Strategic Capabilities Network

What’s Equitable in Executive Compensation

November 19th 2014

McDowall Associates: Who Are We?

- *A Canadian privately-owned compensation consulting firm founded over 20 years ago.*
- *A team of 18 associates and growing.*
- *Specialists in compensation consulting and administration:*
  - Compensation Plan Design
  - Board Advisory Services
  - Executive Compensation
  - Position Evaluation
  - Pay Equity Plans and Audits
  - Measuring Pay for Performance
  - Compensation Market Reviews
  - Performance Management
  - Sales Compensation

Our approach to executive compensation consulting is to take a **position on issues** and provide **practical processes** to help our clients achieve their goals

MCDOWALL ASSOCIATES

Let’s Talk About Executive Compensation

Headlines You Never See

CEO Forfeits Stock Options

Pay Day! Company Boss Cashes in Whopping $9,200 RSU Grant

Underwater Stock Options Record Beaten : John Smith's Awards Worthless For More Than a Decade!!!

CEO Turnover is Expensive
- McDowall TSX 120 Company Research

- Of a sample of 12 new CEOs reported in 2012 and 2013, 6 were internal promotions and 6 were external hires.
- At the median, the external hires were 6% more expensive than the internal promotions were
- The external hires were also 6% more expensive than their predecessor CEOs, while the internal promotions were 12% less expensive than their former CEOs
- The external hires also received higher special one-time awards than the internal promotions were given

For this and other executive compensation research articles see www.mcdowallassociates.com and click the *Knowledge* icon

MCDOWALL ASSOCIATES

CEO Turnover is Expensive
- McDowall TMX 120 Company Research

- What is the total cost of CEO turnover? A lot!
- In each of the 12 situations, we added up
  1. the severance payouts to the outgoing CEO,
  2. the difference between the new CEO's target total direct compensation vs. the outgoing CEO's compensation,
  3. the additional cost of any on-hire awards or promotion awards over the new CEO's target awards, and
  4. the incremental value of any special pension arrangements given to the new CEO.
- We found the median total CEO turnover cost to be
  - $8.0 million for the external hire companies, vs.
  - $4.3 million for the internal promotion companies

MCDOWALL ASSOCIATES

Hiring a New CEO
– Let's Start With The Theory

- In line with the academic research, the board wishes to promote an incumbent executive, rather than hire an external candidate
- A consultant is asked to provide a standard CEO compensation review to the selection committee
- The compensation of departing CEO is considered a primary benchmark, along with the incumbent's current compensation
- Market information is weighted relative to the market and the internal executive compensation structure
- No special promotional compensation or awards are deemed necessary
- The resulting compensation package is presented to the executive largely as a "fait accompli"

Hiring a New CEO
– Now For The Reality

- The selection committee has been negotiating in confidence with the leading external candidate and his/her representative.
- Draft compensation terms have been put forward by the candidate
- The consultant is asked by the selection committee to review (and support) the proposed compensation:
  - Base salary
  - Annual incentive opportunity
  - Long term incentive grants
  - Target annual total direct compensation
  - Supplementary pension arrangements
  - Signing bonuses and/or up front equity awards
  - Relocation expenses and loans
  - Perquisites
  - Severance terms

Three Executive Compensation Challenges

- How do you develop compensation plans for the new CEO that align with *immediate/short-term* shareholder interests and also with the *long-term* best interests of the enterprise?
- How do you develop incentive plans that measure the right metrics in an objective manner, yet are flexible enough to change as the company evolves and has to adapt to its changing business environment?
- How do you minimize CEO compensation "hedging?" (i.e. be rewarded well for success, yet still be paid millions for failure?)

What About Stock Options – Do They Really Work?

- "The purpose of our stock option plan is to *align the interests of Executives with those of Shareholders*"
- If that is the case, this is an incentive that works.
  - Directly after the financial crisis, 80% of stock options that had been granted during the last pervious five years were underwater.
- They continue to be the most frequently used long-term incentive plan
  - Yet their dollar value is declining in favour of share-based plans, such as Restricted Stock Units and Performance Share Units

Know What You've Signed up For

- Stock options continue to be viewed with suspicion by the governance "experts"
  - Yet stock options are the most tax effective vehicle for the participants, and allow them to choose when to exercise
- The popular media usually misrepresents stock options when reporting their value as if they were actual "cash in the bank"
  - Option leverage can be spectacular *or* they can be worthless
- Multiple grants over a period of years add to their complexity
- Equity-based compensation is betting on the company's future success
- "Market theory" suggests eventual alignment of share price with profits.
  - In reality operational success and share price are not always neatly aligned, especially over a CEO's increasingly short tenure

What are the Downside Risks?

- Per Roger Martin, the former Dean of the Rotman School of Management and author of "*Fixing the Game*" *:
  - Focusing executives on shareholder value maximization using stock-based compensation does not work as intended
  - Instead, CEOs are encouraged to focus on what they can control: managing share price expectations over the short run, through earnings guidance and aggressive accounting
  - CEOs know that share price expectations are likely to fall, so they have incentive before they leave or retire to cash in on their stock-based compensation awards while expectations are still high

* Harvard Business Review Press, May 2011

Robert Levasseur
Senior Consultant and Principal
tel: 416 644 6584 ext. 201
cell: 416 357 0536
e-mail: blevasseur@mcdowallassociates.com

web site: mcdowallassociates.com

MCDOWALL ASSOCIATES