Volume 21, 2012

Board Governance Series

Growth and Value in a Volatile World
PwC

Executive Compensation Challenges in a Volatile Economy
Meridian Compensation Partners, LLC

Digital Volatility and Director Literacy
BoardVantage

CORPORATE
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Dear Corporate Director:

If there was a weather forecast for inside the boardroom, it might warn of clouds and continuing storms. In the 21st edition of the Board Governance Series we examine volatility in various aspects of board life. From executive compensation to cyber security to corporate growth, you are working in stormy conditions and we hope these three webcasts will help you navigate the squall.

The good news is that in a tumultuous market, attracting and retaining talent may be easier to accomplish than in an up market. However, ensuring you are paying your talent for performance during difficult market cycles is arduous. In one interview, we analyze executive compensation challenges occurring during down markets and offer tips to overcome these obstacles. In another interview, we go digital, discussing how board members are dealing with the cyber world and embracing technology, and how cyber risk is impacting boards and their companies. Finally, we cover what CEOs are saying about economic growth and what they expect of directors. More than half of the CEOs surveyed believe the economy will contract this year, and they see their board members as advisers to help them navigate the volatile economy.

After you've read the interviews with our premier business advisers, please visit our website to watch the Q&As and browse for other relevant information. Our contributors' websites, too, offer a wealth of additional resources. We pride ourselves on providing the most up-to-date board information to offer a beacon of light as directors make their way through the turbulent economy.

TK KERSTETTER
President
Corporate Board Member
An NYSE Euronext Company

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Growth and Value in a Volatile World

Tom, you came last year to talk about PwC's CEO survey. PwC has been conducting the survey for 15 years. This year you titled the survey "Delivering Results, Growth, and Value in a Volatile World," which is an interesting title. Could we start by having you summarize some of the findings?

The most important finding is a dip in confidence among CEOs. Roughly 40% of CEOs were optimistic about their own revenue growth this year as compared to almost half last year. That's a pretty significant dip in optimism from a year ago. I think the events in Europe are taking their toll; that's the major reason they cite for having less confidence. The other important finding is that almost half of CEOs believe there's going to be a contraction in the global economy this year. So what we see is that though there's still some optimism about revenue growth for individual companies, there is pessimism about overall economic growth. We've never seen contradictory reactions like this in our previous surveys.

Tom Craren
Managing Partner, Brand and Thought Leadership
PwC

Did the CEOs say what role they see their boards playing in managing through this volatile economy?

They want more of a consulting relationship with their boards. One of the CEOs we interviewed face to face said that he looks to his board as key advisers to help him navigate through this difficult time. If you think about where companies are doing business today, it's all over the world. It's in places they don't necessarily know very well. They're also dealing with new kinds of technology. They're dealing with digital transformation. So they need help from knowledgeable people. And what they'll tell you is that they increasingly look to their boards as a source of highly experienced advisers to help them navigate through the sheer complexity of business.

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What are some of the other trends that you found in the CEO survey results?

There's a continued interest in the emerging world. They see these markets as the source of a huge new middle class, and it's undeniable that this is going to create enormous growth opportunities for them. So despite all their concerns about new risks in these markets, they're still investing in China. They're looking at places in East Asia. They're looking at the Middle East. Even Africa has become a source of growth for them. CEOs are looking to invest in new growth opportunities, even though they are deeply concerned about Europe in particular. They're still focused on business issues that support growth; they're worried about having the right people and the right talent deployed around the world. They're worried about deploying technology in a way that helps them compete. And of course, they are still worried about costs.

Now, one area you didn't just mention is risk. I hope companies are still concerned about managing risk.

They are, but I think you'll increasingly hear the word resilience in the future, rather than traditional terms, like risk management. Because business has become complex, companies can't always anticipate and plan for every kind of risk they might encounter. For example, if you're not familiar with laws or customs in Asia, how can you identify all types of risk, much less manage them? What they're saying instead is that if something bad happens, they want to survive it; they want it not to really hurt the company. Japan is an example. The tsunami basically wiped out Japan's auto industry for nearly a year. CEOs don't want an event like that to wipe out their businesses, so they're looking to become more resilient—developing the ability to bounce back quickly—rather than trying to anticipate every kind of risk.

Tom, did the CEOs have one or two major concerns, overall?

I think their biggest concern is that they're competing on a global scale, and they feel like the U.S. government is not supporting them and doesn't understand how powerful that trend is. A lot of them, at least in the face-to-face interviews, expressed that sentiment and said, "Gee, can't the government see that the world is becoming a very competitive place for us, for U.S. companies, and why can't they be more helpful? Why do we have this adversarial relationship going on now?" We've heard that a lot.

Thanks, Tom. We could certainly talk for hours and hours about what you found. This was a great way to highlight some results, and people can view the complete results on PwC's website, www.pwc.com/ceosurvey.

Executive Compensation Challenges in a Volatile Economy

Today we want to talk about executive compensation challenges in a volatile economy. Shareholders have been so focused on executive pay, pay for performance, total increase in pay, and the perceived disconnect between pay and performance. Companies across industries are reviewing their performance metrics and their compensation structure to ensure that the programs they have set up are pleasing to management and shareholders. How does having a business that is strongly impacted by macroeconomic factors make it more difficult for companies to retain key talent?

Retention is always an issue in a volatile market. When the market is hot, competition for talent becomes very intense. Companies that need to recruit in those circumstances often find that there's a very limited supply of good candidates and they have to overpay to attract them. On the flip side, though, when the market is soft, they run into the opposite problem, which is that the retention programs they have in place for their good employees can be significantly devalued by these macroeconomic effects. For example, their share-based compensation programs may be significantly less valuable. And in the case, for example, of stock options which are under water, they may have no retention value at all. One of the strategies that companies can use to try to deal with this market volatility and to make sure that they have the key talent they need in a hot market is to try and upgrade their talent pool when the market is soft. So when they're in a down market, they can look for key talent. It's a great time to try and hire people. There's often a really good supply of terrific candidates out there. There's time and opportunity to properly vet candidates, and it can be significantly less expensive to try to attract employees in that circumstance, really for two reasons. The first is that the softer market means that the compensation that key employees can demand will be lower, and the second is that where they have retention programs at their current employer, those programs may be significantly less valuable, and so it can be much less costly to try and buy those programs out. So selective hiring in a soft market is fairly easy. The real difficulty is trying to retain that talent when the market rebounds.

Christina Medland
Senior Consultant
Meridian Compensation Partners, LLC

> **Selective hiring in a soft market is fairly easy. The real difficulty is trying to retain that talent when the market rebounds.**

Resource companies, like oil and gas companies, often encounter special challenges when it comes to compensation. How can those types of companies make sure they're getting pay for performance right? And while you're answering, are there any solutions that would help companies across all industries?

Companies in the resource sector share two common characteristics. The first is that share value and shareholder experience can be more significantly affected by commodity price or macroeconomic factors than they are by management effort. Excellent management and increased share price don't necessarily go hand in hand. The second is that these businesses tend to be capital intensive, which means that it requires a quite significant investment and often a very long period of time in order to generate shareholder returns. Many businesses outside the resource sector obviously share one or both of these characteristics. These characteristics drive three compensation challenges. The first is retention, which we've talked about a little bit. The second is making sure that you have a really strong connection between pay and performance. And the third is this challenge of motivating employees to do things today and tomorrow that will generate returns in the long timeframe of the business, which may be 10 years down the road.

How do companies retain and motivate employees over the long term when there is such an emphasis on short-term performance?

This is a really tricky issue. Exxon Mobil has just completed a big shareholder outreach and explained its compensation philosophy. Exxon Mobil is a company which has a very, very long timeframe for generating returns, and it has now closely tied its compensation programs to that very long timeframe. For example, one half of the chief executive officer's annual compensation is paid in the form of restricted shares. Half of those restricted shares vest at the end of five years, which is a very long time, relative to market. The other half, though, vest on the later of 15 years and retirement. Exxon Mobil is of the view that this very long vesting period ensures that its executives are going to have very significant shareholdings for the long term, and it believes that this will affect how management makes decisions today, knowing that they, themselves, are going to be affected 10 years from now because they're still going to be shareholders. What really remains to be seen, though, is whether this kind of a compensation plan, which is significantly more demanding of management and, of course, requires a much longer employment and shareholding commitment, will be effective to attract, motivate, and retain the key people that they need to drive their strategy.

That will definitely be a company to watch and see how those executives react as time goes on. It will also be interesting to see if other companies follow the idea because it is very outside of the box for compensation right now.

Digital Volatility and Director Literacy

As CEO of BoardVantage, you work with boards in the digital field, and in today's environment, it's important that board members are capable of using an e-portal or an iPad for board work, but that doesn't necessarily make them "digitally literate." Do you find the board members you work with are digitally literate and are interested in learning more about the digital world?

No matter what profession you're in, there will always be a spectrum of digital literacy, but where you fall within that spectrum is much less important today than it was a few years ago. Even a short 24 months ago, directors had to be tech-savvy to be effective with board portals. But that is no longer the case; going paperless today is a hassle-free experience for directors of all stripes.

Of course the iPad has a lot of to do with it. It removed a usability obstacle that kept technology adoption from taking off. That's why today you see genuine excitement about technology from a wide range of directors, whether they are progressive or traditional.

Joe Ruck
President and CEO
BoardVantage

How does cyber security play into this, Joe? Are directors concerned about this risk?

Again, it is a spectrum; there are certainly directors who don't seem to care. On the other hand, there are many more who care a great deal. It's our position that the latter group is right—directors should care.

For a long time, a paper process was the only option for boards... Now, with the advent of the iPad, the door has opened, and directors have become more receptive.

In particular we believe that directors should pay close attention to the interplay between technology and discoverability. That's because, with the advent of the iPad, the risk of discoverability has increased dramatically. Often, directors don't realize this.

Consider the following typical scenario. When directors are on a flight en route to a meeting, they often would like to review meeting materials, but they lack a network connection. That means they have to download information to their iPad in advance of departure. At this point they will have the access they desire, but unless that boardbook with the directors' notes can be purged remotely by the corporate secretary's office after the meeting, you're counting on the directors to do that task locally, a task which they may easily overlook. Instead, what you need is a system that maintains central control over all content that has been downloaded, so that, after the meeting, without relying on the directors' actions, it can be purged from their iPads remotely. Having a method that is a digital equivalent to the traditional way the GC collects and shreds boardbooks is the only way to eliminate the discoverability risks introduced by the mobility of the iPad.

Joe, on the topic of cyber risk, another term that comes up a lot is "cloud computing." How do you see that fitting into the boardroom, if it fits at all?

Cloud computing is one of the hottest technology trends at the moment. It is particularly popular in the consumer space. But for board work, we believe that the cloud should be ruled out because it carries too much security risk.

Possible exceptions are organizations with minimal security requirements. For example, in instances where there are public access requirements—school boards or local governments come to mind—that is, of course, a very different situation than what you'd find in a Fortune 500 company. Even nonprofits often have security and privacy requirements, so the cloud is not necessarily suitable for that sector either. In general I would say that the cloud is good for personal use and for some selected business use, but anytime confidentiality is a factor, it is not a wise choice.

We've been talking about digital literacy for boards. Do you see anything coming on the horizon that will continue to help boards with their duties in a safe way that's easy for board members to understand?

For a long time, a paper process was the only option for boards. About eight years ago that began to change, but adoption was slow. Now, with the advent of the iPad, the door has opened, and directors have become more receptive. At times, I get the impression that directors are making up for lost time. That's why we think about the iPad as the beginning of the digital board era. Boards who were once skeptical about technology are now becoming advocates. All of a sudden it's a race to satisfy their insatiable demand for technology.

There is a common theme in all of it, and that is the shift from one-way to two-way communication. We anticipate a trajectory that goes from boardbook access to board process and on to collaboration, with elements borrowed from what you see in enterprise collaboration systems, but much more secure and much more controlled to meet the security standards that boards require.

Thanks, Joe, for sharing your thoughts on digital literacy. The cyber world can be volatile, especially for people not armed with the knowledge of how to protect their information, so your thoughts are very relevant.

Series Host

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