Hands on reward for hands on management
Anonymous
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Hands on reward for hands on management

Top Pay Research Group

Abstract A paper presented at Henley Management College focusing on the issue of appropriate pay schemes and financial incentives for executives in the 21st century.

Keywords Reward, Employee benefits, Merit pay, Remuneration

Effective payment schemes

Before discussing the main issue of the presentation, I think it is important to share with you our views on effective pay schemes in the new millennium when an increasing number of people aspire to be extremely wealthy in the way that their parents might have thought indecent.

The television-driven increase in the value of professional sportsmen, entertainers and even weather girls has introduced the concept of acquiring significant wealth in one generation to a mass rather than an elite market. This is a new social phenomena in the UK but not in the USA.

An effective executive compensation scheme recognizes the fact that old ideas of employer loyalty are dying fast among executives and professional staff up to 45 and, arguably, after that age it is not so much loyalty to an employer, as loyalty to their employer's final pension scheme and ageist attitudes that stops many staff shopping around.

This change has accelerated over the past two decades as placement and search consultants have added to the natural volatility of well qualified executives who have increasingly become a graduate cadre in the UK, as they have been for years in the USA and France.

Our analysis indicates that most of the movers and shakers are loyal to:

1. Managing their own career.
2. The skill sets and professional qualifications which they have or are developing. This is particularly prevalent among MBAs.

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3. The possibility of significant capital gain from share-related incentive schemes or from setting up on their own.

4. The concept of a reasonable salary and annual bonus of 20 to 30 percent as almost automatic if they have skills that are in continuous demand.

Given this reality, the complaints of many chairmen and human resource directors that loyalty to a single employer is dead, is clearly correct but too many of the incentive schemes we see are based on the assumption that there remains a traditional and natural employer loyalty among this group, which can be encouraged with traditional profit-sharing-type schemes designed on the basis that the beneficiaries are old style employees rather than well qualified individual money makers currently renting their skills to you.

The increasing sophistication of accounting and computer analysis systems allows management to measure contributions to shareholder value much more accurately via:

1. Increasing pre-tax profits.

2. Increasing gross margins.

3. Enhancing balance sheet fixed asset values.

4. Enhancing intangible asset values such as brand, public awareness and public trust attitudes.

5. Promoting and hyping shares above the intrinsic value of the underlying company.

Given these factors, we consider an effective current pay scheme in the private sector, whether the employer is an industrial or consumer company, a professional partnership or even a charity, needs to have the following characteristics:

- The remuneration committee or executives who set the parameters for reviews understand that it is the targets against which performance is measured that are increasingly more important than the size of the rewards themselves. A single criterion such as divisional profit is very unlikely to be the best measure for any executives other than the divisional CEO and companies must give more thought to how to use the information now available to them to set more relevant performance triggers for their senior executives.

- At least 90 percent of total remuneration has to be geared around the unit which the individuals can control, rewards based on the holding company's or other superior unit's performance, do not act as an incentive.

- Salaries should not be far above or below a median but the incentive system should offer potential rewards above the expectations of the group involved.

- Wide differentials are unfortunately inevitable as most organizations depend upon the drive, skill and dedication of no more than three or four people.

- Payment currency, whether cash, shares, additional benefits or the right to a gap six months, needs much more attention than it has had in the past. You should, as far as possible, offer the bonus beneficiary the maximum choice.

- Executive and professional turnover of rates of 20 to 25 percent are acceptable, however, bonus banks and the release of generous incentive payments over time if performance continues to be good should be part of the system so that leavers sacrifice a significant amount of unpaid bonus, whether in the form of cash, options, shares or lifestyle benefits.

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Hands on reward for divisional management

As institutional investors can only buy the shares of quoted companies, usually the holding company of a group of operating subsidiaries, the whole debate about corporate governance, added shareholder value and the remuneration of directors via shares or options in the companies for which they work has tended to take place at the quoted company level.

At Top Pay Research Group, we are beginning to understand the problems this creates in providing proper long-term incentives for the management of major divisional or subsidiary units.

As delegates to this conference will be aware, the dramatic swings in share valuations, as different sections of the market go in and out of favor, can create quite unfair winners and losers amongst those holding quoted company options.

Institutional investors believe, and I can quite see from their standpoint why they believe, that unless they, as investors, have realized a significant profit, or at least seen added shareholder value from the investment in a company's shares, it is unfair that the management group should, through options, have a one way bet and do not share the pain of a (short-term) falling share price.

Hands on reward

However, this is a mistaken view as an executive holding options that were worth £400,000 and are now underwater feels this loss every bit as much as a shareholder. However, they are not subject to external criticism, other than from partners, for "investing" in the options in the first place.

One result of this is the unhealthy amount of time and attention being spent on possible trade sales by many UK boards as the only method of raising their short-term share price and option values.

This is already leading to first-class companies being purchased at a very low price by private venture capital groups and seems likely to lead to a return of the unfocused conglomerate, where companies with highly priced paper snap up other groups trading at a significant discount even if they are not in the core market areas of the purchaser.

Institutions have been opposed to the conglomerate ever since the great days of Hanson Trust and BTR as they want to invest in quoted companies in specific sectors and make separate investments in other industries, rather than have a conglomerate management team take the decisions for them.

However, the current situation in so many sectors of British industry appears likely to lead to the return of exactly the type of opportunistic conglomerate institutions claim they do not like.

The insistence upon options and long-term share schemes being based on the results of parent companies has led to incentive problems on divisional boards, where most of the profits are earned and bonuses tend to be annual cash schemes. Divisional

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executives often participate in group options, or the group ESOP scheme, but in most cases do not feel they have sufficient influence on the price of the group shares for this to be any real incentive.

A further disadvantage is that divisions are often anti-cyclical with each other and their own parent, this is why they were purchased in the first place. However, the number of holding company options, based on group results rewarded to directors in divisions that are out-performing and under-performing, are often the same. Many groups quoted on the main exchange, and one or two on AIM, with market caps of £50million plus are actually conglomerates of three or four different operating units in related but different markets and suffer from this problem.

One of the major fault lines in British private sector remuneration policy is the under-provision of targeted longer-term incentive schemes for divisional operating management. The under-valuation of so many of these (non core) divisions is demonstrated by the price at which their corporate owners often sell them on to a buyer. This mirrors the problem of quoted companies in several sectors where take-over premiums are often 50-100 percent above the current market price because their LSE/AIM valuation results in a continuous and heavy discount to fair value.

The Top Pay Research Group is involved with five groups who are trying to tackle this issue. Our experience to date highlights most of the problems:

1. *Valuation.* Although subsidiary companies, or operating divisions usually produce their own accounts that are filed with relative authorities, they are often not a full reflection of corporate value. The holding company usually offers a treasury function, and is the bank for the group. It may well choose to value assets for overall tax reasons in a way that does not properly reflect their value in the subsidiary's balance sheet. For any option or phantom share system to work properly there must be an agreed standard for valuing the unit and particularly its fluctuating goodwill.

2. *Taxation.* Many of the current medium term investment schemes, such as the Enterprise Management Initiative, expanded in the recent budget, can be used by public or private parent companies. You cannot use this type of option scheme for subsidiary company shares, which automatically denies executives who hold shares in such companies the tax benefits that come with EMI status. EMI options can be converted into shares taxed on a capital gains tax basis plus taper relief rather than the much more damaging income tax and national insurance costs of an unapproved share option scheme.

3. *Jealousy.* In situations where divisional management can earn very significant sums, if the division itself outperforms a peer group or the budget set for it by its holding company, divisional directors can often earn sums similar to, or even in advance of those on the holding board, including their divisional chairman who is answerable for their activities to the main board.

   Although in theory main board directors should not mind, as the group benefits from this success, in practice they do feel very strongly that unless the directors of the division are better paid because they run the US, or European regions where remuneration patterns are higher and it is unfair that this should happen.

4. *Ambition.* Many holding companies want to take all the strategic decisions at group level, with the operating divisions simply implementing group policy. If, however, the division starts to have its own remuneration policy and is aiming to exceed what

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its holding company has set as its targets, it can start to evolve its own divisional strategy which might not be totally in line with the holding company plan. We can all see the sort of problems this could lead to but in our experience, divisional strategy initiatives often yield better returns than a passive acceptance of group strategy which may not be as ambitious or profit orientated as it should be.

5. *The age of divisional management.* Divisional management is usually much younger than holding company management and at a point in their lives where they have maximum domestic outgoings on mortgages, school fees and other expenditures as we all have, or remember having, when we were in our 30s and 40s.

   We see mistakes being made by boards of directors in their 50s who assume that, because they favor options and long term plans that could make them millionaires over time, the same view will automatically be held by their own staff, many of whom are 15 years younger, facing a completely different earnings outgoings equation who will sacrifice jam tomorrow for more money now to balance their domestic budgets.

   This means that divisional resistance to remuneration schemes not paid in cash and not paid out quickly can be significant.

6. *Currency fluctuations.* Whilst a group may be operating in five or six currencies and have a very sophisticated treasury function which offsets its various exposures and decides whether or not to cover forward, divisional currency exposure can be quite different, with 80 percent of its turnover in a single currency not necessarily that of its host country.

   Very few divisions, in even the largest groups are allowed to manage their own currency exposure and results may be very badly affected by adverse swings between, say, the dollar and sterling or sterling and the euro.

   When the year is ruled off, this may result in a 30-40 percent decrease in what the division sees as its proper profit allocation and justify a complaint that it was not, because of a group policy, allowed to lay off it's currency exposure and reduce the loss.

   Whilst I am not advocating a break up of the central financial or treasury function in a multi divisional group, I am saying that, if divisional long term incentives are to work, the relationship between the division's finance director and the central treasury function in both currency and treasury management – the division may be lending significant cash to the group – are issues that have to be resolved. Otherwise there can be a lot of resentment when the profits, against which bonuses are assessed, are struck each year.

7. *Entrepreneurial board and divisional leadership.* In the very well established international groups, such as BP Amoco, Nestle, Unilever and Accenture, entrepreneurial divisional managements have been encouraged for years and the systems to give them the necessary freedoms are in place.

   However, the contention of this paper is that, in a number of medium to large quoted British companies, these systems have not been encouraged and the current approach to highly centralized control, including long term incentive remuneration and, in some cases, short term bonuses, is antagonistic to the concept of the entrepreneurial division. As a member of the Institute of Personnel Development,

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I am sad to have to say that part of the problem is the development and expansion of central group personnel departments that are not just advisory units but tend to lay down, with the encouragement of the chief executive, very rigid policies controlling pay at the top levels of operating divisions.

One of the difficulties is that most senior human resource management have had no line or profit responsibility and have great difficulty in understanding the personality of entrepreneurial managing directors.

If you are going to build an entrepreneurial board based on entrepreneurially led divisions, it is essential that the main board empowers divisional managers to set up incentive schemes which are relevant to their particular business and its cycle.

The success of venture capital groups in managing this issue in their wholly, and partly owned, subsidiaries is a very major factor in their continuous creation of shareholder value.

Investors and main board directors usually feel that the right balance for long term and even annual bonuses should be around 60 percent related to the division for which the executive works and around 40 percent from the group above them. This is designed to ensure that they are more cooperative in accepting policies that suit the bigger unit and it is also hoped that it will form a bonus based loyalty bond between management up and down the company.

I used to believe this was correct but in the hard world of profit and incentives, I am now fairly certain that the maximum amount of any individual's remuneration, that depends upon performance in a unit above the one in which they work, should be 10 percent.

The loyalty of a management team is to the division or unit they can control themselves and, although they pay lip service to being part of a big organization and are very happy if share options result in windfall profits, they do not really feel that this is much to do with them and/or their team. Their loyalty is, as it probably should be, devoted to units where they can make a significant difference because they control its short and, hopefully, long term destiny.

Given this, what sort of remuneration techniques can help foster entrepreneurial divisional leadership?

1. The timeframe of long-term incentives.

   Whilst senior management in a company probably do not expect to change employers again before they retire, this is simply not true of their divisional managers, probably in their 40s and expecting to move on to a main board, either in their own company or elsewhere in the next five years. For this reason, the longest period which, in our experience, you can expect a management team to wait for earned but delayed payment rewards is three years. For this to offer effective handcuffs, you need to set up an overlapping system whereby every year a new three year performance bonus system starts so that, as one pays out, the executives in the team are into the first and second year of the subsequent schemes, and would sacrifice any built up benefits if they left the group. Most managements accept the philosophy behind this thinking, the difficulty being implementation. Organizations moving from a one year to a three

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year bonus scheme, face a bonus famine for the first two years of the new system before the first year's bonus is paid in full.

It is therefore necessary to either phase in the new system over a three year period, so that the annual bonus reduces as the three year bonus starts to bite. Alternatively you can allow beneficiaries to borrow against money in the bonus pool.

2. The bonus bank

One way of implementing this policy is to have a bonus bank. Each year the collective bonus pool is paid into the bank and individuals are allowed to draw up to 20-50 percent of their salary as a short term bonus, with the remainder rolling up, to be paid either in years two and three or else as a balloon payment at the end of the three year period.

In order to make this delay acceptable, it is usually necessary to offer interest on the delayed bonuses held in the bank. For entrepreneurial companies, that wish to provide very high incentives, a popular system is for subsequent bonuses not just to apply to salaries but to unpaid bonuses in the bank. This produces a very highly geared situation in which the bonus bank deposits increase quite significantly each year. Bonuses are usually paid in cash and impact the divisions own profits in subsequent years as the payments can be quite substantial. To allow for this we suggest that bonuses must be entirely self-financing, coming from profits above those budgeted or alternatively the profit bonus itself is part of the budgeted cost base.

3. Do shares or share schemes have a role

This may strike you as a surprising heading as I have spent most of this paper describing why incentives based upon group equity or group options are failing to incentivate divisional management. However, under roll-up accumulator or bonus bank systems the use of company shares in an ESOP as an alternative to cash as a payment currency can be very sensible.

Executives are offered a choice between taking cash or company shares at the point of payment, and in some cases, I think legitimately, they can be forced to take shares if the total amount due is over a certain absolute figure, say £200,000 or a percentage, say 150 percent related to their salary.

From the companies point of view an advantage of part-payment in shares, which have to remain in the ESOP, for a year or two, is the additional hand-cuff in the whole roll-up incentive scheme.

This is an important issue as one of the dangers with accumulator schemes is that when the rolled up sum, maybe £200,000, is received by the executive he/she may leave to set up their own business or take a sabbatical couple of years.

There are no limits to the number of shares a company can hold in its ESOP scheme, thought institutions get worried if the percentage goes over 5 percent as they would, mistakenly, rather have the shares purchased in the market and cancelled.

The increased cost of warehousing shares in this way via, normally, a separate loan facility guaranteed by the company, can be offset by the dividends due on the holding so that the net interest cost can be a low 2-3 percent.

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Unfortunately it is not possible to use options as an alternative payment currency when bonuses vest. There are two problems first, options actually do not have any value at the point of issue, they only acquire value if the shares on which they are based appreciate, and despite the use of the Black Sholes' model not many executives would be willing to swap hard-cash for the possible benefits implicit in an option.

Secondly, institutions are extremely concerned about the number of shares available under option. This was not particularly difficult when most of the quoted companies on the London Exchange were fairly asset heavy, manufacturers, chemical companies, construction, hotel groups etc.

However, the rise of the service economy has resulted in many groups now having 50-60 percent of their total costs in their payroll. For such companies the percentage of shares allowable under options, 5 percent for executive and 5 percent for all employee approved savings related schemes, is not sufficient to provide the incentive currency they need.

Many high-tech and other people businesses put option schemes over shares representing 10-20 percent of their issued equity in place before their placing to overcome this straightjacket. They will, and are, having problems when their original option schemes vest, expire or need to be cancelled and re-issued to have any worthwhile purpose.

Example

The XXX Group

(This is an actual company)

The XXX Group, founded by the chairman and one or two colleagues who left ZZZ plc in the 1970s, has grown into the largest property building and development group in Britain.

Until four years ago, it was called XXX XXXX and concentrated on building up market houses across the south of the country.

Since the change of emphasis to brown-field sites, it has become the biggest development of mixed use sites in the country, providing industrial and commercial premises, houses, flats and community housing, plus leisure and other site facilities including at Imperial Wharf – a new railway station.

It is creating total communities in an attempt to cut down commuter traffic in the future.

The group operates through regional divisions such as AAA and BBB, which are themselves larger than many quoted building companies.

The growth of the group has to some extent overtaken its traditional remuneration systems which were based on:

- Market-related salaries.
- Cash bonus up to 100 percent of salary for meeting unit, divisional or group targets in full, but 95 percent achievement earned nothing.
- Options over group shares for both main board, subsidiary board and senior executive staff.

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As delegates know, the house building and development sector has been lowly rated by the investment community since the property slump in the early 1990s.

For this reason, the group share price did not reflect the huge increase in turnover, profits or earnings per share over the past five years. The option and share schemes introduced over the past ten years were in the money but did not reflect, in the eyes of the beneficiaries, the value they had added to the group.

The main attraction to ambitious managers joining the group was the de-centralized management style that gave real authority to unit and divisional managers to develop their businesses as they wanted, as long as they were budgeting profit growth of, at least, 20 percent a year.

The main threat was not that managers would join a competitor but with the cache of a XXX unit managing directorship behind them, would borrow £1 million and go into business for themselves as the founders of XXX had done 30 years earlier.

In their 50-strong senior executive cadre, there were at least 20 individuals capable of doing this if the group did not make it more attractive to stay with XXX.

Our review and recommendations

The most important thing was to maintain the de-centralized style of the group where divisional and unit managing directors retained significant compensation power.

Review and recommendations

At the same time, it was clear that the group could not maintain the growth rates of the past as its size mitigated against sufficient sites being available to allow this to continue.

However, units that had three years ago been looking at budgets with an annual profit of £3 million, were now controlling activities and profit budgets of £20 million and an achievement of 90 percent of this budget was of significant importance to the group.

We agreed the following structures with the remuneration committee:

- That the remuneration committee would only directly control main board remuneration and remuneration concepts at divisional level.
- That salaries should continue to be at no more than median market levels.
- That annual bonuses should be capped at 150 percent rather than 100 percent of salary.
- That instead of a single profit target triggering a 100 percent bonus, there should be an escalating bonus payout from 90-130 percent of target achieved.
- All divisional bonuses would be payable in cash but executives would have the choice of allocating part of their bonus to an ESOP scheme and acquiring company shares which could continue to appreciate free of tax.
- That bonus pools generated by the managers of any unit meeting their collective targets would be distributed on a 70/30 basis, whereby 70 percent was payable automatically related to salary and 30 percent was discretionary to the unit managing director plus one executive from the next layer up to guard against the blue eyed boy syndrome.

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- If bonuses were over 80 percent of salary, the surplus had to be paid into a bonus bank for release over a three year period.
- That the group share option scheme would be phased out for those below the main board.
- That divisional management would have the right to adjust the individual salaries within their operations but that they should be subject to a senior staff review budget set at a percentage of the current collective salary costs. At the moment they need to clear individual awards with group executives.

The purpose of these changes is to give more remuneration power to divisional boards whilst maintaining some central control.

Checklist for the remuneration committee on divisional remuneration

The remuneration committee's responsibility at divisional level is to ensure that the systems in use are likely to be effective and contribute towards the group's long-term business plan.

They should not get involved in the individual awards to executives other than divisional CEOs if they do not sit on the main board.

However, they should ensure that the systems in use have the following characteristics:

1. That 90 percent of the rewards are concentrated on divisional performance and below the division on unit performance.
2. That significant bonuses should be available for over-target performance. However, if this could result in bonuses of more than 50 percent of base salary, a bonus bank or delayed payment system should be considered.
3. That the targets used within each scheme, are relevant to individual executives' abilities to deliver and that simplistic targets such as divisional profit against budget are at least questioned in terms of their effectiveness.
4. Divisional managements should not be entitled to pay above market rates salaries which can be an easy hiring option without specific group clearance. Executives' extra income should come from bonuses. Guaranteed first year bonuses are acceptable.
5. Divisional budgets for collective senior executive salary increases should be seen by the remuneration committee. These might vary wildly between divisions in different market sectors or in different countries but, generally, we recommend they are signed off by the committee as well as the group CEO.
6. The remuneration committee should question the use of options or incentives based on group equity at divisional level even if this is clearly the preferred choice of institutional investors.
7. The chairman of the remuneration committee should be willing to argue the toss with significant institutional investors, and clearly state the committees incentive strategy for divisional and main board directors before any awards are made. In too many companies this is left to the company secretary. Which brings me on to my last point.
8. The chairmanship of the remuneration committee, properly done, is a major job taking an extra three to four days a year on top of a normal NXD commitment. It is usually underpaid and it's increasing importance is not fully recognized by companies or their advisers.

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