

Does your Incentive Compensation System add value?

Ideally, an incentive compensation system focuses the mind and actions around drivers of value and encourages and rewards value creation.

Many schemes we have reviewed either have challenges in meeting this objective or result in implementation challenges.



One scheme we recently reviewed had a component based on relative total shareholder return ("TSR") performance. TSR performance was defined to be relative to the performance of the companies ranked 201 to 300 in the ASX 300 Industrials Index. Our research showed that there were only 19 industrial companies in the 201 – 300 group of the ASX 300.

Further, most had experienced a significant downturn during the GFC so that the base earnings were either negative or very low. Consequently, the company, which had not experienced a significant downturn in earnings, would be unlikely to be able to match the growth of the corporate companies, which would likely experience a significant recovery of earnings. Thus the scheme had a negative rather than motivating effect.

Also, the financial press, shareholders, shareholder activist groups and ASIC are increasing scrutiny of these schemes and providing adverse publicity to those that appear to reward poor performance.

How does your scheme perform? Is it linked to value creation? Will it be seen to be paying for poor business performance or not paying for strong performance?

Criteria that can be used to inform this judgment evolve from the features of a 'good' incentive scheme. Key criteria that Value Adviser Associates considers in designing and evaluating an incentive scheme include:

1. Ensuring alignment between managers and shareholders and encouraging a value creating culture; and closely linked to this is;
2. Improving motivation and productivity;
3. Being simple, transparent and easy to explain to management and shareholders;
4. Encouraging retention of good management and attracting the right people; and
5. Having a payout that is a 'reasonable' cost to shareholders as well as having low administration effort and cost.

Taking each of these in turn:

1. Ensuring alignment between managers & shareholders and encouraging a value creating culture

A challenge here is to establish a starting point. If there is acceptance by the Board that a primary objective of the business is to create and deliver value for shareholders, then this is the starting point. It is certainly the one we endorse.

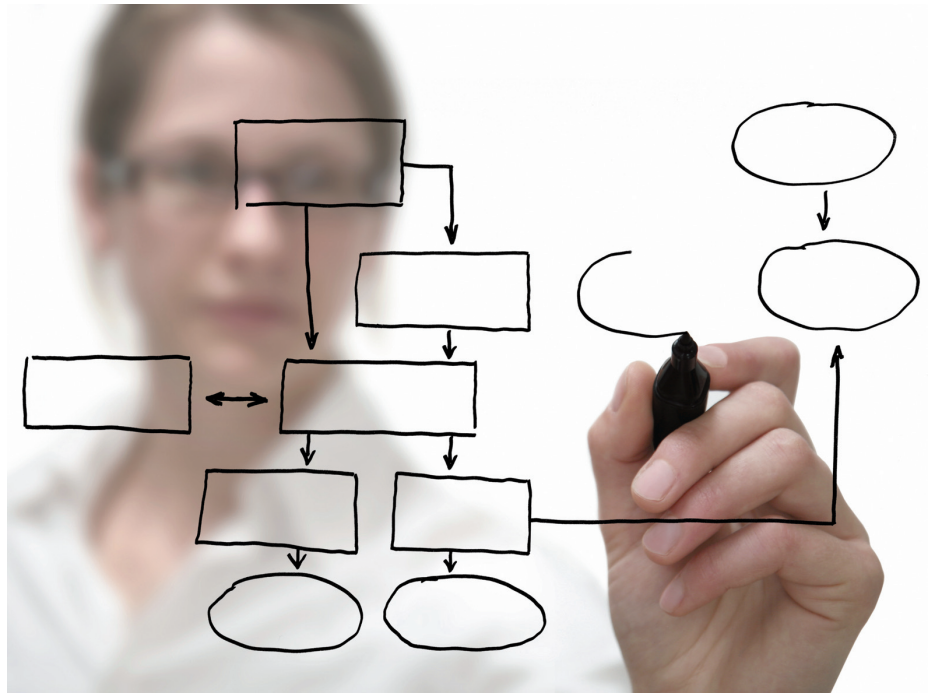
It is essential to recognise that shareholder value has a long term focus [contrary to some opinions]. This means the scheme requires a long term focus. We note that many schemes have short-term and long-term components. This is not a problem provided the short term measures and targets are consistent with a long term view (e.g. they are derived from the first years of a long term plan). For example, while not necessarily advocating EPS growth as a measure or focus, one plan we valued derived its EPS growth target from its long term financial plan, which had been valued and reflected the long term strategy of the business. This makes good sense.

Linking the scheme to creating and delivering long term shareholder value can be achieved in a number of ways. These include:

- » Issuing shares (including Phantom Shares) and/or options to management so that they experience the gains and losses that shareholders experience;
- » Relating the performance bonus to either absolute or relative TSR performance. Typically the relative performance assessment is based on that of peers;
- » Using financial measures that are plan-based targets, where the plan reflects business strategy, has been valued and has been established as the best alternative;
- » Measuring economic profit or EVA[®] year-on-year improvement against a predetermined pattern, perhaps derived from the current market value;

- » Ranking against peers on financial measures such as earnings or EPS growth, although we prefer ranking against the plan;
- » Using activity measures that link through to key value drivers.

These are listed in order of the directness of the link to shareholder value. Given the challenge in establishing the most direct (and controllable) link between decision responsibility and change in business value, the mix of incentive plan performance measures often changes from the CEO through the GM of BUs and below. CEO measures will comprise overall business performance measures like TSR whereas activity drivers are more likely further down the hierarchy.



Clearly, unlisted companies and BUs are denied the capital market measurement of TSR so a substitute is required which means moving further down the list. For example, the GM of a BU may have targets like Economic Profit, Return on Investment or Return on Equity for the Business Unit, in addition to Total Shareholder Return if the overall business is listed. Central to the design, regardless of the incentive mechanism chosen, is reinforcement of the planning and performance measurement regime in place in the organisation – on the assumption that these processes are the most appropriate.

Often we find that a performance measurement regime is not appropriate because it focuses on growth / size rather than on value creation. Sometimes value creation requires reducing size rather than growing.

2. Improving motivation and productivity

This is perhaps obvious (and closely linked to point 1), but improving motivation and productivity means setting attainable targets that at least provide 'at market' compensation for solid performance. Note our recent experience with a scheme that unintentionally set unattainable Earnings per Share growth targets (see text box above).

People are marvellously inventive and do focus on 'what gets measured gets done'. This creates some interesting challenges with schemes that limit both the downside and upside of incentive payments. A plan can be de-motivating once the upside cap is hit and can encourage 'warehousing' performance for next year in these circumstances. On the other hand, if there is little chance of performance targets being hit this year, there is an incentive to apply the 'big bath' treatment by throwing all downside into this year to clear the way for next year or to simply reduce effort – even unconsciously.

3. Being simple, transparent and easy to explain to management and shareholders

An incentive plan will not motivate if it is not understood. A black-box generally creates suspicion. Nor will it overcome shareholder skepticism if it appears overly complicated and not easily explainable by Board members and business managers.

This can be a challenge – particularly because value and the value drivers for a business are not always well understood. Education and reinforcement can assist for both shareholders and management / employees. While there can be considerable complexities in business valuations, the basic principles can be expressed simply.

We argue, however, that it is essential for employees to see how their efforts impact value drivers. This can usually be achieved by having activities drivers linked to the financial drivers.

4. Encouraging retention of good management and attracting the right people

There are very high costs of changing management, mostly indirect. Consequently it is most desirable that the incentive scheme attracts and works to retain good management.

There is some balancing here. It is desirable for management, particularly senior management, to feel the gain and pain of shareholders. However many have mortgages, school fees etc. to meet. Consequently one challenge is to establish the 'best' mix between base and incentive pay. This will vary across individuals. Our focus here is on the incentive component.

Ideally, the incentive component is set so that the expected outcome meets the expected outcome of a 'sensible' market-assessed remuneration scheme. There tends to be less of an issue with retention when firm performance is better than the target than in the reverse case.

Consequently there needs to be some focus on the latter case – how to minimise retention risk in business downturns.

One mechanism is a performance bank. A performance bank can be established to help deal with retention and also to promote a long term focus.

A performance bank is a vehicle into which the annual reward is paid. Of the balance in the bank, one part, say one third, is paid in cash or shares to the executive. The other part remains in the bank until the same process is followed the next year. This encourages retention as it will take a number of years to access the bonus for a particular year. Usually the executive will generally forfeit the balance upon departure. The bank also provides a buffer in downturns when a negative bonus can kick in e.g. when shareholder returns have been below the cost of capital.

Other retention components include designing a scheme that is based on long term performance (e.g. a series of plans of say three years) and invoking vesting periods for shares or options.

Clearly an issue may arise if 'good' management experiences, or foresees several years of negative bonuses. Ideally, the expected bonus trigger point is not revised in these circumstances because the link between shareholder and manager pain would then be broken. However, there may be some circumstances where this could be considered.

5. Having a payout that is a 'reasonable' cost to shareholders as well as having low administration effort and cost

While this objective is relatively self-evident, shareholder concern about cost usually arises from poor alignment rather than the absolute cost. Nevertheless, concern is expressed that upside in incentive plans should be invoked to limit the cost. However, the other side of the argument is that, if the plan is linked to value creation, then unlimited upside is simply a sharing that is highly correlated with shareholders' experiences – both management and shareholders are 'winning'.

Concluding comments

We encourage the remuneration committee to agree upon, document and prioritise the overall objectives of the executive incentive plan. In our view, this provides the best starting point to revisit actual plans to ensure they are meeting these objectives.

Naturally we would be delighted to explore these thoughts further with you and your Board. 



Dr Steve Bishop

Director

p: 03 9626 4300

s.bishop@vaassociates.com.au

 Value Adviser Associates
creating, capturing and communicating value

Melbourne | Brisbane | Adelaide
www.vaassociates.com.au | Freecall 1800 912 226

Value Adviser Associates Pty Ltd | ABN 54 131 852 607