

Best Practices in Executive Compensation

Understanding Meaningful Metrics and Strategies
Governing the Coordination of Benefits

Presented by

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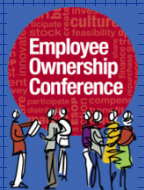
Overview

1. The best concepts supporting deferred, discretionary equity, equity-equivalent and cash compensation plans are treated here. A few case studies are summarized.
2. We do not deal here with other excellent reports and studies on the design of current cash compensation and bonus packages.
3. What we have seen lacking in terms of best practices in both the literature and real world is the coordination of disparate qualified and non-qualified plans.
4. This is a brief review of approaches to deferred executive compensation plans which can be integrated into a company's benefit structure to recruit, reward and retain key players. Others have dealt with 409A, 409(p), etc.



A Few Words About Current Cash Compensation

1. First, base compensation and cash bonuses must be peer group competitive; a compensation study can readily ascertain that.
2. Performance bonuses should be a percentage of base comp and tied to individual results; they are needed in nearly all cases, but do not always effectively recruit or retain key personnel...can be viewed as a kill-and-eat benefit.
3. To have your key people align their interests with the fate of the company, the delayed gratification of success and the potential for loss are critical. Just as for any owner.



We Understand the Compensation Vehicles Available...but How Do We Decide?

Some Key Questions:

1. How can we keep the system of rewards simple enough to understand and yet provide the often complex, targeted benefits we want?
2. In this era of MVA, EVA metrics and the like, how analytical should or must we be?
3. If we have an ESOP, how does a key executive plan help (or hurt) the ESOP participants?

To Understand Some of the Compensation System Engineering, Let's Start Here=>



A Cautionary Tale of a Simple System: An ESOP as an All-Purpose Benefit Package

1. Established an ESOP in 2000, over time acquired 68% of the shares, paid off the ESOP loans and grew to have 200 employees.
2. Had no discretionary equity or equity-equivalent key executive plans external to the ESOP.
3. Had a share price appreciation which amazingly averaged 40% for six of the next eight years (prosperous defense contractor).
4. Had an average participant age of 49.3, a vesting schedule which provided 100% after one year of service and immediate eligibility upon employment.
5. Had a valuation which mentioned the 'repurchase obligations,' but with no definitive projections.
6. And then, after the nice years of high earnings and share price appreciation, they saw the profits flatten out at a level which could not support the existing ESOP payout policy and capitalize further high levels of growth.



Can We All Have this Earnings “Problem”? Please?

While this company had to be sold to comfortably retire the stock repurchase obligations, the goal originally was to remain locally owned and operated.

What could have been done with some foresight relative to planning and executive compensation strategies?

Some Features of the System Engineering of this “Plan”

1. The value of all equity incentives was concentrated in a single stock.
2. The value for the minority shareholders was directly coupled to the majority interest ESOP “fair market value” valuation.
3. The minority group had an exceptional incentive to grow the company (a good thing), but this grew the retirement plan stock value equally (a problem).
4. Lest we say, “I’d never do that...” let’s note that there are analogs of these issues in many compensation programs.

What Our “Simple System” Owners Could Have Contemplated if the End Game Was Not a Sale

1. The executive benefits could have been decoupled from the ESOP stock FMV share price, but dependent on enterprise growth (i.e. they could grow faster than the stock):
 - The entire equity risk of the private company did not have to be pushed off on the retirement plan.
 - Discriminatory deferred compensation booking a liability would have slowed the company value growth, permitting retention of the original objective.
 - Other forms of equity comp (e.g. restricted stock) could have diluted ownership percentages, but still not impaired the ESOP from a fiduciary viewpoint.
2. Key executives would have had personal plans which incentivized growth while recruiting/rewarding/retaining them and their ultimate replacements.



Before We Talk About Coordinating Disparate Compensation Plans...

1. The nature of key executive compensation plan in a private company should be a direct function of the end game:
 - Is the company being groomed for a strategic sale? An IPO?
 - Is it intended to remain locally owned and operated as long as possible?
2. If no end game sale is planned, then do not create later large benefit costs which can unreasonably depress the market or economic value created for long term owners of any form of equity.
3. The ESOP example is instructive when considered in the light of risk versus reward.



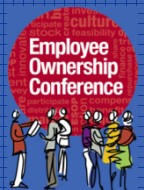
Risk and Reward

(The Divorce That Will Never Happen)

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It is the responsibility of the board of directors or the compensation committee it establishes to properly apportion financial benefits. How should this be done?



Characteristics of Compensation Packages

(Both are Performance Driven: The Risk/Reward Should Differ)

Risk



Key Executives

Unfunded

No Guarantee

Greater Return

Last in Line

Reward



Non-Key Personnel

ESOP Funded

No Guarantee, but
Lower Risk

Lower Return

First in Line for
Funding & Payouts



What is the Basis for Assessing Risk vs. Reward for Executive Compensation?

LEARNING FROM A BAD EXAMPLE

Enron's risk management manual showed an “interesting” performance metric used to compensate executives:

"Reported earnings follow the rules of and principles of accounting. The results do not always create measures consistent with the underlying economics. However, corporate management's performance is generally measured by accounting income, not underlying economics. Therefore, risk management strategies are directed at accounting, rather than economic, performance."

American Business Review June 2004,
Vol. 22 Issue 2, p82



Best Basis: Good Practices Always Point to Real World Results - Market Value

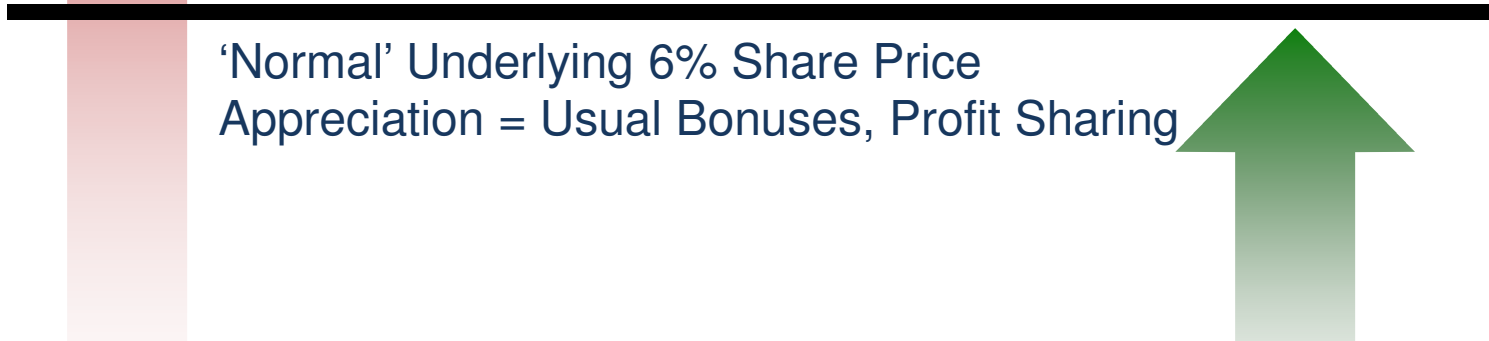
1. This ENRON notion of 'accounting value added' was essentially the it-is-what-we-say-it-is school of thought. Some private business owners still work that way.
2. On a positive note, the reason ESOPs can work so well with discretionary key executive plans is that there must be an independent Fair Market Value established each year.
3. This FMV intrinsically contains an analysis of the WACC and the risk rate associated with the going concern.
4. These parameters can then be part of the substantiation of long term rewards in non-qualified plans, both for baseline compensation and performance awards.



An Example of Building Incentive Packages Fairly from a Baseline



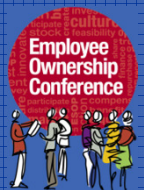
Exceptional 10% Underlying Share Price Appreciation: Key Exec Deferred Compensation Plan is 'Funded.' This Balance Sheet Asset is Cash First for the ESOP Obligations and Second for the Key Executive Compensation.



'Normal' Underlying 6% Share Price Appreciation = Usual Bonuses, Profit Sharing



Underlying 2% Share Price Appreciation = No Compensation Incentives for Key Execs



A Pay As You Go Key Executive Plan: Defined Contribution Deferred Compensation

1. A defined contribution model with the discretionary amount to key players defined and contributed each year only as the award criteria are met.
2. This is not a defined benefit model assuring some ending benefit (e.g. a percentage of average ending compensation).
3. The assets accumulate on the balance sheet subject to a “considerable risk of forfeiture.”
4. At payout time, the participant receives the accumulated benefit per the terms of the plan.
5. Benefits do not unduly impair market value, can serve other purposes in the accumulation phase and can be tied to individual performance centers.



What One Private Company Did: Defined Contribution Deferred Compensation

1. With 200 employees in a cyclical industry hard hit by the downturn (construction), the Board confronted the issue of retaining the president and chief financial officer.
2. The new DC plan provided for annual contributions as a percentage of pay triggered by net profits after bonuses and qualified plan contributions.
3. Contributions started at net profits of \$500K, and ranged from 20% of pay up to 50% of pay at \$2M.
4. Besides a 10 year vesting period, benefits were delivered with death or a change of control.
5. Accumulated benefits were subject to a risk of forfeiture until the installment payouts began.
6. The impact on ESOP stock value was minimal according to the appraiser, and the plan was deemed essential to growing value.



Stuff Happens...When There is a Lack of Coordination or a Change in the End Game

1. Two owners of a government contractor sold 30% of their stock to rising management in a fully taxable MBO with seller notes.
2. Rising management also received stock options for 18% of the common equity.
3. Two years later, the owners then wanted an ESOP to buy the rest of their S corporation shares.
4. With their growth and their options in the money, we recommended selling the company; they demurred.
5. The ESOP debt put the options under water, low exercise probability reduced value.
6. Options diluted overall value (but they were OK).



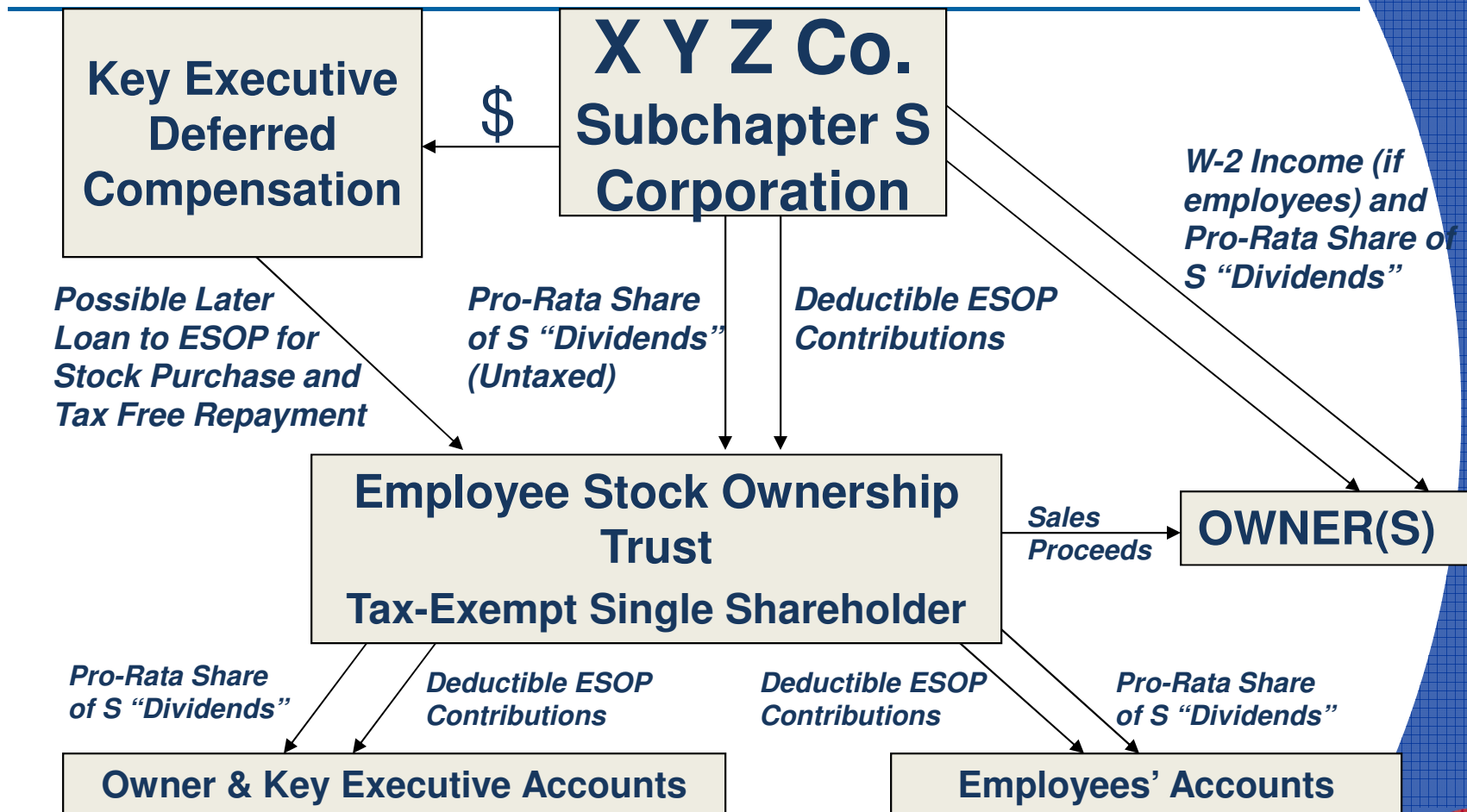
Some Rules of the Road for Successful Compensation Strategies

1. Keep programs as simple as possible in small to mid-market private companies, especially with ESOPs.
2. Build compensation packages on two foundations: the fair market value created for the company as a baseline, and peer group studies for performance bonuses in any form.
3. While there may be a school of thought that the ESOP should 'go where the wind blows,' we find it much more fiduciarily prudent to manage an ESOP for as much stable growth as possible – mitigate some risk at the cost of some reward.
4. Allocation of risk and reward cannot be a zero-sum game...all plans and participants should benefit, in proportion to the *relative risks and rewards*.
5. Tie non-qualified benefits to individual profit centers, have reasonable and tailored payout periods, use defined contribution models where possible and communicate clearly.

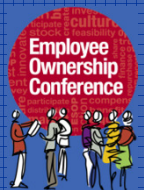


Private Company Example: The Sub S ESOP

Tax Sheltered Stock Purchases + Build-Up of Key Executive Capital to Support Ownership Transition (Possible 100% Tax-Exempt Operation).



The IRS counts key executive deferred compensation as a type of 'synthetic equity'. This is not typically an issue for well designed plans with over 30 participants. For smaller plans, both the qualified (ESOP) plan and the non-qualified plan often need careful future coordination to comply with this provision of the IRC 409(p) anti-abuse rules.



THANK YOU!

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