The FORUM EXECUTIVE Renaissance FORUMS

May 2009

Compensating Executives in Private Companies

by Larry Comp and Terry Lauter Comp

LTCperformance strategies

The Challenge

Owners of small to medium-sized entrepreneurial companies often find themselves frustrated in their efforts to construct properly designed executive compensation packages. This is generally because: (1) executive roles in these organizations tend to be broad and less well defined, making them difficult to benchmark; (2) competitive compensation survey data is often limited and difficult to comprehend; (3) there are a multitude of variables that can and should impact base/ incentive compensation levels, such as an organization's size, industry, geographical location, ownership, stage of evolution and degree of profitability; other considerations include the executive's scope, experience and performance; and (4) private company owners are less likely to share equity and are ill-prepared to offer alternative forms of long-term compensation.

So, given the complexities surrounding executive pay, what should business owners know to help them be better prepared for handling their executive compensation responsibilities? Below are some thoughts addressing each of the four key executive compensation components: base salary, short-term incentive pay, long-term incentive pay, and perquisites.

Base Salary

The role of base pay is to compensate executives for handling their day-to-day responsibilities. Executives also look to their salaries to help them maintain their standard of living. Many experts recommend establishing executive salary levels within a comparable range; often stated as "at or slightly below market." Salary offers should be high enough to warrant serious consideration, but low enough to be able to provide significant upside potential via any short and long-term incentive programs. While increases for non-executive employees have averaged around 4% over the last several years, those of executives have been in the range of 5-6%+.

Short-term Incentive Pay

The purpose of short-term incentive (bonus) pay is to reward executives for their contributions during a 12-month period. This component represents an organization's most potent vehicle for driving performance and behavior. Unfortunately, the vast majority of companies fail to achieve their intended objectives with their STI Programs. Properly designed incentive programs should align and focus participants toward achieving a balanced set of organizational (financial and non-financial) goals, while also strengthening the relationship between executive pay and performance. Properly established performance metrics will go a long way toward helping to ensure that goals provide reasonable "stretch" and that performance can be measured more objectively. Thresholds should be established to ensure a minimum acceptable level of financial performance is achieved to "fund" the program and therefore minimize the likelihood of "entitlement." The STI Program should also be "leveraged" to provide significant rewards for superior achievement.

Long-Term Incentive Pay

While public companies routinely grant stock awards, owners of most small to medium-sized private companies resist sharing equity. This often makes it difficult for them to coax high caliber executives to join their firms. There are, however, other forms of long-term compensation; e.g. long-term incentive (cash) plans and "proceeds" plans that, when properly designed, can yield a "win-win" solution for all key stakeholders. These types of plans should, of course, be carefully designed to motivate participants to take the right actions and make the appropriate decisions to drive long-term organizational performance and value. The monetary value of this component of total compensation should be competitive, without being excessive.

Perquisites

Private companies have an opportunity to offer meaningful "perks" in an effort to attract and retain top executive talent. Consider eliminating perquisites that convey status differential such as executive parking, first class air travel and country club memberships. These rewards serve to create or expand the gulf between executives and the managers they need to engage to drive success. Instead, focus on "perks" that will enhance an executive's health, productivity, security and financial well being, such as physical examinations, lap-top computers, and reasonable change of control, severance and outplacement provisions, Also, consider offering a properly designed nonqualified deferred compensation plan as an increasingly popular voluntary vehicle for capital accumulation and investment diversification.

Conclusion

The importance of hiring, motivating, and retaining top-notch, well-suited executive talent cannot be overemphasized. Good executives significantly outperform average ones, and exceptional executives can make the difference between an organization surviving and thriving. Establishing the right executive compensation plan comes down to two fundamental elements: (1) intelligent design and (2) proper communication. The compensation package should be designed to effectively attract, motivate, focus and retain. On the other hand, since initial hiring costs may range from $30,000 to $150,000+, the package should be cost effective and yield a solid return on investment (ROI).

Also, since trust levels have significantly diminished over the last few decades, appropriate efforts should be made to ensure that the executive(s) understand the various components comprising the compensation package and are clear as to what is expected to meet the needs of all key stakeholders. Offering a well thought out/ constructed compensation package that is properly communicated can not only help private companies compete for top talent, but also lessen the likelihood of undesirable confusion, conflict and turnover down the road

---

Larry Comp and Terry Lauter Comp are Principals with LTC Performance Strategies, Inc. a prominent performance development and total compensation solutions practice located in Valencia, California. They can be reached respectively at: lcomp@ltcperformance.com and tcomp@ltcperformance.com. For more information, visit www.ltcperformance.com.