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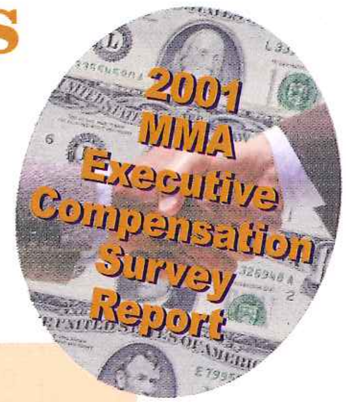
Executive Compensation may be lower than it should be in closely-held companies.

2001 MMA Executive Compensation Survey Report p. 12

Well-Structured Executive Compensation Plans Will Help Ensure a Healthy Business



By Edmund B. Ura

Almost every manufacturer eventually brings in an "outside executive." Whether it's to provide an essential, but missing, skill set or to infuse new life in the company through outside ideas — it will happen.

Sometimes growth forces the issue. The 2001 *MMA Executive Compensation Survey*, part of the four-report *MMA H.R. InfoSeries*, suggests several revenue points at which companies tend to bring in outside executives; $10 million, $20 million and $50 million, depending on the company's type of manufacturing. Sometimes, a change in control from one generation to the next, or the end of a battle for power among siblings or partners, sparks it. Occasionally, a new owner sees what the previous owners never could. However, no matter what the cause, eventually your company will have to hire executive level talent from the "outside."

A broad range of issues are raised, both philosophical and practical, when a company first considers hiring an outside executive. These issues, from the exposure of confidential personal financial information to the decision about whether company stock will be offered to the "outsider," often result in gnashing of teeth and long hours of agonized discussion. For those who have tried and failed on the first attempt to hire from outside, the result can be long years of avoidance before the necessary attempt is made again.

Thousands of books and journal articles offer advice on the philosophical aspects of hiring the outside executive, but few truly address the market realities, such as those exposed by this year's survey:

- The vast differences in compensation levels between professional vocations make "same pay" policies for siblings or partners in a manufacturing firm dysfunctional, particularly in comparison to outside executives' compensation plans.
- Holding down family or partner executive compensation places a significant burden on the process of hiring outside executives.
- Holding down executive compensation unnecessarily impedes the accumulation of wealth and makes transition of ownership more difficult than it needs to be.
- The illusion that privately-held companies cannot mirror the attractive programs of their publicly-traded cousins unnecessarily restrains creativity in executive compensation program design.

The bell tolls for "same-pay" philosophies

It's very easy to spot an "old-style," closely-held or family-owned company from a survey questionnaire. They are revealed by a series of jobs with the same base salary, from the top operating executive to the office manager. Often families set base salaries at the same rate in order to minimize conflict among siblings, in an attempt to be "fair." In many such situations, however, what is done to achieve "fairness" usually results in the opposite — resentment and frustration. Regardless of where the base level is set, one result is clear: paying several senior-level managers, from diverse functional areas, the same base will result in overpayment of some and underpayment of others, relative to the market. About a quarter of the more than 100 companies participating in the *2001 MMA Executive Compensation* survey illustrate this pattern.

The first step in sound executive compensation planning for a closely-held manufacturer is to realize that the labor market is just as important for senior managers as it is for tool and die makers. The competitive market must be taken into account when planning executive pay, in order to set the stage for the entry of outside executives, and to show insiders (even family members) that pay does relate to contribution. This reality is underscored by the results of the survey, which once again revealed that closely-held companies are holding down executive pay growth in the face of rising professional and managerial salaries — setting the stage for disastrous results in the future. Figure 1 below illustrates the trend of base pay for three key executive positions, as represented by regression predictions, for a $20 million manufacturer, over the last nine years.

Figure 1

If a family's or owner's philosophy is that the company's income should be shared, it should be provided for elsewhere, not in base compensation and incentive programs. Sharing in these areas is dysfunctional for everyone, and achieves only a patina of harmony under which lies a high level of resentment.

Bringing in the outside executive

In the past, the normal "entry point" for outside executives was the manager or junior executive frustrated with the hectic pace and anonymity of the large corporate world, who longed for peace and quiet, as well as recognition, and thought it could be found in a small- to mid-sized company. Typically, the tradeoff was future compensation "potential" for peace of mind; rarely did an individual take a pay cut in order to move to the perceived idyllic job. Survey data from prior years illustrated that executive compensation in smaller manufacturing companies was at, or close to, that of middle managers in larger firms.

The new reality is that middle management market pay levels have increased to the point where they exceed — often by 20 or 30 percent — the opportunities available in executive roles in smaller companies. For a relatively conservative illustration of this point, consider the accounting and financial profession, which has experienced relatively stable compensation growth, and is also a prototypical example of an entry point into the closed-company world. Figure 2 (top) illustrates the change in potential over the years.

In 1993, an accounting manager leaving a larger ($50 million in sales or more) company for a smaller (less than $50 million) company to become a controller would see virtually no compensation impact. By this year, the difference between the two jobs has increased more than 250 percent, to the point at which our hypothetical accounting manager, at the mean of the market, would see a pay reduction of 10 percent, as well the lost income potential, to take the formerly attractive job at the smaller company.

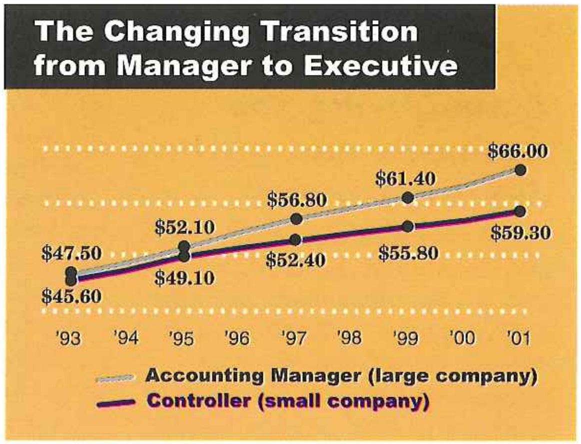


Figure 2

Very recently, a client expressed her frustration concerning the seeming inability of her outside executives to translate her strategic vision into an operating plan. Without considering any of the individuals involved, it was clear that her situation was similar to that of many company owners. How do you treat these "outsiders" that are brought in to modernize the company and move it forward? If an owner wants "executive-level" strategic planning, independent thinking and the spirit to make a long-term, high-level effort, the individual must be treated like — and paid like — an executive.

Clearly, smaller companies' executive compensation programs, as expressed in the survey results, illustrate that for some positions, owners are either willing to settle for, or only able to attract, "follow-the-book" managers. ▶

Transferring the business and getting the wealth out

Whether it was opening a tool and die shop in the 1940s or a "dot-com" in the 1990s, most business owners started with the same premise — an "idea" that they planned on taking to the point where they could develop "wealth." True wealth, of course, is measured by the assets held by an individual, but in practice what feels like wealth is the liquid assets readily available to an individual. Business owners can translate their equity to cash by borrowing against their business, or through the more common method of selling the business, either to family members or outsiders.

A common mistake business owners make is to hold down their compensation in order to increase the value of the business, thinking they'll take their "windfall" when the business is sold. Unfortunately, as many find to their dismay, their children or outside investors simply don't put a value on effort expended 30 years ago when deciding how much they wish to pay for what's in the plant today.

The answer to this problem is a well-structured, accounting- and tax-advantaged approach to executive compensation. Building a truly competitive compensation plan has the multiple advantages of not only eliminating the competitive disadvantages noted earlier, but also putting cash in the hands of those who built the company or those who might, one day, use that cash to purchase the company. Well-designed compensation plans can ensure that the cash remains available to the company until it's needed.

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Yes, you can be creative too!

Twenty years ago, the "creative" approach to compensation in a family-owned company was the end-of-the-year, annual bonus based on profits. Today, the small, private company has the same opportunities that any public monolith has to provide competitive executive compensation. The opportunities lie less in the reality of what can or can't be done, but simply in devising creative methods to design an attractive plan. Privately-held companies can use equity or "phantom equity" to mirror performance — not only the company's, but the stock market's as well — using formulas and indices to "imply" a value for the stock that will reflect not just the strategic plan of the owners, but simulate the value of the company to an independent purchaser.

Creativity in executive compensation plan design is not simply a windfall for compensation consultants. It's a necessary response to the realities of today's competitive marketplace. Whether it's the family, the founders or the outsiders, everyone at the executive level must be focused on the company's vision. Necessarily, this requires thinking beyond the end of the fiscal year. It's no surprise to owners or executives anywhere to hear of decisions made on December 30 to impact the current year's bonus compensation — often to the detriment of next year's results.

It's obvious that long-term compensation strategies are essential to the accomplishment of long-term results. However, while more than three-quarters of executives in the 2001 survey participate in annual bonus plans, far fewer than 10 percent participate in plans that measure performance over more than one year. It's hard to imagine expecting outside executives, without an equity stake of their own, to act like owners if their behavior is motivated toward only short-term results.

Building in an insurance policy

What keeps all of the creativity and cash payments to owners safe from the IRS and the Securities and Exchange Commission? First, rely on sound business information from your company's professional advisors. Second, establish an outside component to the Board of Directors. Outside directors serve an important role. In addition to the obvious function of providing exper-

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tise and an outside view of planning and progress, they provide a "disinterested" view on compensation programs, which lends support to decisions and provides evidence in cases where the "reasonableness" of compensation is brought into question. Because of the minute number of companies reporting independent or "outside" directors, this year's survey eliminated information concerning their pay practices.

Small- and mid-sized companies must respond effectively to significant challenges in the years ahead if they expect to grow in a highly complex and competitive marketplace. A company's direction must be set by those with a vision, and by those at the executive level who translate that vision into operational plans and programs. To ensure that your business attracts and retains talent, executive compensation programs and policies must be developed that are competitive, and encourage long-term commitment to the company.

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