ILLUSTRATION BY JT MORROW

A Comp Consultant and an Activist Debate Finer Points of Executive Pay

Conversation facilitated and edited by Judy Warner

Glenn W. Welling, founder and chief investment officer of Engaged Capital, is straight from the school of activist fund management taught by the legendary Ralph Whitworth of Relational Investors, the activist equity fund that at its peak managed more than $6 billion. Welling learned fund management and engagement at Relational as a principal before launching his own firm in 2012 to invest in small- to mid-sized public companies. His most recent success was transforming the board of Medifast where CEO Michael MacDonald acknowledged in a published interview that the arrival of activists, including Welling, hastened a needed board overhaul. When it was over, the Medifast board had shrunk from twelve to nine directors—eight incumbent directors had resigned or retired and five new, independent directors were appointed, including Welling—who reportedly are better qualified to oversee the direct marketing-based weight loss company. In the past year, according to *The Deal*, Welling has been one of the standout activists, successfully placing new directors on the boards of multiple corporations. Welling serves on the compensation committees of two companies—Medifast and Jamba—and chairs the comp committee at Rovi Corp. *NACD Directorship* paired Welling with Robin A. Ferracone, the founder and CEO of Farient Advisors, a prominent compensation and performance consulting firm, to share views on compensation practices. What follows is an edited transcript of their discussion in Farient's Los Angeles headquarters.

Glenn W. Welling: I have been investing in companies for 25 years and one of the most significant lessons I've learned is that people do what they are paid to do. Pay is really important in driving behavioral change. We are different from other activists in that we tend to spend a lot of time with compensation committees trying to get pay aligned very early on in our process. We're identifying companies that we believe are good businesses that are undervalued and where there's opportunity for significant change that will alter the valuation. One of the first things we look at is the company's compensation methodology, including the metrics and the targets that are driving behavior, to see if they are driving value for shareholders.

Robin A. Ferracone: So if you see a company that has a compensation program that is not optimally designed, my guess is you would say, "Oh good, that's an opportunity. We can really help turn this around and get some value."

Welling: It's just one of the first things we look at.

Ferracone: What if the pay system isn't the problem, then what?

Welling: It's not always the fact that management is being paid on the wrong metrics or the wrong targets that's driving the behavior. I will tell you, when we find companies that have significant issues, pay is usually a part of it. But it's not always the issue. It could be that the company has selected the wrong strategy or has a flawed business mix or is not executing, or is allocating capital poorly. Because we look at so many companies, we see many different issues affecting their ability to drive value for shareholders. Regardless of the issue or issues being addressed, aligning pay with the key drivers of value is always helpful in driving behavior.

Ferracone: In listening to you talk what strikes me is that it's valuable to do what I call "peeling the onion," because if you go down a layer or two, you can figure out where the strategic opportunities are and how that should play into the overall measurement system. If you don't peel the onion, you could find that the comp system is actually encouraging the wrong behaviors. One of the things that I've observed in comp systems is they tend to be more macro these days; in other words, companies measure performance at a big-picture level, and allow for a lot of strategic interpretation, rather than honing in on the key areas that deserve greater focus.

Welling: I tend to err on the side of simple and developing pay systems that evolve with the business. So if the issue now is that the company's profitability needs to improve and we believe it's a cost structure issue then this year's short-term pay might be really focused on cost reduction. However, after costs are under control and the company is generating significant amounts of cash flow, the key driver of value may be investing those cash flows wisely and the best metric to drive that behavior may be return on invested capital. And those metrics and targets should be disclosed so shareholders can hold management accountable.

Consultant Independence

Ferracone: Let me shift gears here and ask what your view is on the independence of compensation consultants because this is an important question today.

Welling: What's frustrating as an outsider is that when you look at a lot of comp plans you wonder how it was possible that there was an independent consultant involved, because either the absolute pay is extremely high for underperformance or the targets are ones that management can achieve but aren't going to create value for the shareholders. We struggle when we look at a lot of these plans where targets are set at levels that are too easy and on performance metrics that are not aligned with the company's long-term business plan.

Ferracone: Independence really has to apply to both the consultant and the comp committee. It can't be an either-or. Ultimately, management, the board, and the consultants are all working for the shareholder—or should be.

Welling: Independence has to start with the comp committee because the consultants should be working for the comp committee. They're not working for management. If the comp consultant doesn't perceive that the board is engaged in the way that they need to be, then the comp consultant has to alert the board to that issue and spend the time with the board making sure they fully understand the comp plan that's being put in place. All too often I see comp committees that actually don't understand the comp plan. They really don't understand in great detail how management is getting paid. That's a problem.

Ferracone: A good comp consultant will do the heavy lifting in that process. That's what we get paid for.

On Creating Value

Welling: A lot of work needs to be done before you start worrying about what the right peer group is. Number one is how much val-

Robin A Ferracone

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ue is management's plan going to create? And of that value, how much do you want to ascribe to the management team and how much of that value should accrue to the shareholders? In other words, what's the sharing equation that we want to establish between management and shareholders? But first and foremost, the board must ask: "Will this plan create value and, if so, how much?"

Ferracone: Do you have a rule of thumb on what sharing ratio as a percentage of value makes sense?

Welling: I tend to yield to the way private equity firms look at it. So, I would say 4 to 5 percent of the value that's created should accrue to the senior management team. And based on that determine how big the bonus pool is. And then, what metrics do we want them to achieve to get to that bonus pool?

Ferracone: Where do you draw the line on who to include in senior management?

Welling: A lot of companies like to push equity below the direct reports to the CEO. That needs to be considered because those employees may be critical to executing the strategy. Certainly the minimum starting point is the CEO and his direct reports. And then you've got to look at it on a company-by-company basis.

Ferracone: If you're defining senior management as the CEO and direct reports that's a sizable number. How many people are you sharing among?

Welling: How much of the pool goes to the CEO depends on his importance to the successful execution of the strategy. Usually in earlier stage companies, the CEO has a larger impact on the execution of the strategy versus later stage businesses. Typically, I see the CEO with about 50 percent of the pool.

On Peer Groups

Welling: As a large shareholder, I am very happy for management to get rich as long as the shareholders get richer. The challenge with traditional peer group analysis for me is there is nothing that shows how much value each of the CEOs within the peer group created. I am happy to pay you outside the range of your peers if, in fact, you've created wildly more value than any of your peers. And so, relying on peer group construction to drive the pay process and the sharing arrangement always bothers me because underperformers get paid too much and outperformers get paid too little.

Ferracone: We agree then that most comp consultants look at the target pay and they don't do a good enough job of looking at the performance leverage in the plan and how much upside and downside there is for a higher or lower performance. If you look at both the pay and performance sides of the equation you should get to a similar point. And if you look at realizable pay, not just target pay, you should also get to a similar point.

Welling: I sit on three comp committees, one of which I chair. What I see from the comp consultants is the first thing they want to do is to create a peer group. And my message is usually, no, the first thing we want to do is make sure you understand the short- and long-term plan and what metrics measure performance and what targets are being set so that you can begin a discussion as to whether we have the right metrics and the right targets. And once we've got that we'll start talking about the peer group.

Ferracone: That's the key lesson: If you are doing the job well, you recognize that the lynchpin of a good pay program is the measurement system; that means paying attention to performance measures and goals.

Welling: Maybe a better way to think about peer-group construction is to show outperformers, underperformers, and mid-range performers in a much broader way if you're able to double, triple, quadruple the value, that puts you in the top quantile—not top quantile of revenue, not top quantile of absolute market cap, but actual performance. Maybe that's a better way to construct peer groups.

On CEO Pay

Ferracone: How do you keep the pressure on performance through the incentives? One of the mistakes I see is that companies raise the target pay of executives to retain them, rather than let performance and realized pay take care of retention. To what extent can comp committees rely on realized pay rather than fixed pay and still protect against poachers?

Welling: What I like to see is a CEO with tremendous pay leverage in his pay package where it would be very expensive to leave. So the CEO always has significant pay at risk but that pay is high if she performs.

Ferracone: So pay is at risk and a lot of it is unvested.

Welling: One of my consistent pet peeves is annual grants that reset based on what the stock price is. I'm a fan of big grants every three or five years that vest based on performance. If you've got a CEO that's executing, he doesn't want to leave because he's got big grants that are vesting over that time period.

On Value-Based Metrics

Welling: What is sorely lacking in many companies' compensation plans are what I would refer to as value-based metrics. When you look at the research that's been done across the most public markets what you see is that a small percentage of companies have value-based metrics embedded in their compensation plans. Why aren't these value metrics a more significant and material component to the way those CEOs are paid?

Ferracone: Usually a value-based metric is defined in its simplest terms as earnings minus a capital charge for debt and equity employed, and getting people to understand how that is calculated so they can manage to it has been very difficult. As a result, we need to look at the whole equation to see how a value-based message is delivered. In other words, it becomes important to look at what drives value. Very often, as long as there is a positive spread between return on capital and the cost of capital, then you have to grow with the right spread. And that's where I think the system can break down because you need both the growth and the return spread to build value. Instead of measuring growth in value with a traditional value-based measure, like Economic Value Added, we tend to measure the components of value growth (like earnings growth and returns), and sometimes total shareholder return (TSR) directly, because these types of measures tend to be more understandable by plan participants.

Welling: What frustrates me is the lack of prevalence of value-based metrics across companies more broadly. We've been talking about value-based metrics for more than 25 years now. Why do you think there are so few companies that have deployed value-based metrics? Is this a management issue, a board issue, or do you think it's that the comp consultants aren't comfortable with them?

Ferracone: It's simply easier for companies to communicate and for participants to understand the components of value creation, that is, growth and returns and ultimately TSR, rather than a single value-based measure.

On Planning for the Long Term

Ferracone: With respect to large, episodic grants, I get concerned that there's so much riding on special grants that vest all at once, so that the risk-taking will be greater and the financial outcomes will be concentrated around vesting dates. How do you, particularly as an investor, ensure that you're not encouraging executives to just manage for the short-term, and that you're really getting a long-term sustainable result from them?

Welling: That's the alignment you've got to strike between your short-term plan and your long-term plan. And to me, your long-term plan is really a series of short-term targets that get you there. So it's a series of annual targets that are set based on your long-term plan that gets you to your long-term compensation targets, which hopefully incorporate some measure of TSR and the drivers of TSR as that should be the goal of all long-term plans.

Ferracone: So the key is trying to set out a longer-term plan but then make sure that you're marching in the right direction on an annual basis. My experience is that the best managed companies actually look down to the business unit level to where the value-creating platforms are, and they look at comp at those levels even though those positions may not be held by named executive officers who show up in the proxy. It's not necessarily within the legal definition of what compensation committees have to look at, but it's a practical business definition of where the value-creating platforms are.

Welling: I agree. It's a broader issue in a lot of boardrooms where your fiduciary duty is to make sure that you're governing this business on behalf of the owners. Compensation is absolutely a part of that. When you have a company that's got multiple businesses within it, which most do, the comp committee should be part of the process in setting executive compensation targets for all the key executives.

Glenn W. Welling

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