Guiding Principles of Executive Compensation

Chapter 6

How to respect family values and competitive realities in a nonpublic company

Don Delves

The design of effective compensation systems at nonpublic, closely held companies requires a deep understanding of the business's purpose, mission, vision, strategy and objectives—as defined by the owners. This chapter describes the application of the overarching and operating principles of executive compensation (EC) at Three Pillars Corp., a fictitious company based on a compilation of actual companies and situations. Creating the right compensation systems meant understanding the owners' evolving sense of purpose, and using the EC principles to align performance more closely with corresponding business strategy and objectives.

In 2008, Three Pillars Corp., a diverse hotel, restaurant and core manufacturing company, faced a complex new challenge. The $6 billion privately held company had just appointed its first nonfamily CEO and tasked him with reinvigorating its core business lines after the global recession. Even before the downturn, the corporation's hotel and restaurant chains and core manufacturing unit had languished, with the brands viewed as tired by many consumers and industry observers.

The most visible aspect of the company's challenge was rebuilding its brands. Specifically, the new leadership team, along with the company's board, led by second generation family members, grappled with multiple issues related to defining and realizing Three Pillars Corp.'s evolving *purpose*. The company aimed to continue its longstanding tradition to deliver both shareholder value and benefits to a broader group of stakeholders including employees and the community at large using tools such as philanthropy. At the same time, the family wanted to increase its return on investment from the corporation and its business units.

Three Pillars Corp. approached this multifaceted challenge partially through a comprehensive, principles-based approach to compensation. We will discuss in detail the principles Three Pillars Corp. used and the steps the company took to overcome purpose-related challenges. But first we turn to the definition of a nonpublic company and general issues related to creating a principles-based approach to compensation.

What makes nonpublic companies distinct?

For our purposes, a nonpublic, or closely held company, is a relatively large corporation owned by an individual, group, investment firm, or family (or a combination these owners) that includes:

- Founder-run organizations

- Family businesses owned by family shareholders
- Investor-owned companies held by a single investor or consortium of investors
- Co-ops owned by members
- Employee stock ownership plan (ESOP) companies owned by employees

When applying a principles-based approach to compensation at such companies, it's important to understand what makes each of these businesses distinct, as specified below.

- *The "personal" factor.* It's easier to ask owners of closely held companies (versus public), why they're in a business, and about their short- and long-term aspirations, and how they connect to the business's purpose, mission, vision, strategy and objectives. Any themes uncovered should be built into the compensation system's design.
- *Fewer conventional mandates.* Closely held companies have fewer inherent mandates for size, profitability, growth, or other variables, leaving owners freer to pursue distinctive goals.
- *Longer-time horizon.* Many nonpublic companies have a longer time horizon than their public counterparts, partly because they are not subject to scrutiny for short-term results.
- *Issues around long-term incentives (LTIs).* Closely held companies may not be able to offer stock-based, long-term incentive plans as easily as their public counterparts. This raises questions related to the objectives, form (stock or cash), dilution, voting rights, dividends, valuation and monetization associated with LTIs.
- *Shifting ownership.* Many nonpublic companies face buyouts, intergenerational transfers or other shifts in ownership. With new owners come new interests, orientations and objectives that will influence the design of compensation systems.

The next section illustrates the use of the overarching and operating principles to address the owners' sense of purpose at Three Pillars Corp.

Three Pillars Corp.'s purpose and compensation evolve

The many complex issues related to purpose and compensation that Three Pillars Corp. faced as it sought to reinvigorate its own businesses compounded existing hurdles the Great Recession created for all companies. The business had recently elevated a successful CEO of the company's core manufacturing business to the top executive position, replacing the second-generation CEO, the founder's son. Working closely with his executive team and the board, the new CEO was expected to drive greater profits by boosting the profiles of its hotel and restaurant businesses, while maintaining the already-strong performance of its core manufacturing unit. This would both boost the family's cash flow and allow it to continue its employment, philanthropy and other efforts that sustained its positive community impact.

Central to Three Pillars Corp.'s challenges was the issue of *purpose*. The owners' stated purpose reflected an inherent conflict: the family's desire for greater returns to realize its lifestyle and community-related objectives ran counter to reinvesting significantly in core brands. Second- and third-generation family members took great pride in the brands the company's founder and patriarch had built and grown, and the owners wished to uphold this legacy by rejuvenating Three Pillars hotel and restaurant businesses, both of which needed attention and reinvestment.

Incentives were key drivers to realize these goals, as the owners' complex and potentially conflicting interests had to be aligned with those of the new management team, a mix of successful and talented operating executives recruited to develop creative strategies and solutions. The family hoped that these leaders were more likely to turn around the business than more conventional corporate executives. But the owners also knew that the managers would recommend high-cost initiatives that would require superior executive management skills, and that the new team expected compensation commensurate with their qualifications and capabilities. This would place greater pressure on Three Pillars Corp.'s cash flow and likely delay increased returns for the family.

Ultimately, the owners effected a compromise, putting aside their short-term needs for cash in order to fund management strategies and incentives. This meant paying to develop a new high-end hotel concept, and rebooting the company's restaurant chain: remodeling to reflect a more modern concept and décor, management changes, menu updates and a reemphasis on customer service. Overall, these moves honored the spirit and legacy of the historic brands while updating them in a meaningful way, boosting their long-term value.

Simultaneously, at the family's direction, the management team gradually reduced corporate overhead. This was a very sensitive issue, given the family's commitment to being an employer of choice and maintaining an iconic corporate presence in the local business community, as represented by recognizable office building in the company's base city. The buildings housed Three Pillars Corp.'s corporate headquarters and were emblematic of the family's presence and leadership in the local business and civic communities.

During this period, Three Pillars Corp.'s compensation system emphasized long-term performance and returns over short-term results. The owners' clarity of purpose allowed them to reinvigorate the company with investments that would create greater long-term returns for the business and the family and boost the leadership team's engagement and accountability. Specific performance measures such as business unit or regional growth determined management's incentives, encouraging executives to "fix things" with the promise of future rewards.

Three Pillars Corp. and the operating principles

As discussed earlier, the overarching principle of purpose was central to Three Pillars Corp.'s rejuvenation, as new incentive systems at the corporate and business unit level were required to align management with the owners' evolving sense of why the company should exist and what its primary objectives should be. Below we discuss the most relevant operating principles that supported

compensation-related decision-making, as grouped by their section within the full set of operating principles.

Section I: Governing objective and executive compensation philosophy

Operating Principle 3: Long-term: Each organization's business and people strategies should align with long-term value creation and should drive the design and management of the organization's compensation programs.

Based on the owners' goals, the new nonfamily CEO and his team developed a comprehensive strategy and business plan to reinvigorate the business and its brands over the short and long term. For example, the team created 2015 and 2020 visions with milestones related to significant increases in revenue, profits and cash flow. We worked closely with the management and board to ensure incentives were aligned with the achievement of the business plans associated with those time horizons.

Since the business plans explicitly detailed results, measures and timing, performance measures and goals could be built into either the annual or long-term incentive plans as appropriate. Operating income, revenue and specific strategic objectives and milestones were used in the annual plan to reflect results that needed to be achieved within 12 months and had a high level of importance and urgency.

The long-term program was a three-year, cash-based plan built on achieving net income and return on capital goals for each business unit and the company as a whole. Goals were set based on the company's three- and five-year vision and business plan.

Operating Principle 4: Organizationally aligned: Executive compensation programs should also be aligned with the organization's culture and individual employee characteristics and, when possible, consider stakeholder preferences.

It was important that the new incentive plan align with Three Pillars Corp's purpose as a business and its mission and vision as a responsible employer. Elements of the plan needed to align with the organizational culture and stakeholder preferences. This included preferences of the family—especially those members on the board—and independent directors. The compensation system had to help uphold the organization's emphasis on family, teamwork and camaraderie—along with its healthy sense of paternalism—and enhance the motivation and performance level of the newly recruited executives and the long-term, loyal insiders.

Moreover, because the family wanted to avoid any wholesale reduction in people or programs, the pay structures and systems had to motivate performance, but also avoid draconian measures or metrics. For these reasons the plans focused much more on growth and brand enhancement than on cost reduction. While many other companies would have focused on cost reduction in their incentive plan,

Three Pillars Corp. chose to focus on growing revenues, profit margins and efficiency measures. A concerted effort was also made to streamline and rationalize corporate functions.

Section III: Performance-based pay

Operating Principle 1: Favor line-of-sight and alignment rewards: For senior executives, a majority of total rewards should be in the form of incentive compensation, a majority of incentive compensation should be in the form of LTIs, and a majority of LTIs should be focused on shareholder alignment and/or line of sight (i.e., retention-focused incentives should be the smallest LTI component).

We helped to ensure the new compensation system emphasized rewards that management could see, influence and control. That meant selecting performance measures to which management had demonstrable line-of-sight, such as operating income, revenue growth, efficiency measures and return on capital. Senior executives understood the measures and what was needed both individually and as a team and/or business unit to influence them. Measures were selected and weighted depending on an individual's placement within the company —corporate, business unit or below. It was rare to provide incentives to retain employees.

Operating Principle 3: Balance incentives: The incentive plan design should reflect the organization's desired balance of shareholder alignment and line-of-sight-related objectives through the selection of LTI vehicles and the weighting and selection of incentive measures.

Developing the right system required a conscious balancing act between line-of-sight incentives and shareholder alignment to accomplish the owners' objectives, with greater focus on the long term than the short term. For Three Pillars Corp., this meant favoring line-of-sight objectives that would drive long-term growth and value. The incentives were designed to find the right answer to the question, "How much performance by when?" by balancing the needs and goals of shareholders and management. Moreover, the incentives sought to reward achievement of the fresh strategy once it started to produce meaningful returns and cash flow.

Operating Principle 5: Align to strategy: Performance measures, while subject to periodic validation, should be selected in light of the organization's long-term strategy.

As discussed above, the management team created a multi-year strategy linked to specific performance measures and a plan that included annual and LTIs, with emphasis on the long term. The owners wanted more cash out of the business, but were willing to sacrifice short-term cash flow to achieve long-term strategic growth, margins and returns, as represented by specific measures for their company's businesses. Short-term performance on these measures would help generate long-term cash flow as measured by earnings, margin, returns, brand strength and market share.

Key Takeaways

Here are the most important takeaways related to closely held companies.

- *Purpose is king.* In closely held companies, the overarching principle of purpose has a critical role and function related to all aspects of the business, including incentive systems. Unlike public companies, we can ask the owners of closely held companies to articulate what they see as the primary reason(s) for the company's existence, along with their ownership-related short- and long-term goals. We may then use these inputs to inform the design of compensation systems.

- *It's not just about money.* Many closely held companies embrace a purpose that may include nonfinancial objectives, such as serving the interests of multiple constituents and providing broader service to the community. Again, this will guide development of incentive systems.

- *Alignment is critical.* The overarching compensation principle of alignment plays a critical role in ensuring the interests of management —as related to purpose— are aligned with those of the owners of closely held companies. These interests include both the goals and objectives of owners and the related time horizon, which in many cases is much longer for private than public companies.

- *The talent challenge*. Closely held businesses face special challenges competing with public companies for talent. Engagement and retention are particularly challenging because nonpublic companies have a longer-term focus, often retain talent longer than public companies and use incentive tools that are less liquid than publicly traded stock. As such, LTIs and equity or equity-like vehicles must be designed carefully, in a highly customized way.

Pitfalls of designing compensation systems in nonpublic companies

Incentive systems in closely held companies present several pitfalls.

- *Crafting public company solutions for private company incentive plans.* Trying to fit a public company solution into a private company framework is a mistake. Each emphasizes and prefers distinct pay levels, pay mixes, pay vehicles and time horizons for important reasons, as we've discussed in this chapter.

- *Seeing shareholder return as the only objective.* Do not assume that short- or long-term shareholder value maximization or total shareholder return is the only objective in a closely held company. While long-term value creation may be important or even critical, owners often value sustainability, cash flow and good corporate citizenship highly as well.

- *Assuming homogeneity of ownership opinions.* Don't assume consensus of ownership opinions on purpose/objectives. In closely held companies, multiple owners or generations of owners will likely diverge regarding needs and preferences related to growth, cash flow, risk, reinvestment and other key areas. It is the job of the board, top management, human resources and the consultant to understand, articulate, define and measure the interests of owners. This depth of understanding may require a significant amount of discussion and consensus building.

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