Agenda

A Financial Times Service

The week's news from other boardrooms

A Financial Times Service

Is It Time to Change Pay Metrics?

Print | Close Window

Is It Time to Change Pay Metrics?

Article published on October 25, 2010
By Katie Wagner

Improvements in the economy and uncertainty that remains about the future business environment are good reasons for boards to revise their executive compensation programs' metrics for their next fiscal year, according to several experts.

As the economy has emerged from the brink of disaster, directors might feel comfortable about making changes to their compensation programs for a number of reasons.

Many boards reacted to the crisis by revising their pay metrics to adapt to stock price declines, lower customer demand, limited access to loans and other effects of the downturn.

Now that the economy has improved, **Mike Halloran**, a compensation consultant at **Mercer**, says he suspects that more boards will reinstate pre-crisis pay metrics.

The crisis also drove some companies to hold off on making changes because of heightened scrutiny of executive pay from shareholders. Those boards might also see now as a good time to revise their pay plans.

"I might expect to see a little more change in 2010 than in 2009, because in 2009 people were coming off a year when performance wasn't that great and I think there was some paranoia about changing metrics or just making the hurdles too short," says **Jim Heim**, a managing director and compensation consultant at **Pearl Meyer & Partners**. "I think in 2009 [boards] might have been a little more hesitant because they were unsure of whether it would look like they were tinkering with them to drive performance for shareholders or tinkering with the metrics to ensure a payout."

At the same time, despite improvement in the market, boards are still struggling to set goals because of uncertainty around where the economy is going, says **Doug Friske**, the global head of executive compensation consulting at **Towers Watson**. *Agenda*'s most recent board confidence index bears this out. Directors are far more optimistic about their own companies. The average score of directors' confidence for their companies was 90.5; for the economy it was 21. Those numbers are out of a possible score of 100, which would indicate a fully positive outlook across the board.

"The volatility in the economy and uncertainty around companies coming out of the recession are still driving companies to fine-tune plans," Friske says.

When companies face economic uncertainty, boards are apt to turn to relative metrics such as relative total shareholder return. Indeed, according to the compensation consulting firm **Radford**, 131 new companies, including **Tesoro**, disclosed using relative TSR as a pay metric for the first time this year. Relative TSR addresses the uncertainty by pegging executives' payouts to how peers performed.

Still, only six of 89 directors who responded to *Agenda*'s recent survey listed a relative metric as one of the top three measures used in their executive pay programs. These metrics included relative TSR, "peer rate of return," relative share price and "relative unit performance to market performance." Relative TSR, which is generally known to be the most popular metric for measuring a company's performance against its peers', was offered by only two of the directors.

It seems likely that these numbers will increase next year.

"We've seen almost all boards we talk to at least ask about relative metrics," Heim says.

More directors have also been seeking information about measures of capital efficiency, such as return on invested capital (ROIC), compensation consultants say. "ROIC is a good metric for comparing companies across industries, because your results don't vary too much based on whether or not you have significant infrastructure or even based on whether you're financing via debt or equity," Heim says.

Although experts think more companies will incorporate capital efficiency metrics and measures that allow them to directly compare themselves to their competitors into their compensation programs, they expect EPS, profit and revenue growth to remain more prevalent (please see related story on page 8).

"As we went into 2009, many companies turned their focus to cash flow or working capital in response to potential limitations in their ability to access the capital markets and similar liquidity concerns," says Friske. "Now that capital markets appear to have stabilized and operating results have improved, they're turning their emphasis back to profit and growth."

Why Two Boards Use Relative TSR

Analogic's long-term incentive program bases 50% of its awards on how its TSR compares to the TSR of 16 companies of similar size and industry.

Fred Parks, chairman of Analogic's compensation committee, says he likes using the relative TSR metric, which can be measured every day, because it's "absolutely definitive."

"There's going to be very little, if any, judgment applied at the end of the period," he says.

Intel, which began using relative TSR as a metric in its long-term incentive program last year, adopted it, in part, to decrease the program's level of emphasis on stock options.

The company replaced some of the stock options included in its long-term incentive opportunity with performance-based shares to provide more "stability" to its executives and better manage shareholder dilution, among other reasons, says **Ogden Reid**, the company's VP of compensation and benefits.

An Information Service of Money-Media, a Financial Times Company