

Case Study on CEO Target Compensation

Background

XYZ Technologies is an S&P 500 company located outside of Boston. XYZ's chairman and CEO — Nancy Smith — is 55 years old and joined the company as CEO five years ago. Prior to joining XYZ, Nancy was the CEO of a very successful mid-sized technology company. Prior to hiring Nancy, XYZ terminated its prior CEO as his performance over his three-year tenure was not strong and the board disagreed with the former CEO's business strategy; there were no internal succession candidates. Under Nancy's strong leadership over the last several years XYZ's financial results, growth rates, and total shareholder return (TSR) have been positive and on par with the broader indices, however, relative TSR lagged the company's peers (few of which are direct competitors) over the prior three- and five-year periods. XYZ has received a "for" recommendation from ISS in each of the last five years and has passed say on pay each year with 90%+ support from shareholders.

Compensation history

Over the last five years, the compensation committee has provided Nancy with meaningful increases in total direct compensation (TDC). In early 2019, Nancy's target TDC increased by almost 15% and now approximates the market 55th percentile. In addition, we note the following:

- Over the last five years, bonus payouts varied with annual performance and have ranged from 65% to 150% of target.
- Payouts under XYZ's three-year PSU plan have generally been somewhat below target since awards are based on XYZ's TSR relative to peers and internal financial long-term goals.
- Long-term incentives are delivered using a mix of 50% PSUs, 25% RSUs and 25% stock options.
- Nancy holds a combination of unvested PSUs, RSUs, and options with a current value of approximately \$15M. She has not sold her vested shares (except to pay for taxes). In addition, her actual outright stock ownership is close to \$6M.

Historically, the company's compensation philosophy has been to target TDC approximately at the market median though it has varied by executive depending on tenure, performance, etc. Overall equity usage rates are generally consistent with peers and there are sufficient shares available in XYZ's shareholder-approved plan to make 2020 and 2021 awards.

Decision time

It is time for the compensation committee to determine the CEO's 2020 target compensation. In a preliminary conversation with the compensation committee chair, Nancy has expressed her opinion that her pay should be targeted closer to the market 75th percentile. She casually mentioned she has received some calls from headhunters and that the executive labor market is extremely tight. Median market rates have increased by approximately 10% on a year-over-year basis (from \$7.3M to \$8.0M).



The table below provides XYZ's current CEO compensation relative to the peer group market data at the 25th, 50th and 75th percentiles.

Overall, the board has been pleased with the CEO's performance, aligned on the business strategy and keen to retain and motivate her. They do not want Nancy to leave as she has significant credibility with investors and is highly regarded by the vast majority of stakeholders. The CEO and board have implemented a fairly robust succession process and several top executives have been given stretch assignments that have broadened their responsibilities, but none are ready for the top job just yet. Some on the compensation committee are nervous there could be some say on pay risk if they give Nancy a large pay increase as XYZ could have issues meeting future CEO pay and performance tests that proxy advisors annually conduct.

Pay Element	XYZ 2019 (\$000's)	Competitive Market Pay (\$000's)			Recommended 2020 (\$000's)
		25 th %ile	50 th %ile	75 th %ile	
Base Salary	\$850	\$800	\$900	\$1,000	TBD
Target Bonus (% of Salary)	125%	100%	125%	150%	TBD
Target Total Cash Comp	\$1,913	\$1,600	\$2,025	\$2,500	TBD
Long-Term Incentives	\$6,500	\$4,500	\$6,000	\$8,000	TBD
Target Total Direct Comp (TDC)	\$8,413	\$6,100	\$8,025	\$10,500	TBD

Key Questions:

1. What level of target TDC should the committee recommend for 2020 and why?
 - a. What factors/ information should be considered in determining the CEO's target compensation?
2. What do you think about the broader Board's performance?
 - a. Is Nancy the right CEO for XYZ?
 - b. Should succession planning be factored into the decision-making process and, if so, how?

Process:

Work with your table to discuss the situation and deliberate as a compensation committee would on CEO compensation as if in executive session. We will then select 2 tables to present their recommendations and answers to above questions to the overall group. This will be followed by a group discussion.