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Why Not Pay Executives Like Private Equity Does?

Long-term executive incentives could better align the financial interests of executives with those of shareholders.

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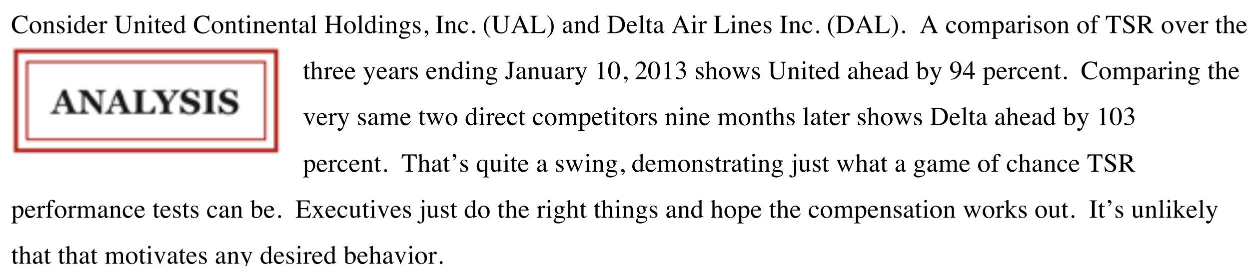
With their proliferation of plan-design alternatives and features, long-term executive compensation practices have become more and more complex over the years. Where once there was restricted stock and stock options we now have performance shares, stock-appreciation rights, performance cash, deferred stock units, performance units and countless other faintly dissimilar alternatives.

What's more, the quest for better and better mousetraps has led to incentive methods that often do a worse job of actually motivating management to think and act like committed long-term owners.

For example, consider that many long-term incentives now have some sort of "performance test" that determines the degree to which the award vests. One common type of performance test measures total shareholder return (TSR) in the form of dividends and share price appreciation against a list of peer companies. Typically, if TSR ranks atop the peers, 200 percent of the award vests with less vesting at lower TSR ranks. Bottom quartile performers often get no award.

That seems logical. The better the share price performs against peers the more shares management gets. If the only reason the share price increased is the industry did well and the company is bottom quartile against peers, then the award is forfeited. This is designed so awards are not excessive for just being lucky.

As good as that sounds, there are numerous problems with TSR performance tests. Executives can earn a lot more or less based on different starting and ending points, making performance tests a bit of a lottery.



Consider United Continental Holdings, Inc. (UAL) and Delta Air Lines Inc. (DAL). A comparison of TSR over the three years ending January 10, 2013 shows United ahead by 94 percent. Comparing the very same two direct competitors nine months later shows Delta ahead by 103 percent. That's quite a swing, demonstrating just what a game of chance TSR performance tests can be. Executives just do the right things and hope the compensation works out. It's unlikely that that motivates any desired behavior.

Perhaps more importantly, TSR performance tests do not motivate smart business-unit portfolio management and capital-allocation choices. Although a management team can move its company into areas with better growth and return on capital opportunities, if it does so, it will be compared to new peers with potentially better TSR. This may

diminish the financial benefit to management and can stand in the way of motivating the right portfolio-management decisions.

Perhaps compensation committees should look to how private-equity motivates executives. Management wins if private-equity investors win and vice versa. Managements typically earn a "promote," which is an equity participation that increases depending on how high the IRR is for the investors. They don't tend to worry as much about whether the success was skill or luck; they simply reward success. And perhaps that helps them achieve more success.

Often there is a minimum return for investors before management participates. That can be anywhere from 5 percent to 10 percent and is often described as an internal rate of return, or IRR. Any value created above that is shared between management and investors according to a formula. For example management might get 15 percent, 20 percent or 25 percent of any value created above the minimum IRR.

Often there is another, higher threshold of IRR, above which management will share in an even higher percentage of the value created. Though the specifics vary, it is usually the case that the more money investors make, the more management earns, which forges a very strong alignment of their interests.

Public company compensation committees could reach outside their normal comfort zone and implement long-term compensation structures that work more like those in private equity. They could directly copy the private-equity arrangements or use a simplified stock-option structure designed to accomplish similar objectives.

To emulate the typical private-equity deal, a company could establish a subsidiary for the purpose of holding treasury stock that management might earn going forward. The subsidiary could be financed with, say, 10 percent in equity from management, either via paid-in capital or a time-vested grant. The remainder could be financed with debt or preferred stock with a pay-in-kind feature so the amount of financing builds every month to set a minimum threshold before management participates.

The value of management's stake would increase if the value of the company grew faster than the pay-in-kind financing. That would replace the typical annual equity grants over, say, five years, with a single front-loaded opportunity. Thus, the size of the equity pool would need to be calibrated to deliver an appropriate high, medium and low payoff under different share-price performance scenarios.

Admittedly, implementing such a structure is fraught with all sorts of legal, accounting and tax complications, and may prove confusing for investors and proxy advisory firms.

A simplified stock-option structure can be used to mimic the private-equity approach in a way that is more consistent with normal public company practices. In place of the next five years of equity grants, management could

be granted one front-loaded package of stock options that might come in five tranches, each with different vesting dates and exercise prices.

The first tranche might vest in one year and have an exercise price 8 percent above a benchmark share price, say the three-month-trailing average price. The second tranche might vest in two years and have an exercise price 16 percent above the benchmark share price. And so on. Each tranche might be exercisable over one to three years after they vest.

That package would provide a huge potential payoff if management was very successful and very little payoff if they failed to create value. Though this sort of plan carries a greater potential for retention risk if the share price declines, that must be weighed against the potential for a much stronger motivation to succeed. Many companies will find that weaving some elements of this into their normal compensation approach can be beneficial even if they choose to not embrace it completely.

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