

EXECUTIVE COMPENSATION: 7 Rules for Success



1

Establish Compensation As A Strategic Tool

Executive compensation is one of the largest investments most companies make. And it is an investment... if done right.

Having the right senior executives on the team, aligned to the overarching business strategy—and short- and long-term goals—are key drivers of success.

Yet far too many companies don't approach executive compensation strategically. Instead, they pay modest annual salary and bonus increases across the board, rewarding tenure vs. performance. Over time, this creates high fixed-cost structures and doesn't necessarily support the company's long-term growth.

A strategically designed executive compensation plan enables a company to:

- attract top talent;
- align and motivate senior executives to achieve

their specific goals while collaborating to achieve the company's goals;

- reward and retain the top-performing executives, while communicating to underperformers that they are not meeting expectations;
- bring in new talent and skills as needed; and
- reduce turnover and build a robust C-Suite pipeline for long-term success.

To do so, business owners and stakeholders must first determine the priorities of the business (e.g., increase cash flow, position for sale/IPO, increase equity value, gain market share, etc.), along with defined time-horizons and success metrics.

The short- and long-term compensation components then need to be tied to the short and long-term goals of the business in a manner that accelerates value creation.

2

Define Your Compensation Philosophy

An integral first step to crafting a successful executive compensation plan is to define a company's compensation philosophy by answering the following core questions:

- Is the company going to "pay for performance" vs. employee tenure?
- What is the competitor set for each position? In other words, who are you competing against for talent?

• Are you looking for individual performers and individual targets or team targets and rewards (e.g., based on the company's level of profitability)?

• Do you have clear goals and objectives for the compensation plan—and specific metrics—to enable you to determine if the compensation plan is working (e.g., growth rate, profit margin, EBITDA)?

3

Factor In Your Ownership Type And Growth Stage

Some companies have constraints and can't issue equity or stock options, but that doesn't mean they can't provide long-term incentives, such as phantom equity plans or long-term cash incentives, to key executives.

Fast-growing and early-stage companies may be better off using limited cash to fuel investments and put more of their executives' compensation in equity and other future payouts, while some profitable companies may be better off using cash incentives vs. diluting shareholders' equity ownership.

Private companies have specific advantages and disadvantages relative to public companies. Play to your strengths by focusing on:

- longer term horizons (private companies don't have the quarterly earning pressure)
- non-financial metrics for measuring performance
- company culture as an advantage

4

Weigh The Relative Importance Of Specific Roles And Executives

Some companies are very profitable or have the necessary funding to pay for top-tier executives across the board, but most private companies have to make trade-offs about the relative importance of specific roles and executives.

If you face financial constraints, determine which positions require top-quartile talent vs. average performers, and be prepared to pay top-quartile compensation for those positions.

For instance, a Tech company may want a rock star engineer or head of R&D but only need a solid VP of sales. Conversely, a manufacturer in a mature market that is focused on cash flow

vs. growth may want a great COO or CFO to maximize efficiencies and profit but may be fine with just a solid head of engineering.

Also consider the relative performance of each executive. Are they a top tier performer in a strategically important position—or are they an average performer or in an average importance position?

If the executive is not a top tier performer in a strategically important position, consider benchmarking against median vs. top-quartile executives for that position.

5

Weigh The Relative Needs Of The Executives

For each position and person, determine if you want your compensation to be more competitive on short-term or long-term compensation, or both. This decision is often based on the individual the company is looking to attract and retain.

Some individuals, age cohorts and job titles tend to be more risk averse (e.g., finance, engineering) than others (e.g., sales) and value guaranteed compensation (e.g., competitive base salary and benefits) more than long-term incentives (e.g., stock options).

Compensation best practices dictate that it's often better to win on short- or long-term compensation than to be average across the board to be more attractive to a specific person whose risk profile matches that target. Most companies can't be top quartile on all elements and for all positions, so it's better to be surgical and put limited compensation resources into those areas that will give you the biggest ROI.

6

Benchmark Your Compensation Program's Competitiveness Annually

The pandemic of 2020 and the labor shortages that ensued have made this one of the most challenging times for companies to offer competitive compensation programs that will ensure the long-term health of their business.

Companies' ability to attract and retain exceptional talent in this era depends heavily on offering the right pay and benefits packages to the right people. It's therefore critical for companies to be proactive and conduct an annual benchmark of executive compensation programs against peers.

The differences between companies (by size, ownership type, sector, growth rate, etc.) are vast, so it's important to determine if the company is paying at the intended levels relative to comparable companies.

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Communicate Your Value—And Priorities

Just as important as benchmarking against peers and competitors is sharing the collected data and the overall strategic plan with key executives.

More than half of CEOs say they aren't able to quantify or estimate the increase in their equity value in the past fiscal year because their company does not communicate the value of annual equity gains adequately.

A compensation plan should share value that is created in the company to not only reward performance but also keep goals aligned, retain and attract talent, and accelerate value creation.

Furthermore, as companies evolve and shift, compensation plans should follow pace. For instance, a company embarking on a digital transformation journey should revisit its compensation strategy across its IT executives to

ensure it is emphasizing the value of the function in meeting the company's objectives.

Once the company has identified its priority areas for the short- and long-term, it must choose the specific incentive vehicles and types that make sense within that context (e.g., cash bonuses, equity, phantom equity, profit sharing pools, etc.)—and communicate those decisions clearly to executives to drive alignment.

Defining time horizons for measuring performance also allows companies to determine whether compensation plans are helping or hurting the achievement of the company's goals. Private companies have the distinct advantage of being able to identify KPIs to tie individual compensation to metrics that more meaningfully measure that individual's performance.

LEARN MORE

Chief Executive Group, the publisher of Chief Executive magazine, surveys thousands of private companies each year to produce our CEO and Senior Executive Compensation for Private Companies report.

In 2021, more than 1,400 companies shared their compensation program, along with the impact Covid-19 may have had on cash compensation.

The report showcases more than 140,000 data points and provides benchmarks (by quartile) for each component of compensation by senior executive position, company size, growth rate, profit level, industry, geography, type of ownership and other key variables.

It is designed to help companies structure the right combination of salary, bonus, benefits, perks and equity incentives.

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