Executive White Paper

Why Long-Term Value Sharing Matters

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Why Long-Term "Value Sharing" Matters

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Value sharing is an issue that, sooner or later, every enterprise leader must confront. For example, many responsible for driving business growth wonder whether some kind of long- term incentive will enable higher performance; and if so, which approach is best—stock, performance units, phantom equity or some other value sharing plan. Issues such as cost, impact on the P&L, and other related financial considerations funnel into a discussion whose conclusion very often is, "let's take this up again next quarter." Next quarter soon becomes next year, which subsequently evolves into an inertia induced "never." In the meantime, worries usually fester about diluted productivity, insufficient engagement or the proverbial entitlement mentality.

The origin of this evolution is the inability of leadership to adequately answer a fundamental question: "Can a business improve or accelerate equity appreciation by sharing value with employees?" In fact, the answer to that query is "yes, *if* you do it right." To bolster that assertion, this article offers five compelling reasons why including employees in long-term value sharing improves every shareholder's position and, therefore, why adopting such a program is critical for any company seeking breakthrough growth.

However, before going any further, let's first define what we mean by long-term value sharing. Then we can move on to the five arguments for integrating such plans into a company's rewards structure.

The Future Company

Most chief executives and owners envision a future company that is, in one way or another, bigger and better than the present business. The ability to achieve that future requires that employees—particularly key people—be compelled by that vision and are able to see themselves making a significant contribution to its fulfillment. Most ambitious, forward- thinking companies seek to make the future success of the business more tangible and

meaningful to high producers by instituting a method of sharing value with those that help create it.

In private companies, this is often accomplished with solutions that range from equity sharing to performance unit plans, profit pools and phantom stock agreements. Public companies more commonly employ restricted stock, options or their variations to create the alignment they seek. Performance-based deferred compensation is another common tool both public and private companies use to drive results and inspire long-term value creation.

Each company must determine which plan or combination of plans will best encourage the outcomes it wants to achieve. It is not the intent of this article to make a judgment about which is most effective or to describe the advantages and disadvantages of different value sharing approaches. Instead, we want to consider why such plans matter and how they make companies more productive while multiplying wealth for all stakeholders.

One important note. In this article we make a distinction between value sharing and incentive plans. It's a subtle but important difference. The term "incentive" implies a company will reward certain "behaviors"—and that the plan is the chosen mechanism to influence those behaviors. Too often, this becomes manipulative and the plan backfires. When it does, both employees and owners are left frustrated.

Value sharing, on the other hand, rewards certain defined "outcomes." It has a different philosophical foundation. Through this approach, ownership makes assumptions about what kind of value increases can be realized through the achievement of certain targeted or superior performance results. It then determines how much of that value it's willing to pay out or "share" to produce those results. It shares "the wealth," if you will, from additional value that has been created (beyond the ongoing performance levels needed to sustain the business) with those that help produce it. It's a self-financing approach; no value is distributed unless that value has been first defined then produced.

With that understanding as a "jumping off point," let's now move on to why long-term value sharing matters.

#1: Value Sharing Attracts the Best Talent and Magnifies Results

To achieve sustained success, companies must attract and keep talented people that know how to compete and *are willing and able to assume a stewardship role in representing shareholder interests towards growth*. For such a relationship to be properly fostered, owners and other

stakeholders (in this case, key talent) must share both the risks *and* the rewards associated with value creation.

Those of superior talent are attracted to this idea. Individuals best equipped to contribute to the future success of the business will see it as an opportunity to have what amounts to a mini-entrepreneurial experience within the construct of someone else's business model. As such, they view the company as a mechanism for wealth creation, not just a place to express their passion and talent. And shareholders should want employees with that perspective representing their interests.

In a recent interview with TV talk show host Charlie Rose, Mark Zuckerberg, founder and CEO of Facebook, said it this way:

> I actually think the biggest thing for us is that a big part of being a technology company is getting the best engineers and designers and talented people around the world. And one of the ways that you can do that is you compensate people with equity or options. Right?
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> So you get people who want to join the company both for the mission because they believe that Facebook is doing this awesome thing and they want to be a part of connecting everyone in the world. But also if the company does well then they get financially rewarded and can be set.
>
> … we`ve made this implicit promise to our investors and to our employees that by compensating them with equity and by giving them equity that at some point we`re going to make that equity worth something publicly and liquidly -- in a liquid way. *Now, the promise isn`t that we`re going to do it on any kind of short-term time horizon*. *The promise is that we`re going to build this company so that it`s great over the long term.* And that we`re always making these decisions for the long term. (From a transcript of an interview on Charlie Rose, PBS, on November 12, 2011. Emphasis added.)

The point Zuckerberg is making has little to do with whether or not a company plans to share equity or go public. There's a larger principle he's defining. When companies can attract and retain the kind of people that think and perform as he describes, they are in a unique position to sustain results. This is because a distinct and lasting interdependency emerges between the employees' skills and the company's resources that extend those skills (capital, co-workers, suppliers, products, technology, etc.). Talented contributors soon learn that their skills are not as unique and applicable *outside* the company (that is providing the laboratory for nurturing and magnifying them) as they are within the enterprise. That's a good mindset for company talent to have because of the mutual dependency it creates.

Such interdependence is reinforced and validated when long-term value creation is rewarded through value sharing, as Zuckerberg indicates. When employee skills connect with company resources in the right way, superior results are produced. To be effective, the compensation program should then provide a remunerative link to that outcome which confirms and magnifies the sense of partnership owners wants to convey. That link "seals the deal," so to speak, and financially ratifies the interdependent nature of the relationship more completely.

#2: Effectively designed long-term value sharing plans reinforce the company's business model

A sustainable business model depends, in large part, on a culture that is committed to and, ideally, "invested in" that model's reinforcement and success. This is foundational to a competitive advantage. As a result, having key members of a workforce aligned financially with the business model makes both common and strategic sense. The importance of this concept stems from the nature of the virtuous cycles the model is intended to produce. The need for these self-reinforcing performance patterns was articulated well by Ramon Casadesus-Masanell and Joan E. Ricart in their Harvard Business Review article entitled *How to Design a Winning Business Model*:

> Not all business models work equally well, of course…Above all, successful business models generate virtuous cycles, or feedback loops, that are self-reinforcing. This is the most powerful and neglected aspect of business models.
>
> Our studies show that the competitive advantage of high-tech companies such as Apple, Microsoft, and Intel stems largely from their accumulated assets—an installed base of iPods, Xboxes, or PCs, for instance. The leaders gathered those assets not by buying them but by making smart choices about pricing, royalties, product range, and so on. In other words, they're consequences of business model choices…
>
> …The consequences enable further choices, and so on…Smart companies design business models to trigger virtuous cycles that, over time, expand both value creation and capture. (*How to Design a Winning Business Model*, Harvard Business Review, January 2, 2011)

Four Seasons, Verizon and Amazon each have distinct business models and, by extension, unique virtuous cycles. So, it only stands to reason that their compensation strategies will be equally distinct. While they may share some common approaches to rewards (giving equity for example), the metrics and measures that stand as gate keepers to payouts (or earned shares, as the case may be) must reflect and reinforce the virtuous cycles relevant to each business. Companies that don't have a long-term plan for value sharing that does this can't expect their

workforce to treat those cycles as the sacred sources of sustained success they are intended to be.

Long-term value sharing reinforces a business model by communicating to key people where the leverage points are and what those employees' role is in the model's fulfillment. If they understand that connection, and their long-term pay holds them accountable for achieving those outcomes, the virtuous cycle is protected.

 # 3: Value Sharing Protects against Bad Profits and Promotes Good Profits

In his book *The Ultimate Question*, Fred Reichheld, a Bain Fellow and founder of Bain & Company's Loyalty Practice, offers the following on the subject of profits:

> Too many companies these days can't tell the difference between good profits and bad. As a result, they are getting hooked on bad profits.
>
> The consequences are disastrous. Bad profits choke off a company's best opportunities for true growth, the kind of growth that is both profitable and sustainable. They blacken its reputation. The pursuit of bad profits alienates customers and demoralizes employees.
>
> While bad profits don't show up on the books [at least they aren't identified there as such], they are easy to recognize. They're profits earned at the expense of customer relationships.
>
> Whenever a customer feels misled, mistreated, ignored, or coerced, then profits from that customer are bad. Bad profits come from unfair or misleading pricing. Bad profits arise when companies save money by delivering a lousy customer experience. Bad profits are about extracting value from customers, not creating value. (*The Ultimate Question*, Fred Reichheld, Harvard Business School Publishing Corporation, 2006, 3-4.)

Long-term value sharing arrangements, if designed properly, become a self-enforcing means of perpetuating good profits. Everyone has an interest in good profits if everyone's wealth multiplier rises or falls on the ability of the company to sustain the right kind of profitability.

Conversely, companies that focus solely on short-term results (in terms of "at risk" pay) set themselves up for bad profits. Leaders of such companies can (and do) talk all they want about building value for the customer and improving return on equity for shareholders; but if they pay people in a way that communicates the opposite, how can they expect employees not to pull

them into the bad profit trap? In this sense, long-term value sharing protects the company's interest in developing good profits, acting as a kind of insurance policy against a strictly short-term focus.

#4: Long-term value sharing promotes an ownership mindset

Businesses need employees in leadership roles that understand "what's important." Such individuals must be able to embrace a stewardship role in aligning their focus with that of shareholders. They need to define what's important in the same terms as ownership when they go about fulfilling their responsibilities. For most companies, a list of "what's important" would include, but not be limited to, the following:

- Drive growth (revenue, net income, EBIDTA or other measures)
- Improve margins/profits
- Manage costs

Each of those areas of emphasis has long-term implications. As a result, executive and management level employees must be able to focus on maintaining the company's performance engine in each of those categories *while* moving the organization to its next level of growth. In other words, it must sustain and innovate, as well as maintain and drive, simultaneously. In such a context, compensation plays a key role in communicating "what's important." To the extent key producers are incented in the same way shareholders are (which doesn't necessarily mean equity participation), they are more likely to think in strategic instead of just tactical terms in their approach to getting results.

Aon/Hewitt makes this point in their report (written by Johanna Zemmelink-Pope) entitled *Performance and Rewards: Broad-Based Incentive Plan Design*:

> An incentive plan is successful only to the degree that it supports the strategic imperatives of the organization…Understanding the nature of the talent needed to deliver on the strategies and how, as part of the total rewards offer, an incentive plan can serve to attract, retain and motivate that talent is also important. This knowledge is necessary in order to identify and prioritize the key objectives of the incentive plan. For example, an organization's key objectives may be to:
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> - drive growth;
> - motivate individual and/or collective performance;
> - focus behaviors;
> - share organizational success; or
> - meet the attraction and retention challenge posed by talent competitors.

> After reviewing strategy, a number of metrics that could serve as markers for successful execution will surface…It is essential to choose and prioritize [those] metrics taking into consideration and balancing:
>
> - long-term impact/sustainability vs. short-term results;
> - income statement vs. balance sheet outcomes;
> - expense vs. investment;
> - individual vs. group performance;
> - corporate vs. business (or smaller) unit performance;
> - revenue growth vs. profitability; and/or
> - organic growth vs. growth by acquisition.
>
> (Aon Hewitt, November 2010, http://www.aon.com/canada/thought-leadership/ready/nov10-performance-and-rewards.jsp.)

Such metrics and measures reflect strategic, ownership thinking. And a business can't expect the key part of its workforce to think long-term if the company's compensation strategy tells it to focus its attention strictly on the next 12 months or quarter. As a result, an approach to compensation that includes a long-term value sharing component creates alignment between ownership and employee thinking. The default position of most employees is to think short- term. However, if there is a meaningful, vested interest in balancing short and long-term results, because of how individual producers are paid, those same people will more naturally evolve to a stewardship thought process.

#5: Value Sharing Builds Trust and Trust Accelerates Results

At its core, value sharing is about turning a company's workforce into partners in building the future company. Such a philosophy presumes ownership feels that sharing value with those who help create it is as much a matter of fairness as one of strategy. Truth is, fairness is smart strategy. Why?

Companies that want to effectively compete must have a culture that is capable of perpetuating success, and has that expectation. The culture of confidence that takes root in such environments is the ultimate source of a competitive advantage, because culture is not "copyable." Another company may be able to replicate your products but it can't reproduce your culture.

Confidence is rooted in an environment of trust. Value sharing communicates and builds trust because, in part, it is a *fair* approach to rewarding those responsible for value creation—and

trust is the key to accelerating results. In his book *The Speed of Trust*, author Stephen M. R. Covey makes the case this way:

> Whether it's high or low, trust is the "hidden variable" in the formula for organizational success.
>
> …A company can have an excellent strategy and a strong ability to execute; but the net result can be torpedoed by a low-trust tax or multiplied by a high-trust dividend. This makes a powerful business case for trust, assuring that it is not a soft, "nice to have" quality. (*The Speed of Trust*, Stephen M. R. Covey, Free Press, February 2008)

When you pay people in a way that communicates you want them as partners in building the future business, you are, in essence, saying: "I have confidence in you and trust your ability to get results. To prove it, I'm willing to share the value you help create." Unfortunately, many business leaders don't think about compensation as this kind of trust conduit. As a result, they often view long-term value sharing arrangements as an additional cost item that needs to be minimized or eliminated. They fail to recognize that trust accelerates value *creation*…and value *sharing* builds trust.

Start with a Clear Philosophy

How to effectively and strategically involve others in long-term value creation should weigh heavily on anyone responsible for making sure that the business of the future is bigger and better than the one that exists today. Forward thinking companies recognize that. Given that, where does one begin in his or her quest to successfully develop a long-term value sharing approach?

Before considering *which* plan is "right," wise leaders will begin with the development of a compensation philosophy that addresses how the company will nurture a culture of confidence through its approach to rewards. Such a philosophy should address the balance the company will maintain between short and long-term value sharing, and guaranteed versus at risk compensation. Determining the plan that will best reflect that philosophy then becomes much easier.

Hopefully, this article has helped the reader determine that it is worth the effort to push through the early stages of the process in establishing a sound value sharing approach. Those that do will emerge at the other end more confident in their ability to recruit and retain top talent, secure in their capacity to meet the performance standards associated with their growth goals and able to produce a culture capable of sustaining that success. No time in the future will prove better than today to address this vital component of compensation planning.

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Thomas J. Jordan specializes in the design, implementation, funding and the administration of executive and key employee incentive plans. As part of his exit planning advisory services he has developed stay bonuses, stock appreciation rights, phantom stock plans, executive deferred compensation plans and performance- based incentives for hundreds of organizations.

Tom has spent over 20 years as a leader in the compensation industry, serving as President and Chairman of the Executive Compensation Institute, a Senior Advisor on Compensation Strategy with M Financial, and as a Strategic Advisor to The VisionLink Advisory Group. He has helped over 400 companies create compensation programs as a critical component in his development of their transfer and succession strategies.

Thomas J. Jordan is the founding President of The Exit Planning Institute of South Texas. He holds a Bachelor of Arts degree in Economics from Millsaps College and a Master of Science degree in Financial Services from the American College of Financial Services. He is also a Certified Exit Planning Advisor.