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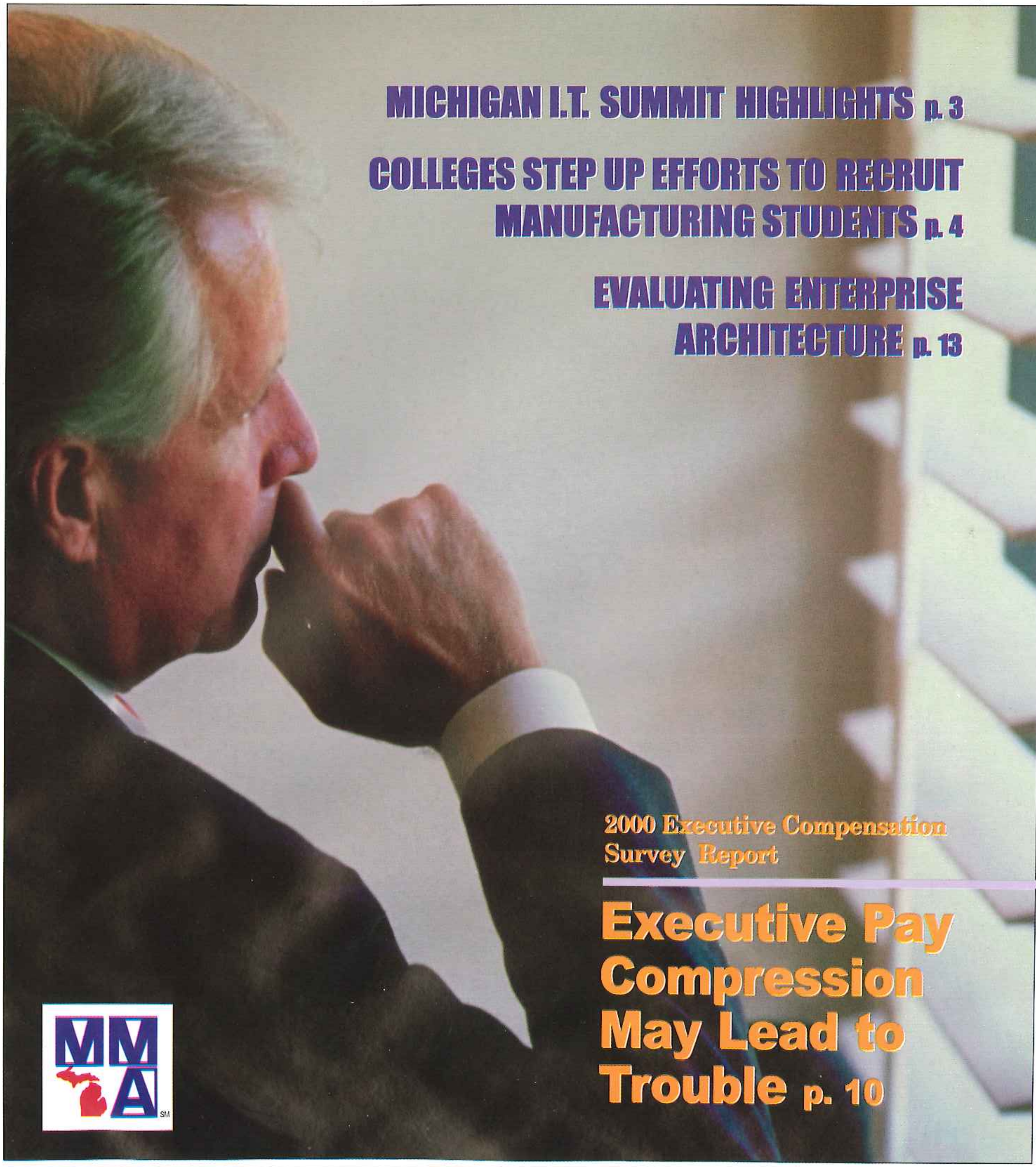

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MMA

2000 Executive Compensation Survey Report

Report Shows Evidence of Pay Compression

By Edmund B. Ura

Conservative executive compensation programs in Michigan's manufacturing community may lead to trouble in the near future, as pressure from rising professional and management salaries may cause dangerous pay compression. The results may be an unrealistic restraint on compensation for key employees, as well as an inability to attract, motivate and retain qualified, non-owner executives.

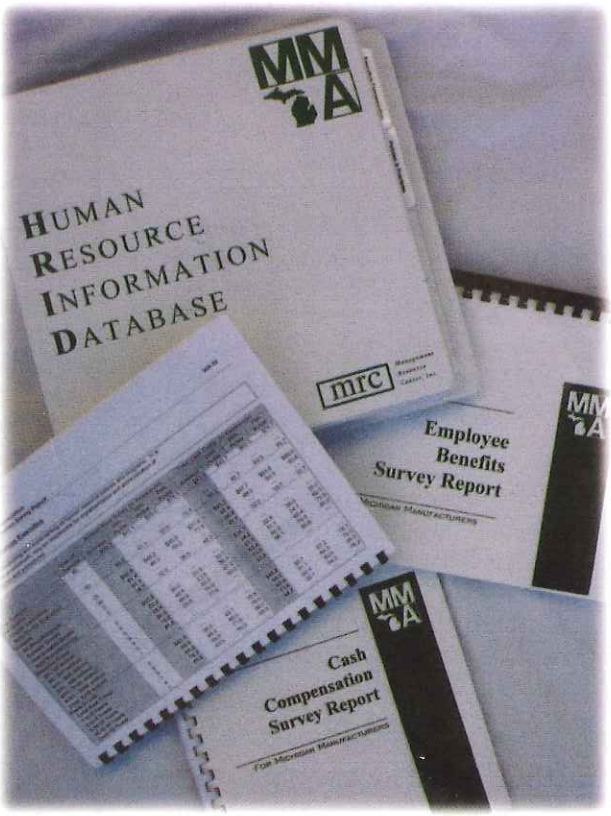
These possibilities are underlined by the results of the recently published *MMA Executive Compensation Survey Report* conducted by Management Resource Center, Inc., for the Michigan Manufacturers Association.

The popular media continue to attack corporate executive management for "excessive pay" and it's relationship to the pay of "rank and file" employees. However, just as the average Fortune 100 industrial company bears little resemblance to the average Michigan manufacturing firm, so the average Michigan manufacturing executive's compensation program bears little resemblance to the seven- and eight-figure compensation packages reported in the national media.

Understanding Executive Compensation

Executive compensation is a mystery to most people, which is why it is such an easy target for exaggeration. The typical executive compensation program consists of four major elements:

Base pay — Like any other employee, executives receive an annual salary. Typically, for a manufacturing firm, executives are the highest paid employees. That is the last generality that can be made about base pay. In publicly-traded companies — from which most media reports are drawn — executives are paid salaries reflecting competitive rates in the labor market for their skills. Most reputable studies validate the notion that base pay levels increase with the complexity of the job and, in most situations, can be readily predicted by the size of the company.



Despite the hype, most CEOs leading industrial companies providing thousands of jobs and pouring millions of dollars into the economy typically earn much less than second-string players on small-market basketball teams.

Privately-held companies, which make up the vast majority of manufacturing employers, provide an entirely different angle on executive compensation issues. Owners and family members tend to think not only of the salary they earn in a given year, but the wealth that they gain from leaving money in the business, and thus are less likely to require as much base pay as if they did not own the business.

Additionally, owners are more likely to be conservative in setting base salaries to be paid throughout the year, relying on end-of-the-year bonuses to make a reasonable total compensation package. As the *MMA Executive Compensation Survey* has illustrated over the years, owner-executives typically earn a smaller salary than their non-owner counterparts.

Because media reports focus on

large, publicly-traded employers, they overstate executive pay and do not provide a realistic view of the true state of the pay that owner-executives receive. For example, an "average" Michigan manufacturing CEO earns just over $140,000 in salary. CEO base salaries are much lower in smaller manufacturers, with over half earning less than $90,000 per year.

Annual incentives — The annual bonus is a vehicle used to reward executives, as well as many other employees, for their performance over a year. The public generally thinks of bonuses as a type of "profit sharing" which, in fact, was a common measure for determining bonuses in the past.

Bonus plans are in place for most executives in Michigan (at least 75 percent in almost every executive job) but the measures used to determine their actual amounts have come a long way. Controlling for the few small manufacturers who pay most of their CEO's compensation in the form of a bonus, the actual bonus awards tend to be relatively conservative.

While very large companies' bonus plans may exceed 50 percent of base pay, the typical small manufacturing CEO has a bonus target of less than 40 percent, and lower level executives can expect 20 to 25 percent of base pay in their annual incentives.

Interestingly, as more and more employees become eligible for incentive programs, and begin to understand what actually is involved in earning awards, there is less and less opposition to the concept.

Long-term incentives — The long-term incentive component of the executive compensation program is by far the least understood. Fundamentally, a long-term incentive program is any plan that rewards performance over several years, typically three to five. These plans can have cash payouts or may use equity vehicles such as stock, or stock-equivalents. Cash plans are easy to understand and are typically not controversial. Most Michigan manufacturing firms do not have cash, long-term incentive plans.

Stock plans — typically restricted stock or stock options — are usually the headline issues, because they can generate the appearance of huge "profits." On the other hand, of course, there is very little notice when stock options cannot be exercised because their current price is below the option price or when the profit earned is relatively small. In fact, many options go unexercised for these very reasons.

Stock options are generally misunderstood because they are very difficult to "value" except when they are exercised. A stock option is simply an "option" to purchase a share of stock at a given price (usually the then-current market price) for a certain length of time, until some point in the future. An option has a value in and of itself. How to value it, however, has been a major debate for years, and there is no sign a simple solution will be found any time soon.

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The easily understood value is the profit that is made when the option is exercised. That profit comes at a price, however. The exercise price must be paid by the executive. For example, if I have an option to buy a share of stock at $10, and the current price is $12, I can pay $10 to exercise that option and if I then proceed to sell the share I just bought, I will realize a $2 profit. That is an extremely simplistic explanation, of course; many companies provide financing to make exercise more realistic, and short-swing sales rules and capital gains taxes quickly eat up the profit. What the public needs to understand is that for every $1,000,000 stock option "payout," somewhere several million dollars were probably paid by the executive to purchase the underlying shares, and there will be many thousands of very happy shareholders who earned similar money for that executive's work.

Much of this is probably academic to readers of this article, because the vast majority of Michigan executives do not participate in stock plans of any type. Only about 10 percent of the participants reported a long-term compensation program, and typically only the most senior executives were participants. The primary reason for this is that most companies are privately-owned, and do not have stock available for options or grants.

Once again, media reports on stock plans are highly deceiving. Lost in recent "revelations" that "two-thirds of all workers" get stock options is the fact that the quoted statistics refer to studies of the largest U.S. industrials and ignore the vast majority of the workforce in the government and service sectors or those working for small or privately-held companies. The fact is that, of the 20,000 or so Michigan manufacturing workers ▶

in the companies participating in the 2000 study, no more than 500 are participants in any kind of stock plan.

Perquisites and supplemental benefits — Long the focus of attacks on executive compensation, tax regulations have taken the "fun" out of perquisites. While company cars remain a staple for top executive compensation (about 75 percent), club memberships have gone by the wayside, with less than a third of the participants reporting such a benefit. Rising in popularity — in fact, nearly doubling in prevalence in 2000 — are the "counseling" perquisites; provisions for tax/financial and legal counseling.

Why Conservative Compensation Might Hurt

The tight labor market, the increased need for highly-skilled employees and the success of automotive and other manufacturing employers have resulted in dramatic increases in individual pay levels throughout Michigan. This has occurred in an almost "invisible" way, as surveys statistically do not always validate the reality of hiring and retention difficulties reported by nearly every company.

Premiums of 20 and 30 times above reported labor market rates are being paid to attract even marginal talent, and as one Human Resource executive succinctly put it, "half of my time is spent looking for high quality employees and the other half of my time is spent making sure that none of them become indispensable."

The pressure this causes is obvious. Most companies will not give their managers and executives 20 to 30 percent raises simply because the funds need to be given to new hires or to their subordinates who threaten to leave. This may reduce the pay differential between manager and staff member to minimal levels, or in some extreme cases result in the manager earning less. The concern is most significant for small manufacturers who suffer the most from pay compression. This problem is borne out by the results of the two most recent MRC InfoSeries compensation surveys.

An Example: Engineering Professionals and Management

In last fall's *MMA Cash Compensation Survey*, participants reported salaries for engineers that match, or in some cases exceed, the average salaries for engineering executives reported in the *MMA Executive Compensation Survey* in March. This trend appears even more dramatically when controlled for size. For example, overall average base pay for senior product engineers was reported at just less than $60,000 last fall. The comparable statistic for top engineering executives this spring is $81,200. Assuming a conservative four percent increase in salaries on January 1, the senior engineering staff earned about 75 percent of their managers. In smaller companies (less than $10 million), senior product engineers averaged about $67,000, compared to only $72,000 for the top executive in that group. January 1 raises likely brought senior subordinate pay to within three percent of executive pay.

While part of this problem can be explained by different samples and matches in survey jobs, the fact remains that while reported professional and management pay levels, as well as executive pay levels, increased sharply in 1999, executive pay does not appear to have continued this trend in 2000. Real-world experience seems to indicate that pay for all other employee groups will continue to increase as long as the economy remains strong and the workforce continues to remain at, or about the same, size. MMA

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The 2000 *MMA Executive Compensation Survey* provides information on pay for executives in 18 different job categories. Data on more than 600 executives was provided by 110 participants who submitted questionnaires in February and March of 2000.

Available now, the report provides information on base pay, bonuses, total cash compensation and W-2 earnings for all employers and in four company revenue categories. Data is also compared by bonus eligibility, company ownership and status as a "senior executive" of the company.

In addition to pay information, survey results include information on annual and long-term bonus programs, supplemental benefits and perquisites. For more information on this report, contact Management Resource Center, Inc., at 248-362-6745.

To order a copy of this, or any of MMA's human resource reports, use the order form on the inside back cover of this magazine.