You gets what you pays for

Executive pay is a sore topic for many people. But while styling the perfect remuneration strategy is incredibly tricky, that doesn't mean we shouldn't try. **Nigel Mills** goes back to basics with a framework for getting it right

Since the start of the global financial crisis in 2008, executive remuneration schemes have been subject to intense scrutiny by the government, the media and the public. Pressure from stakeholders has caused many organisations to implement performance-related pay schemes that encourage long-term sustainability.

Few companies get to devise the perfect incentive scheme from scratch. A remuneration consultant is often brought in when a problem with an existing set-up gets out of hand. But a realistic plan for many is to aim for "as good as you can".

But what do we mean by "remuneration strategy"? Simply put, it should be the breakdown between the various remuneration elements in the compensation packages for the executives and employees that make up the workforce of the business concerned. The diagram, above right, depicts the various components of an executive remuneration structure, although in most situations not all these components will be offered.

FIVE OBJECTIVES

Those are the components – the easy bit. But what about the objectives for an executive remuneration strategy? That's more complicated. It should:

- Motivate executives to achieve, and hopefully to exceed, performance targets – within the accepted risk parameters of the company.
- Enable the company to retain its key executives. They must see a good probability of targets being achieved, for example. If the company has been doing well, executives should have accumulated deferred bonuses and long-term incentive plan (LTIP) awards, which are likely to vest over the coming years. Un-vested, in-the-money awards act as handcuffs on successful executives.
- Enable the company to attract high-calibre executives from other companies. It might be acceptable to recruit one person on a one-off package, but consistently having to pay higher remuneration to external hires is evidence that the incumbent executives' pay should be increased – or it might raise questions over the competence of the existing management.
- Allow executives to be "let go" at a reasonable cost in the event that they fail to make the grade. It might also be important to have appropriate non-compete and anti-poaching clauses in their employment contracts.
- Involve total costs acceptable to shareholders. Levels of salary should not be excessive. The costs of bonuses and long-term incentives measured as a percentage of profits, cashflow, turnover, increases in shareholder value (and other appropriate metrics) should not be excessive. Nor should benefits and pensions. Inevitably, different stakeholders will have different views on what "excessive" is.

THREE QUESTIONS

Clearly, we also need some definitions – of terms such as "excessive" and "long term" if we're going to meet those objectives. So a remuneration strategy

REWARD COMPONENTS

EXTRINSIC Things to which we can assign a monetary value	Base cash	Date coverage begins	**TOTAL CASH**
		Cash pension allowance	
	'Bonus	Cash bonus	
		Deferred bonus	
	Long-term incentives	LTIPs	**TOTAL DIRECT COMPENSATION**
		Options	
		Restricted shares	
	Benefits	Pension	**TOTAL DIRECT REMUNERATION**
		Health insurance	
		Life insurance	
	Perks	Cars	
		Contracts	
		Clubs	
		Counselling	
INTRINSIC	Other non-cash rewards	Quality of work and life	**TOTAL REWARD**
		Affiliation	
		Development scope	
		Achievement and self-esteem	
		Power	

also has to answer the three questions:

- What is the company paying for? The choice of performance measures is at the heart of the debate on pay for performance.
- How much? Benchmark remuneration data can help, in particular for base pay and benefits, but also with levels of incentive plan pay-outs. Different types of business need to approach this part of the package carefully because incentive pay has to be affordable to the business and its shareholders.
- When should it be paid out? Salary and benefits have to be paid in real time; pension should also be funded as you go along, ideally in a registered pension scheme, which cannot ultimately be paid to the beneficiary until after retirement. It is the different incentive plan design structures that can provide some flexibility to the employer as to when this part of the package should be paid out.

In most situations, the executive incentive plan is based on a combination of an annual bonus plan and some form of long-term incentive arrangement. A key issue is the balance between these two components and upon what (performance) criteria each should be based. A further key decision is whether there's an opportunity to reward executives with shares in the parent company, either as part of the annual bonus plan or as part of the long-term incentive.

CAAARRS

The answer to those questions can be found in a useful acronym: CAAARRS – communicate, achievements, affordable, acceptable, recognition and reward success.

An incentive strategy should communicate to participants what is expected of them, over both the short term and the longer term. That's critical. But to do so, you need the other elements – the things to be communicated.

That starts with what achievement(s) are being targeted for that particular participant – they must be relevant to the executive concerned. And he or she needs to believe that their efforts and actions

> An incentive strategy should communicate to participants what is expected of them, over the short and long term

can influence those achievements. For example, the annual bonus plan for the chief executive and the other executive directors may be telling them that the key focus is to increase group profits or return on capital employed or operating margins or cashflow. For those not sitting on the board the annual incentive plan may be telling them that the key focus is on divisional sales or profits – or possibly expansion into new markets.

The finance function has an important role to play in setting those achievements – and the hurdles needed for the incentive to pay out. It also has a duty to ensure the plan is affordable to the business and acceptable to shareholders. As part of the

MATCH THE REMUNERATION SCHEME TO THE BUSINESS

TRADITIONAL PRIVATE COMPANY	TRADITIONAL LISTED COMPANY	ALIGNMENT TO SPECIFIC STRATEGIC FOCUS	RECOVERY	START UP
		May assume growth strategy with major capex in early years		
Market median salary	Market median salary	Market-based salary	Salary and bonus must be adequate to recruit and retain. Bonus likely to be low compared to market	Conserve cash, so low salaries and negligible bonuses
Generous bonus potential paid in cash after year end	Median bonus potential with part deferral into shares	Lower bonus		Lots of equity and share options
Relatively small annual share option or long-term investment plan (LTIP) award with absolute financial targets, vesting after three years – often based on phantom shares	Annual LTIP award with three-year relative total shareholder return (TSR) or absolute earnings per share (EPS) targets to provide upper quartile opportunity	One-off LTIP award with three- to five-year timeframe. Based on a mix of absolute financial and relative TSR measures. Reward emphasis is on LTIP with large payout if successful.	One-off LTIP for key executive team – to vest half after three years half after five years. LTIP structure typically gives management 10% to 20% of upside	Salary and bonus increases only when cashflow is OK
Generous pension	Pension			

budgetary process, the finance function should model the cost of the incentive plans, from both a P&L and from a cash cost perspective under a number of "what if" scenarios, starting with "on budget" performance.

Where the incentive plans involve some form of share (or equity)-based element, the cost in terms of equity dilution for existing shareholders should also be modelled, as should the P&L cost incurred under IFRS2 (or, if relevant, FRS20), *Accounting for Share-Based Payments*.

Of course, what is affordable and what is acceptable to shareholders aren't always the same. It will depend on a number of factors relating to the type of business it is and at what stage of development it is (see box above right).

That leaves us with RRS – recognise and reward success. Clearly if the level of achievement is below threshold, there should be no pay-out under the plan for that participant. On the other hand, if the actual level of achievement is at the upper end of the performance matrix and falls within the "exceptional" category, then the amount of reward and recognition should be at the maximum level as allowed for under the plan. Common sense, really.

There should be no surprises for the employer or for the employee when it comes to pay-out time

The watchword here is "no surprises". There should be no surprises for the employer or for the employee when it comes to pay-out time. That's why the communication component is so important. There should be no surprises for shareholders either.

A TALE OF TWO BUSINESS MODELS

When you're designing or revising an incentive package, it is also vital to understand the model and the financial dynamics of the business, as well as its long-term strategy. To understand why, let's take a look at two examples.

The first is a profitable, family-owned manufacturing business with no members of the family in the management team. Turnover is £30m, EBITDA £5m. The family shareholders want a growing dividend stream – but they would accept an offer for the business if someone would pay a premium price.

A reasonably steady-state business would suggest a fairly balanced remuneration package for management. For the key executive team – eight to 12 executives, say – salaries would be at the median of the market. One would expect to see the annual base salary as the largest single element of the remuneration package, even for the chief executive.

The annual bonus opportunity would be in the range of 25% to 40% of salary for on-target performance and twice that amount for maximum performance. It would typically be a cash-based plan that

FAST GROWTH	PRIVATE EQUITY-BACKED COMPANY
Reward strategy may be similar to start-up or strategic alignment	Market salary and pension
Method to create value may be linked to sale to third party	Small or zero annual bonus potential based on progress, especially cashflow/profit targets
	Tax-effective sweet equity (shares issued after a PE deal). Highly geared. Nil if threshold not achieved. Can ratchet to 20% + of equity. Only pays out on exit

BONUS BUILDER

Setting bonus plans is always tough. They rely on getting the targets just right – and keeping people motivated over time.

A good annual bonus plan will normally have a sliding scale of payouts and be linked to a percentage of salary. The most senior executives might receive 40% of their salary for on-target performance, but with the opportunity to receive 80% of their salary (capped) for exceptional performance. The next tier down may receive say 25% of salary for on-target performance and 50% for exceptional performance.

So it's vital the plan communicates what is considered to be on-target achievement (usually something good, a bit above budget) and what is exceptional. Executives need to believe in the target-setting process and that even the exceptional level of achievement is possible. There is little point in setting targets that executives simply do not believe in.

For the LTIP, the plan should communicate the key focus or the key performance indicators over the longer term, which could be three, four or five years. These might be to increase earnings per share, for example, or total shareholder return over the longer term; or they could be to provide a profitable exit for existing shareholders by way of a trade sale or IPO.

would pay out in full, dependent on the achievement of the performance criteria, with no deferral, within three months of the financial year end.

The long-term incentive should reward the team for growing the value of the business (as reflected in its dividend yield) over the longer term. It could follow a number of different design structures, but would most typically involve annual grants of share options or phantom performance shares that vest three to five years later, also dependent upon the achievement of pre-set performance criteria.

In many private companies of this sort, the family is unwilling to allow executives to own any real shares in the business. If this is the case, the long-term plan may be based on phantom shares, which are valued based on a formula that should be linked to the real value of the business.

It may be appropriate in this case to value the phantom shares on a yield basis reflecting the emphasis on the dividend stream. If the business was eligible to implement an HMRC-approved enterprise management incentive (EMI) plan, it should do so. EMIs are tax advantaged share option schemes.

As an alternative, let's consider a private equity (PE)-backed business, highly leveraged with sales of £200m and EBITDA of £35m. Long-term strategy for the PE house is an exit by way of trade sale – ideally within five years – after growing EBITDA to £60m. Different PE houses have widely different approaches to remuneration strategy. The remuneration package for the team in this example – typically between 10 and 15 execs – might comprise generous salaries, then very low or zero annual bonus potential but generous, equity-based, long-term incentives, which would vest only when the PE house achieves its exit. The long-term incentive would involve the key management team making a sizeable commitment of their own in acquiring shares or an interest in shares at the outset. They would therefore have some "skin in the game". The long-term incentive for the management team could result in them ending up with around 20% of the value of the business at exit, thus ensuring the most significant component of their remuneration package is their LTI. In this example, they could be looking at £40m or £50m of value – if everything went according to plan.

Those two examples are just scratching the surface. There are many different types and structures of executive remuneration strategies (there are seven basic examples in the diagram above).

This is not an exhaustive list – and each company has to blend a strategy that will suit its situation and objectives. But using the basic framework and a bit of CAAARRS, hopefully you'll find everyone driving in the same direction. ■

Nigel Mills is a director of remuneration consultancy MM&K, which he joined in 1985 after six years with Price Waterhouse. He is a faculty member: nigel.mills@mm-k.com

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