

Restoring Investor Confidence by Reinventing Pay for Performance For The Knowledge Economy

Real Work, Real Leadership, Real Value

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Evaluating Leadership Performance

- How do you really measure Leadership Capital that contributes to short, medium & longer term Value Creation ?
- How do you structure the organization, design differentiated metrics & decision making/authority into the organization to unleash intellectual capital & create value at ALL Leadership Levels ? How many organizational layers are really required ?
- What leadership capabilities & mindsets should be recruited / developed to deliver value creating performance & return, medium to longer term?
- How do you link to Performance to Compensation ?

Our Journey of Discovery

- Boards, CEO's, CFO's and Investors using inadequate metrics & many companies NOT structured for long term value creation
 - Board Governance & Pay for Performance is not working - systemic problems
- Linking Organization Structure / Design and Value Creation
 - Creating the Viable / Sustainable Business Model
- Levels of Work and the Complexity Based Organization™
 - A new model for accountability & decision making for the Knowledge Economy
- Leadership Value Added - LVA™
 - Assessing / Developing Leadership at all Levels that delivers real value
- Measuring & rewarding what really counts!
 - There really is still NO link between pay & performance in most organizations!

Accountability

Wrong Work & Wrong Metrics

- Too many CEO's and their executive teams are held accountable for the wrong work and wrong metrics
 - Mostly operational and short term
- Many companies have title and pay inflation relative to the real work their executives are currently held accountable for, and the true value created

From Owner's Capitalism to Manager' Capitalism & Back ?

- “Manager’s capitalism emerged where the corporation came to be run to profit its managers not maximize the return on invested capital for the majority owners”
- “When executives are paid to raise the price of their company’s stock rather than increasing their companies value they don’t need to be told what to do:
 - First, increase revenue, cut costs, raise productivity, launch new technologies, develop new products services, and meet your public guidance targets without fail
 - When ‘making it and doing it’ does not work, meet your goals by financial engineering & pushing accounting principles to the edge
 - When that is not enough - CHEAT”

John Bogle, Founder and Chairman, The Vanguard Group

Reforming Corporate Governance

- Equity Capital is not free
 - No charge for Cost of Capital in calculating earnings / pay linked to earnings
- Stock Options are not free
 - Dilution
 - Cost of an option on the open capital market
- Many Boards, VC's, CEO's, CFO's think they are ?
- “If you can realign executive pay, it's the predicate to corporate governance reforms.”

*Bill Patterson, Head of AFL-CIO's
Office of Investments*

Finance, Accounting & Value Creation 101

- Too Many Accounting Measures Don't Capture Real Value Creation
 - Revenue / Cost / Earnings = EBIT, EPS
 - Cash = EBITDA
 - Investment Return = ROA, ROE, ROCE, CFROI
- Value Creation = Economic Profit
 - EP = Invested capital X (ROIC - WACC)
 - If ROIC < WACC then value is destroyed
 - EP = NOPAT minus a capital charge \$ for invested capital
- May also need to include a “Risk” adjustment threshold
 - Risk free T-bill - 4 to 5 %
 - Where is pay linked to risk adjusted return & value creation ?

Restoring Confidence in Measuring Leadership Performance

- Generally Accepted Accounting Principles = GAAP is flawed
 - Fosters earnings game - too many degrees of freedom on reporting
 - Fails to expense stock options, includes pension gains and asset sales in earnings
 - Mixed model including historical cost, amortized cost, current value
 - R&D, Marketing, HR investments are expensed and not matched to revenue
 - Does not include a cost of capital (WACC) charge in calculating true earnings and true viability of the business model (8 - 12 % cost)
 - Varies by country around the world
- S&P Restoring Some Credibility in Earnings Data-
“Core Earnings”
 - Expense Stock Options
 - Exclude pension gains
 - Included restructuring charges from ongoing operations
 - Exclude gains and losses on asset sales
 - 83 % of GAAP Earnings and this does NOT include a capital charge

Earnings Per Share is NOT an Effective Measure

- Does not tell you
 - Risk
 - Capital Intensity / New Capital required for Growth
 - Charge for Cost of Capital
 - Time Value of Money
 - Future Free Cash Potential
 - Most companies, does not include cost of stock options
- Is used because of
 - Simplicity
 - Commonality
 - Can be manipulated to give you the number

Equity Compensation & Quarterly EPS

- “I wish managers would throw earning per share overboard and had the fortitude to run their businesses based on more appropriate long term economic measures”
- “Managing earnings at the expense of value creation is undesirable”
- “Too often equity compensation is going to everyone, and our view is that incentives should be matched up with the levers that an individual can really control”

Mike Mauboussin, Chief Investment Strategist, CSFB

Investment Management 101

- Recent 10 year Returns (ending May 2003)
 - S&P 500 (US) = 10.8 %
 - S&P/TSX Composite (CDN) = 7.8 %
 - MSCI World Equity = 6.8 %
 - Vanguard Total US Bond Index = 6.9 %
 - ScotiaMcLeod Bond Universe = 8.7 %
 - T-bill - Risk Free Rate = 4.0 %
- Capital Markets are Efficient, Strategic & Forward Looking
 - Biotech & Internet - Big Market Caps & NO Earnings

Internal Value Creation & Market Value Added / Total Enterprise Value & Shareholder Returns

- Correlation of Business Performance and MVA / TEV
 - Economic Profit / Free Cash Flow = 50 %
 - Return on Equity = 35 %
 - Earnings Per Share Growth = 18 %

Source: Credit Suisse First Boston

Wealth & Value Creation Two Measures

Δ Economic Profit (EP) =

Yr/Yr Δ Net Operating Profit
After Tax minus Weighted
Average Cost of Capital

Positive	Hidden Value	Value Builders
Negative	Value Destroyers	Value Myths
	Negative	Positive

Market Value Added (MVA) =

Δ Total Market Value of Shares & Debt
Minus (Total Capital Raised+ Retained Earnings)

Leadership, The Business Model & Value Creation In Canada

Δ Economic Profit =

Yr/Yr Δ Net Operating Profit
After Tax minus Weighted
Average Cost of Capital

Positive	<u>Hidden Value</u> 11 %	<u>Value Builders</u> 24 %
	<u>Value Destroyers</u> 48 %	<u>Value Myths</u> 17 %
Negative (65 %)	Negative	Positive

Source

1996-1999 Corporate Renaissance Group
Canada Wealth Creation - 453 Public Companies

Market Value Added =

Δ Total Market Value of Shares & Debt

Minus (Total Capital Raised+ Retained Earnings)

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Leadership, The Business Model & Value Creation In the U.S.

Δ Economic Profit =

Yr/Yr Δ Net Operating Profit
After Tax minus Weighted
Average Cost of Capital

Positive

Hidden Value

US 8 %

CDN 11 %

Value Builders

US 57 %

CDN 24 %

Negative

Value Destroyers

US 10 %

CDN 48 %

Value Myths

US 25 %

CDN 17 %

US = 35 %

CDN = 65 %

Negative

Positive

Source

1994-1999 MVC Analysis of
Stern Stewart 1000 = 773 companies

Market Value Added =

Δ Total Market Value of Shares & Debt

Minus (Total Capital Raised+ Retained Earnings)

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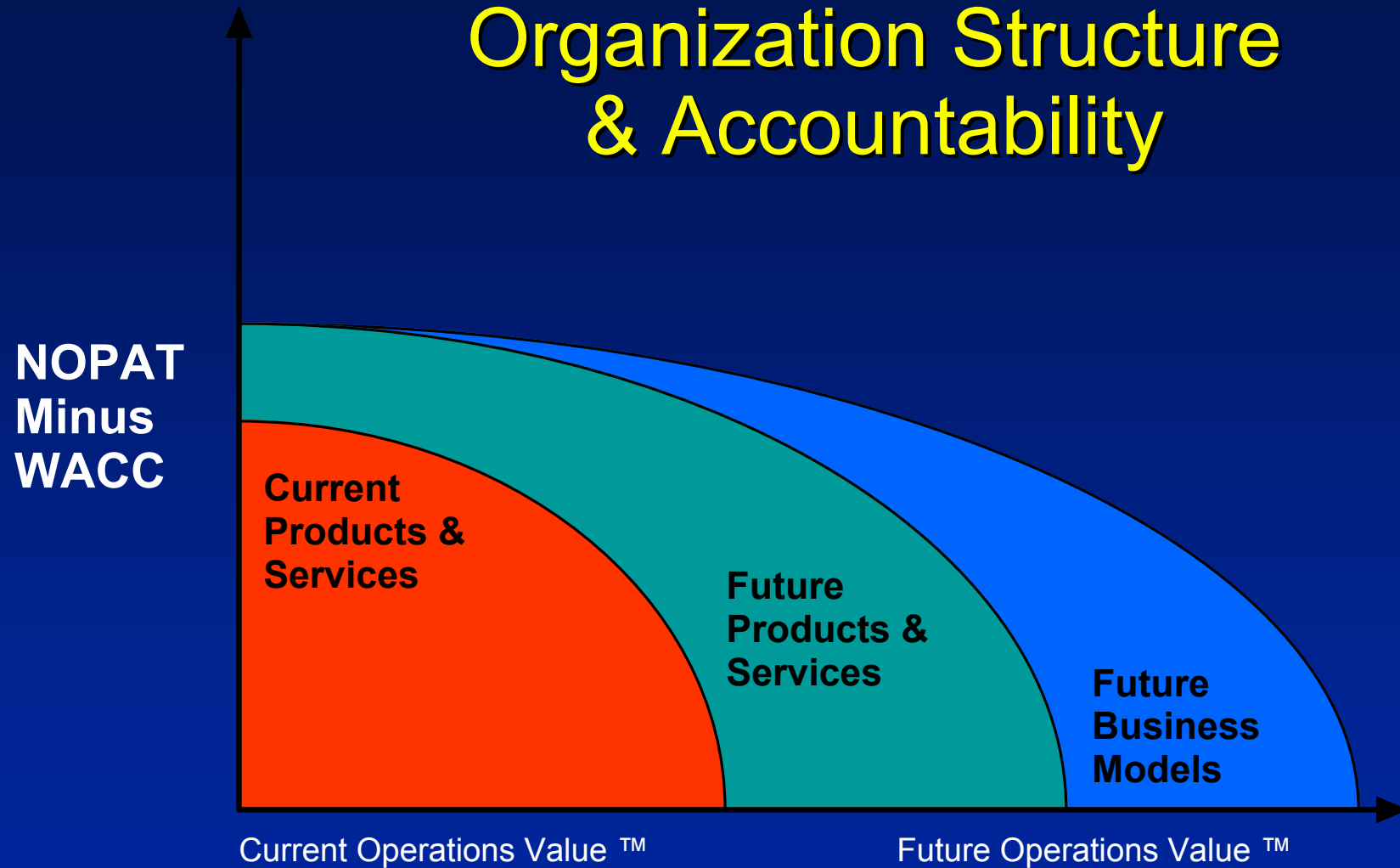
MVC Research Performance Measures & Enterprise / CEO Compensation

- 55 % S&P 500 only measuring and paying based on 1 year results - does not measure value & viability of the business model (NPV or \sum of Δ in net operating profit after tax after cost of capital 3 + years)
- Only 11 % S&P 500 measuring results beyond 3 years
- Less than 2 % measuring beyond Financial Measures: Customer, Suppliers/ Partners, Employees , Environment
 - Governance system is flawed - fails to recognize the complex , non-linear relationships between the enterprise and its business system design, all resource inputs, & the interface with all external stakeholders / societies that impact business system viability, 2- 5 years +

Leadership & The Business Model Make A Difference

Industry Sector / Company	5 year Avg Shareholder Return 94-99	5 yr ² in MVA 94-99 \$ millions	5 yr ² in EP 94-99 \$ millions
Metals - Alcoa	16 %	\$ 5,509	\$ 1,141
Metals - Nucor	4 %	\$ -1,983	\$ -146
Chemicals - Dupont	20 %	\$ 23,196	\$ 4,217
Chemicals - Great Lakes	- 8 %	\$ - 2,964	\$ - 186
Healthcare - Pfizer	49 %	\$ 132,793	\$ 1,264
Healthcare - Bausch & Lomb	6 %	\$ 95	\$ - 17
Retail - Walmart	10 %	\$ 113,538	\$ 638
Retail - Toys-R-U's	- 16 %	\$ - 8,836	\$ - 417
Semiconductor - Intel	50 %	\$ 150,391	\$ 2,886
Semiconductor - National Semi	- 4 %	\$ - 1,345	\$ - 45
Software - Oracle	38 %	\$ 29,263	\$ 833
Software - Novell	- 3 %	\$ - 1,222	\$ - 290

Market Value Organization Structure & Accountability



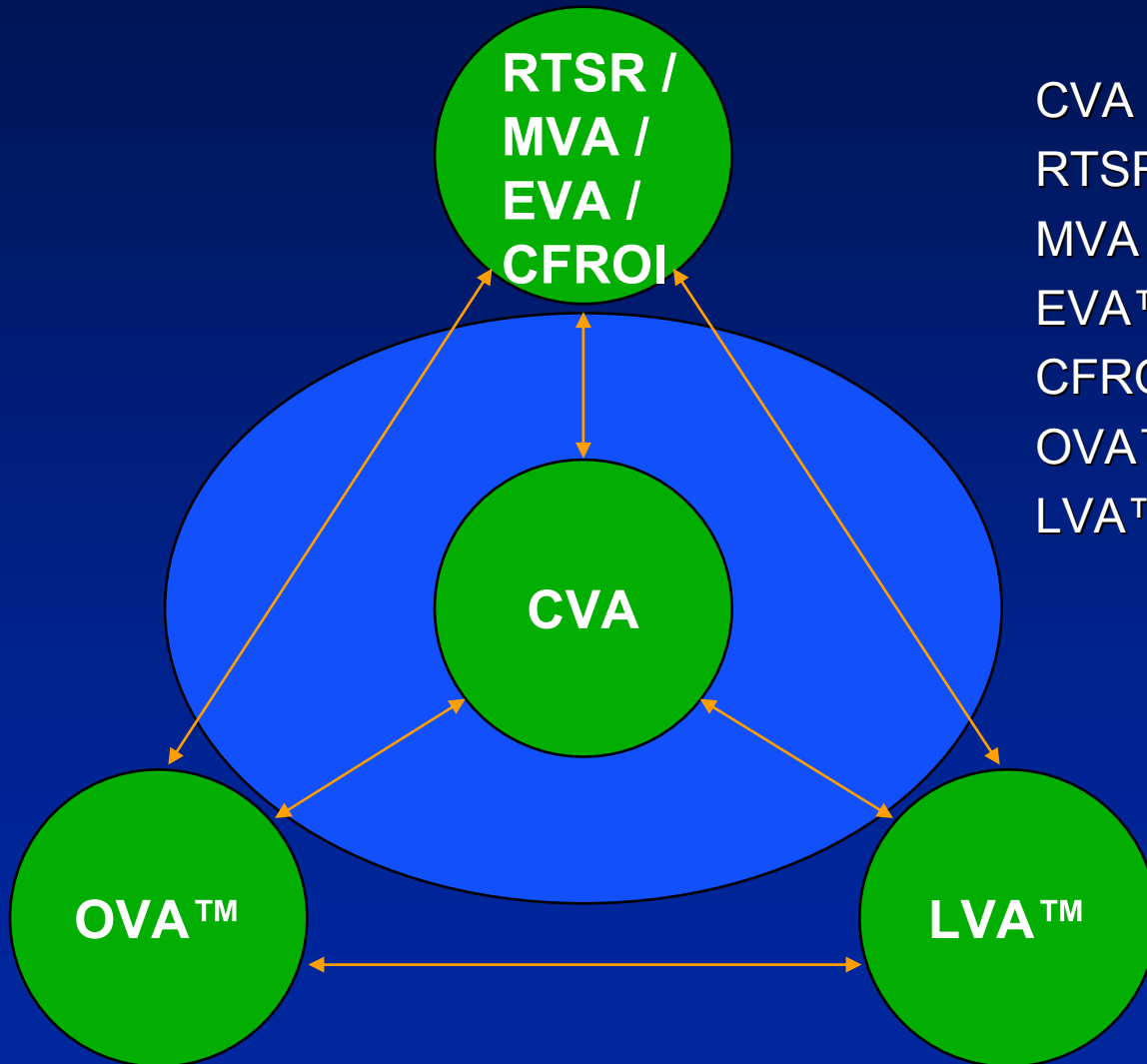
Competitive Advantage Period

COV and FOV trademark Stern Stewart

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Value Creation Model

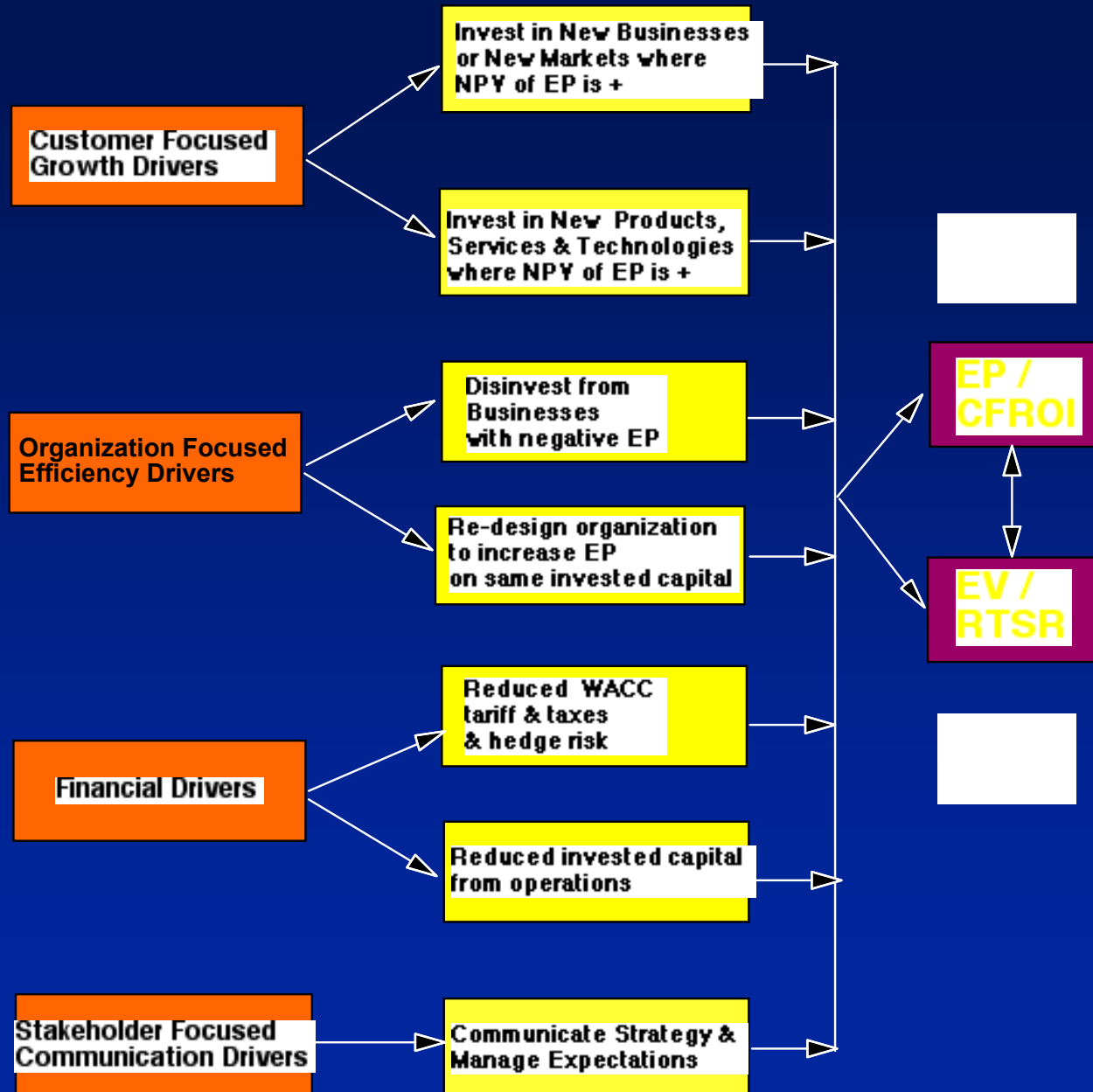


- CVA = Customer Value Added
- RTSR = Relative Total Shareholder Return
- MVA = Market Value Added
- EVA™ = Economic Value Added (Stem Stewart)
- CFROI = Cashflow Return On Investment
- OVA™ = Organization Value Added (MVC)
- LVA™ = Leadership Value Added (MVC)

Value Drivers

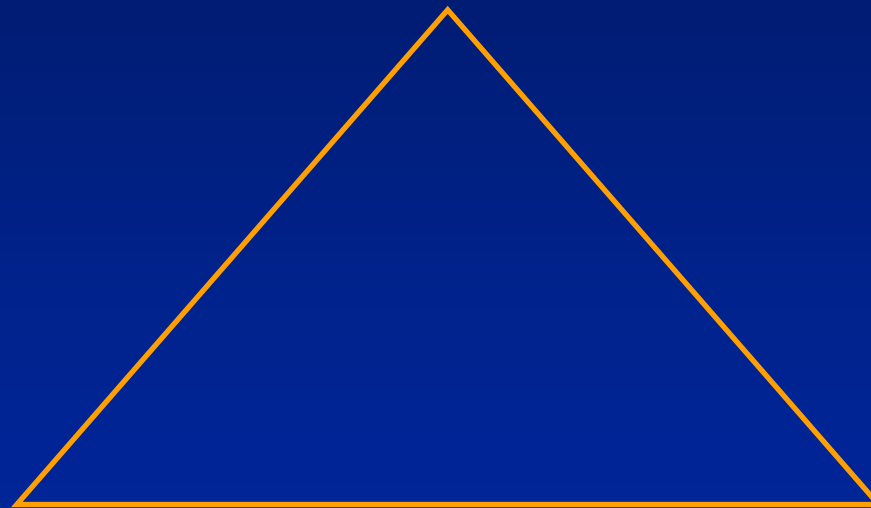
Path To Value

Value Measures



Designing Levels of Accountability and the Complexity Based Organization™

Business Planning &
Performance Measurement



Organization / Work Design

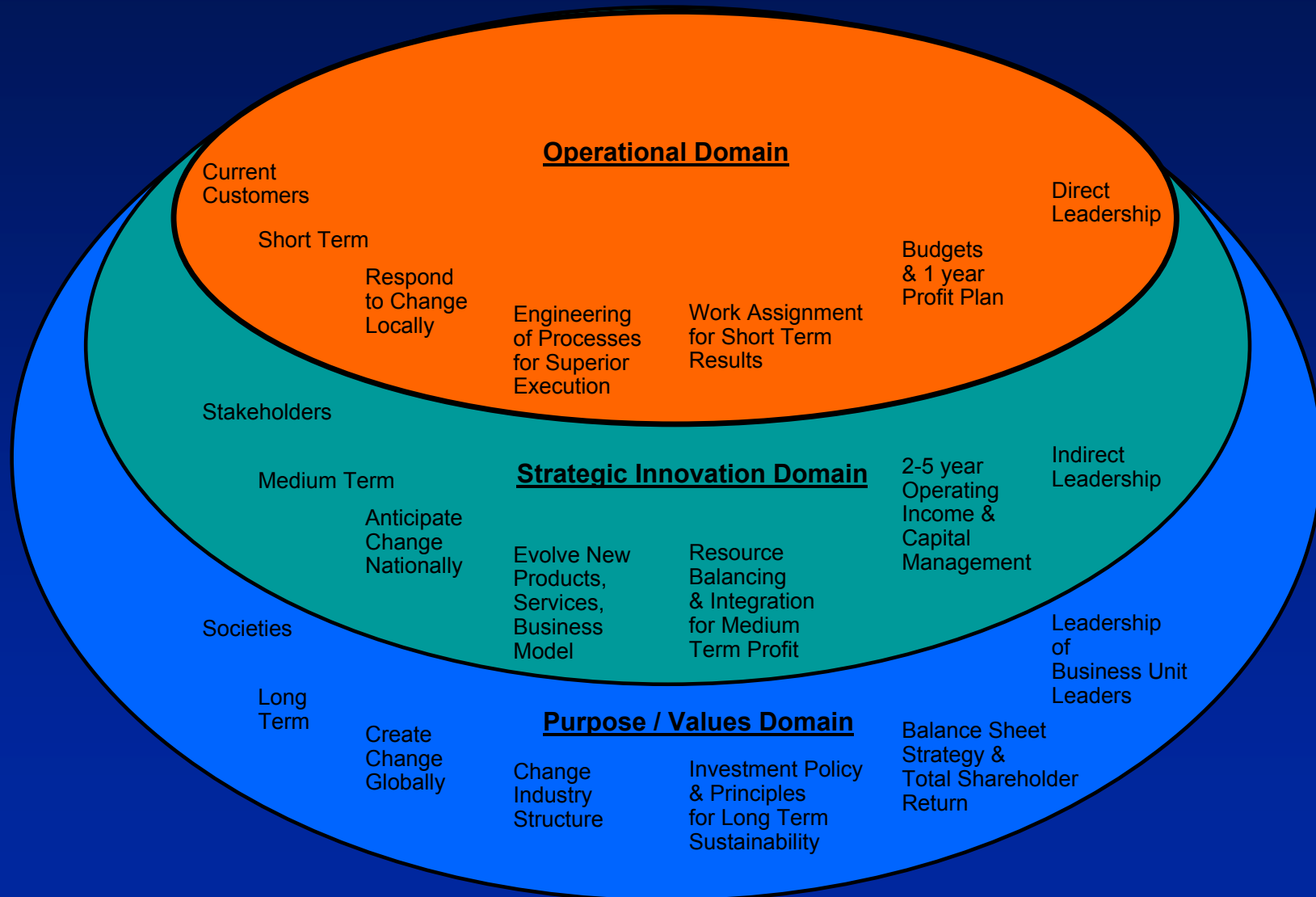
Leadership Capability
& Talent Management

Creating The Right Structure of Work Design & Accountability

Organization Value Added-OVA™

- Too many managerial layers NOT adding real value !
 - Big titles and over paid for lack of unique contribution / decision authority
- Work that creates a unique output, adds to future growth & viability of the business, & uses resources efficiently
- Nested Work Processes & Accountability structure where roles have distributed & differentiated decision making that varies by each Level of Work Complexity
- Executive Leadership is about creating the right structure that provides clarity of work design for career development & executive selection, concurrent with creating value

Three Distinct Work & Leadership Domains For Value Creation

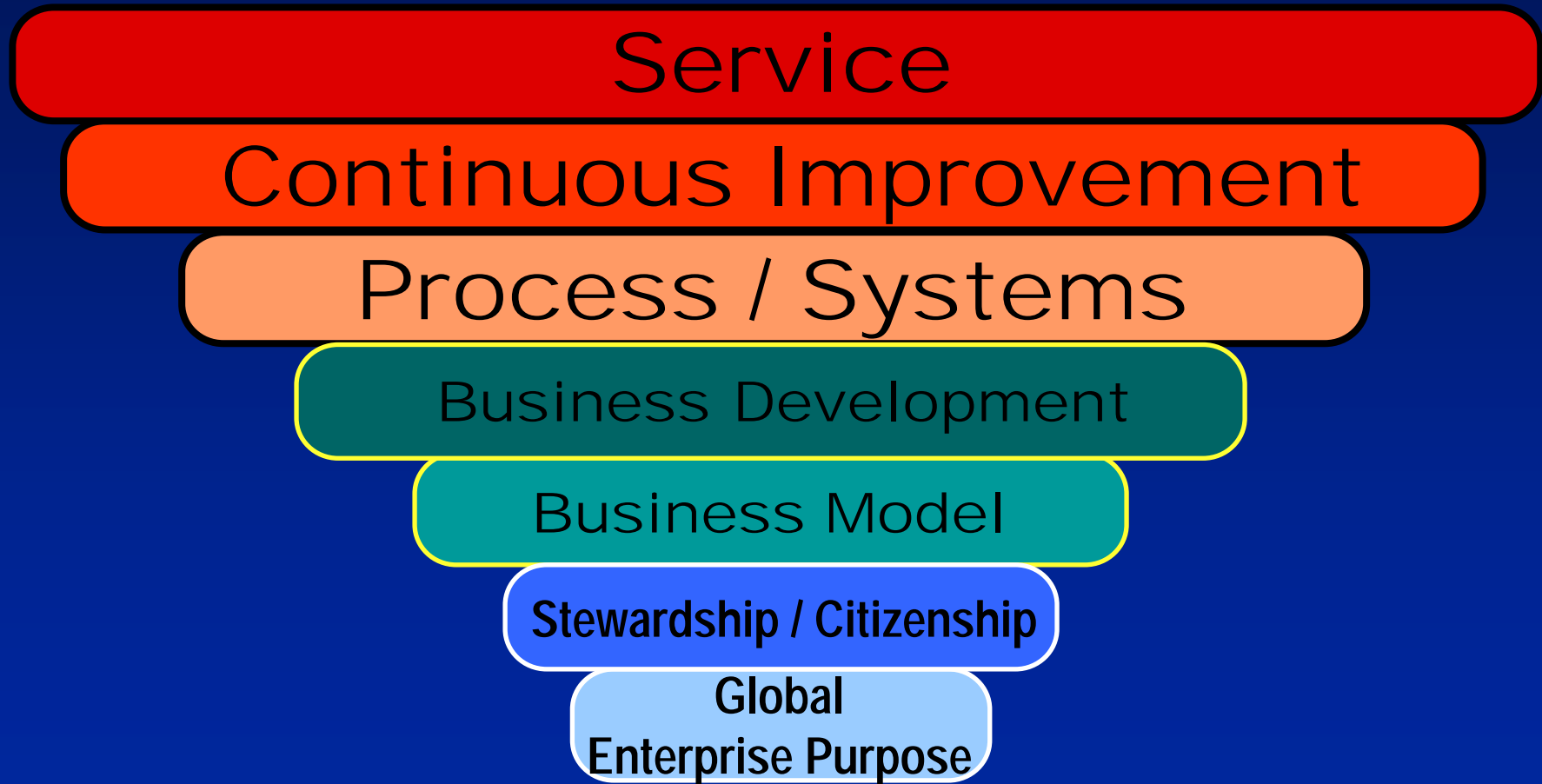


Complexity Based Organization™

(Levels of Work Complexity & Accountability)

	Innovation Level	Planning Horizon	Resource Management	Results	Leadership	Customer
Growth Horizon 1 <i>Defend & Extend Core Business</i>	Service					
	Quality / Continuous Improvement					
Growth Horizon 2 <i>Build New Businesses For Medium Term Profitability</i>	Process					
	Business Development					
	New Business Model					
Growth Horizon 3 <i>Strategic Investments To Secure Long Term Future and Enterprise Sustainability</i>	Stewardship / Citizenship					
	Global Enterprise Purpose					

Complexity Levels of Innovation



Complexity Levels of Leadership

Lead Self

Lead Team

Lead Others Who Lead Teams

Lead Multiple Functions/Processes

Lead Business

Lead Businesses

Lead Global Enterprise

Complexity Levels of Resource Management & Planning



Planning & Resource Management Complexity Jumps

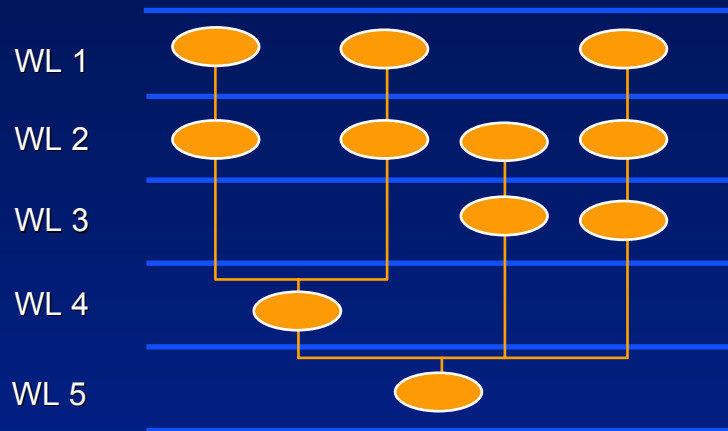
- Elliott Jaques' findings on time-span:
 - Planning
 - Discretion
 - Accomplishment
- US Army 10 years + of Leadership research confirms quantum jumps in conceptual capability at each Complexity Level as # 1 predictor of executive success, potential or derailment
- MVC Assoc Intl research (350 + interviews, etc) confirms levels of conceptual capability & time-spans still valid

Complexity & E-Capability

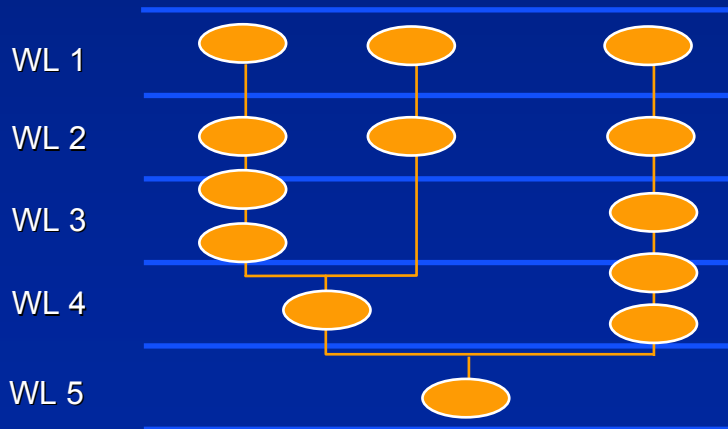
- Each Level of Work is different & requires different focus & different skills
 - WL 3 - E-Process (automating processes through the Internet)
 - WL 4 - E-Commerce (selling new products / new services on-line through the internet) LL Bean, AMEX, Wells Fargo, American Airlines
 - WL 5 - E-Business (transforming the business model & value chain and becoming a customer led enterprise through the internet) Dell, Cisco, Schwab
 - WL 6 - E-Industry (transforming the industry structure through the internet - i.e. B to B exchanges like GM/Ford/Daimler-Chrysler = Covisint)
- Some delegated WL 4 and WL 5 work to WL 3 capable team members - result was a website design and automation of existing processes vs. E-Business strategy

Layering Across Levels of Work Complexity

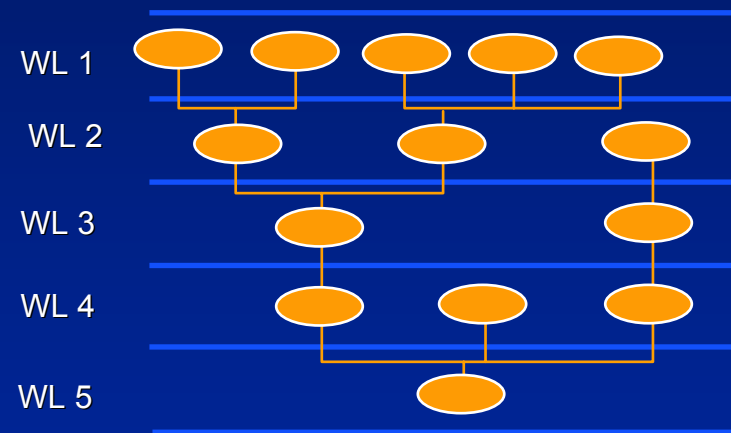
GAPS



JAM-UPS



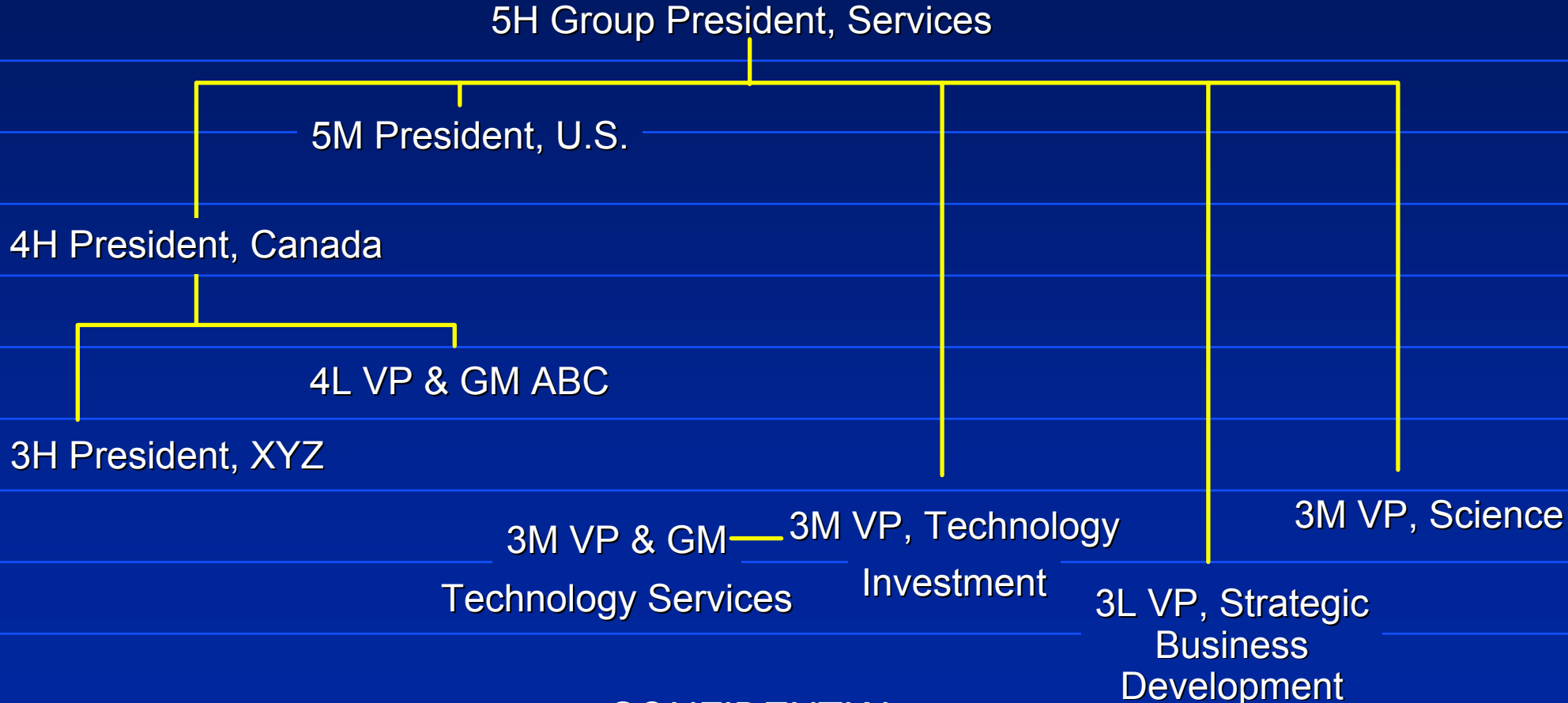
CORRECT



Complexity Level

6H
6M
6L
5H
5M
5L
4H
4M
4L
3H
3M
3L

Organization Value Added -OVA™ Audit



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Leadership & Value Creation

Leadership Value Added-LVA™

- Quantum Difference in Role Design & Skills to Create Customer and Shareholder Value between:
 - General Manager of Business Unit (partial P&L)
 - General Manager of Business Unit (full P&L)
 - General Manager of Multiple Business Units (multiple P&L's = Sector of Businesses across multiple geo-political systems and diverse cultures)
 - General Manager of Global Enterprise (multiple business sectors operating across multiple continents, geo-political systems, & cultures)
- MVC 400 + interviews - surprising number of Board members, CEO's, top HR and leading Executive Search Firms had no discernable point of view on the real differences

Compensation Strategy For a New Organizational Model

- Recognize different Levels of Work & Organization Value Added-OVA™ in determining the hierarchy of Performance Measures
- Differentiates **duration of time of Performance Measurement**
 - based on the Level and Complexity of Work & value created (NOT size of business, budgets & team managed), HR locked in an old industrial model for Job Evaluation & Compensation, with NO link to value creation
- Should include Customer, Company, & Societal measures otherwise will sub-optimize business viability over time
- Link Compensation for public company to metrics / drivers for both:
 - **Internal Value Creation** = Economic Profit AND
 - **External Wealth Creation** = EV / MVA / RTSR metrics
- Decide on Policy for STIP & LTIP plan linked to Performance Measures and Real Value created - **UNCAP BONUSES**

Summary

- There is a direct link between organization structure, leadership capability & market cap in the Knowledge Economy
- **Design the organization structure so value is created in each nested Work Level.**
 - Govern the firm recognizing the Business Strategy and link to Complexity Levels of REAL WORK = Organization Value Added- OVA™
- **Recognize there are differentiated Levels of Leadership capability.**
 - Recruit / Develop executive leadership talent based on Leadership Value Added-LVA™ to drive long term value creation = contribution to Economic Profit & MVA / RTSR
- Design metrics & reward / compensation strategies to reward **REAL WORK & REAL LEADERSHIP** that creates **REAL VALUE** long term!