Making sense of

What is the right way of aligning executive pay and shareholder value? First, say **Orit Gadiesh**, **Marcia Blenko** and **Robin Buchanan**, be clear about what really drives a company's value. Second, link pay to successful strategy execution, as well as to outperforming peers in the stock market

Sidney Taurel, CEO of the US pharmaceutical company Eli Lilly, gathered his firm's 41,000 employees for a video-conference in October 2001 to outline far-reaching cost reductions. Standing in the cafeteria of Lilly's headquarters in Indianapolis, 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 $3 billion profit in 2000, according to analysts.

No one at Lilly would receive pay increases in 2002, Taurel explained, and managers would have to give up bonuses and stock grants.

Then Taurel delivered a blockbuster message of his own: he had asked Lilly directors to slash his 2002 salary to one dollar. Employees in the cafeteria got to their feet and applauded.

In an era of ambiguous compensation plans for top managers, Taurel's request for a cut in his own pay sends a clear signal of accountability. But compensation plans should not rely on individual acts of responsibility, however admirable. Instead, they should make the link between executive pay and shareholder value explicit and systematic.

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: nearly 100% oppose option repricing, 82% say they want to discontinue rich severance packages, and 70% are against awarding bonuses tied to acquisitions. Yet 63% 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 executives also share in the downside (see Fig 1).

Tying executive compensation to sustained value creation will not happen simply by linking compensation to shareholder returns. Management teams could be focused on the wrong priorities but benefit from a rising market. Or, indeed, they could be doing exactly the right things but still be penalized as a result of forces beyond their control.

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

This message is clearly reinforced by research we have conducted on sustained-growth companies. Our analysis of more than 2,000 global companies shows that only one in 10 achieves sustained profitable growth over a 10-year period, defined as real average revenue and net income growth greater than 5.5% and positive return on capital.

What characteristics do the top performers share? Most notably, their senior managers have made the right strategic decisions to define their businesses appropriately and to achieve clear leadership.

In addition, they create a culture of performance focused on excellence of execution, from the leadership team right down to front-line operations. In many of these cases, executive compensation is an important lever.

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 recognize that the front line drives the bottom line and so cascade appropriate measures and incentives to key employees;
- they build trust with compensation systems that are simple and transparent to employees as well as to investors.

Even with the right measures in place, unless the incentives to perform are palpable, compensation becomes a blunt tool or, worse, a scheme that only rewards mediocrity

executive pay

Clockwise from left: Sidney Taurel, CEO of Eli Lilly; Michael Dell, CEO of Dell Computer; and Lord Browne, CEO of BP

Be clear on measures that matter

The successful growth company Dell Computer Corp, which recently reclaimed industry leadership in personal computers, illustrates many of these features. Over the years, the company has isolated the most important factors driving value in its business.

Indeed, Dell's strategy of cost and customer leadership has not wavered in more than a decade. Cost leadership, for instance, hinges upon Dell's ability to manage inventory levels, working capital, return on invested capital and service support costs.

Customer leadership for a company such as Dell is determined by how well it executes order

Executive compensation diagnostic

Is your strategy clear?
Can it be translated into action?
Is it measurable?
Does it have the potential to transform your business?

Do you measure the true drivers of value in your business?
Do you link your executive compensation to what drives value – key strategic and financial measures as well as relative share price?

Are your executives motivated to create a dramatic upside for shareholders?
Is there a downside for mediocre performance?

Are key front-line employees focused on the same goals and motivated to deliver results?
Do incentives reinforce a "performance culture"?

Is your compensation system simple and transparent?
Does everyone understand how pay is linked to performance?

fulfilment, product performance and lifetime ownership cost, and growth in revenue and operating profit at its business units, as well as in the company at large.

With a clear picture of what drives value in its business, Dell can tie compensation to the measures that matter. The pay system starts with base salaries for Dell executives that are generally below those of their peers at other hi-tech companies.

A bigger potential slice of the pay package comes in the form of long-term, equity-based compensation that helps motivate managers to grow shareholder value.

The reward for successful strategy execution is built into Dell's annual bonus, which uses key value drivers such as operating profit margin and customer satisfaction metrics to set ambitious targets for executives.

In 2001, for instance, the CEO, Michael Dell, received only 25% of his possible bonus for the year, even though the company performed well relative to its peers. The reason? The business fell short of hitting some of the aggressive internal targets that had been set.

Of course, hitting relevant strategic targets will not automatically lift a company's share price. But performance improves when companies understand the potential of their businesses over the medium term – the next three to five years, say – and then focus on the most critical levers for achieving that value.

At the same time, it is important to choose stretch goals that are attainable. And companies should take care not to focus their efforts – or their constituents – on a single measure. Invariably, it is a basket of measures that really drives the value of the business. This will include profit growth and return on capital, as well as strategic measures such as Dell's metrics for cost leadership.

BP was reminded about the dangers of putting too much focus on a single measure last October. The energy producer had emphasized production as a key performance measure. When BP acknowledged that its production volumes would grow only 3% in 2002, well below its 5.5% target, BP's share price fell. The lesson, according to BP's chief executive Lord Browne: "No one target should be allowed to get out of proportion."

Even with the right measures in place, unless the incentives to perform are palpable, compensation becomes a blunt tool or, worse, a scheme that rewards mediocrity. Although it sounds strange, executives often receive full pay despite average performance.

> Cascading measures and incentives to key employees appropriately can reinforce execution excellence where it matters most

> Shareholders who understand compensation packages are more likely to accept them – 73% of institutional investors are looking for more transparency

In 2000, 85% of UK corporate leaders received their maximum bonuses and 40% received their long-term payouts for median performance, while 43% of option plans vested after companies hit growth targets of only 2-3% above inflation.

In some industries, beating inflation is a stretch target and serves as a reasonable trigger for long-term incentive compensation to pay out. But for many others, such targets are not ambitious and fall below even the lowest range of analyst estimates.

Tie compensation to strategic targets

Compare these slack objectives to the system operating at Reckitt Benckiser, the UK-based maker of household cleaning products, where compensation is used to help raise the ambition of its managers.

Senior managers' base salaries are well below their competitors', and long-term incentives don't pay out unless the company achieves growth rates that are double the industry average.

But the company's five-year, £60 million compensation plan rewards top executives handsomely if they achieve the tough goals – a real encouragement to produce results. The multi-year aspect of this 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 achieved it by investing in high-growth categories where the company has strong, market-leading positions.

In order to expand operating margins – another target – the executive team took costs out of the company's supply chain and launched a systematic campaign to find higher-margin innovations. To deliver on a third target – improving cash generation – the company tied executive bonuses to increasing net income and reducing net working capital.

Reckitt Benckiser's plan also ensures that its management team feels the pain if shareholders are suffering. Besides using stock-based incentives, Reckitt Benckiser mandates minimum

shareholdings of 200,000 shares for senior executives and 400,000 shares for the CEO.

The company's compensation plan prohibits repricing options and requires that bonuses be withheld when targets are not reached. "I want to make people sweat," says company CEO Bart Becht.

In other words, when the downside of mediocre performance is real and immediate, it gets results.

Some companies do link executive compensation to both shareholder value and strategic target but then fail to focus the rest of the organization on the same goals. Appropriately cascading measures and incentives to key employees can reinforce execution excellence where it matters most.

The online trading company eBay recognizes that customer service employees on the front lines are vital to profitability: they help build a loyal customer base and encourage existing customers to explore new categories. These key employees are paid on the basis of direct customer feedback, and can access reports on their performance at any time.

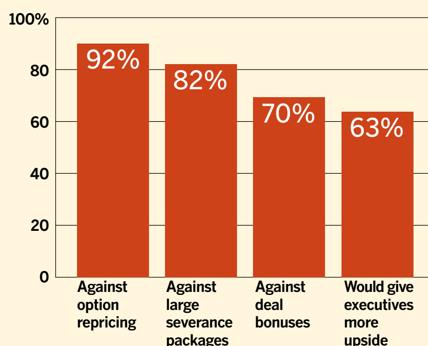
In similar fashion, Nucor, the US steelmaker, has pushed production incentives out to its millworkers, who are key to determining productivity.

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.

When the weekly bonuses are included, Nucor's hourly workers are the highest paid in the industry – but the company is one of the most efficient in terms of labour costs per tonne produced.

This approach has helped to make non-union Nucor the most productive steel producer in the US, measured in tonnes per employee, and has led the company to $113 million in profit in 2001 – despite a deep recession in the industry.

Fig 1: investors are willing to give more upside as long as the downside is palpable



Source: Bain interviews with 42 institutional investors April/May & August 2002

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 such packages are paid for.

Indeed, shareholders who understand compensation packages are more likely to accept them – 73% of institutional investors are looking for more transparency, according to our survey (see Fig. 2).

When Reckitt Benckiser laid out their executive compensation plan for 2000, the initial reaction of the media was hostile. "Forty executives at Reckitt Benckiser could between them receive shares worth more than £60 million under its proposed five-year incentive scheme," wrote the *Financial Times*.

But scepticism turned into broad support once the performance requirements for the plan became clear, as reflected in the same *Financial Times* article: "The incentives may look generous but in relation to some classic UK schemes the targets are demanding."

Practical steps

The right compensation plan, including appropriate incentives that pay out over a number of years, can help companies to achieve sustainable performance.

Firms can make their compensation do more by taking some practical steps.

Be clear on measures that matter

» Develop a clear strategy and understand what drives value.

» Choose metrics that reflect key value drivers. For a retailer, metrics driving value might include relative market share or same-store sales growth; for a PC-maker such as Dell, for example, it would include return on invested capital, as well as cost leadership and customer satisfaction.

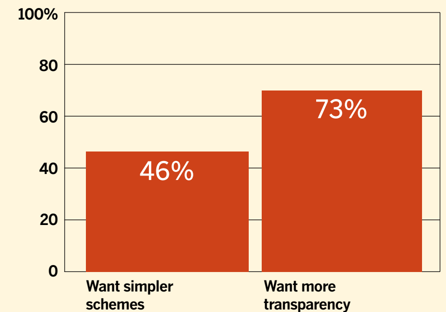
Tie compensation to strategic targets

» Base total compensation on hitting a blend of key metrics that reflect strategic and financial goals.

» Reinforce a performance mindset by making compensation as variable as possible. At companies such as Dell and Reckitt Benckiser, top executives expect up to 75% of their compensation to be at risk. Bonuses and incentive compensation should be linked to value created, with the possibility of zero reward if targets are not met.

» Set appropriate time frames. Most strategic goals cannot be achieved in a year. Where executives champion acquisitions, for example, they should be compensated on achieving the synergies they forecast and not on doing the deal. Or, when executives depart, they could face multi-year payouts on severance, to keep their longer-term interests aligned with the firm's.

Fig 2: transparency is critical to investors



Source: Bain interviews with 42 institutional investors April/May & August 2002

Cascade incentives

» Identify those key front-line employees whose actions are critical to achieving company goals.

» Choose a small number of the right operational measures that these employees influence and link incentives in a simple way.

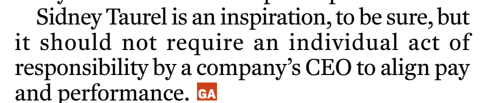
» Be careful not to cascade too broadly, or the result will be a costly and complicated system that fails to drive the right behaviours.

Be simple and transparent

» Design a compensation plan that passes a simple test: can ordinary people understand it? If they can, then compensation can reinforce the behaviours that create value.

» Turn executives into shareholders. Mandate minimum stock shareholdings that represent a significant portion of executives' net worth during their employment period. And consider granting restricted stock, not just stock options, or providing share matching programmes.

The debate on executive compensation is set to run, 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.



Sidney Taurel is an inspiration, to be sure, but it should not require an individual act of responsibility by a company's CEO to align pay and performance. GA

CV ORIT GADIESH/MARCIA BLENKO/ROBIN BUCHANAN

Orit Gadiesh is chairman of Bain & Company. Marcia Blenko is a Bain vice-president based in London. Robin Buchanan is Bain's senior partner in London.