

*The "Learn & Earn" Series™*  
January 28, 2010

# "The Five Essentials of Pay for Performance"



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.

Each person taking the course must respond to the monitoring events from their own computer. You may not share a computer when taking the course

We're happy to provide a copy of today's slides, course syllabus/summary, and a CD of the presentation. Information will be provided at the close of the presentation about requesting these.

**For questions during today's presentation:**

Use the question panel  
To the right of your screen

# Course Objectives

- Understand what “pay for performance” means
- Understand why “pay for performance” matters
- Understand how to properly balance shareholder and employee interests
- Understand how to sustain a “pay for performance” plan

# Key Concepts



- A “pay for performance” philosophy links shareholder and employee visions
- “Line of Sight” means employees and owners share a unified financial vision
- “Pay for performance” should fuel growth and build superior shareholder value to be considered successful
- “Pay for performance” is about creating wealth for both shareholders and key employees
- When done properly, “pay for performance” is self financing

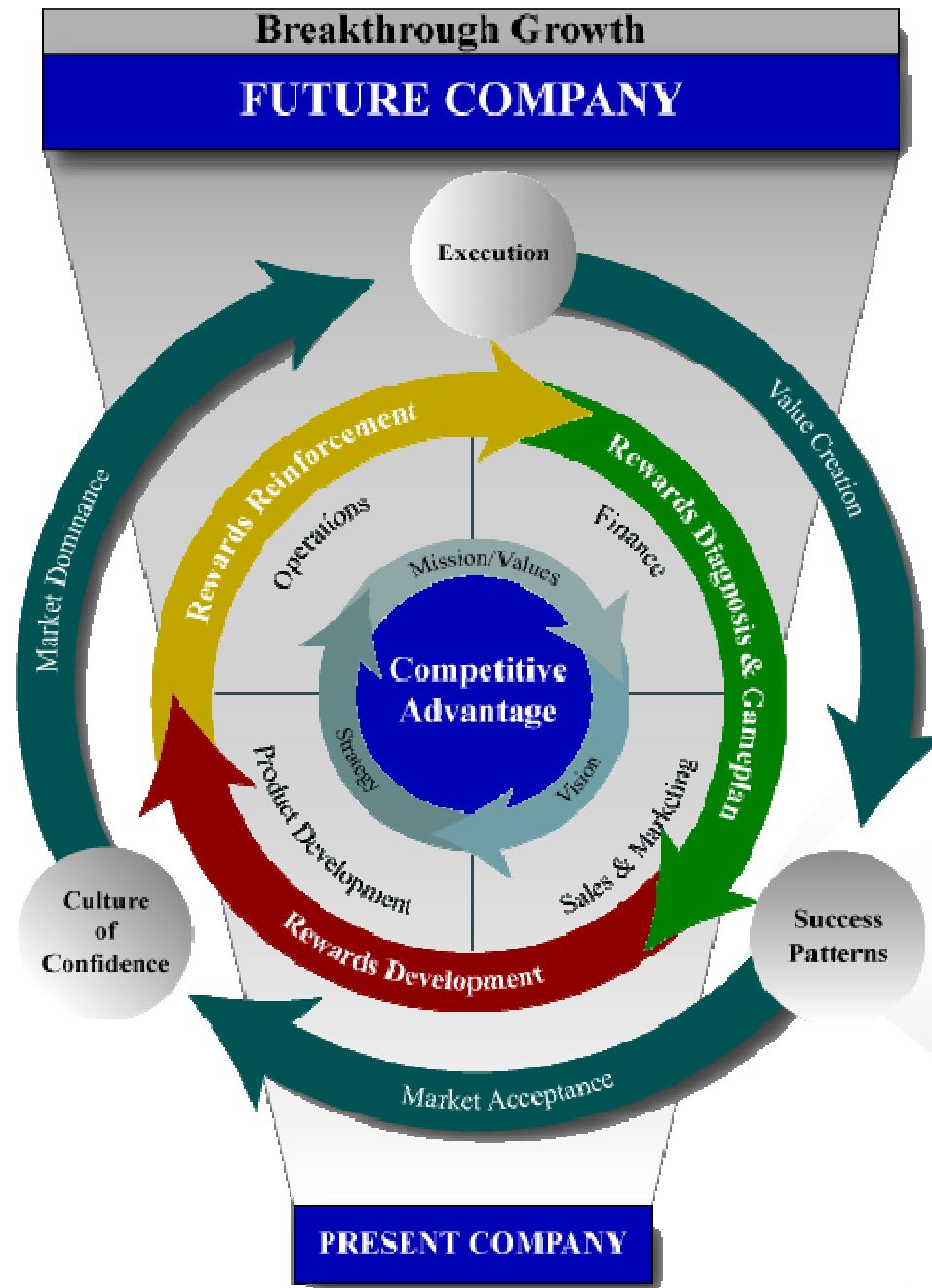
# Objectives of a “Pay for Performance” Strategy

- Recruit and retain highest quality employees
- Communicate and reinforce the values, goals, and objectives of the company
- Engage employees in the organization's success
- Reward contributors for successful achievements



# Why Worry About Pay For Performance?

- What does it do for your clients?
- What do they get from their efforts?
- Is it effective?



# The Five Essentials

1. Must tie performance awards to shareholder financial objectives
2. Must employ the proper mix of compensation elements
3. Must result in meaningful dollars
4. Must embrace performance that employees can impact
5. Must effectively communicate and reinforce

# Poll #1



## Essential #1

Must tie performance awards to shareholder financial objectives

# Essential #1

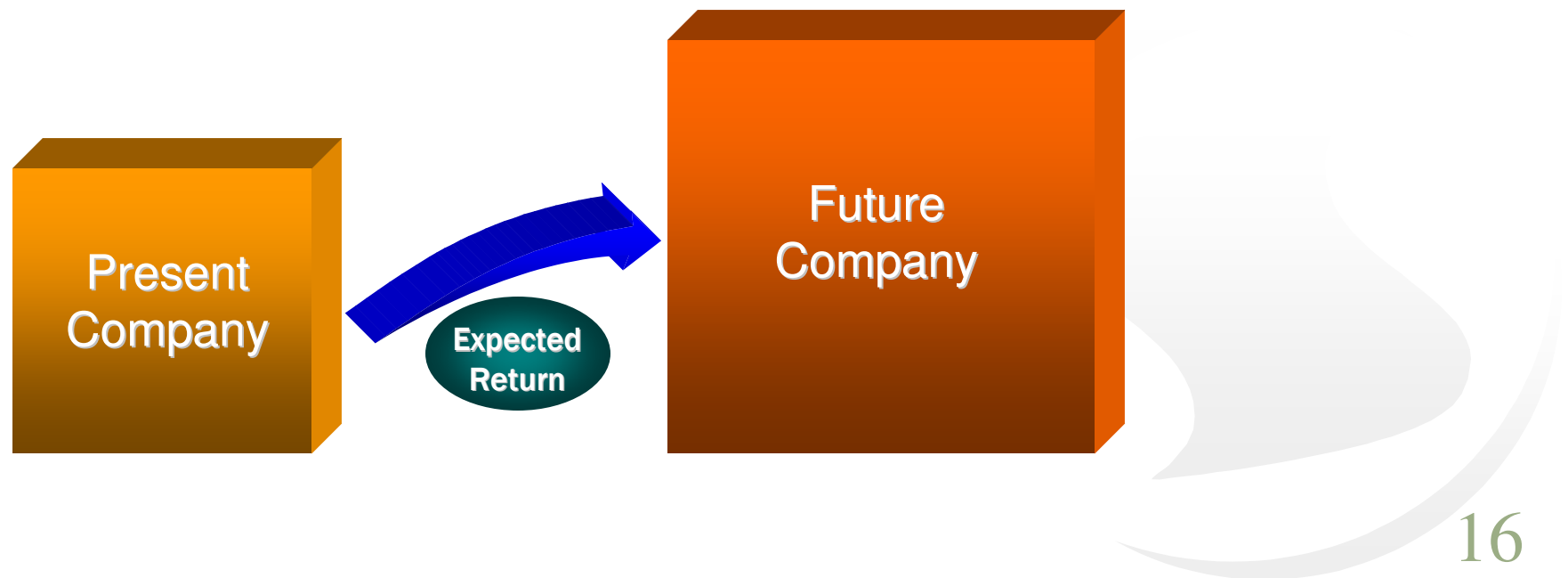
- All companies have a financial responsibility to shareholders
- Compensation should be evaluated like any other investment by the company
  - “Should we invest in a new machine or in our bonus plan?”

# Essential #1

- Does the incremental investment contribute to company financial success?
  - Hard dollars – more revenues, profits, cash flow, stock value, etc.
  - Soft dollars – increased productivity, turnover reduction, improved client service, etc.

## Essential #1

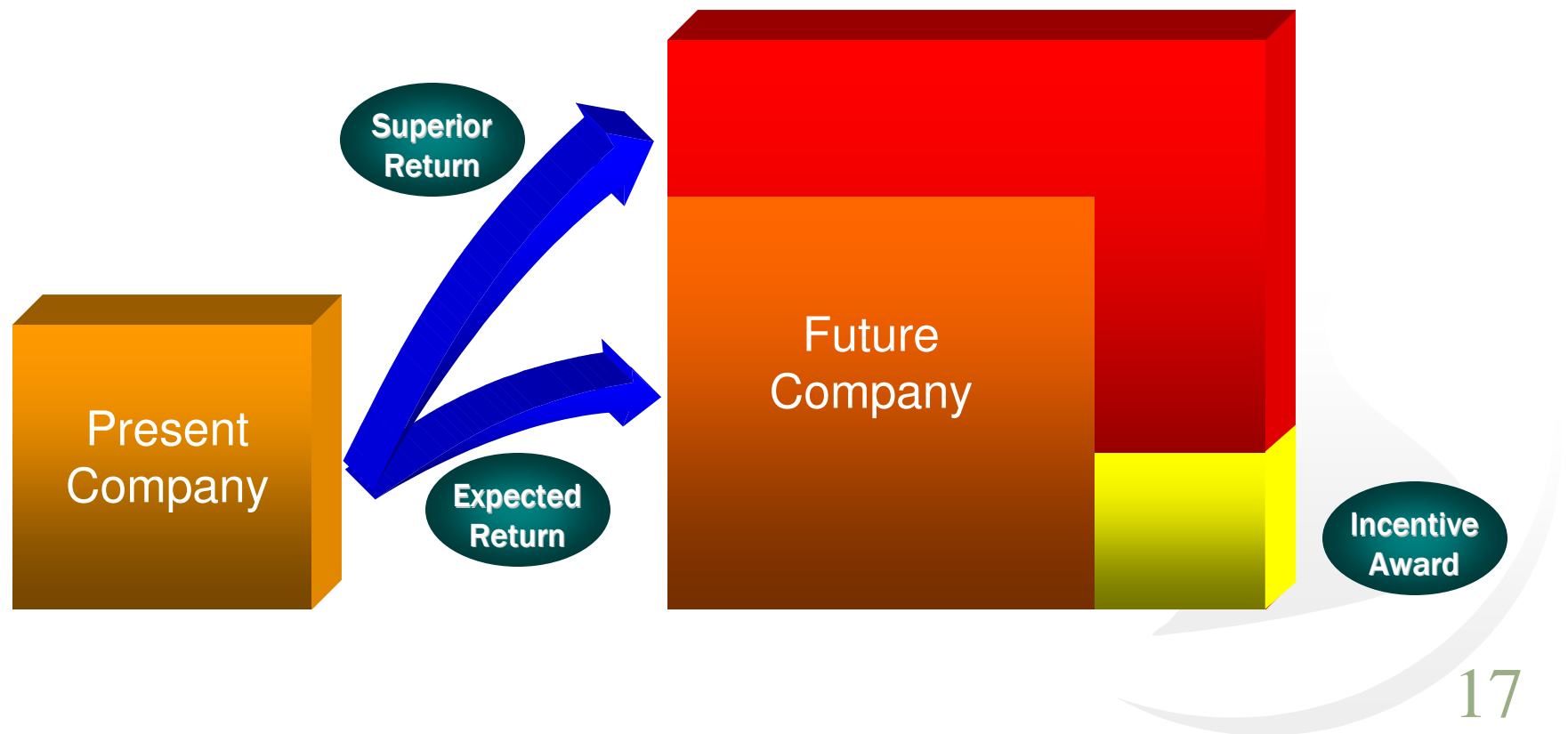
How should we think about compensation as an investment?





# Essential #1

How should we think about compensation as an investment?



# Tally Sheet

Year	1	5	10
Value Created for Shareholders	\$ 5,000,000	\$ 35,000,000	\$100,000,000
Cash Incentives Paid to Employees	\$ 350,000	\$ 2,650,000	\$ 9,750,000
LTIP Vested Value for Employees	\$ 0	\$ 1,950,000	\$ 5,680,000
Total Paid or Vested for Employees	\$ 350,000	\$ 4,600,000	\$ 15,430,000
% of Value Created Paid or Vested	7%	13%	15%

## Essential #1

# Example Investments

Hard or Soft Dollar Expectation	Compensation "Investment"
Enhance annual profits	Short-term incentive plan (annual bonus)
Double revenue in 4 years	Performance Unit Plan tied to revenue growth
Increase shareholder value	Phantom stock plan
Secure executive longevity	Deferred compensation plan with vesting schedule

# Essential #1

**Sample plan with a direct  
shareholder alignment**

*Phantom Stock*

## Essential #1

# Phantom Stock

*A long-term incentive designed to create the mentality and financial rewards of ownership without diluting equity.*

- Establish a hypothetical stock price
- Determine whether company will grant shares or artificial options
- Determine eligible group
- Target an overall range of grants (based on concrete objectives)
- Begin systematic process of issuing grants

## Essential #1

# More on Phantom Stock

- Share price does not have to equal actual stock price
- Formal business appraisal not necessary
- Payments made from cash
- Vesting schedule
- Distribution events may vary from plan to plan

## Essential #1

# Phantom Stock Example

- FoxHill establishes phantom share value of \$11 per share
- Shareholders identify goal of sharing 10% of equity value with key employees over 6-8 years
- Grant guidelines are established for Target performance (15, 20% of salary)
- Superior goals produce higher grants (30 or 40% of salary)

## Essential #1

# Lots of Variations

- Phantom Stock Options (SAR)
- Deferred Stock Units
- Combination programs



## Essential #1

Must tie performance awards to shareholder financial objectives

# Poll #2



## Essential #2

Must employ the proper mix of  
compensation elements

## Essential #2

# What is the proper mix of pay elements?

Salary

Bonus

Retirement

Stock Options

LTIP

Deferred Compensation

Core Benefits

Executive Benefits

Phantom Stock

## Essential #2

**Does the mix of compensation vehicles support:**

The company's needs?

The employees' needs?

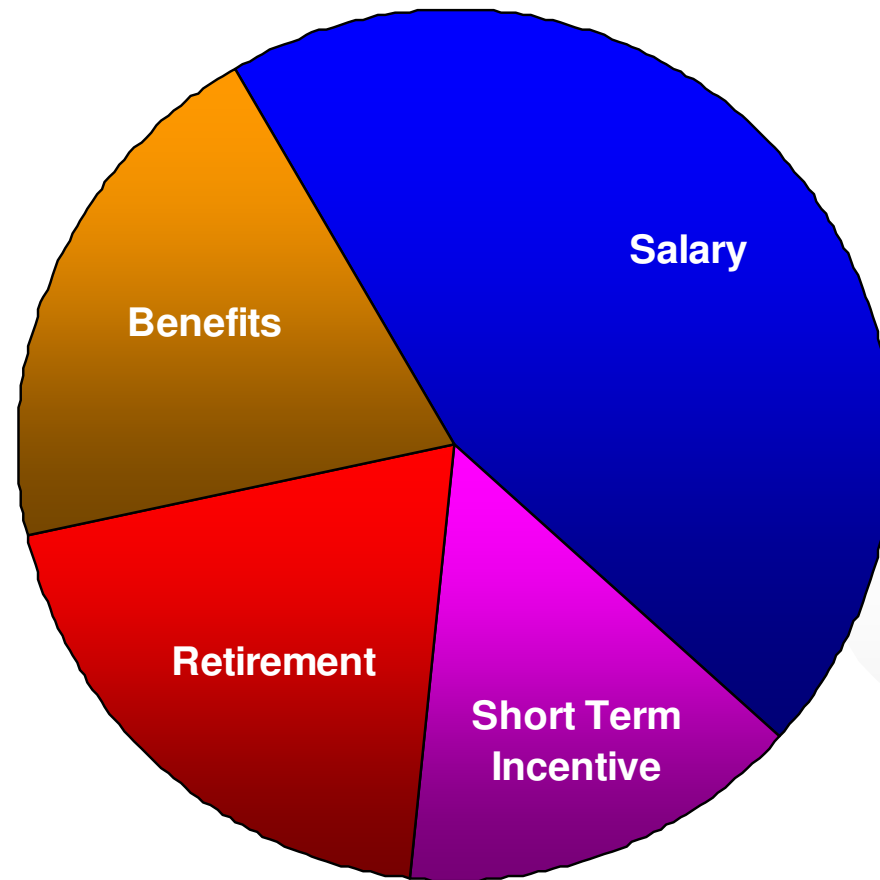
## Essential #2

# Why vary the mix?

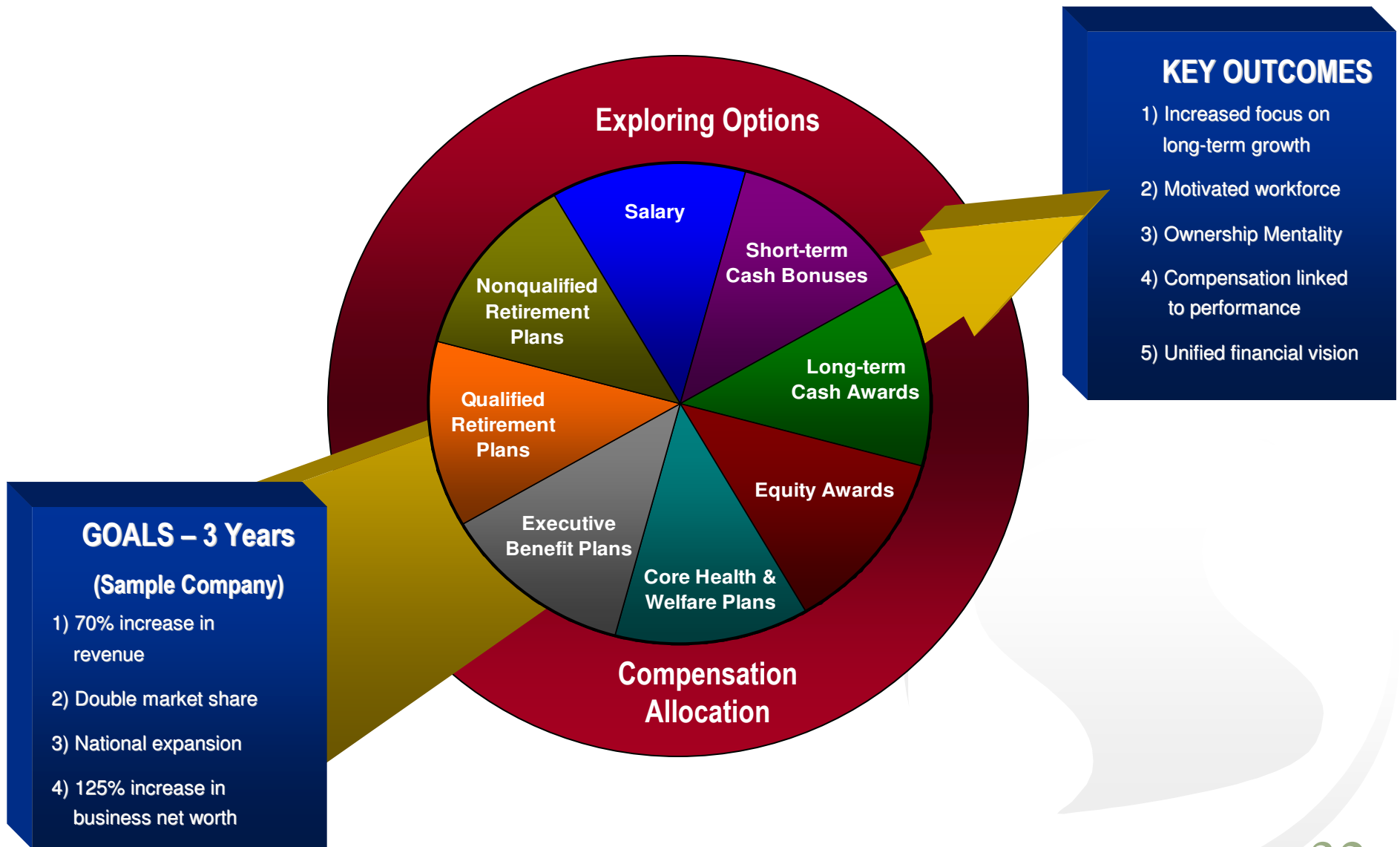
- Increased productivity
- Satisfaction quotient
- Retention goals

## Essential #2

# Typical Compensation Allocation



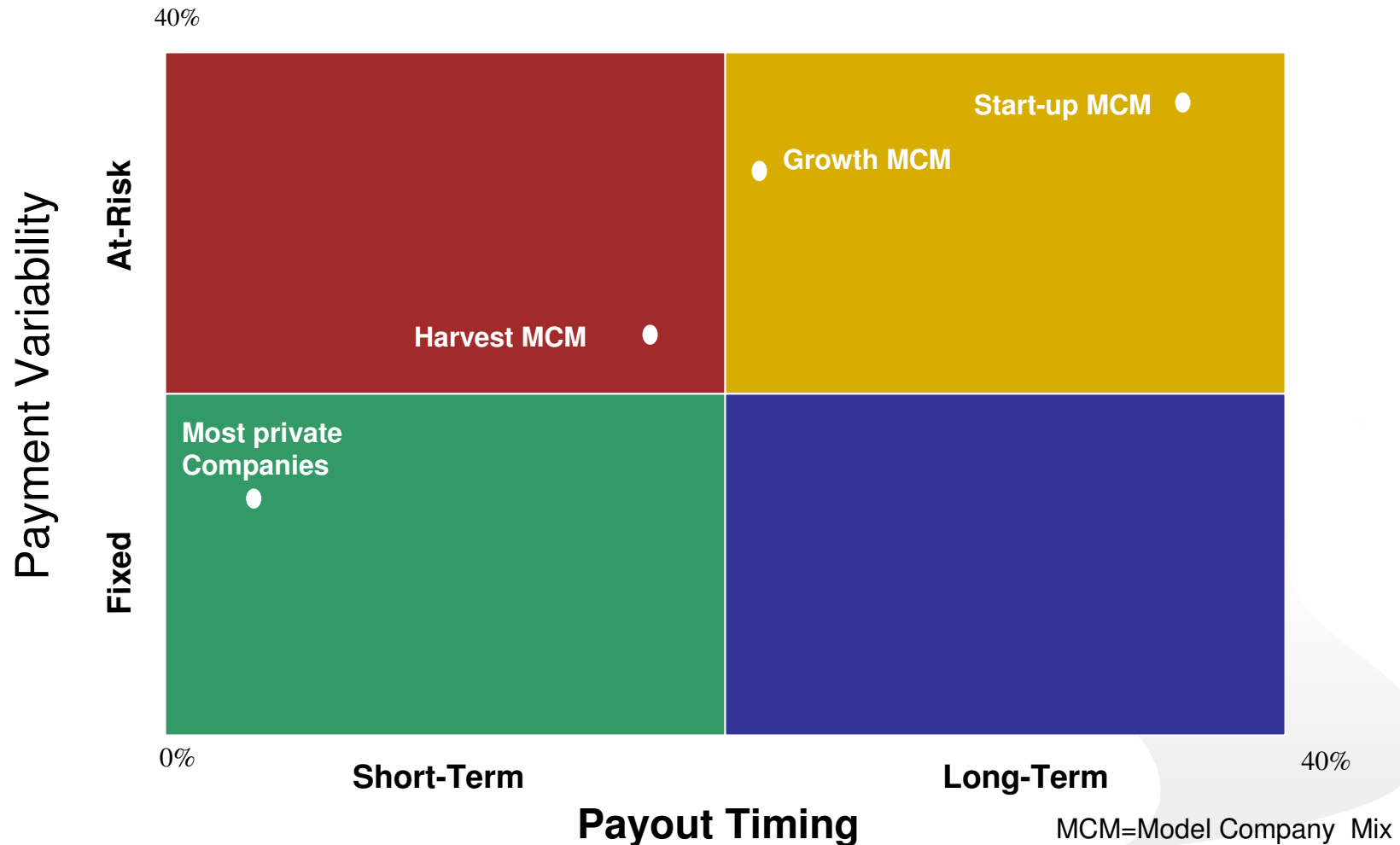
# Allocate the Compensation Investment





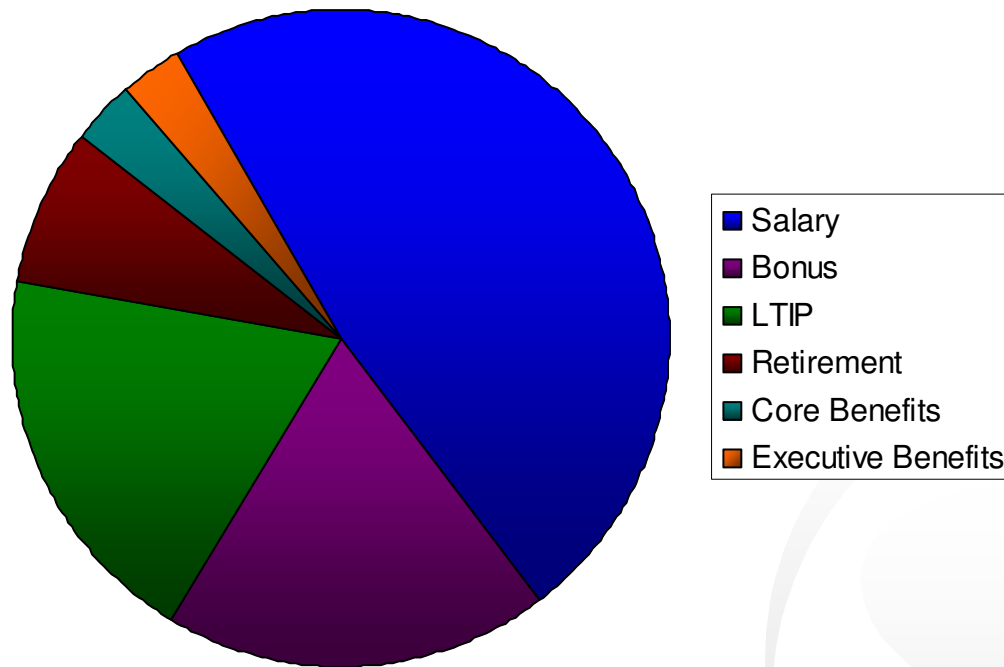
## Essential #2

# Total Rewards Positioning



## Essential #2

# Sample Total Rewards Allocation



## Essential #2

Must employ the proper mix of  
compensation elements

## Essential #3

Must result in meaningful dollars!

## Essential #3

- We are align the behavior of our people with business goals
- We are communicating a financial partnership
- Is the reward significant enough to create that unity?
  - Get and keep people excited

## Essential #3

# The Balance You Are Seeking

- Meaningful and motivational to the recipient
- In line with shareholder growth goals and expectations

## Essential #3

### Example:

- Senior manager with annual salary of \$150,000 and annual bonus of \$75,000
- In 10 years, total LTIP accumulation of \$200,000—probably too low
- In 10 years, total LTIP accumulation of \$2,000,000—probably too high

## Essential #3

# Rules of Thumb

- Short-term incentive plans
  - 40-80% of salary for top managers
  - 25-40% for 2<sup>nd</sup> tier managers



## Essential #3

# Rules of Thumb

- Long-term incentives (for key contributors)
  - 40-80% of salary for top managers
  - 25-40% for 2<sup>nd</sup> tier managers

# Essential #3

## Recommendation

- Build financial model that projects low, mid and high growth rates
- Carve out long-term plan projections that will generate specific, identifiable dollar payouts at each level
- Assess individual employee dollar values. Review these amounts while considering shareholder return along with employee expectations and rules-of-thumb (remember the Tally Sheet concept)

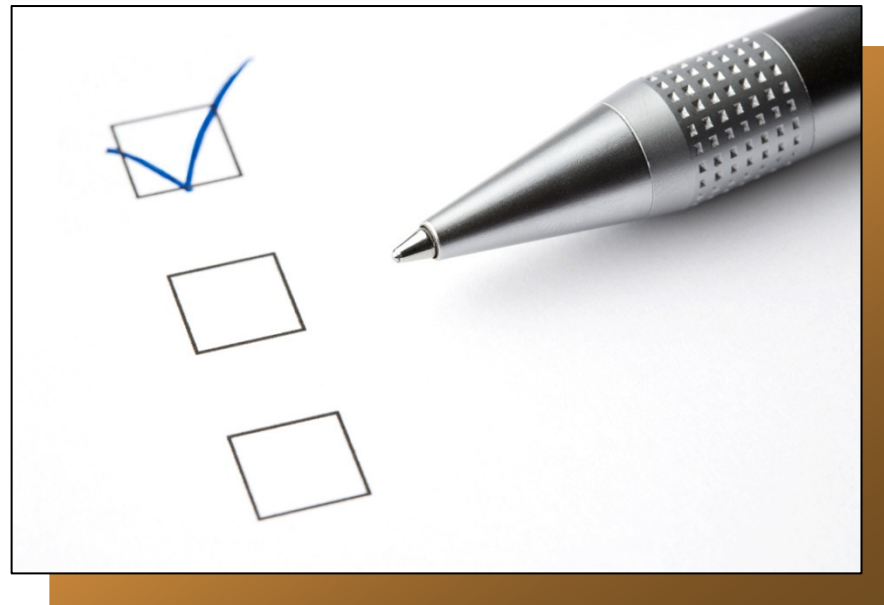
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## Essential #3

The employee award must be (a) achievable, and (b) meaningful

# Poll #3



## Essential #4

Must embrace performance that  
employees can impact

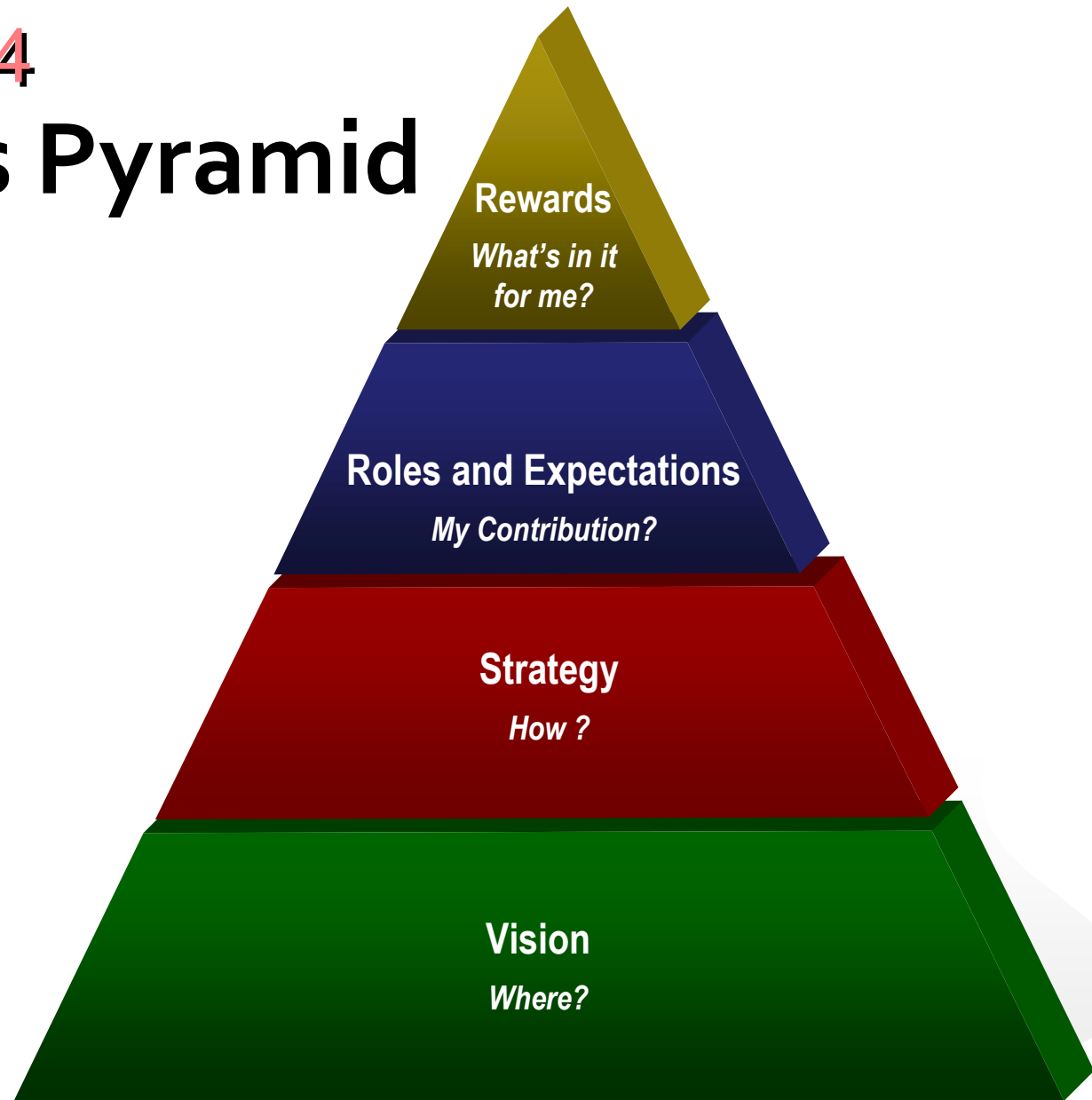
## Essential #4

# This is called “line of sight”

- “I can see precisely how my performance aligns with my pay!”
- Employees are frustrated or indifferent if they don’t feel they can impact performance (and hence their pay)
- There is also no “investment return” for the company
  - “I can’t affect the stock price!”

## Essential #4

# Rewards Pyramid





## Essential #4

Example long-term incentive idea  
with “line of sight”

*Performance Unit Plan  
(PUP)*

## Essential #4

# PUP

*A long-term cash incentive designed to reward employees for helping to achieve company growth*

- Establish a plan “term” (such as three years)
- Award “units” (PUPs) to employees based on their individual performance
- Redeem PUPs only at the end of the term
- PUP begins with a set value (e.g. \$100)
- Redemption value based on performance metrics (value may be substantially higher)

## Essential #4

# How are the PUPs valued?

PUP value tied to specific, measurable performance components of Randy's job

## Essential #4

# PUP Example

- Randy is awarded 50 PUPs valued at \$100 each
- At end of 3 year cycle, Randy's PUPs are valued at \$240 each

## Essential #4

# More on PUPs

- PUPs are forfeited for early termination
- A new PUP cycle may begin each year
- Serves as a retention tool
- Focuses participants on long-term operational results

## Essential #4

Must embrace performance that  
employees can impact

## Essential #5

Must effectively communicate  
and reinforce

## Essential #5

### Communicating and reinforcing the promise

- Employees have to know what is expected in order to strive for the goal
- Coaching and reinforcement are the keys to long-term focus and commitment



## Essential #5

# This is about getting results!

- Impossible to over-reinforce  
("Here's our value prop for you!")
- Establish the conditional nature of  
the promise ("must deliver on our  
plan; here's your role")

# 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

**Caveat:**

## Essential #5

# Additional Rewards Reinforcement Initiatives

- Letters and other direct, written communication
- Internet access to account values
- Modeling tools
- Personal financial planning

## Essential #5

Must effectively communicate  
and reinforce

# The Five Essentials

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# Next CPE Course:

## **“Do Incentive Plans Really Work?”**

To be held on:  
Thursday, May 27<sup>th</sup>, 2010

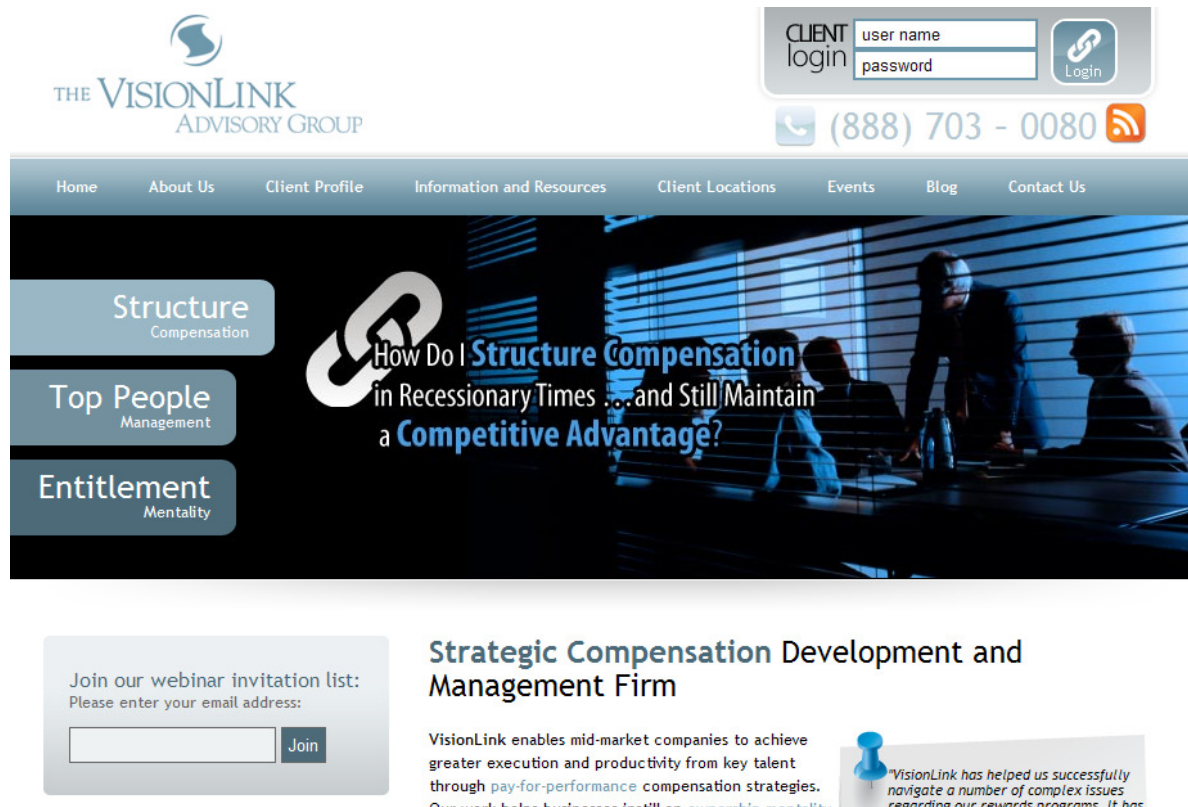
# Next Online Webinar:

## **“How Shareholders Should View Compensation”**

To be held on:

Tuesday, February 23<sup>rd</sup>, 2010

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# Questions?

# 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, course syllabus/summary and a CD of today's presentation

# Thank You!



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