

*The "Learn & Earn" Series™*

December 6, 2012

# "Compensation that CEOs and Shareholders Can Endorse"



THE VISIONLINK  
ADVISORY GROUP

Today's Presenter:

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# Course Credit


Per State Requirements:


To receive CPE credit for today's course, you must respond to at least 75% of the monitoring events – given in the form of polls.

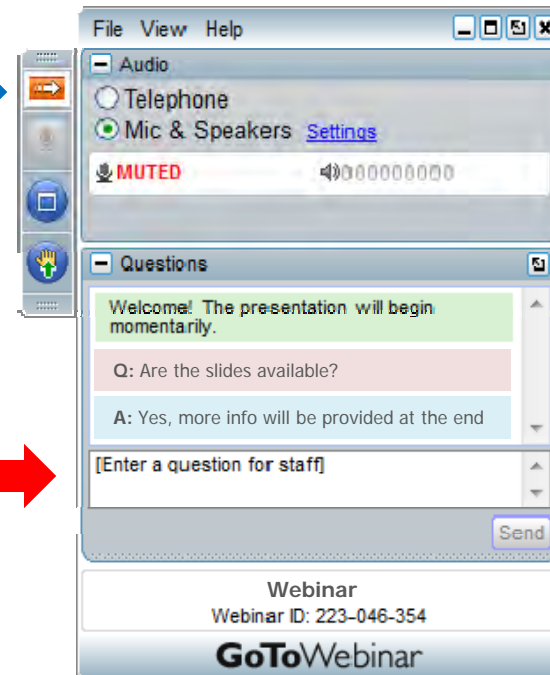
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# Course Objectives

- Create an understanding of value creation and sharing
- Demonstrate how return on compensation can be measured
- Discuss what value should be shared in an organization, how to share it and why it matters
- Illustrate how value sharing should be communicated

# Key Concepts



- Company leadership must clearly define value creation
- Return on compensation can and must be measured
- There is a performance “class” and a growth “class” of sharing that must be addressed
- There are steps to effective value sharing
- Communication is a critical element in aligning shareholder and employee interests

# Value Creation and Sharing

## *What Does it Really Mean?*

### Case Study

(Source: Chief Executive Magazine, May/June 2012 Edition)



**Underwriters  
Laboratories**

Keith Williams





# Keith Williams



- Assumed leadership of UL in 2005
- Company carrying considerable debt
- Losing market share
- Low employee morale
- UL had become bureaucratic and “siloed”
  - Regional divisions undercutting each other

# 5 Core Changes



## Compensation (Value Sharing):

- Took away local measurements driving management incentive plans—all paid on same metrics
  - “We live together and we die together”
- Aligned everyone behind company success
  - “I call it ‘pay the company first.’”

Williams clearly defined what value creation meant and how it would be shared

# Pay the Company First



“Basically, up to the company’s operating profit target, all of the profits go to the company; and only after that target is met, do we start funding the incentive pool.”

Example: If UL’s target is \$80 million--

- 100% of first \$80 in profit goes to company
- The next \$20 million goes to the incentive pool
- From there on, 50/50 between company & incentive pool

# Pay the Company First



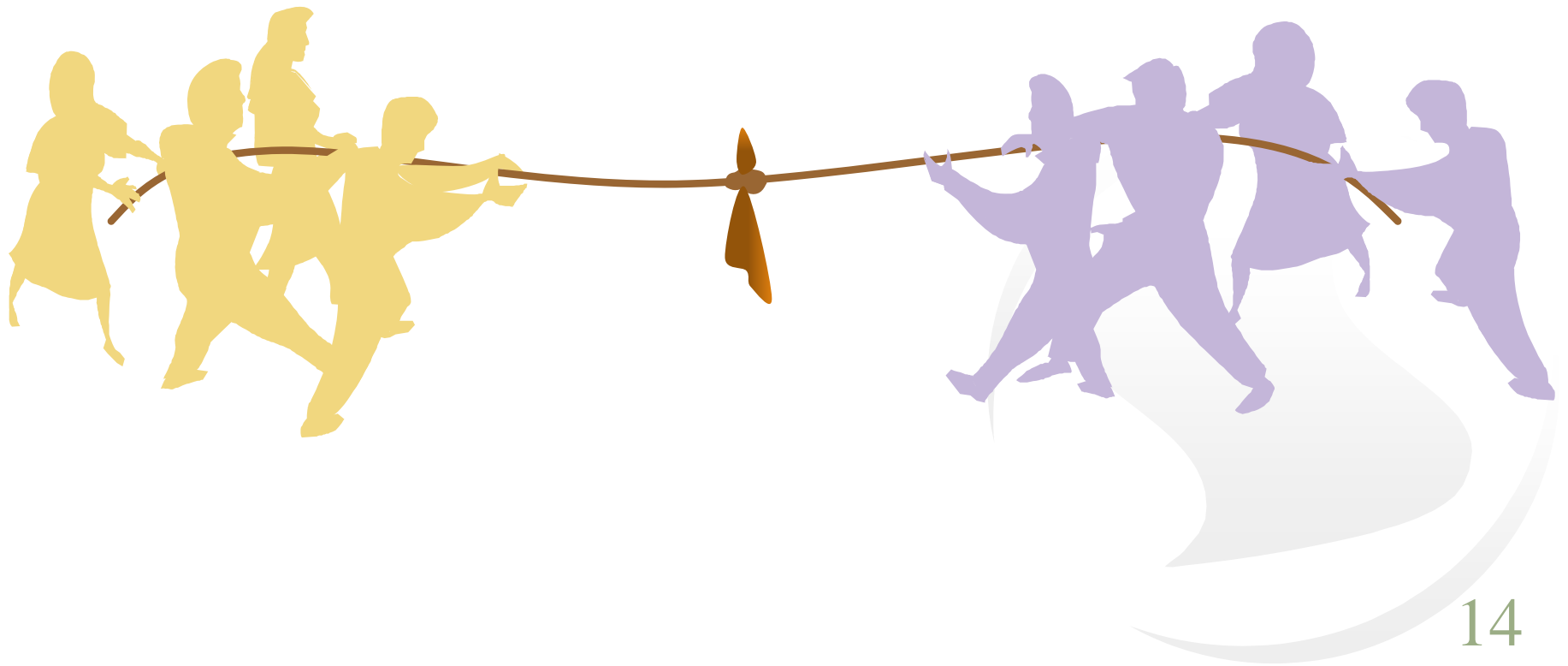
Once value creation is defined, compensation can follow a formula for sharing value in a way that aligns key producers with the company's business plan and priorities.

## 3 Key Distinctions

- Willing to tie all executive incentives to the same metrics
- Willing to identify a minimum return on equity threshold that must be met before any incentives are paid
- Willing to share significant upside beyond the threshold (no cap)



# Expectations



# Expectations



# Poll #1





# Pay the Company First



**ROTRI™**

**Return on Total Rewards Investment™**

Measuring the return on your compensation investment



# How much is the Total Rewards Investment?

- Salaries
- Commissions
- Bonuses
- Deferred award accruals (LTIP)
- Core benefits
- Executive benefits
- Retirement contributions
- Payroll taxes



**What return do you get on that investment?**

\_\_\_\_\_ %



# ROTRI™ Example:

Capital Account	\$ 20,000,000
Cost of Capital	12%
Capital Charge	\$ 2,400,000
Operating Income	\$ 10,000,000
Productivity Profit	\$ 7,600,000
Total Rewards Investment	\$ 25,000,000

ROTRI™	30.4%
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(ROTRI™ = Productivity Profit/Total Rewards Investment)

# ROTRI™ Example:

Capital Account	\$ 20,000,000
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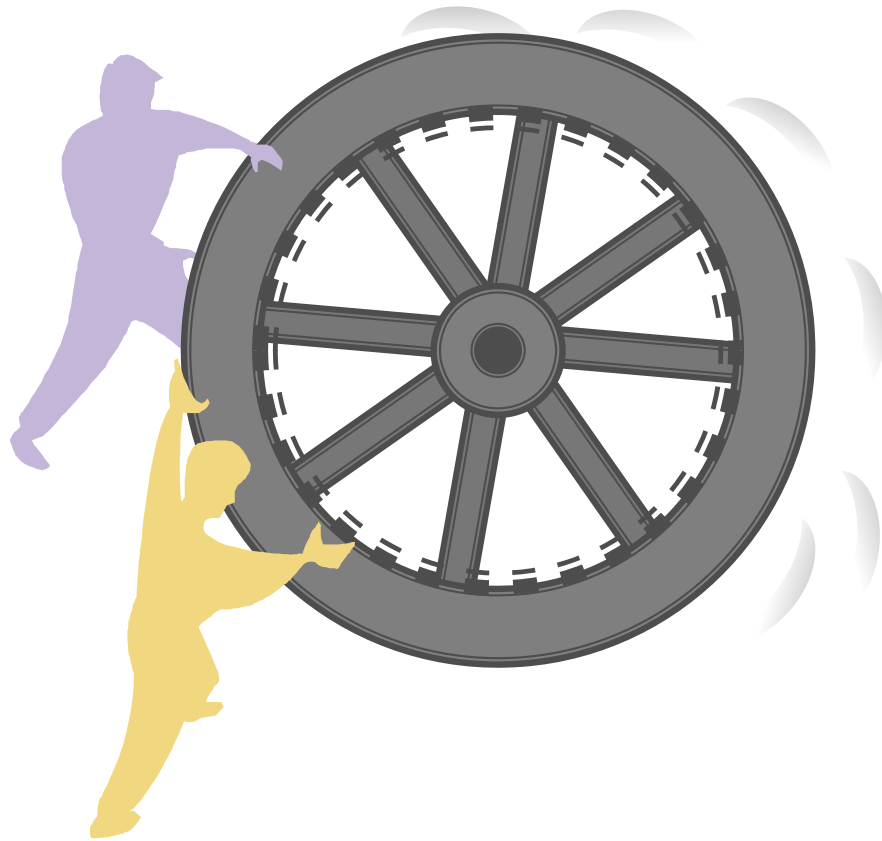
ROTRI™	30.4%
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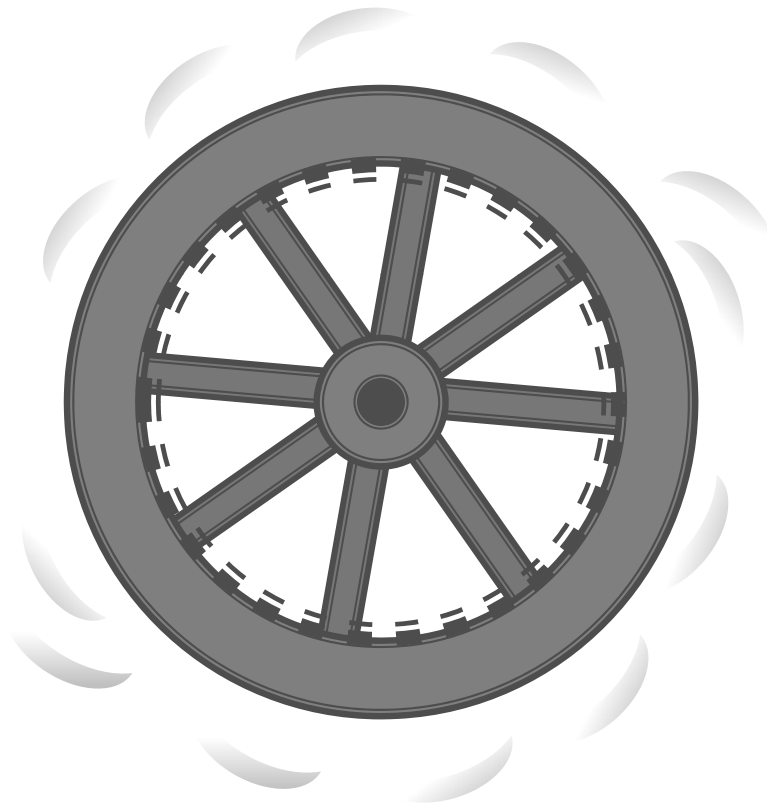
***Variable Pay Plans (Value Sharing) are financed from Productivity Profit***

# When do employees have an “Ownership Mentality”

They have to “get” the following:

- We have a business model and strategy that are sustainable over time and produce a competitive advantage
- We all have to do our part to be productive (do things faster, easier, cheaper, bigger)
- Owners are committed to sharing the financial value we help create—after we’ve produced an appropriate return for them
- That value will be meaningful if we reach our full capacity







# Who would object?

## Traditional Approach

- Salaries based on market standards (the “tyranny of the median”)
- Bonuses are then based on a percentage of salary (with a cap)
- Ownership is restricted to a small group
- Compensation is tightly budgeted

## Value Sharing Approach

- Salaries based on your unique skills and expected contribution
- “Bonuses” reflect value you help create (short-term value sharing plan, with no cap)
- Ownership is something to be nurtured in everyone (and a long-term value sharing plan is essential)
- Compensation is a reflection of the return on human capital

# Poll #2



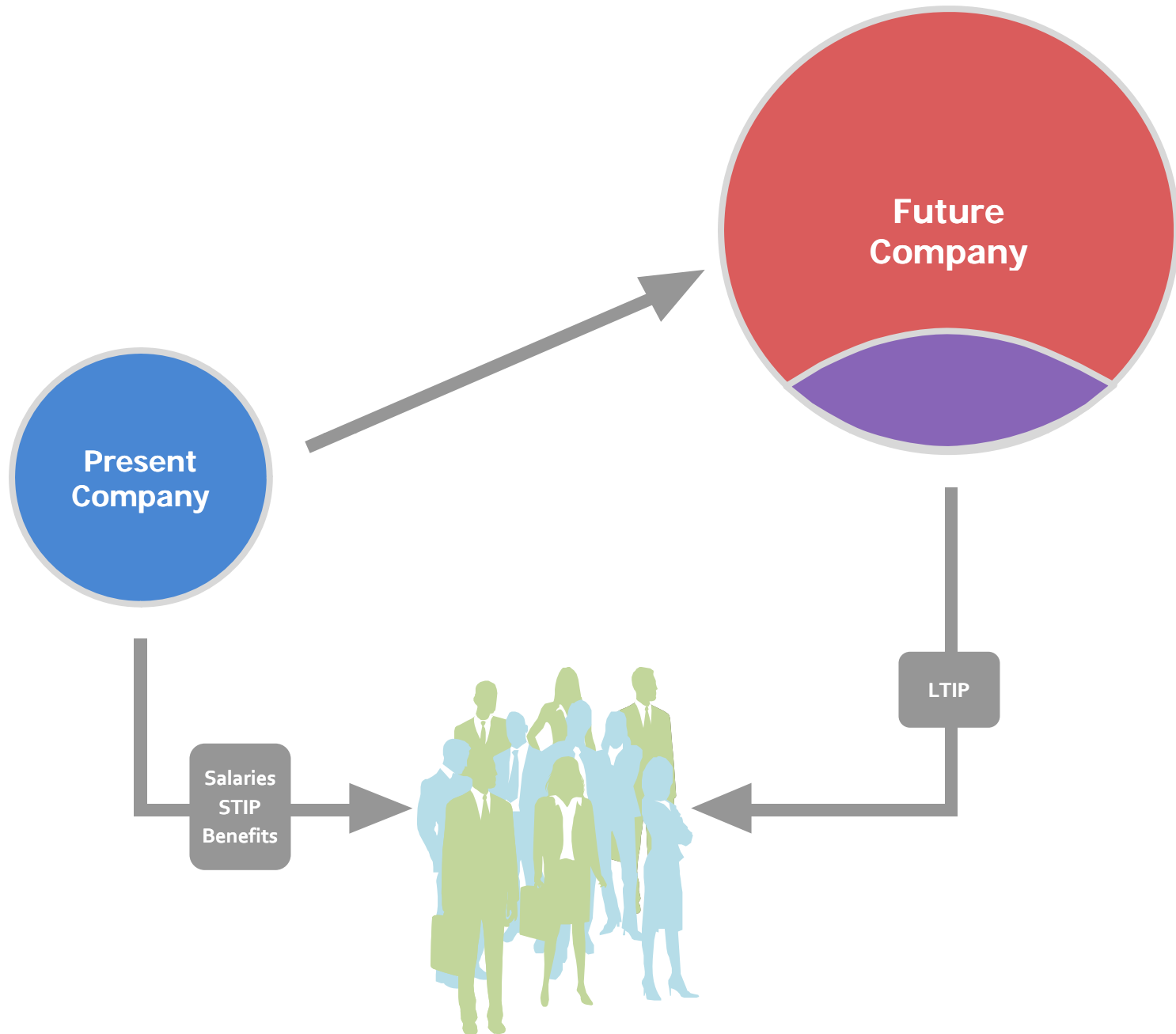
# What value do we share?

## ■ Performance Class

- Paid to help company meet its “budgeted” or targeted level of performance (short-term value sharing plan; bonuses; incentive plans)
- Message: “**Operate our current company successfully**”

## ■ Growth Class

- Paid for building market (enterprise) value over time (long-term value sharing plan)
- Message: “**Build our future company**”



# Why Long-Term Value Sharing Matters



# What Happens When You Do It?

1. Value sharing attracts the best talent and magnifies results
2. Value sharing plans (effectively designed) reinforce the company's business model
3. Value sharing protects against bad profits and promotes good profits
4. Value sharing promotes an ownership mindset
5. Value sharing builds trust and accelerates results



# When You Don't Do It:

1. You will not attract the best possible talent
2. You can't be certain that pay aligns with the business model
3. You might be promoting bad profits instead of good profits
4. You will not have a complete ownership mindset
5. Employee trust and confidence will not be as strong as possible

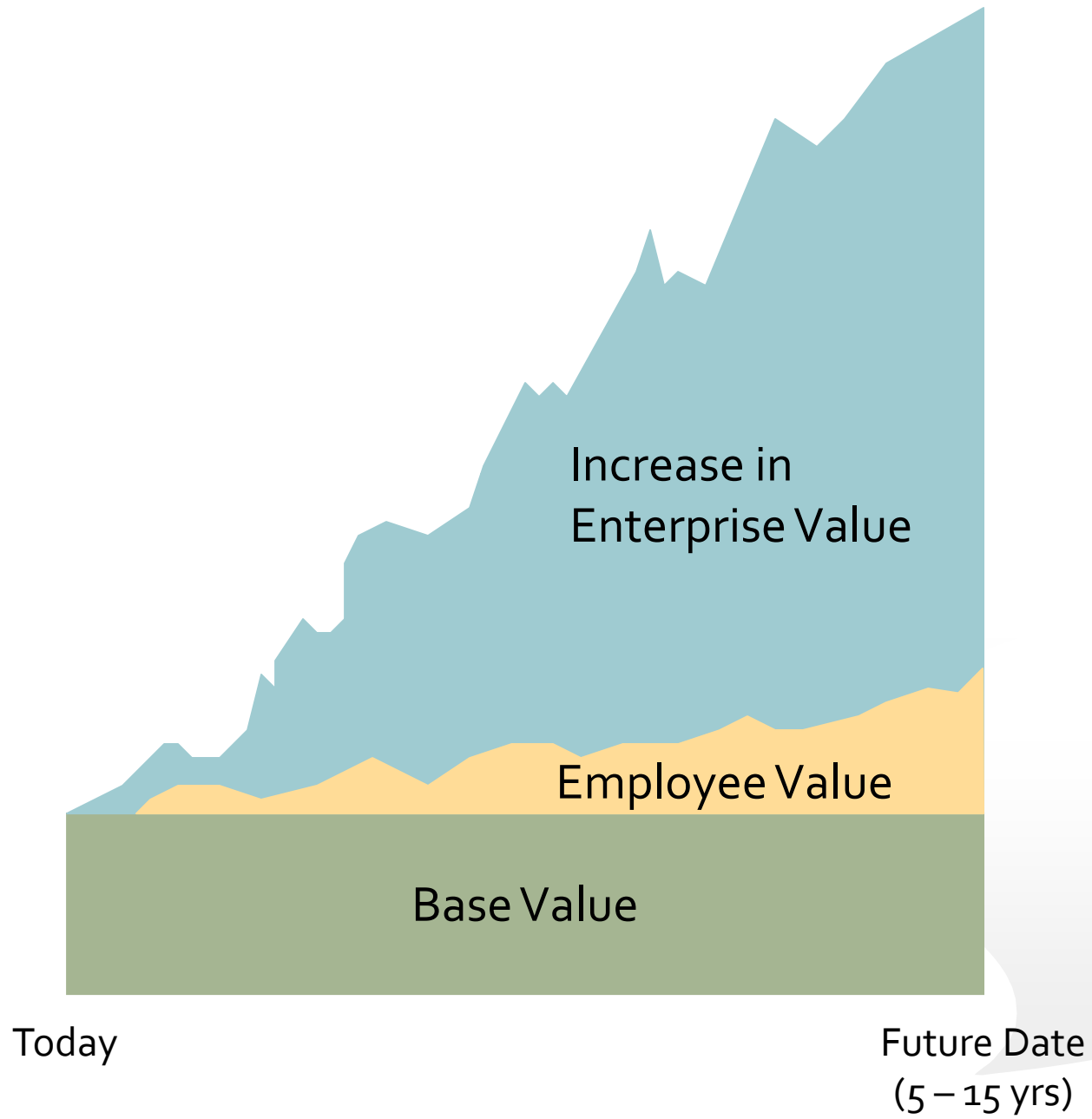


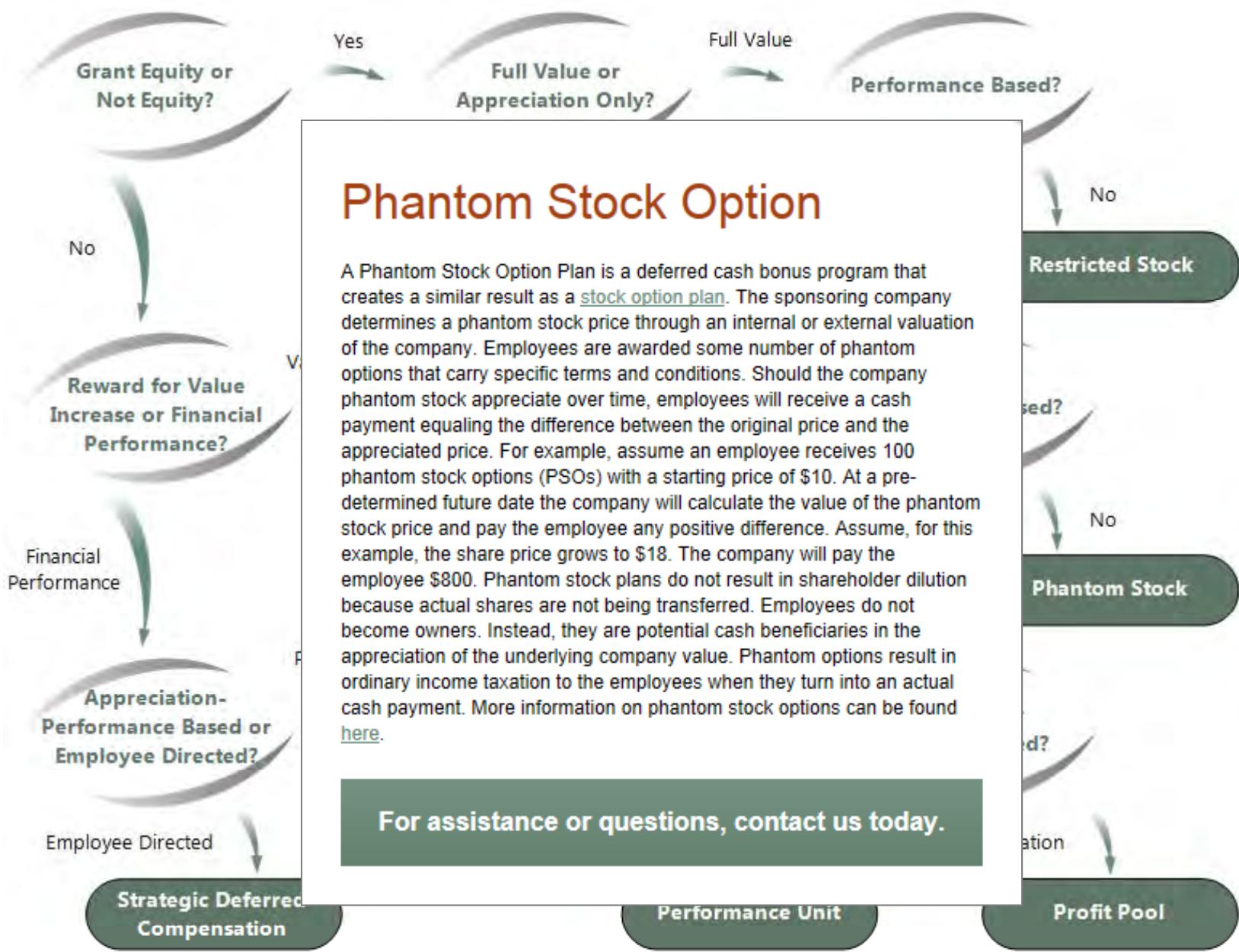
# How to Share Long-Term Value Effectively

- Picture your future company
- Determine the right value to share with those who help create it
- Select the right plan
- Build it with care and know-how
- Communicate and promote it









## Phantom Stock Option

A Phantom Stock Option Plan is a deferred cash bonus program that creates a similar result as a [stock option plan](#). The sponsoring company determines a phantom stock price through an internal or external valuation of the company. Employees are awarded some number of phantom options that carry specific terms and conditions. Should the company phantom stock appreciate over time, employees will receive a cash payment equaling the difference between the original price and the appreciated price. For example, assume an employee receives 100 phantom stock options (PSOs) with a starting price of \$10. At a pre-determined future date the company will calculate the value of the phantom stock price and pay the employee any positive difference. Assume, for this example, the share price grows to \$18. The company will pay the employee \$800. Phantom stock plans do not result in shareholder dilution because actual shares are not being transferred. Employees do not become owners. Instead, they are potential cash beneficiaries in the appreciation of the underlying company value. Phantom options result in ordinary income taxation to the employees when they turn into an actual cash payment. More information on phantom stock options can be found [here](#).

**For assistance or questions, contact us today.**

Go to "Tools" at [PhantomStockOnline.com](http://PhantomStockOnline.com)

# Build it with care and know-how

Develop an Effective Financial Model



# Sample LTIP Model – P&L Forecast

	C	E	F	G	H	I	J	K	L	M	N	O	P	Q
1	Target	P&L Forecast												
2	P&L FORECAST	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
3		Actual	Actual	Actual	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected
4	Net Sales	35,015,667	32,524,143	39,156,444	45,000,000	49,000,000	52,000,000	55,000,000	60,000,000	66,000,000	72,600,000	79,860,000	87,846,000	96,630,600
5	Cost of Goods Sold	19,375,516	17,230,214	21,541,211	24,750,000	26,950,000	28,600,000	30,250,000	33,000,000	36,300,000	39,930,000	43,923,000	48,315,300	53,146,830
6	<b>Gross Profit</b>	<b>15,640,151</b>	<b>15,293,929</b>	<b>17,615,233</b>	<b>20,250,000</b>	<b>22,050,000</b>	<b>23,400,000</b>	<b>24,750,000</b>	<b>27,000,000</b>	<b>29,700,000</b>	<b>32,670,000</b>	<b>35,937,000</b>	<b>39,530,700</b>	<b>43,483,770</b>
7	Selling Expenses	466,785	455,120	483,803	546,750	595,350	631,800	668,250	723,000	801,900	862,090	970,299	1,067,329	1,174,062
8	G&A	5,367,425	5,653,767	6,100,910	6,986,250	7,607,250	8,073,000	8,538,750	9,315,000	10,246,500	11,271,150	12,398,265	13,638,092	15,001,901
9	Interest Expense	48,176	45,388	35,503	36,213	36,937	37,676	38,430	39,198	39,982	40,782	41,597	42,429	43,278
10	<b>Income from Operations</b>	<b>9,757,765</b>	<b>9,139,654</b>	<b>10,989,211</b>	<b>12,680,787</b>	<b>13,810,463</b>	<b>14,657,524</b>	<b>15,504,570</b>	<b>16,916,802</b>	<b>18,611,618</b>	<b>20,475,978</b>	<b>22,526,839</b>	<b>24,782,850</b>	<b>27,264,530</b>
11	Interest & Dividend Income	81,135	52,187	14,171	14,454	14,744	15,038	15,339	15,646	15,959	16,278	16,604	16,936	17,274
12	Gain (loss) on Sale of Investments	(15,596)	1,061	-	-	-	-	-	-	-	-	-	-	-
13	Gain on Disposal of Equipment	9,202	1,750	(9,559)	-	-	-	-	-	-	-	-	-	-
14	Increase in Cash Surrender Value of Life Insurance	67,622	72,272	62,044	63,285	64,551	65,842	67,158	68,502	69,872	71,269	72,694	74,148	75,631
15	Other Income	705	29,525	384	-	-	-	-	-	-	-	-	-	-
16	<b>Earnings Before Taxes</b>	<b>9,900,833</b>	<b>9,296,449</b>	<b>11,056,251</b>	<b>12,758,526</b>	<b>13,889,757</b>	<b>14,738,404</b>	<b>15,587,068</b>	<b>17,000,949</b>	<b>18,697,448</b>	<b>20,563,525</b>	<b>22,616,137</b>	<b>24,873,934</b>	<b>27,357,435</b>
17	Provision for Income Taxes	145,400	26,200	104,000	191,378	208,346	221,076	233,806	255,014	280,462	308,453	339,242	373,109	410,362
18	<b>Net Income</b>	<b>9,755,433</b>	<b>9,270,249</b>	<b>10,952,251</b>	<b>12,567,148</b>	<b>13,681,410</b>	<b>14,517,328</b>	<b>15,353,262</b>	<b>16,745,935</b>	<b>18,416,987</b>	<b>20,255,072</b>	<b>22,276,895</b>	<b>24,500,825</b>	<b>26,947,074</b>
19	Interest Expense	48,176	45,388	35,503	36,213	36,937	37,676	38,430	39,198	39,982	40,782	41,597	42,429	43,278
20	Depreciation	966,850	875,917	853,121	878,715	905,076	932,228	960,195	989,001	1,018,671	1,049,231	1,080,708	1,113,129	1,146,523
21	<b>EBITDA</b>	<b>10,915,859</b>	<b>10,217,754</b>	<b>11,944,875</b>	<b>13,673,454</b>	<b>14,831,770</b>	<b>15,708,308</b>	<b>16,585,693</b>	<b>18,029,149</b>	<b>19,756,102</b>	<b>21,653,538</b>	<b>23,738,442</b>	<b>26,029,493</b>	<b>28,547,237</b>
30	Share Price multiple			5	5	5	5	5	5	5	5	5	5	5
31	Formula Value			\$ 55,930,151	\$ 62,750,482	\$ 69,966,626	\$ 75,481,459	\$ 80,077,599	\$ 85,879,065	\$ 93,380,533	\$ 102,228,885	\$ 112,056,874	\$ 122,856,160	\$ 134,723,536
32	Formula Share Price (EOY)			\$ 6.28	\$ 7.00	\$ 7.55	\$ 8.01	\$ 8.59	\$ 9.34	\$ 10.22	\$ 11.21	\$ 12.29	\$ 13.47	
33	Annual Increase in Formula Value			\$ 6,820,330	\$ 7,216,144	\$ 5,514,833	\$ 4,596,140	\$ 5,801,466	\$ 7,501,468	\$ 8,848,351	\$ 9,827,989	\$ 10,799,286	\$ 11,867,378	
34	Annual Increase in Formula Value Since Plan Inception			\$ 6,820,330	\$ 14,036,475	\$ 19,551,308	\$ 24,147,448	\$ 29,948,914	\$ 37,450,382	\$ 46,298,734	\$ 56,126,722	\$ 66,926,009	\$ 78,793,384	
37	Assumptions			2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	
39	Increase in Net Sales			14.3%	8.3%	6.1%	5.8%	9.1%	10.0%	10.0%	10.0%	10.0%	10.0%	
40	Cost of Goods Sold as % of Net Sales			55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	
41	Selling Expenses as % of Gross Profit			2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	
42	G&A as % of Gross Profit			34.5%	34.5%	34.5%	34.5%	34.5%	34.5%	34.5%	34.5%	34.5%	34.5%	
43	Annual Increase in Interest Expense			2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	
44	Annual Increase in Interest Income			2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	
45	Annual Increase in Gain/Loss on Investments			0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
46	Annual Increase in Gain/Loss on Disposal of Equipment			0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
47	Annual Increase in Cash Surrender Value			2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	
48	Annual Increase in Other Income			0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
49	California Franchise Tax			1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	
50	Annual Increase in Depreciation			3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	



# Keys to Success



Clarity

Believability

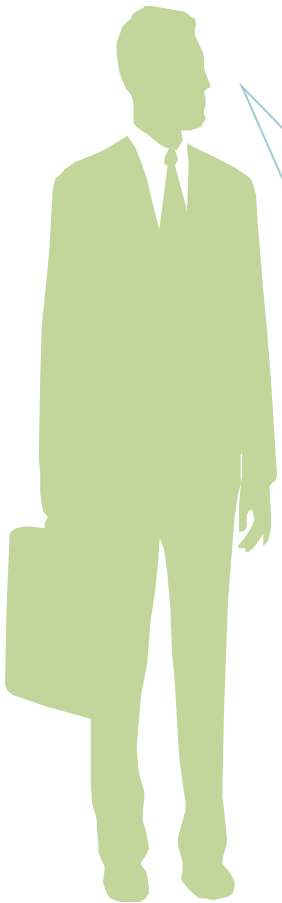
Meaning



# CEO

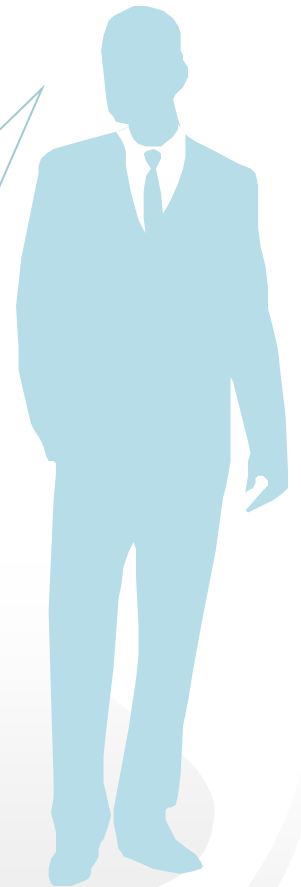
# Clarity

# Employee



These are the specific results that create enough value to generate bonuses. This is how your plan works.

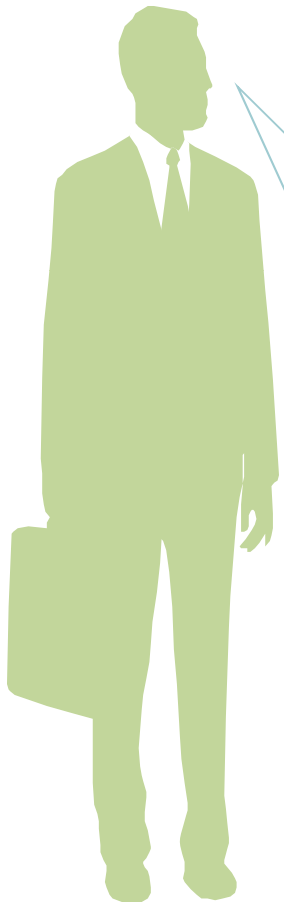
I understand what results we're seeking. I see how I can contribute. I understand how the plan works.



# CEO

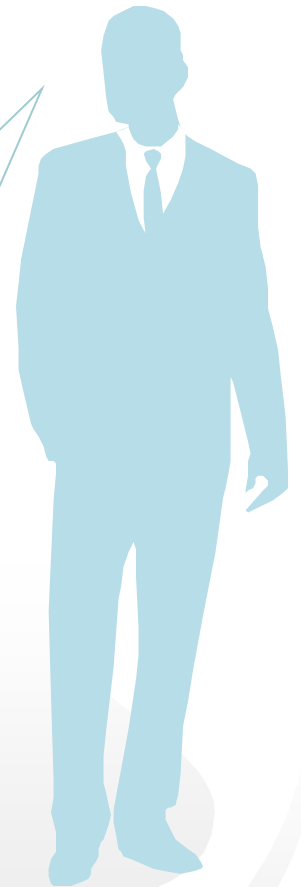
# Believability

# Employee



Here are the results we're expecting. Here's how we plan to get there. Here's why we're confident these results are achievable.

I understand the results. I understand what has to happen to achieve them. I believe we can do it.

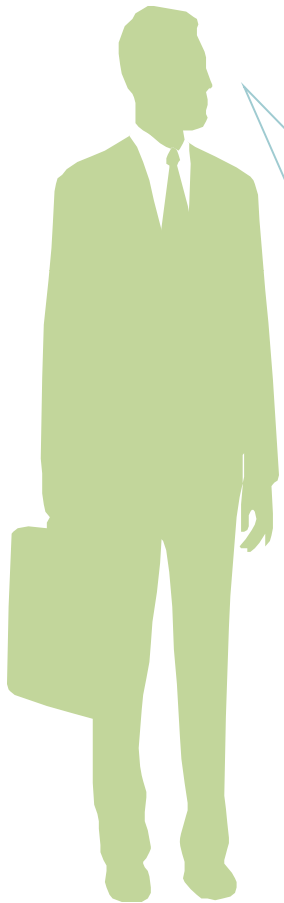




# CEO

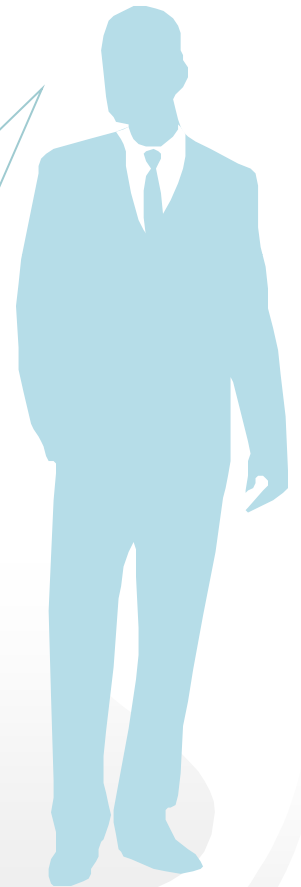
# Meaning

# Employee



Here's how much you should expect to receive if we hit our minimum, expected and superior result levels.

Each of those amounts is fair for the results achieved. I'm enthused and grateful to be a part of this plan.



# Poll #3



# Communicate and Promote the Plan



1. Explain, celebrate and reinforce the total value proposition
2. Communicate a sense of partnership
3. Project the wealth multiplier opportunity

# Employee Value Statement



# Key Producer Employee Value Statement

Year	1	2	3	4	5
5-Year Plan Achievement Level	100%	100%	100%	100%	100%
Current and Inflated Salary	\$ 160,000	\$ 166,400	\$ 173,056	\$ 179,978	\$ 187,177
Cash Incentives Paid at Target	\$ 64,000	\$ 66,560	\$ 69,222	\$ 71,991	\$ 74,871
LTIP Vested Value at Year End	\$ -	\$ 74,000	\$ 186,000	\$ 311,000	\$ 448,000
Retirement Plan Value (at 7%)	\$ 17,120	\$ 36,123	\$ 57,169	\$ 80,428	\$ 106,086
Total Cash Received	\$ 224,000	\$ 232,960	\$ 242,278	\$ 251,970	\$ 262,048
Total Wealth Accumulation	\$ 17,120	\$ 110,123	\$ 243,169	\$ 391,428	\$ 554,086
Total Paid or Accumulated	\$ 241,120	\$ 567,083	\$ 942,407	\$ 1,342,636	\$ 1,767,343

# Line of Sight



# Creating Long-Term Value for Premier Talent

- Pay the company first; tie this to your explanation to employees about how you define value creation
- Share the upside value in clear, believable and meaningful ways
- Make sure a long-term plan locks them in
- Communicate, communicate, communicate



# Next CPE Course:

## **“What is Phantom Stock and Why Do I Keep Hearing About It?”**

To be held on:  
Thursday, January 17, 2013

If you have three or members that can attend, we will make a specific presentation just for your firm on a mutually agreed upon date.  
(Indicate interest on survey.)



# Next Public Webinar:

## “What Problem is Your Compensation Strategy Solving?”

To be held on:  
Tuesday, January 22, 2013

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### How should I Share Value?

What constitutes an effective incentive plan? How much should be short-term and how much long-term? Do incentives really work?

Learn More

WHAT IS PHANTOM STOCK? HOW SHOULD I SHARE VALUE? HOW DO I END ENTITLEMENTS?

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**06/21/2012** - CPA CPE - Compensation that Drives not Hinders Growth

**06/26/2012** - Creating an Ownership Mentality without Giving Away Equity

**07/19/2012** - CPA CPE - Do Incentive Plans Really Work?

**07/24/2012** - Success Stories in Pay for Performance

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**ASK THE RIGHT QUESTIONS**

Creating an effective compensation program starts with knowing which questions to ask. Can

**FOLLOW THE RIGHT PROCESS**

Success in compensation development depends on a process that addresses both structural issues

**CHOOSE THE RIGHT COACHES**

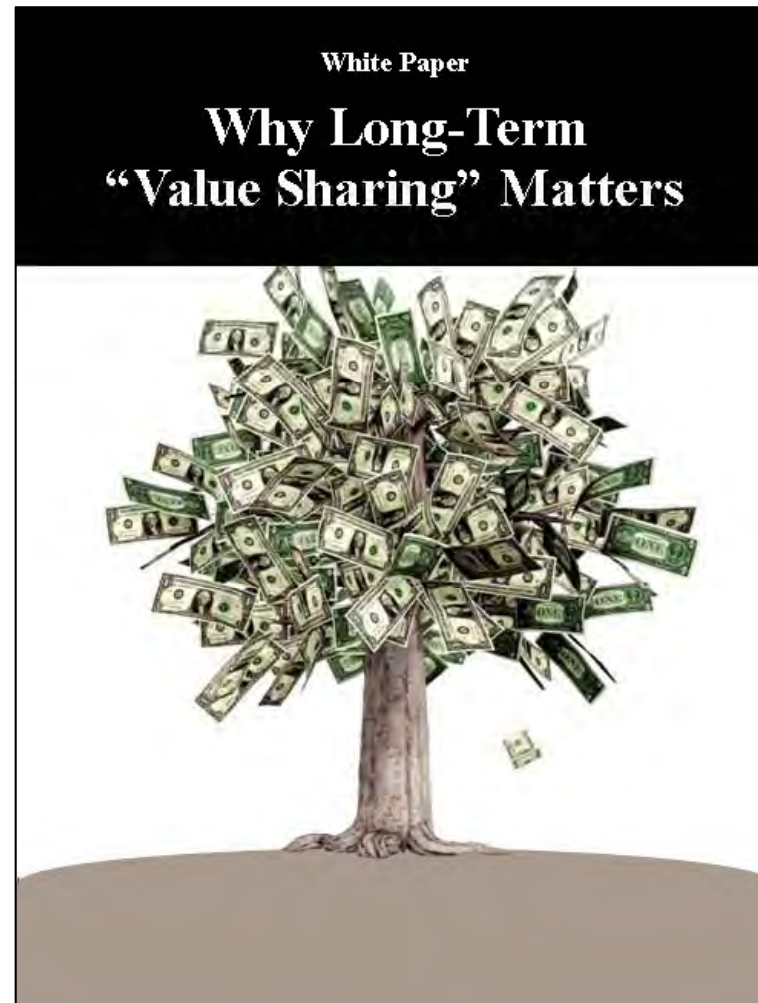
Listen to experts. Here's the latest thinking of two of VisionLink's growth strategy leaders. Tom

You can also subscribe to our blog

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

The screenshot shows the Phantom Stock website homepage. At the top left is the logo for Phantom Stock, 'The Equity Alternative', featuring a green arrow pointing up and to the right. To the right of the logo is a dark green navigation bar with white text links: KNOWLEDGE CENTER, TOOLS, BUILD A PLAN, BLOG, ABOUT US, and CONTACT. In the top right corner, it says 'POWERED BY VISIONLINK'. Below the navigation bar is a large light gray banner. On the left side of the banner, there are three green arrow-shaped buttons pointing right, labeled 'WHAT IS IT?', 'WHAT WILL IT CHANGE?', and 'WHERE DO I BEGIN?'. To the right of these buttons, the text reads 'A way to share ~~equity~~ Value', where 'equity' is crossed out with a red line and 'Value' is written in red cursive. In the top right corner of the banner, there is a red play button icon and the text 'Phantom Stock Watch overview'. Below the banner is a grid of four white boxes, each representing a website section. Each box has a title, an icon, and a short description. The first box is 'KNOWLEDGE CENTER' with an information icon and the text 'Explore our wiki and find the answers to your Phantom Stock questions.' The second box is 'TOOLS' with a briefcase icon and the text 'Decide whether Phantom Stock is a fit for your company.' The third box is 'BUILD A PLAN' with a wrench and screwdriver icon and the text 'For "do-it-yourselfers." Follow this guide to create your own plan.' The fourth box is 'BLOG' with an RSS icon and the text 'Read the latest discussions about Phantom Stock and other value sharing strategies.' At the bottom of the page is a dark green footer bar with white text links: Knowledge Center, Tools, Build a Plan, Blog, About Us, Contact, and a copyright notice: © 2010 PhantomStockOnline.com.

# NOW AVAILABLE!



Express interest on the final survey

# Thank you for attending

Please complete our survey form immediately following our presentation.

**This will be counted as a monitoring event.**

You may also request a copy of the slides a  
from today's presentation

# Questions?

# Thank You!



## **Ken Gibson**

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ADVISORY GROUP