

## What Does it Mean to 'Pay for Performance'?

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One of the most used, and perhaps overused, mantras following last year's market crash has been 'pay for performance'. The Wall Street Journal has published over 200 stories in the past three months alone containing the phrase, and the notion that firms ought to pay managers according to how they perform is becoming as widespread as details about what this actually means are elusive. When one looks back at how some reaped millions in bonuses by underwriting or investing in doomed securities, and believes that had proper incentive contracts been in place, the crash might have been averted, what sort of arrangement do they have in mind?

Ironically, the companies at the center of some of the most storied executive compensation disasters from the past eighteen months laid out incentive plans in their proxies that they deemed adequately linked to financial performance:

***Human Capital Strategy and Compensation Philosophy:** Establish performance-based compensation programs tied to annual and long-term Company, business unit and individual goals, which are structured to align the interests of employees with those of stockholder*

~Lehman Brothers' 2008 Proxy Statement<sup>i</sup>

Furthermore, literature and business school training revolving around corporate governance typically centers on areas such as board structure, voting rules, anti-takeover provisions, and the equity stake of directors and senior managers – leaving a lot to be desired when it comes to how to properly design incentive systems. The above are critical areas, but we've witnessed just how their effectiveness can be made impotent if 'pay for performance' is implemented incorrectly and managers have incentives to take enormous risks and make value-destroying investment decisions. How should performance be measured and pay administered?

A paradigm of corporate governance is that managers, as agents hired to act on behalf of shareholders' interests, are responsible for earning an adequate return on invested capital. Ironically, the majority of compensation plans used by public companies are driven by P&L metrics, and make no account for the capital shareholders have invested into the balance sheet<sup>ii</sup>. They typically reward for Earnings Per Share or Earnings Before Interest Taxes Depreciation and Amortization performance delivered that may have actually destroyed shareholder value. For example, one of the easiest ways to drive EPS is to borrow and invest the proceeds in projects earning as little as the marginal cost of borrowing; for EBITDA the growth hurdle involves earning a measly incremental return above 0%.

Incorporating the balance sheet into the equation can be equally problematic if it's not done properly. Setting a Return on Invested Capital (ROIC) target can lead to underinvestment for a company in a high-return business (accepting positive-NPV investments below the current ROIC hurts incentive plan participants) or overinvestment for a company in a low-return business (accepting negative-NPV investments above the current ROIC benefits incentive plan participants). Likewise, Operating and Free Cash Flow measures fail to evaluate management's contribution to shareholder value. A classic example demonstrating this is the battle between retail rivals Kmart and Walmart in the 1980s. Kmart generated considerable cash year after year, while Walmart invested aggressively in high-return expansion investments such that it had to tap the capital markets on multiple occasions to replenish cash. Following that decade, we know Walmart's share price has followed a course opposite both its Free Cash Flow, and unfortunately, Kmart's share price.

The most sensible way to design an incentive plan is to revisit the fundamental principle that investors expect managers to earn a reasonable return on their invested capital. Returns can be measured from two perspectives. The first involves measuring the operating returns of the business, and comparing it with the weighted average cost of capital for the firm. This "spread", when multiplied by the amount of capital invested, produces the Economic Value Added (EVA<sup>®</sup>) by the company. It is an appealing approach because it can be drilled down into the organization. Front line employees removed from decisions that affect share price can still be rewarded according to the actual vs. expected profit of their divisions. The targets to which managers are held accountable can be properly and cleverly dissected from a firm's share price. Simply put, the more growth attributed to valuation (think Google rather than an Electric Utility), the higher the investor expectations embedded in the current share price. One can also extrapolate expectations from analyst reports and objective industry forecasts, to the extent they exist.

Incidentally, the underlying soundness of this first perspective is garnering well-earned attention in this economic crisis. This past May, the Australian Prudential Regulation Authority, Australia's financial sector regulator released a statement<sup>iii</sup> saying:

*"One such method that APRA expects regulated institutions to apply, irrespective of other techniques that may also be adopted, is for **profit to be measured net of the cost of capital employed** in supporting the relevant product, portfolio or business. The basis for this approach is that the level of capital employed should reflect the level of risk associated with the product, portfolio or business and **the cost of that capital is as much a business expense as employee expenses, IT costs and other business expenses.**"*

The second perspective for measuring returns involves comparing Total Shareholder Return to expected performance. This approach will be addressed in the next blog post.

<sup>i</sup> United States Securities and Exchange Commission. 2008. *Proxy Statement Pursuant on Form 14-A for Lehman Brothers Holdings Inc.* (Commission File Number [001-09466](#)), Washington, DC.

<sup>ii</sup> O'Byrne, Stephen F. 2009. "Why Capital Efficiency Measures Are Rarely Used in Incentive Plans, and How to Change That." *Journal of Applied Corporate Finance* 21(2): 87-92.

<sup>iii</sup> Australian Prudential Regulation Authority. 2009. *Prudential Practice Guide*. (PPG 511- Remuneration), Barton ACT.