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VIEWPOINT ORIT GADIESH AND MARCIA BLENKO

The weapon of executive pay

High rewards for top managers can succeed only if the right strategic targets are set

How can top managers be paid so much when their companies are achieving so little shareholder value? The problem with this burgeoning debate is that it usually focuses on the total amount of compensation, rather than the link between compensation and shareholder value.

Good managers deserve rewards. Those who set high targets for value creation and meet or exceed them are worth a lot of money. That is certainly the view of institutional investors. But the critical question investors are asking about executive compensation is not "how much are we paying?" Rather, it is "what are we paying for?"

Interviews conducted by Bain with 42 institutional investors in the UK and the US underscored this point. Almost all (39) opposed option repricing; 29 were against awarding bonuses tied to acquisitions; and 34 wanted to discontinue rich severance packages.

Yet significantly more than half (26) were willing to approve compensation plans that gave senior managers a larger share of the value they created for shareholders – as long as executives also shared in the downside.

Tying executive compensation to sustained value creation will not happen simply by linking compensation to shareholder returns. Management teams could be focused on the wrong priorities but benefit from a rising market. Or they could be doing the right things but be penalised as a result of forces outside their control.

The most successful compensation systems have an equity component to align management and shareholders but also pay out for successful strategy execution. To do this, companies need to be clear about what drives value in their businesses and tie compensation to the measures that matter, such as customer retention for a bank or like-for-like sales growth for a retailer. In the best systems, executives must outperform ambitious internal targets and their peers in the stock market.

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Dell Computer, which recently reclaimed industry leadership in personal computers, illustrates many of these features. Dell executives are paid base salaries equal to or lower than those of their peers at other high-technology companies. Long-term equity-based compensation helps motivate managers to increase shareholder value. Annual bonuses hinge on achieving a number of ambitious financial and non-financial targets based on Dell's strategy of clear cost and customer leadership.

Last year, for instance, Michael Dell, chief executive, received only 25 per cent of his possible bonus, although the company performed well relative to peers. The reason? The business fell short of some of its aggressive internal targets.

Of course, hitting strategic targets will not automatically lift a company's share price. But performance improves when companies understand their business potential and focus the organisation on the most critical levers for achieving it. Unless the incentives to perform are palpable, compensation becomes a blunt tool – or, worse, a scheme that rewards mediocrity.

In fact, executives are often paid to underperform. In 2000, 85 per cent of UK corporate leaders received their maximum bonuses, 40 per cent received long-term pay-outs for median performance and 43 per cent were awarded option plans for hitting growth targets of only 2-3 per cent above inflation*.

In some industries just beating inflation is considered a tough target. But for many others such targets are not ambitious and fall below even the lowest range of analysts' estimates.

Compare this with the system at Reckitt Benckiser, the UK-based maker of household products. Senior managers' base salaries are well below their competitors' and long-term incentive schemes do not pay out unless the company achieves growth rates that are double the industry average.

But the company's aggressive, five-year compensation plan promises £60m-worth of options to reward the top 40 executives if they hit growth targets double the average – real encouragement to produce results. The multi-year aspect of this system focuses managers on sustainable, not short-term, growth.

Reckitt Benckiser's plan also ensures its managers feel the pain if shareholders are suffering. As well as using stock-based incentives, the company sets minimum shareholdings for senior managers, prohibits repricing options and withholds bonuses when targets are not reached. "I want to make people sweat at night," says Bart Becht, chief executive.

Some companies link executive compensation to shareholder value and strategic targets, only to fall down on implementation. What goes wrong? Some neglect to tailor the measures to their own strategic situation. Others use measures that are too complicated and lose their impact. Many companies miss the important front-line employees or spread the incentive schemes too broadly through the organisation, creating a costly and complicated system.

Good things happen when key employees throughout the company share the same goals for value creation. Online trader eBay drives profits by building a loyal customer base and encouraging existing customers to shop from new categories. Customer service employees on the front line are vital to profitability; their pay is based on direct customer feedback and employees can look at reports on their performance at any time.

Transparency is a powerful benefit of getting the pay-performance link right. Companies that are clear about how value is created in their businesses can defend compensation packages to investors and employees with credibility. Ensuring that everyone knows exactly what they are paid for can be highly motivating, as Dell, eBay and Reckitt Benckiser understand. When that happens, compensation becomes the competitive weapon it ought to be.

******Andersen Directors Remuneration Report, September 2001***

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