

Making pay for performance work

Towers Watson's Autumn Conference



Short-Term Incentives

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Why do short-term incentives exist?

- ✓ To tie people costs to affordability/profits
- ✓ To share in business success / foster sense of inclusion
- ✓ To focus employees on specific goals and behaviours
- ✓ To motivate employees to perform better in order to receive higher pay
- ✓ To provide fair levels of pay reflecting an employee's individual contributions
- ✓ To attract high-performing individuals to the organisation
- ✓ And therefore – to be market competitive in terms of structure of pay

The **number of reasons** and **importance of each reason** will vary by company, and even employees group, based on variables such as:

- Company philosophy and values
- Employee / union perspectives
- Impact of marginal increases in individual effort on business performance

The premise behind short-term incentives



Expectancy Theory

*An increase in **effort** will lead to attainment of **desired performance** which leads to receipt of **fair reward** that is valued by the recipient*



Question for Group

“

Do short-term incentives motivate your employees to
perform better?

”



Why are short-term incentives still important when long-term business success is the key objective?

- Although most industries operate according to a long-term business strategy, short-term incentives are still critical because:
 - It is easier to set annual targets and objectives than multi-year ones
 - It is easier to measure annual performance than multi-year performance
 - Employees rely on receiving regular payments for personal budgeting purposes
 - The decisions that most employees make most of the time impact business performance within a one-year timeframe (exceptions include executives and planning department)
 - Employees may not be in same position or even with same employer over multi-year period

The latest trends in Short-term Incentives

The incentive pool

is typically determined using financial and non-financial methods for tiered plans, pure financial results for organisational wide plans and for individual incentive plans have a budgeted approach using a sum of targets

Profit

is the most commonly used metric used to determine bonus pay-out levels for tiered and organisational wide plans, and individual performance rating from the Performance Appraisal system for individual incentive plans

Individual award payments

are the same for most organisation-wide plans but more differentiated in other plan types

A threshold of 70% – 80%

of performance or a discretionary performance threshold are the two most common scenarios

94%

of companies award payment in cash and only 8% defer the award

0% and 150%

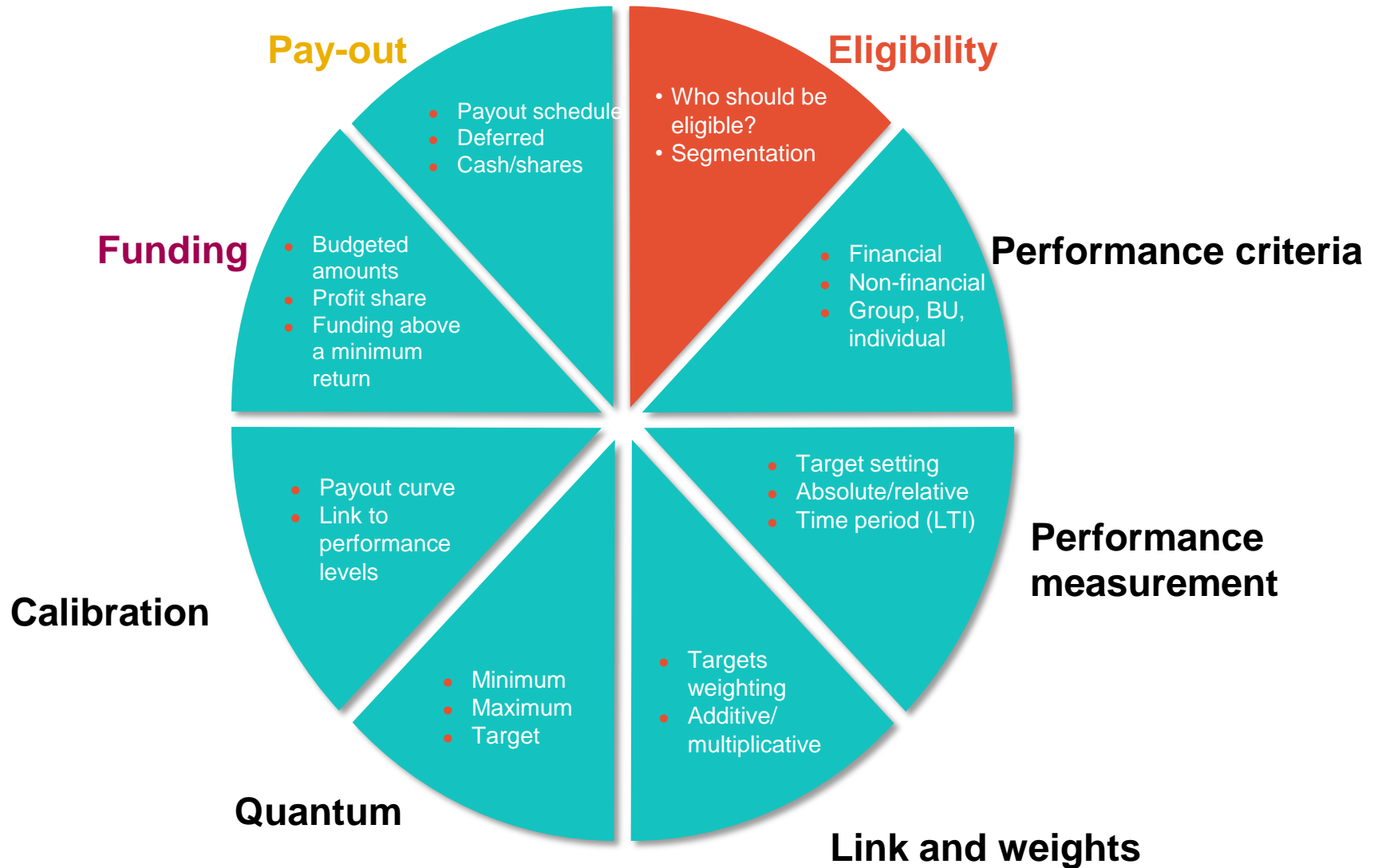
represent the median percentages of target that a low and high performer typically receive respectively

1/3

of companies only pay someone a bonus if they are in employment on the date the bonus is paid

of companies have introduced new plans and have the same focus for the coming 2 to 3 years

Design parameters to consider in incentive plans

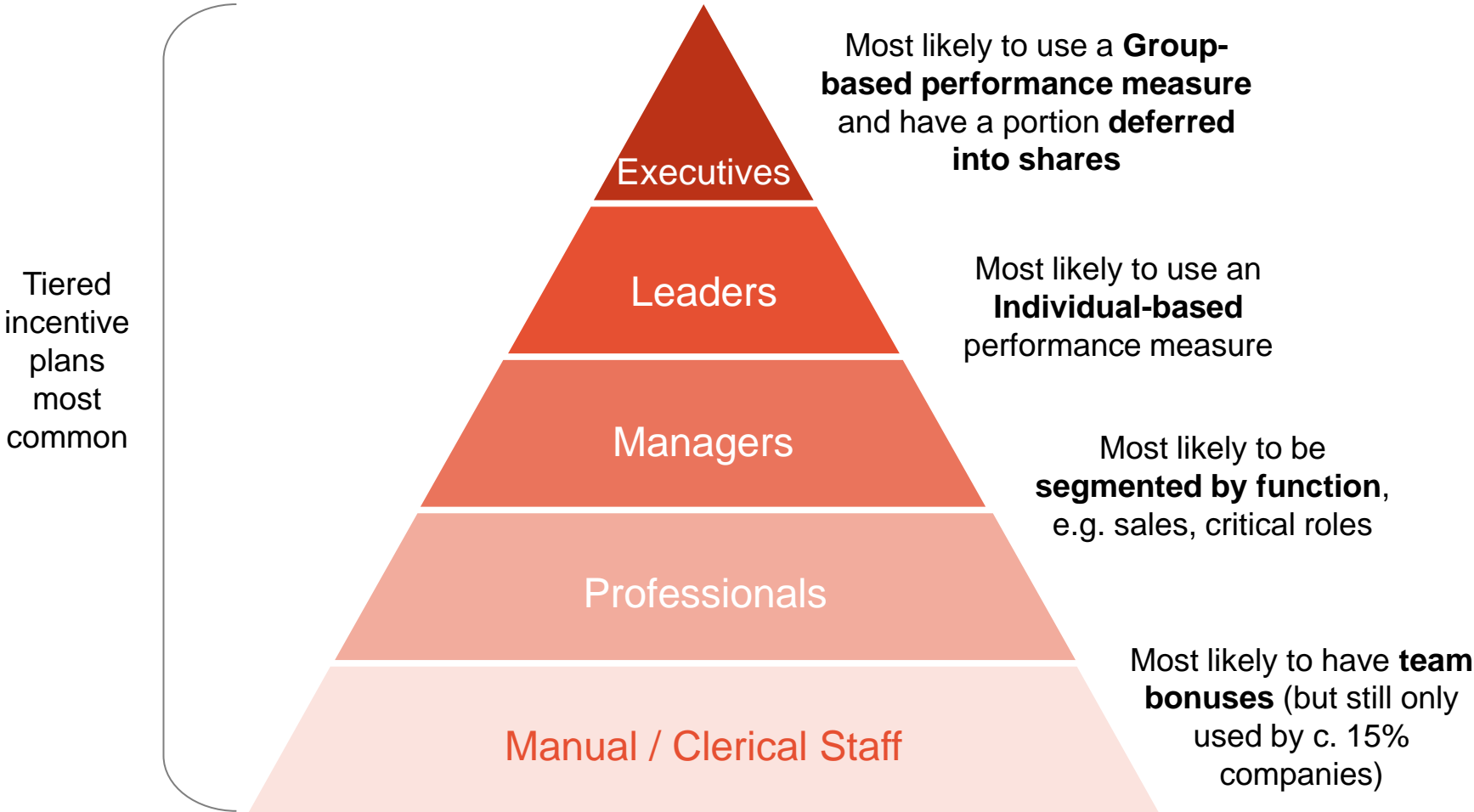


Potential combinations

Design Decisions	Some alternatives	
Participation	<ol style="list-style-type: none"> 1. Executives Only 2. Executives & Mid-Managers 3. All Employees 	3
Performance Criteria	<ol style="list-style-type: none"> 1. Group Sales 2. Group Profit 3. Business Unit financials 4. Milestone achievements 5. Individual Behaviours 	5
Performance Measurement	<ol style="list-style-type: none"> 1. Relative to peers 2. Relative to budget 	2
Links & weights	<ol style="list-style-type: none"> 1. Additive 2. Multiplicative 3. Matrix 	3
Quantum	<ol style="list-style-type: none"> 1. Market aligned 2. Based on funding pool 3. Same for all 	3
Calibration	<ol style="list-style-type: none"> 1. Market aligned 2. Based on funding pool 3. Same for all 	3
Funding	<ol style="list-style-type: none"> 1. Sum of targets 2. Based on profit pool 	2
Pay-out	<ol style="list-style-type: none"> 1. Quarterly 2. Annual Cash award 3. Shares 4. Deferred cash 	4

= **6,480** potential STI designs!

Eligibility



Question for Group

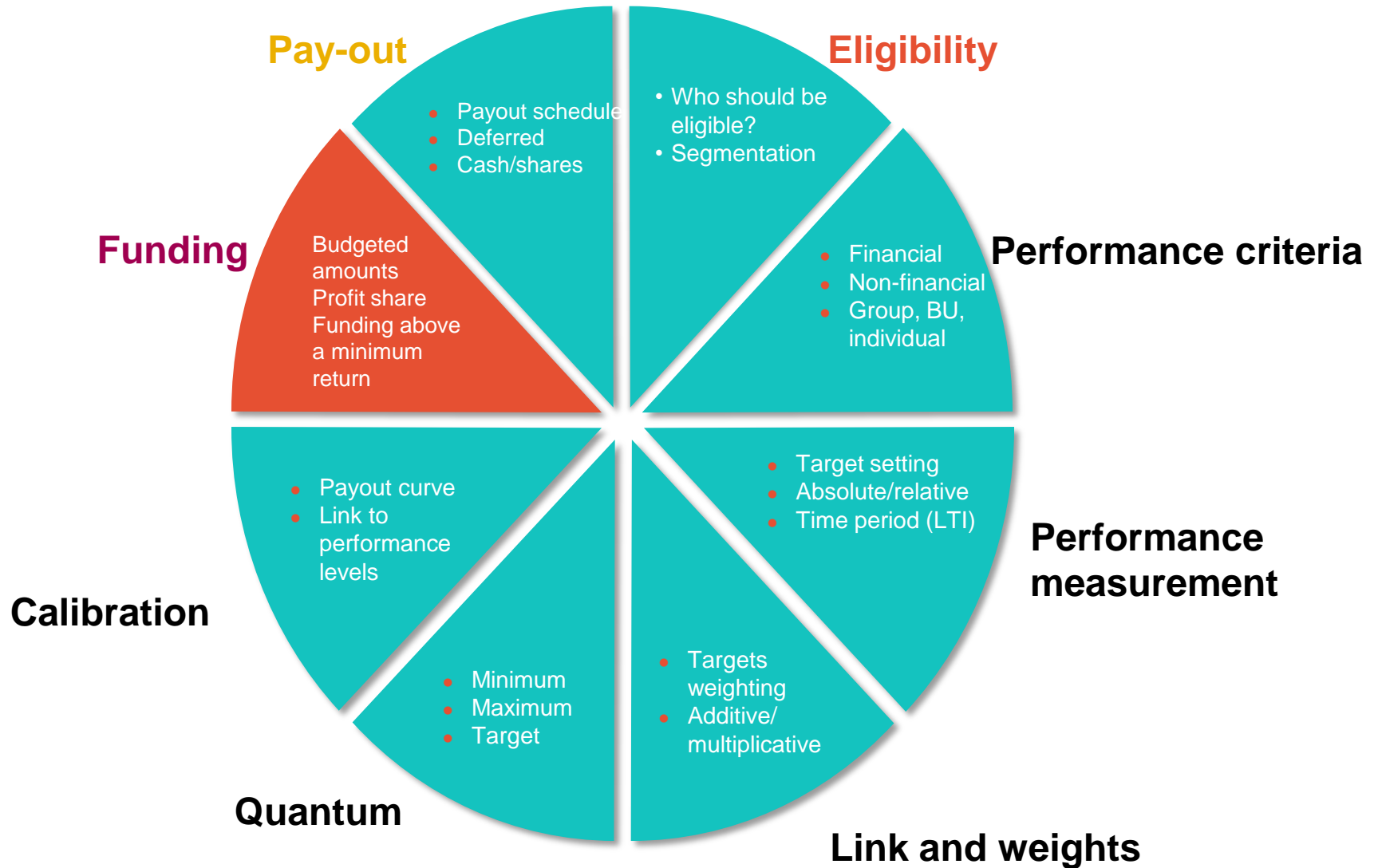
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Has your company made any **changes to eligibility levels** in the last five years?

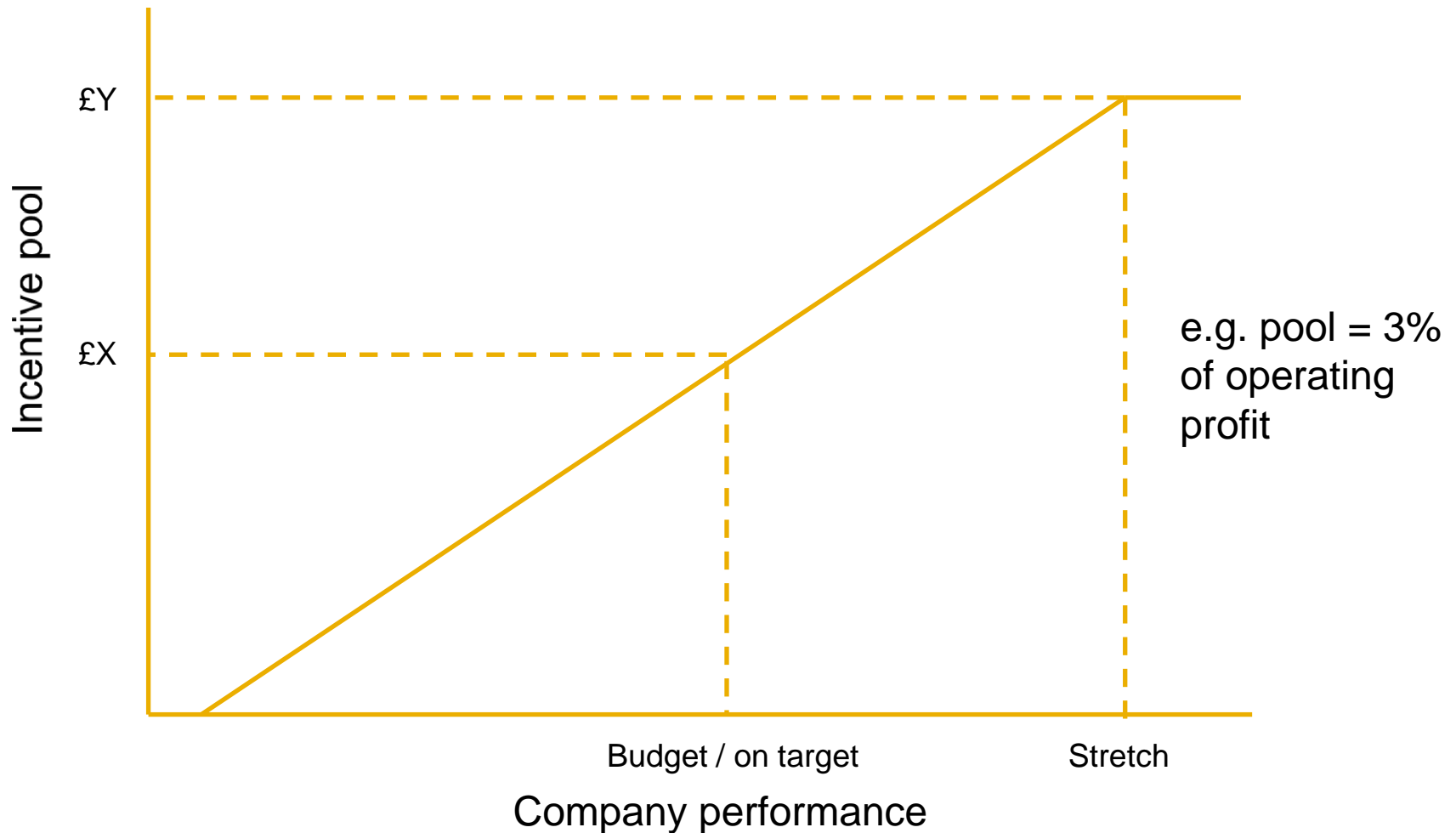
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Design parameters to consider in incentive plans



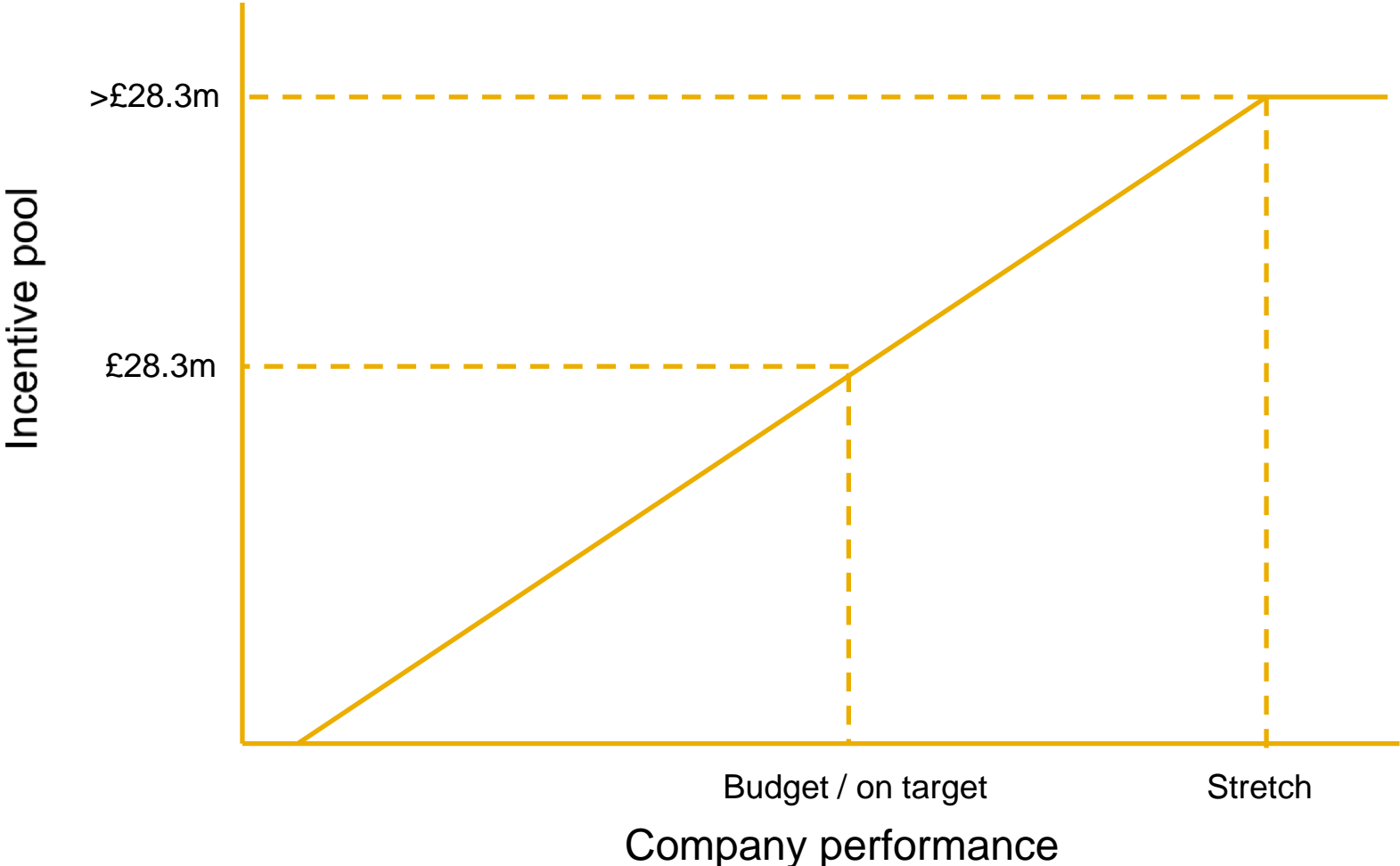
Short-term incentive plan funding can be 'top down'...



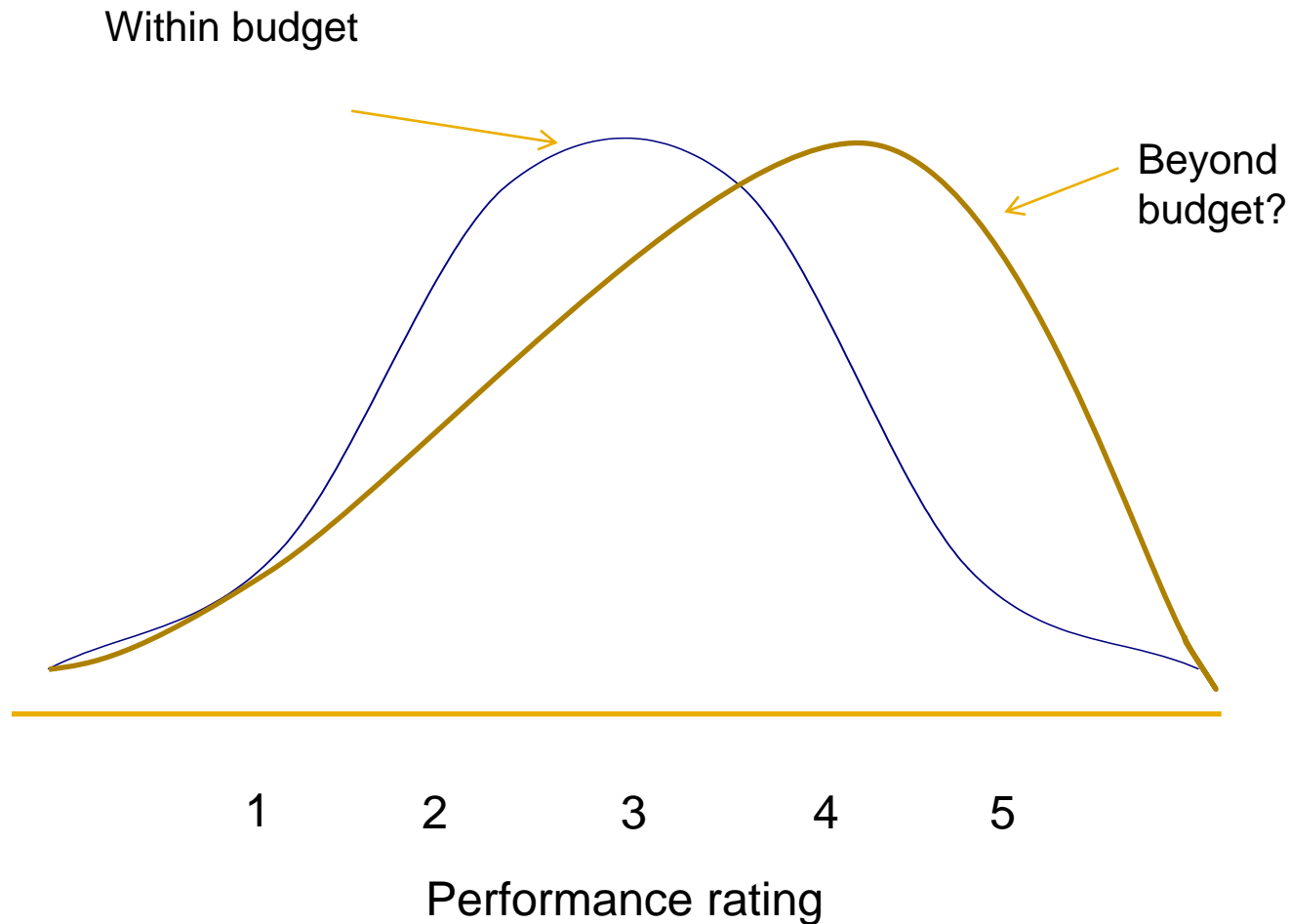
... or bottom up...

Employee group	Number of employees	Average salary	Target STI (%)	Target STI (£)
A	10	£300,000	60%	£1,800,000
B	150	£100,000	40%	£6,000,000
C	300	£60,000	25%	£4,500,000
D	1,000	£40,000	15%	£6,000,000
E	4,000	£25,000	10%	£10,000,000
Total incentive pool				£28,300,000

... or a combination of both approaches



The degree of flexibility in funding places greater or lesser emphasis on performance ratings and distribution of awards



- Forced ranking
- 'Rob Peter to pay Paul'
- Discretionary

Question for Group

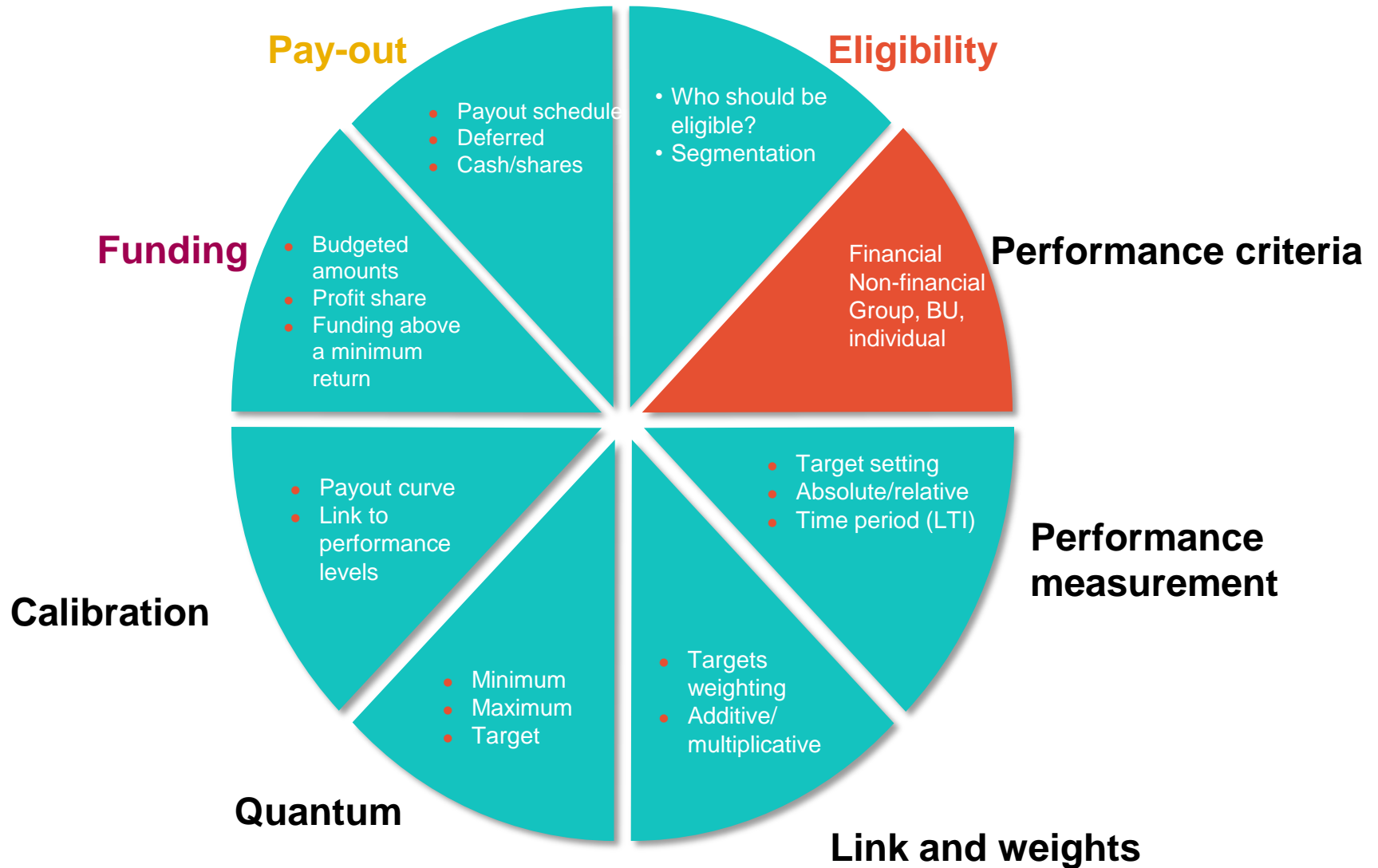
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How are short-term incentive awards funded at your company? How do you differentiate higher performers? Does the process work well?

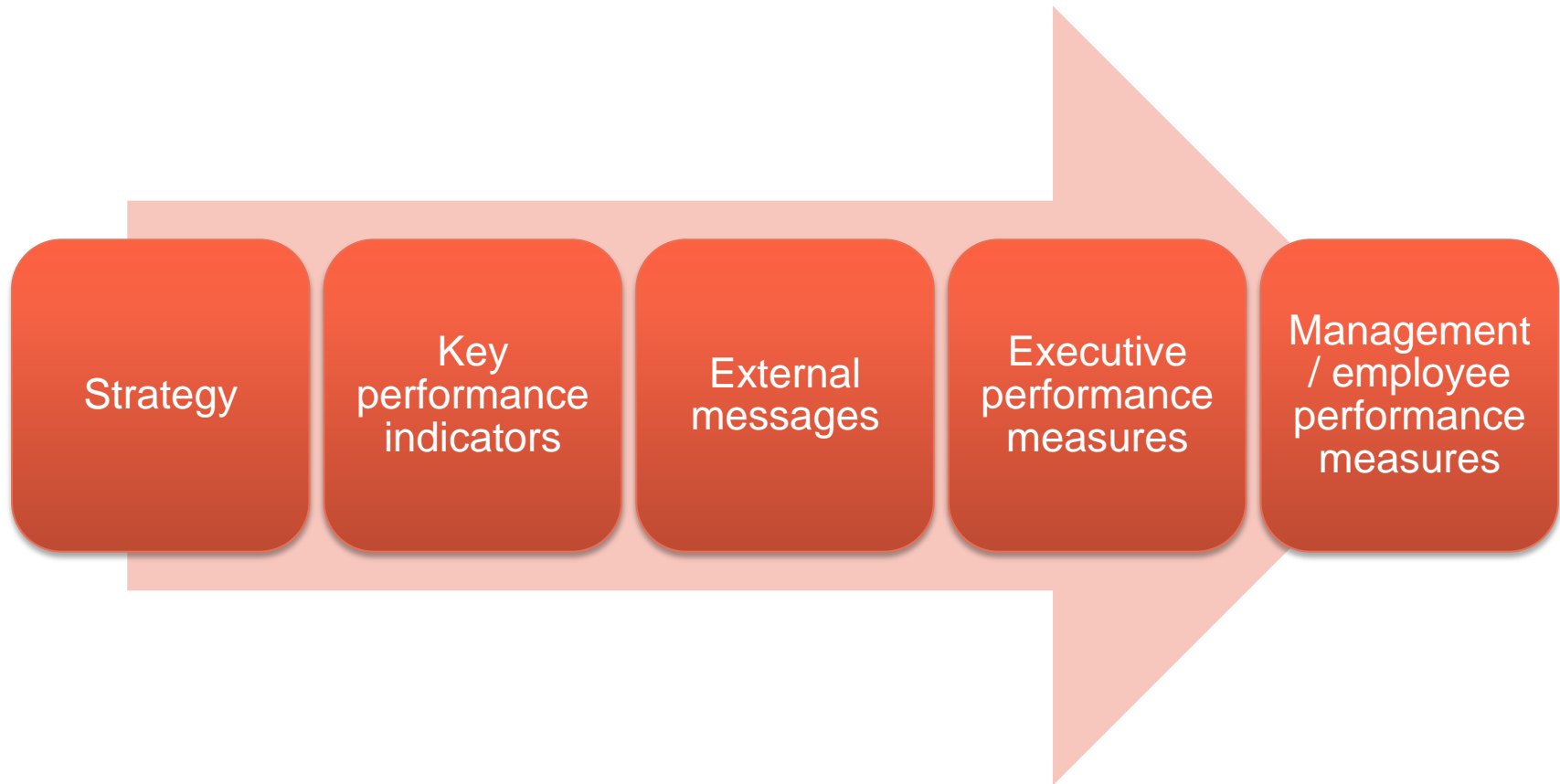
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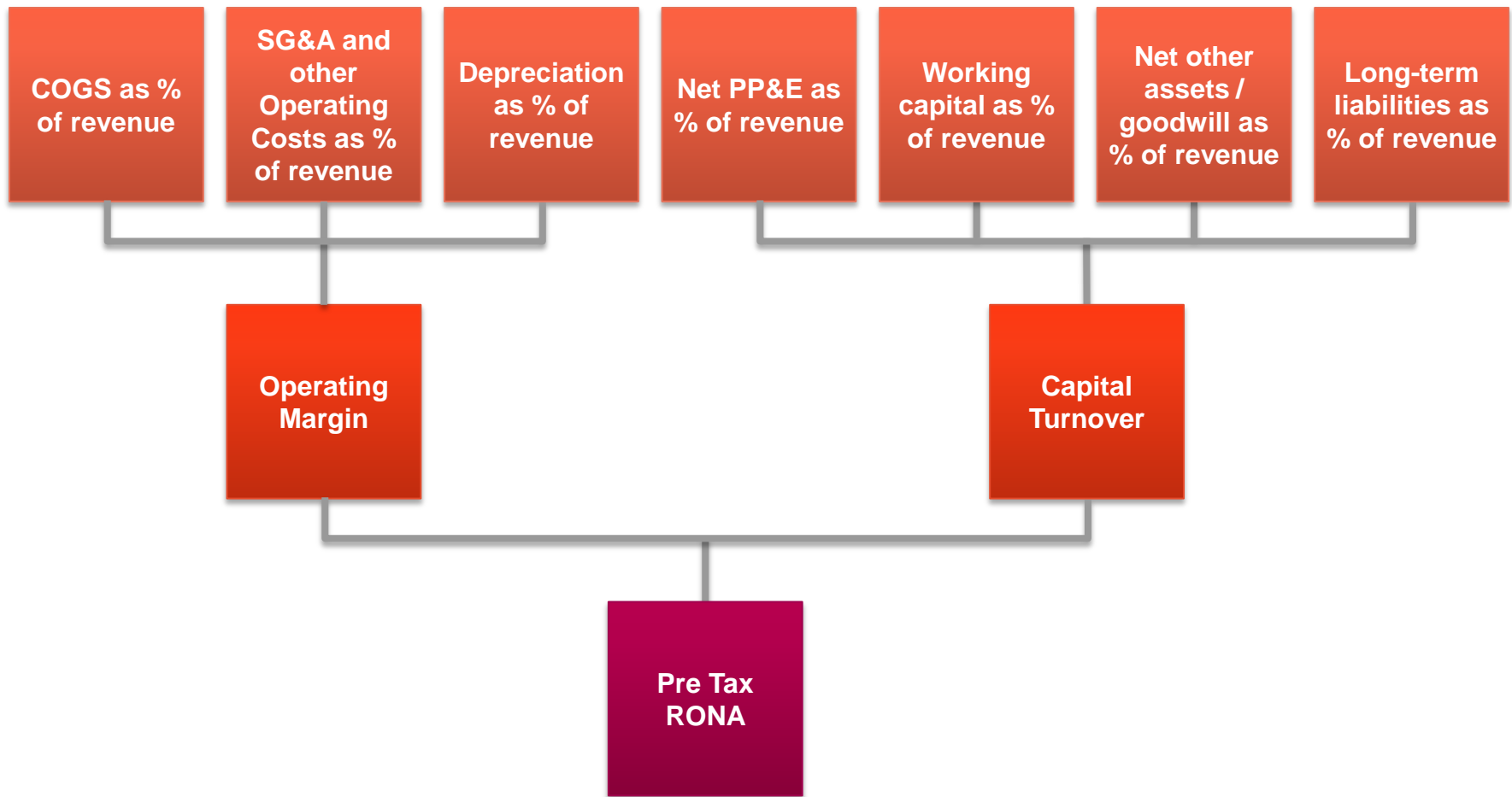
Design parameters to consider in incentive plans



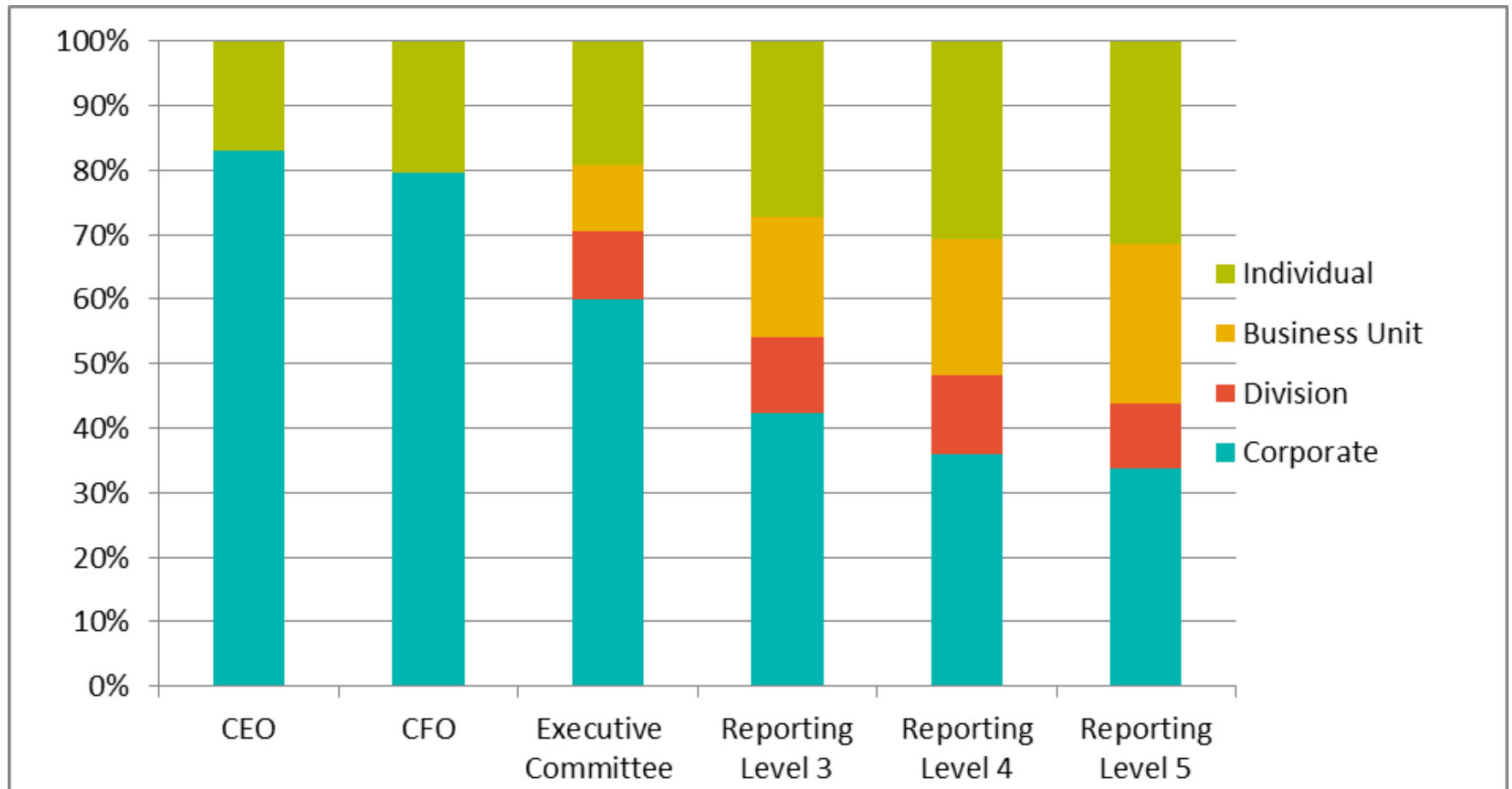
Incentive performance measures should support achievement of business objectives



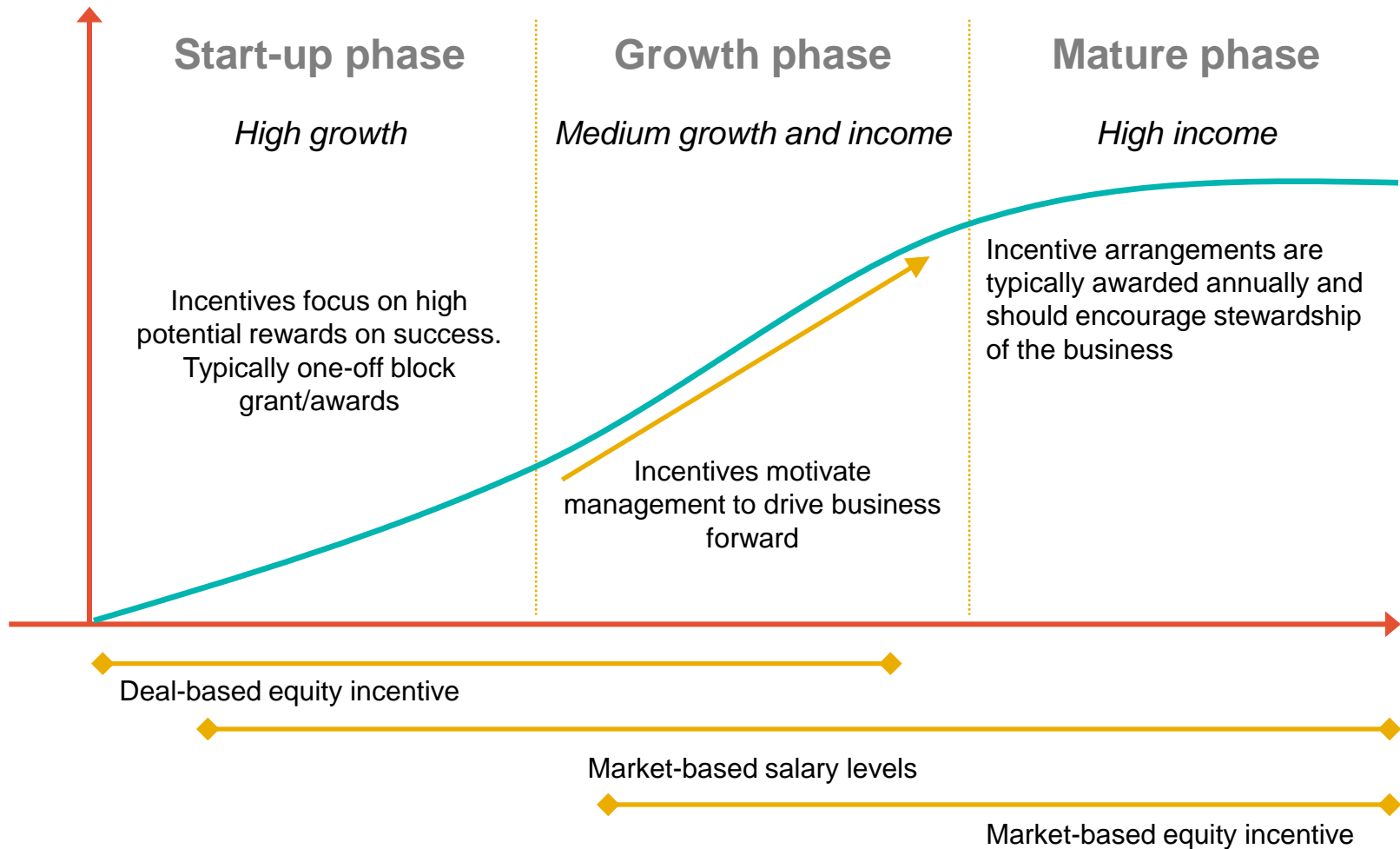
Value tree analysis can help identify linkages between headline measures and levers that employees can pull



The emphasis on individual / business unit measures generally decreases with employee seniority



A company's position on the growth/income curve can be a good place to start when considering performance measures



Growth phases have different characteristics, including implications for performance measures

	Start-up phase	Growth phase	Mature phase
Business profile			
Business aim	<ul style="list-style-type: none"> • Proof of concept/ breakthrough • Create new market or displace an industry/region 	<ul style="list-style-type: none"> • Top line growth • Build out capability/brand • Build the business/profit growth 	<ul style="list-style-type: none"> • Efficiency/maintain market share • Own the market/monopoly • Milk and defend the franchise
Executive role	<ul style="list-style-type: none"> • Entrepreneurialism/ breakthrough thinking 	<ul style="list-style-type: none"> • 'Doer'/'Deliverer' 	<ul style="list-style-type: none"> • Custodianship • Manage the franchise
Culture	<ul style="list-style-type: none"> • Intellectual • Aspirational • Freewheeling 	<ul style="list-style-type: none"> • Pragmatic/hands on/can do/needs must 	<ul style="list-style-type: none"> • Professional/expert management
Capital volume	<ul style="list-style-type: none"> • Low 	<ul style="list-style-type: none"> • Low but growing fast • Phased financing 	<ul style="list-style-type: none"> • High
Core finance	<ul style="list-style-type: none"> • Equity lots • Debt light 	<ul style="list-style-type: none"> • Debt/equity mix • Role of mezzanine financing 	<ul style="list-style-type: none"> • Mainly debt to get equity leverage impact
KPIs			
Categories	<ul style="list-style-type: none"> • Milestones 	<ul style="list-style-type: none"> • 'Growth in' measures 	<ul style="list-style-type: none"> • 'Return on' measures
Examples	<ul style="list-style-type: none"> • Patents • Market entry • Proof of concept • Growth in turnover • Breakeven profit 	<ul style="list-style-type: none"> • Revenue/market share • Gross margin • Operating profit • EBITDA/EBIT • PBT/Earnings • EPS 	<ul style="list-style-type: none"> • PBT/Earnings/EPS • Return of Capital Employed • Return on Equity

Question for Group

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How are short-term incentive performance measures selected at your company? Are they well aligned with strategic objectives?

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Implementation & Communications

Regardless of design, successful incentive plans tend to possess certain common traits around perceptions and understanding

Motivating	<ul style="list-style-type: none">• Employees understand their roles and how they can 'win'• Employees believe that they can win• Employees believe that the reward for winning is worthwhile
Fair	<ul style="list-style-type: none">• Perception that goals for all participants have equal stretch and performance has been fairly assessed
Simple	<ul style="list-style-type: none">• Easily understood by participants
Aligned with role	<ul style="list-style-type: none">• Employees understand how they can influence outcomes
Champions	<ul style="list-style-type: none">• Managers 'own' the plan and see it as a tool to improve performance
Return On Investment	<ul style="list-style-type: none">• Management and shareholders feel there is a sufficient return on investment
Support	<ul style="list-style-type: none">• Infrastructure (processes and systems for tracking performance) in place• Business literacy and training used to link employees with key business drivers

Question for Group

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What steps has your company taken to **enhance level of understanding and perceived value** of short-term incentives?

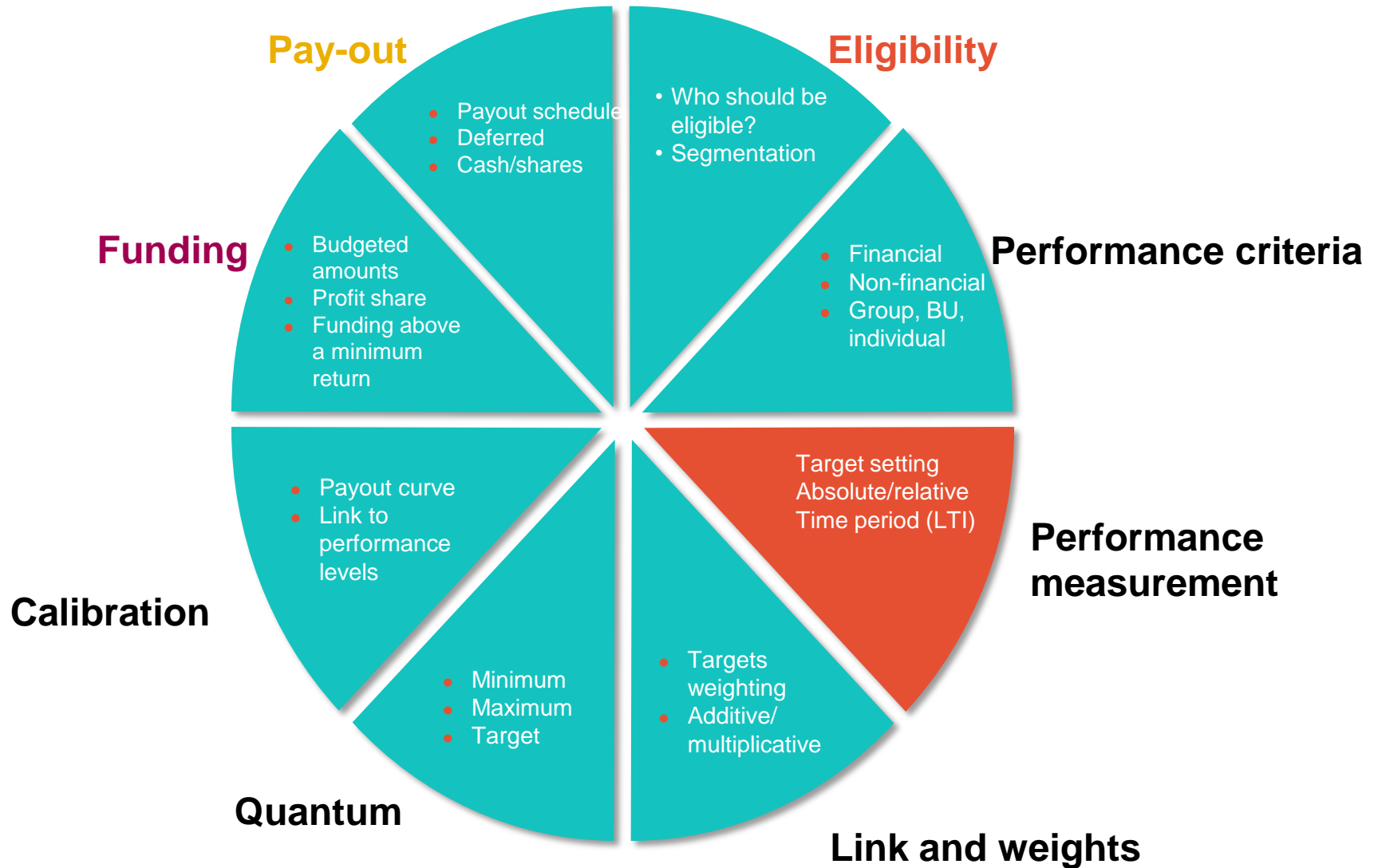
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Any Questions



Design parameters to consider in incentive plans

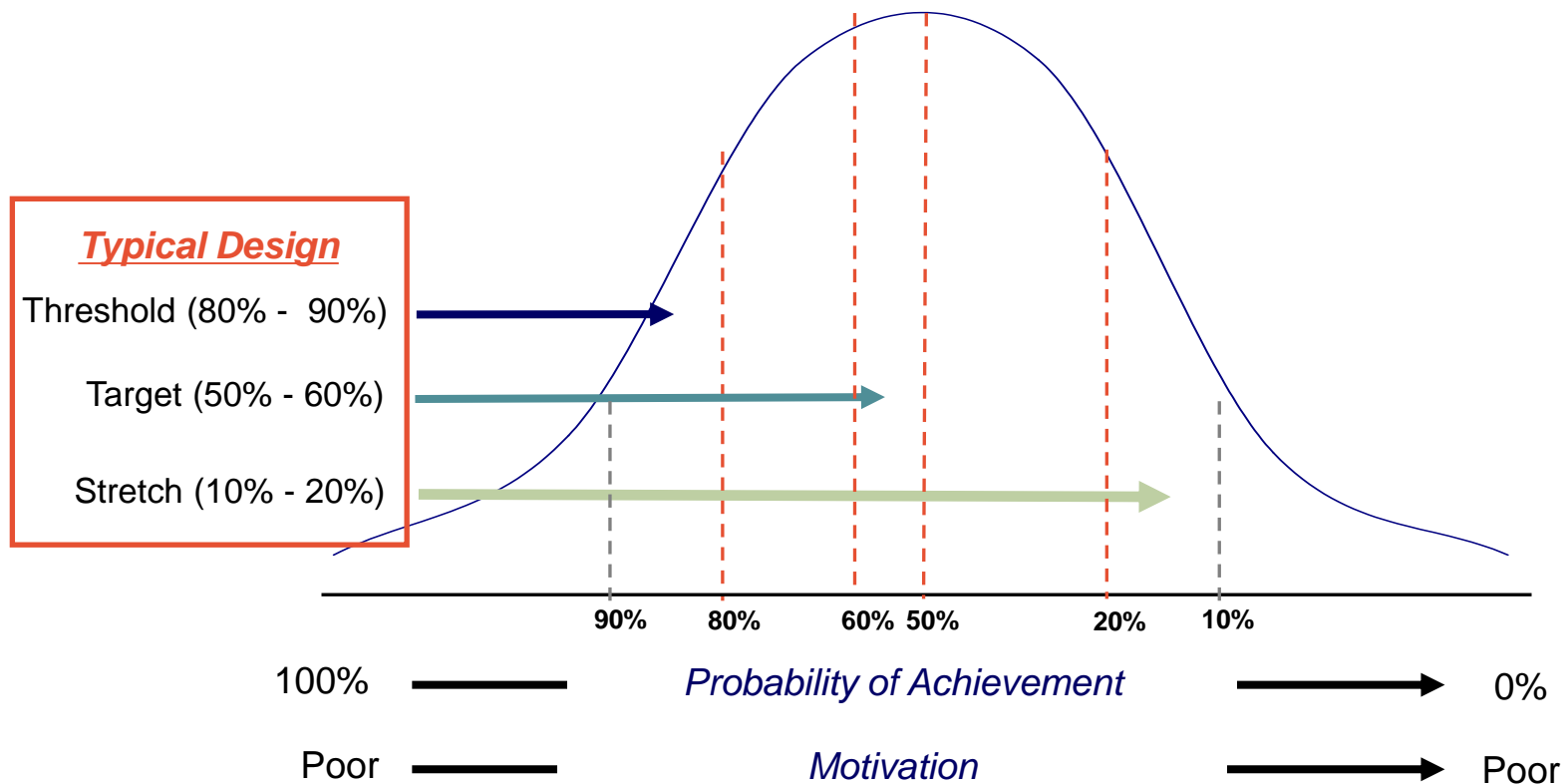


Financial performance targets are usually set by reference to a range of inputs

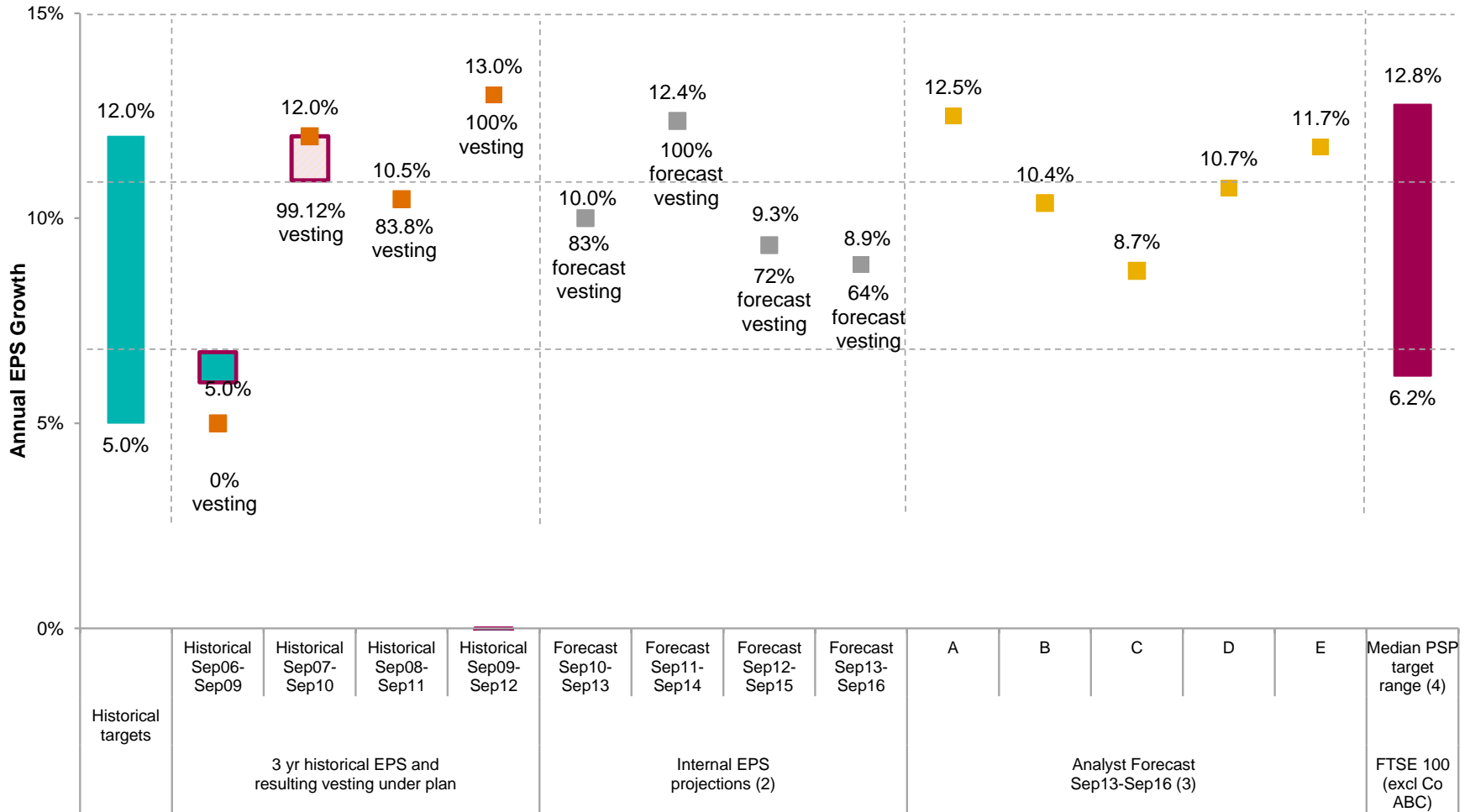


It can be helpful to consider threshold, target and maximum performance in the context of the expected distribution...

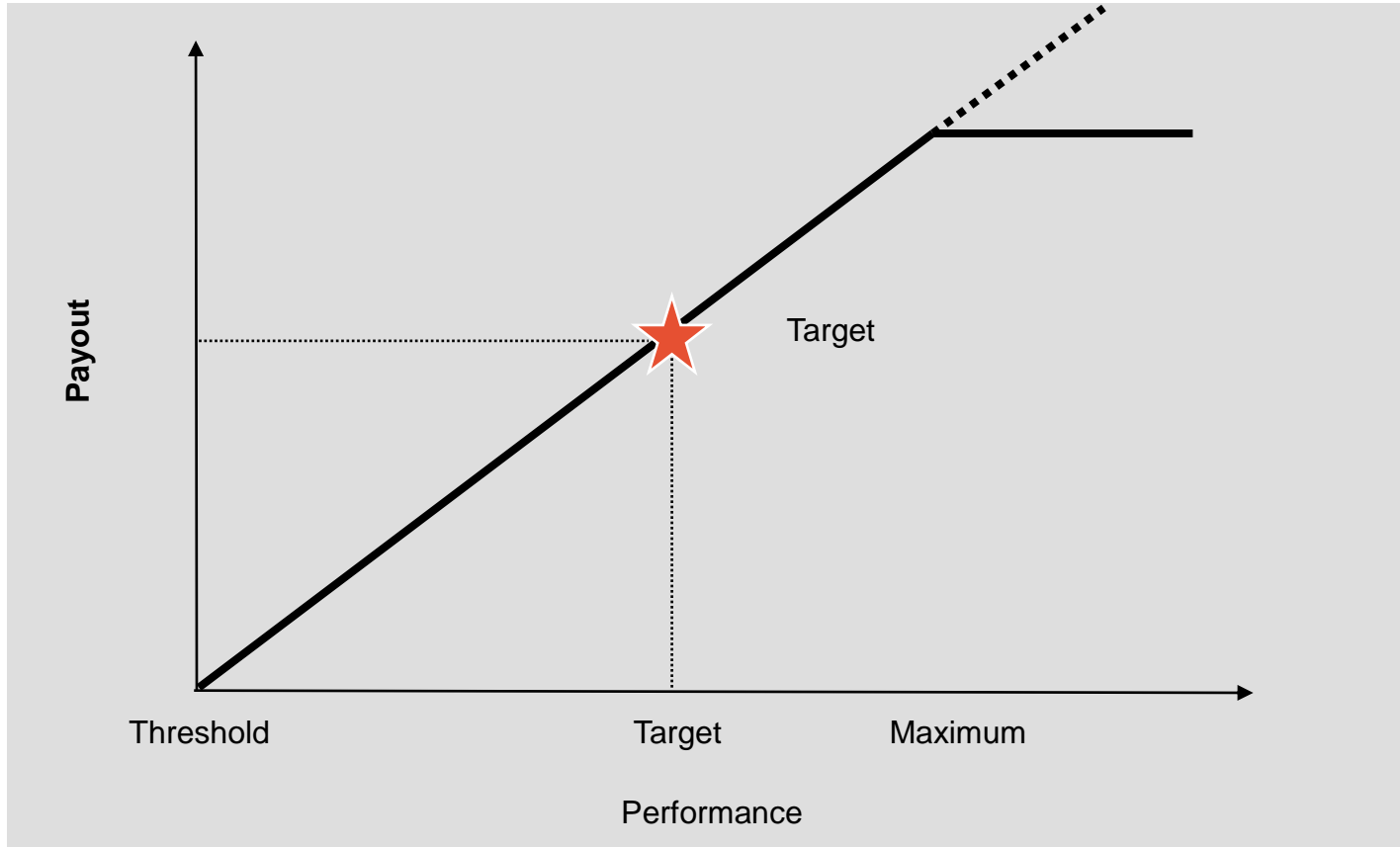
Performance ranges may be established based on the probability of achievement and subsequent motivational impact



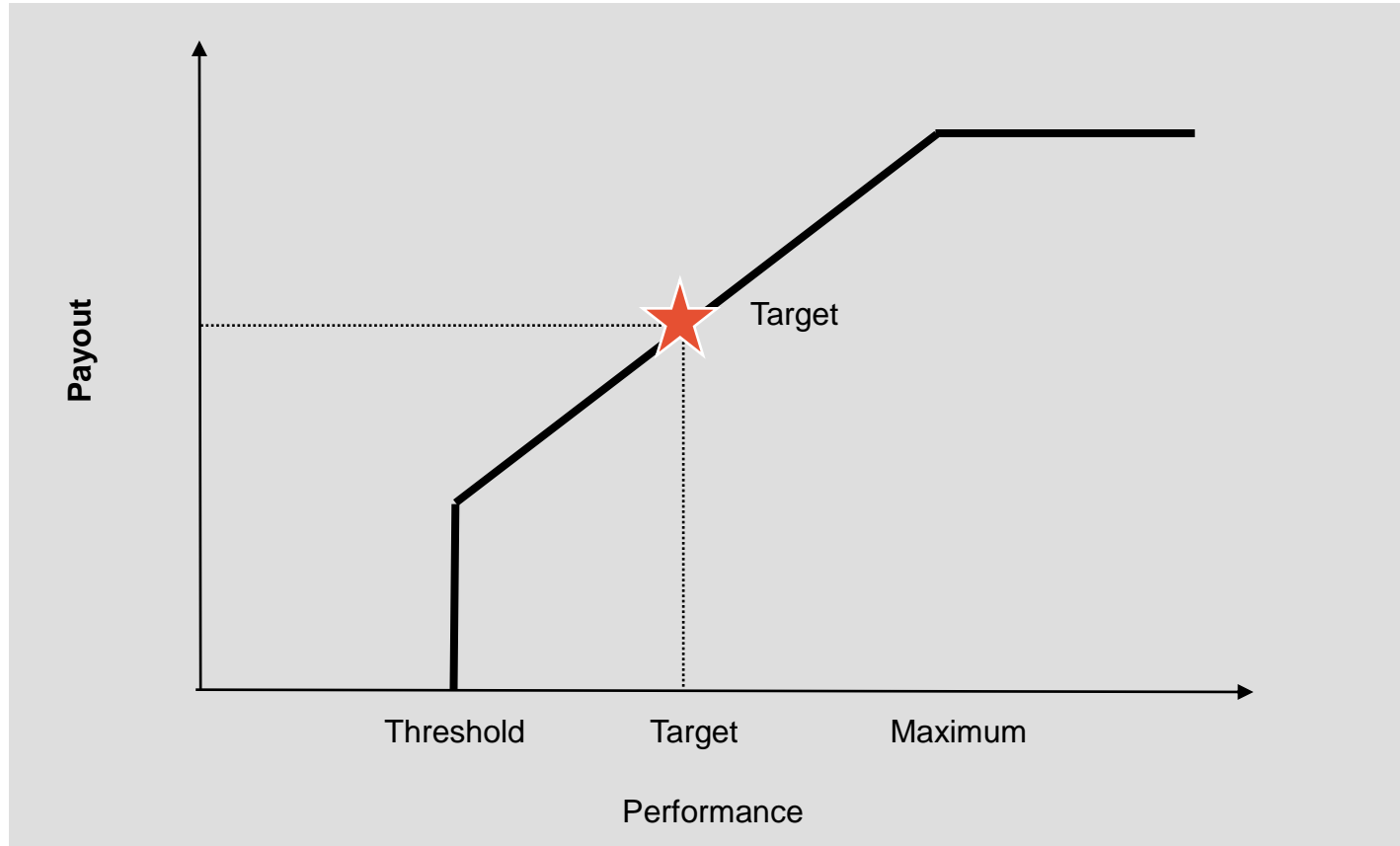
...alongside other key inputs to provide a balanced view



The degree of performance/payout leverage is also a key factor – should you offer a broad performance range...



...or a narrower range with higher leverage (perhaps appropriate when targets can be set with more certainty)



Question for Group

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How does your company determine short-term incentive performance targets? Do all stakeholders support targets every year?

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