Fixing executive pay

Management feature

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On October 1st 2001, Sidney Taurel, Eli Lilly's chief executive officer, gathered the pharmaceutical company's 41 000 employees via videoconference to outline far–reaching cost reductions. Standing in the cafeteria of Lilly's Indianapolis headquarters, Taurel added up the financial impact of losing patent protection for Prozac—the blockbuster antidepressant that accounted for over a third of Lilly's $2,8 billion profit in 2000.

No one would receive pay increases in 2002, Taurel said, and managers would give up bonuses and stock grants. Then Taurel delivered a blockbuster message of his own: He asked directors to slash his 2002 salary to one dollar. Employees got to their feet and applauded.

In an era of ambiguous compensation plans for top managers, Taurel's request to cut his pay sends a clear signal of accountability. But compensation plans shouldn't rely on individual acts of responsibility, however admirable. Instead, such plans should explicitly and systematically link executive pay and shareholder value.

The critical question institutional investors are asking about executive compensation is not: "How much are we paying?" Rather: "What are we paying for?"

Bain interviews with some 40 institutional investors in the UK and US underscore this point: roughly 90% oppose option re–pricing; 82% say they want to discontinue rich severance packages; and 70% are against awarding bonuses tied to acquisitions. Yet, 63% say they are willing to approve compensation plans that give senior managers a larger share of the value they create for shareholders—as long as senior managers also share in the downside.

Indeed, when pay is the measure, most executives still don't feel the same pain as their shareholders. In 2001, when stock prices of the S&P 500 fell 13% and corporate profits were down 35%, median total compensation for CEOs rose in nearly all industries, ranging from an increase of 31,6% in construction to 0,3% in financial services, according to the most current data on executive compensation compiled by The Conference Board. The exceptions were retail and telecommunications where CEO compensation was unchanged.

Tying executive compensation to sustained value creation will not happen simply by linking compensation to stock price. Management could be focused on the wrong priorities, yet still benefit from a rising market. Or it could be doing exactly the right things, but still suffer due to forces outside its control.

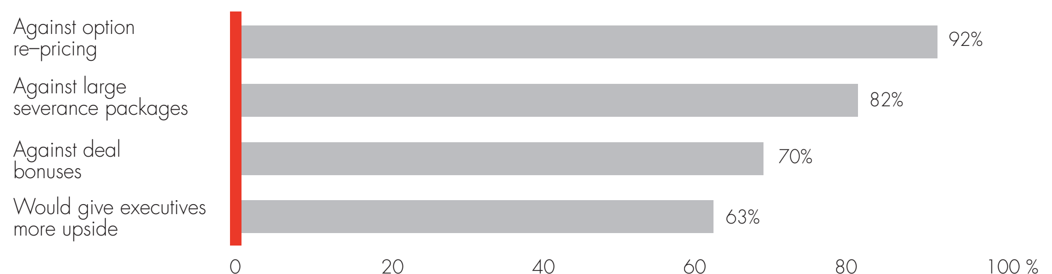
The best compensation systems pay out for successful strategy execution while including an equity component to align management and shareholders. Executives are pushed to outperform both ambitious internal targets and their peers in the stock market.

The companies that appear to get real benefit from linking pay and performance apply four basic principles:

- They are clear about what drives value in their businesses; they communicate it widely—internally and externally—and they measure what matters.
- They tie compensation to the real value created—reflecting the performance of both share price and the underlying business over time.
- They recognise that the frontline drives the bottom line, and cascade appropriate measures and incentives to key employees.
- They build trust with compensation systems that are transparent to both employees and investors.

Figure 1: Percentage of investors would pay executives to put more skin in the game

Source: Bain interviews with 42 institutional investors April-August 2002



Be clear on measures that matter

Dell Computer has built a pay system that hits many of these marks. Dell's strategy of cost and customer leadership hasn't wavered in a decade. Cost leadership, for instance, hinges upon Dell's ability to manage inventory levels, working capital, return on invested capital, and service support costs.

With a clear picture of what drives value, Dell's pay system starts with executives' base salaries, which are average among high–tech companies. A bigger potential slice of the pay package comes from long–term, equity–based compensation that helps motivate managers to increase shareholder value.

The reward for successful strategy execution is built into Dell's annual bonus, which uses value drivers such as operating profit margin and customer satisfaction metrics to set ambitious targets for executives. In 2001, for instance, CEO Michael Dell received only 25% of his possible bonus, although the company performed well, compared to its peers. The reason? The business fell short of hitting some aggressive internal targets that would have helped Dell reach its profit potential a few years out.

Tie compensation to strategic targets

At Reckitt Benckiser, UK–based maker of household cleaning products, senior managers' base salaries are below their competitors', and long–term incentives don't pay out unless the company achieves growth rates that are double the industry average. The system's multiyear aspect focuses management on sustainable, not short–term, growth.

To earn bonuses, Reckitt Benckiser executives must show measured progress toward the company's strategic targets. Net revenue growth that exceeds the industry average is one such target; executives achieve it by investing in high–growth categories where the company has market–leading positions.

The plan also ensures that management feels the pain if shareholders are suffering. Besides using stock–based incentives, Reckitt Benckiser mandates minimum holdings of 200 000 shares for each senior executive and 400 000 shares for the CEO. The plan prohibits re–pricing options and requires that bonuses be withheld when targets aren't reached. "I want to make people sweat", says CEO Bart Becht.

Cascade incentives

Some companies do link executive compensation to both shareholder value and strategic targets, but fail to focus the rest of the organisation on the same goals. However, online trading company eBay recognises that customer service employees on the frontlines are vital to profitability; they help build a loyal customer base and encourage existing customers to explore new categories. Which explains why key employees' pay is based on direct customer feedback.

Another example is US steel maker Nucor, which has pushed production incentives out to its mill workers. The company pays hourly workers about half as much as the competition, then adds weekly cash bonuses that can double or triple the hourly wage depending on the amount of quality steel handled by a work team on its shifts. When weekly bonuses are included, Nucor's hourly workers, all non–union, are the highest–paid in the industry—yet the company is one of the most efficient in terms of labour costs per ton produced.

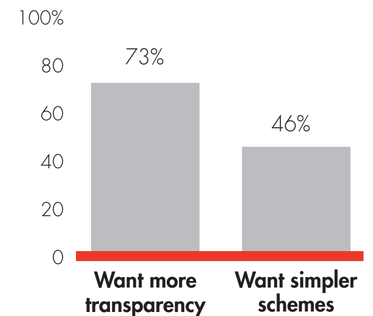
Be simple and transparent

Once companies have linked compensation to what drives value, they can explain compensation packages to employees and investors with credibility. Compensation has greater impact when everybody knows what he or she is paid for. Indeed, shareholders who understand compensation packages are more likely to accept them.

The debate on executive compensation is set to run, particularly with company performance lagging, and the stock markets feeling their way through uncertain economic times. But this debate will be more productive if companies and shareholders focus on the right question—not on whether executive teams are overpaid, but how compensation can be linked more effectively to sustained and superior performance. Sidney Taurel is an inspiration, but it shouldn't take an individual act of responsibility by the CEO to align pay and performance.

Figure 2: Transparency is critical to investors

Source: Bain interviews with 42 institutional investors April-August 2002



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