Shareholder Value Advisors

Designing Corporate and Business Unit Incentive Plans

For the senior officers of a publicly traded company, the stock price provides a better measure of management performance than operating measures such as excess EVA improvement. The stock price recognizes changes in the value of future growth opportunities. An operating performance measure can incorporate proxies for the value of future growth opportunities, e.g., the sales growth rate, but never provides as accurate a measure of change in future growth opportunities as the stock price.

Stock based incentives for senior corporate officers, like all incentive plans, require a balance of alignment, leverage, retention and shareholder cost objectives:

Alignment: Giving managers an incentive to choose strategies and investments that maximize shareholder value.

Leverage: Giving managers sufficient incentive compensation to motivate them to work long hours, take risks, and make unpleasant decisions, such as closing a plant or laying off staff, to maximize shareholder value. The best measure of leverage is wealth leverage, i.e., the sensitivity of management wealth to changes in shareholder wealth.

Retention: Giving managers sufficient total compensation to retain them, particularly during periods of poor performance due to market and industry factors.

Shareholder Cost: Limiting the cost of management compensation to levels that will maximize the wealth of current shareholders.

Many plans are adopted with little examination of the reasonableness of the balance. For example, companies often make large, up-front stock option grants (which provide high wealth leverage) without considering the substantial risk that the options will fall out of the money (and lead to high retention risk). The retention risk of a large, up-front option grant can be substantially reduced, without destroying the strong wealth incentive, by granting the option in the money and indexing the exercise price to the performance of a peer company portfolio. But this alternative is rarely pursued because of unfavorable tax and accounting treatment. Another alternative, which provides a weaker incentive, but much less retention risk, is a policy of annual fixed share option grants. Large, up-front stock option grants are a dangerous policy because they involve more risk that a company can reasonably be expected to live with. The danger in taking too much risk is that the company will be forced to take actions, e.g., making replacement grants at lower exercise prices when the stock price drops, that undermine its credibility with investors and employees.

At the opposite extreme, a policy of competitive annual grants limits retention risk and shareholder cost, but provides weak wealth incentives. With a competitive grant policy, a company recalibrates the number of option grant shares each year to maintain the expected value of the option grant at a competitive level. For example, if 10,000 option shares at $50 provides a competitive option grant value in year one, but the stock price drops to $25 in year two, a company with a competitive grant policy will increase the option grant shares to 20,000 in year two. A competitive grant policy provides a weak wealth incentive because current performance has no effect on the value of future years' compensation. This means that a large component of management wealth, i.e., the present value of expected future compensation, is completely insensitive to changes in shareholder wealth. Few companies that adopt competitive grant policies do the analysis necessary to understand the strength of the incentives provided by their total compensation program.

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The first step in developing a reasonable balance of alignment, leverage, retention and shareholder cost objectives is to understand the implications of alternative design features. We quantify the implications of alternative design features in the following steps:

1. We develop 100 Monte Carlo simulations of stock market and operating performance over the next five years.
2. We calculate total compensation payouts and the value of stock and option holdings for each year in each scenario for the baseline total compensation program.
3. We calculate measures of alignment, leverage, retention risk and shareholder cost for the baseline total compensation program.
4. We modify the baseline total compensation program to reflect a change in plan design or policy, e.g., a change from competitive to fixed share option grant guidelines, repeat steps 2 and 3, and then assess the change in alignment, leverage, retention risk and shareholder cost resulting from the program change.

For business unit executives in a multi-unit company, the stock price does not provide a better measure of management performance than operating measures such as excess EVA improvement. If a business unit represents 10% of the market value of a company, a doubling in the value of the business unit increases the stock price by only 10% (so the stock price is not an accurate measure of business unit performance). But the doubling in business unit value will have a very substantial effect on the business unit's excess EVA improvement and could easily double the payout from a business unit EVA bonus plan. This means that a corporate stock option provides a very weak incentive to increase the value of the business unit.

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