

Performance-Based Executive Compensation

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Introduction and Objectives

- Generate straightforward discussion and focus on key steps to implement performance-based executive compensation
- Four key factors impede improvement:
 - Confusion on defining pay for performance
 - Reconciling apparent tradeoffs in corporate governance vs. pay for performance
 - Inertia on past practices and making tough choices
 - Advisors (both consultants and lawyers) lacking objectivity and skill

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One Pay for Performance Definition

- “Incent and reward performance that benefits shareholders”
 - Recognizes incentives help shape behavior. Balance between incentives and sound governance
 - Short-term performance assessments where real results only partially clear. Errors will be made
 - Stock price over long periods best indicator of management value add. Heavy long-term incentive emphasis and ownership balances program
- ❖ Shareholder value is created by prudent risk-taking. Aggressive incentives within bounds important to drive and create value

Confusing Landscape of Perceptions

Topic	Historical View	View During “Bubble” Period	Today’s Politically Correct View	Today’s Reality
GAAP Accounting	Flawed	Very Flawed	Pure truth	Flawed
Stock Options	Imperfect	Perfection	Necessary evil	Imperfect
Restricted Stock	Lacks performance focus	Used by underperformers	Lack of performance focus is a plus	Mild performance focus
Bonus Designs	Linked to earnings	Linked to earnings	Unintelligible: Highly objective but avoid any measure management can manipulate	Linked to earnings and other measures
Generous Contracts	Not necessary	Necessary	Receive <u>careful</u> scrutiny	Receive <u>careful</u> scrutiny
Relative Performance	Difficult	Difficult	Panacea and workable	Often difficult
Compensation Committee Role	Moderate engagement	Superficial review	Independent review trusting no one	Significant engagement with trusted advisors

Impossible to Please Everyone

Group	Executive Compensation Agenda	Implications
Compensation Committees	Do the right thing and protect themselves	
Institutional Shareholders	Not a high priority	
ISS	Focus on shareholder voting	<ul style="list-style-type: none">• Take sensible actions
CALPERS	Politically driven	<ul style="list-style-type: none">• Recognize varying agendas
Major Independent Shareholders	High priority for economics	<ul style="list-style-type: none">• Greater focus and better questions
Employees	High priority for messages	<ul style="list-style-type: none">• Competitive practice less of an excuse/rationale
Press	Increasingly unbalanced	
SEC	Trying not to appear completely out of touch	

Pay for Performance Checklist

- Sound and informed Compensation Committee
- Appropriate peer group and use of data
- Effective bonus design and measures
- Sensible base salary and benefit levels
- Significant long-term incentives
- Substantial stock ownership guidelines
- Moderate contracts and terms
- Progressive change-in-control provisions
- Negligible perquisites
- Competent and aggressive advisors

Peer Groups and Use of Data

- Always consider variety of reference points
 - No single peer group perfect or sufficient
 - Develop variety of sources
- Data must be used smartly
 - “Better to be approximately right than exactly wrong . . .”
 - Simple percentiles should not mechanically drive compensation positioning
 - Markets change over time and so should targets
 - Keep market information current

Bonus Design and Measures

- Annual bonus helps both focus performance expectations and reward achievements
 - Blend of objectivity and discretion
- Viable performance measures (and many variations)
 - Financial results
 - Revenue growth and new products
 - Market share
 - Quality and productivity
 - People-development, etc.
- Working assumptions: Management is honest and motivated by incentives. Appropriate design has leverage to reward excellent results. Compensation Committee has appropriate safeguards but unlikely to independently detect fraud in short-term

Bonus Goals

<u>Improvement Over Prior Year</u>	Typically Best Alternative	<u>Relative to Competitors/Peers</u>
<ul style="list-style-type: none">● Simple common approach	<ul style="list-style-type: none">● Linked to budget/broader expectations	<ul style="list-style-type: none">● Attractive concept (“Handicap Race”)
<ul style="list-style-type: none">● Goals often easy/hard, depending on prior year	<ul style="list-style-type: none">● Requires careful determination of difficulty	<ul style="list-style-type: none">● Difficult to compare results due to business differences
<ul style="list-style-type: none">● May create over-emphasis on ST earnings	<ul style="list-style-type: none">● Room for customized measures	<ul style="list-style-type: none">● Usual delay in determining results/communication

Bonus Plan Measurement

- Measure where performance actually impacted
 - Corporate
 - Business
 - Individual
- Culture and business dictates whether allocations “formulaic” or “discretionary”
 - Key is expectation-setting and motivation
- Individual payouts from 50%-200% of target/normal
 - Need to have meaningful differences

Bonus Plan Funding

- Objective of fairly rewarding performance
 - No artificial constraints (i.e. 10-20% chance of outstanding)
 - Science and art in creating payout scheme
- Funding should range from 50%-150% of normal/target
 - Exceptions based on circumstances

Standard Long-Term Choices (and Variations)

Vehicle	Key Feature(s)	Comments
<ul style="list-style-type: none">● Plain vanilla stock options	<ul style="list-style-type: none">● Stock price increase	<ul style="list-style-type: none">● Incentivizes growth, but volatile
<ul style="list-style-type: none">● Indexed stock options	<ul style="list-style-type: none">● Outperform index	<ul style="list-style-type: none">● Fine theory but questionable motivation
<ul style="list-style-type: none">● Restricted stock	<ul style="list-style-type: none">● Retention and stock price	<ul style="list-style-type: none">● Stable value but weakened motivation
<ul style="list-style-type: none">● Performance awards	<ul style="list-style-type: none">● Achieve absolute or relative goals	<ul style="list-style-type: none">● Difficult to forecast and an overlap with annual bonus

Potential Long-Term Directions

Feature	Potential Direction
Stock Options	Half or more long-term value for senior executives
Stock Option Term	5 - 7 years
Restricted Stock	Heavier weighting down into organization
Longer-Vesting	4- and 5-year vesting
Indexed Options/ Performance Awards	Good theory but tough to make work
Award Differentiation	Most 75%-125% of target; \approx 25% outliers
Valuation	Realistic value; no more “always same number of shares”
Award Timing	Same as annual bonus

Lies and Ownership Guidelines

1. Will respect you . . .
2. From The Government and here to help you . . .
3. It is a real Prada bag for \$30 . . .

AND

4. CEO 3 – 5x Base Salary ownership guideline is meaningful and important
- Meaningful ownership guideline should be 3-5x total compensation for CEO
 - Time to abandon the window dressing and get serious
 - Retain 50% of net shares

Executive Contracts/Agreements

- Provide for moderate severance
 - Mitigation for longer payouts
- Generally do not guarantee title/position
- Non-compete/non-solicitation provisions
- Termination for real cause to include forfeiture of everything not yet paid
- Finite term without automatic renewal
- ❖ Evenhanded agreement providing executive protection with reasonable terms

Change-in-Control Provisions

- It is not 1980s with corporate raiders
 - Time warp exists on many provisions
- 3x severance with tax gross-up is usually excessive
 - Difficult to defend except that others have done it
 - Little analysis or forethought
 - Single vs. Double Trigger
 - Overly tight definitions of “good reason” counterproductive
- 100% vesting of all long-term wasteful
 - Should convert to new public stock with vesting and adequate protections
- Impossible to justify windfalls based on 20-year-old practices. Lawyers and consultants have not been held accountable

Benefits and Perquisites

- Sensible designs reflecting recent learnings
- Executive retirement designs need to be affordable/competitive
 - Bonus inclusion (none, partial, or all)
 - Highest 3 or 5-year in a cyclical business
 - Early retirement subsidy (i.e., full at age 60)
 - Below-market discount rate for pension
 - Many competitors have abandoned plans
- Moderate perquisites
 - Had to justify excessive/visible entitlements

Summary and Call to Action

- Reasonable compensation peers and data usage
 - Variety of reference points
- Aggressive bonus design consistent with business
 - Customized measures
 - Variation in individual allocations
 - Combination of objectivity and judgment
- Significant equity awards
 - Split between stock options and restricted stock
 - Shorten option periods and lengthen vesting
- Truly significant ownership guidelines
- Sensible contracts
- Modernize change-in-control provisions
- Moderate benefits and perquisites
- ❖ Significant progress can be made towards pay for performance with tough decisions and objectivity