for the slope of the performance curve to be steeper or flatter, for performance above or below target, or even to have more complicated relationships (for example, with a flat "landing strip" near the target performance level, with abrupt cliffs on either side of that strip). The lesson here is yet another opportunity for compensation committees and management teams to apply a combination of judgment and multiple analytical techniques across the entire range of performance/payout outcomes. Minimally, there should be a dialogue between management and the compensation committee on the committee's desired degree of difficulty (expressed as estimated probability of attainment) at the various performance levels.

Failing to consider the "sharing ratio" of profits between management and shareholders along the payout curve. An often-neglected tool in the incentive compensation toolbox is to consider how much sharing (of value or profits) would take place between the company and its shareholders, and management, if the company performed at the levels described in the incentive plan goals. Many compensation committees avoid this kind of analysis because there is really very little market data to inform a committee member as to the "right" level of sharing. (Aggregate incentive plan payout information is not a required public disclosure.) Even so, it can be valuable just to consider what the sharing fraction looks like for the current cycle, compared to the company's own history with prior cycles. If the payout fraction associated with the proposed set of goals is materially higher or lower than what has been experienced in prior years, or if the trend is noticeably up or down, a compensation committee may wish to investigate further. Conducting this analysis is uncomplicated and not particularly costly, but can add significantly to understanding.

Using "timeless standards" reflexively instead of deliberately. While a minority practice, there are some companies that apply "timeless" standards more or less automatically. For example, a company's practice might be simply to state that the overriding goal is always 10% growth (top- or bottom-line), regardless of what might be going on in the company's business environment. Certainly there is a case for using immutable standards for performance: there is no risk that they will get "worn down" over time, which can happen when goals are set based on what is viewed as attainable for the current cycle. However, the timeless standard may be wholly inappropriate for the current "facts on the ground." The standard could be far too easy or far too difficult to attain, creating windfalls or starvation, just based on whether the company is currently in an up market or a down market. Incentive plans that create these outcomes—irrespective of the plan participants' levels of effort—tend to lose their incentive focus and indeed become de-motivating. A compensation committee wishing to engage with this approach should consider carefully how stable the company's prospects are and how much "noise" is likely to be introduced by the surrounding market environment, from cycle to cycle.

Inadequately telling the compensation story. At the end of the day, the pay program can be perfect, but none of it matters if nobody knows about it. Best practice has become to engage *internal* stakeholders with regular planned communiques on program design and particularly current performance against goals. For *external* stakeholders, the proxy Compensation Discussion & Analysis (CD&A) has become the premier tool for "marketing" the executive pay program. The 2014 proxy filings from General Electric and Coca Cola are instructive. Both companies make imaginative use of leading-edge innovations in proxy disclosure in order to tell their story in the best possible terms, including proxy summaries, pay/performance alignment stories, and extensive use of visually appealing information presentations. The net result is a document that is easy and even enjoyable to read, as opposed to a compliance document. In the future, we expect to see more small and mid-size companies investing more heavily in the marketing efforts associated with their CD&A as many larger companies have done in the last few years.

Summing It All Up

There have been many changes in the landscape for executive compensation in recent years. There is more scrutiny—more "sunlight"—on executive compensation decision making than ever before. Changes to executive pay have thus far been focused on elements of pay design that are less related to the core pay-for-performance mission, such as excise tax gross-ups and severance. But we believe this is changing.

The next frontier will be new levels of scrutiny of a company's chosen performance measures and related goals. Unlike many of the prior revisions to pay programs, the pay/performance relationship comes up for evaluation at the beginning of *every* award cycle—effectively every year! Fundamentally, companies can prepare themselves for this new reality in two important ways: 1) by putting the business strategy and plan at the center of incentive plan design, and ensuring that the Compensation Committee is well acquainted with the plan and its assumptions; and 2) by using multiple lenses to evaluate performance measures, goals, and the pay/performance relationship. This approach will provide companies and their committees with the ability to stand-up to external criticism by having the business strategy and company's economic model as the cornerstones of their incentive arrangements.