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With the economic pressures organizations are facing, there are a host of different approaches for companies to correlate performance with pay. Depending on your organization's business objectives, unit objectives and individual objectives, this approach could look completely different for you than it does for the company next door. One constant remains the same across all companies and competitors- the criticality of your talent. Compensation, though just a component of employee engagement and retention, is a critical one to continually evaluate and fine-tune. By doing so, you will ensure you are rewarding appropriately to keep your organization and your employees motivated and moving ahead in the right direction.

TalentQuest engaged our partner John Markson at MarksonHRC to share his expertise around this hot topic. John has over 25 years of experience consulting on executive and broad-based compensation and benefit issues and has consulted with some of the world's largest companies on plan design, administration and implementation. Below, John shares his insights on how the metrics executives are measured upon are shifting and how many organizations are retaining their key talent by restructuring their rewards.

"What Kind of Performance Are You Paying For?"
Evaluating Executive Compensation and Equity

-John Markson
President, Markson HRC

The resilient recession together with large bonuses paid out by soon-to-be bankrupt Wall Street banks has spurred lively discussion around the topic of executive compensation. In particular, it has forced a wide-spread reassessment and scrutiny of what, until now, has seemed a business truism along the lines of buy low and sell high: "paying for performance". This reassessment is taking place at all levels but particularly in compensation for key executives.

In addition to keeping us up at night, poor business conditions can inspire us to rethink common practices and challenge prevailing wisdom. Pay systems should be closely examined to ensure that they are rewarding actual value creation and not merely the financial results that are often independent of performance.

Let's take a look at an actual example to bring this concept to life.

Recently, I attended an executive team meeting of a large, publicly traded construction company where they discussed 2008 fiscal year bonuses and 2009 goals in a business environment about as gloomy as any had seen. No one was buying houses and commercial development projects were limited to relatively minor build-outs. None of the stock options granted during the prior five years were even within sniffing distance of being exercisable.

Until now, the company had a compensation program they saw as best practice. Bonuses at the top were paid out based on two quantifiable goals: revenue and EBITDA growth. These goals cascaded down through the organization in various forms so that there was a strong line-of-site to company-wide goals from the administrative assistants on up. In order to provide to provide alignment with shareholder objectives, stock options were granted down to the manager level and were as much as 50% of anticipated compensation at the C-level.

Now the executive team was faced with the prospect of paying out (and receiving!) zero bonuses for 2008. Stock option recipients began to see their options as something akin to German deutschmarks in the 1920s.

In one sense the management team recognized that the system had worked. Performance had been poor, so bonuses should also be poor, right? Not quite. Results certainly were poor but performance by many measures was outstanding. This was not an exercise in semantics. There was serious concern about retention of some of their high performing talent – particularly when the job market picked up.

Revenue had not grown and EBIDTA had sunk but performance in both areas was among the best in the industry. The sales force seemed to extract every dollar the market was offering, the financial staff had made sure their were no surprises for wall street and had suggested and implemented several key cost-saving initiatives around the supply chain and human resources had helped reduce headcount by 20% and somehow still maintain a sense of morale. The stock price was in the tank but its decrease was less than any other major public builder.

For this company at least, there was a significant difference between results, as dictated largely by the market, and performance. This gap has always existed but it is being highlighted under the prevailing economic downturn.

Absolute vs. Relative Performance

While by no means a trend, based on my discussions with compensation professionals and corporate management and boards, companies are responding to this gap is by reassessing their measure of “results” to better isolate measures of performance. In determining compensation structures, companies are reconsidering their definition of performance and moving away from numerical standards such as sales, revenue growth, margins and expense reductions towards *more nuanced approaches that measure performance differently.* This new approach places more emphasis on relative measures as more accurate indicators of value creation. I have seen many companies incorporating these ‘revised’ performance measures, including new clients added, relative growth in revenue, relative growth in earnings and specific operational efficiencies, business planning and programs, client and employee retention, market share. Some of these cannot immediately be measured with a financial index but are extremely valuable to your organizational sustainability and long-term growth.

Considering everyone in your competitive space is struggling to some degree to stay afloat, challenge your executives with the key questions that grapple with this relativity concept… i.e. “What are you doing differently/better than your competitors? What cost-cutting measures have you introduced? How are you positioning yourself to grow? To gain market share? To remain in or attain the top tier?” These are going to be the differentiators that distinguish both individual and organizational performance.

However, the caveat to this new approach is for public companies in particular, wherein some cases shareholders may resent management receiving large bonuses when the company performs poorly in absolute terms. You should carefully evaluate your specific company position (public, private, etc.) and your stakeholders before significantly shifting your compensation structure.

For senior management, one recommended approach is to use a measure of *absolute performance as well as relative performance.* This combination of relative and absolute measures is more comprehensive in terms of overall organizational impact and value. For example a CEO bonus payout might be based on a matrix like the following with 50% attributable to relative revenue and 50% to EBITDA.

Bonus paid as a Percentage of Target

	Relative Increase in Revenue/EBIDTA Against

		Competitive				
		Top 10%	10%-40%	40% - 60%	60%-75%	Bottom 25%
Absolute Change in Revenue/ EBIDTA	Greater than 10%	200%	175%	150%	100%	50%
	5% to 10%	150%	125%	100%	75%	25%
	-2% to +2%	100%	75%	50%	50%	0%
	-2% to -10%	75%	50%	25%	25%	0%
	Less than -10%	50%	25%	0%	0%	0%

A company that experienced 0% increase in revenue and 0% increase in EBIDTA but performed in the top 10% of the competitive community in revenue growth and the median in EBIDTA growth would payout a cash bonus of 75% of target (50% * 1.0 + 50% * 0.5) = 75%.

The point of this exercise is to promote performance and the behaviors that create success rather than the success (or failure) itself which can result from factors having nothing to do with individual performance.

Rewarding Employees with Equity

Unfortunately, for many smaller companies, the above illustration is a theoretical exercise only. They simply do not have the cash to payout significant bonuses even if performance, relative or otherwise has been outstanding. These companies are looking for any means possible to retain their top performing talent, regardless of short-term results, so that when better times return they still have a business.

This lack of cash has forced smaller, closely held companies to be more creative in their employee recognition approaches and begin using significant equity grants for the first time- albeit in different ways than public companies. Until recently, private companies would rarely grant equity compensation below the top one or two executives. They preferred to keep equity closely held and use pure cash bonuses to reward results/performance. With cash short, equity now looks like the best compensation game in town.

The big challenge for private firms is that as they do not have a public market for their stock, and stock price is usually determined based on a formula or valuation. But, no matter what the valuation is, the company is the only market maker and must ensure that it has cash on hand to purchase equity grants back from their employees. It could be a financial disaster if valuations showed large gains but cash flow was poor at the time employees decided to sell their stock.

Private companies can avoid this dilemma by adding performance triggers on the payout. Examples of triggers include:

- Stock can only be sold when a transaction occurs
- Options do not vest until revenue reaches a specific $ threshold
- Options and stock grants do not vest until net earnings reach a specific $ threshold.

Properly structured equity grants are an excellent, proven way of retaining your top talent without depleting scarce cash. Smaller companies that have never thought of using equity compensation should reconsider the approach making sure that payouts are also based on value creation with appropriate guards against insufficient cash. Adding the appropriate trigger condition to a stock sale will ensure that your company has sufficient cash to buy the stock.

Every company is facing some degree of competitive and economic pressure, and employee engagement is absolutely critical to keep your organization afloat. Creative compensation approaches will reflect your commitment to respond to changing market and economic conditions and to reward your employees appropriately. The ideas mentioned are just the tip of the iceberg- I encourage you to routinely evaluate your compensation structure and customize each component to the unique needs and demands of your business and your executive team.

For specific questions or comments regarding this article or the broader executive compensation arena, please contact me anytime at jamarkson@marksonhrc.com.