February 23, 2010

"How Shareholders Should View Compensation"

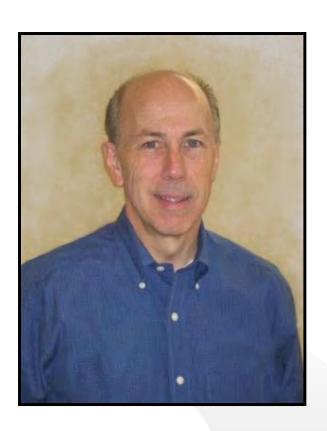




Today's Presenter:

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We're happy to provide a copy of today's slides. Information will be provided at the close of the presentation.

For questions during today's presentation:

Use the question panel
To the right of your screen

Key Concepts



- Improving shareholder value should be a core purpose of any compensation strategy
- As a result, shareholders have a vested interest in how compensation is structured
- Every compensation plan should produce a return on investment
- The right compensation allocation creates a more efficient return
- If you first define owner growth goals you'll build more effective compensation plans

Recent Wall St. Journal Report

Higher Pay Ratio Drags Lazard to a Loss

Lazard Ltd. said Wednesday that <u>it wanted to lure Wall Street bankers</u> who have grown disenchanted with the tight pay restrictions and relatively meager cash salaries offered by bigger banks.

The bank also <u>moved to sweeten its own compensation during 2009</u>, <u>paying out seven of every ten revenue dollars to employees</u>. The compensation changes pushed Lazard to a surprise fourth-quarter loss, even as its core merger-advisory business and asset-management unit improved.

Lazard's moves highlight one of the divisive issues of banker pay: whether top performers at big investment and commercial banks will be lured elsewhere, weakening those banks' prospects.

...and another



Morgan Stanley Gets Earful on Pay

Morgan Stanley Chief Executive James Gorman's <u>pledge last week to</u> <u>reduce the firm's compensation ratio followed prodding from some large shareholders</u> about unusually high employee payouts in 2009, according to people familiar with the situation.

Company officials acknowledge being questioned by investors since Morgan Stanley reported three weeks ago that compensation and benefits last year were equal to 62% of net revenue at the New York company.

This is not a new issue... just a more public one

Remember Jack Welch?

- \$9 million annual retirement benefit, plus perks—very controversial
- Less than 3/100ths of 1% of value created during his tenure (0.03 of \$396B)
- Total comp during his entire period of service was less than 2/10ths of 1%
- Would you pay that?

The Shareholder Issue



"We are paying our top 5 people *\$1,000,000 in compensation. What are we getting for it?"

*Or whatever figure is appropriate for your company.

Examples on following slides are for illustration purposes only

What are you getting?



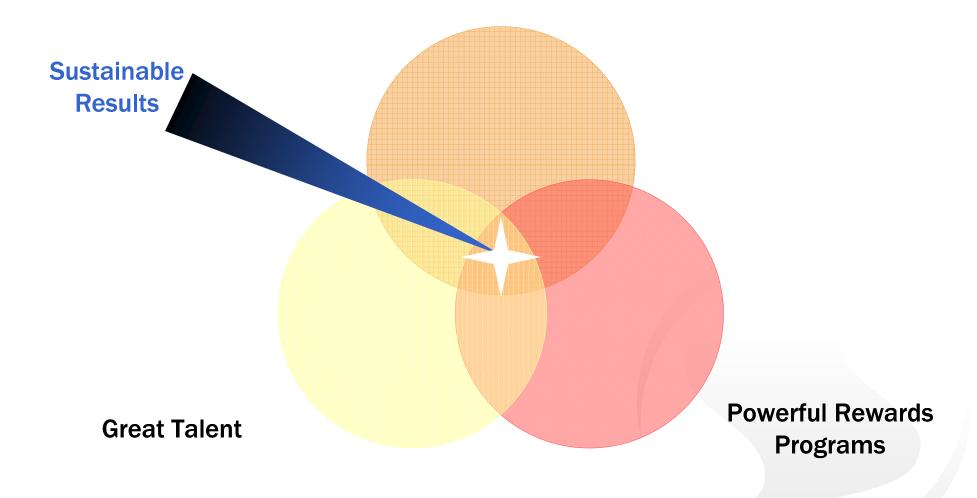
<u>Implication</u>

If the objective is growth, different results are being sought in the future than are being attained currently. Therefore the pay cannot remain the same.

Assume a company with \$10 million of revenue and \$1 million of profit

- What would have to happen to grow to \$3 million in 5 years?
- What would this mean?
- Is compensation the only answer?

Visionary Business Plan



Eight components of pay



- Core benefits
- Executive benefits
- Qualified retirement plans
- Supplemental retirement plans

- Salary
- Short-term incentives
- Long-term incentives (cash)
- Long-term incentives (equity)



	Annual		Target LTIP	Target LTIP	Core	Executive			
	Salary	Target STIP	Cash	Equity	Benefits	Benefits	QRP	Target SRP	Total
Donna Smith	180,000	72,000	36,000	36,000	8,500	9,000	5,400	41,479	388,379
Greg Hill	160,000	48,000	24,000	24,000	8,500	7,500	4,800	37,529	314,329
Alex Redding	160,000	48,000	24,000	24,000	8,500	7,500	4,800	56,703	333,503
	500,000	168,000	84,000	84,000	25,500	24,000	15,000	135,711	1,036,211

Fixed Commitments

	Annual		Target I TID	Target LTIP	Core	Executive			
	Annual Salary	Target STIP		Equity	Benefits	Benefits	QRP	Target SRP	Total
Donna Smith	180,000				8,500		5,400		388,379
Greg Hill	160,000				8,500	<u> </u>	· · · · · · · · · · · · · · · · · · ·		314,329
Alex Redding	160,000	48,000	24,000	24,000	8,500	7,500	4,800	56,703	333,503
	500,000	168,000	84,000	84,000	25,500	24,000	15,000	135,711	1,036,211

Variable Commitments

	Annual Salary	Target STIP	_	Target LTIP Equity	Core Benefits	Executive Benefits	QRP	Target SRP	Total
Donna Smith	180,000	72,000	36,000	36,000	8,500	9,000	5,400	41,479	388,379
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	500,000	168,000	84,000	84,000	25,500	24,000	15,000	135,711	1,036,211
	Committed	564,500			Can be or is self- financing		471,711		

The Compensation Pantry



How do these slices differ?



When they're paid



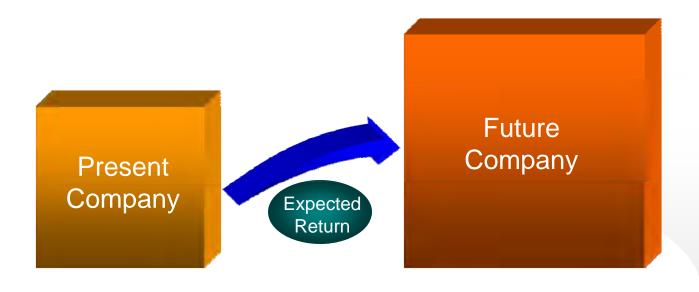
Whether they're paid (or how much they'll be worth when received)

Form of Pay	Purpose	Standard	Investment	ROI	
Salaries	Provide for the current cash needs of our executives	40-50th percentile for peer group	\$500,000	Achieve ROA standard of 0.75%	
Short-term Incentives	Enhance current cash payments to executives for achieving top and bottom line annual goals	30-40% of base salary	\$168,000 (Target)	15% revenue growth and 12% margin	
Long-term Incentives (Cash)	Retain execs; focus them on long- term earnings growth; align with shareholder interests; meet wealth accumulation needs	15-20% of base salary	\$84,000 (Target)	Long-term growth in earnings (double earnings = share 13% of new value)	
Long-term Incentives (Equity)	Retain execs; focus them on long- term earnings growth; align with shareholder interests; meet wealth accumulation needs	15-20% of base salary	\$84,000 (Target)	Long-term growth in earnings (double earnings = share 13% of new value)	
Core Benefits	Meet basic security needs of the executives	5oth percentile for peer group	\$25,500	ROA of 0.75%	
Executive Benefits	Enhance basic security needs and meet market standards for perquisites	50th percentile for peer group	\$24,000	ROA of 0.75%	
Qualified Retirement	Provide wealth accumulation opportunity for executives	4oth percentile (3% of salary)	\$15,000	ROA of 0.75%	
Supplemental Retirement			\$135,000	ROA of o.9%	

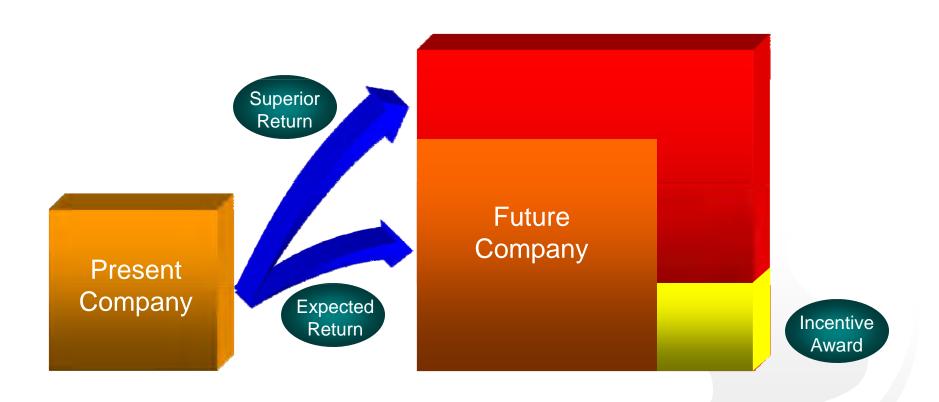
Another view: Excess return

What does it mean to triple net income over 5 years?

How should we think about compensation as an investment?



How should we think about compensation as an investment?



Current Equity Value	EOY	10% GR (Threshold)	11% GR	12% GR	13% GR	14% GR	15% GR
25,000,000	1	27,500,000	27,750,000	28,000,000	28,250,000	28,500,000	28,750,000
	15	104,431,204	119,614,737	136,839,144	156,356,759	178,448,449	203,426,541
	Annual increase in value		15,183,533	17,224,407	19,517,615	22,091,690	24,978,091
	Cum Value Increase Above Threshold		15,183,533	32,407,940	51,925,555	74,017,245	98,995,336
	% Shared		10%	15%	20%	25%	30%
	\$ Shared		1,518,353	4,861,191	10,385,111	18,504,311	29,698,601
	Net Increase for SH		13,665,180	27,546,749	41,540,444	55,512,934	69,296,736
	New SH Value		118,096,384	131,977,953	145,971,648	159,944,138	173,727,940
		IRR	10.9%	11.7%	12.5%	13.2%	13.8%

Implication

If the objective is growth, different results are being sought in the future than is being attained currently. Therefore the pay cannot remain the same.

Need? Pay for Performance

Pay For Performance Objectives

- 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

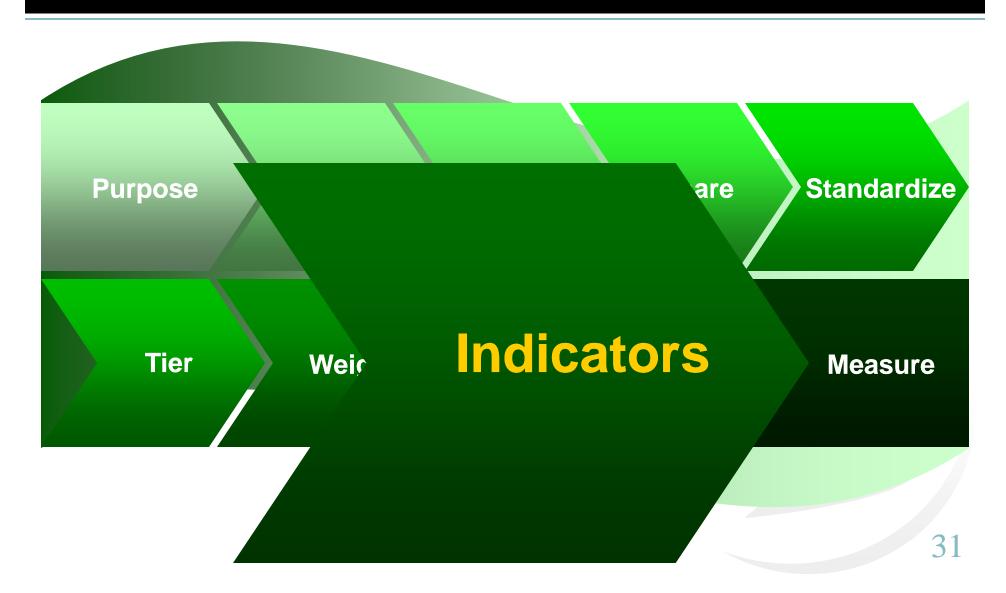
Building an Incentive Plan

A Unique Process



Building an Incentive Plan

A Unique Process



Indicators:



- Measurable
- May or may not be in financial statements
- Track progress towards strategic objectives
- Reflect improvement in productivity

Indicators:



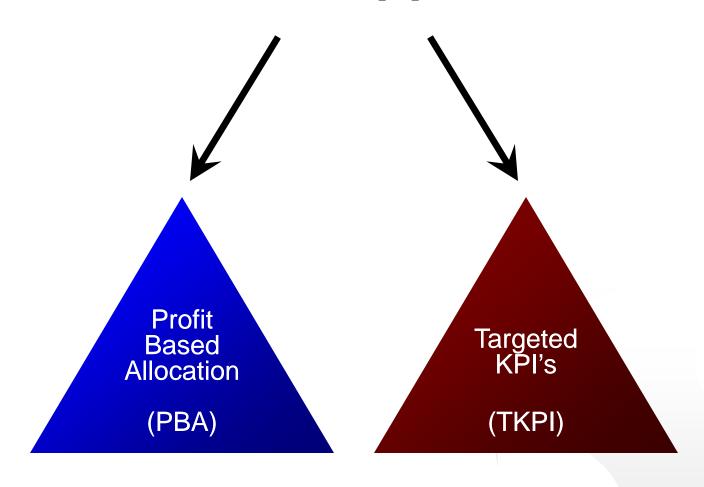
- Could be a number or a percentage
- Could be tied to budget (i.e., % of budgeted target achievement)
- Could be an improvement over prior period
- Could have a minimum threshold
- Could be tiered

In all cases:

- Seeking to improve performance
- Seeking to influence behavior
- Not trying to "motivate"
- Trying to "focus" through communication and reinforcement
- Trying to reinforce an ownership culture

Build a Sense of Partnership: Create a Unified Financial Vision for Growing the Business

Two Core Approaches



Profit Based Allocation (PBA)

A percentage of annual profits awarded to employees

The award amount is divided among employees based on a pre-determined formula

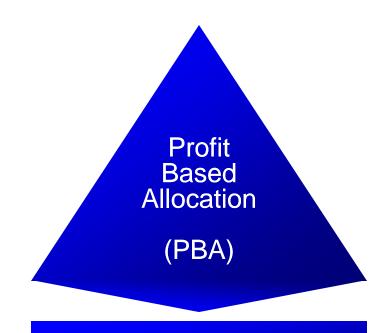
Paid at year-end

Targeted KPI's (TKPI)

Employees assigned a "targeted" incentive value – often based on a percentage of salary

Achievement of award is tied to multiple specific measurements or "metrics." Metrics can vary person to person.

Typically paid at year end, but may be quarterly.



Focus

Solely annual profits

Value

May be open-ended

Design

Relatively simple

Essential

Strong Performance Management System

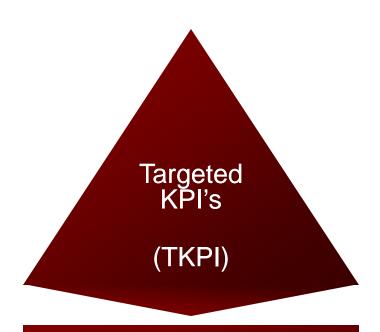
PBA—Best Practices

- Define profits
- Select "benchmark" or "growth" approach
- Identify threshold
- Select percentage to share (fixed or tiered)
- Select allocation formula
- Determine whether employee awards will be influenced by personal performance

PBA—Dangers



- Failure to create line-of-sight
- Apathy
- Morale
- Lack of strong performance management system



Focus

May include company, dept, team & individual metrics

Value

Typically capped

Design

Can run from basic to complex

Essential

Selecting the right metrics

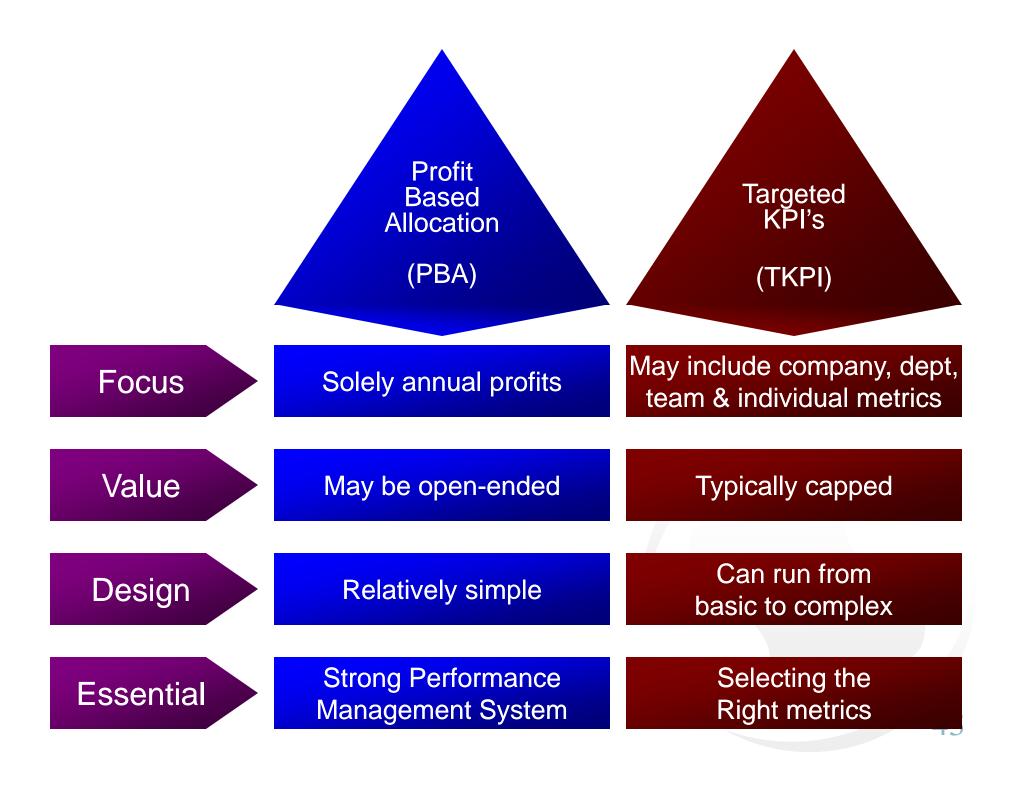
TKPI—Best Practices

- Select range of targets
- Select components
- Select drivers (metrics)
- Select performance tiers (eliminate all-ornothing)
- Set up measurement systems

TKPI—Dangers



- Miscalculation
- Gaming
- Sandbagging
- Misalignment



Indicators



Selecting Indicators for a TKPI Plan

Indicators



Identify the indicators that will be used to measure performance in each area.

For example:

Company - Revenue growth and Net Income;

Department - Improvement in Customer

Retention goal; Collections rate;

Employee Productivity factor;

Individual - performance goal achievement

2010 Performance Matrix

Loans 36,000	100%	115%	130%	140%	150%
33,000	80%	100%	115%	130%	140%
30,000	60%	80%	100%	115%	130%
27,000	45%	60%	80%	100%	115%
24,000	30%	45%	60%	80%	100%
	\$ 81,000	\$ 85,500	\$ 90,000 Deposits	\$ 94,500	\$ 99,000

Company Indicators

Return on Equity

Return on Assets

EPS

Gross Sales

Net Income

Earnings Before Incentives

EBT, EBIT, EBITDA

Economic Profit (Productivity Profit)

Revenue per employee

Profit per employee

Customer satisfaction indicators

Department Indicators

New Loans

Deposits

Net Interest Spread

Gross Sales

Gross Margin

Overhead Percentage

Average Daily Room Rate

Average Daily Occupancy Rate

Contribution Margin

Expenses to Budget

Production Quotas

Employee Retention Percentage

Registrations

Client Referrals

Alpha

Number of MBOs met

Critical step:

Sensitivity Testing

Sensitivity Testing



- Tie incentive plan to annual budget projection
- Test highs and lows
- Test each matrix
- Show ROTRI™
 - Open up the incentives to be as high as possible

Is it possible for the shareholders to get their highest return by paying unlimited incentives?

ROTRI™ - Return on Total Rewards 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	\$ 2,000,000
Cost of Capital	12%
Capital Charge	\$ 240,000
NOPAT	\$ 1,000,000
Productivity Profit	\$ 760,000
Total Rewards Investment	\$ 4,500,000
ROTRI™	16.9%

(ROTRI = Productivity Profit/Total Rewards Investment)

PBA Allocation Schedule

Productivity Profit	Award %	
First \$500,000	10%	
Next \$500,000	15%	
Amounts over \$1,000,000	20%	

ROTRI[™] Table

NOPAT	Productivity Profit	Award Amount	Owner's ROTRI (\$\$)	Owner's ROTRI (%)
\$1,000,000	\$ 760,000	\$ 89,000	\$ 671,000	14.9%
\$1,500,000	\$1,260,000	\$177,000	\$1,083,000	24.1%
\$2,000,000	\$1,760,000	\$277,000	\$1,483,000	33.0%
\$3,000,000	\$2,760,000	\$525,000	\$2,235,000	49.7%

Rewards Pyramid Rewards What's in it for me? **Roles and Expectations** My Contribution? Strategy How? Vision Where?

Rewards to Results



For compensation to do its part in changing results, the following must occur:

- Both the model and the compensation plan must be understood
- Both the model and the compensation plan must be valued
- The results must be believable (achievable)
- Employees must be committed (ownership)
- Results must be measurable (concrete)
- Results must be communicated (regularly)

Purposes of a good incentive plan

- Demonstrate a financial partnership with employees
- Communicate the outcomes and results most valued by the organization
- Create flexible means of rewarding high performers and recognizing special circumstances and achievements

Addressing the Shareholder Issues

- New value is created (sustainable profits)
- Results are measured and monitored
- Competitive advantage is enhanced
- Employer of choice attained
- A culture of execution is developed

First Step

- Where are we now?
- VisionLink's Tool:
 - Alignment Appraisal™
 - A focused look at your current practices with a comparative eye on "World Class Compensation" standards. "Is your total rewards program enhancing or slowing growth?"
 - Process—(1) employee survey, (2) current practices summary, and (3) completion of a profile questionnaire

Quantitative and Qualitative Assessment

Does the company develop and carry out an effective **Practices** pay philosophy and associated strategies? Is there a superior level of commitment and passion on the part of employees that manifests itself in Engagement consistent execution? Is there a measurable return to shareholders that can be attributed to the contributions of employees, **Productivity** especially key talent? Is there a unified financial vision for growing the business and do employees have an ownership Partnership mentality? Company leadership consistently and effectively communicates the Total Rewards opportunity available Clarity to employees

Special Offer

This Appraisal is typically \$1,800.

For today's webinar attendees only:

No cost if survey scheduled by

March 10, 2010

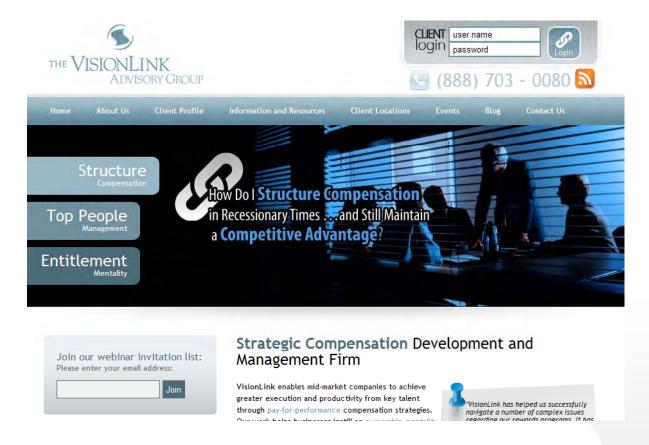
Indicate interest on final survey

Next Online Seminar:

"Why CEOs Should Drive the Company's Compensation Strategy"

To be held on: Tuesday, March 23rd, 2010

Check out our website: www.VLadvisors.com



You can also subscribe to our blog

Questions?

Thank you for attending

Please complete our brief survey immediately following our presentation.

We value your input.

You may request a copy of our slides and more information about the Alignment AppraisalTM.

Thank you!



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