Executive Compensation

What to Expect From Your Pay Consultant

By Roger Brossy and Blair Jones

Consultants don't provide their most valuable service in the form of answers to tough questions. They do so by posing the tough questions in the first place. While compensation committees need answers about compensation data and pay program design, they will get more value by expecting their consultants to act as thought partners.

A productive advisory relationship develops when consultants and directors treat compensation as a management tool. Directors should expect consultants to understand corporate strategy, identify performance measures and designs to support that strategy, know how those designs may conflict or align with shareholder needs, and fashion a pay program that navigates the differences. Here are the top five questions consultants should lead directors to explore.

What Should the Pay Plan Accomplish?

A plan that doesn't motivate executives to work differently is a plan stuck in neutral. A plan that drives executives to distinctive outcomes is one in high gear. A good pay advisor will help you choose measures, weightings, and vehicles deliberately.

A building products company, for example, had a standard pay program featuring sales and earnings growth as measures. The problem was that even with good results on both counts, the stock was not rising. The board's pay advisor pointed to weak returns on capital. Meetings with investors confirmed that their biggest concern was that returns didn't exceed the cost of capital. To ensure growth that created shareholder value, the board approved a new pay component that paid out only with higher returns.

A retailer also had a program measuring sales and earnings. In contrast, however, the worry was that as executives built outlet stores—for which they were paid well in restricted stock and options—margins declined even as sales and earnings grew. Although the plan stimulated growth, it was the wrong kind. It also diluted the brand. The advisor's analysis of the opportunity to better align the pay program with stated strategic priorities helped spur deep conversation with the board and management. A new program aimed at increasing growth in global sales, average daily transaction value, and luxury store openings improved margins and spurred a restoration of the brand to its luxury-store roots.

Consider how the plan drives individual or team accountability, what the current circumstances require, and how the pay plan design can help drive alignment between these two elements. An auto manufacturer, for example, had a long-standing strategy that challenged each region to operate and perform independently. For a time, the individualized approach made sense: the Asia-Pacific region focused on growth and market share, while the North America region focused on quality, cost containment, and cash flow.

But as supply chains became more integrated, and as product innovation priorities converged, the consultant began discussions with management noting that executives working together would boost company fortunes faster than working for their region alone. The company shifted the weighting of its pay plan measures to stress global metrics. That helped validate a new culture and the best path to value creation.

As the experience of each of these companies shows, just as company strategies for creating value change, so should compensation programs. Pay advisors can help raise the right questions at the right times, allowing directors to get the most from their consulting relationship.

Where Are the Land Mines?

Your pay program may have unintended consequences, such as sending ill-advised signals, creating inappropriate payouts, and other land mines that an outside advisor could spotlight.

A retailer with aggressive growth aspirations wanted to weight comparable-store sales heavily in its pay program. Conversations with their consultant highlighted that the measure, though commonplace, risked motivating executives to do the wrong thing: boost total sales while hurting profitability by maintaining unprofitable stores, pursuing excessive promotion, and giving away inventory. How could the company avoid the consequence of overzealous—and unprofitable—growth? The company added an overall margin measure in comparable-store sales. That adjustment motivated executives to expand briskly, but only so long as they grew profitably.

A high-end apparel maker had a pay program that stressed aggressive earnings growth. The pay advisor, however, identified a problem: more than half of the incremental growth was paid out to executives. This was a land mine buried in an otherwise sensible program. Shareholders would think the payouts unreasonable, and the company could anticipate proxy season criticism. The company reworked its plan to create fairer sharing of gains.

Such cases point to the need for directors and consultants to ask, Does compensation balance the provision of good value to shareholders and good pay for management? Has the committee rigorously tested the factors that concern investors and could have unintended consequences?

How Will Investors Respond?

A big mistake is to get through a say-on-pay vote and overlook criticism that could be lost amid noisy feedback. Directors need to look deeper. Is your advisor asking, "Are we sure this is what investors want? Let's go talk to them." Often, nuggets of insight emerge in investor conversations.

A high-tech defense contractor had a program that rewarded executives for boosting productivity. That gave the company a persistent cost advantage, but over time, share-price gains stalled. When the board met with shareholders, directors learned why: investors believed high productivity was priced into the stock, and they sought growth to drive the next leg up in the stock price.

With help from its consultant, the company explored the relationship of multiple possible metrics to shareholder returns. The company ultimately introduced cash flow and sales growth to its incentive programs to demonstrate the wherewithal to invest in growth as well as growth itself. In time, the company rose from the bottom third of its peer group to the top third in total shareholder return (TSR).

A medical supply company in a turnaround wasn't performing at historical levels and was worried about executive retention. Peer group pay and performance comparisons used by the proxy advisors showed misalignment. The board's pay advisor suggested the company consider shorter-term pay limitations coupled with a longer-term transformation plan that would pay out more generously once turnaround objectives were achieved. This solution aligned the fortunes of management and shareholders. Shareholders also had confidence that executives would not be overpaid for lagging performance, but they would still be encouraged to hit turnaround goals and improve earnings step by step.

Directors can expect their consultant's help in deciphering investor feedback and navigating solutions that match investor preferences and business imperatives.

Does the Plan Respond to Market Trends?

Boards want to ensure they don't fall behind as the world of executive compensation changes. For example, boards are now concerned with clawbacks, gender pay equity, and appropriate long-term incentive measures, among other concerns.

A pay advisor can elevate the conversation beyond following the crowd: How should the clawback provision be constructed to take account of losses that aren't reflected in the current numbers and losses to the company's reputation—all while targeting the right people and not hurting the wrong ones? What needs to happen culturally to prevent the clawback from needing to be applied in the first place? What is the best process for the board's involvement in discussions of pay equity across the organization? To what extent are pay issues more about representation than pay? What are investors really asking for when they focus on return on invested capital or relative TSR? How can the metrics in both the annual and long-term incentive plans be designed to work together and best move the needle on both outcomes? Your consultant can help you separate the substance of trends from the idea *du jour*.

When Should We Instigate Change?

Committees often wait a year too long to act, thinking they can eke out 12 more months with the current model. They do so at their risk. A good idea is to conduct an annual review of the pay program and its philosophy, metrics, and incentives. Is the program delivering payouts without signaling to executives which fork in each strategic road they should be going down? If so, expect your consultants to help you rethink your program.

One practical approach is for the compensation committee to hold a meeting in tandem or right after the board's annual strategy meeting. Directors can then better reflect on the philosophical approach to rewards, who is being rewarded, and the range of outcomes. Your consultants will be especially helpful in serving as the outsiders who see when to flip the switch of change. They are often able to play the critical role of "calling the strategic question."

Directors who have not recently revisited the rationale for their pay program may realize that the compensation discussion is the tail that wags the strategy dog. As the burden of responsibility for the effective structuring of incentive pay grows, directors can expect consultants to ask questions that get to the heart of pay program as both a management tool and shareholder communications device—and those questions will assure that you are getting the most out of your pay consultants as business partners.

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