

PEBA Forum

Incentive Goal Setting In Stormy Waters: Strategies to Survive and Succeed

April, 2010



Discussion agenda

Background & Introductions

What is incentive compensation?

Alignment with Compensation Strategy

Basic Components

Impact of “risk” in plan design

Questions and Discussion

This will be a lot more fun if it is interactive!

Introductions

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And the audience?

- Who is engaged in managing compensation programs?
- Who has designed an incentive plan?
- How did it work?

What is incentive compensation?

- Incentives differ from bonuses:
 - Pre-established goals and objectives
 - Pay at risk
- May be the single largest variable costs for the organization
 - Particularly if it is broad based
 - But is there a return on investment?
- A key management tool
 - Ability to attract and retain
 - Some (but not all) would argue that \$ motivates

What do you think?

Incentives communicate what is important

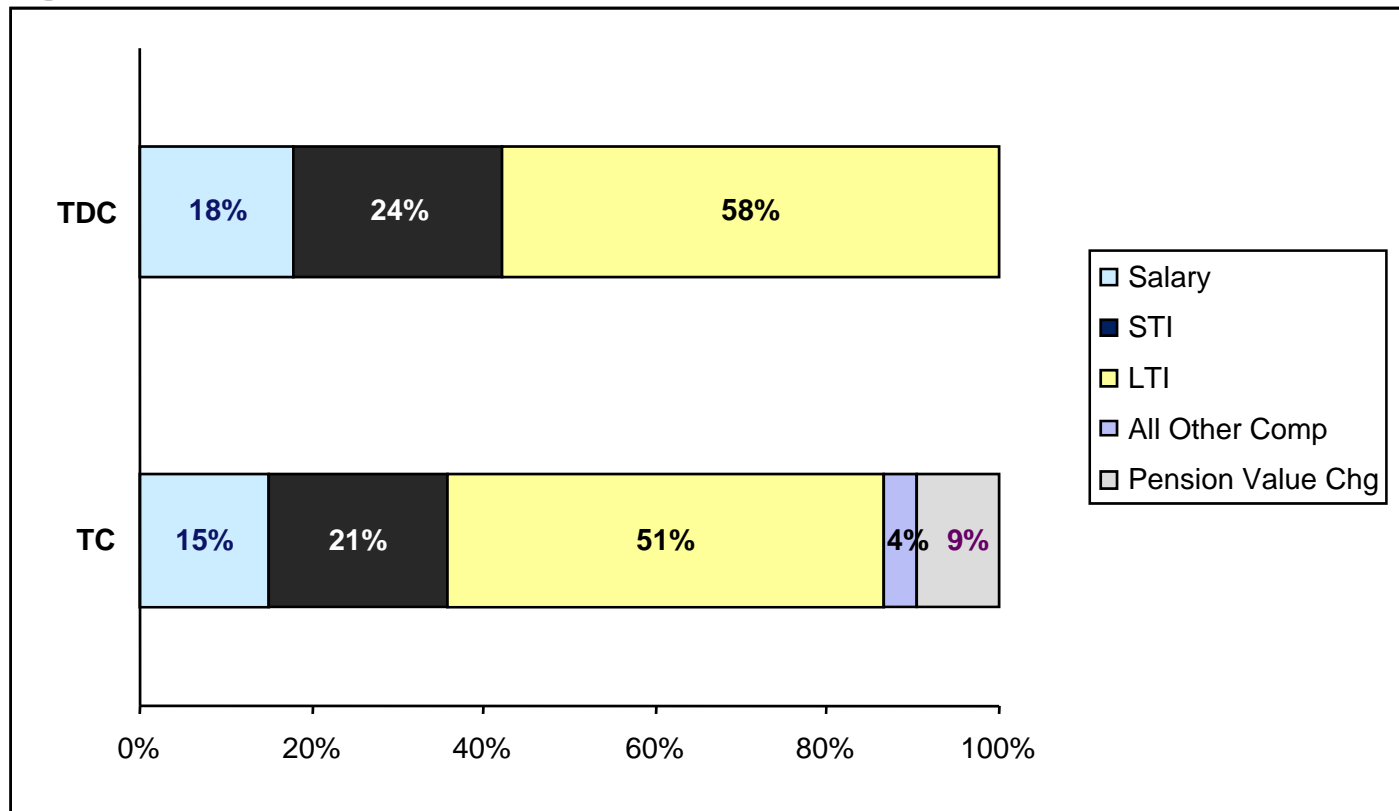
- The reward system tells people that this is important
- People will focus performance on what they are paid for
- Incentives set the boundaries of acceptable results
- Incentives set the level of risk-reward
- However, easy to talk about but maybe hard to do...particularly in turbulent times

Types of incentive compensation

- For this discussion we are taking a very broad look at the topic...Concepts that are applicable in thinking about:
 - Annual incentives (typically for management but could include workforce)
 - Long term incentives (typically between 2-10 years)
 - Sales compensation (to lesser extent – this could be topic for complete presentation)

Start at the top

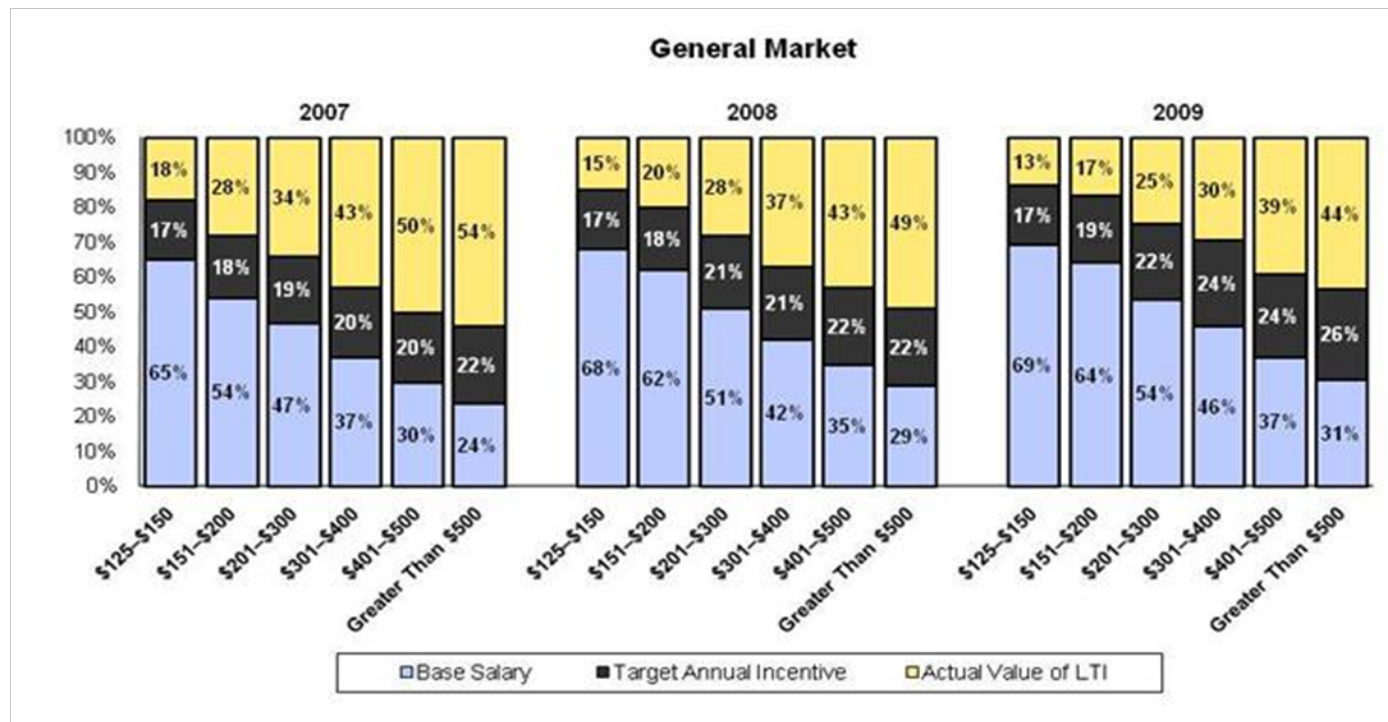
- At the extreme, (CEO level) incentives are dominant, especially long term.



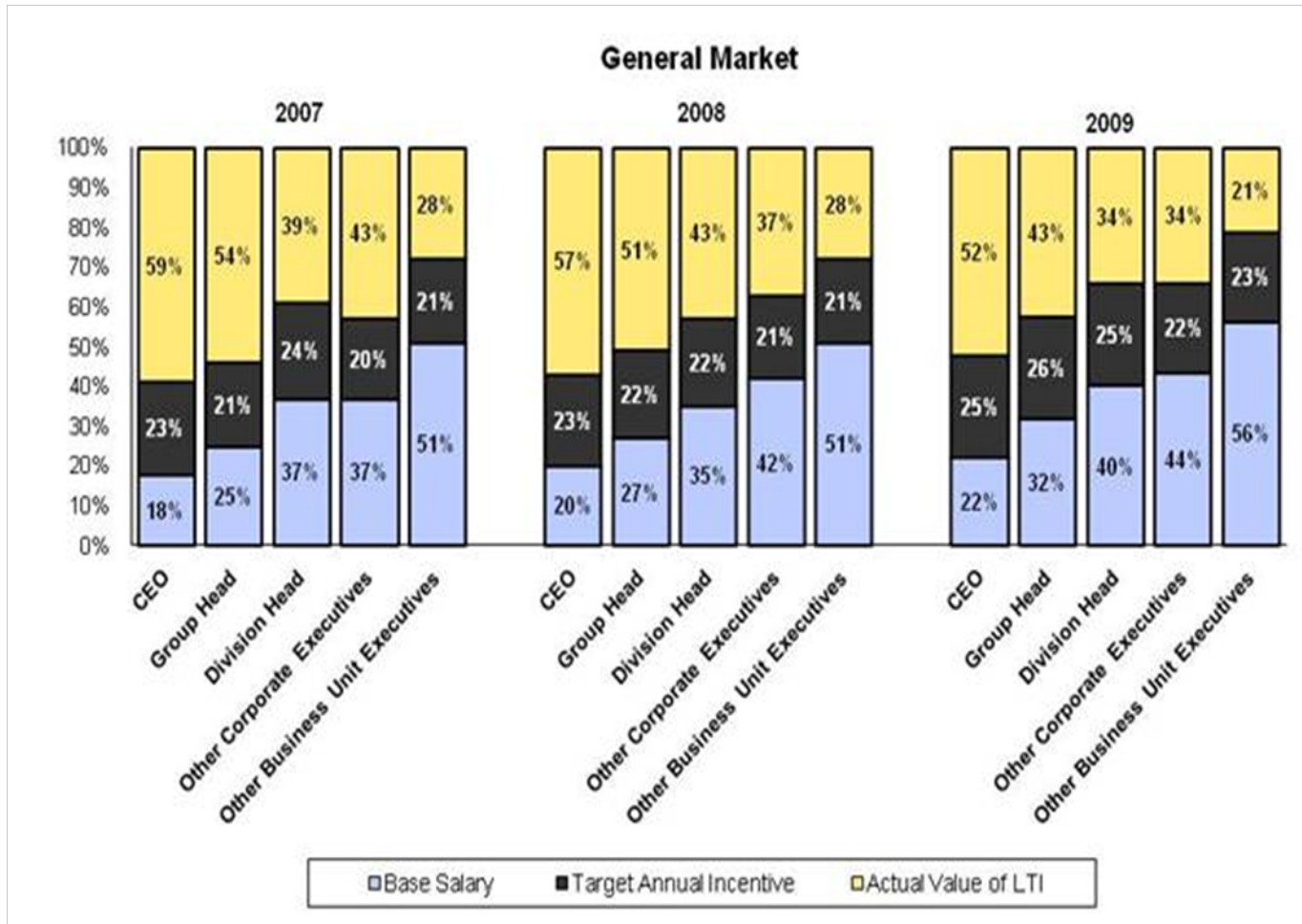
Includes only constant incumbents

Management incentives important too

- Incentives are an important element of pay at all levels of management – viewed below by salary ranges (see trends in mix) – away from fixed compensation and from short to long term focus:



Incentives by executive job type



Leverage affects importance

As leverage increases, the need to accurately measure and forecast increases:

Percent of Base Pay	Does it matter?
> 80%	<ul style="list-style-type: none"> • Incentive program will dramatically affect motivation. • Goals must be viewed as achievable and directly impacted through personal performance
20% to 50%	<ul style="list-style-type: none"> • Incentive program will moderately motivate • Goals must be viewed as achievable and team based.
<10%	<ul style="list-style-type: none"> • Incentive program will not significantly motivate. • Often more aligned with profit or success sharing

Key issue – alignment



Theory – why should Incentives work?

The following theories are key in understanding the rational and conditions for incentive plans to work

- **Expectancy theory** implies incentives will work if the following conditions are met
 - expectancy that the target is achievable
 - link to personal performance
- **Goal setting theory** is based on the principle that incentives can be used to **gain commitment** as well as focus efforts, encourage and motivate incumbent to achieve the objectives. We work better and smarter if we know the goals.

Incentive plan design decisions

- Participation—who should be included?
- Performance metrics – financial, non financial?
- Performance targets/standards - degree of difficulty
- Plan leverage, or “elasticity”
- Timing (annual, quarterly, monthly)

You guessed it – goal setting hits the heart of the process!

The same plan with more or less difficult goals can have quite different impacts on motivation!

Critical success factors

Strategy	Design	Execution
<ul style="list-style-type: none"> ▪ clear understanding of what the corporation/ team/ individual has to achieve <u>and why</u> ▪ minimal external/ uncontrollable factors at play ▪ commitment to review and re-evaluate against changing strategic goals 	<ul style="list-style-type: none"> ▪ resources are in place to enable participants to reach goals (attainability) ▪ Predictability – ability to effectively forecast performance and set goals accordingly 	<ul style="list-style-type: none"> ▪ executive/board support ▪ investment in communication ▪ Performance is managed through managers, not through the plan alone

Best Practice is less likely about design and more likely about execution and alignment with strategy

Impact of the downturn

For many organizations, the critical success factors have been thrown in the air this year

- parameters have completely changed
- business plans are rendered obsolete
- demand and expectations are lowered
- lack of clear management support of plans
- nobody is sure what performance will be this year.

Levers in plan design

There are multiple moving parts to setting goals in a plan:

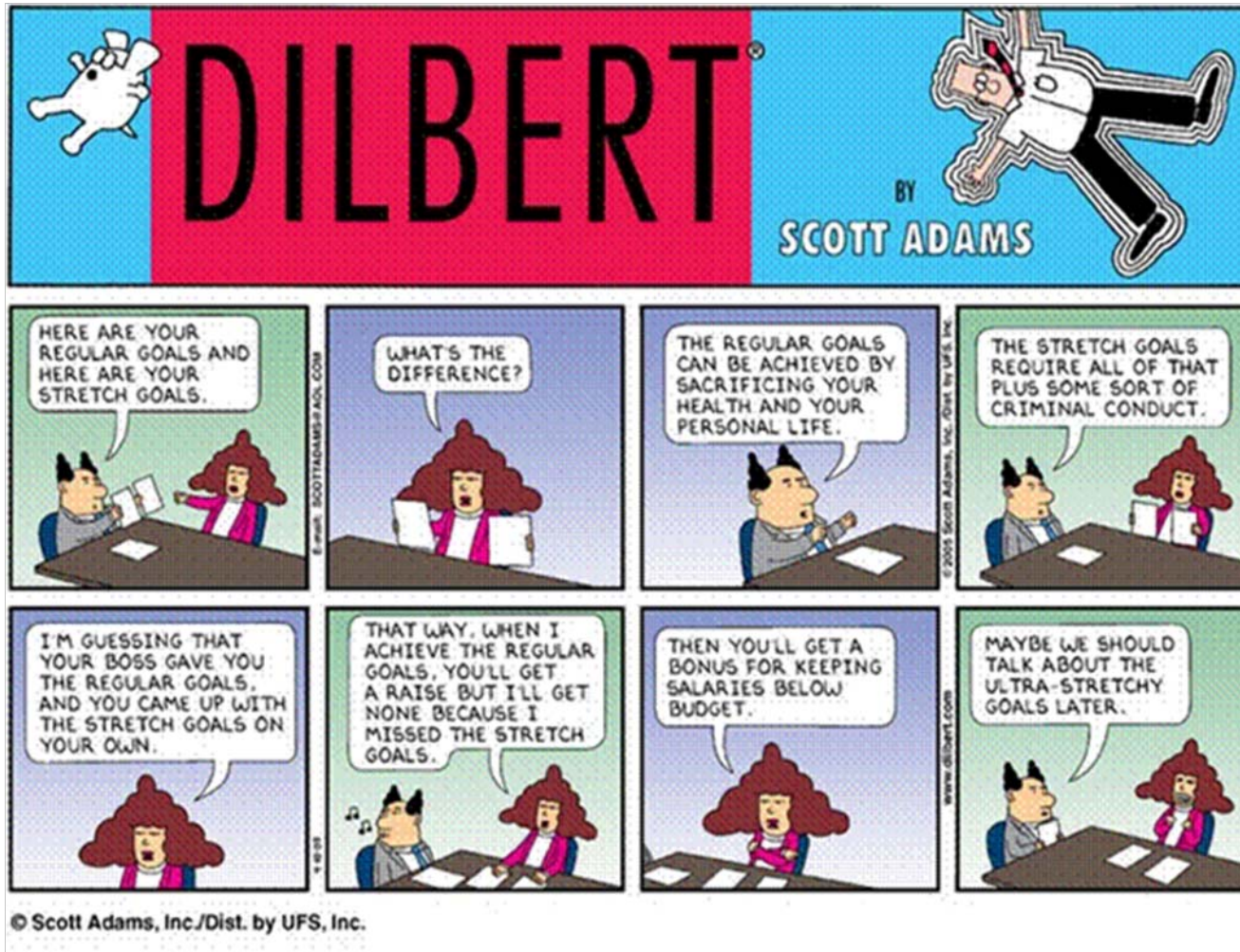
- **Strategic plan** – determine what is important
- **Forecast/budget** – typical basis for setting annual objectives
- **Standards of performance** - establishing performance payout ranges
- **Leverage** – determining how much pay at risk
- **Measures** – trend towards multiple measures to reduce risk and increase “line of sight”
- **Role specific** – inclusion of individual job factors

Goal-setting challenges

Risk of setting goals too high

- Consistency with market and demand
- Economic pressure on prices
- Last year + 10% planning mentality – unreasonable in down economy
- Variance across departments, business lines
- *End result – less effective plan – relative performance good but absolute against internal plans is not.*

Goal-setting challenges



Goal-setting challenges

Risk of setting goals too low

- If market is rebounding and demand high
- Market takes advantage of lower prices to increase volume
- Last year + 10% planning mentality – base may be too low
- Variance across departments, business lines
- *End result – ineffective plan, pay not related to performance, angry shareholders*

Which organization would you rather work for?

■ Organization A

- Sets salaries at 50th percentile
- Sets goals at the 75th percentile, and threshold at 50th with high leverage to produce P75 compensation if hit targets
- Achieves performance at 50th percentile and pays out nothing, producing bottom quartile pay for median performance.

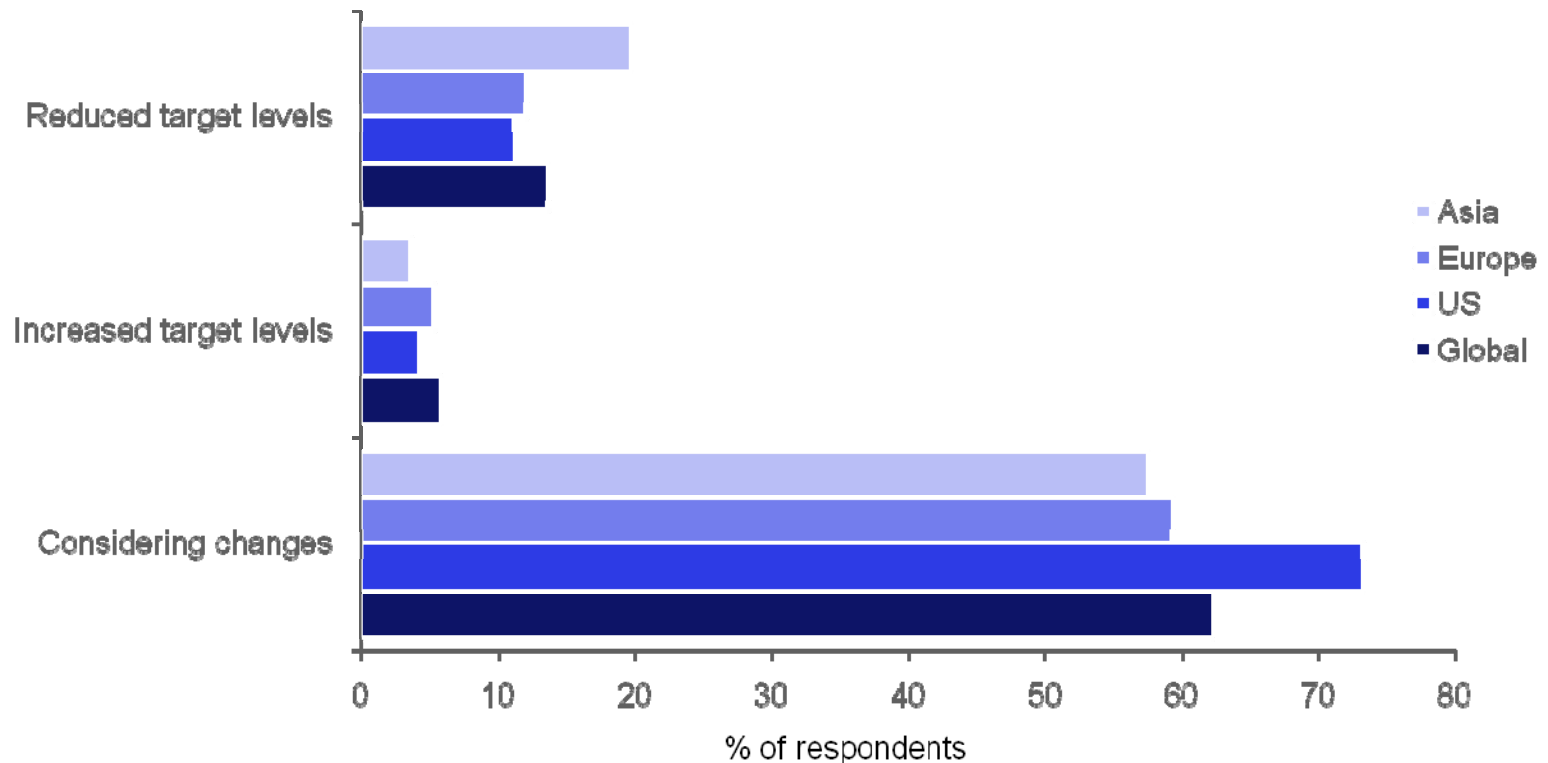
■ Organization B

- Sets salaries at the 50th percentile
- Sets goals at the 50th percentile, with threshold at 25th with typical market leverage to produce pay levels that align with performance.
- Achieves performance at 50th percentile and pays out at target for median level pay for median level performance.

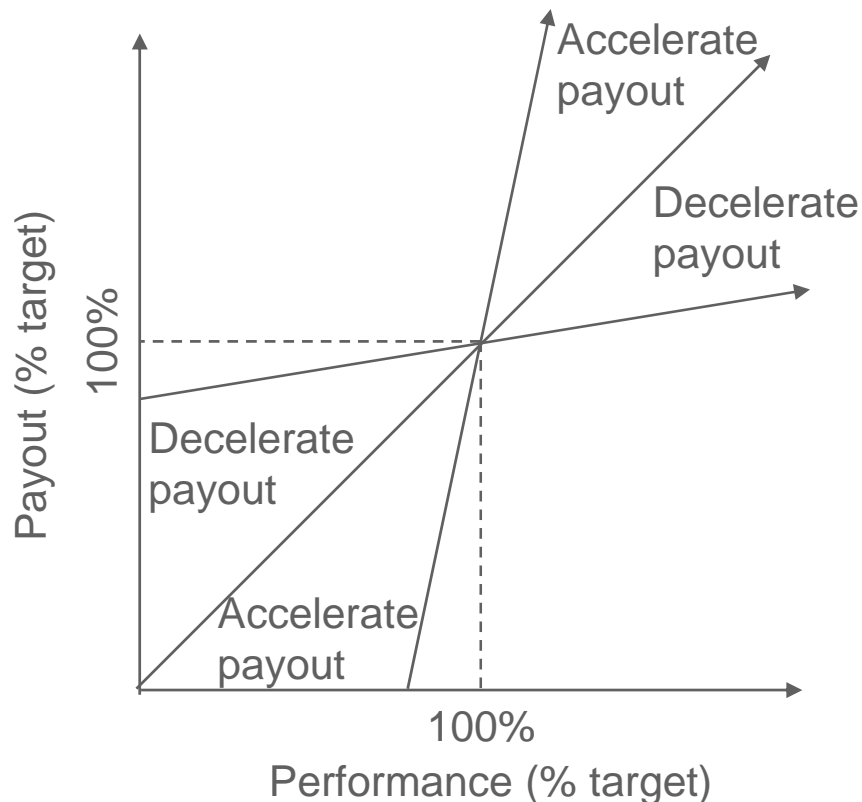
Sometimes it doesn't pay to think you are a super hero regarding performance!

Volatility in the “market”

Some change is in the air, however during 2009 those who decided to reduce target levels outnumber those who have decided to increase them, by a two to one margin.



Plan Leverage

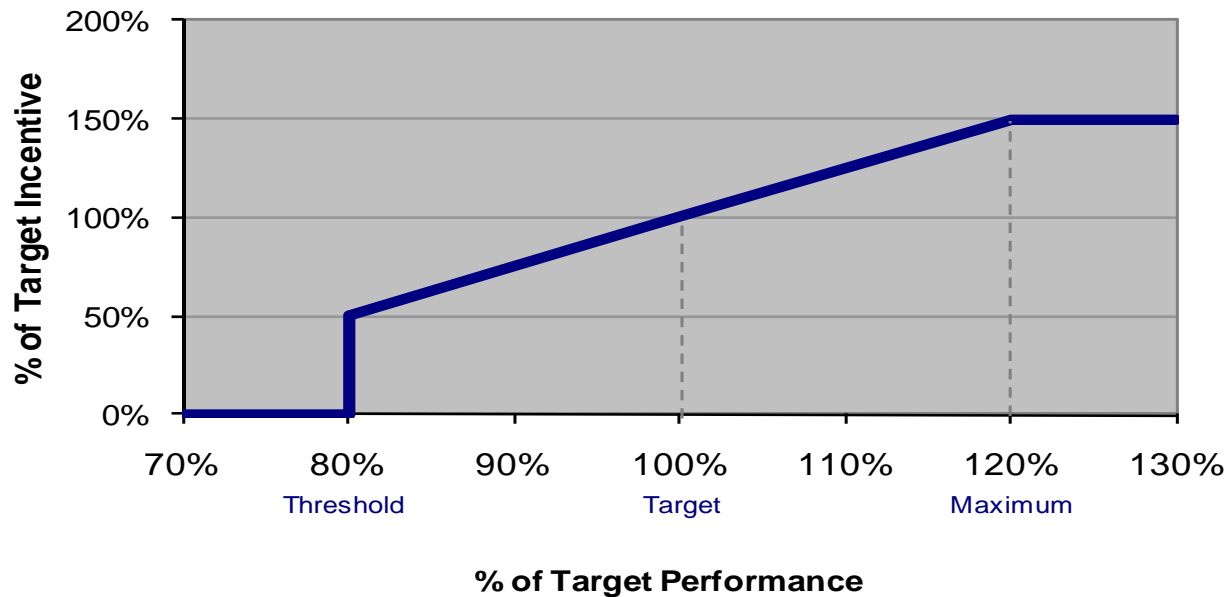


	Below target	Above target
Accelerate if...	<ul style="list-style-type: none"> achievement of target is a stretch early wins are needed. 	<ul style="list-style-type: none"> focus on rewarding above target performance above expected performance is more valuable than target performance.
Decelerate if...	<ul style="list-style-type: none"> target is an expected achievement progress up to target requires less effort. 	<ul style="list-style-type: none"> goals are set too low Performance constrained by organizational capacity to deliver.

Common Designs

Equal weights to performance above and below target.

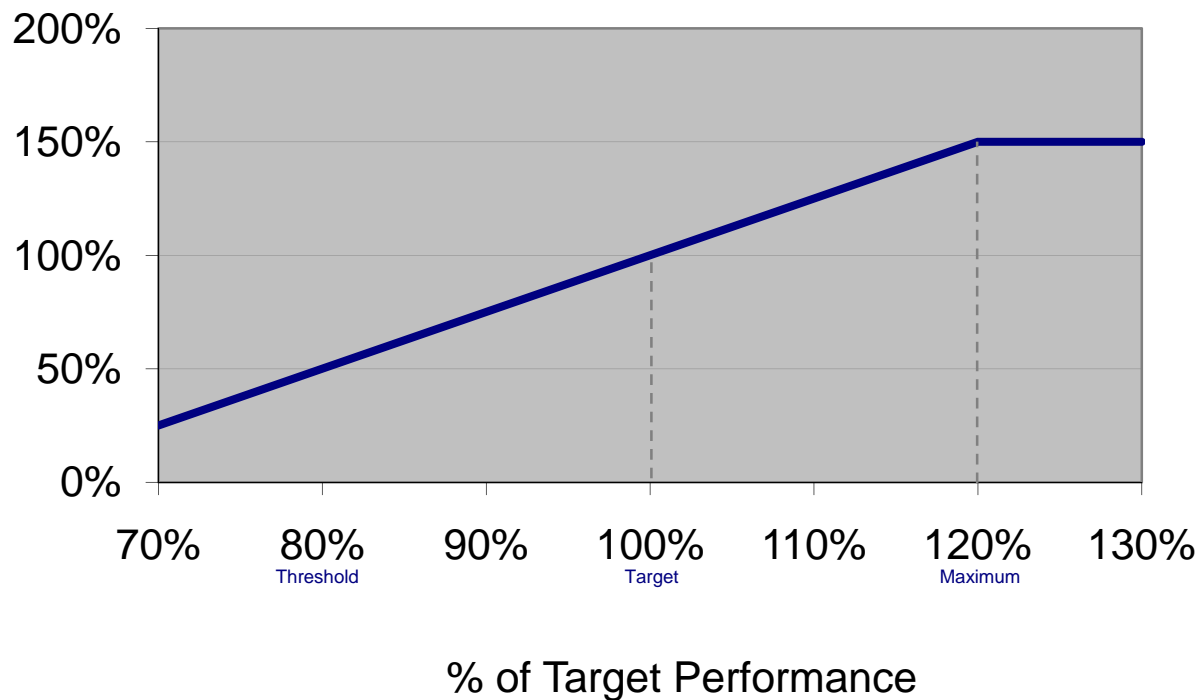
- We are seeing this approach more frequently to address uncertainty.
- There may not be a good rationale for anything other than a straight payout line. **Caution - % performance is illustrative and will differ by measure.**



Leverage - Common Designs

Equal weights to performance above and below target.

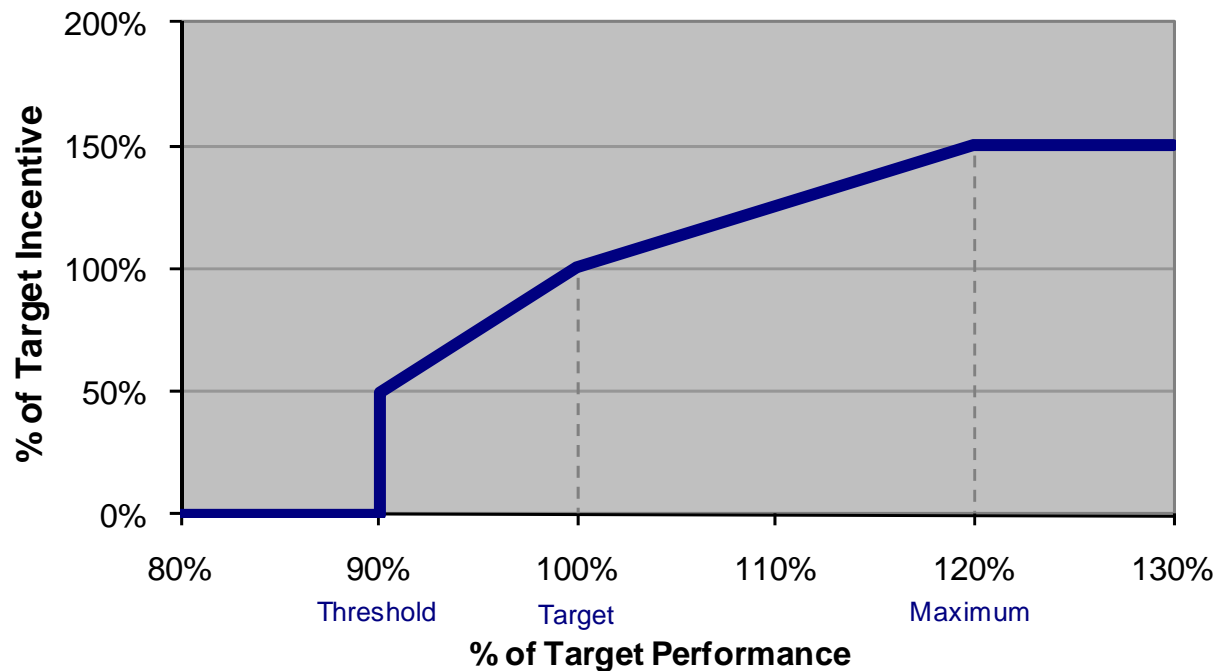
- No threshold – employee protection



Common Designs

Performance below target is weighted more than above target.

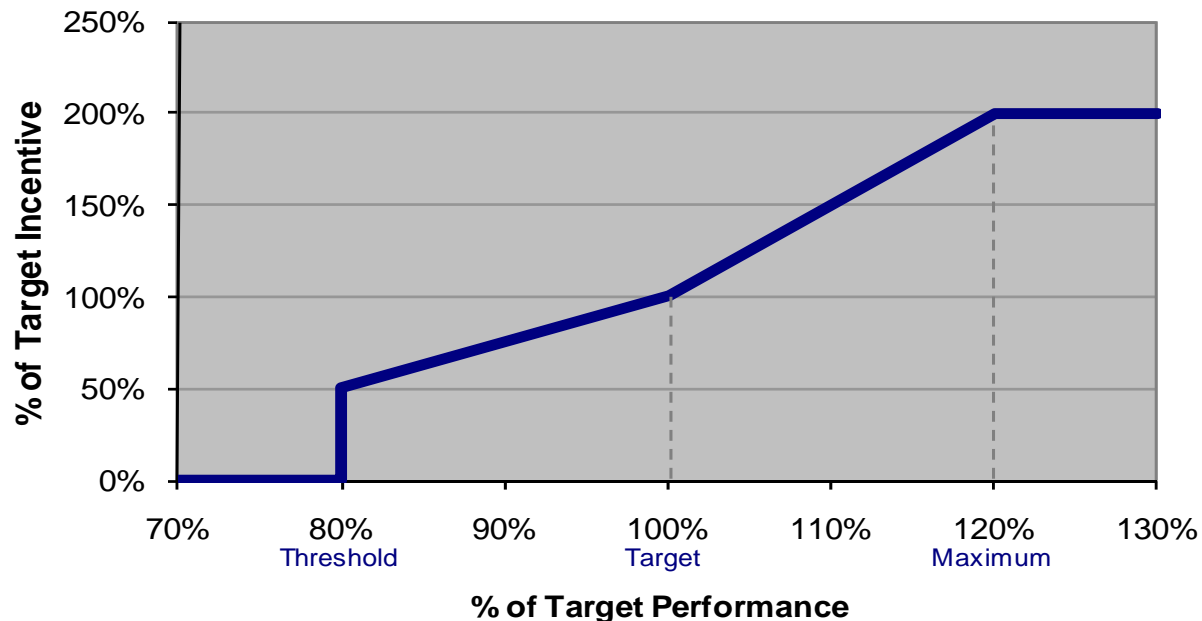
- Important to get to target but above target has diminishing returns.



Common Designs

Performance above target is weighted more than performance below target.

- Business benefits from above target with no negative long term consequences.



Impact of market volatility on incentive design

- Broaden the performance range (within acceptable limits)
- Flatten the performance curve to recognize volatility and uncertainty
 - Less downside risk
 - Less upside potential
- Shorten the award period (quarterly? Semi-annual?)
- Add relative metrics in addition to budget performance
- Greater use of subjective/discretionary and/or qualitative awards for some or all incentive
 - Operational and milestone awards
- Retention awards for top talent
- Double trigger for determining if any incentive payouts will be made.

Performance measures are based on:

- **Enterprise** – typically a component that increases in weight based on job size, and job role (staff often higher percentage than line)
- **Business** – depends on operating model as to whether business > geography or vice versa.
- **Geography** – depends on operating model as to whether geography > business or vice versa.
- **Unit** – subset of business unit or functional measures.
- **Individual** – where position is a subset of the above, question relates to how much of incentive compensation is based on this factor vs. more team based measures of performance. More individual measures leads to more managerial complexity and higher probability that individual performance comes at expense of team performance but potentially more line of sight. Use of a multiplier approach creates winners and losers and can also damage team work.

Long-Term/Executive Compensation

In the past, LTI plans avoided goal – setting

- **Stock Options** - Opportunity to purchase shares at a fixed price at any time over the term of the option – *more popular in a growth market*
 - Concerns as to whether they will have value in down economy
 - Concerns over potential windfall in market turnaround
- **Restricted Stock** - Grant of a full share with time or performance based vesting restrictions – *more popular in a flat market*
 - Time
 - Targeted performance

Long-Term/Executive Compensation

But current thinking has moved sharply in the direction of performance based LTI plans

- **Performance plans** - Typically three year performance periods, paid in cash or stock
 - Fastest growing component of LTI – *more popular with shareholders*
 - But hard to do

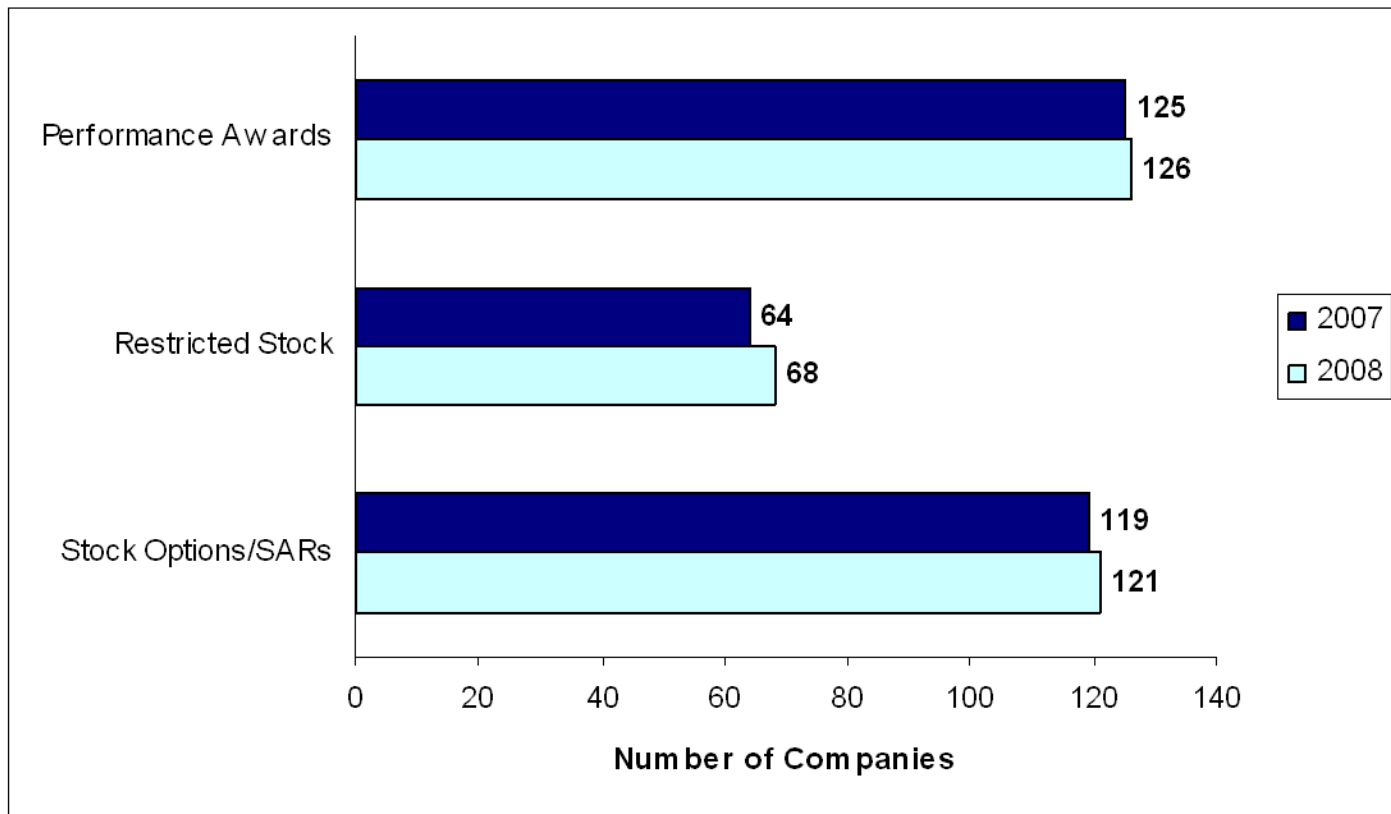
Over 50% of the CEO's in our most recent WSJ study received a significant portion of LTI in a performance plan.

Long term incentive practices – US and global

- **Move towards more performance** – performance shares and performance units replacing time-vested restricted stock.
- **Retrenchment from value to shares** – with share prices below historic highs, companies are balancing value vs. shares, reducing value relative to grants made early in 2008.
- **Full value vs. appreciation plans** – Stock options losing ground relative to full value plans.
- **Restricted Stock** – still strong, and valuable for retention, but losing ground to performance plans.
- **Performance shares** – gaining ground, carving into stock options and restricted stock grants.
- **Performance units** – an alternative to performance shares – sometimes settled in stock.
- **Global trends** – LTIs still represent the most significant differentiator of country pay, with the US still leading the pack in LTI value, but the gap has narrowed somewhat and plans are becoming more standardized.

Plan prevalence

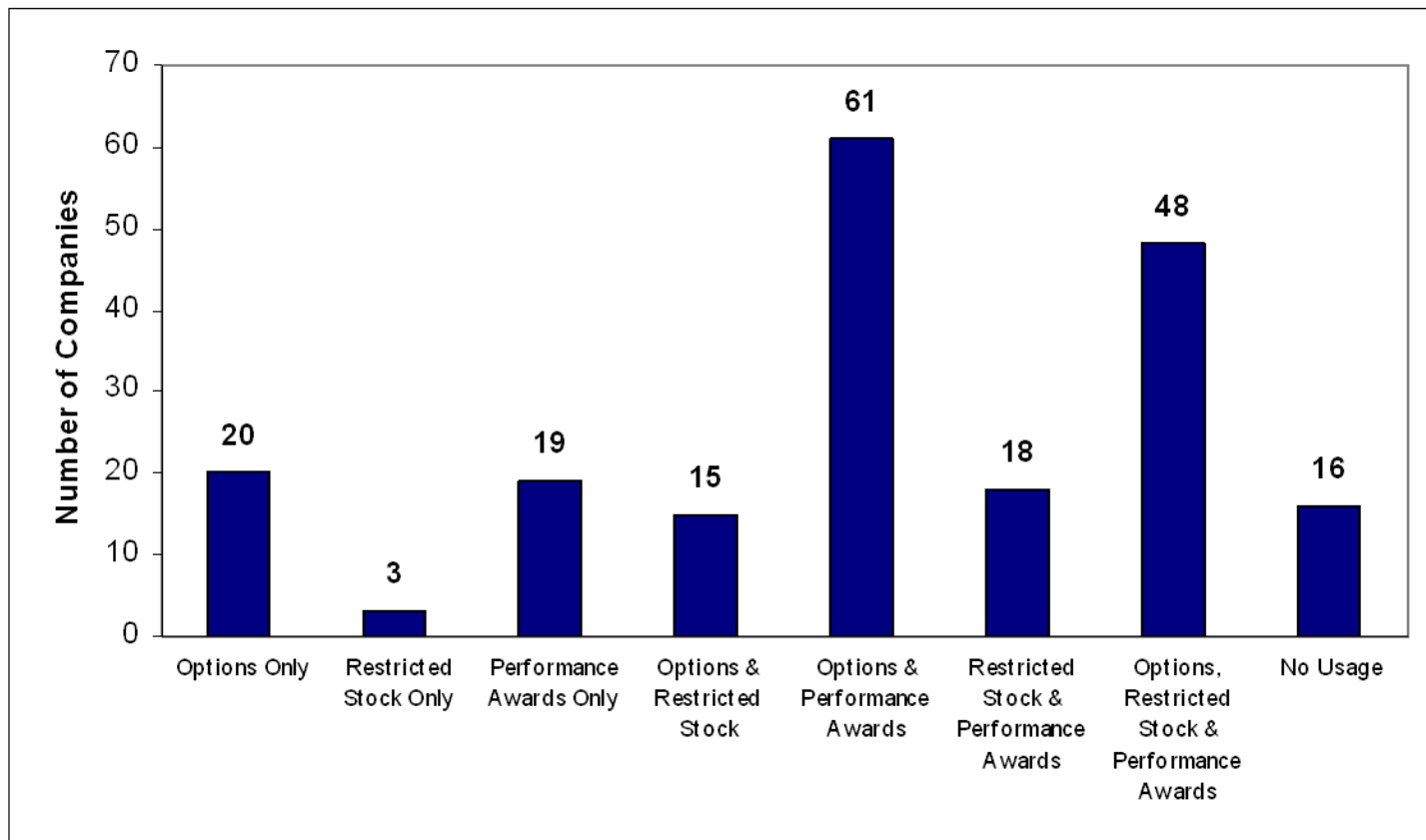
- When we look at only those executives who were in place for all of 2007 and 2008, we see a bigger edge for performance awards and little year-over-year change overall



Includes only constant incumbents

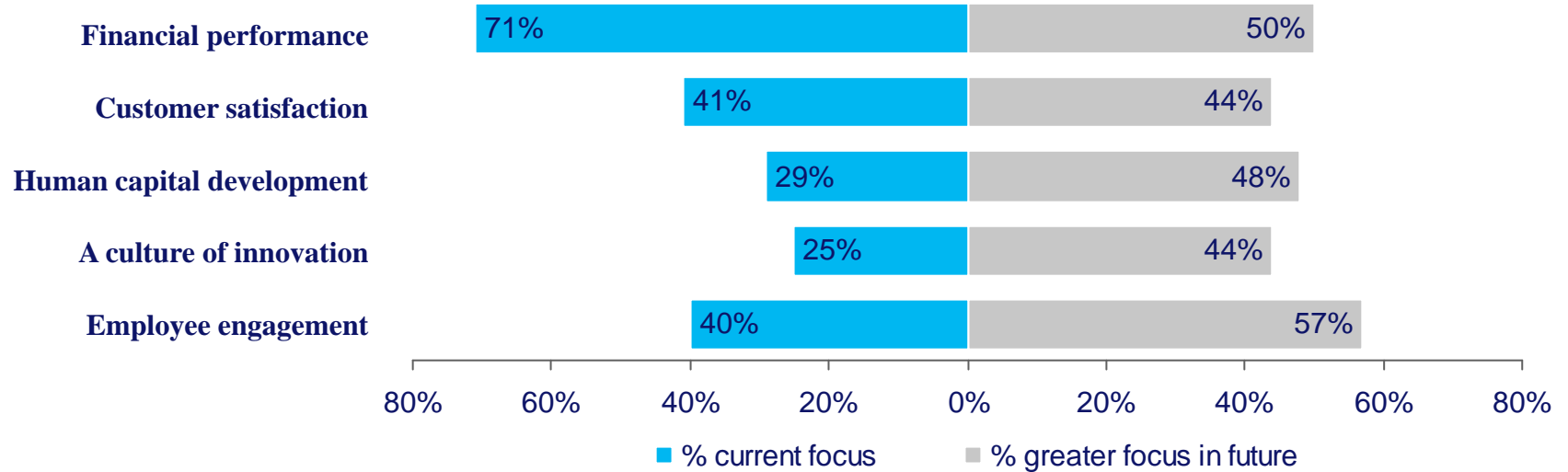
Plan prevalence

- Of companies that grant LTI to their CEOs, 71% of companies now take a “portfolio” approach. This includes a significant gain in companies (24%) using all three vehicles



Balanced performance

Measure types

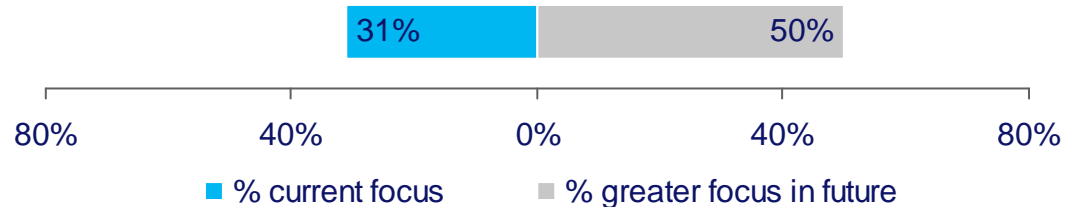


Achieving short term objectives



Timeframes

Achieving long term objectives



A Time of Change and Regulatory Engagement

New Compensation Principles

- A new concern in plan design is the increased focus on "risk".
- Earlier this year the Obama Administration released the **five guidelines on executive pay** as a foundation for sound compensation design. Specifically:
 - Compensation Plans should properly measure and reward performance
 - Compensation should account for the time horizon of risks
 - Compensation policies should be aligned with sound risk management
 - Golden parachutes and supplemental retirement packages should be re-examined to see if they truly align the interests of executives and shareholders, and
 - There should be greater transparency and accountability in the process of setting compensation
- Note that two of the five specifically address risk.

Employees' Biggest Concerns: Top Themes (2009 Hay Group Study)

1. Job Security/Layoffs

2. Salary Concerns – Reduced Merit, Frozen Pay, etc.

3. Cost-of-Living / Inflation

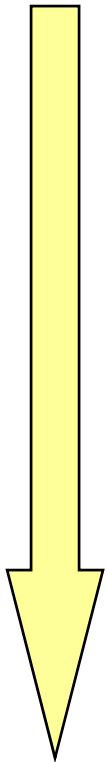
4. Reduced Revenue / Number of Customers

5. Lack of Bonus Payout

Lack of Bonus Payout ranked fifth. Cost-of-Living / Inflation was not a top theme in the U.S., but is a major concern globally. In the U.S., the loss of value in 401(k) and other retirement plans was a major concern.

Top 5 areas of focus

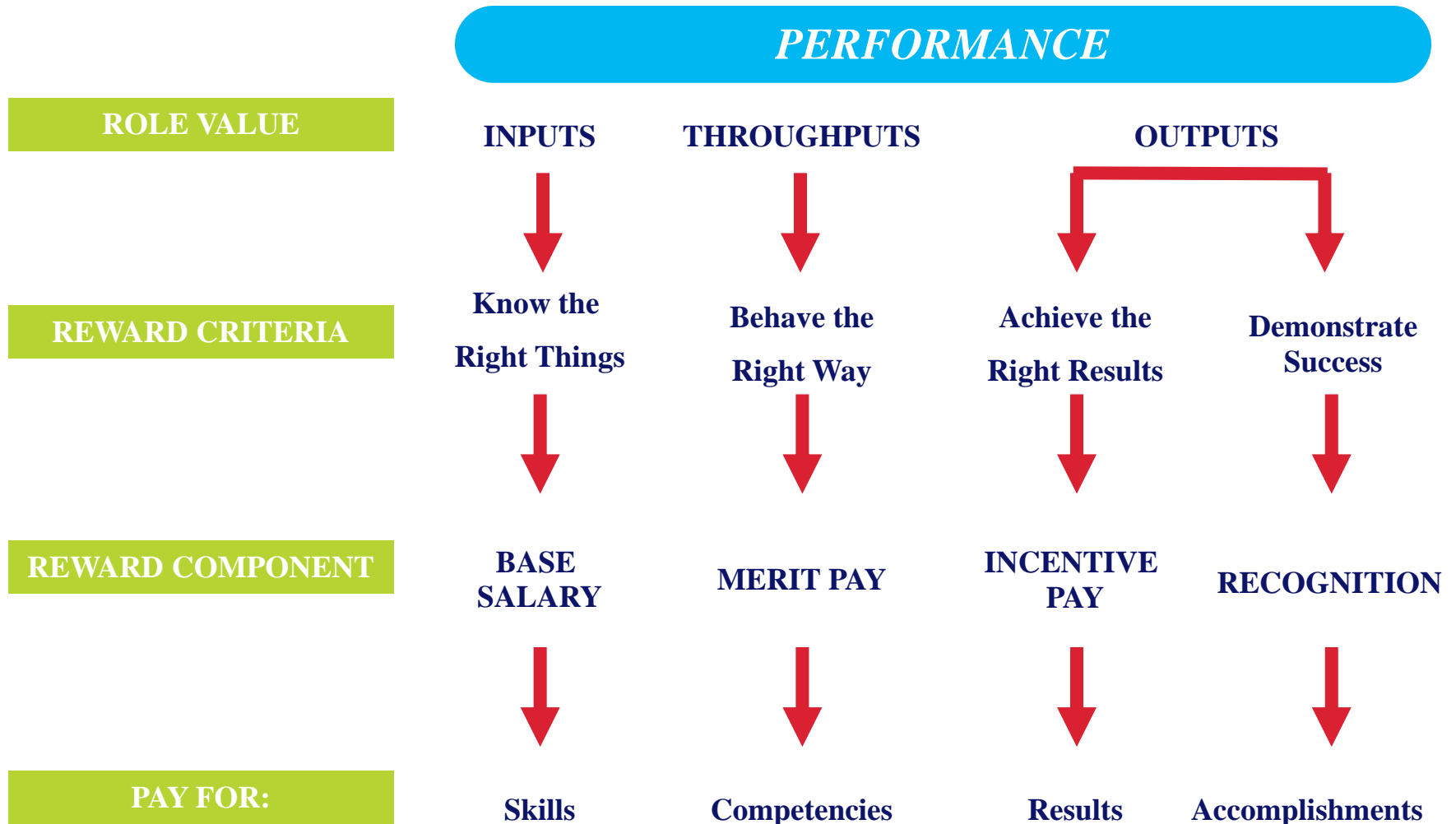
*Shorter
Term*



1. Clear and frequent communications – to focus on what is important.
2. Pruning the rose bush – when making cuts do on performance basis
3. Retaining your top talent – incentive differentiation a part of solution
4. Taking a broader reward perspective – incentives not only way to reward performance
5. Ensuring a solid reward foundation – have a strong performance management process. Don't rely on incentives as a surrogate manager.

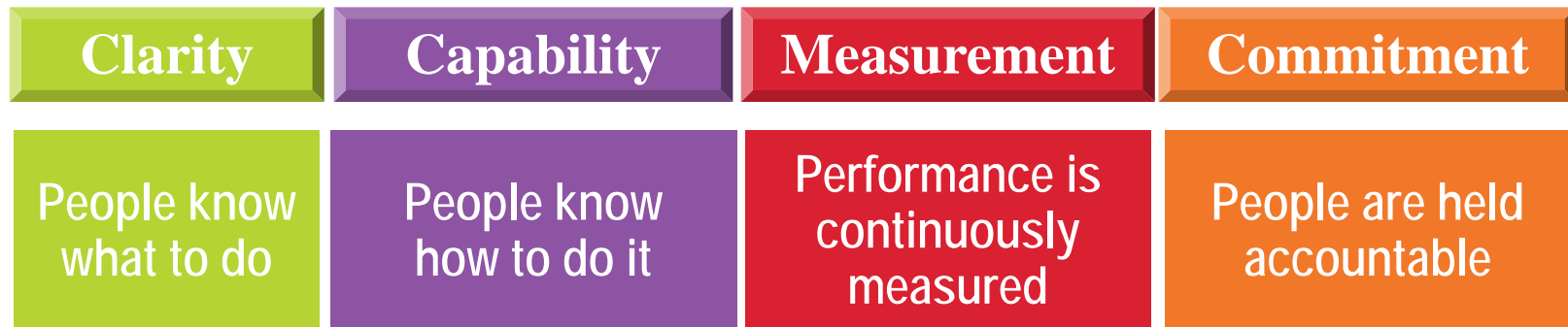
*Longer
Term*

Aligning Rewards with “Performance” Criteria



What it takes to implement strategy successfully

Key Success Factors



Executing well on all of the above creates a company culture that supports strategy implementation.

Incentives help create clarity, determine business measurements that are important, and create a culture of commitment

Conclusions

So what should plan designers do??

- Understand the objectives of plan design, for example :
- Understand the financial reality – ability to pay
- Understand how accurately your company can set goals
- Understand the objectives of plan design, for example :

Talent management

Risk management (fixed v variable)

Incentive

Inclusion

Competition

Conclusions

And most of all...

- Understand there is no one right answer!!

Thank you

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