

# Shareholder Value Advisors

## ***Balancing Competing Compensation Strategy Objectives***

The conventional approach to compensation strategy assumes that there is no need to balance competing objectives because the fundamental objectives of compensation – alignment, leverage, limited retention risk and reasonable shareholder cost – can all be accommodated by a competitive pay policy with a high percentage of pay at risk. The theory is that the conventional approach:

- Aligns management and shareholder interests because compensation is based on stock price appreciation and operating performance measures that are highly correlated with shareholder return (e.g., EVA),
- Provides strong leverage because a high percentage of pay is at risk,
- Has limited retention risk because compensation is recalibrated each year to a competitive position target, e.g., 50th percentile pay, and
- Has reasonable shareholder cost because the expected value of annual compensation is not allowed to increase above the competitive position target.

The flaw in this argument is the assumption that a high percentage of pay at risk implies a strong wealth incentive. A competitive pay policy makes future pay independent of current performance. A competitive pay policy targets the dollar value of the compensation opportunity and adjusts the option shares (and bonus performance target) to provide the targeted dollar value. For example, if 10,000 option shares at \$50 provides a competitive option grant value in year one, but the stock price drops to \$25 in year two, a company with a competitive grant policy will increase the option grant shares to 20,000 in year two. This annual re-calibration of option grant shares ensures that future option value is unaffected by current performance. This means that a large component of management wealth, the present value of future compensation, is completely insensitive to changes in shareholder wealth. This makes it very difficult to achieve substantial wealth leverage.

An executive's wealth leverage is a weighted average of the wealth leverage of current compensation, the present value of future compensation and stock and option holdings. If an executive has a high percentage of current year compensation in stock options and a highly leveraged bonus, the wealth leverage of current year compensation can be greater than entrepreneurial wealth leverage, e.g., 1.2, but this does not result in substantial total wealth leverage. The present value of future compensation can easily be 7 times the expected value of current compensation, so total wealth leverage, before considering stock and option holdings, is only 15% of entrepreneurial wealth leverage:

$$(1/8) * 1.2 + (7/8) * 0 = .15$$

To approach entrepreneurial wealth leverage, an executive in a company with a competitive pay policy needs to hold nearly two-thirds of his wealth in options (which typically have wealth leverage of 1.5 or so):

$$63\% * 1.5 + 37\% * 0.15 = 1.00$$

This requires a very large option grant. If base salary is 25% of current year compensation, an option on stock equal to 110 times salary is needed to provide entrepreneurial wealth leverage.

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A much less costly way to achieve entrepreneurial wealth leverage is to increase the wealth leverage of the present value of future compensation. This can be done by using fixed share concepts in the option grant guidelines and bonus plan design. However, fixed share concepts increase retention risk or shareholder cost (or both). To balance the objective of a strong wealth incentive against the competing objectives of tolerable retention risk and reasonable shareholder cost, we need to model the implications of alternative total compensation programs. We typically do this in the following steps:

1. We develop 100 Monte Carlo simulations of stock market and operating performance over the next five years.
2. We calculate total compensation payouts and the value of stock and option holdings for each year in each scenario for the current total compensation program.
3. We calculate the wealth leverage of the current total compensation program (as well as its alignment, retention risk and shareholder cost).
4. We set tentative wealth leverage objectives, e.g., 60%, 80% and 100% of entrepreneurial wealth leverage.
5. We set a tentative constraint for retention risk, e.g., a 5% probability that expected annual total compensation falls 25% below median market compensation levels.
6. We identify, for each wealth leverage objective, alternative program changes that will achieve that wealth leverage objective and satisfy the retention risk constraint; the program changes may increase wealth leverage by increasing retention risk, e.g., fixed option grant guidelines, increasing shareholder cost, e.g., increasing target bonus levels, and/or using more efficient plan designs, e.g., indexed options.
7. We quantify the incentive effects, i.e., the improvement in company performance, needed to give each alternative a net shareholder cost of zero (relative to the current program).
8. We assist company management and/or directors in making judgments about the likely incentive effects of the tentative wealth leverage objectives and deciding which wealth leverage objectives maximize shareholder wealth.

At some point in the future, as compensation research advances, we would hope to offer statistical evidence, based on peer company data, of the expected impact on firm performance of the wealth leverage increase. This would provide direct evidence of whether the expected benefit from a stronger incentive exceeds its cost.