AN INTERVIEW WITH OUR CEO

Chris Crawford, Kevin Kuschel, and Jordan Lee

In a recent National Association of Corporate Directors panel, Longnecker & Associates' CEO, Brent Longnecker, was asked a series of questions related to current hot button compensation topics. Through his extensive work as both a consultant, executive and director, his insights into these various topics are interesting and even edgy at times. While his answers aren't typical of the "middle of the fairway rhetoric" we so often hear, the logic and evidence behind them is irrefutable. We have summarized 5 key hot button topics below with Brent Longnecker's commentary on each:

1. Is the public's perception of executive compensation correct – that it's just too high?
2. You mentioned pay not being aligned with performance. Why is pay not in alignment with performance?
3. What do investors want with executive pay?
4. What are your views on relative TSR?
5. What are your thoughts on the bonus payout debate of formula vs. discretion?

QUESTION 1: IS THE PUBLIC'S PERCEPTION OF EXECUTIVE COMPENSATION CORRECT—THAT IT'S JUST TOO HIGH?

Media sensationalism around executive compensation is at an all-time high. This creates great ad revenue and makes for great copy but that's it. However, this coupled with the Great Recession of 2007-2009, caused the public to believe that not only are executives overpaid, but that anyone can be one. Both are simply not correct. First, not everyone is created to be a leader/executive no more so than every football coach is Bill Belichick. We depend on these leaders to build companies, create jobs, create a greater tax base, donate to our community charities and arts while creating value for their shareholders in the most competitive environment to-date. Leader/executives are a unique breed no different than Belichick, Popovich, Jordan or Magic.

As for the perception of compensation being too high—this too is simply not accurate. CEO compensation, adjusted for company size, performance and inflation has virtually remained flat over the last 15-17 years. In fact, the "outlier" media-reported, pay packages we read about are an incredibly small percentage (<5%). Most executives are paid well within reason even though top performers are usually not in alignment with pay which is tremendously disturbing.

As one executive recently told me, "Highly paid does not equate to overpaid! Its basic economics – supply and demand."

To put it even better, another CEO asked me "I don't get up every morning seeking to be average or perform average, so why should I expect my compensation to always be average especially when I outperform all my peers?"

QUESTION 2: YOU MENTIONED PAY NOT BEING ALIGNED WITH PERFORMANCE. WHY IS PAY NOT IN ALIGNMENT WITH PERFORMANCE?

There are several reasons why Corporate America has taken performance out of pay. Some reasons include, but are not limited to:

1. Outlier excessive pay packages that get reported by the media. They paint all executives with a "broad brush" of excessively. However, most executives and their pay are not even remotely excessive. Media bias has created this and it is key we keep this in perspective.
2. Lazy Outside Advisors. Outside advisors that are simply lazy and wanting to take an easy P50 view on every company they advise and not having a clue and/or desire to put forth the effort to design packages that are custom to the companies, their culture, their competitive environment and are performance based.
3. Proxy Advisory Firms. Proxy advisory firms that have annuity business models they wish to sustain that not only constantly "move the goal posts", but also create fear in Corporate America, especially with public company directors. It is important to remember that none of these firms and/or their analysts have ever (or will ever) run a company.
4. Fearful Independent Directors. Being a director is not easy. Directors who do not understand executive pay and/or who are more afraid of losing their board seat than doing what is right for the company and its shareholders, also play a role in the demise of performance in pay today.
5. Poor Shareholder Outreach. Companies that do not have a good shareholder outreach program position themselves poorly in their discussion of pay. The ability to share what, why and how with shareholders and institutions, and how you are using it to differentiate yourself is critical. Using compensation to attract, retain and motivate the key talent needed in today's ultra-competitive world economy is a must, so share it!
6. Activist Shareholders. Jay Lorsch and Harvard contend that activist shareholders have different agendas than our typical long-term hold shareholders and institutions. As such, they have a way of influencing pay away from performance and to what they desire with their holdings.
7. Finally, the SEC and how they have pay reported. We need realized pay in proxies yesterday! What gets reported now is simply for accounting purposes and it drives everyone crazy. The media loves this fact! It is rarely even close to what the executives receive. Further, performance is not tied to yearly reporting proxies and for many industries, it takes years for a find or a new patent to generate revenues. Performance is not a quarter and/or a year and Corporate America along with e SEC need to find better solutions to how pay is reported.

Bottom-line, Pay-For-Performance is critical for our companies—public, private and not for profits and our Country. With our federal deficit at 105% of our annual GDP (and growing), we must get performance back into pay to motivate Corporate America to not just survive, but to thrive and be the dominant country we need to be for all our citizens.

QUESTION 3: WHAT DO INVESTORS WANT WITH EXECUTIVE PAY?

With respect to investors today versus years gone by, there has been a shift in Corporate America from management in the 80-90s, to board members through the first decade of the 2000s, to the newly empowered investors of today. Where ongoing communication between boards and their shareholders was the exception and proxies were written to obfuscate, today transparency and open dialogues are the norm. Further, as Dodd-Frank regulations got enacted: ISS and other proxy advisory firms became more emboldened; and now—with a new pro-business administration in office—we have seen significant change while now we wait for even more. But while we wait, one key question isn't necessarily "what will change going forward?", but what do investors want from our executive compensation system and are we delivering regardless of who is in the White House?

The purposed intent behind the Dodd-Frank Act and most all the SEC changes we have seen in executive pay since 1992 have been within the context of encouraging better communication between companies and investors. This was the intent, but sometimes the results simply do not line up with the intent—and that has surely happened here. Transparency and communication have gotten better, however the lack of understanding of executive pay appears to have grown wider, in turn. This has created a very antagonistic situation of win-lose when today we need more of a "win-win". We all know that investors and institutions have different perspectives and goals and do not speak to Corporate America, collectively. We also know that not all leaders/ boards and CEOs are not created the same so the way they communicate executive pay is different as well. However, all that said, there are some common themes when it comes to pay for executives.

In general, most investors agree that they do not want to be in the board room. What they do want though, is for board members to do their jobs by being educated, planning and making decisions that are in shareholders' best interests. Then, they want these companies to clearly and proactively communicate their plans and decisions, accordingly. These expectations pertain to executive compensation, as well as any other executive matters. The key message here is that investors want regular communications of decisions that they deem to be defensible—they like to know the what, why and how's. They like knowing how leadership and the board are using pay to differentiate itself in their ability to attract, retain and motivate the talent needed to crate shareholder value. Investors believe that executive compensation is a "window into the boardroom." In other words, if the executive compensation program is transparent, reasonable, and sensitive to company performance, then investors feel as though other aspects of corporate governance will have integrity as well.

Investors expect the executive compensation programs and decisions to have integrity, e.g. the program design is consistent with the business strategy and needs of the company, and the committee actions are consistent with the program design.

QUESTION 4: WHAT ARE YOUR VIEWS ON RELATIVE TSR?

Long-term performance-based equity plans with Relative Total Shareholder Return (Relative TSR) metrics are undoubtedly among the fastest growing compensation vehicles in the US market today. Virtually every company utilizing a performance share or performance unit plan use or consider Relative TSR as a driving metric.

The rise of equity programs with Relative TSR metrics has been driven by both the direction of proxy advisory firms that like this metric as well as the growing desire by Compensation Committees to create strong, visible links between executive compensation and performance associated with shareholder value creation. Yet, despite the possibility of Relative TSR plans to deliver such a link, more work remains to refine program features and to account for all potential performance outcomes. Three notable examples come to mind:

1. The energy industry at present, where Relative TSR could punish sound strong-balance sheet companies when compared to companies recently restructured;
2. The use of Relative TSR in short-term incentive plans and how it can "double down" when combined w/ a stock-based long term incentive plan; and
3. Situations where relative performance may be strong, but absolute stock returns are weak, or even worse, negative.

Therefore, understanding Relative TSR pitfalls is key when thinking about using it for compensation. Typically, Relative TSR plans are created for equity award vehicles, usually performance share plans providing recipients with a variable payout of shares based on how a company's stock price performs against a comparator set. Comparator sets may include a discrete list of select peer companies or a market index like the S&P 500. While there are several design variables to consider when creating a Relative TSR plan, the core concept always remains the same: more shares are earned when a company performs well against a comparator group, and fewer, or no shares, are earned when a company performs poorly against a comparator group. Due to the simple mechanics described above, Relative TSR plans are generally viewed as a step in the right direction by executive compensation and corporate governance advisory firms and regulators. However, scenarios can occur where shareholders lose value at the same time plan participants earn payouts, perhaps even above-target payouts. For example, this can happen when a company's stock price falls, but by a lesser extent than all or most of its peers or comparator group. Once thought to be a very unlikely scenario, outcomes of this nature became a reality in down markets—like we have recently seen in energy. Understandably, shareholders question payouts, which while seemingly appropriate on a relative basis, appeared to ignore the fact that absolute company performance is weak.

The above possible bad aspects, coupled with how a Monte Carlo valuation (used for performance share plans), can impact the accounting in such a way as to make this downright ugly.

A key question remains for companies considering Relative TSR plans: How can Compensation Committees become more adept at managing real or apparent disconnects between annual and long-term plans along with relative and absolute performance issues when using Relative TSR metrics?

QUESTION 5: WHAT ARE YOUR THOUGHTS ON THE BONUS PAYOUT DEBATE OF FORMULA VS. DISCRETION?

Over the past several years, the amount of attention and heat on this topic has escalated as the Securities & Exchange Commission ("SEC"), proxy advisors such as Institutional Shareholder Services ("ISS") and Glass Lewis, shareholder activists and activist law firms continually push for more transparency, more linkage to pay and performance, and more formulas in company incentive programs. Conversely, compensation committees and boards have been elected by shareholders to determine fair and reasonable compensation considering several factors, including but not limited to market competitive costs, complexity and size of the organization, tenure of the executive, and yes performance. These board members, better than anyone, typically know the industry and company and what it takes to attract, retain, motivate and reward key executives appropriately. Thus, there is an escalating power struggle between company boards and institutional advisors over the fairness and reasonableness of incentive compensation payouts.

There is a strong argument that is made for companies to establish purely formulaic incentive plans at the beginning of the year. Proponents of formulaic bonuses indicate they can accomplish the following:

- Reduce the amount of gaming that is perceived to occur by boards and management;
- Provide transparency as to the goals and objectives of the Company;
- Reinforce decision making that should be in shareholder best interests;
- Create connections between employees, executives, board members and shareholders where interests are aligned; and
- Directly link actual pay with actual performance of the Company.

These tenets of formulaic incentives are reasonable. However, the last one is the crux of the matter. Said another way by a respected compensation committee chair, "I know better at the end of the year how our company did than an excel spreadsheet would predict at the beginning of the year". Predictive modeling has always been tricky business, but add the volatility of the 21st century economy and it's downright near impossible.

The last couple of years of proxy statements filed by oil and gas companies will be Exhibit A for this ongoing debate. Oil and gas prices didn't look all that pretty in the third and fourth quarter of 2014, plummeting from $110/barrel earlier in the year to $60/barrel at the end of 2014. However, very few saw the perfect storm of economic events that would drive prices below $30/barrel and seriously plague the industry in both 2015 and 2016. The result? Most energy companies with 2015/2016 formulaic bonuses pushed by ISS, institutions and activist investors have produced above target payouts while stock prices dropped in half. Compensation committees across the US have wrestled with what do we do? Let the formula payout to retain credibility in the plan or make a discretionary call to recognize an imperfect formula at the beginning of the year. Every compensation committee seems to have weighed their own set of facts and circumstances and derived their own conclusions. While there doesn't seem to be a perfect answer for this difficult dilemma, those companies that stuck to the formula may likely face more serious criticism and "votes against say on pay" by the very institutions that encouraged the formulaic incentive in the first place.

Guiding principles to good incentive plan design practices as it relates to formula vs. discretion:

- The ability for a compensation committee and management to use both positive and negative discretion is an important element to factor into annual incentive payouts.
- The discretionary portion, or weighting as a part of the whole payout, should be established in the beginning. For example, if a CEO has a targeted payout of 100% of base salary, 20%-50% of the final payout may be tied to discretionary decision making. This allows the compensation committee and management to adjust for unforeseen events and resulting performance.
- There may be key objectives the company routinely assesses in discretionary decision making. If this is this case, these overarching objectives should be communicated to employees and shareholders.
- In the event the compensation committee or management utilizes discretion, positive or negative, that produces an incentive payout result different than the formula, the committee should crisply articulate the why behind the decision making for the benefit of employees and shareholders.
- The final incentive payout and total compensation provided to the executive team should pass the smell test. If company performance was great, incentive payouts should be great. If company performance was not great, incentive payouts should not be great.

LONGNECKER
& ASSOCIATES
ALL IN.

281.378.1350 | **LONGNECKER.COM** • **Houston:** 11011 Jones Road, Suite 200 | Houston, Texas 77070
Dallas: 13155 Noel Road, Suite 900 | Dallas, Texas 75240 • **Denver:** 1873 South Bellaire Street | Denver, Colorado 80222