

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

Real Work, Real Leadership, Real Value

□ Mark Van Cleef

Managing Director, MVC Associates International

Mark@mvcinternational.com

www.mvcinternational.com

Toronto • Tampa

416-399-9061



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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

$\Delta$  **Economic Profit (EP)** =

Yr/Yr  $\Delta$  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)** =

$\Delta$  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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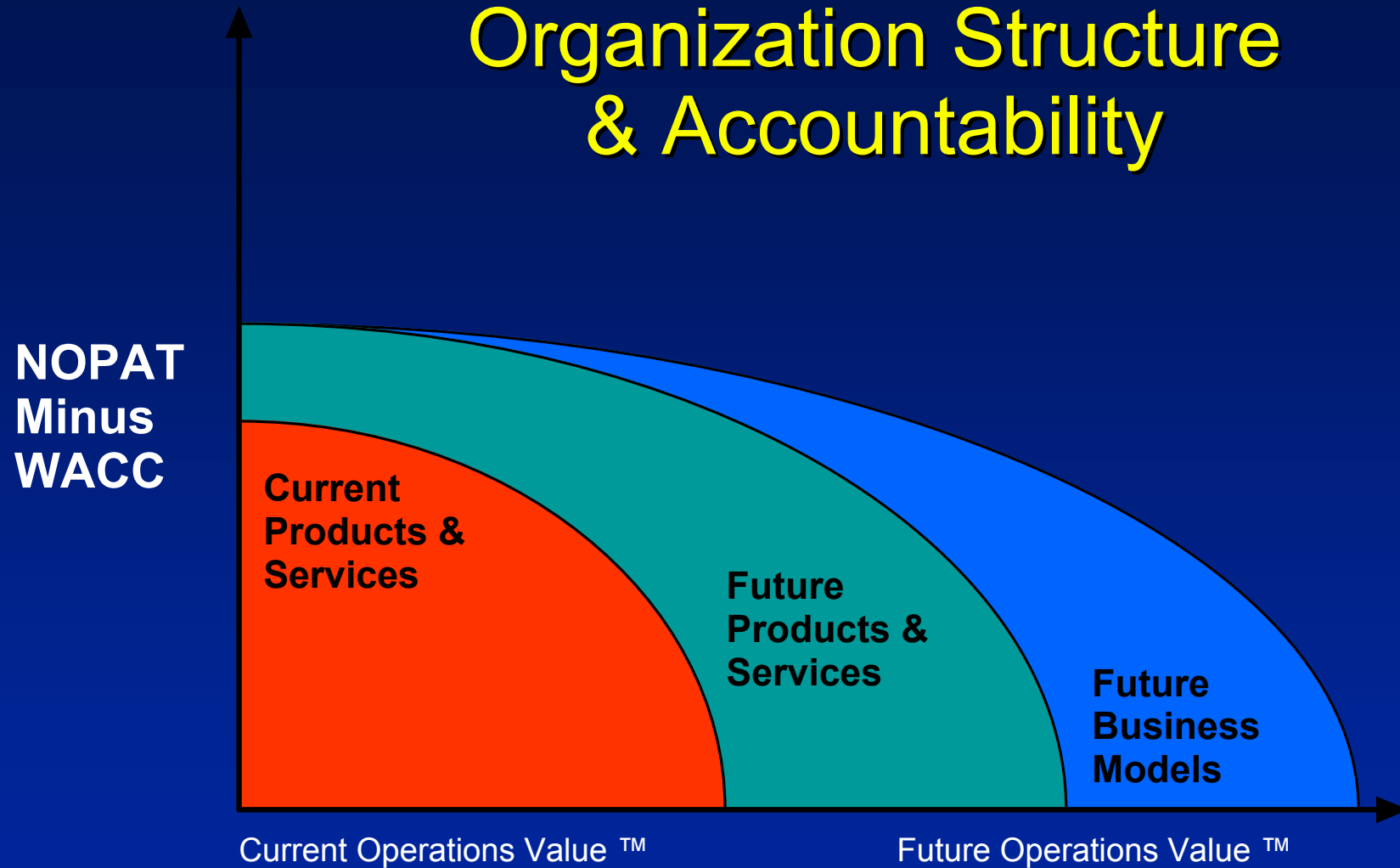
# MVC Research Performance Measures & Enterprise / CEO Compensation

- 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  $\Delta$  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 <sup>2</sup> in MVA 94-99 \$ millions	5 yr <sup>2</sup> 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-Us	- 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



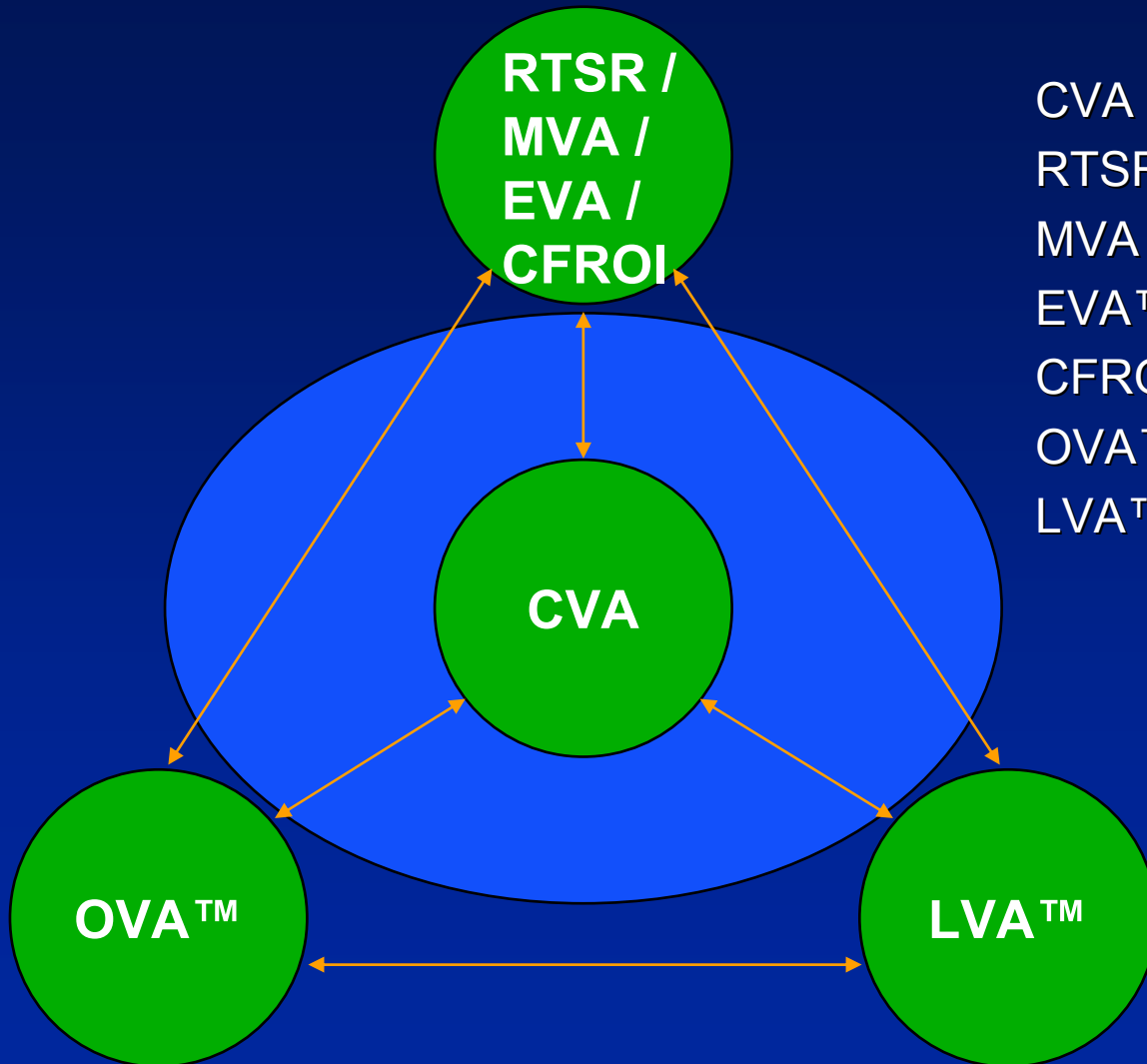
## Competitive Advantage Period

COV and FOV trademark Stern Stewart

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# Value Creation Model

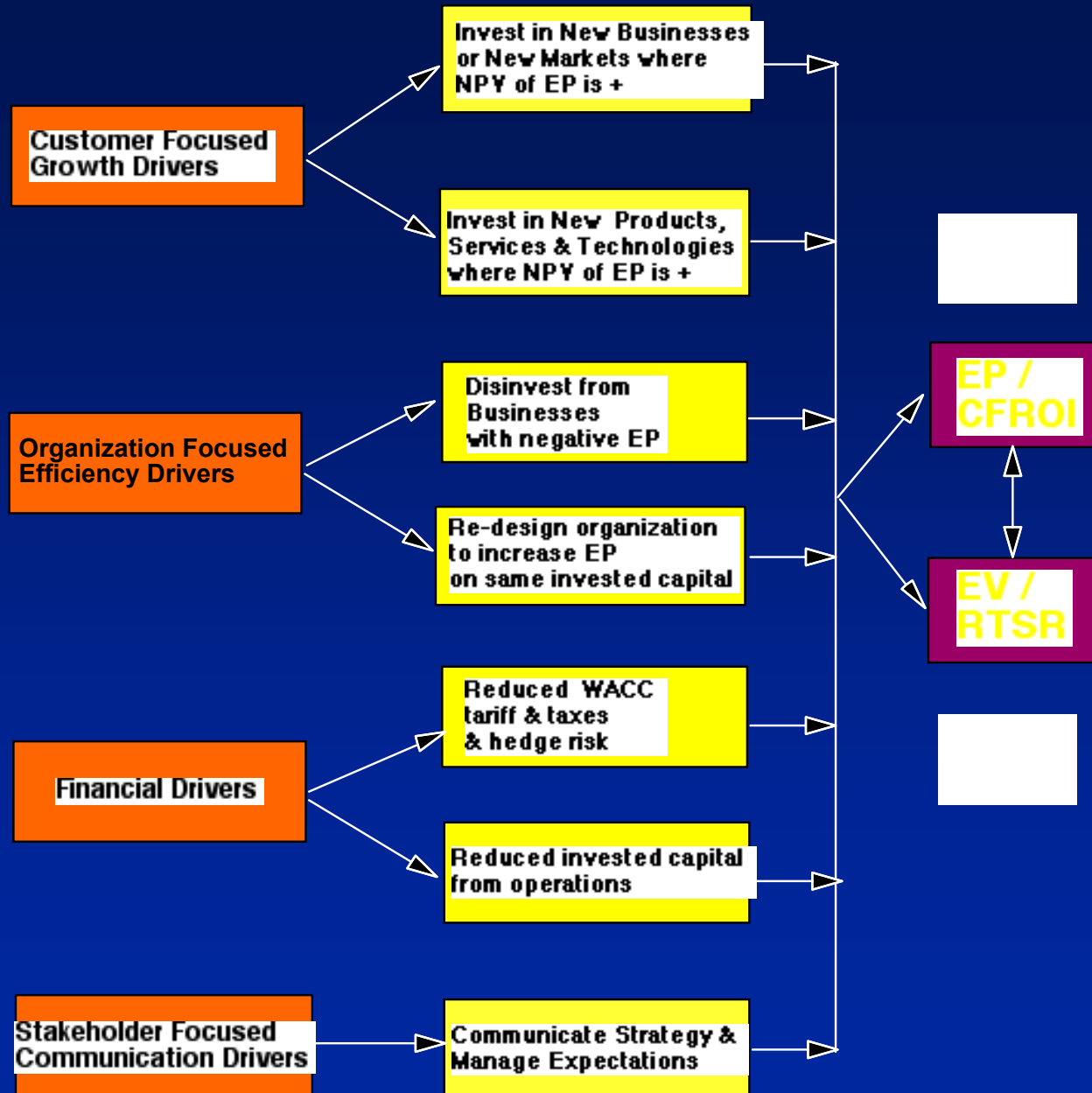


- CVA = Customer Value Added
- RTSR = Relative Total Shareholder Return
- MVA = Market Value Added
- EVA™ = Economic Value Added (Stem Stewart)
- CFROI = Cashflow Return On Investment
- OVA™ = Organization Value Added (MVC)
- LVA™ = Leadership Value Added (MVC)

## Value Drivers

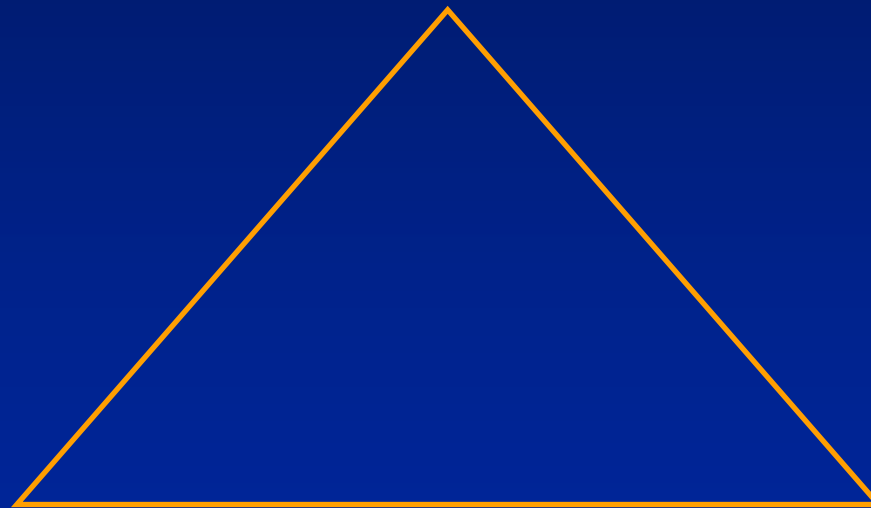
## Path To Value

## Value Measures



# Designing Levels of Accountability and the Complexity Based Organization™

Business Planning &  
Performance Measurement



Organization / Work Design

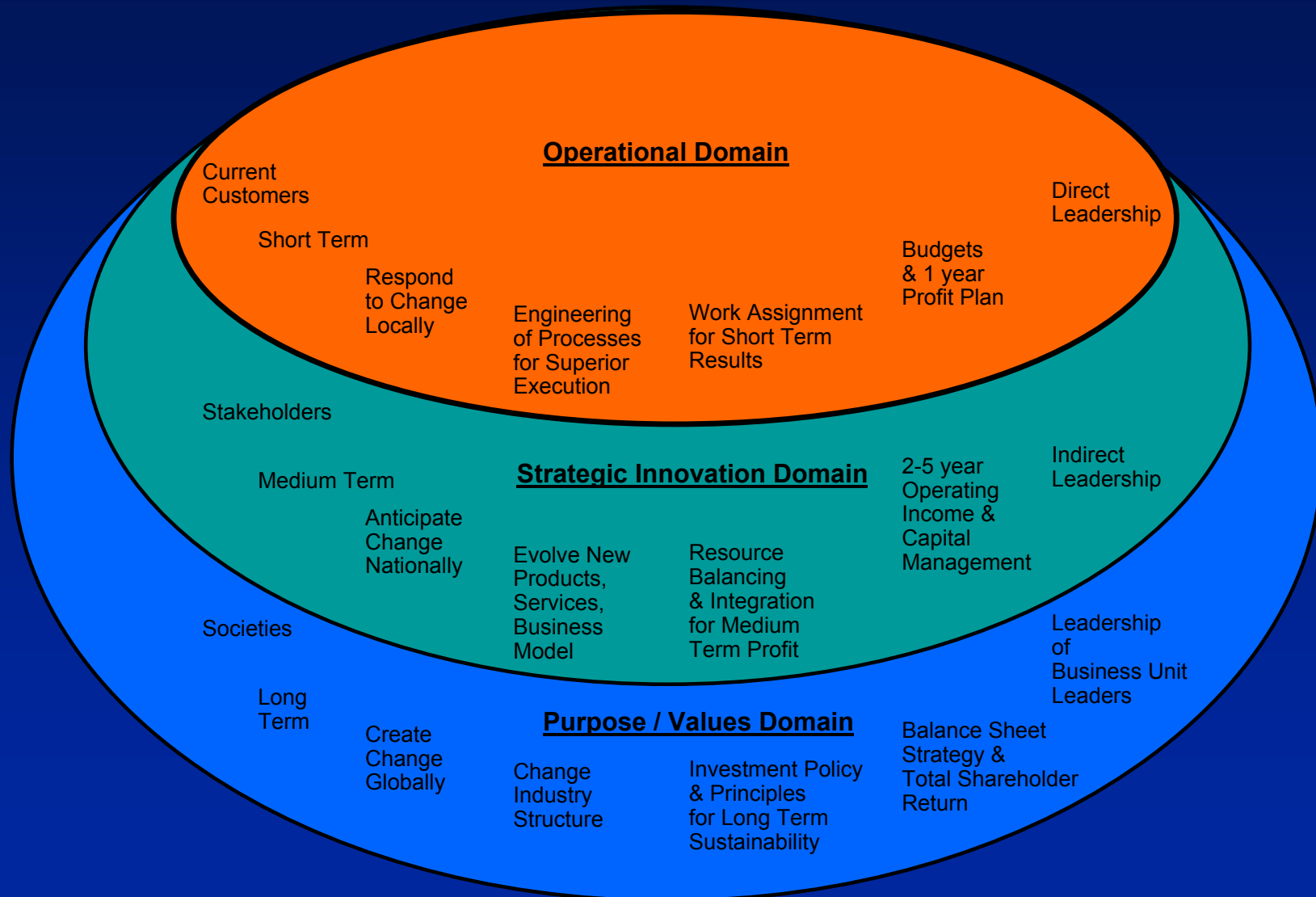
Leadership Capability  
& Talent Management

# 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



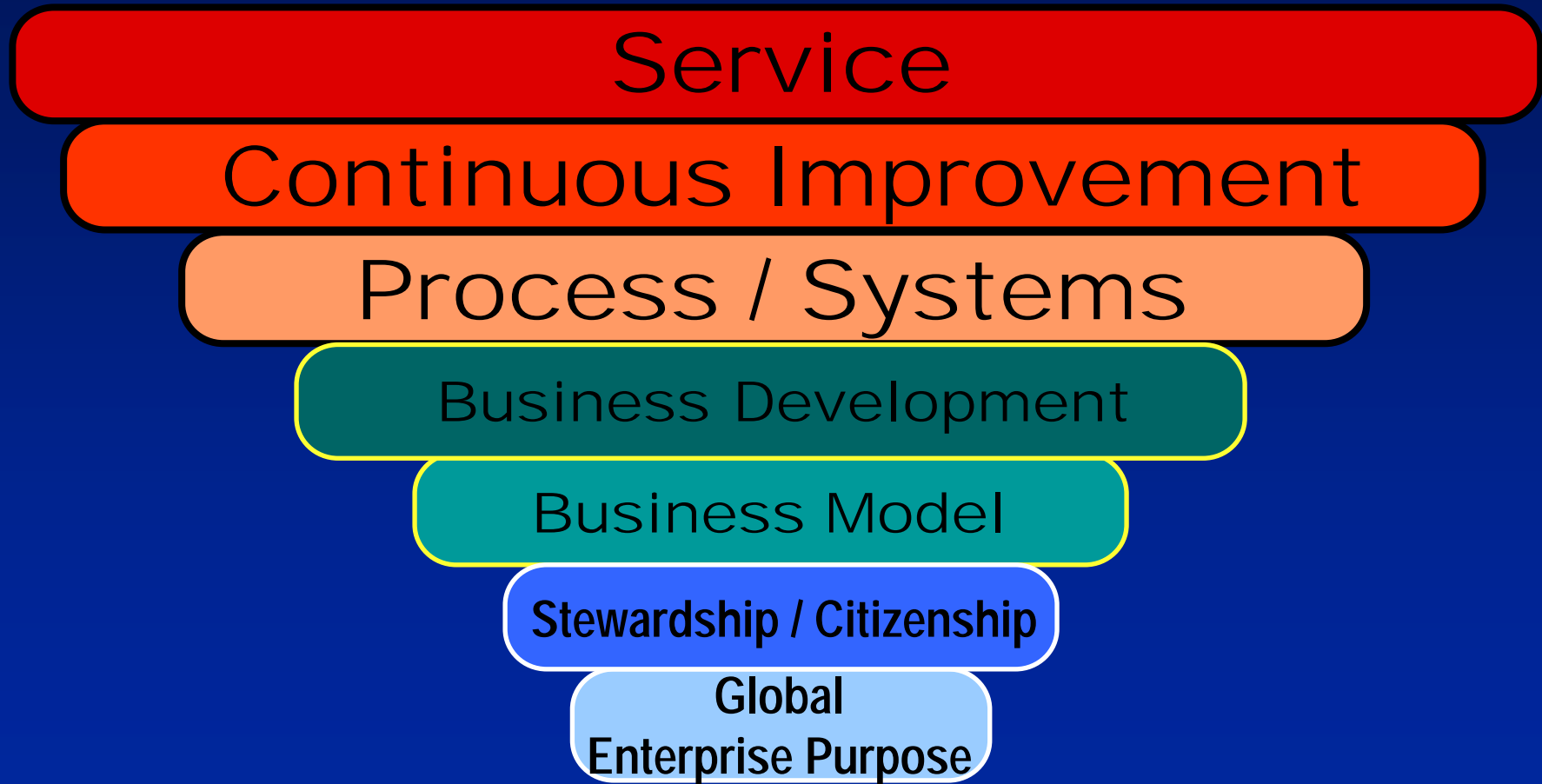


# Complexity Based Organization™

## (Levels of Work Complexity & Accountability )

	Innovation Level	Planning Horizon	Resource Management	Results	Leadership	Customer
<b>Growth Horizon 1</b> <i>Defend &amp; Extend Core Business</i>	Service					
	Quality / Continuous Improvement					
<b>Growth Horizon 2</b> <i>Build New Businesses For Medium Term Profitability</i>	Process					
	Business Development					
	New Business Model					
<b>Growth Horizon 3</b> <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

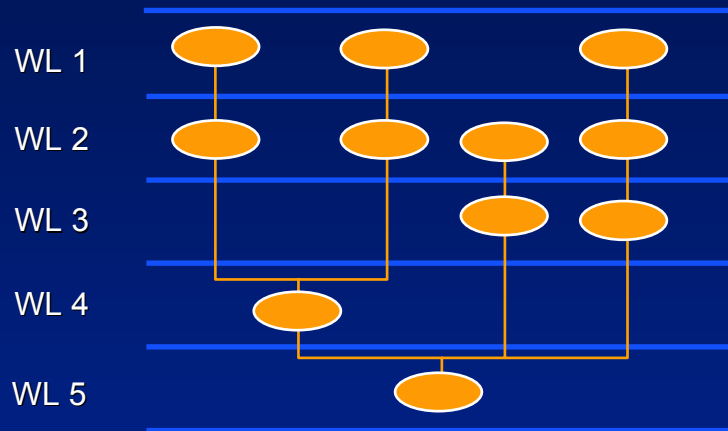
- Elliott Jaques' findings on time-span:
  - Planning
  - Discretion
  - Accomplishment
- US Army 10 years + of Leadership research confirms quantum jumps in conceptual capability at each Complexity Level as # 1 predictor of executive success, potential or derailment
- MVC Assoc Intl research (350 +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

# Complexity & E-Capability

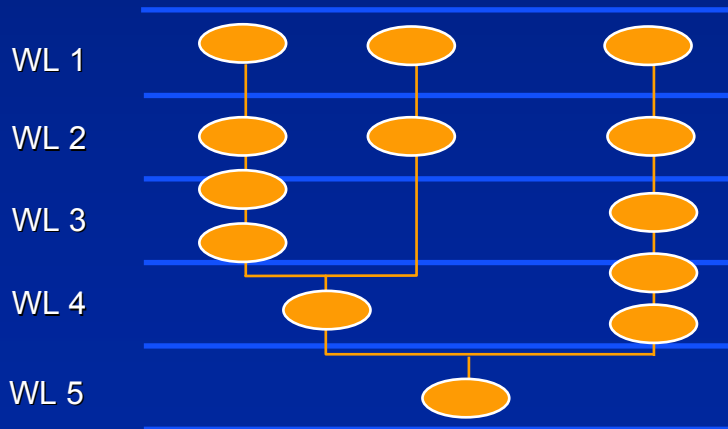
- Each Level of Work is different & requires different focus & different skills
  - WL 3 - E-Process (automating processes through the Internet)
  - WL 4 - E-Commerce (selling new products / new services on-line through the internet) LL Bean, AMEX, Wells Fargo, American Airlines
  - WL 5 - E-Business (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

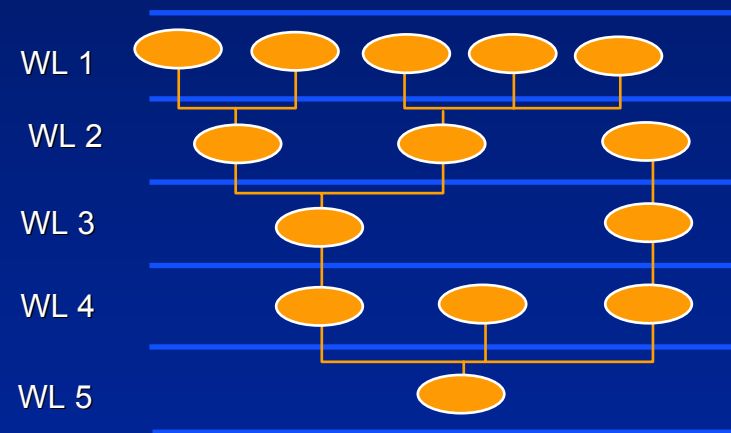
GAPS



JAM-UPS



CORRECT



**Complexity Level**

# Organization Value Added -OVA™

## Audit

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

5H Group President, Services

5M President, U.S.

4H President, Canada

4L VP & GM ABC

3H President, XYZ

3M VP & GM  
Technology Services

3M VP, Technology  
Investment

3L VP, Strategic  
Business  
Development

3M VP, Science

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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!