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On 1 February 2010, MM&K held a dinner for clients, most of whom were Board Chairmen, CEOs or Chairmen of Remuneration Committees. Over dinner, there was a discussion about:

The Focus for Incentive Plans should be Value Creation

Summary

Companies should be focused on building long term value. But the executive remuneration package to support this will continue to need a mixture of short term and long term elements, to support immediate business priorities as well as providing a share of long term value creation. The balance and measures for the components of the package will need to vary between different types of company and over time within a company. And packages need to deliver substantial rewards when executives achieve more than what is asked of them, and they need to avoid rewarding failure. Remuneration Committees have to manage pay to support fully the Board's strategy, and have to stick by their pay decisions when institutional shareholders see pay priorities differently.

Introduction

Cliff Weight introduced the subject. His key points were:

1. When I see a £20 note in the street, I bend down, pick it up and say "that's a bonus".[1] Using bonus to describe remuneration lacks clarity and confuses what we are trying to do. I have always tried to get my clients to distinguish between profit sharing, bonus and incentive. Incentive comes from the Latin **incendo** - to rouse up or set on fire.
2. Is it not time to go back to basics? Ask the question what do we want management to do? Cliff suggested:

Do these operational things in the short term		Beat the competitors in the medium term		Share price growth in the long term
Rewarded by		*Rewarded by*		*Rewarded by*
Annual incentive, plus deferred and matching plans		LTIPs and annual deferred/ matching plans		Options and share ownership

3. TSR measured relative to other companies over a 3 year period is often the wrong approach. It can be difficult to find good comparators, and TSR can be subject to too many extraneous factors (so is not an incentive). It can reward management who take on more risk and over focus on short term results at the expense of long sustainable performance.
4. When the tide comes in all the boats rise. (When the wind is behind, the golf drive goes further than when the wind is against!) This may result in a bonus for shareholders, but should not drive incentive pay.

A lively discussion ensued. Some of the points made were:

1. Bonus is a bad word. We should use the term Variable Annual Compensation or some other term which better describes what we mean. Using Bonus in this loose way is unhelpful.
2. Companies should reward executives through "Variable Annual Compensation". Companies need to steer executives' activities and Variable Annual Compensation is one tool to do this. Companies are trying to do a mixture of things, and the balance of the package has to reflect this. They also do different things at different times – the focus now might be to generate cash and avoid a rescue rights issue (the worst thing in a crisis).
3. It is sometimes necessary to adjust targets, so as to give executives the chance to go for something that is achievable. Targets that are unachievable are a turnoff. NEDs need to ensure that management are doing their best. If an executive does the right thing, and achieves what you want, you have to find a way of rewarding him. Institutional shareholders, the ABI, NAPF etc sometimes fail to understand this. It is better to take grief from shareholders and shareholders' representatives, than lose management's focus.

[1] See Stefan Stern Article in FT 15 Jan 2010 from where I plagiarised this point

4. Paying partly in shares is a 'no-brainer' - though it is a problem deciding how many shares to award. Fixing grant policy on number of shares rather than value can overcome distortions due to temporary share price changes.
5. Share vesting measures have been changing. Nobody present liked relative TSR as a measure. Measuring performance relative to other companies using financial metrics (e.g. profit, EBITDA, cash flow, profit margin, sales growth) can be a sound underpin to incentives and reward.[2] An example was given of restricted stock which vests on average ROC over the vesting period. There is also a problem in finding comparators for companies when, because of the area of business or point in the life cycle, there are none.
6. Companies need to pay executives at a sufficient level to attract, retain, motivate and keep them enthused. An executive who feels he/she is under-rewarded will be turned off and/or go elsewhere. So pay has to be competitive – both in amount and opportunity.
7. Rem Coms need to make decisions which are in the best interests of the company, which may not co-incide with shareholders views.[3]
8. **"Idiots" versus pussycats!** We (NEDs on Rem Coms) think they (fund managers, shareholders, corporate governance people, the ABI, NAPF, etc) are "idiots" and naive: and they think we (NEDs on Rem Coms) are pussycats who always roll over and give in to management's demands. Neither side seems to have a very high opinion of each other. This is not very helpful.
9. The short term focus and rewards of fund managers are a problem. They are measured on relative performance to other fund managers, often over a 3 month period. This drives them to look at companies where short term movements in share price might occur. It drives them to accept takeover bids so as to boost short term results. NEDs who had personally been at the receiving end of their company being sold out by fund managers had a very low opinion of such fund managers.
10. Most who were present are involved in businesses which are managed for the long term, rather than to be grown and sold.
11. There was much criticism of the Private Equity model of company management which many present felt was overfocused on short term results and obtained benefits through financial leverage. The model discourages executives from building long term businesses. They are normally looking at a maximum of 6 years before they want an exit. Others argued that the PE model works well, albeit the "naughties" saw banks offering too much leverage: the large majority of PE deals do see growth in employment numbers and in operating margin over a four to five year view.
12. One diner suggested the possibility of negative salaries for traders who use the capital and brand of their parent company. Is it not logical that if traders are demanding x% of the profits, that they should be aligned on the downside as well as the upside with shareholders?
13. The question of how to allow for solvency requirements in Variable Annual Compensation Plans was raised and debated. Should there be a charge for the cost of capital? The answer depends on the company culture. If the culture of rewards is to share profits (and losses) with shareholders then one approach is required. However if the focus is on rewarding executives for operational goals under their control in the year then another approach is required.
14. The majority view was that the Board should set the strategy and the Rem Com should set the Variable Annual Compensation Plan, to reflect annual operational goals and pay out if, and to the degree, they have been achieved. If they need to be reviewed and some discretion is required, the Rem Com should be confident in its ability to explain the necessity of this.
15. Explanations of remuneration and new plans should be done by the Chairman (and the Chair of the Rem Com). They should not expect to always be warmly received by institutional shareholders. If more companies did this then perhaps the fund managers and pussycats would move closer together?!

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[2] See http://www.mm-k.com/obermatt.html for more information on how to do this.
[3] The new proposed Corporate Governance Code recommends rewards should promote the long-term success of the company and the ABI latest guidance is to "aim at sustainable long-term value creation".