Eric Hosken & Daniel Laddin
Eric and Daniel are both Partners at Compensation Advisory Partners LLC

Balancing pay for performance with shareholder alignment

A practical look at how companies can juggle these competing objectives based on market compensation design approaches

In designing compensation programmes, two key objectives that are universally shared among public companies are 1) ensuring that the pay levels of executives move with their performance and 2) aligning the interests of executives with those of shareholders. The general appeal of these objectives is that they both ring true in terms of fairness.

It is hard to argue that executives should be paid based on their performance, just as it is hard to argue senior executives running a publicly-traded company should not have their interests aligned with the shareholders of the company. What is not obvious to all compensation committee members, shareholders and shareholder advisory firms is that these two objectives are different from one another and that how they are prioritised relative to one another has implications for compensation design. In this article, we will clarify the differences between these two objectives, highlight situations where they conflict with one another and discuss how companies balance these competing objectives in practice, based on market compensation design approaches.

Pay for performance

Pay for performance is the mantra of shareholders, activist investors and shareholder advisory firms and critics of executive compensation practices. How do we define pay for performance? We would argue that a pay for performance compensation scheme is designed to lay out specific performance targets for an employee to provide an incentive to the employee. The most effective incentive schemes will select measures of performance that effectively measure the results that an employee can control versus factors that are out of the employee's control.

The challenge is identifying performance measures that are within the employee's control, but are also viewed as drivers of the company's long-term value. For employees deep down in an organisation, effective pay for performance compensation schemes can be based on simple piece rate schemes (e.g. number of widgets made per hour). For sales professionals, commission schemes are used to tie their compensation to the value of their sales. These types of programme send clear signals of what is important and create a clear link between what the employee delivers and what they are paid.

As job scope becomes broader a single clear metric may not be as easy to determine. For an executive management team, pay for performance compensation schemes are typically designed based on internally established financial performance goals, subject to approval by the board of directors. The performance goals used in these compensation designs are typically derived from the company's financial statements and include financial measures, such as earnings per share (EPS), revenue growth, return on equity (ROE), return on invested capital (ROIC), etc. From the perspective of the executive management team, the achievement of the financial plan over a one-year term is frequently viewed as an effective incentive. The management team recognises that external factors may make it more or less challenging to achieve the financial plan, but they largely feel that they have the ability to impact their success and that they can make decisions over the course of the year to improve the chances of making the plan. This can be very effective, but can also create its own challenges, such as focussing on achieving the goal to gain a payout in that year, despite some of those decisions being detrimental to the company long term.

In practice, executive compensation designs are frequently criticised for making adjustments to the performance measurement calculation to adjust for the impact of external factors that were not anticipated at the time the performance goals were established. For example, today, many compensation committees in the United States are struggling with how to adjust for the impact of changes in exchange rates on reported earnings. Many global companies headquartered in the US established financial plans based on the exchange rate at the beginning of 2015 and as the dollar strengthened over the course of the year, they have seen their performance decline relative to the pre-established objectives. It is clear to most compensation committee members that changes in exchange rates were not within the executive management team's control, so from the perspective of a pay for performance incentive, it may be appropriate to exclude the impact of changes in exchange rates from the calculation. However, a criticism of making this type of adjustment is that the shareholders are not insulated from changes in exchange rates and that the value of non-US earnings did decrease from the perspective of a US shareholder. We would argue that this perspective is less about pay for performance and more about the alignment of management with shareholder interests. Hence the tension between shareholder alignment and driving performance through incentives.

BALANCING ACT
It's hard to achieve a perfect incentive structure

Pay for performance is the mantra of shareholders, activist investors and shareholder advisory firms and critics of executive compensation practices

Alignment with shareholder interests

One of the challenges for a publicly-traded company is that the executives that run the company are generally not the owners of the company. Instead, the executives act as managers of the company on behalf of shareholders. Economists refer to this situation as the principal–agent problem. There is a potential that the interests of the agent (the executive management team) may not be the same as the interests of the principal (the shareholders). Ideally, the shareholders would like the executive management team to manage the company to promote shareholder interests exclusively. However, economic theory finds that the executive management team is likely trying to maximise its compensation and minimise its effort and while this may not be entirely true at the individual level, there is some truth to it.

One way for shareholders to encourage management to act in its interests is to make executives shareholders. Once executives have meaningful ownership of company shares, at least a substantial portion of their wealth is tied directly to outcomes for shareholders. However, providing all executives with meaningful enough equity such that it alone aligns their interest can be quite expensive and for » those deeper in the organisation may not have as much visibility/line-of-sight to how their performance drives stock price, a multi-pronged approach to incentives is typically most effective. Because shareholders' interests can be defined in different ways, multiple long-term incentive vehicles, coupled with well thought through annual incentives are used to align management with shareholders:

- Restricted stock/stock units: Ensures that executives are focussed on the absolute performance of the stock price and concerned about increases and decreases in the stock price
- Stock options: Stock options focus management on increasing the stock price, but provide limited incentives to protect against downside risk
- Relative total shareholder return (TSR) performance shares: Reward executives based on relative outcomes for shareholders

All three of these vehicles focus management on shareholder outcomes in different ways. However, none of these vehicles is at all prescriptive to the management team about how the shareholder outcomes are achieved. Management could improve the stock price by cutting costs, increasing market share, using capital more efficiently, etc. By using these vehicles, shareholders are sending the implicit message to management that they do not care how management increases the stock price, they just want stock price results.

Balancing pay for performance and shareholder interests

In practice, compensation programmes do not focus solely on either one of these objectives. For example, almost all companies use their annual incentive plans as a pay for performance vehicle. That is, most companies design the annual incentive plan around internally established performance objectives and determine the actual level of annual incentive earned based on the degree to which the executive management team succeeded in achieving the objectives laid out for them. Few companies link annual incentive payouts directly to shareholder outcomes because in most cases, one-year stock price performance outcomes are viewed as highly volatile and a limited indicator of executive management's performance.

Where practices become more complex and where there is significantly more variability across companies' approach is in long-term incentive design. Over a long-term timeframe, establishing internal financial performance goals that are credible is a challenge. Despite goal-setting challenges, management teams often favour having at least a portion of their long-term incentive compensation based on internally established financial performance goals linked to the company's strategic plan. From the perspective of the management team, holding them accountable for achievement of the strategic plan can be more motivational than paying them based on stock price outcomes that are often viewed as out of their control (See pie chart, right).

From the perspective of shareholders and shareholder advisory firms, there is generally support for having some portion of the long-term incentive tied to long-term financial performance objectives. However, with limited ability to predict beyond a short timeframe there is some concern that executives may be setting performance goals that are not particularly aggressive under these plans. Often this is less a result of management trying to set soft targets and 'game the system' and more a function of them balancing the need for motivation, retention and performance with imperfect information. Typically, the goals are set by management and approved by the board or compensation committee. While all executives would prefer a bigger payout, all things being equal, the long term is not just a tool for aligning with shareholders, it is a tool the CEO and senior leadership use to motivate the organisations they run and send a signal of what the strategic and operating priorities are for the company. If a company does not perform well vs. its peers or other benchmarks, the stock market will eventually reflect that in the share price. And if your senior management hold meaningful equity (e.g. stock options, shares, etc), they could stand to lose a lot more wealth than they hope to gain by getting an incremental payout under a performance plan that sets easy goals.

This is one of the primary reasons why companies have migrated to long-term incentive structures that use multiple vehicles (91 per cent of companies)[1] with 36 per cent using three vehicles. To further support a holistic view of performance, of the companies that use performance-based, long-term incentives, 60 per cent use more than one metric.

A recent analysis conducted by CAP found that performance plans tend to pay out approximately 93 per cent of the time. They have a bias towards paying out above target (54 per cent), but still they pay out below target approximately 35 per cent of the time (See bar chart, below).

In order to limit the ability of executives to 'game' the long-term incentive plan by setting weak performance goals, some shareholders and shareholder advisory firms (e.g. Glass-Lewis), frequently express a preference for relative performance assessments. The most common form of relative performance measure used in compensation programmes is relative total shareholder return (TSR). The popularity of this measure is partially due to its strong alignment with shareholder outcomes on a relative basis. However, it is more of a challenge to measure financial performance measures on a relative basis vs. peers, so many companies fall back on relative TSR as the easier option for relative performance assessment.

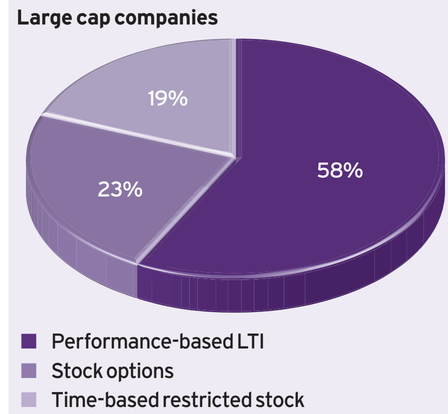
In practice, what we see at many large companies is a compensation programme that balances different objectives through a portfolio long-term incentive design approach. For example, while approximately 50 per cent of the Fortune 200 companies granting performance shares use relative TSR as a measure in the performance share plan, 80 per cent of these companies use it in combination with a financial performance measure.

Conclusion

Creating the perfect incentive structure is probably unachievable. The best programmes tend to take a holistic view of performance and create a healthy tension when an executive is making decisions. For example, 'should we build another plant so we can sell more widgets, despite the investment generating a return below our cost of capital?'. An effective incentive programme encourages executives to think of these questions and balance the trade-offs.

[1]Based upon CAPs analysis of 100 large cap companies

LONG-TERM INCENTIVE MIX



AVERAGE LONG-TERM INCENTIVE PAYOUT DISTRIBUTION