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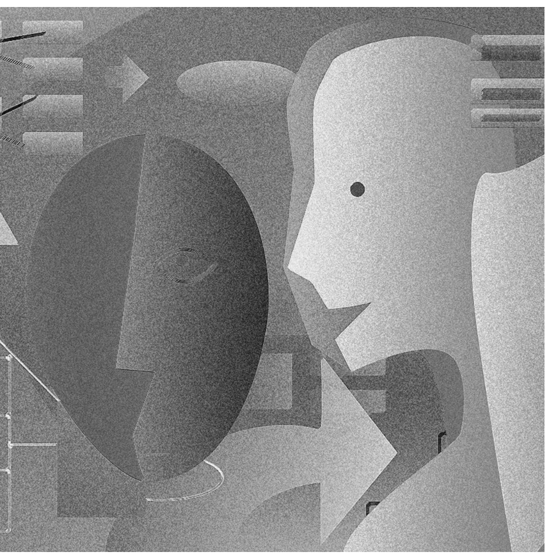


Tackling the challenge of aligning pay with performance

There is no shortage of advice for compensation committees of publicly-traded companies. The Conference Board, the National Association of Corporate Directors, the Business Roundtable, and many others are weighing in on the role of compensation committees, particularly when it comes to establishing executive pay programs to achieve a desired level of performance. The nature of the advice, however, has been more in the way of "guiding principles" than implementation instructions.

How should companies align executive pay with performance? Until recently, share price appreciation was the definitive guide for the "right" performance – that is, anything above the strike price – which explains the heavy reliance on stock options. But times have changed: options are falling out of favor in part because stakeholders perceive that executives are benefiting from market performance rather than underlying corporate performance.

While there is no silver bullet for selecting measures and performance targets, a comprehensive and rigorous approach can create a rational and defensible link between pay and performance. This *Perspective* describes the tools and processes that compensation committees can use to answer the following questions:

- How should we define performance?
- What targets are appropriately difficult?
- How do we calibrate pay to performance?

Ingredients for a healthy pay-for-performance discussion

There are a number of analytical tools that can provide directors with information to help evaluate various metrics and performance levels and strengthen the link between executive pay (cash and equity) and corporate performance. These tools do not replace management's input or directors' judgment; rather, they help increase understanding and create greater insight. We believe that the best approach is a collaborative one among the committee, the committee's independent adviser, senior management, and the company's human resource and finance functions.

Healthy debate over the issues identified by analytical tools provides the basis for

- compensation committees to meet the test of reasonableness and the demands of effective governance, and
- senior management to motivate and direct the company's workforce.

Identifying the right performance measures

The primary objective of most incentive plans is to drive performance so that over the long term the value of the entity to shareholders will increase. Selecting the right performance measures is one of the most important aspects of establishing the appropriate link between pay and performance. But determining what is "good" performance and selecting where an organization should focus its attention is not always so obvious.

There are two broad categories of measures – internal and external. Internal measures, such as financial results or operational objectives, are different from stock price or total shareholder return (TSR), which are external. Stock performance has long been favored, but for many organizations it *alone* is rarely the best judge of an executive's contribution to performance. Stock price is influenced by market factors outside of management's control and does not reflect day-to-day decision making. So, what role should equity and stock price have in executive compensation programs?

*Performance Sensitivity Analysis*SM *(PSA)* can help committees answer this question. Each company faces a unique risk environment in the capital markets. PSA analyzes the source of volatility in a given company's stock compared to a peer group of companies with similar industry or business profiles. This analysis gives directors new insights into how firm-specific behavior contributes to TSR as compared to industry and general market factors. PSA thus provides a quantitative basis for setting the degree to which equity performance – and the related risk – should be part of incentive compensation design.

Exhibit 1 shows the risk profiles of a group of industry peers and the market-, industry-, and firm-specific factors influencing TSR volatility. Compared to its peers, Company 1 has low TSR volatility, and most of it was the result of external – industry and market – risks. This information played a significant role in the company's decision to reduce its emphasis on

Exhibit 1
Sources of Risk in Total Shareholder Return

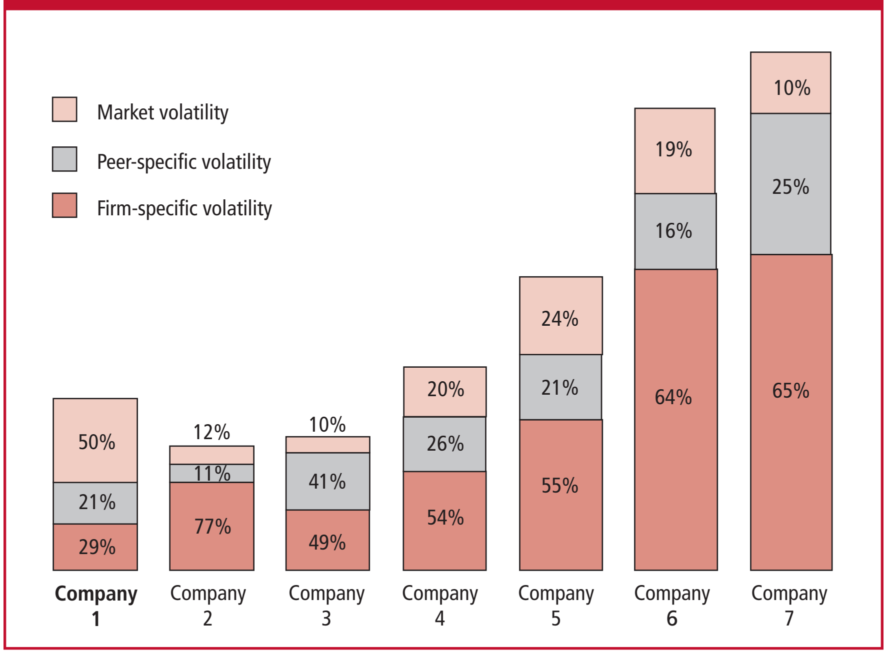
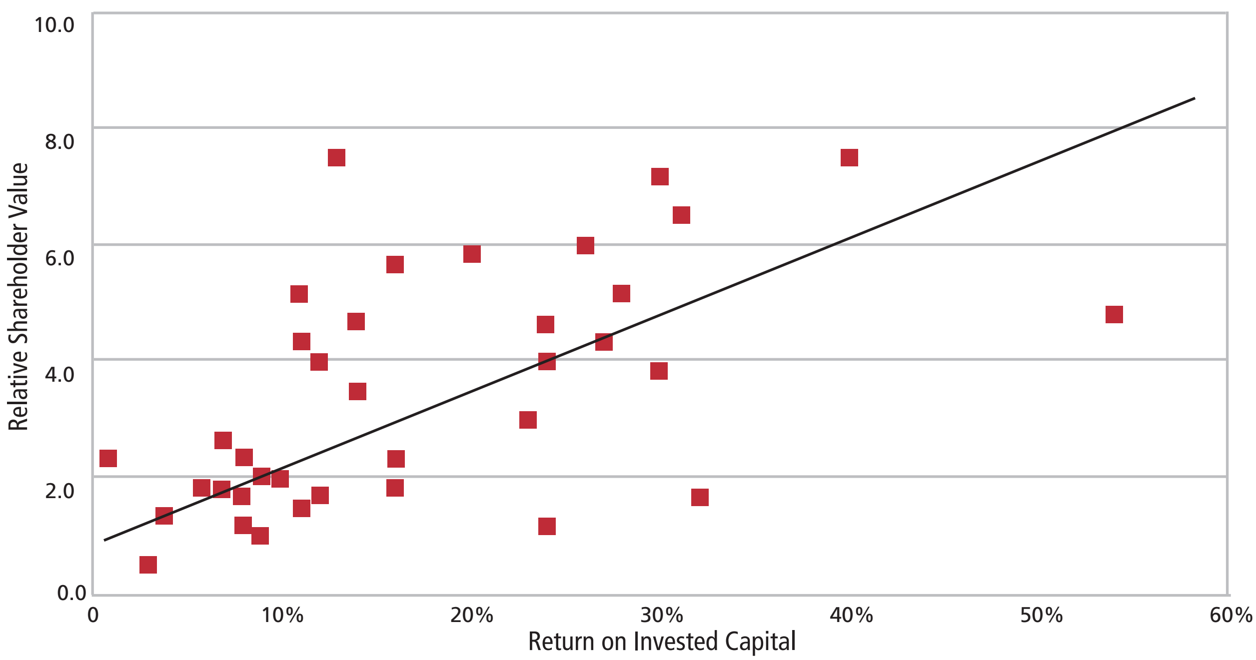


Exhibit 2
Return on Invested Capital vs. Relative Shareholder Value
FYE 1993-2003



equity compensation and to add relative performance metrics to its long-term incentive plan.

After a company has addressed the role and importance of equity and share price, the next decision requires an assessment of how to measure success from an internal perspective and ensure that performance measures are aligned with creating shareholder value.

Shareholder Value Analysis provides a basis for understanding how financial performance on selected internal key metrics relates to shareholder value creation. There is a wealth of historical data available on the performance of US companies and the market, often at a level granular enough to identify the key drivers of shareholder value. Through regression analysis, it is possible to identify how performance on a given measure or on multiple measures links to shareholder value creation over the short, medium, and long term.

Exhibit 2 shows why one company decided to incorporate return on invested capital (ROIC) in its executive incentive plan. In analyzing historical data, the company found a very high correlation of ROIC to shareholder value in its peer group.

Of course, identifying appropriate performance measures goes beyond strong correlations and financial analysis of potential outcomes. Each company has a different business strategy, its own point on the maturity curve, and a unique culture. These factors, as well as common sense considerations about the measures – accuracy, reliability, simplicity, consistency across plans, and transparency – should influence the final selection of measures. But initiating the discussion with factual information about which measures drive shareholder value is often a valuable approach.

Setting targets

Setting appropriate performance targets to link performance measures to pay can be a difficult task, especially when new programs are expected to address multiple years. Management budgets and long-range forecasts are useful starting points for the discussion, but, given the difficulty of forecasting, they should not be relied upon as the only inputs into the target setting process. The key questions include:

- Are the performance targets meaningful (is there sufficient stretch)?
- Are they reasonably achievable (what is the probability of earning a payout)?

As with measure selection, a number of analytical tools can help evaluate the difficulty of performance targets.

Relative Performance comparisons are often an important component of performance target setting. Although not necessarily a predictor of the future, the company's historical performance compared to its peers and the broader market can help directors assess whether targets are achievable and meaningful. Targets are often set within a range of historical peer performance, for example, at the 50th or 60th percentile for target payouts, and 70th to 80th percentile for upside performance. Other companies use these historical comparisons to set payout guidelines for achieving target levels of performance, for instance, for three out of five years.

Beyond peer comparisons, *External Expectations Analysis* can be used to determine if the selected performance goals are sufficient to meet expectations built into the company's current market value. Stock analysts' reports are an important external source for these insights. Their research often focuses on specific industry metrics and expectations that they consider indicative of success and provides some input into the target-setting process. Performance targets can easily be derived that are directly comparable to analysts' projections of earnings per share (EPS) or cash flow.

Beyond analysts' reports, the performance improvement expectations built into stock price can be directly analyzed. The value of current performance can usually be quantified with reasonable assumptions. Looking at the gap between the current value of operations and market value, future growth expectations can be identified and should be considered in evaluating targets.

Finally, a *Comprehensive Financial Picture* looks at the interrelationships between measures and underlying performance drivers. The board should first consider the broader financial implications of performance against a specific metric and then test the implications for one or more underlying measures before signing off on the incentive plan's performance goals.

For instance, in Exhibit 3, EPS goals are translated into revenue growth and the net margin performance required to achieve the goals. This evaluation helps a compensation committee determine whether the overall performance required to achieve a range of EPS outcomes is reasonable.

Exhibit 3
Projected EPS Given Revenue Growth and Operating Margin

	Revenue Growth						
Net Margin	-10%	-5%	0%	**5%**	10%	15%	20%
10%	$0.47	$0.50	$0.53	**$0.55**	$0.58	$0.60	$0.63
9%	$0.43	$0.45	$0.47	**$0.50**	$0.52	$0.54	$0.57
8%	$0.38	$0.40	$0.42	**$0.44**	$0.46	$0.48	$0.51
7%	**$0.33**	**$0.35**	**$0.37**	**$0.39**	**$0.41**	**$0.42**	**$0.44**
6%	$0.28	$0.30	$0.32	**$0.33**	$0.35	$0.36	$0.38
5%	$0.24	$0.25	$0.26	**$0.28**	$0.29	$0.30	$0.32
4%	$0.19	$0.20	$0.21	**$0.22**	$0.23	$0.24	$0.25

Calibrating pay to performance

The final requirement in aligning pay with performance is putting the pieces together and making sure that "how much" is reasonable given the measures and performance targets.

Neither boards nor shareholders like surprises. From a governance standpoint, boards have an obligation to understand how the incentive plan will operate at both anticipated and unanticipated performance levels. This is particularly the case if plan payouts are not capped.

Scenario Testing provides a basis for committees to understand the implications of actual payouts relative to performance. Payout levels against results should always be evaluated under a variety of potential performance scenarios. This testing often leads to discussions about the payout curve. A straight-line payout between threshold, target, and maximum is common but may not be appropriate in all cases. The question is: does performance that is halfway between threshold and target goals warrant half the payout? The answer is at the heart of the calibration discussion. In some cases, the answer is "yes," and the straight line is appropriate. In others, it is a decided "no," and the payout curve between threshold and target may look like a hockey stick with minimal payouts until performance nears target.

Cost-Benefit Analysis helps to quantify the relationship between aggregate payouts and the underlying value delivered to shareholders. Two common approaches are to measure incentive plan payouts (1) as a percent of net income or other returns, and (2) as a percent of incremental performance improvement (for example, year-over-year net income growth). Regardless of approach, it is incumbent upon a committee to understand whether the costs of the program and the selected performance goals are commensurate with the results for shareholders.

A note of caution: accurately benchmarking the cost-benefit analysis relative to other companies is very difficult, as there are significant differences between companies – even those in the same industry – in terms of organizational structure, staffing levels, pay mix, and incentive participation. Therefore, evaluating the cost-benefit is often a test of "reasonableness" rather than an exercise in explicit benchmarking.

A word about transparency

Transparency is one of the guiding principles for improving governance of executive compensation. This implies simplicity in design as well as comprehensive disclosure. Simplicity in design is a laudable goal but very challenging where the incentive plan is supporting complex business structures and strategies. A good test for whether a design is simple enough is if it can be communicated effectively – both internally and externally.

Boards should communicate openly with shareholders, investors, and employees when a plan is put in place and when payouts occur. The proxy statement provides the opportunity to discuss how the plan will operate, what the measures are (proprietary details need not be disclosed), and the potential range of payouts. After payout, the proxy statement should include a follow-up disclosure about the results and the payouts, and the company should consider a press release to provide context for the payouts. In fact, given the new Securities and Exchange Commission rules regarding compensatory arrangements, prompt disclosure of awards for named executive officers will be required. (For more information on the new SEC disclosure requirements, go to www.mercerHR.com/perspective and select the August 4, 2004 Special Issue *Perspective*.)

Summary

Performance measurement need not become so complicated that it cannot be addressed effectively in the boardroom. But delivering a relatively simple plan design with pay and performance appropriately aligned requires rigorous factual analysis supported by appropriate tools and healthy debate. Ultimately, this approach both enables a committee to meet governance standards and equips senior management to use performance measures as a more effective management tool.

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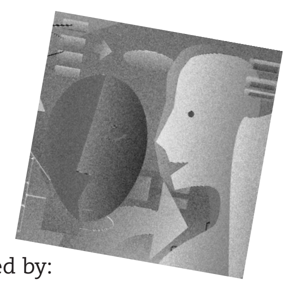

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