Shareholder Value Advisors

Determining Competitive Compensation Levels

A competitive compensation policy, which recalibrates compensation each year to maintain a competitive position objective, e.g., 50th total compensation, is undesirable because it leads to weak wealth incentives (see Designing Strong Wealth Incentives). But competitive compensation analysis is very important because it is a key part of designing strong wealth incentives.

Strong wealth incentives require fixed share policies, e.g., fixed share option grant guidelines, that make the value of future compensation opportunities dependent on current performance. If a CEO receives an annual grant of 100,000 option shares, an increase in the stock price from $10 to $20 increases the amount of stock under option by $1 million, while a decline in the stock price from $10 to $5 reduces the amount of stock under option by $500,000. If the initial grant (100,000 shares exercisable at $10 per share) provided a median total compensation opportunity, then the same grant provides above average total compensation at a stock price of $20 and below average total compensation at a stock price of $5. The strong wealth incentive provided by the fixed share grant is not sustainable unless the value of the grant in poor performance scenarios is sufficient to limit retention risk to a tolerable level. We often use 75-80% of median total compensation as the threshold of unacceptable retention risk. Keeping the expected value of total compensation at or above this level in poor performance scenarios normally requires setting initial compensation opportunities above median competitive levels.

We estimate competitive compensation for a company's executive positions in the following steps:

1. Identify labor market competitors ("peer companies").
2. Match jobs.
3. Determine the elements of compensation to be considered, and calculate the value of each element for the peer company executives.
4. Annualize "lumpy" elements of compensation (e.g., large stock option grants).
5. Adjust for pay inflation.
6. Adjust for differences in size between the company and the peer companies.
7. Calculate the size adjusted pay distribution and relevant percentiles, e.g., 50th percentile, 75th percentile, for each position.

We rarely statistically adjust competitive compensation data for company performance because there is normally very little relationship between company performance and the expected value of annualized total compensation. An extended discussion of our approach to competitive compensation analysis can be found in chapter 8 of *EVA and Value-Based Management* by S. David Young and Stephen F. O'Byrne.

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