"Choosing & Using the Right Measures & Goals in Long-Term Compensation Plans"

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Guest Speakers:

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Opening Statement

Many companies are now adopting or considering adopting long-term incentive plans where value realized by participants is contingent on achievement of specific performance goals, which are often not stock-price based.

While these types of long-term incentive plans provide opportunities to focus management on results that will drive shareholder value, they don't come without significant risk of unintended consequences. Examples of unintended consequences include: choosing measures that do not lead to long-term value enhancement, that are not relevant to your company's current imperatives, or that can foster counter-productive behaviors; setting goals and calibrating payouts that ultimately over-reward mediocre performance, or conversely, setting the bar so high that motivation is weak and retention damaged.

The keys to making these types of plans work and avoiding the unintended consequences are well-chosen performance measures based on thorough analysis of your own value imperatives and thoughtfully set performance goals. Most companies have found this easier said than done, especially over multi-year performance periods where the potential payout size is large. The rewards for getting it right are great — a motivated, focused management team can make a real difference in intermediate and long-term results. But in getting there, lessons learned from those who have been there can help you avoid the pitfalls.

Moderator: Let's open the floor to your questions while we add some foundation context to today's event in the interim. Just type in your question above the HELP icon and click "Send" – it is that easy!

QUESTION

When should you have, or not have, a performance-based long-term incentive plan?

ANSWER

Roger Brossy: There are many reasons to consider a performance-based long-term incentive plan; that is, one with separate measures, not just fair market value stock options or restricted stock. These include:

(1) Philosophical: It provides rewards less dependent on the vagaries of the stock market,

(2) Practical: It makes restricted stock 162(m) tax deductible,

(3) Motivational: It helps focus management on key imperatives,

(4) Organizational: It allows focus on business unit value creation, not just corporate, and

(5) Conservational: It allows a company to use fewer shares in its approved plans.

Any company that is considering a performance-based long-term incentive plan needs to be sure that it has the ability to set meaningful and sound long-term objectives and goals, the ability to calibrate those objectives and goals in terms of what good and bad performance is, and finally, the ability to measure and track the goals. Putting in plans that will stand the test of time requires a thoughtful, analytical and business-based approach, and clear objectives for what you want to accomplish.

QUESTION

What are most companies typically trying to accomplish with a performance-based long-term incentive plan?

ANSWER

Rich Semler: At a basic level, a company may want to minimally meet the 162(m) requirement for tax deductibility, or it may have a real need to improve management retention. Both of these are not really performance-oriented. The performance-oriented plans either focus management on ongoing strategic objectives, or focus management on urgent imperatives.

QUESTION

What are your thoughts on the often heard issue that it is just "too hard to set 3-year goals" given our changing business environment as a reason to pass on traditional mid-year incentive or long-term incentive plan (LTIP) programs?

ANSWER

Roger Brossy: This is definitely a real issue. Relative growth measures answer it to some degree. In other words, tracking our total return to shareholders (TRS) versus a peer group shows how we deliver for shareholders relative to our competitors. Similarly, if we measure growth in revenue versus peers we are then tracking performance that accounts for the market conditions we and our competitors face. Beyond relative measures, the question becomes, "Are there standards of performance we should achieve over a multi-year period when the ups and downs of the economical cycle will more or less play out?" The answer is often yes in relatively mature industries, but in nascent or volatile industries it can be a "no". By standard performance, I mean that we might see an expectation that over a multi-year period the market expects to see 10% earnings growth from companies in our sector.

QUESTION

I thought 162(m) plans are always based on performance. What do you mean when you say a 162(m) objective is not always a truly performance-based plan?

ANSWER

Roger Brossy: A company may want to grant part of the long-term incentives to senior management as restricted stock, but to retain tax deductibility any long-term incentive has to have a performance component. Attaching a minimal performance requirement to the restricted stock in addition to a time vesting requirement makes the grant qualify for tax deductibility. The performance goal doesn't have to be a very hard goal to achieve; just one that the company might not achieve.

QUESTION

The right measures must differ to some degree by industry. Does anyone have tips on banking?

ANSWER

Rich Semler: In the banking industry, intermediate and long-term performance is generally best measured by a combination of earnings growth and return on equity (ROE), although attention must be paid to credit risk. While risk-adjusted return on capital (RAROC), which accounts for the statistical credit, operational, and other risks, is a powerful tool, the number of assumptions that go into its "black box" by nature often limit its usefulness for most banks. If you use ROE, you need to be careful to provide for adjustments in the event of new equity issuance or stock buybacks. In some cases, other factors that can drive value, such as non-interest income, can be used, although ROE helps account for this itself.

QUESTION

Can you provide examples of the types of performance-based plans to consider?

ANSWER

Rich Semler: Typically, we are talking about the following kinds of plans:

- Cash Performance Plan - which sets objectives for a two to four year period and pays out at the end in cash (or stock) based on goal achievement. A new cycle can start every year, or for high stakes focus and protection, cycles can be end to end.

- Performance Share Plan or Performance Restricted Stock Plan - which sets objectives, the achievement of which results in the vesting of the awards and a payout in stock, with the payout thus reflecting any change in the stock price over the period. This is accounted for much more reasonably under FAS123 (option expensing) than the old variable accounting.

- Performance Stock Options - largely a theoretical exercise, since they require so many shares and are often not valued by the recipients, but a favorite idea of the academic community.

QUESTION

Can you give some examples of urgent imperatives and the measures you should use?

ANSWER

Roger Brossy: Being saddled with a lot of debt as a result of having been spun off by a parent company – survival depends on reducing that debt, so you could put in a performance-based plan with cash flow goals. But you need to be careful that you are not constraining necessary maintenance and investment. Another example would be a company that is transitioning from a long period of very high revenue and earnings growth via acquisitions to a more mature company. You have a management team used to doing deals and a stock market that rewarded them for that, and now there aren't many good acquisition targets left, and the market is penalizing the stock price. A company in this situation probably has a lot of integration issues, so if that's the case, a performance-based long-term plan with a combination of a growth measure (earnings or revenue) and an efficiency measure (income margin or return on capital) would focus the management team on a different way of operating. You could put more weight on the efficiency measure, too.

QUESTION

Besides picking measures, what else should I have on a checklist to make sure I thought of everything to set up it up right?

ANSWER

Rich Semler: Well, as a start, the key items after you determine your objectives are the performance period and structure (i.e., overlapping or end-to-end performance cycles), the measure or mix of measures, how the measures (if there are more than one) are integrated, how much leverage will be in the performance goals and in the payouts, will there be any kind of cap on the value received by participants, what kinds of external events or changes you want to exclude in the evaluation process (those not reflective of true results or, in some cases, those outside of management control), how you want to evaluate the outcome (e.g., relative to your company's historical performance or maybe peer performance, or some industry standard). And, you must always anticipate the reactions of participants: will they be excited, motivated and retained, and how will they (or the Board) deal with changes in the environment (i.e. anticipate what can go wrong, and balance financial theory purity with practical human resources considerations).

QUESTION

We've got a plan proposal under discussion that uses the same metrics as our annual incentive plan (primarily earnings before interest, taxes, depreciation and amortization (EBITDA), along with a few operational measures) to determine award level for the LTI plan. The motivation is therefore to both perform in the short-term and drive stock price up over the longer term. I'm concerned that this is setting us up for unintended consequences. Can you comment?

ANSWER

Roger Brossy: Generally we would want to see if a long-term plan gives us a chance to balance out what might be carried to extremes in an annual plan. In your case, the question to focus on is "how will EBITDA over the long-term be prone to misrepresent our performance?" Private equity investors like EBITDA because it is good indicator of the operational performance of a business. But over the long run, a public company needs to be concerned about what it is delivering below the operational level. Specifically, are we returning on the capital employed? We could chew through considerable capital while kicking up EBITDA. Tax strategy (or lack thereof), interest expense and other factors are missed by EBITDA. Consider using some kind of return measure at the net level.

QUESTION

If you find that you have made one of the fatal mistakes in choosing measures, how do you "back out" and get yourself redirected?

ANSWER

Rich Semler: It depends on which fatal mistake you've made and at what point in either anticipating or actually experiencing the ill consequences you are encountering. If the plan is simply not paying out for reasons not connected to true performance, it's possible to suspend the plan and start over. If the plan is paying out too much, in many cases, the Board has the discretion to reduce payments, although this can be extremely controversial with management. If counterproductive behaviors are occurring as a result of the plan and it is impossible to suspend the current plan, we have found that a combination of management pressure, appropriate use of the annual incentive plan as a corrective measure, and an announcement of what a new LTI plan will be based on can reverse the situation.

QUESTION

Although it is not performance driven, in light of the Financial Accounting Standards Board (FASB) announcement about expensing options is there any future for or reason to continue an Employee Stock Purchase Plan (ESPP)?

ANSWER

Rich Semler: A number of our clients, including some who have voluntarily expensed already, have either cut back, suspended, or are seriously considering this for their ESPP. Given that typical usage is for 20%-30% of employees, and the expense is significant, other companies are willing to have the expense so far because of its favorable reception by employees, although they may be adjusting the look-back feature to contain expense.

QUESTION

What is the typical frequency of long-term grants and length of performance period?

ANSWER

Roger Brossy: The typical frequency is 3-5 years with a bias toward three and four. The basic idea behind this is that it represents for most industries a full business cycle and it is also an intermediate term between the annual incentive and the up-to-ten year term on a typical option. For management level and executive level participants it also represents a period in which the horizon is reasonable and therefore retention power is good.

QUESTION

Do you see plans using key measures from a 3-year strategic plan or, given the ever changing landscape, are you seeing more plans being built on the sum of annual business plan goals over a 3-year period?

ANSWER

Rich Semler: Most typically, companies are using 3-year strategic planning numbers or some kind of fixed metric of good performance (for example, 10% earnings growth, 10% margins). That said, in some companies, the difference between a strategic plan and 3 year's worth of budgets is difficult to distinguish. We also must note that most strategic plans we've seen are shaped like the famous hockey stick -- calling for the big recovery in the later years.

QUESTION

Are these performance-based plans exclusively measured on individual performance, company performance, or a combination of both?

ANSWER

Rich Semler: Typically, these long-term plans are thought of like stock options, although they may be based on a business unit rather than just corporate performance. As such, there is typically not an individual performance element in these types of long-term plans.

QUESTION

How often should the performance objectives for a long-term incentive plan be reviewed?

ANSWER

Roger Brossy: It is pragmatic to review them every cycle of grants. Sure, we'd like to design the architecture that is enduring and lasts forever, but the world changes fast. That doesn't mean they need to be changed every cycle, but they should be reviewed.

QUESTION

Other than stock options, what other viable long-term incentive plans would you recommend?

ANSWER

Rich Semler: The other primary long-term incentive plans today is a cash LTIP, which pays out after 2-4 years based on cumulative performance, and may payout partly in stock. We believe that performance share plans, which under FASB issued Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (FAS 123) are not subject to variable accounting for the stock price itself, and whose payout is a function of both the performance goals and the change in the stock price over the performance period will become much more prevalent under stock option expensing rules. While there has been a lot of academic interest in performance stock options, these are rarely used because they require a large number of shares and are not valued much by management.

There are few pitfalls to using cash. It is containable from a profit and loss (P&L) impact standpoint. If there is other stock-based compensation (options and/or restricted shares), cash can be an effective balance to pay what is driven off of stock price. This is particularly true in volatile stocks.

QUESTION

Can a measure be a performance goal indexed against other competitor companies?

ANSWER

Roger Brossy: Yes. But, there is one thing you need to keep in mind. Financial measures are fraught with problems because every company has its own reporting nuances about what will or will not show up in a particular measure, and the adjustments to create a level playing field are often complex and controversial. For that reason, we believe that total return to shareholders (TRS) is the only valid measure that is not subject to accounting adjustments or distortions.

QUESTION

Is it more common to see a single or multiple measures of performance in an LTI plan?

ANSWER

Rich Semler: You should use at least two, that way one will offset the shortcomings and unintended behaviors and consequences of the others; but not more than three or four, as the plan becomes too complex and it loses its ability to focus participants.

QUESTION

Interesting that you say that a typical grant frequency is 3-5 years. I've only worked at companies that do annual overlapping awards, and that is what our consultant is recommending now. Is there still a large minority that do annual grants? Discuss the pros and cons please…

ANSWER

Rich Semler: Typically, most companies make new grants every year, although the measurement period is 3-5 years. Some companies, where they want real focus on a corporate imperative, do not use overlapping cycles, but a self-contained period, which may be 2-5 years, which generates a much larger payout and more careful attention. We believe that, where the measures and goal setting is buttoned up and the performance imperative clear, the end-to-end cycle works better, but the risks of getting it wrong are higher.

QUESTION

For organizations that have LTIs, what measures are most prevalent?

ANSWER

SBCG: The two most common measures are some form of earnings (EPS, net income) and total return to shareholders, each used by about 35% to 40% of companies with long-term performance plans. The third most common is some kind of return (e.g., ROE, ROA, RONA, ROI) used by about 20% of companies, followed by some type of EVA/cash flow/economic profit used by about 10% of companies.

QUESTION

If we were to have a 3-year performance plan, should we have specific annual goals (leading to the optimal goal) with small payments in the first 2 years and the largest payment at the end or is it better to have the 3-year duration and then have a one and only large payment at the end? Also, would it make sense to have a financial threshold for payment (which could or could not be the same as for the short-term incentive) under which no payout would be made (even if the LTI goals are met)?

ANSWER

Roger Brossy: There is probably more context needed to give a full answer to this. But one question to consider is why you would need to pay in annual increments if you already have an annual incentive plan. (Sometimes when we transition into a new plan, we might make "progress payments" but that is a transition strategy). Obviously, the more you concentrate on the total award opportunity the more focus and direction you will get from participants. With respect to a financial threshold…yes, a financial threshold can make plenty of sense if the primary measure(s) being used in the LTI is operational.

QUESTION

We are located in a hot bed of innovation in high tech (Silicon Valley) but our product cycle is significantly longer (years vs. months) than the high tech companies. Yet, we need to compete for talent in the long-term incentive arena. By the way, we are also foreign owned and do not have stock options. We currently have a long-term cash incentive plan based on the achievement of specific drug development milestones; these milestones determine our success (we are a research division of a large pharmaceutical company). The LTI targets are based on biotech and pharma LTI targets...Are we on the right track? Do you have other advice/recommendations as to what measures and goals to use?

ANSWER

SBCG: It sounds like you have three tricky issues:

- First, you are a division of a foreign owned company without stock options competing in Silicon Valley where stock option wealth has been a primary talent expectation.
- Second, you are a research division, and long-term compensation for R&D functions is always complex and situational.
- Third, your current plan is based on drug development milestones and without knowing the exact nature of these; it is difficult to predict unintended consequences.

That said, I think there are a few issues for you to initially focus on:

1. You need plans with sufficiently achievement opportunity for meaningful payouts to attract and retain the research talent, so some form of LTI is probably necessary.

2. The payoff for a successful new drug can be huge, and it would be appropriate to explore methods of sharing in the ultimate economic impact of the drugs developed, either in the long-term plan or separately from it.

3. While drug development milestones are good indicators of what is moving through the pipeline, all potential drugs are not equal and you probably need to be careful not to cause an over-focus on less risky but ultimately less important new drug research.

Generally, I think you are on the right track, and need to balance having intermediate term payouts (such as classic three or four year LTI plans) based on milestones, with larger potential future payouts linked to the actual value created by new drugs developed. There are a number of ways it could be structured from some type of royalty payment to some pre-determined percentage of revenue or gross profit (potentially after a hurdle that addresses development costs). It could be a significant retention tool ("you have to be here to get it"). Structuring the large potential award to be paid out only if the drug is a hit could help to make such a program palatable to your parent company.

QUESTION

Although introducing a performance based plan seems the right step from a strategic perspective, what if executives prefer to delay implementation due to their lack of confidence in long term forecasting ability?

ANSWER

Roger Brossy: A sincere concern about forecasting ability should be heeded. We've indicated in some earlier responses that relative performance measures can be useful in some settings. Otherwise, management may be right and the ultimate arbiter of performance is share price appreciation as rewarded through options or variants thereof.

QUESTION

We are in a business (long-term care pharmacy services) for which there are few publicly traded companies of similar size. Therefore, relative measures are difficult for us. Any suggestions?

ANSWER

Rich Semler: There is no reason you need to have publicly traded peers to have a long-term incentive plan. In fact, many plans drive off of measures and goals of what is needed to enhance the value of your company with no direct reference to peers. You could base your long-term incentives on appropriate financial measures, etc.

QUESTION

Would this type of long-term plans be used in conjunction with options and/or time-vested restricted stock -- and, if so, how might you weight the different vehicles?

ANSWER

Roger Brossy: Yes, we believe that a mix of long-term incentives is appropriate. Top management should have a meaningful amount of opportunity in options because, their detractors to the contrary, options continue to be the most effective way to reward for the growth in investor value. But balancing this with the retention power of restricted stock and/or the focusing power of an intermediate long-term plan (units or shares) that is tied to performance measures provides an effective blend. We expect to see fewer options used for down-the-line managers and broad based employees...and to see more restricted stock used there. It is a more efficient reward tool, more consistent in its ability to deliver pay and becomes more or less accounting neutral with the advent of option expensing/fair value accounting.

QUESTION

In a cyclical, commodity business where management cannot control the price of the commodity and there is no ability to differentiate because it is a commodity, what long-term incentive measures have proved to be meaningful?

ANSWER

SBCG: There are several items to consider. First, can and should management be held accountable for "decomoditizing" the product (for instance, paper is a hard-to-differentiate forest product, but in a vertically integrated paper company, branded paper achieves a premium price). If so, consider building an incentive that recognizes pricing margin and brand penetration over several years. Second, if the product cannot be differentiated, is there something that can? (e.g., service, distribution, add-ons, etc). If so, focus measures on factors that get at performance in these areas and as a test, consider looking at relative growth vs. direct peers, which is, in the long-run, a good test for whether your efforts are providing an advantage in the form of gaining market share.

Absent these situations, a company can look to determining what the long-term drivers of success will be in both times of high and low prices. Businesses that produce commodities, such as oil and gas, or metals mining, are very capital intensive. Management could be measured on what they can control, such as cost per unit produced or return on capital. Reducing costs through structural changes in costs that don't affect long-term performance (i.e., a more efficient way to do something or a more efficient machine, rather than deferred maintenance), or making investments with appropriate return on capital will improve profits (or minimize losses) in times of low prices, and providing substantial profits in times of high prices. In addition, a company can consider some kind of earnings measure with partial neutralization for the commodity's change in price by the end of the performance period vs. the price when the goals were set. However, at the end of the day, recognize that when financial results are poor, shareholders suffer, and that LTI payouts cannot completely ignore these absolute results, even if not under management control.

QUESTION

Generally, how long does a company keep an LTI? If you have two to three long term measures that straddle years, over the course of say 4 years, does the plan effectively end in four years?

ANSWER

Roger Brossy: The most typical plans are as follows:

1. Annual, overlapping grants of three year cycles (continuing retention value, ability to reset if goals are off base but too many goals for most people to really keep track of),

2. End-to-end cycles of three years...so a new grant is made at the end of each three year cycle (lots of focus, easy to remember and communicate just a few simple goals but things go awry if the goals turn out to be off-base. Also retention power is nil the day a cycle ends),

3. Four-year cycles that start every other year. (This gives overlapping cycles and still allows goals to be reset...cycles are of course longer).

Those three are most typical, but other permutations can, and of course, occur.

QUESTION

For multi-year long term plans (e.g. 3 to 5 years) paid in cash at the end of the long-term period, are there any constructive receipt issues in the interim years before the long-term performance award payment?

ANSWER

Rich Semler: No, there are no constructive receipt issues since the award is not earned.

QUESTION

How prevalent are long-term performance measures that are not based on financial (hard) results? (another way to phrase this is, "How prevalent are long-term measures that are based on internal measures such as succession planning, business development activity, etc.")?

ANSWER

SBCG: Typically we see very soft and judgmental measures such as succession planning and business development activity as more appropriate for individual performance measurement. For most companies, individual performance is a factor of the annual incentive plan, not the LTI plan, which is a much more team oriented and is typically driven by company-wide results (think stock options). Softer and more individual measures or activity-based measures are simply weak foundations for the size of the payouts required to make a long-term incentive plan effective and motivational.

Generally, we believe that corporate or business unit focus for long-term incentives is appropriate, and that measures should be hard, but not necessarily only financial. There are certainly situations where non-financial measures like operational/productivity measures in a mono-line business, quality, or customer satisfaction merit consideration, all of which can lead to financial results. The risk is that anytime perceptions are involved, the measures become trickier and less reliable. Customer satisfaction is a classic example. The actual measurement of how customers perceive their satisfaction level is, of course, a pretty big industry and experts in it agree that is fraught with issues. These range from the nuances, such as the differences between those customers who will reply to a survey from the total body of customers, to the more blunt, like the recent utility case in California where it is alleged that employees were filling out customer satisfaction surveys that resulted in $28 million paid in customer satisfaction related awards.

The real issue in thinking about financial versus non-financial is to think about what drives shareholder value, and then to focus on whether those drivers can be reliably measured and linked to pay.

QUESTION

Is the opportunity to retest, that is having another go at a performance hurdle that has not been met, a common practice? Is this the preferred practice by 'blue chips'?

ANSWER

Roger Brossy: Under historic accounting rules where we set accelerated vesting in place as a way to get fixed accounting but still engineer a performance based plan, we often would set up plans where branches of restricted stock would vest as cumulative performance measures were achieved. If it was missed in one year, it could be made up in the next at yet a higher bar of performance. This approach is a good way to mitigate some of the business cycle volatility. But as we noted earlier, you would not want to provide for early payouts, i.e., in years one and two. Think about doing it in years, 3, 4 and 5. To pass a sanity check on shareholder value, make sure the bar is raised each year to reflect the next increment of required performance.

QUESTION

In your experience, what is the prevalence of long-term incentives in the “not-for-profit” sector?

ANSWER

SBCG: Many not-for-profits adopted some form of LTI during the 90’s stock market boom in order to compete with the stock option wealth being generated in the for-profits. Some of these were called phantom stock plans, although in truth they were simply a long-term cash incentive.

Developing meaningful long-term incentives for not-for-profit companies, as opposed to defensive retention vehicles, is often dependent on the clarity of the not-for-profit's mission and the definition of what success looks like in quantitative terms. Often, not-for-profits have membership constituencies whose primary interest is narrower or even at times in conflict with some of the classic value enhancing measures that long-term plans often use. Other times, the long-term measures of success and the contributions of the executive team to achieving that are difficult to quantify and may not be inherently suitable for a long-term incentive payout.

QUESTION

What are your thoughts regarding the outright grant of shares of stock with either a time-vesting or performance-vesting?

ANSWER

Roger Brossy: Our objectives would be very different for these two types of grants. Time-vested restricted stock is about retention with some additional affiliation or "common fate" value provided by the tie to stock price. Performance shares (also performance vested restricted stock) is about driving or focusing on performance and integrating the reward with share price. Using both might be appropriate, but again, very different purposes for each of them.

Rich Semler: Also, we think that time-vested restricted stock may become much more common at lower levels than it is today, and that performance shares will become much more common, perhaps along with stock options, at senior levels.

QUESTION

We are a privately owned company with 120 employees. We have four business divisions split up as developer, mortgage services, onsite property management, and energy service. How can we set up a LTI and what are the key measurements you suggest that are relevant for each division?

ANSWER

Rich Semler: Our experience with real estate companies is that there are two models: under one of which development, mortgage, or property management services are interconnected, and one under which they run very separately. To the extent that your business model limits the interaction of these units, you could consider long-term incentives for each. Generally, the issues for measures involve careful analysis of your specific accounting for these units, for example, the extent and type of derivate hedging in your mortgage unit, the value of stockpiled land carried at purchase price on your books in real estate development, etc., so that long-term performance measurement is not distorted. In general, real estate development and mortgage finance create value by a combination of adjusted earnings and return on capital employed, with risk accounted for. On the other hand, property management is largely an efficiency business, and energy service could be either, depending on how you run it.

QUESTION

Assuming a LTIP design has 2 components, is there an ideal ratio between what the value stock options would provide in a LTIP plan vs. performance units?

ANSWER

Roger Brossy: There is some art involved in this one. Two key dimensions to consider are:

1. Is the right answer different by level, and
2. How confident are we about our goals and measures – are they truly the measures that will drive shareholder value and are the goals stable and appropriate.

With respect to the organization level piece, options could be the more important element for the very senior management who are driving our ultimate company value. Performance shares can be a way to get a larger set of managers focused on the measures that are more immediately in our control (vs. share price). I do think when we look at CEO pay over the next few years it will still be unusual to see more than 50% of grant opportunity in the form of performance shares. I would be a concerned investor in corporate America if it becomes the case, because I would still want to see share price appreciation be a meaningful piece of total opportunity.

QUESTION

Could you address incentives for privately held companies? We have 300 employees and are solely owned by one person. What would you recommend based on this for a company with annual revenues greater than $100 million?

ANSWER

SBCG: Privately held companies, like not-for-profits, adopted long-term incentive plans as a defensive measure during the stock market boom, as employees were leaving for the lure of stock options elsewhere. The privately held company response can be grouped into two buckets - phantom equity and cash long-term incentive plans.

Phantom equity tries to mirror increases in market value that stock-based plans of publicly traded companies would otherwise provide (value that is substantially "paid for" by the market, including existing shareholders, but not the company). It is often problematic because a big increase in value (say, through multiple expansion) puts a big strain on the private owner. Specifically, the cash flow from operations probably doesn't come close to the potential payouts required under a formula-value or third-party valuation system where the market value is racing ahead of earnings.

The default to this is therefore a *cash long-term incentive plan* that is tied to goal achievement that is believed to drive shareholder value. This allows the payouts to be more contained and "within boundaries" that a market valuation approach doesn't have.

The issue for a privately held company can actually be clearer than for a public company, and we have seen some exceptionally successful long-term incentive plans at privately held companies. The reason is that the owner is willing to directly surrender some portion of his or her share of future profits to make the long-term incentive payouts, but does not want to actually surrender any ownership. One can often model incremental financial results to which the owner expects the executive to contribute, where the focus provided by the plan helps to motivate the executive to achieving the goals, particularly when the executive believes that the excess results generated to the owner are well worth the payout to the management. Much depends on the owner's view of the contributions of management and its ability to create this incremental value.

QUESTION

A lot of analysts look as cash flow per share as a primary measurement – is cash flow a better measure than earnings per share (EPS)?

ANSWER

Roger Brossy: It has the advantage of not being distorted by accounting measures like depreciation, and in the new world, fair value accounting distortions (like option expensing). It's good over the short-term as a performance measure when a company has an urgent need to raise cash, but over the long haul there is a risk that inadequate investment can impair long run viability of the company.

QUESTION

Many companies use EPS as a goal in long-term incentive plans. Why is this good, or not good? Is EPS growth better than net income growth?

ANSWER

Rich Semler: EPS growth has long been recognized as a factor that influences stock price performance. Its detractors point to the many accounting issues that make net income a fuzzy indicator of near-term performance. The chief difference between EPS growth and net income growth is that EPS is affected by shares outstanding, so it is affected by stock buybacks and issuances (including stock acquisitions and options). Net income growth shows real change in the earnings. Net income has its drawbacks – you can increase it by issuing stock for acquisitions, for example. The real issue is that neither of these speaks to the quality of earnings, like income margin or return on capital.

QUESTION

What are the advantages and disadvantages of having plans based on business unit performance vs. corporate performance?

ANSWER

Rich Semler: Most long-term plans are based on corporate performance, as this is a good place to unify the management team as a whole. It particularly makes sense if the annual plan is already taking into account business unit performance. It also makes it easier to transfer a participant from one business unit to another during the performance period. This is not as much of a problem in annual plans, but is a lot more trouble if you have three-year performance periods and overlapping cycles starting each year and you try to pro-rate the awards for three different plans. In addition, if one business unit has a history of poor performance and payouts, it's hard to get good people to go to that business unit. On the other hand, if you have very autonomous business units that are not very interdependent, then a business unit incentive can be a significant performance driver.

QUESTION

Are global companies being guided by the different accounting and expensing approaches [FASB and International Accounting Standards Board (IASB)] in terms of setting absolute vs. relative (market related) objectives? Different accounting measures and goals?

ANSWER

SBCG: The general principle amongst FASB and IASB is to create consistent and integrated principles so that reporting is as congruent as possible across country lines. In terms of measuring performance, it is important to document the accounting standards being used - whether they are U.S. Generally Accepted Accounting Principles (GAAP) or modified (and consistently applied) from GAAP. Expensing is another matter. If you mean expensing options – well that's a whole other topic that we expect to learn more about later today: FASB just released its proposal this morning.

QUESTION

Do different corporate governance approaches/rules in diverse countries significantly impact goals and measures selected by global organisations?

ANSWER

SBCG: No. The development of a cash long-term incentive itself is very affected by local customs, governance approaches, taxation rules in different countries, and even the country's view of large payouts. That said, most investors regardless of country are for the creation of enterprise value as the determinant of long-term incentive payouts. There are at various times in our experience different industry biases at work in different countries so that at any given time one country might be more focused on growth and another more focused on returns, but these are largely at the margin. In our view, these biases need to be balanced in the incentive plan in any case by a thorough exploration of what creates sustainable long-term value for your enterprise.

We have worked with a number of global organizations that successfully applied the same measures of value creation across many countries where it truly reflected their business results.

Certain features of the actual incentive plan design need to consider local tax law rules on deferred compensation, tax law rules on stock based plans, etc., which vary country by country, and which can affect the appropriate way to structure a plan for that country. Global organizations already deal with these differences on an exceptions basis in their stock and deferred compensation plans.

Moderator comment: We had better conclude today's chat with Rich Semler and Roger Brossy. We' like to thank them for their time and resources on helping us with your questions on various

LTI issues. Most of all, we'd like to thank you (Society members) for your participation today! We hope that you enjoyed this Society benefit.

Questions either inadvertently not addressed or not specifically answered during the real-time chat

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QUESTION

Could you describe an example of a goal that might reward mediocre performance?

ANSWER

SBCG: Any goal that is not fully analyzed in a variety of contexts and that turns out to be too easy. For example, if your target performance level is below the rate of inflation and/or below analysts' expectations and/or below the industry average, a full payout could be an issue.

We think that an adequate goal for a full payout needs to balance absolute performance with relative performance. For example, 15% earnings growth is typically quite good (absolute performance); however, in an industry where earnings are growing by 25%, 15% does not look so good (relative performance).

QUESTION

For a privately held company, how would you measure growth in asset value?

ANSWER

SBCG: Measuring growth in value for privately held companies can done in a number of ways, and can be fairly specific to the purpose of measurement or the industry. If a company wants fair value accounting treatment (for granting stock options), it will need to obtain an outside opinion as to its value. Typically such outside opinions are based on analyses of publicly traded peer companies, where some multiple of stock price to financial performance is determined for the company's industry (e.g., book value multiple, revenue multiple, earnings multiple, cash flow multiple), and then applied to the same financial performance measures of the company in question. In addition, a liquidity discount is often also applied to this multiple. In a situation where value does not have to be as precise, (e.g., for measuring performance in a cash performance plan), a company can use whatever set of measures it believes will lead to value or can historically or typically be shown to lead to value, and then calibrate the measures as it deems appropriate.

QUESTION

What are some "hurdles" or "obstacles" involved with starting up this type (long-term compensation) of program? If approved, who monitors the program, how frequently, and who approves final payment?

ANSWER

SBCG: There are two major hurdles — (1) choosing the right measure(s), and (2) setting and calibrating the goals vs. payouts.

Once such a program is approved and instigated, human resources in conjunction with accounting/finance usually monitors progress towards goals on at least a quarterly basis, and often on a monthly basis. Compensation Committees should be provided with updated actual performance vs. goals and estimated payouts on a regular basis at least once a year. Approval of final payments on an individual basis for senior executives and often on an aggregate payout basis for lower level executives and managers is typically done by the Compensation Committee and Board. In addition, there typically needs to be an audit trail of the calculations.

QUESTION

Do you advocate the umbrella type plans that several consultants recommend which have large payouts and use 162(m) allowable downward discretion to the real internal goal (goal adjusted for certain events beyond management's control)? Or just roll the dice with end-to-end cycles and try to set the goals and explicitly build in every conceivable event (beyond management control) that could materially impact results as an allowable adjustment?

ANSWER

SBCG: The umbrella type plan you describe is fine provided that there is a separate set of measures and goals that the Compensation Committee will use to actually determine how much that downward discretion will be. This second set of measures and goals is communicated to all participants, and it should be clear from such goals that the actual size of payouts is highly likely to be much smaller than the large payment suggested by the umbrella plan measure. Formula plans focused on real, expected results create a stronger focus, but need to be calibrated much more carefully.

QUESTION

What types of long-term goals are consistent with "enhancing enterprise value" for a non-profit organization in the public sector?

ANSWER

SBCG: The type of goal depends on the nature of the non-profit organization, as an increase in value is a function of the mission of that organization. In a university, an increase in value might be measured by increasing the size of the endowment, the academic standing, and the quality of faculty and students recruited, etc. In a credit union, an increase in value might be measured by growth in assets, soundness of credit, etc.

Such measures are very specific, and whenever possible should be quantitative; however, given the type of mission most non-profits have, these measures of necessity typically involve more qualitative assessments. As a result, they lend themselves less easily to large long-term incentive payouts.

QUESTION

Where do you start for picking performance measures for a long-term plan?

ANSWER

SBCG: You start with the company’s situation. Is it a young, high growth company, or a maturing company? How does it make money and what are the drivers of the business? (e.g., low margins with high volume; custom engineered products with high margins and low volume; product oriented or service oriented; rapid product obsolescence or household staple). Analysis of your own history and that of your competitors can help you determine what drives success (sustained shareholder value), and seeing what the analysts and investors are saying also can help. This forms a context for determining if a particular measure makes sense or not.

QUESTION

Are there any "rules of thumb" to make this measure selection process easier?

ANSWER

SBCG: First, you should probably have at least two measures so that the risk of getting unintended behaviors from one measure is offset by the behavior the other measure encourages. Second, don't have too many measures, usually three at the most. Last, it often helps to think of measures in three categories – stock price, financial, and operational. Stock price measures provide the least line-of-sight but the greatest shareholder alignment. Operational measures are just the opposite – great line-of-sight but potentially indirect shareholder alignment. Financial measures are somewhere in between. Stock price measures include stock price goals and total return to shareholders. Financial measures include franchise growth (revenue, sales units, market share), profitability (income, EPS, margins, cash), and capital returns (EVA, return on capital, return on investment, return on equity, return on assets). Operational measures include productivity, transaction or unit cost, quality, customer satisfaction, and safety.

QUESTION

How do you measure performance after an unplanned event occurs, like an unexpected but opportunistic acquisition or divestiture, or an accounting change, during the performance period?

ANSWER

SBCG: The best way is to set up in advance in the definition of the measure that for performance measurement purposes, such changes will be excluded. For most long-term incentives, it is important to provide for neutralizing the effects of unplanned acquisitions. One good way to do this is to adjust the goals based on the projections contained in the acquisition approved case presented to the Board — holding management responsible for what it promised.
