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Executive Compensation as a Support for a Growth Strategy



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With the continuing economic rebound, top-line growth once again appears as an imperative topping company agendas. In a recent poll of more than 650 CEOs, the majority selected sustained and steady top-line growth as their top concern (*USA Today*, 2006). Many companies have exhausted, or are close to exhausting, their options for taking out costs or realizing operating efficiencies as a means for driving profit growth. While growth through acquisition remains a viable alternative for many companies, acquisitions have inherent risks, and many fail. Ultimately, to ensure long-term health and viability, attention must turn to organic growth.

Successfully achieving top-line growth, especially organic growth, requires excellence in the development, deployment and execution of strategy. First, the organization must identify the primary drivers of future growth: Does success lie with the right product or service offerings, effective brand management and/or efficient distribution? (Burchman and Jones 2005.) Resources then must be positioned and managed effectively to support the strategy's key elements. Finally, the company requires the necessary capability — the right number, type and quality of people — supported by the right programs, tools, processes and technology (Jones and Hatfield 2005).

Effective execution also requires sustaining motivation and commitment throughout the organization to meet the established growth goals.

Compensation can be critical to building and sustaining motivation and commitment, as well as ensuring the required talent is available and focusing in the right direction. Compensation can ignite the discussion of and bring clarity to company goals and objectives, motivating people to take on a growth strategy and successfully execute it.

A well-designed executive compensation program can spur growth in two ways: Compensation can help a company attract the right talent to the key roles responsible for driving top-line growth. In addition, with the right leadership in place, incentive plan design can reinforce the growth strategies through performance measures and goals that influence corporate and/or business unit top-line growth.

Attract the Right Talent to the Right Roles

A first step in driving a growth strategy is to structure rewards in a way that favors roles integral to driving top-line growth.

Directing pay to positions with the greatest impact on a company's growth strategy requires interpreting external market data in the context of relative internal value. Executive roles with higher strategic importance in achieving the key elements of the growth strategy should be positioned higher versus the market.

Consider the following examples:

- ▶ The pay of individuals in high-impact roles might be positioned at the 75th percentile of the market.
- ▶ Roles with average impact would be positioned at market median.
- ▶ Roles with less strategic impact would be paid somewhat less than median.

In this way, limited compensation dollars are allocated in a manner that delivers the greatest opportunities to positions with the highest impact on growth.

The key is to assess a position's strategic impact using factors derived from the company strategy. While all company functions are important, certain functions and roles more directly impact how the business competes in the marketplace. For example, a discount, "big box" retailer like Wal-Mart thrives on supply-chain management. It would view positions with high strategic impact as those that ensure a supply of products on time and in the right quantities, negotiate the lowest possible prices from producers and ensure strict efficiency in packaging and delivery. In contrast, a high-end fashion retailer like Neiman Marcus would place a higher value on merchandising. Its strategic roles might include buyers and those positions that create product displays that tap into key consumer trends and entice consumers to purchase.

Companies can use a structured process to identify how different roles influence the different drivers of internal value. The overall internal value assessment then can be linked to target pay positioning. This approach to differentiating pay positioning can be tied to base salary, short-term incentives or long-term incentive (LTI) opportunities.

As an example, a consumer products company had major weaknesses in product development, causing it to seriously lag key competitors. Given that new products were fundamental to its growth strategy, the company had to attract and retain the best possible talent to bolster product development. Thus, it positioned pay for these positions at the 75th percentile. In contrast, all other jobs in the company were positioned at median market levels.

Directly Reward Top-Line Growth

The most straightforward approach to aligning compensation with growth objectives is to make revenue growth one of the principal metrics for determining short- or long-term bonuses. However, one needs to use care in adopting revenue growth as a

bonus determinant. Too much emphasis on top-line growth can lead to unintended consequences. The result could be growth for growth's sake, without regard for whether or not that growth is profitable. For example, a company could pursue short-term pricing advantages to bolster unit growth and revenues with disastrous consequences for longer-term profitability. Too many acquisitions fail to grow profitably because they were made either at too high a price or without the needed synergies to realize adequate returns.

Balance Top-Line Growth and Profitability/Returns

To avoid these types of unintended consequences, it is important to properly balance top-line growth and profitability—and possibly ROI (return on investment) — in compensation program design.

One means for achieving this balance is to combine growth and profitability metrics in an incentive payout matrix (See Figure 1). A matrix makes the tradeoffs between growth and profitability both explicit and transparent. These tradeoffs can be adjusted to meet the

needs of the business at a given time. For example, the emphasis can tilt more toward top-line growth or bottom-line profitability as the business needs require.

An aerospace company with multiple business units effectively used a matrix approach to spur growth. Management wanted to encourage new thinking and innovation in its now-mature business units. While the company's returns led the industry due to strong operational effectiveness, growth had stagnated. In the past, incentive plans had rewarded returns handsomely. While the company still wanted to encourage high productivity, it knew the emphasis needed to change. Otherwise, the businesses would milk themselves into obsolescence. So the company developed a matrix of revenue growth and operating profit margins and "tilted" the payouts to reward incremental growth more significantly. However, growth that did not exceed a certain profit margin resulted in limited or no payouts.

A performance multiplier provides an alternative approach. A performance multiplier allows a company to calculate its bonus pool based on metrics such as

FIGURE 1 Illustrative Incentive Matrix: Payout as a Percentage of Target

Revenue Growth	Operating Profit Margins					
	<10%	10%	15%	20%	30%	40%
0%	0%	0%	25%	50%	60%	70%
5	0	40	55	70	90	100
10	0	50	70	85	105	115
15	0	60	85	100	120	130
20	0	80	100	115	135	145
25	0	100	120	135	150	165
30	0	120	140	155	175	190
35	0	140	160	175	200	215
40	0	160	180	195	225	240
45	0	180	200	220	250	265
50	0	200	225	250	275	300

earnings growth and/or ROI. The results can then be modified up or down based on absolute growth targets or top-line growth relative to peers.

As Figure 2 on page 43 shows, companies can provide such performance “kickers” based on absolute or relative performance. In either case, the first step is to evaluate performance on a core metric, such as earnings growth (as shown in the example). Once performance has been determined, the kicker can reward actual results or relative performance.

“Step 2 (Alternative A)” in Figure 2 illustrates the performance multiplier a consumer products company used to emphasize growth. The company’s primary bonus plan metrics focused on earnings growth. However, if revenue growth goals exceeded targets, executives were awarded a “kicker” that added additional dollars to their bonuses. In “Step 2 (Alternative B),” the multiplier is based on relative growth versus peers. As with Alternative A, the rewards for reaching maximum can be rich, making the journey well worth the effort.

The matrix is intuitive and allows for shifting the emphasis to meet business needs. The growth multiplier gives a sense of something more to strive for, but can add complexity to the calculation. Either can help balance top-line growth with profitability and returns.

Incorporate Key Drivers of Growth to Provide Line of Sight

Sometimes measuring top-line growth directly appears too far removed from the activities that executives and managers control in their jobs. This can be especially true for business unit executives. Examining the drivers of growth can sharpen the focus (Burchman and Jones 2005).

As a first step, growth goals can be allocated to the business units and product lines to create more direct line of sight for individuals and greater accountability throughout the organization for achieving the top-line growth objective.

The next step is to identify the most critical elements of the growth strategy, the measures of success for those elements, and the teams and functions that impact those measures. It can also be instructive to determine where accountabilities for growth are shared to make sure that key parts of the organization are working together to optimize growth. A “value tree” can be a useful analytical tool for tracing the line of sight from employee accountabilities to the drivers of growth.

Value trees can extend throughout the organization to pinpoint critical measures for each department or function. The drivers may be financial or strategic/operational. The latter generally includes determinates of customer value, measures of the system and process effectiveness, the strength of organizational capabilities and the ability to sustain performance.

Figure 3 (page 44) provides an example of a value tree. Based on this value tree, the consumer products company previously discussed decided that its primary path to growth was in product innovation. As shown in Figure 3, key employee groups united under a series of objectives designed to drive innovation. The executive team’s goals focused on new product development, measured by market share and the percentage of revenue derived from new products. Measures for the product development management team included development cycle time and three-month/six-month penetration of new products. The distribution management team shared these measures, bringing clarity and cohesiveness to the entire management team.

The measures can be incorporated into the core incentive program or into a special incentive that either supplements or replaces any existing incentive compensation programs. For example, a direct marketing company established a milestone bonus pool. The achievement of key financial goals (e.g., revenue goals, margin goals and profit or cash-flow goals) and nonfinancial goals (e.g., product volume, establishment of systems and infrastructure)

FIGURE 2 Two Views of a Revenue Growth Multiplier (Performance Multiplier and Relative Performance Multiplier)

STEP 1: Evaluate performance on core metric (in this example, earnings growth)

ACTUAL EARNINGS GROWTH

PERFORMANCE LEVEL	EARNINGS GROWTH	INCENTIVE AS A % OF BASE SALARY
Maximum	15%	60%
Target	10%	30%
Threshold	7%	15%
Below Threshold	Below 7%	0%

PERFORMANCE MULTIPLIER

STEP 2 (Alternative A): Modify based on *absolute* revenue growth

ACTUAL REVENUE GROWTH

PERFORMANCE LEVEL	ACTUAL EARNINGS
Maximum	15%
Target	10%
Below Target	Below 10%
COMPANY	15%

PERFORMANCE MULTIPLIER
(Enhancement only if revenue growth is at or above target)

Guideline	Award Multiplier
Maximum	1.5x
Target	1.25x
Below Target	1.0x (i.e., no adjustment)

Final incentive award = 30% x 1.5 multiplier = 45% of base salary

RELATIVE PERFORMANCE MULTIPLIER

STEP 2 (Alternative B): Modify based on *relative* revenue growth

ACTUAL REVENUE GROWTH COMPARED TO PEER GROUP

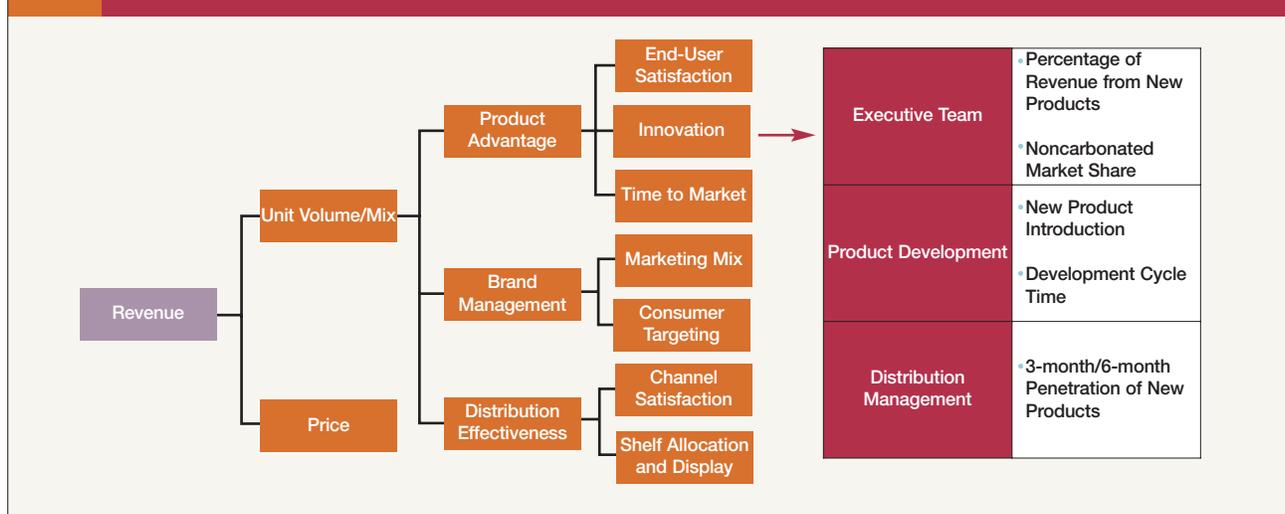
PEER GROUP	THREE-YEAR AVERAGE REVENUE GROWTH	
Company A	14.2%	75th
Company B	12.9%	
Company C	10.5%	
Company D	7.3%	50th
Company E	4.5%	
Company F	2.7%	
Company G	2.2%	25th
Company H	1.9%	
Company I	1.7%	
Company J	0.3%	Unsatisfactory
Company K	0.2%	
Company L	0.1%	
COMPANY	13.6%	75th

RELATIVE PERFORMANCE MULTIPLIER
(Enhancement only if revenue growth is at or above competitive median)

Guideline	Percentile Ranking of Revenue Growth in Peer Group	Award Multiplier
Maximum	75th	1.5x
Target	50th	1.25x
Below Target	Below 50th	1.0x (i.e., no adjustment)

Final incentive award = 30% x 1.5 multiplier = 45% of base salary

FIGURE 3 Value Tree to Identify the Drivers of Growth



funded the bonus pool. A portion of the pool was paid as milestones were achieved, but payments were “back-end loaded,” reserving most of the pool for rewarding successful product development.

Use the Right Measurement Timeframe

Selecting the right measurement timeframe is a critical success factor in rewarding top-line growth. Cost cutting is largely under management’s control, and thus tends to lend itself to shorter measurement timeframes. Growth initiatives, by their nature, are heavily dependent on customers’ decision-making, and consequently involve longer lead times and higher levels of uncertainty.

Companies must consider whether annual and/or long-term incentive (LTI) plans or some sort of special incentive are most appropriate for addressing growth initiatives. Many companies measure top-line growth in a long-term incentive plan, while focusing on key drivers in their annual incentive plan. For example, a recruitment firm had a record of growth but knew that for long-term success, it had to grow faster than the competition. Therefore, the company focused on strategies designed to outpace the competition and steal market share. Because these strategies would take

several years to achieve, the company included specific growth metrics in its long-term performance share plan and incorporated drivers of growth in the annual incentive.

Similarly, a subscription-based business established a long-term goal of top-line growth and drove that goal through annual incentive metrics targeted to the various functions. For example, annual incentive measures focused on acquiring new subscribers, reducing churn and selling a broader range of new features to customers. Success in these measures would grow the top line in the longer term.

Given the greater uncertainty associated with the payback period on growth initiatives, companies may want to build added flexibility into the pay design. Additional flexibility can take the form of a “catch-up” feature allowing participants to re-earn incentive amounts if goals are achieved later than originally anticipated. However, catch-up features must ensure that cumulative results and ROIs adequately offset the longer, required timeframes. For example, a Midwest manufacturer incorporated a catch-up feature in its performance share plan. The company put a stake in the ground about its ultimate performance target, but recognized that it could take a few years to reach it. So the performance share design allowed participants two

years of opportunity to earn the shares (i.e., if the shares were not earned after a two-year performance period, participants had an additional chance to earn them in year three if the ultimate targets were reached).

Set Goals with Adequate Stretch

A final consideration in rewarding top-line growth is to understand what is “doable” based on both internal and external benchmarks. This involves looking at goals from the top-down and the bottom-up.

A “top-down” perspective examines what is required to meet shareholder obligations. For example, a company can examine its success in past growth initiatives and establish internal benchmarks. External benchmarks consider the experiences of key competitors in the industry or “best in breed” companies in other industries, within the sector or in other sectors. Ultimately, growth objectives should be sufficient to meet or beat top-line and bottom-line market expectations for the company and the industry.

A “bottom-up” view in goal setting focuses on organizational capabilities — the performance improvements each business unit or function can practically deliver to achieve desired results. This perspective examines the key strategies and drivers of growth to determine how much growth the organization can deliver. For example, the subscription-based business previously described focused on acquiring new subscribers, reducing churn and selling a broader range of new features to customers to achieve its growth objectives. It benchmarked each of these factors against median and top-tier industry performers as well as looked at its top-performing regions in order to set objectives for each measure.

These two perspectives are then reconciled to determine what the company will do. Thus, the organization can establish goals that are sustainable, achievable and have adequate stretch.

CEOs focused on organic growth need to plant the right talent in the right roles and nourish that talent with an enriching, results-oriented executive compensation program. The program should drive revenue growth through annual and long-term metrics that also balance top-line growth with profitability and returns. An individual’s impact on the drivers of organic growth must be made tangible for all participants, and the rewards must come at meaningful intervals. Finally, goal setting needs to be as organic as the growth desired. Goals should marry two perspectives — what is needed to meet shareholder obligations and what is practical given organizational capabilities. In the end, organic growth is all about proper cultivation.

Self-Assessment

To determine how a company might use compensation to drive its growth strategy, consider the following:

- ▶ What are the anticipated sources of future growth:
Acquisitions? Brand extensions? New product lines?
- ▶ How will different parts of the organization and different roles contribute to this growth?
- ▶ What positions have the greatest impact on the growth strategy?
- ▶ What are the new behaviors that should be encouraged through new and/or revised incentive plans? How will different units need to work either independently or collectively to achieve these goals?
- ▶ How will it be known when growth goals are being achieved? What metrics are being used?
- ▶ What are the barriers to accelerating top-line growth?
- ▶ Is the compensation program currently an enabler of growth, neutral or a potential barrier?
- ▶ Is an additional investment in growth-oriented compensation anticipated, or would funds from existing programs be reallocated?
- ▶ Where are pay for high-impact positions, average impact positions and positions with lower impact placed?

The answers could reveal that a key strategic lever — namely pay — is being underused. With the right program in place, those top-line growth projections may be only a few performance cycles away. **WJ**

Resources Plus

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