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Long-Term Incentives Spur Owner-Like Thinking

The path to encouraging executives to think and act like owners is through properly structured long-term incentives.

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With the recent uproar among many large shareholders over executive pay, one would expect incentive programs to now be designed to motivate executives to create tremendous value for shareholders. Quite to the contrary, however, many of the features that have been added to "improve" executive pay are actually at odds with the decisions required to drive shareholder value over time.

OPINION

To be sure, there are many uncertainties in business, and often luck can have an immense impact on whether a company does well. The longer the time horizon we examine, however, the more these "lucky" factors tend to offset each other and the more an executive's influence on success shines through. This is one of the main reasons that long-term incentives are so much more effective at encouraging and rewarding value creation results than short-term bonuses are. (See "Are Bonuses An Obstacle to Shareholder Value?")

One change in executive pay has been an attempt to wring out the effects of luck and determine whether or not an executive truly has created value. These days executives tend to have more performance tests in their long-term incentives for precisely this reason.

Instead of simply granting an executive restricted stock, many companies now tie the eventual vesting of the stock to company performance. Such performance is measured by comparing internal results to goals or calculating total shareholder return (TSR), which reflects dividends and share price appreciation, against a group of peer companies.

For example, if a company delivers TSR at the median of its peer group, the grant of stock may vest as is. If the TSR is in the top quartile, the executive may get 150 percent or more of the original grant. If it's in the bottom quartile, the executive may forfeit his or her grant. The intent is to provide more reward when a stock-price increase results from out-performance over peers rather than just a general rise of all the stocks in the industry or even the overall market.

Of course, that raises the question of whether shareholders would rather have a TSR of 20 percent per year that is below a peer median or a 5 percent of TSR that is above. Does this type of incentive encourage executives to invest more in strong industry segments and invest less in or divest a weak segment?

There are many similar situations in which executive pay features have been added with the best of intentions, but a potential breakdown in the linkage between pay and value creation prevails. Rather than just blindly following industry pay practice, directors on a compensation committee should carefully consider the behavior they want to encourage and how the features they design into their incentive plans align with that behavior.

In essence, they should try to encourage managers to think and act like owners. Managers should treat the capital of the company as if it were their own and pursue opportunities and manage risks the way a private owner would. This alignment of interests tends to motivate executives to deliver better results.

The following list of considerations can serve as a guide when designing long-term incentives:

- **True Long-Term Perspective**: Short-term actions such as cutting marketing, R&D, training or other soft investments to meet year-end goals can harm the long-term prospects of the business. Desirable long-term investments often create concerns during the launch period before they pay off. Long-term incentives should encourage executives to live with any negative reaction in the short term in hopes of getting paid if and only if results eventually materialize. That will enable them to make such investments more freely, while also maintaining accountability for ultimately delivering results.
- **Real Money at Risk**: Private-equity investors often require executives to put some of their own money into a deal, and they find that this ensures a proper perspective on risk and reward. While public companies rarely ask executives to commit their own money, this shouldn't stop them from designing incentives that build restricted and non-guaranteed money in order to serve the same purpose. To affect their behavior, the

quantum at risk must be meaningful relative to the executive's personal wealth and must truly decline if performance and shareholder value decline.

- **Substantial Upside**: Sometimes it seems that incentive plans are designed to avoid extreme payouts so an executive isn't too high on the compensation rankings -- a situation that could potentially embarrass directors. But if incentives are designed properly, executives should be able to make as much money as possible, since that indicates that the board is presiding over a very successful company. Many companies would benefit from more differentiation in pay between strong and weak periods of shareholder value performance - very high pay when performance is strong and very low when it is not.

One simple way to accommodate these three high-level objectives is through front-loaded and gradually vesting stock options with rising exercise prices. The term "front-loaded" indicates that several years of grants are all delivered at the start of the program instead of a portion each year. That avoids the problem of the share price doing poorly this year and the next year's options carrying a much lower exercise price, and vice versa. In essence, it provides more long-term pay for performance leverage by granting the next three or five years of options all at once, while still allowing them to vest gradually in the same way as would occur with the annual grants.

The exercise price of the stock option could be at the money when it is granted and rise at a minimum rate of return determined by the board. The options would only pay out if the share price grows at a faster rate than the exercise price. The starting exercise price and the rate of change can be varied to provide different levels of risk and reward to suit the objectives of the board. A package of several combinations can often provide the best overall package.

It is relatively straightforward to simulate outcomes with such a program and see that the rewards will be weak if share price performance doesn't keep up with the rate the exercise price rises. This is much like a leveraged buyout in which owners and managers don't earn much if the value doesn't rise significantly (but without the risk of layering debt on the company).

On the other hand, if the share price grows at a fast rate for several years in a row the payoff can be truly outstanding. The rising exercise price makes such options lower in value than traditional fixed exercise price options so a larger quantity must be delivered to provide the same value of compensation. This large upside potential tends to encourage a more entrepreneurial approach by management, with a heavy emphasis on execution and results.

Very importantly, instituting such a compensation plan also tells investors that management is confident in its ability to deliver value growth and has put its money where its mouth is.

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