Playing Hardball with the Big Boys

By David A. Westman, James C. Kauss and Jason R. Senner, RSM McGladrey, Inc., Performance Solutions Practice

Many small- and middle-market companies don't believe they are in competition with corporate "big boys," whether in terms of product offerings, service models and the quest for superior executive talent or pay. This belief could be especially strong in privately-held companies, where owners may see themselves as insulated from the competition.

QUICK LOOK

- The talent pool for executives is limited and sound compensation practices are central to attracting and retaining key players.
- Some companies may be operating under the mistaken impression that their peers are not offering stock options to their executives.
- The key to an effective executive compensation program is to relate compensation opportunities directly to performance measurement.
- HR professionals should demonstrate the potential for candidates to substantially share in the company's success.

Stocks and long-term incentives are the name of the game in recruiting executives, regardless of company size.

However, many such companies have come to learn – and grudgingly accept – the realities of the situation: Competition knows no bounds. The same is true for executive talent and their compensation needs. Many smaller companies realize that to succeed, they also need top talent and should be willing to offer competitive compensation levels and components of pay, such as motivating with potentially lucrative short- and long-term incentive opportunities. As some smaller companies look to upgrade their compensation programs, they find a lack of targeted data available, especially for long-term incentives specific to their size.

In light of these facts, RSM McGladrey Inc. has conducted a compensation study of manufacturing companies with annual sales ranging from $5 million to $250 million. (See Figure 1.) The study covers 389 publicly-held companies located throughout the United States and provides compensation practitioners with competitive norms and other basic market information to help develop new or evaluate existing compensation programs. (See Figure 2.)

While this study focuses on publicly-held companies, the implications for privately-held companies are just as critical as they compete in the same marketplace for talent. The talent pool for executives is limited, regardless of the size or ownership structure of a company, and sound compensation practices are central to attracting and retaining key players.

FIGURE 1: STUDY FACTS

- Includes total compensation data: base salaries, annual incentives, stock options, and other compensation as reported in company proxy statements
- The total value of executive stock option wealth creation, focused on (1) value realized through options exercise and (2) value of unexercised options at year-end (both vested and unvested)
- Includes data reported by size of company, geographic location, and manufacturing industry sub-segment.

Compensation practices for 11 top positions:

- Chief Executive Officer
- Top Operations/Mfg./Division Head or General Mgr.
- Chief Operating Officer
- Top International – Division or Sales/Marketing
- Chief Financial Officer
- General Counsel
- Top Marketing and/or Sales Position
- Executive/Senior Vice President
- Top Technical/Info Systems Position
- Chairman of the Board – non CEO
- Top Engineering Position

FIGURE 2: CHIEF EXECUTIVE OFFICER COMPENSATION

Data by Size of Organization

Companies/ Incumbents	Data Section	Base Salary	Annual Incentive	Total Cash	Value of Stock Options	Other Comp	Total Comp
All Companies =356	med	$245,118	$28,169	$289,297	$11,541	$0	$361,689
	avg	$262,692	$86,414	$349,106	$134,564	$24,391	$507,927
	75th	$311,000	$117,510	$416,041	$113,284	$1,477	$536,533
	25th	$189,901	$0	$215,693	$0	$0	$256,174
150-$250M =51	med	$343,550	$149,484	$496,214	$60,122	$0	$664,953
	avg	$356,143	$181,853	$537,996	$289,334	$105,426	$930,688
	75th	$373,421	$250,669	$706,186	$262,181	$7,540	$1,028,591
	25th	$268,050	$42,827	$363,706	$0	$0	$438,632
$100-$149M =65	med	$273,833	$58,950	$356,199	$57,494	$0	$492,256
	avg	$295,641	$115,607	$411,248	$213,147	$5,830	$630,225
	75th	$330,527	$124,967	$460,408	$214,979	$5,055	$643,947
	25th	$251,997	$0	$266,433	$0	$0	$342,320
$50-$99M =96	med	$244,476	$5,183	$280,621	$0	$0	$332,649
	avg	$261,525	$71,532	$333,058	$124,150	$24,878	$481,827
	75th	$293,681	$101,083	$404,671	$75,468	$322	$486,826
	25th	$203,967	$0	$232,344	$0	$0	$267,750
$5-$49M =144	med	$207,074	$0	$241,087	$2,525	$0	$289,880
	avg	$213,766	$50,052	$263,819	$56,136	$5,237	$325,192
	75th	$256,901	$69,285	$319,873	$83,475	$0	$406,213
	25th	$160,446	$0	$182,805	$0	$0	$212,063

- Total compensation levels for CEOs varied widely, ranging from $109,089 to $2,719,120.
- Median total compensation was less than average, primarily due to varying stock option practices and values among companies. This holds true for many positions in the study.
- As anticipated, annual incentives and the average value of stock options consistently increased for each size category.

Stock Option Use and Opportunities Lost

The research data indicate that stock options play a major role in long-term compensation at most companies. (See Figure 3.) Overall, more than half of the incumbents in the 11 positions surveyed received stock options last year. The average data for stock option values granted ranges from $30,811 to $134,564, with the highest value granted being nearly $3.4 million.

However, it appears that many companies are not fully taking advantage of stock options. For example, 45 percent of chief executive officers (CEOs) sur-

FIGURE 3: INCREASE IN STOCK OPTION USE

Stock option use has increased dramatically for many reasons, including:

- Attracting high-quality executives in a more competitive employment market
- Increased interest in the rising stock market
- Providing a long-term orientation in executive decision making
- Establishing a shareholder identification among key executives, linking rewards to the shareholder value of the company
- Rewarding executives for outstanding performance
- Protecting and/or rewarding executives in the event of change in control
- Retaining key executives

veyed did not receive options. Less than half of CEOs in the $50 million to $100 million sales category were not granted stock options during the year.

So, why aren't more companies taking advantage of this popular reward vehicle? A number of possibilities exists. It may be that stock options are not available due to dilution concerns, or executives may have failed to meet performance goals. Additionally, program cycles may dictate biennial or triennial grants, and executives who received a relatively large grant in past years may not be eligible for another one at this time. However, it could be that some companies in the sample simply are not keeping up with the market and may be operating under the mistaken impression that their peers are not offering options to their executives.

Wealth Creation and Retention

Another area examined was the value of previous stock option grants and the possible retention effects for top executives. Interestingly, less than one-quarter of CEOs, chief financial officers (CFOs) and chief operating officers (COOs) exercised options last year, even when they had "in the money" options – options that are worth money because the stock price has risen above the strike price. (See Figure 4.) Indeed, most executives had significant levels of unrealized gains in unexercised stock options at year-end. (See Figures 5 and 6.)

FIGURE 4: GAIN FROM STOCK OPTIONS EXERCISED IN LAST FISCAL YEAR

	Average	Highest
CEO	$149,453	$11,194,000
COO	95,275	3,045,000
CFO	44,559	362,500

- Less than one-quarter of executives exercised options last year.
- However, those exercising realized substantial gains.

This underscores the fact that a substantial portion of executives' future income is at risk, subject to the inherent uncertainties of the stock market. Also, due to vesting restrictions, there is a significant amount of "unexercisable," in-the-money stock options (more than $200,000 on average for CEOs), suggesting that such stock options may work well as a retention vehicle. Executives with significant value tend to remain at their companies either because they will wait until a substantial portion of the options become exercisable or potential employers may not be willing to "buy out" the value of their options.

Size Matters

The data show that average total compensation typically increased for each larger size group, showing a strong correlation between compensation and

FIGURE 5: STOCK OPTION HOLDINGS, CEO

	Outstanding at Year End		
	Exercised During Year	Exercisable	Not exercisable (due to restrictions)
All Companies			
Median	$0	$15,313	$0
Average	$149,453	$573,751	$222,952
75th	$0	$288,750	$67,936
25th	$0	$0	$0
$150 – $250 M			
Median	$0	$155,298	$61,800
Average	$221,685	$919,189	$581,290
75th	$32,269	$444,550	$341,661
25th	$0	$0	$0
$5 - $49.99 M			
Median	$0	$6,570	$0
Average	$57,659	$397,349	$96,115
75th	$0	$117,188	$32,902
25th	$0	$0	$0

FIGURE 6: UNREALIZED STOCK OPTION GAIN OUTSTANDING AT YEAR END

	Average	Highest
CEO	$796,703	$23,098,000
COO	303,355	6,996,000
CFO	255,662	5,831,000

- Most executives had stock options outstanding at year end.
- The unrealized value of options was significant for all positions.

company size. The combination of high annual incentives and stock option grants resulted in all positions surveyed having significant levels of variable pay at risk. (See Figures 7, 8 and 9.) And as companies grow, more executive compensation is at risk, as shown by the amount of variable pay increasing for each larger size group. Both long-term and annual incentive awards play a major role in compensating top executives, especially for the larger companies.

FIGURE 7: AVERAGE ANNUAL INCENTIVES EARNED

Position	Average Annual Incentive Amount	Average Annual Incentive Percent of Salary
Chief Executive Officer	$86,414	33%
Chief Operating Officer	48,625	26%
Chief Financial Officer	36,704	25%
Top Sales/Marketing Executive	38,325	25%
Top Technical Executive	41,370	23%
Top Engineering Executive	23,083	14%
Top Division/General Manager	36,198	22%
General Counsel	28,168	19%
Executive/Senior Vice President	43,993	28%
Top International Executive	29,098	16%
Chairman of the Board (non-CEO)	100,744	46%

FIGURE 8: ANNUAL AND LONG-TERM INCENTIVES

Position	Annual & Long-term Incentives as Percent of Total Compensation
Chief Executive Officer	48%
Chief Operating Officer	40%
Chief Financial Officer	45%
Top Sales & Marketing Executive	33%
Top Technical Executive	38%
Top Engineering Executive	44%
Top Division/General Manager	39%
General Counsel	41%
Executive/Senior Vice President	36%
Top International Executive	24%
Chairman of the Board (non-CEO)	37%

FIGURE 9: ANNUAL AND LONG-TERM INCENTIVES - CEO

Size of Category	Annual & Long-term Incentives as Percent of Total Compensation – CEO
$5-$49M	34%
$50-$99M	46%
$100-$149M	53%
$150-$250M	62%
Total Average	48%

What We Don't Know

The study clearly indicates that executives in today's small and mid-sized companies are capable of earning significant total compensation. What the data do not show is the relationship between the earned compensation and the performance levels of the company and the executives. The key to an effective executive compensation program is to relate compensation opportunities directly to measured performance, so executives are motivated and rewarded for achieving company goals. Companies that do this well will have the best of both worlds: good performance and motivated, well-compensated executives.

Recommendations

For Public Companies

Many public small and mid-sized companies still may not be taking full advantage of stock options as a form of long-term compensation. Failure to offer stock options may not only make it more difficult to attract qualified professionals, it also may increase the chances that current executives will be lured away by more lucrative offers, as seen time and again in recent years. One program strength was the high level of compensation at risk through increased use of incentives. These companies should continue to leverage more compensation to incentive programs, especially stock options, as they are usually the best choice for most companies.

For Privately-Held Business Owners

While the study examined publicly-traded companies, most small and mid-sized manufacturing companies are family owned or privately held. Designing an executive compensation package for a family business can be very difficult, and hiring professional executives from outside the organization is like charting new territory. While such companies can certainly attract an individual who reports to one owner, rather than numerous shareholders, keeping executives satisfied requires compensation packages that are market competitive. To that end, it is essential to use compensation programs that have a value-creation focus similar to stock-based plans, like stock appreciation rights, phantom stock or long-term performance plans. Like stock options, these types of programs are structured so there is significant incentive to increase the company value.

For Human Resources Professionals

HR professionals are faced with the challenge of an ever-shrinking pool of available talent. Executives, with the required leadership, technical, managerial or international experience, are at a premium. To attract these individuals, HR directors should structure programs like those suggested above. They should demonstrate the potential to substantially share in the success of the new company to convince candidates to sign with the company.

A Note on Dilution and Market Conditions

For public companies, stock options are a continually viable vehicle, but may need to be supplanted in consideration of market concerns. One issue is dilution; it is questionable whether shareholders will continue to accept dilution of their stock's value. Offering stock options to a wide range of employees over an extended period may reduce the stock's value and cause shareholder dissatisfaction.

A second factor is stock market volatility. If the market experiences a sustained downturn, executive earnings may be severely reduced. Companies should monitor the market and shareholder opinion to ensure their compensation programs remain competitive.

Long-Term Incentives – More than a Trend

While stock option use is in vogue at small and mid-sized companies, use is not consistent. Both public and private organizations should continue to offer significant opportunities tied to value creation to be competitive and increase company value.

Regardless of the opportunity level or program structure, it is clear that reliance on long-term incentive opportunities rather than annual cash is becoming the status quo, not just a trend. Continued confidence in the stock market, combined with a limited number of available trained executives, indicates stock options are currently an attractive reward method for small and mid-sized companies.

Long-term incentive programs can be designed for any company, and should be implemented to keep up with market practice. Compensation linked to long-term performance is critical not only as an attraction and retention tool, but more importantly as a motivation tool. In linking an executive's compensation to company value, there is a greatly enhanced incentive for the executive to drive up that value through increased performance. This is the key to using long-term incentives to motivate value-increasing behavior. WS

ABOUT THE AUTHORS –

David A. Westman is a managing director, James C. Kauss is a senior manager, and Jason R. Senner is manager and survey director for RSM McGladrey, Inc., Performance Solutions Practice.

FOOT NOTES

Visit our Web site at www.worldatwork.org and go to Information Central. There you will find ResourcePRO, a powerful database that holds almost 4,000 full-text documents on total rewards topics.

For more information related to this article:

- Select the Rewards Category: Compensation
- Type in this key word string on the search line: "stock and long-term incentive" OR "executive and recruiting" OR "executive compensation and performance"