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A White Paper

WEALTH ACCUMULATION INCENTIVES A NEW BREED OF REWARDS

The executive compensation reward component that we are calling “wealth accumulation” is a new category for most executives, as well as for most designers. Used correctly, wealth accumulation incentives have immense power.

VIVA LA DIFFERENCE

The biggest difference between wealth accumulation incentives and more traditional ways that executives create wealth -- SERPs, deferred compensation, and long-term incentives like stock options and restricted stock -- is that wealth accumulation incentives are *incentives*. The first criteria for determining whether a program falls into this new category is whether or not it is performance based. The second criterion is whether it is truly “super long term” or career based.

We’ve developed a groundbreaking new wealth accumulation plan species that links long-term wealth accumulation directly to performance. Called the grahall Performance-Based Wealth Accumulation and Retention Plan—or gPB-WARP—this revolutionary plan, unlike traditional retirement or stock option plans, is designed so that a portion of the executive’s total reward program and ultimately their wealth accumulation rewards are based on company performance, stock performance, or a combination of both. These plans go beyond the “alignment of shareholders” and effectively combine career incentives and defined contribution retirement plans with deferred compensation awarded only when the corporation beats the competition. Before we get in the details regarding the gPB-WARP, let’s talk about the traditional plans.

TRADITIONAL PLANS

Let's first review traditional plans:

- A defined benefit retirement plan depends on the executive's last few years of compensation, his retirement age and years of service. The benefit *does not* vary with financial and stock price performance. Usually the plans vest after five years.
- A "long-term" incentive plan typically has either stock option awards or restricted stock awards that vest after three or four years. This benefit is the gain in the stock price. The executive can cash in on this benefit whenever he or she feels it is opportune.
- A deferred compensation plan permits or requires the executive to defer some current compensation into either a fixed rate of return account or a broad set of stock mutual funds. These plans allow the executive to choose the future date when they will receive the money.

Each of these traditional plans may have a place in any company's executive total reward strategy. However, none of them puts the executive in the shoes of the owner whose wealth is based upon the company's absolute and relative performance.

gPB-WARP

The grahall Performance-Based Wealth Accumulation and Retirement Plan (gPB-WARP) differs from the other traditional plans. It provides an alternative way of looking at wealth accumulation for those organizations that believe some portion of (a) retirement, (b) equity incentives, and (c) deferred compensation should be tied to the value an executive brings to an organization and how that value compares to other possible investments the shareholders could have made.

A gPB-WARP uniquely integrates retirement with deferred incentive compensation programs and then lengthens the time frame. It gives the executive an incentive to grow the stock on both an absolute and relative basis. A gPB-WARP operates within a performance-based, defined contribution framework. If an executive adds value to an organization his wealth accumulation and retention account will go up, and if the company performs poorly prior to his retirement it will go down. Plan contributions are largely funded out of earnings in excess of target.

These plans ensure that exceptional retirement income is reserved for only those executives who perform exceedingly well. Organizations implementing a gPB-WARP know that their executives have more of an incentive to perform.

Let's look at two examples of gPB-WARP design.

- In a gPB-WARP driven by company performance, the percentile of company performance would determine what percentage of total rewards would be deposited into the wealth accumulation account. As company performance improves, the contribution is increased because of both an increasing contribution rate and an increasing bonus to which the rate is applied. Plan contributions are funded out of earnings in excess of a target.
- In a gPB-WARP driven by both company performance and share price appreciation, wealth accumulation balances would be linked to both. The contributions of the plan each year would vary depending on company performance, as illustrated in the previous example. Once contributed to the plan, a percentage of the account would be "pegged" to company stock performance, with the remaining percentage pegged to other investment indices.

THE RESULT

Due to new proxy disclosure requirements, coupled with shareholder sensitivity to executive compensation, boards may find the gPB-WARP a good alternative to traditional retirement plans. The gPB-WARP will ensure that CEOs who are not performing up to snuff will not receive excessive retirement money at company and shareholder expense. gPB-WARPs also gives executives a good incentive to perform at their best, and allows them to share in the growth of the business.

BUYING INTO IT

Wealth accumulation should not be strictly in the form of company stock. There is an optimal amount of ownership that should be required of an executive and some of this wealth should be subject to lengthy vesting, and therefore lost if the executive leaves the organization to pursue other interests. Wealth creation should be a balance between a threshold level of ownership in the company's stock, as well as a portfolio of stocks that allow the executive to benefit from a diversity of investments consistent with their personal needs.

HITTING THE TARGET

If the executive team is able to generate sustained wealth that is at the 75th percentile for a particular risk category, then it follows logically that the wealth accumulation of the executive should also be paid, in terms of wealth creation, at the 75th percentile of organizations of similar size and complexity. On the other hand, if the organization's performance is below the 50th percentile for its risk category, then the executive should receive little or no wealth creation at all.

SHORT TERM MIRACLES NEED NOT APPLY

A gPB-WARP is well suited to motivate executives to perform critical strategic initiatives because they are extremely motivational and directional in nature. Additionally strategic acquisitions, geographic expansion, repositioning of an organization's value stream, and integrating new acquisitions or products are all factors that could be tied to a gPB-WARP. A gPB-WARP should be used for periods of time greater than five years.

HERE'S THE DOOR, SEE YA!

An executive who isn't adding value above the 50th percentile in terms of wealth creation for shareholders will be, under the gPB-WARP, underpaid compared to his peers. This could be encouragement for him to leave and then, with this program, you can attract an executive with the ability to make your organization a premium performer.

NO HIT AND RUN

In a gPB-WARP plan, we recommend 10-15 year cliff vesting. The earliest schedule we recommend is 50% vesting after five years, with prorated vesting of the additional 50% over a second five-year period. This extended vesting is appropriate especially when the other components of the executive reward program are providing levels of compensation for the executive.

HOW MUCH IS TOO MUCH

While boards and organizations spend a lot of time determining how an executive is to be paid year-to-year, they often overlook how much wealth an executive accumulates.

Being aware of how much wealth an executive stands to earn throughout the course of his career allows boards to determine whether or not that mix is appropriate and at what point additional compensation will not correlate to increased performance. Understanding wealth accumulation should challenge boards to rework compensation plans until they are satisfied with the mix.

A wealth accumulation analysis must take into consideration base pay, bonus, performance shares, matching shares, challenge grants, deferred compensation, and retirement. And provide one figure that represents an executive's total wealth accumulation. The analysis must be broken down so the board can see just how each of the above factors contributes to the executive's overall wealth, how much is performance-based, and how much is not. Then the board will be able to determine whether the figure is too much or too little, as well as whether the plan reflects the right mix.

APPROACH AND METHODOLOGY

Our approach to wealth accumulation analysis is based on certain assumptions. The assumptions change based on the executive, the company, and the features of their compensation plan. The assumptions, which are based on compensation information collected from the proxy statements filed with the SEC, include:

- The base salary of the executive increases by 5% annually.
- The bonus is equal to 100% of base salary.
- There is a 10% growth in the stock price each year.

The analysis also considers how long performance shares are granted to the executive, as well as at what percentage of base salary they are paid out. It is assumed that performance shares are paid out at 100% of base salary until a determined year, and then 200% after that year.

COMPARE AND CONTRAST

We would like to end this chapter by leaving you with two important thoughts. First of all, it's not okay to take your eye off the ball when it comes to how much wealth an executive stands to accumulate. Second of all, we would like to see more companies replace what we feel is the most misused total executive reward strategy components—executive retirement plans, deferred compensation, and stock options—with the gPB-WARP.