

# **WorldatWork Feedback: Executive Reward**

**Matthew Melville**

*HR Director: Reward*

*Foschini Group*

# Benefit from WorldatWork

- Content
  - Level
  - Depth
- “Hooks”
- Distillation
- Immersive, Problem-solving environment
- Strong focus on Executive Reward

*Personal and Situational  
Learning – What was Learnt  
vs. What was Taught*

# The Story...

"Measurement"

"Portfolio Approach"

Optimising the Reward Outcome

Tough 2 years = learning the hard way

"Consolidated Modelling of Reward Outcomes"

# MERCER



MARSH MERCER KROLL  
GUY CARPENTER OLIVER WYMAN

**TOTAL 2010**  
**REWARDS**  
WorldatWork Conference & Exhibition



May 18, 2010

## Long-Term Incentives: The New World Order

Mike Halloran, Senior Partner

Ben Voss, Principal

[www.mercer.com](http://www.mercer.com)

THE FOSCHINI GROUP HR

# **2008 / 2009 Everything Changed....**

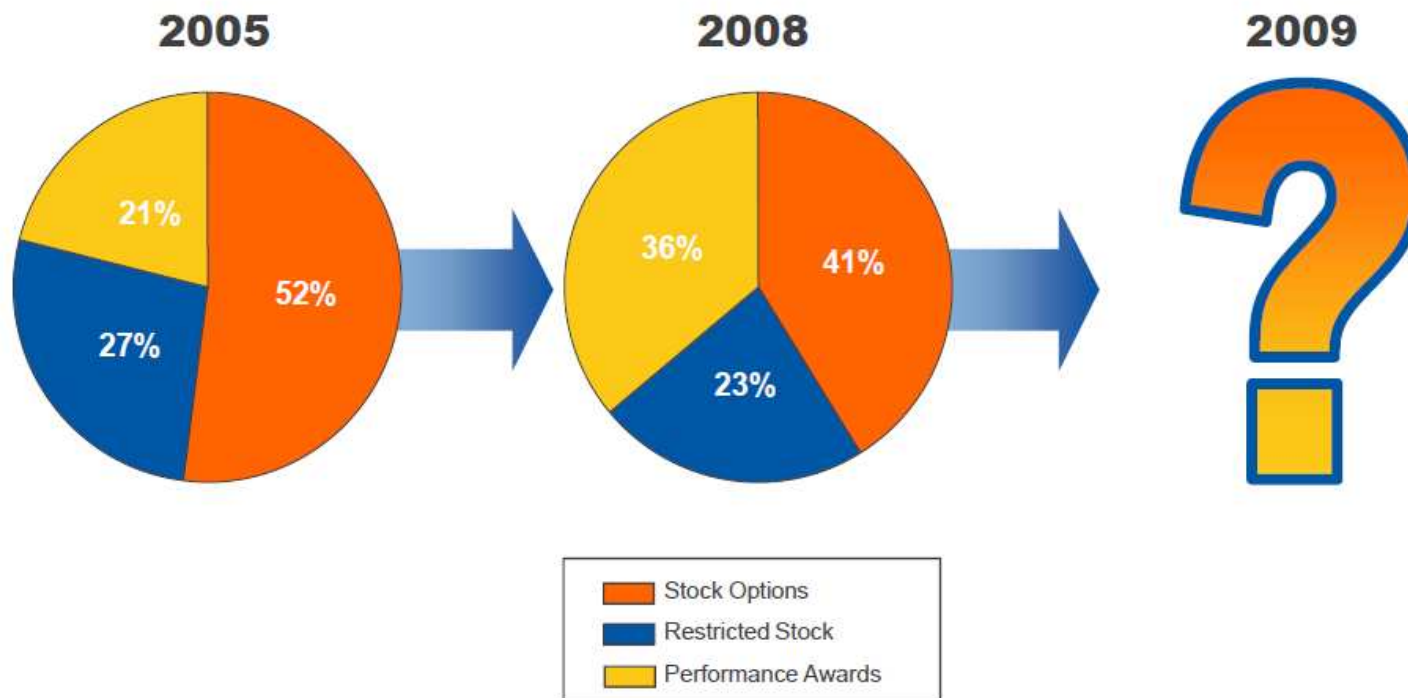
- **35-40% drop in markets (highest since 1937)**
- **Base Pay Frozen / Cut**
- **26% Companies changed their LTI Mix**
- **Underwater Options (73% granted over last 3 years – underwater)**
- **Conflict:**
  - **Lower Prices = Higher burn rates of shares**
  - **Goal Setting challenges / Measurement**
  - **Inadvertent Reward (Value maintained, low share prices – Face Value issues)**

# Language

- **Stock / Share Options**
  - Employee gets growth on # of shares
- **Performance Awards**
  - Subject to organisational performance
- **Restricted Stock**
  - Employee gets # of full shares, restricted from selling

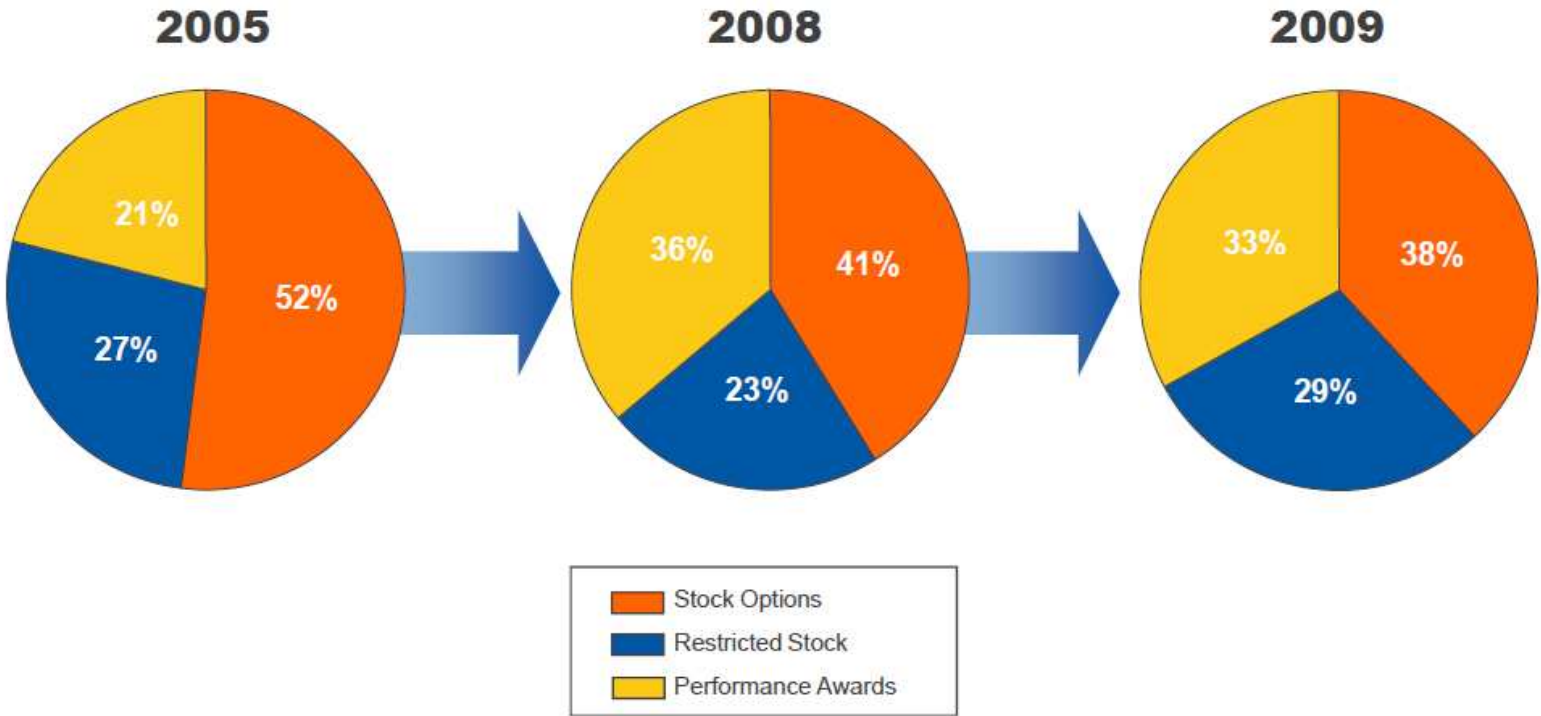
Recent trend (pre-2009): Fewer options and more performance plans

### Average Long-term Incentive Mix



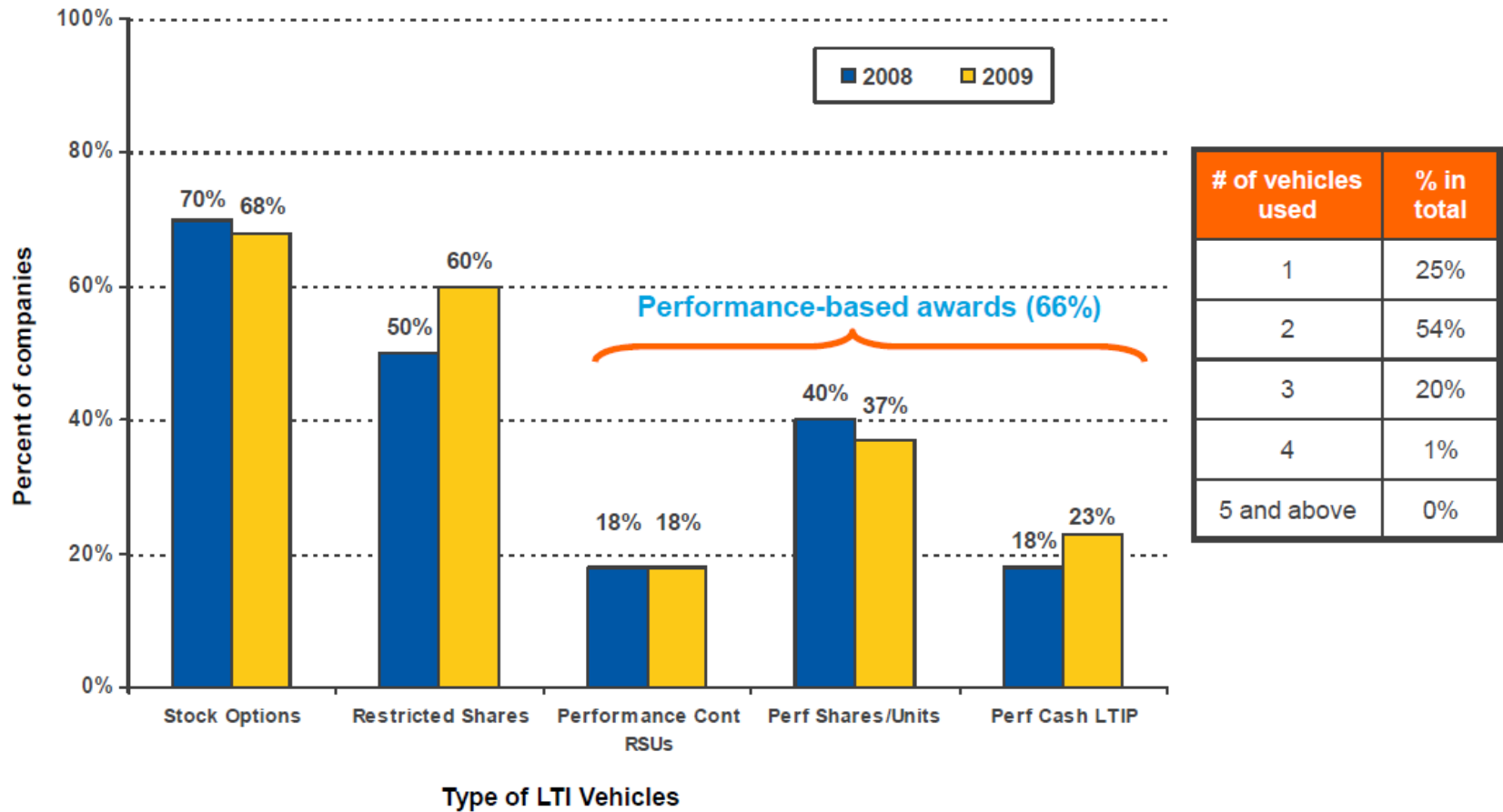
Then the market turned . . .

### Average Long-term Incentive Mix



## LTI: Prevalence of vehicles

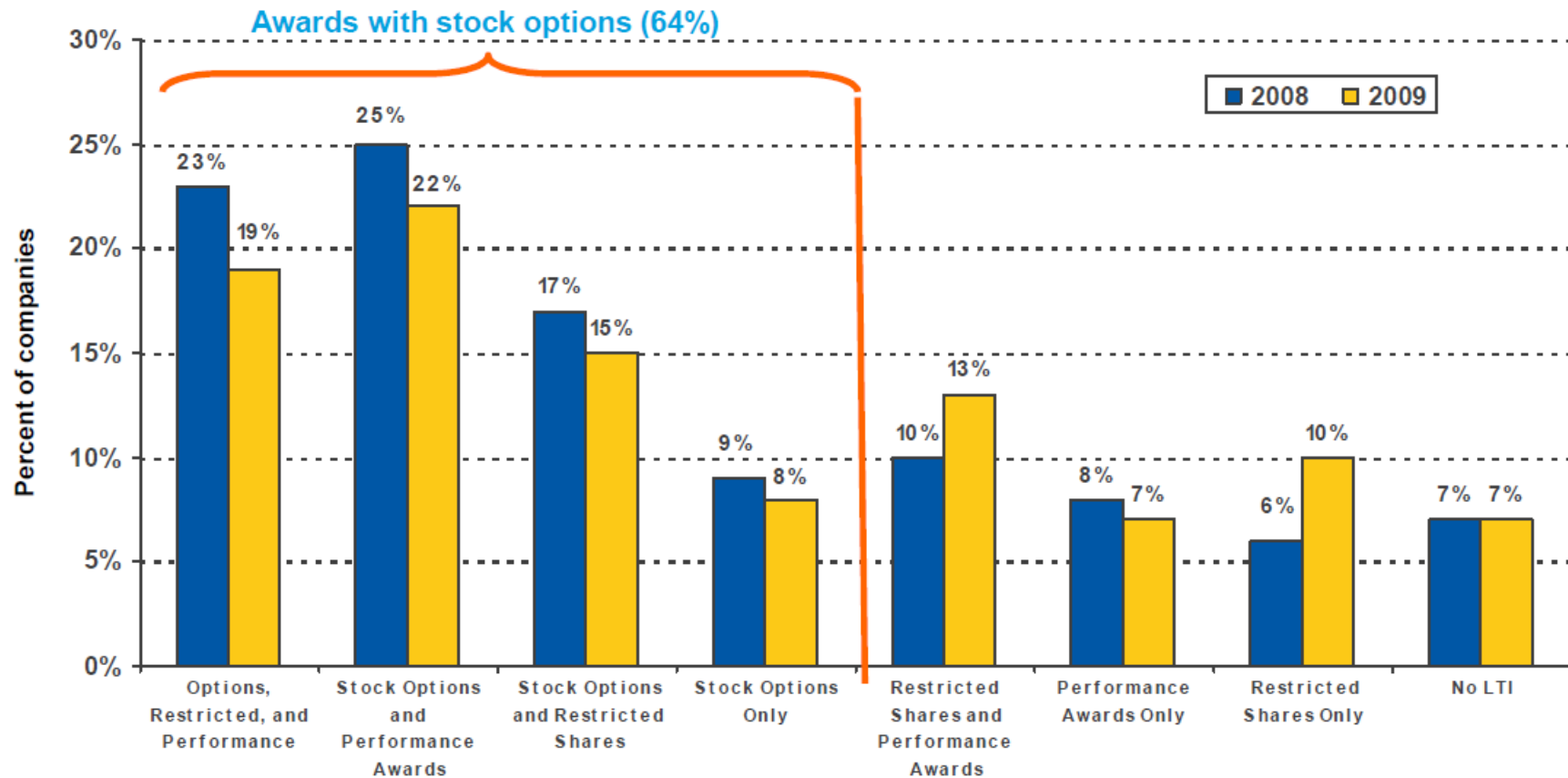
*Awards based on performance are nearly as common as stock options*



Note: Some companies use multiple plans, so numbers do not add to 100%

## LTI: Prevalence of vehicles

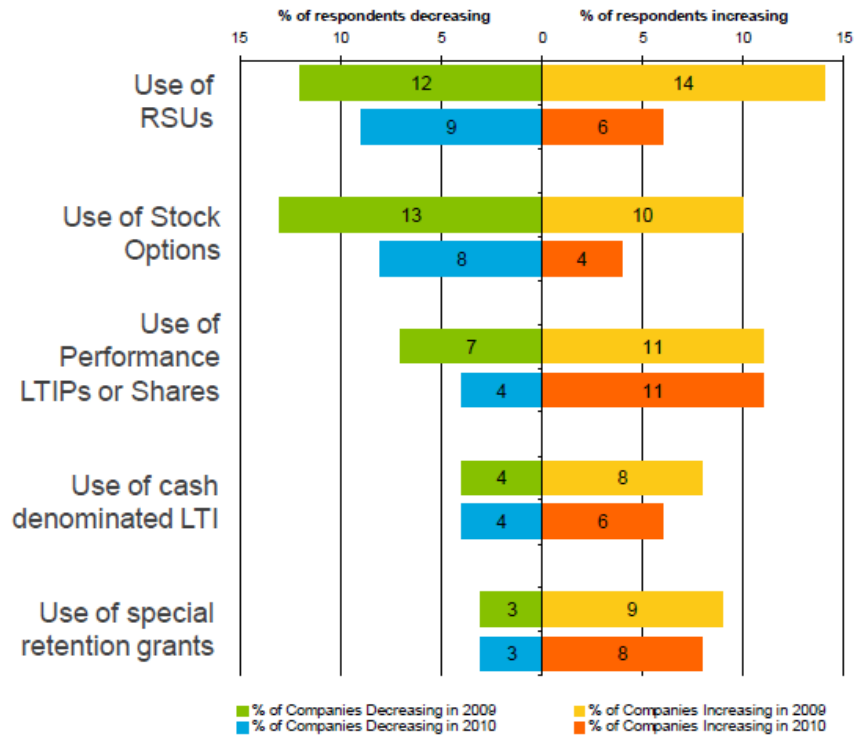
*Majority of companies use a mix of vehicles*



## 2010 outlook: Long-term incentives

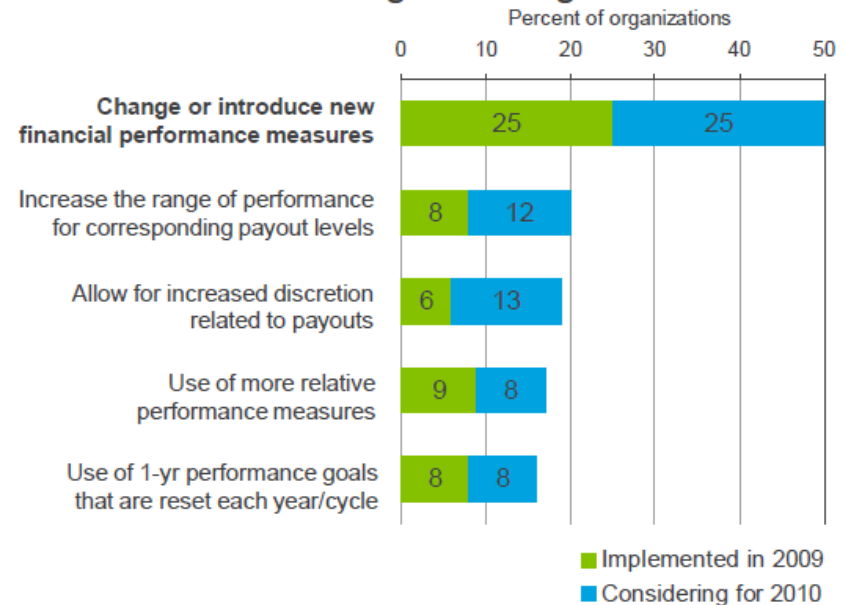
Vehicle mix and linkage to performance are prevalent design considerations

### Prevalence in LTI Changes for Executives



Once burned.....

### Performance Share/Long-term Incentive Program Changes



# Trend toward Performance-Based Equity Continues (After a hiccup...)

- **Pure Share Options**

- High Dilution
- Volatile
- Not Performance Based

- **Restricted Stock**

- Small, focused doses
- Retention a "viable and relevant objective" (King 3...)
- But, hard to defend no performance conditions

- **Despite 2009 "hiccup" – trend will continue**

## Plan design considerations: Market practices

- Most keep their plans relatively simple

Number of Metrics	Percent of Companies
1	52%
2	31%
3	11%
4+	6%

- Most measurement periods are three years

Length of Period	Percent of Companies	
	2008	2009
1	7% <sup>(1)</sup>	13% <sup>(1)</sup>
2	2%	5%
3	83%	77%
4+	8%	5%

*(1) Effectively called long-term due to delayed payment period, often with restricted stock*

“Pay-at-risk” spectrum for LTI





# Beyond Black-Scholes: New Considerations in Calibrating LTI

Michael Lennartz

Stephen Zwicker

TOWERS WATSON 

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# **New Methods in Calibrating Long Term Incentives**

# Big Question – How Much to Grant?

- OR..... What is Fair Value?
- Own experience / multiples – Guidelines Fair Value / face value. Expected Value?
- Unintended Consequences
- **KEY: Accounting Approach may not be best approach for Reward**
  - Accounting – IFRS 2, fair value at **grant date**  
*"Opportunity Cost: For how much could this award have been sold to an investor?"*
  - Reward – **intended value on delivery / vesting / conversion**  
*"How do I incentivise and reward good performance?"*

# Own Scenario

- **Share Scheme design has been iterative, “layered”:**

- **Option / Deferred Delivery Schemes**
- **Share Appreciation Right**
- **Forfeitable Share Scheme – 3 flavours**

## **Risk:**

- **Isolated design**
- **Design can focus too much on new scheme, old staying “as is”**

# Two Key Points

- **Accounting valuation may not be best allocation guide**
- **Modelling of entire “portfolio” of shares schemes essential**

# Balancing Act (“LTI’s 101”...)

- Investors compensated for risk (“Opportunity Cost”)
  - Employees rewarded for performance
- BUT**
- In ways that align them with shareholders

# Different Effects... Different Income, Different Shareholder Link, Different Influence

- **E.g. Options: Leveraged: Value changes faster than the underlying share price**  
= Valuation Misaligned with Shareholders
- **Performance Shares: Choice of performance condition = makes / breaks shareholder alignment, but also influence**
  - = Market conditions – relate to share price, but **relative** measures preferred
  - = Non-market conditions (cash flow, eps, ROI) – internal metrics
  - = Relative vs Absolute – share fortunes with shareholders?

- **Portfolio Approach (growing trend) adds complexity**

**KEY TAKEAWAY:**

**MODELLING....**

**MODELLING.....**

**AND....**

**MORE MODELLING.....!**

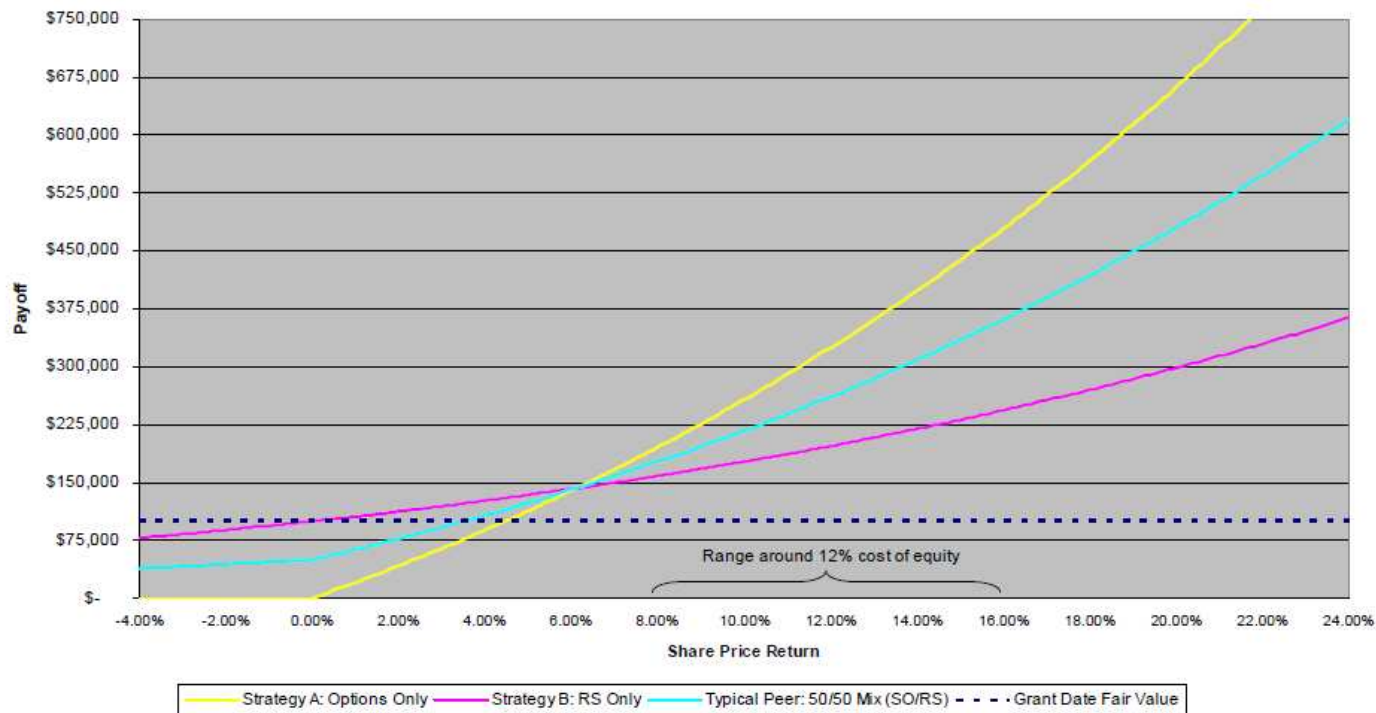
# Two Approaches

- **Deterministic – examine all growth scenarios and model overall outcome**
- **Probability Modelling – most likely outcome(s)**

## Key design concerns that modelling can address

- **Inadvertent creation of “windfalls” – anti-retention**
- **Poor interaction between plans**
- **→ Misalignment with shareholders / market**
- **KEY:**
  - **Accurate and more narrow **targeting** of outcomes by mix and design changes**
  - **Partially exclude negative outcomes with design**
  - **Create a distribution of outcomes for different levels of performance (King 3.....)**

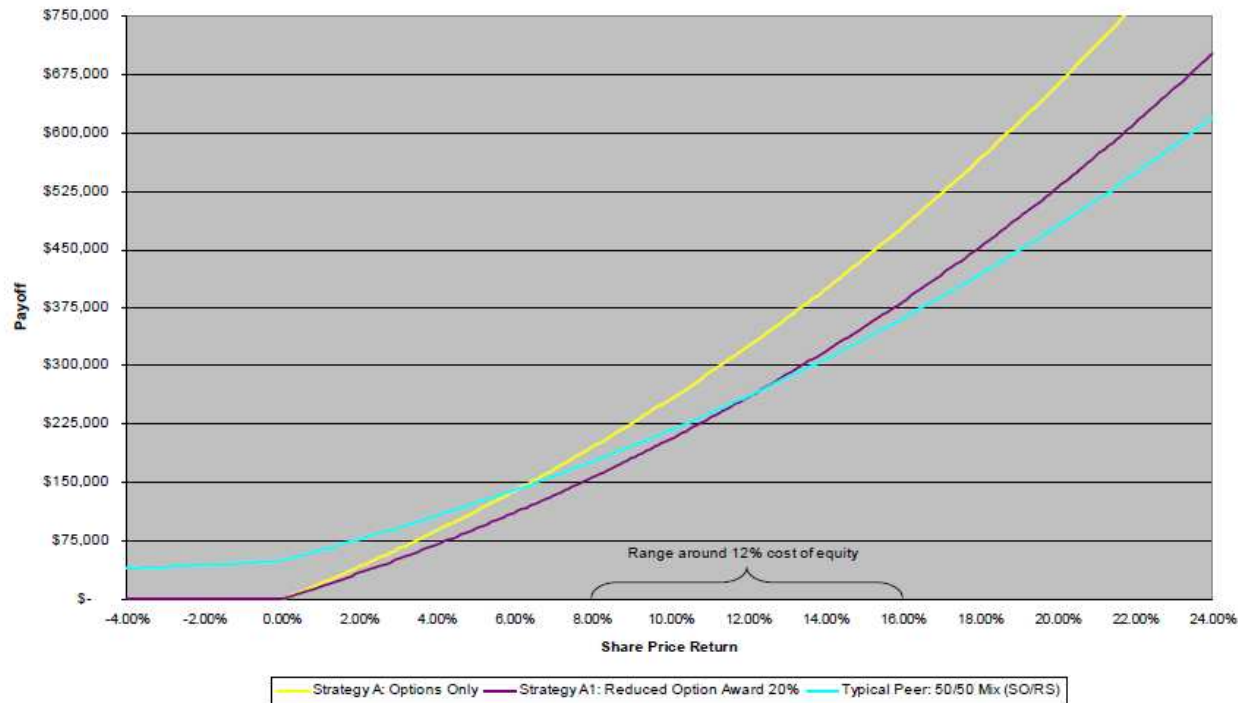
# Payoff Modeling — Deterministic Approach



- Option-only strategy delivers significantly more pay than typical peer within and above critical range, but less at low return levels

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# Payoff Modeling — Deterministic Approach



- Payoff on reduced option award about equal to typical peer at 12% return

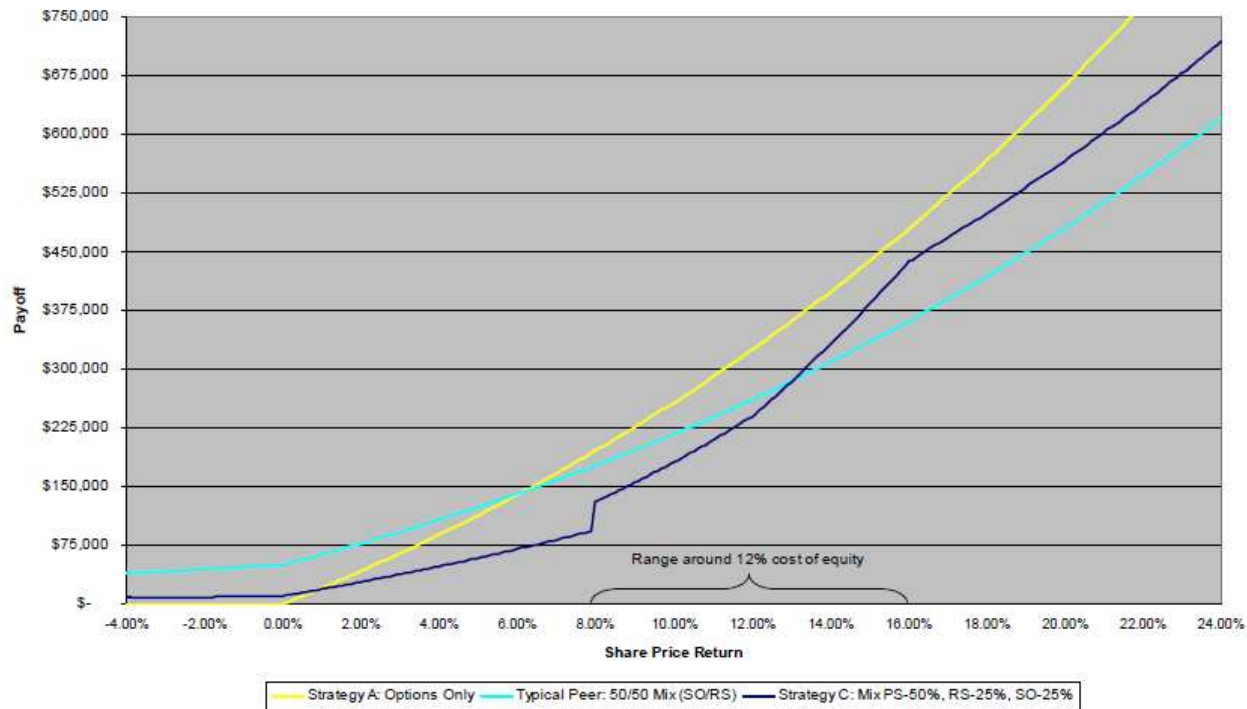
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## Payoff Modeling — Deterministic Approach

### ILLUSTRATION

- What if company wanted to more closely approximate payoffs of typical peer within critical performance range, but wanted to use a portfolio LTI approach?
  - Consider mix of stock options, restricted shares and market-based performance shares
    - Allocation of target fair value is 40% stock options, 10% restricted shares and 50% performance shares
    - Performance shares have a fair value of \$11 and are earned as follows
      - 50% at 8% return
      - 100% at 12% return (cost of equity)
      - 200% at 16% return

# Payoff Modeling — Deterministic Approach



- Payoff on LTI portfolio approximates typical peer at about 12% return

# Probability Modelling

- **Establish probability of various growth rates**
- **Examine the likelihood of return outcomes and therefore:**
  - **Design around / Limit negative outcomes**
  - **Establish average expected payoffs**
- **Improve LTI Calibration, Design and Portfolio Mix**

**“Elegance is something you can hold in your head without writing it down.” – Donald Knuth**



## Managing in Support of Business Transformation: Pfizer's Executive Compensation Program

Peter T Chingos  
Senior Founding Partner  
Compensation Advisory Partners LLC

Steve Pennacchio  
SVP, Executive Compensation Strategy &  
Programs  
Pfizer

# **Learnings from Pfizer**

## **Process led to Success**

- **Separate Design team – composition essential**
- **Reward Consultant separate to RemCo Advisor**
- **RemCo Communication and Involvement in Design**
- **Interviews with Senior Executive Team**
- **Benchmarking**
- **Modelling**

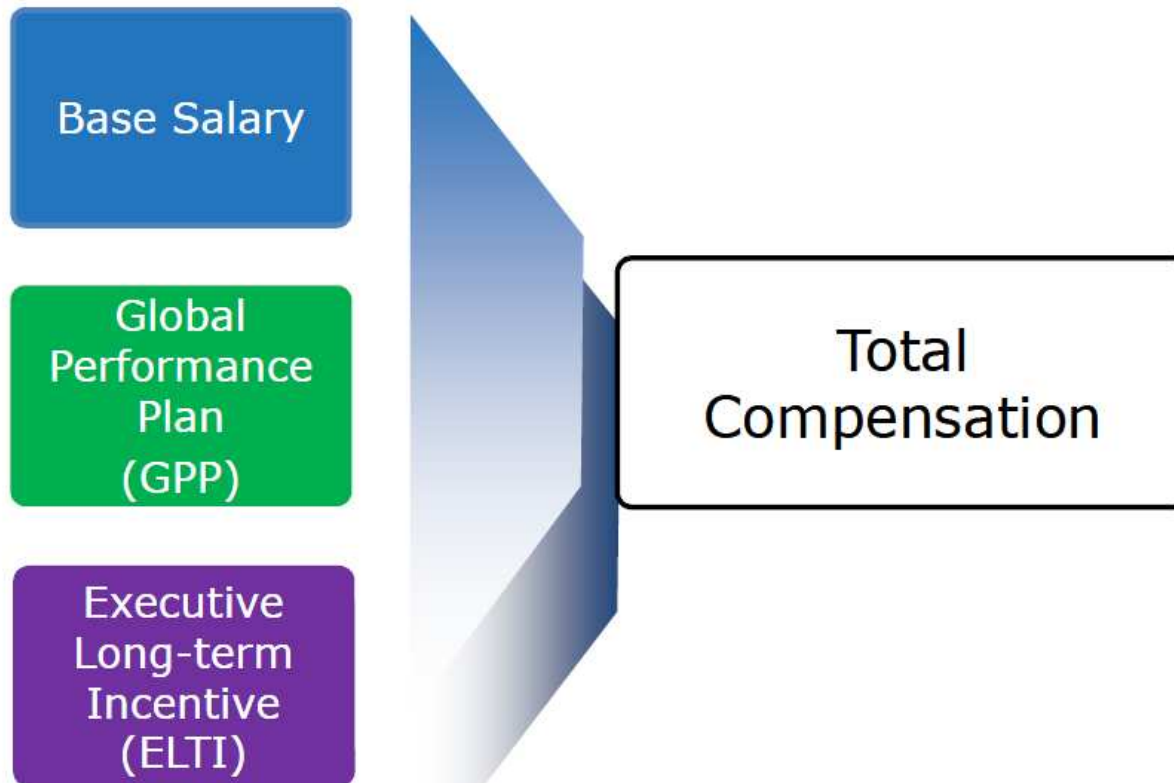
## **Design**

- **Deliberate, focused LTI Mix**

## Key Principles of Pfizer's Executive Compensation Program

- To position total direct compensation (salary, short-term and long-term incentives) at the approximate median compensation values of our peer group companies;
- To place greater emphasis on linking annual incentive awards to short-term financial objectives that support our ongoing business transformation efforts; and
- To reward both absolute and relative improvements in total shareholder return ("TSR") through grants of long-term equity

## Components of the Program



## Executive Base Pay

Base Salary

Annual  
Incentive Plan  
(GPP)

Executive  
Long-term  
Incentive  
(ELTI) Program

- Base salary rewards executives for performing their every day responsibilities
- Base salary is managed through a grade structure
  - Each grade is assigned a salary midpoint which represents market pay for a position
  - Salaries are targeted at the midpoint of the salary range for each grade
  - The salary range is set 25% below and 25% above the midpoint
- At executive levels, performance is rewarded through short and long-term incentives rather than through base salary increases

## Global Performance Plan

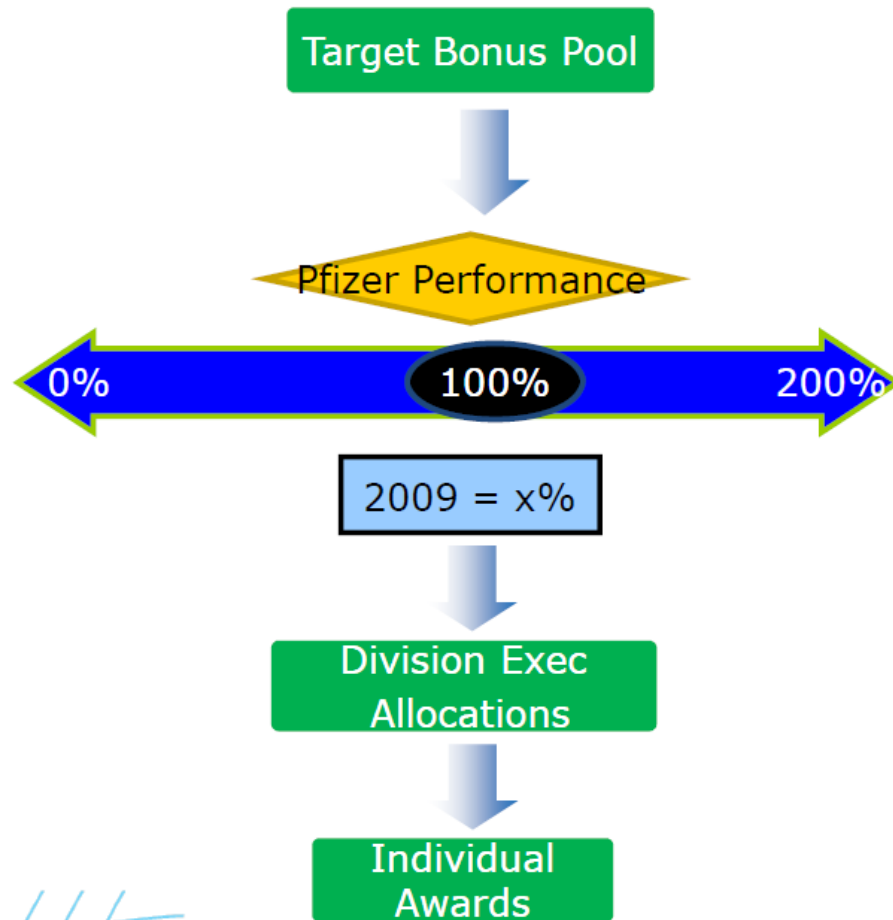
Base Salary

Global  
Performance  
Plan  
(GPP)

Executive  
Long-term  
Incentive  
(ELTI) Program

- GPP bonus targets are expressed as a percentage of salary midpoint for each grade
- Bonuses are funded from a pool based on the achievement of pre-set financial objectives for
  - Revenue
  - Adjusted, diluted EPS; and
  - Cash flow from operations

# Bonus pool funding & allocation tied to Pfizer performance



Target pool is the sum of target awards

Compensation Committee determines overall bonus pool funding based on Pfizer performance

CEO determines division allocations based on performance

Division leaders determine:  
Pool subsets  
Individual Awards



## Executive Long-Term Incentive (ELTI) Program

Base Salary

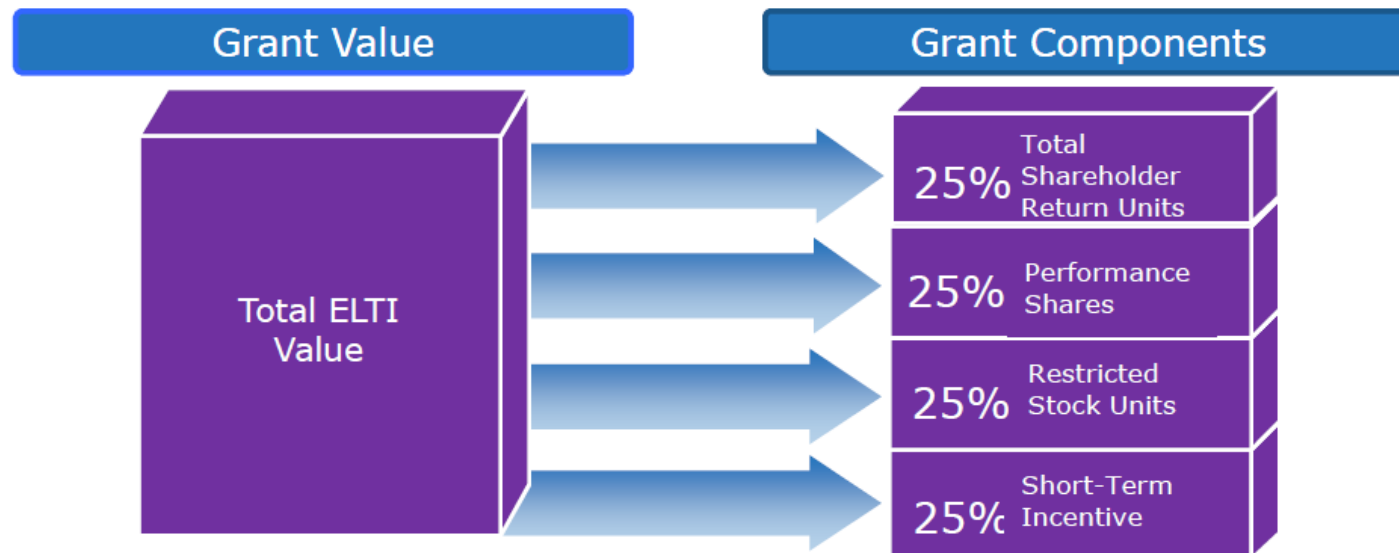
Annual  
Incentive Plan  
(GPP)

Executive  
Long-term  
Incentive  
(ELTI) Program

- Executive Long-Term Incentive (ELTI) award values are targeted at the median of competitive market data
- The ELTI Program is intended to align the interests of our executives with those of our shareholders by balancing the need for short-term results and long-term performance

Portfolio...

## ELTI Components:



- **TSRUs** link rewards to **absolute TSR** over a five-year period
- **PSAs** tie rewards to **relative TSR** over a three-year period
- **RSUs** provide an equity stake and encourage **retention**
- **STI Shift** promotes the achievement of **annual financial objectives**

# Achievement of Executive Reward Objectives

	Performance Shares	Restricted Shares	LTI Shift / Bonus Shares
Shareholder Alignment	✓ ✓		✓
Organisational Performance	✓ ✓		✓ ✓
Retention	✓	✓ ✓	✓ ✓

# Measurement

- **Continued Focus**
  - **Good governance, satisfied investors BUT attainable**
  - **Learnings from crash**
- **Challenges have created greatest learning...**

# Measurement Challenges

- **Relative measurement**
  - Safer space
  - Tough to find peer groups
  - Exposed where composition of market is volatile, consolidations (recent experience)
- **Absolute measures**
  - Inadvertent Over- or Under-Reward (learned this like never before in US)
- **Tight Link to Shareholder vs. Ability to Influence (TSR to EPS to Revenue)**

# Measurement Learning

- **Wide Choice (Relative, Absolute, Market, Internal, ...)** – more creativity than ever
  - **Customisation (E.g. Old Mutual Session...)**
  - **Continuum (Pure Shareholder – Internal Measures)**
  - **No **Either / Or**:**
    - **Portfolio approach**
    - +
    - **Use of Modelling**
- = **optimise and deliver Reward Outcome allows ideal mix**
- = **Manage risk of unintended consequence**

# **WorldatWork – Worth It...**