HaRe Group newsletter: **19 July 2006**

Subject: **Risks in Rewards**

Most market leaders know that a poorly designed incentive plan can erode employee engagement and inhibit business growth. A recent article in BRW provides good support to this notion.

The following issues raised in BRW deserve reiteration:

- Total Shareholder Return (TSR) has become the most common long term performance measure;
- Long term incentive (LTI) hurdles are usually based on TSR outcomes relative to a group of peer companies;
- Any LTI award is often conditional on TSR exceeding the peer group median;
- Maximum LTI awards usually require TSR to significantly exceed the peer group median;
- Market research proves that companies can rarely sustain such high performance.

The simple conclusion is that half of the companies involved will not clear such a TSR hurdle and their executives will not qualify for an award – and most CEOs will know well in advance if they will make the cut.

This constraint presents a major problem since so many executives will have no financial incentive to help lift long term company performance. Those companies that languish in the bottom quartile this year may have little hope of TSR exceeding the peer median next year. In their efforts to boost TSR, some desperate executives may even be tempted to take unreasonable risks to deliver good news (or delay bad news) to investors.

In my experience, successful incentive plans have several common attributes, including self funding, objective performance measures that are relevant to employees, transparent communications and meaningful awards. A key feature in the most effective plans is the correlation of performance and awards, usually structured in at least three levels:

- Threshold performance that delivers a minimum award;
- Target performance that delivers a target award;
- Superior/ stretch performance that delivers a maximum award.

"Threshold" is defined as the lowest acceptable performance that triggers an award. In funding short term incentive (STI) plans, the Threshold is set somewhere below a company's profit target. The minimum payment is low but meaningful, but as profitability improves, the value of the award increases. However, in many LTI plans, the Thresholds have been set to reflect investor expectations, which usually means that nothing less than median is acceptable and many talented executives could go unrewarded. This situation may erode employee engagement and weaken talent retention.

Given this risk of losing talented executives, company boards should reconsider their LTI Thresholds and provide an increasing award for incremental performance improvement up to, and beyond, the peer median TSR. A full award may still be restricted until a company's performance significantly exceeds the peer group median.

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