

INSIGHT

REWARDING THE TOP
MANAGEMENT TEAM

SIMON PATTERSON, PATTERSON ASSOCIATES LLP
DAVID RHOADS, DHR CONSULTING LLC

RESEARCH SUPPORTED BY
NEW BRIDGE STREET CONSULTANTS LLP

MAY 2006



MAKINSON COWELL

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EXECUTIVE SUMMARY

The cost of paying senior management is a very significant investment by the Board.

For those outside a company looking in and trying to understand what is going on, the focus on Executive Pay in the past has been on the information provided in the Annual Accounts - which contains our figures for the Chief Executive and other directors. The figures for the executives in the top management tier immediately beneath are not given. Accordingly, far less time is spent examining the total compensation of this senior management group.

Here we are defining senior management as the CEO, other executive directors ("tier 1"), senior function or business unit heads focused on policy ("tier 2") and other function or unit heads mainly focused on implementation ("tier 3").

Our research, carried out in conjunction with New Bridge Street Consultants, shows that an average large UK company has around 70 people in its senior management team and spends in the region of £30 million per year to compensate them. In this context, compensation includes salary, benefits, pensions, bonuses and long-term incentive schemes. This is a significant sum of money, accentuating the importance of linking pay to the achievement of companies' strategies across this entire management group.

Where the link is inadequate, the return on the investment in the senior management group may be low and, at worst, a culture of mediocrity may prevail. We have identified three potential reasons why pay is disconnected from strategy in some firms. Firstly, the performance criteria themselves may be at fault being, for example, unrelated to strategy, too vague, or too

short-term. Secondly, management and IT systems may not provide decision makers with comprehensive information. And thirdly, there may not be enough differentiation between the most successful individuals and their less talented peers.

Linking pay to strategy is certainly challenging. To address the issues above, management and IT systems should be designed to bring all aspects of compensation together into one database and we have noted that a small (but, at least increasing) number of companies are doing this. A database not only enables a detailed review of individuals but can also drive aggregate comparisons, say, between the variable and fixed components of compensation or between business units.

We believe that performance criteria would be improved by providing guidance on *how* budgeted targets should be achieved. They should recognize the relative difficulty of meeting different targets, for example, in growing businesses as opposed to more mature ones, and of the importance of balancing strategy-related goals with personal objectives and of the long term against the current period.

The third potential reason is (lack of) differentiation between individuals: performance appraisal systems may not be sufficiently robust. A "harsh but fair" approach would see someone who is not operating at the top level, redeployed to a position where they could excel, or else they would be replaced. This approach can then be tied into an executive pay programme that is highly rewarding for those that perform well.

Over the last ten years, pay has climbed inexorably, not just for those on the Board

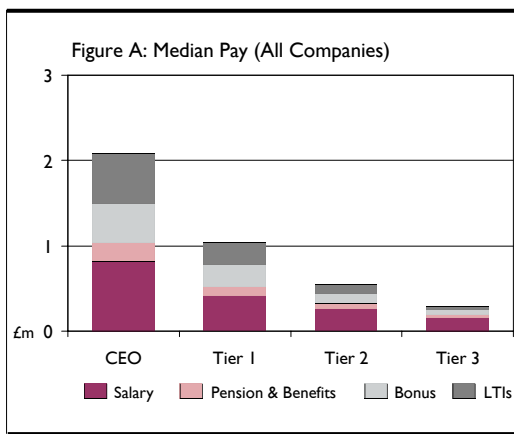
EXECUTIVE SUMMARY

but across the whole of the senior management group. We believe that an analysis we conducted in the mid-1990s holds true today: the pay-for-performance relationship is far less strong in the UK than it is in the US. People may be paid higher amounts in North America but they have to perform at the top level to get them. Private equity firms in the UK are ready to compete for the most talented by offering attractive

rewards closely linked to performance. Fears of a big pay day have taken the edge off incentives, and allowed less distinguished performances to be accepted. We believe that the challenge now faced by those responsible for setting pay and designing incentives is to understand their investment in senior management and link pay to achievement of strategy across the whole senior management group.

SURVEY OVERVIEW AND RESULTS

We undertook a survey in conjunction with New Bridge Street Consultants to collect and analyse data on the pay and incentives offered to senior management teams of large companies in the UK. Seventeen FTSE 100 companies were selected across four key sectors: Finance, Manufacturing, Fast Moving Consumer Goods (FMCG) and Natural Resources. The pay data collected includes salary, bonuses, benefits, pensions and the expected value of long term incentives.



We define senior management as the CEO, other executive directors (“tier 1”), senior function or business unit heads focused on policy (“tier 2”) and other function or unit heads mainly focused on implementation (“tier 3”). The chart above shows the

median total pay for a typical executive in each tier, and how this is made up from the components of pay.

Then, we estimated the total pay bill for a typical company by multiplying the median pay per person in each tier by an estimate of the number of people in that tier. Obviously, the number of people in each tier varies from company to company, depending on how the company is structured, so we made some assumptions about how many people are in each tier, for a typical company.

Below is a summary of the median pay per person, and the assumed number of people per tier:

	Median Total Compensation Per Person £ thousands	Assumed Number of People in Tier
CEO	2091	1
Tier 1	1043	4
Tier 2	560	15
Tier 3	295	50

Using these assumptions, we found that the average company in our survey spends a total of £29.4 million per year on its senior management team.

THE CHALLENGE: LINKING PAY TO STRATEGY

So, we have established that companies spend a great deal on senior management pay. The question then becomes whether there is a sufficient link between this pay and the achievement of the companies' strategies. In the remainder of this paper we explore the potential reasons for a disconnect and identify steps that may be taken towards linking pay more effectively to strategy.

Possible reasons for the lack of a link between pay and the achievement of companies' strategies include:

1. Failure to actively manage compensation costs
 - Information systems and corporate processes may not be set up to facilitate active management and control of senior level pay and awards
 - Insufficient information may reach decision makers within organisations to enable them to track total compensation spend across the senior layers of management
 - Companies may not be organized in a way that allows the information to surface readily, or be managed easily
 - Companies may make pay decisions on an incremental basis, referring to market benchmarks, rather than considering the overall "bang for the buck" they are getting, as they would for other major strategic investments.
2. Disconnect between pay and performance
 - The performance criteria for the senior team may not be demonstrably linked to strategy
 - The "Roadmaps" that the management team should follow to contribute to the overall success of the strategy may not be clear
3. Lack of differentiation between individuals
 - The budget-setting process usually focuses on the numerical targets to be achieved rather than on how they should be achieved
 - Goals may be insufficiently stretching
 - Personal objectives may be given a heavy weighting, despite the fact that they may not be well correlated with overall strategy
 - An insufficient proportion of compensation may be focused on multi-year objectives.

REWARDING PERFORMANCE - AN ILLUSTRATION:

The circumstances described here are fictional but illustrate the way in which an incentive scheme may fail in motivating the senior management team.

Let us suppose that Colin is the CEO of a Global Financial Services company. He has read Lou Gerstner's book and knows the drill -- "great strategy is all about execution". But he has a problem: the team isn't executing.

The strategy is a good one but it must be executed flawlessly. The top team needs to:

- Use the company's geographic spread as

THE CHALLENGE: LINKING PAY TO STRATEGY

- an advantage, instead of a cost burden
- Turn those cross-border capabilities into valuable service offerings, and
- Focus product groups and relationship managers on the most profitable customers - the clients who have money, not the ones borrowing it.

Time is running out because the investors expect earnings growth and one man cannot accomplish this alone. The group of 70 executives in the senior management team have many and varied titles, but they must be the primary drivers of execution.

Hurrying to the Human Resources department (HR), Colin asks if the team's pay can be linked more clearly to strategy. The HR department engage a well known remuneration advisory firm, who research competitor pay practices, among other things, and develop a new annual bonus structure, and a programme of "performance share grants".

Everyone is excited, and the Remuneration Committee approve the new plans enthusi-

astically. What can go wrong?

The company never comes close to achieving its goals: Customer revenue growth fails to materialize, and profit margins are squeezed by intense competition. In the circumstances, you would expect the new performance plan to deliver reduced pay awards, but instead:

- Salaries grow 15% (the competitive market for bankers has heated up)
- More than 75% of the top three management levels get personal performance ratings of "4" or "5" (on a 5 point scale) and performance shares are awarded accordingly. In fact, no-one appears to be able to tell who the top contributors really are
- Significant annual bonus awards are paid to the senior management team
- The value of large stock grants which had been made in the past - spread over the top three management levels - nearly double, because of takeover rumours.

ACHIEVING A MORE EFFECTIVE LINK

Let us now examine what can be done to address the challenge of linking pay to strategy:

- 1: Actively manage compensation costs
- 2: Align pay with performance
- 3: Differentiate between individuals.

I: ACTIVELY MANAGE COMPENSATION COSTS

Desirable information

Managing something well requires good information. In this case decision makers should be intimately briefed on strategy and should want to know:

1. How much is being spent on the compensation of the senior management team
2. How much the number has grown and
3. The reasons for the increases.

In the UK, executive directors' pay and usually that of other top managers is the responsibility of the Remuneration Committee. However, whether it is the committee or another body, all those involved should be well informed.

Companies may simply not be organized in a way which enables total compensation to be managed in one place. Individual pay programmes tend to be managed by specialists across different parts of the organisation, in silos.

For example, for the senior management team (perhaps excluding those handled by the Remuneration Committee):

- Salaries may be determined regionally
- Bonus awards may be determined by business unit
- Long-term incentives (share and options grants) may be determined at the corpo-

rate head office, handled by the company secretariat under the Board's direction

- The pensions department, and its advisors, may handle pensions
- The value of benefits may vary widely and be set locally.

Thus, no one area is accountable for the total investment.

A further complication is that few IT systems are set up to capture and report total compensation by pay component. Systems may be incompatible and some bonus calculations may be done manually. Therefore it may not be possible to examine the total compensation cost for the top three management levels in the way that other major P&L costs are considered.

Introduce a database

A small, but growing, number of companies are beginning to treat total compensation cost like a major investment, rather than a cost of doing business, dictated by the external market. An integrated database that produces management information is the foundation for this approach. This database would include the annualized cost of all pay components - salary, annual bonus, long-term incentives, stock options, pensions and other benefits - by executive, and by business unit over the past 3-5 years. It would also include relevant performance information such as annual performance appraisal ratings, leadership potential ratings and a track record of delivery of results (actual versus budget) over the past 3-5 years.

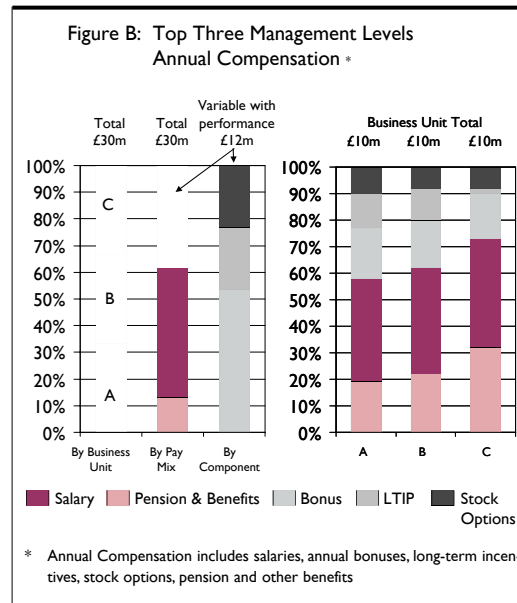
This information would enable the decision makers to answer a number of important questions in a fact-based and compelling manner, and monitor ongoing trends

ACHIEVING A MORE EFFECTIVE LINK

regarding the top three management levels. For example:

- How has total compensation cost grown for the senior management group in recent years?
- Within business units, how does the growth in revenue and earnings compare to that of compensation?
- Is pay mix consistent with changing business unit strategies (e.g., fixed versus performance variable, short-term versus longer-term, corporate-based rewards versus business unit linked rewards)?
- Is enough performance-oriented pay linked to business unit success?
- How does total compensation cost per executive compare across the head office and business units?
- Are the number of executives and compensation cost for any business unit growing despite lagging performance (without a good reason)?
- Are the highest rated contributors and highest potential future leaders being paid enough, relative to average performers?
- Are the weakest performers getting paid too much?

Figure B illustrates how one company reports total compensation cost for their top three management levels. This chart and a number of more detailed supporting analyses, relating pay and performance, are presented annually for review. It provides a useful business context for discussing the allocation of compensation resources across businesses, performance measurement issues, incentive plan design issues and opportunities to improve the link between pay and key business initiatives.



2: ALIGN PAY WITH PERFORMANCE

Strategy execution challenges

In July-August 2005, the Harvard Business Review included an article by Michael Mankins and Richard Steele, titled “Turning Great Strategy into Great Performance”. A survey completed by Marakon Associates and the Economist Intelligence Unit in 2004, covering 197 companies around the world with sales exceeding \$500 million, provided the source for these findings.

In this article, Mankins and Steele, two Marakon Partners, conclude that companies typically realize only about 60% of the potential value of their strategy because of defects and breakdowns in planning and execution. Over 50% of this performance gap can be attributed to issues which could be resolved by effective performance management and reward systems. Specific sources of breakdowns in planning and execution cited by survey respondents included:

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- poorly communicated strategy
- unclear definition of actions required to execute
- unclear accountabilities for execution
- inadequate performance monitoring; and
- inadequate consequences or rewards for failure or success.

We have identified four reasons why some companies may lack a clear and compelling performance measurement and reward roadmap.

First, in most organizations, the annual budget is the primary management tool for translating strategy into action and thus defining bonus targets. Because budgets focus almost exclusively on “what” performance is required (e.g., revenue, cash flow and earnings), less attention may be given to “how” it should be accomplished. Although critical programmes are often identified at a high level, comprehensive implementation guidance is unusual.

Second, targets may over- or under-state near-term business potential. Setting “achievable” goals has been drummed into every formally trained business person, and no-one wants to run a business unit where the team believe their objective is beyond reach. However, some “growing” businesses could probably grow faster - perhaps much faster than targeted - while other more mature businesses may not be able to do much about slowing growth. Ideally, rewards should reflect the ease with which targets can be met.

Third, a number of annual bonus programmes include personal objectives as well as budget-based financial goals. Performance against these personal goals may represent up to 40% or 50% of an executive’s annual bonus, and often these

goals do not have a strong link to overall company performance.

Illustrating this point, a recent audit of the personal objectives for the top three management levels of a major manufacturing company showed that they constituted 40% of their annual bonus opportunity. Most personal goals were vague and subjective; fewer than 10% of them were related to the company’s growth initiative; and over the past 5 years, bonus payouts associated with personal objectives had actually increased despite the company’s poor financial performance.

Finally, compensation for the top three management levels may not be directly linked to executing multi-year business strategies. Corporate stock options and performance share plans reward corporate performance, but provide an indirect link (at best) to long-term business unit results. Several reasons are commonly given for not rewarding business unit performance:

- Measurement and goal setting challenges
- A desire to reward corporate results versus unit performance; and
- Complexities associated with differentiating pay based on differing business unit performance.

Linking pay to business unit performance is a challenge but could be of huge benefit.

Monitor performance

The principle of aligning pay and performance is a common theme described in almost every executive remuneration report. Well-designed strategies consist of key initiatives which are easy to explain and have clear executive accountability. A “Roadmap” can guide executives’ day-to-day decisions and translate longer-term objectives into a

series of shorter-term milestones and key value drivers.

Progress towards delivering against performance commitments should be monitored, reported and discussed regularly. At one high-performing global bank, the CEO has a series of four discussions annually with each of his direct reports about how their team is performing and how they are doing personally against their goals.

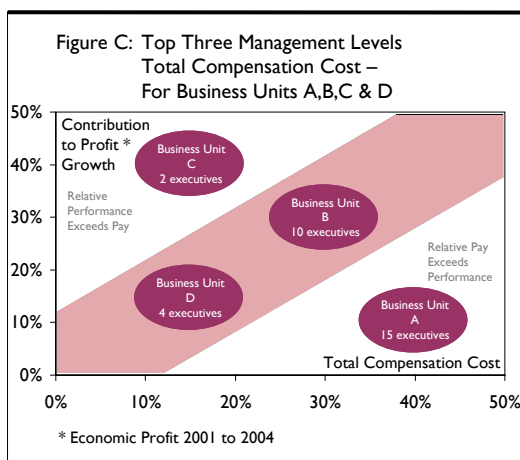


Figure C illustrates one approach to monitoring the relationship between relative pay and performance across a diverse multi-business organization. Four business units' percentage contribution to the growth in group profit is compared to the percentage of total pay allocated to each of these business units.

The shaded zone suggests that over 2001-2004, the performance contributions of Business Units "B" and "D" were reasonably consistent with the share of total compensation paid to the overall executive team. On the other hand, Business Unit "A" contributed only 10% of the growth in profit, while the senior management team received 40% of total compensation. Making matters worse, the team comprised 15, about the

same size as all of the other business units combined. Meanwhile, a relatively small management team at Business Unit "C" (the growth engine of this company) had generated about 40% of the growth in earnings, but received only about 15% of total compensation. While the circumstances might explain the data it could clearly generate a useful debate.

Select appropriate incentives

Bonuses and long-term incentives should reinforce the right behaviours and decisions so that executives know what is expected, how well they are doing and their potential reward.

There are a number of design implications for annual bonuses and long-term incentives for the top three management levels: The following approaches can be considered:

- Base annual bonuses on the achievement of financial goals and key strategic initiatives, and customize them to meet the needs of different business units
- Cascade the CEO's goals across the senior management team
- Separate the financial goals for bonus purposes from the budgeting process. Alternatively, replace the annual bonus with a larger long-term incentive opportunity, or use performance relative to external market indices as a "performance gate" below which no annual bonuses are paid
- Align executives' personal goals with key priorities and value drivers, state them explicitly, and discuss them openly. Ensure that objectives are calibrated across the senior management team
- With the exception of highly integrated

companies, link a large portion of business unit leaders' long-term pay to business unit specific performance, with a link at some level to corporate results

- Consider alternatives for assessing long-term business unit performance including multi-year financial goals, externally-based performance indices and value sharing plans. For example, one manufacturing client recently introduced a private equity inspired long-term incentive plan whereby the leadership team receives 20% of the business's "excess returns" above a standard set by the parent company
- Finally, add up all of the team objectives and see whether they come close to meeting the expectations of the stock market built into the share price.

3: DIFFERENTIATE BETWEEN INDIVIDUALS

Evaluating performance

Companies strive to hire and retain the most talented individuals available. They also seek to promote and differentiate the pay awarded to the most promising executives (i.e., those who achieve the best results versus goals). Succession planning identifies the top players and establishes development plans for them and others.

The highest potential players represent a firm's future leaders, who should in turn be given an opportunity to take on more responsibility and earn special rewards. The performance appraisal system should assess results versus goals as well as the performance of individuals relative to their peers. Calibrating performance against that of peers should provide protection against potential "rater bias" (for example, one business head may have lenient tendencies whereas another may be tough to please).

Despite the best efforts of those concerned, some performance appraisal processes may have limited credibility and add little value.

- Achieving standardization and "fairness" may be challenging
- It may be necessary to take costs out of the business thus limiting the potential to reward the best performers
- It can be difficult to deliver honest performance feedback
- Some may be nervous about creating too big a gap between the top performers and the under-performers.

These constraints may mean that every executive at a certain level receives similar incentive payments - perhaps the same number of shares, or the same bonus (as a percentage of salary). Salary increases may differ by only a few percentage points. "Nil" bonuses may be rare as the appraisal system may not be strong enough to validate such a harsh decision.

Alternative approaches

High performance companies may be passionate about hiring and promoting "A" players. "Top grading", an approach pioneered by Brad D. Smart, Ph.D., has been adopted by a number of organizations including GE, Barclays, Procter & Gamble and McKinsey. Jack Welch is one of the best known proponents of this type of leadership assessment methodology.

In a top grading organization, everyone is classified as either an "A", "B" or "C" player. "B" and "C" players receive development plans and are redeployed into a position where they can be an "A" player or are removed from their position. "A" players obtain additional responsibilities and are given special retention-based compensation. Rigorous behavioural assessment interviews

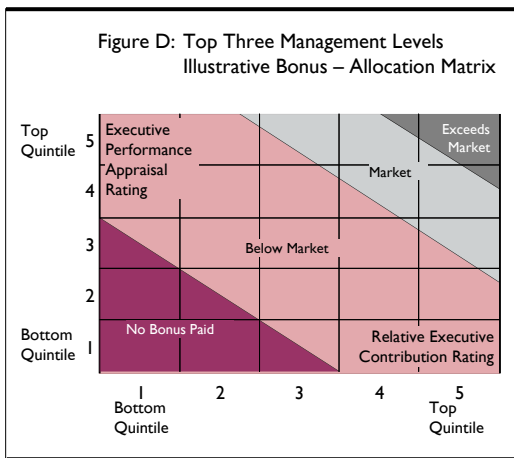
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and effective coaching are key elements of this approach. Top grading companies develop required capabilities in-house, although most initially rely on third-parties to complete the assessments and provide coaching.

An alternative approach adopted by some organizations that are interested in identifying their highest potential executives but unwilling to make the significant investment required by top grading, is to rank executives on a relative basis. Figure E illustrates how one bank allocates its bonus pool based on a combination of “Personal Objectives” and “Relative Contribution”. The executives are ranked by their contribution to, say, profit or another measure (see below) along the horizontal axis with their appraisal rating on the vertical axis.

Executives’ contributions can be ranked, for example, on “their impact on executing the unit’s strategy”, “the degree of difficulty associated with their personal goals” and “living the values of the firm” (among others). Next, at a calibration meeting, each of the members present justifies the rationale for the rankings assigned to their direct reports. After a debate, consensus rankings are agreed upon.

A similar process is cascaded down to the next management level. Finally, only top-quintile performers across two performance criteria - “Personal Objectives” and “Relative Contribution” - receive the highest bonuses, while the lowest quartile performers receive no bonus. This helps direct the largest payouts to top performers and sends a clear signal to non-performers.



Finally, a third approach used by some companies to ensure significant pay differentiation is to enforce performance rating distribution standards (for example, on a 5 point scale where “5” is “best”, no more than 15% can be “5s”, no more than 25% “4s”, etc.). Then, to ensure sufficient pay differentiation, a matrix is used to prescribe differences in salary increases, annual bonus multipliers and long-term incentive grants based on annual performance ratings.

CONCLUSION

Over the last ten years, executive pay has climbed inexorably, not just for those on the Board but across the whole senior management group. The headline-grabbing pay figures enjoyed by CEOs have leaked to the “marzipan layer”. By comparison, shareholders are only now seeing the market get back to the levels attained at the end of the Bull Run in 2001.

Private equity firms now compete for executive talent. Rewards can be very attractive though they are usually highly leveraged to results. Performance is monitored against a plan of action and results are defined as the creation of shareholder value. Over the years a large portion of private equity firms’ superior investment returns can be attributed to hiring top talent.

Analysis we conducted in the mid-90s holds true today: the pay-for-performance rela-

tionship is far less strong in the UK than it is in the US. In other words, the fear of a big pay day has led to less differentiation and a greater chance that mediocre performances may be accepted.

The significant investment in senior management compensation justifies the challenge of successfully linking pay to the achievement of strategy. Whether it is the Remuneration Committee or another group, those responsible for setting pay and designing incentives should make sure that the key doers and those with high potential are properly rewarded. Individuals should be held accountable for their contribution to the company’s results. Management should expect investors to query their policy and assure themselves that the return on the investment in senior management is being maximized.

REWARDING THE TOP MANAGEMENT TEAM

AUTHORS

Simon Patterson

Simon is founder of Patterson Associates LLP. Previously he was Managing Director and co-founder of SCA Consulting. For three years he was a Worldwide Partner with Mercer HR Consulting, when Mercer acquired SCA in 2001. He is actively engaged as advisor to the Remuneration Committee of several FTSE 100 companies, and consults widely on the topic of executive compensation and performance measurement. Simon received his MBA from the Anderson School of Management, UCLA and holds a BSc from University College, London.

Patterson Associates LLP, Brookmount House, 62/65 Chandos Place, London, WC2N 4LP
Tel: +44 (0)207 812 6040 Fax: +44 (0)207 812 6169
e-mail: simon@pattersonassociates.co.uk

David Rhoads

David Rhoads is a founder of DHR Consulting LLC, a Chicago-based consultancy. Previously, he was a Worldwide Partner at L.E.K. Consulting, a London-based strategy consulting firm, and co-founder of SCA Consulting's European based business. He also has been a Senior Global Consultant at Towers Perrin in their Performance Management and Reward practice. He has advised the Remuneration Committees of UK and US-based companies and consults widely on the subjects of compensation and performance management. David received his MBA from the University of Chicago, and holds a BS and a BA from the University of Pennsylvania

DHR Consulting LLC, 101 North Wacker Drive, Suite 2004-D, Chicago IL 60606
Tel: +1 312 525 8057
e-mail: David.Rhoads@dhrconsulting.com

Makinson Cowell is a capital markets advisory firm founded in 1989 that provides independent research and advice to leading companies on their relations with institutional investors. With 70 people in offices in London, New York and San Diego, the firm has special expertise in advising companies on cross-border investment matters.

Makinson Cowell Limited, Cheapside House, 138 Cheapside, London EC2V 6LQ
Tel: +44 (0)20 7670 2500 Fax: +44 (0)20 7670 2501
Makinson Cowell (US) Limited, One Penn Plaza, 250 West 34th Street, Suite 1935, New York, NY 10119
Tel: +1 212 994 9044 Fax: +1 212 994 9055
e-mail: enquiries@makinson-cowell.co.uk

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