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Fixing executive pay

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Setting executive pay should reflect sustained and superior performance. For institutional investors the issue should not be how much executives are paid but what they are paid for.

Sidney Taurel, Eli Lilly's chief executive officer, addressed the pharmaceutical company's 41,000 employees via videoconference in October 2001 to outline far-reaching cost reductions. Standing in the cafeteria of Lilly's Indianapolis headquarters, Taurel added up the financial impact of losing patent protection for Prozac, the blockbuster antidepressant that accounted for more than a third of Lilly's $2.8bn profit in 2000.

No one would receive pay increases in 2002, Taurel said, and managers would give up bonuses and stock grants. Then Taurel delivered a blockbuster message of his own: he had asked directors to slash his 2002 salary to $1. Employees got to their feet and applauded.

In an era of ambiguous compensation plans for top managers, Taurel's request to cut his own pay sends a clear signal of accountability. But compensation plans should not rely on individual acts of responsibility, however admirable. Instead, such plans should explicitly and systematically link executive pay and shareholder value.

That is certainly the view of institutional investors. The critical question they are asking about executive compensation is not "how much are we paying?" but rather "what are we paying for?"

Interviews we conducted with more than 40 institutional investors in the UK and US underscore this point: more than 90 per cent oppose option re-pricing; 82 per cent say they want to discontinue rich severance packages; and 70 per cent are against awarding bonuses tied to acquisitions. Yet 63 per cent say they are willing to approve compensation plans that give senior managers a larger share of the value they create for shareholders – as long as senior managers also share in the downside.

Indeed, when pay is the measure, most executives still don't feel the same pain as their shareholders. In 2001, when stock prices of the S&P 500 fell 13 per cent and corporate profits were down 35 per cent, median total compensation for CEOs rose in nearly all industries, ranging from an increase of 31.6 per cent in construction to 0.3 per cent in financial services, according to the most current data on executive compensation compiled by The Conference Board. The exceptions were retail and telecommunications, where CEO compensation was unchanged by Conference Board calculations (which involve taking into account annual salary and bonus, plus the value of long-term grants and payments, including stock options and restricted stock grants, and long-term performance plan payments).

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Becht: making people sweat

Tying executive compensation to sustained value creation won't happen simply by linking compensation to stock price. Management could be focused on the wrong priorities but benefit from a rising market. Or it could be doing exactly the right things but still be penalised as a result of forces outside its control.

The best compensation systems pay out for successful strategy execution while including an equity component to align management and shareholders. Executives are pushed to outperform both ambitious internal targets and their peers in the stock market.

The companies that appear to get real benefit from linking pay and performance apply four basic principles:

- They are clear about what drives value in their businesses; they communicate it widely – internally and externally - and they measure what matters
- They tie compensation to the real value created – reflecting the performance of both share price and the underlying business over time
- They recognise that the frontline drives the bottom line and cascade appropriate measures and incentives to key employees
- They build trust with compensation systems that are simple and transparent to employees as well as investors

Be clear on measures that matter

Dell Computer has built a pay system that hits many of these marks. Dell's strategy of cost and customer leadership has not wavered in a decade. Cost leadership, for example, hinges upon the company's ability to manage inventory levels, working capital, return on invested capital, and service support costs.

With a clear picture of what drives value, Dell's pay system starts with executives' base salaries, which are average among high-tech companies. A bigger potential slice of the pay package comes from long-term, equity-based compensation that helps motivate managers to increase shareholder value.

The reward for successful strategy execution is built into Dell's annual bonus, which uses value drivers such as operating profit margin and customer satisfaction metrics to set ambitious targets for executives. In 2001, for example, CEO Michael Dell received only 25 per cent of his possible bonus, although the company performed well relative to peers. The reason? The business fell short of hitting some aggressive internal targets.

Tie compensation to strategic targets

Consider also Reckitt Benckiser, the UK-based maker of household cleaning products. Senior managers' base salaries are well below competitors and long-term incentives do not pay out unless the company achieves growth rates that are double the industry average. The system's multi-year aspect focuses management on sustainable, not short-term, growth.

To earn their bonuses, Reckitt Benckiser executives must show measured progress towards the company's strategic targets. Net revenue growth that exceeds the industry average is one such target; executives achieve it by investing in high-growth categories where the company has strong, market-leading positions.

The plan also ensures management feels the pain if shareholders are suffering. Besides using stock-based incentives, Reckitt Benckiser mandates minimum holdings of 200,000 shares for each senior executive and 400,000 shares for the CEO. The plan prohibits re-pricing options and requires that bonuses be withheld when targets are not reached. "I want to make people sweat," says CEO Bart Becht.

Cascade incentives

Some companies do link executive compensation to both shareholder value and strategic targets but fail to focus the rest of the organisation on the same goals. Online trading company eBay, for example, recognises that customer service employees on the frontlines are vital to profitability; they help build a loyal customer base and encourage existing customers to explore new categories. These key employees are paid based on direct customer feedback and can access reports on their performance at any time.

In a similar fashion, Nucor, the US steel maker, has pushed production incentives out to its mill workers, who are key to determining productivity. The company pays hourly workers about half as much as the competition, then adds weekly cash bonuses that can double or triple the hourly wage depending on the amount of quality steel handled by a work team on its shifts. When the weekly bonuses are included, Nucor's hourly workers, all non-union, are the highest-paid in the industry but the company is one of the most efficient in terms of labour costs per ton produced.

Be simple and transparent

Once companies have linked compensation to what drives value, they can explain compensation packages to employees and investors with credibility. Compensation has greater impact when everybody knows what he is paid for. Indeed, shareholders who understand compensation packages are more likely to accept them – 73 per cent of institutional investors are looking for more transparency, according to our survey.

When Reckitt Benckiser laid out its executive compensation plan for 2000, the media's initial reaction was hostile. But scepticism turned into broad

Dell

Dell: only 25 per cent of his bonus

support once the performance requirements for the plan became clear.

The debate on executive compensation is set to continue, particularly with company performance lagging and the stock markets feeling their way through uncertain economic times. But this debate will be more productive if companies and shareholders focus on the right question – not whether executive teams are overpaid but how compensation can be linked more effectively to sustained and superior performance. Eli Lilly's Taurel is an inspiration but it should not take an individual act of responsibility by the CEO to align pay and performance.

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