

# Strategic & Defensible Executive Pay

**In the New SEC Disclosures Era**

**Compensation Standards  
Oct 2006, Las Vegas**



**Consultants in  
Organization Design,  
Leadership &  
Shareholder Value**

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# Agenda

- **New SEC Disclosures**
  - Key points regarding Strategic and Defensible Pay from Corporate Counsel Sept 11/12 conference
- **New Guiding Organizational & Pay Principles**
  - Differentiating Strategic vs. Operational Work, Measurement & Pay
- **New Tools & Analysis for Strategic & Defensible Executive Pay**
- **New CD&A - Beyond Boiler Plate Disclosure**
  - Strategic, Defensible & Material Disclosures for Investors

# Harvey Pitt

(Former Chairman SEC)

- Sept 11/12 Conference - Implementing SEC's New Compensation Disclosures Rules
  - Lack of Correlation Between Executive Pay with Performance is the “Key Outrage” from Investors
  - Boards Need to:
    - Identify for Each NEO role the Key Job Components
    - Identify for Each NEO role the Key Metrics of Success
    - Avoid subjective and easily manipulated metrics
    - Determine the Consequence of Failure to meet success metrics / targets
    - Determine was the Compensation earned / merited & why the level of compensation should be paid & is defensible

# Alan Beller

( Partner Cleary Gottlieb,  
Former Director SEC Div of Corporation Finance )

- Sept 11/12 Conference - Implementing SEC's New Compensation Disclosures Rules
  - CD&A is written from the POV of the Compensation Committee not Management
  - CD&A = Materiality to Investors is a Key Acid Test
  - For Investors to understand the Total Cost of Management
  - Disclose why compensation philosophy / strategy / metrics are consistent with the strategic objectives of the company
  - Analysis undertaken to justify the WHY of compensation decisions - not just compensation calculations

# John Olson

(Partner Gibson Dunn,  
Chair ABA Corporate Governance Section)

- Sept 11/12 Conference - Implementing SEC's New Compensation Disclosures Rules
  - Directors hate surprises & subject to shareholder withhold campaigns
  - CEO / NEO Pay must be justified and Zero -Based analysis every year - rationale for each compensation component
  - Analysis and Disclosures Now Key & Directors need new tools like Tally Sheets, Internal Pay Equity Analysis, & Pay for Performance Analysis
  - Ask the tough questions before the shareholders & media

# Off the Rails U.S. Executive Pay For Performance

MVC Research / Analysis

- Just 60 U.S. Listed Companies over 5 yrs:
  - Lost \$ 700 billion in Market Value Added
  - Destroyed \$ 485 billion in Economic Profit
  - Yet Granted \$ 12 billion to Named Executive Officers in Total Direct Compensation
    - 300 officers - average \$ 40 million / officer
    - 20 of these companies provided full disclosure of metrics and 2 to 3 yr performance periods and would get a “check the box” on Pay For Performance

# Guiding Principles

## Organization Design and Executive Pay

- What is it that CEO roles are really paid to accomplish and how should performance be measured ?
  - Sustained Growth in Intrinsic Enterprise Value
  - Sustained Growth in Shareholder Wealth
- How many levels of management does an enterprise require, what is the differential work at each management level and what determines this ?
  - Optimal number of management levels depends on the business strategy, expected level of growth and innovation

# Guiding Principle

- **Only Differential Executive Work Justifies Differential Executive Pay**
  - If the Top 3 layers of management are doing the same work ( including performance metrics & performance periods ) what is the value-add that justifies current CEO / NEO compensation levels ?
  - Differential Executive Work is the justified basis for Internal Pay Equity Multiplier between Levels of Management



# 70 % of Disclosed CEO roles Designed & Paid Incorrectly

## Too Operational

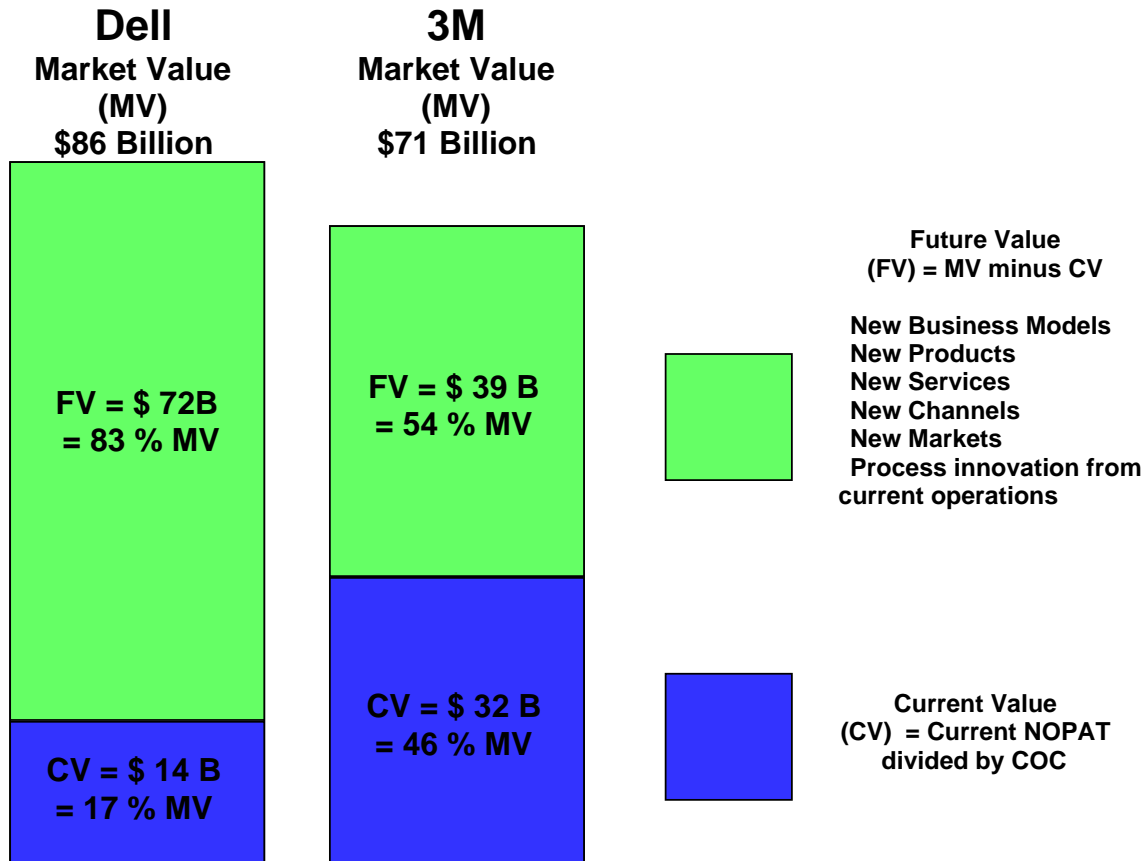
- MVC / Corporate Library / McKinsey
  - ✓ > 50 % top 1800 public companies in North America have failed to create a ROIC > Cost of Capital over 5 years - Business Model /Strategy NOT Viable
  - ✓ 55 % Directors had NO meaningful process or metrics to evaluate CEO role / performance
  - ✓ 85 % not held accountable or paid for business performance (not stock market performance) 3 years or beyond

# Strategic vs. Operational (work, measurement & pay)

- Too many Executive Pay for Performance models are linked to Current Operations & are mismatched to compensation that should be aligned with Higher Level Strategic Work & Innovation
- Too Many Senior Management Layers Paid For The Same Operational Work = redundancy
- Too Many CEO roles are thus overpaid for mostly Operational Work = “wasted compensation”

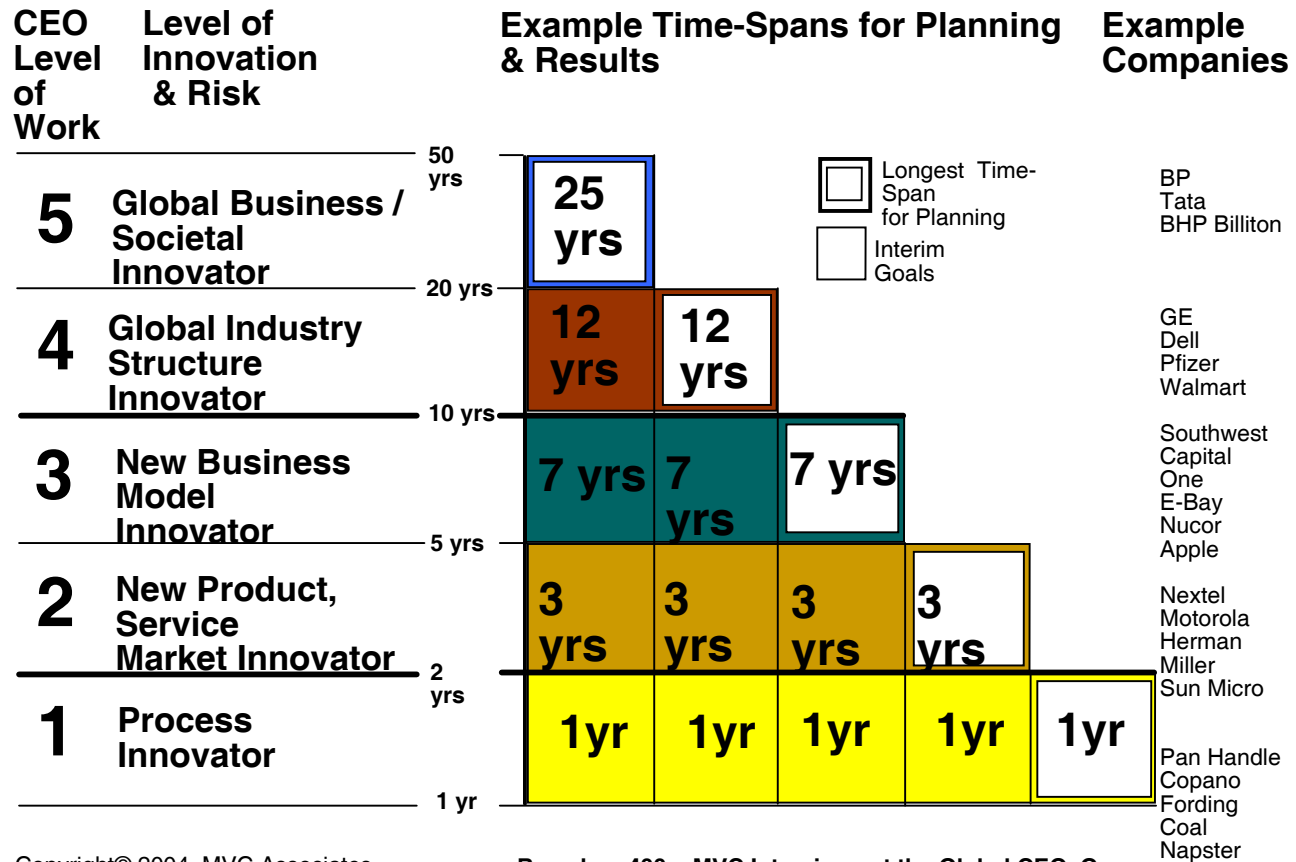
# Guiding Principles

## Valuation / Organization Design / Exec Pay



- 70 % of companies lack the organization design and Pay for Performance Metrics to Support Enterprise Valuation

# 5 Levels of CEO Work / Strategic Accountability



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Based on 400 + MVC Interviews at the Global CEO, Group President, President, and VP/General Manager Levels

# New Board Tools & Analysis

- Defensible Job Matching, Compensation Calibration & Peer Group Analysis
- 4 Yr Pay for Performance Analysis
- 3 Yr Future - Strategic Compensation Payout Sensitivity Analysis
- Future Enterprise Value ( FV ) vs Executive Pay Analysis
- Internal Pay Equity Multiplier Analysis

# Risk of False Pay Disclosure & CEO / CFO Certification

- Need for Defensible Job Matching & Compensation Calibration Processes
- All CEO's roles NOT THE SAME Level of Complexity
  - Eli Lilly vs. Johnson & Johnson
  - Gateway vs. Dell
  - Kimberly Clark vs. P&G
- NO compensation calibration process could understate the pay percentile by 30 to 60 + % depending on peer group - a material false & misleading disclosure for investors

## Level of Work Equitable Pay Multiplier

Leadership Domain	Level of Work & Innovation	CEO to CEO comparison	Example Pay Bands \$ USD	
<b><u>Global Industry</u></b> <ul style="list-style-type: none"> <li>• Current / Future Societies</li> <li>• 10-20 yr + Balance Sheet Strategy, optimizing TSR and Cash-Value-Added for Societies</li> <li>• Transform Industry Structure / Cultures</li> <li>• Create change globally</li> <li>• Leadership of Business Leaders</li> <li>• Identity &amp; Policy Control</li> </ul>	<b>Level 5) Global Business / Societal Innovator</b> <small>Creates enterprise sustainability, new industries (R&amp;D), and wealth creation for global society, by managing the inter-dependencies between economic, environmental, social and political factors worldwide (Stratum 7)</small>	<b>32X</b>	\$3.84m	
			2.88m	
			<b>16X</b>	1.92m
	<b>Level 4) Industry Innovator</b> <small>Model corporate citizenship / stewardship, policy and investment strategies leveraging business models across multiple geo-political, socioeconomic, &amp; technological boundaries (Stratum 6)</small>	<b>8X</b>	1.44m	
<b><u>Business Development</u></b> <ul style="list-style-type: none"> <li>• Current/Future Stakeholders</li> <li>• 2 to 10 yr Investment Plans</li> <li>• New Products, New Businesses &amp; Return on Invested Capital</li> <li>• Anticipate change nationally and globally</li> <li>• In-Direct Leadership</li> <li>• Strategy &amp; Management Control</li> </ul>	<b>Level 3) New Business Model Innovator</b> <small>Transform the business model leveraging customer, competitor, regulatory, capital market, NGO's and other socio-economic factors (Stratum 5)</small>	<b>4X</b>	720,000	
			480,000	
	<b>Level 2) New Product / Service Innovator</b> <small>Integrate and synthesize stakeholder needs resulting in development of new products, services, markets &amp; channels (Stratum 4)</small>	<b>2X</b>	360,000	
<b><u>Operational</u></b> <ul style="list-style-type: none"> <li>• Current Customers</li> <li>• 1 to 2 year profit plan / EPS</li> <li>• Operational &amp; executional efficiency</li> <li>• Respond to change locally and nationally</li> <li>• Direct Leadership</li> <li>• Operational Control</li> </ul>	<b>Level 1) Process Innovator</b> <small>Optimize process, technology and people to deliver a suite of products &amp; services to meet the needs of current customers (Stratum 3)</small>		240,000	
		<b>X</b>	180,625	
			\$120,000	

## Defensible Executive Pay

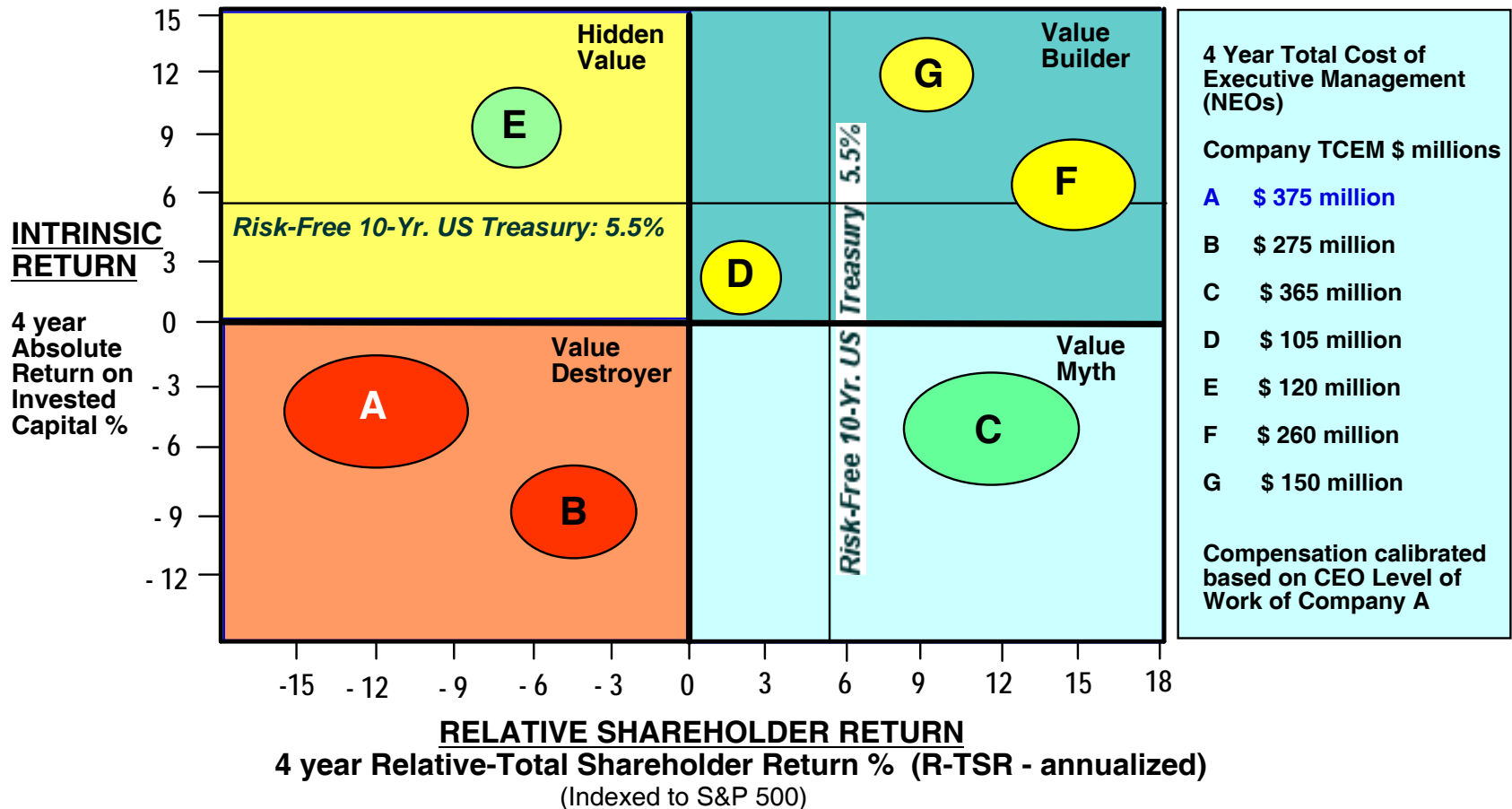
10 + Studies - found  
2 X compensation differential  
& “Felt Fair Pay” for each  
Level of Work (Elliott Jaques, etc)

Size of Revenues & Assets  
does NOT determine  
Level of CEO Work

Differential executive work,  
accountability & level of value  
creation merits Differential  
Levels of Pay (LOP) that is  
defensible to shareholders

# A Total Picture for Defensible PFP

## Pay-for-Performance Financial Returns Analysis Intrinsic & Shareholder Value Returns Compared with Executive Pay ( Select Peer Group )





# No Board / Investor Surprises

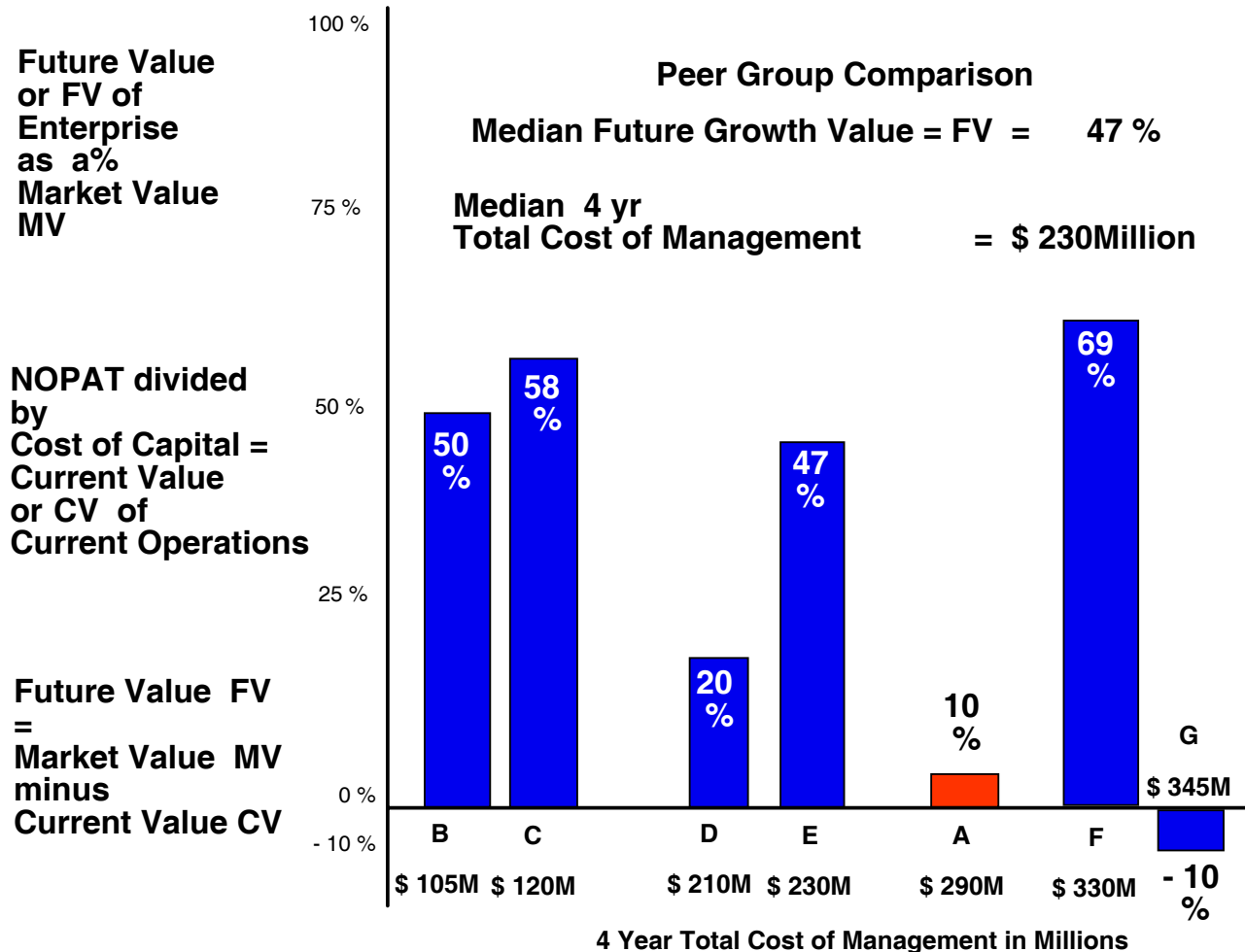
## Developing / Disclosing Future Strategic Compensation Payout Scenarios?

Sample  
Strategic Pay for Performance  
Payout Scenarios - CEO Level 3 Enterprise

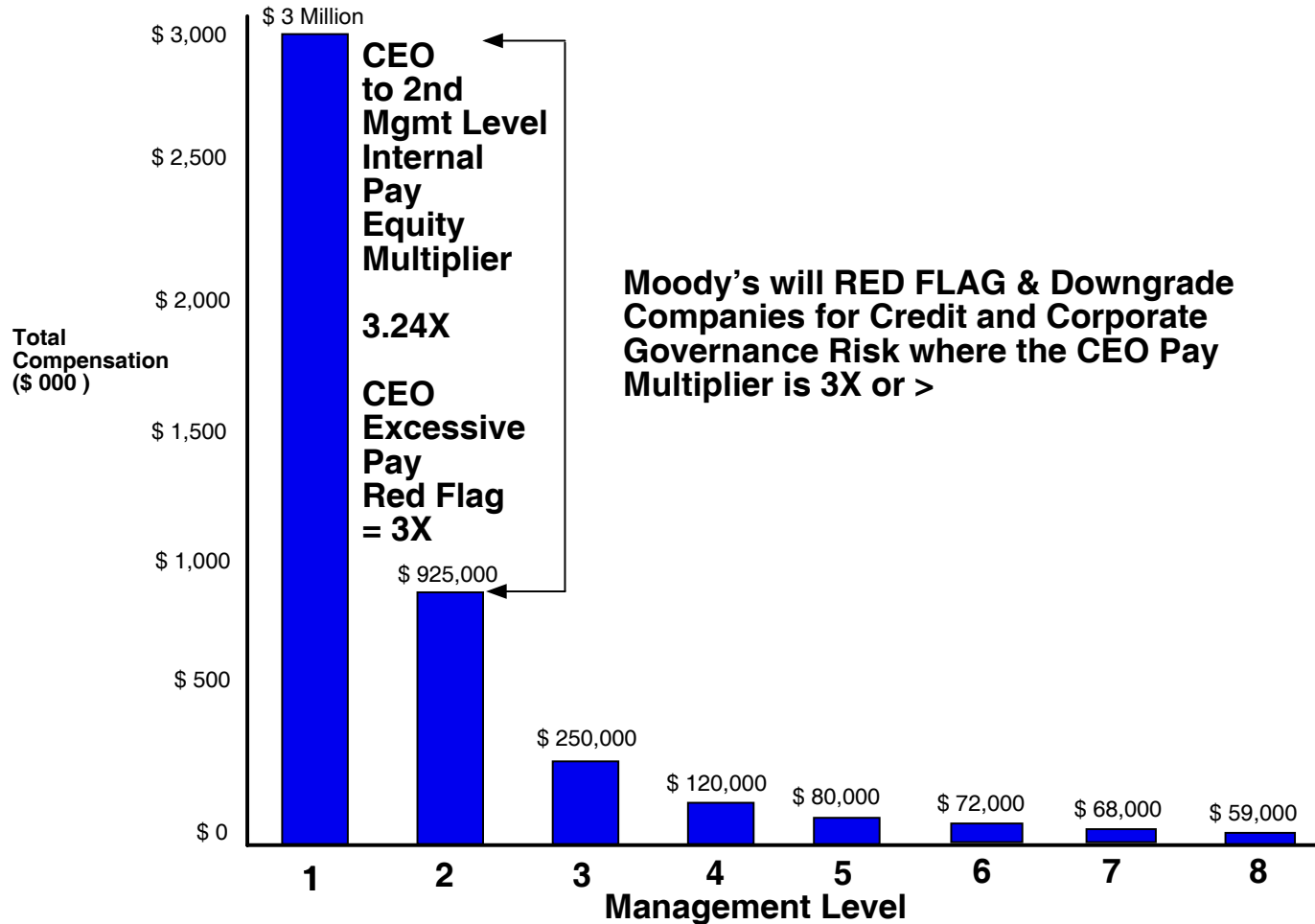
3 yr Cumulative Economic Profit in millions	3 yr Total Cost of Management Targeted Cumulative Total Direct Compensation for Top 5 Named Executive Officers in \$ millions				
\$ 1,000 m	101	105	110	120	200
\$ 900 m	91	95	100	110	190
\$ 800m	81	85	90	100	180
\$ 700m	71	75	80	90	170
\$ 600m	61	65	70	80	160
\$ 500m	51	55	60	70	150
\$ 400m	41	45	50	60	140
	3 yr indexed <sup>2</sup> Market Value Added ( <sup>2</sup> enterprise value minus debt, equity + retained earnings indexed to the Russell 3000)				
	\$ 50 million	\$ 250 million	\$ 500 million	\$ 1 billion	\$ 5 billion

Pay for Performance  
Payout Sensitivity  
Analysis linked to the  
Strategic Business  
Plan, Goals & Targets

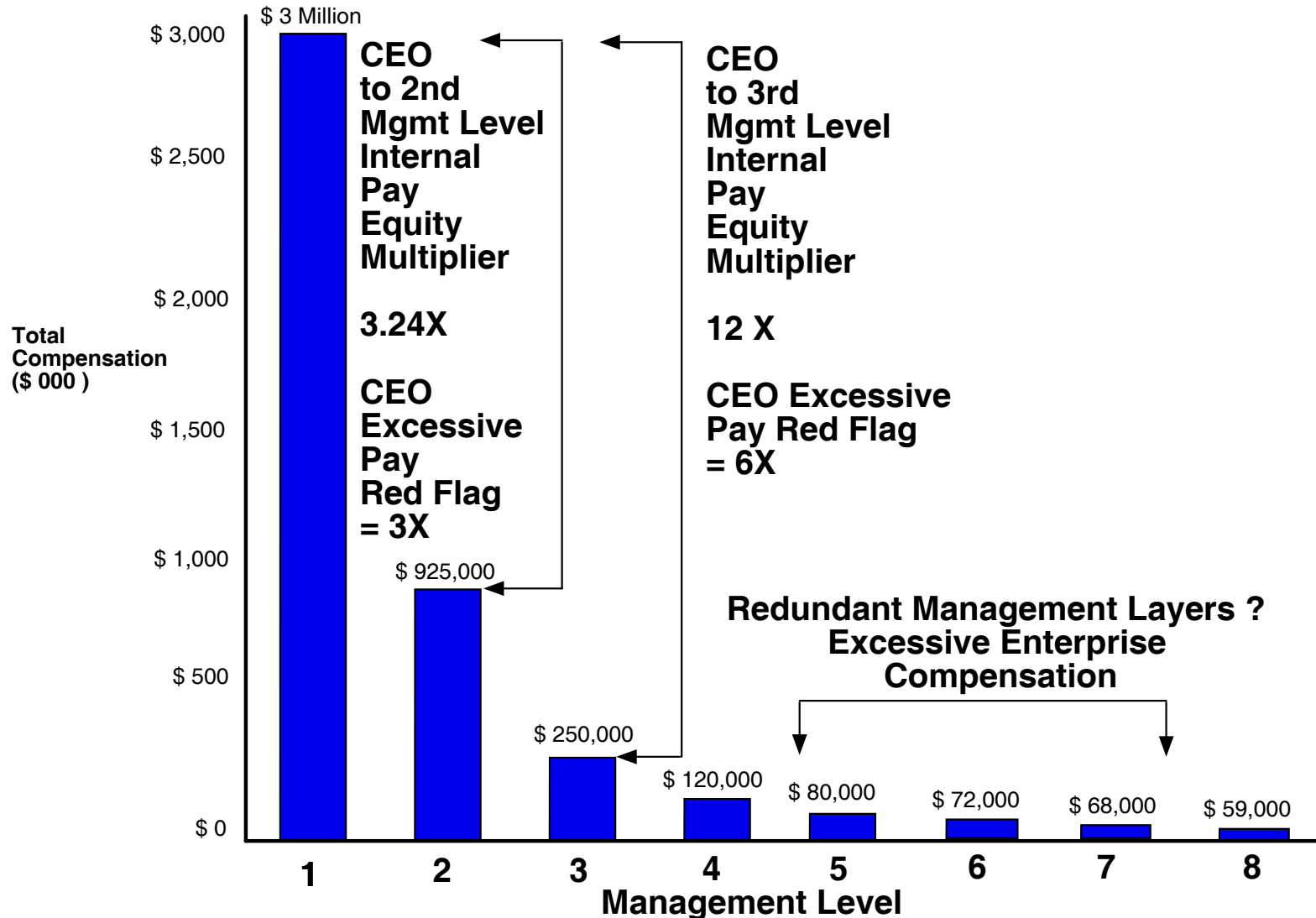
# Expected Future Enterprise Value (FV) & Executive Pay



# CEO Pay Multiplier & Credit Risk



# CEO Internal Pay Equity Analysis



# New SEC Compensation Discussion & Analysis

- Disclosure on “How Much” TOTAL CEO Compensation
- Can only be Justified as Fair / Equitable by Decision Making, Controls & Disclosure that Analyze “For What” compensation is paid:
  - What is the CEO Role paid for ? (Level of CEO Work)
  - What Level of CEO / Enterprise 3 to 5 yr Performance?
  - What Level of Expected Future Growth Value - FV ?
  - What Level of Internal Pay Equity?

# What Boards Need to Do Now!

- Hire expert advisors in Organization & Pay-For-Performance Design (augment compensation consultants)
  - Most compensation consultants as experts in Pay Design & Delivery may NOT meet the legal test to protect the Board as expert in Pay-for- Performance ( Risk of being challenged is for PFP )
  - Tie Executive Incentive design into business strategy, organization design & longer-term measures of BOTH Intrinsic Value & Relative Shareholder wealth creation
- Clearly Define the CEO / NEO Level of Work & Accountability beyond just Current Operations
  - “Strategic Duty” of Directors as a Fiduciary for Shareholders
  - Ensure Alignment of Optimal Organization Design and Pay Structure to create sustainable value
  - Challenge the rationale for each component of executive compensation and its link to the business strategy