The Science of Executive Benchmarking

An Advanced Approach with Extended Precision

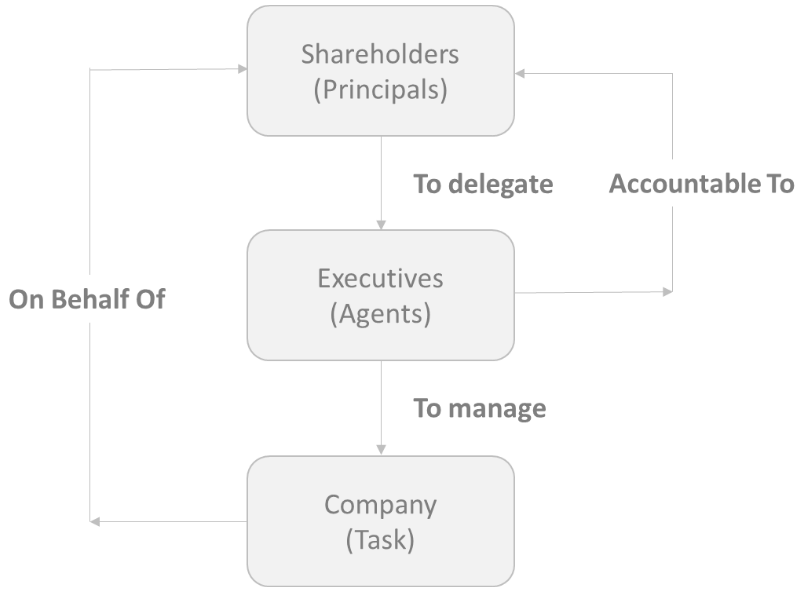
Not every firm is a median company hence not every executive has a median standing in the market. *By Vincent Fung, Bandrick Pang*

Executives are the pilots of business. In aviation, jet pilots are of paramount importance inside the cockpits as well as airline companies. Pilots and company executives both command competitive salary by sharing three common characteristics in economic perspective.

First, they are scarce with slow supply in the market. Being a highly sophisticated profession, a qualified pilot needs to undergo rigorous training and gain hundreds of flight hours whose growth demands much resources as well as time. Competent executives are rare due to the same reason. Furthermore, unlike strictly-regulated aviation industry, business take-off has no “normal procedures checklist”, making every executive job unique and hard to fulfil.

Second, it has discerned impact in critical circumstances. Skilful pilots can be differentiated from normal ones at clutch moment – The value shone when Captain Chesley Sullenberger of US Airways managed to ditch the aircraft on the Hudson River in emergency and prevented an air crash disaster. Good executives may not be able to outperform peers in

Figure 1: Agency Theory



Source: Comptify Analytics

operational front, but it is rather easy when coping with strategic or adverse scenarios.

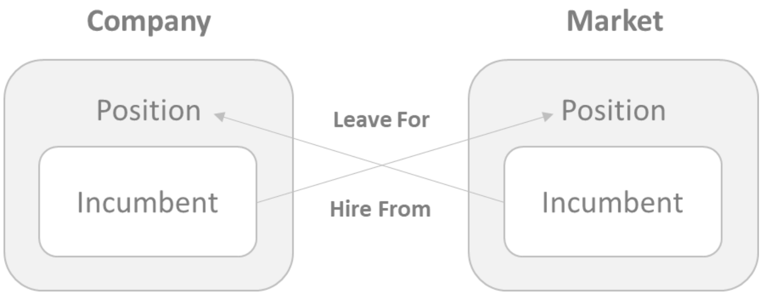
Last but not least, size matters. An airliner holds massive passengers at substantial airfare, multiplied the flight frequency resulting in astonishing sum of revenue for the airline company. For instance, in 2016, each of 230 Cathay Pacific's pilots is carrying the transportation and safety for USD 51 million worth of passengers and cargos altogether. Likewise, executives with billions revenue on their shoulders deserve big paychecks from their service.

Fit-and-Proper Match

In Agency Theory, shareholders are principals while executives are agents with unaligned interests in business (see Figure 1). It has diverse goals and risk appetites between the two parties by nature. For example, some executives may have little incentive to tackle insignificant employee misbehaviours or toxic culture because it is not related, or even not favourable to, their short-term bonus-linked KPIs. Unfortunately, failure in maintaining an uncompromised governance standard would jeopardize the long-term benefits of the company and shareholders.

In terms of compensation, top executives, unlike general employees, are in good position to seek for the highest possible return for the contributions made whereas shareholders may want the reverse of it, i.e. extracting the greatest value on every dollar spent. Quantitative benchmarking serves as a yardstick to provide objective market reference for pinning down a fair and reasonable price between the executives and company.

Figure 2: Rule of Substitution



Source: Comptify Analytics

Compensation benchmarking is directed by the Rule of Substitution. It states that the suitable benchmark group shall be composed of the probable incumbents that could be hired for the current position and the probable positions that the current incumbent could leave for (see Figure 2).

Quantitative benchmarking is a yardstick to provide objective market reference

The appropriateness of the benchmark group is determined by the relevancy of the incumbents. For example, a proficient programmer could be a close, although not exact, substitute for a system analyst position in the sense that both are evolved from the IT stream varied by the degree of sophistication. In contrast, a unique position of an organisation may not exist elsewhere, but one can always look for the second best in the line (e.g. experience or background match) as a starting point for pay evaluation.

Segmenting the Market

According to the pilot analogy, big companies usually have deeper pockets to compensate their executives. However, what is the right measurement to size companies? There are three popular options, namely market cap, revenue and profit, which can be applied as replacements or supplements of each other:

- **Market Cap** – It usually reflects the perceived company value by investors for public firms. It is a universal indicator that can be essentially used for comparing companies of different nature. It is rather volatile and sensitive in response to market conditions. Market cap is by far the most commonly used measurement for listed companies.
- **Revenue** – It is the top-line business performance and usually can be made available for non-listed companies. It does not measure profitability of the company.
- **Profit** – It is the bottom-line business performance and might be considered as a trade secret for private firms so it is less readily available. It

reflects the cost affordability but may fluctuate largely year-on-year.

Based on our research in the Directors Remuneration Report for Listed Companies in Hong Kong, CEOs' guaranteed cash increases in line with the logarithm of the market cap. For smaller companies, this relationship is a straight line while that for larger companies is an exponential curve (with R-Square above 0.9, indicating a compelling correlation). Here the "larger companies" refers to public companies with market cap

Chart 1: Guaranteed Cash (Y-Axis) vs Log Market Cap (X-Axis) for CEO for Smaller Companies with Market Cap < USD 6.5b

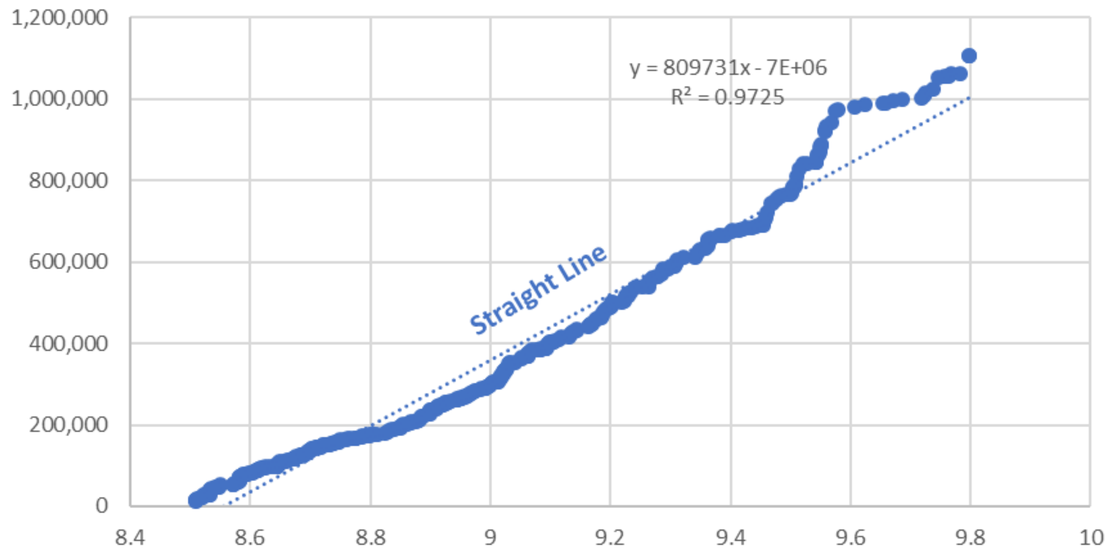
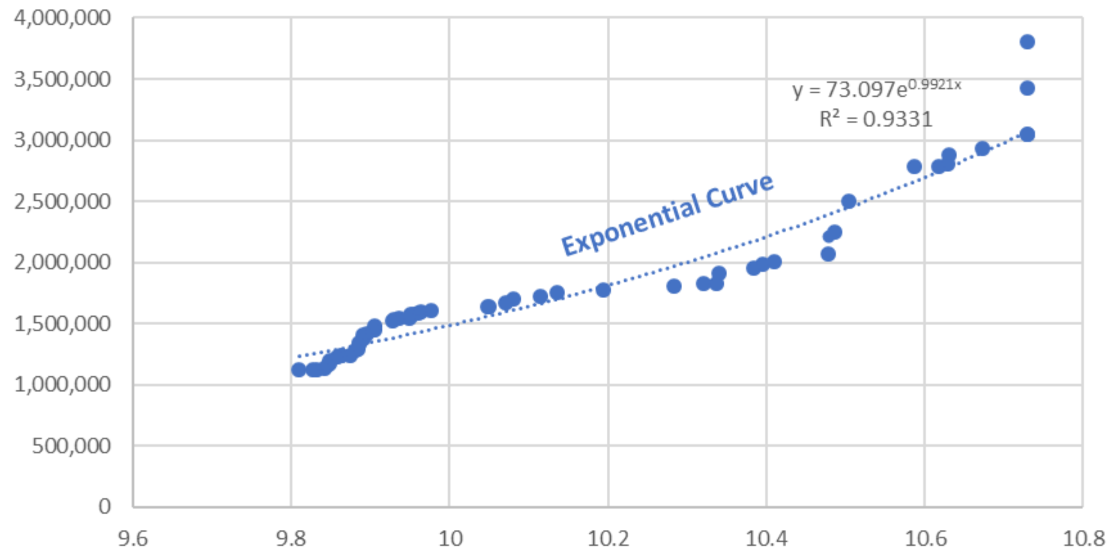


Chart 2: Guaranteed Cash (Y-Axis) vs Log Market Cap (X-Axis) for CEO in Larger Companies with Market Cap > USD 6.5b



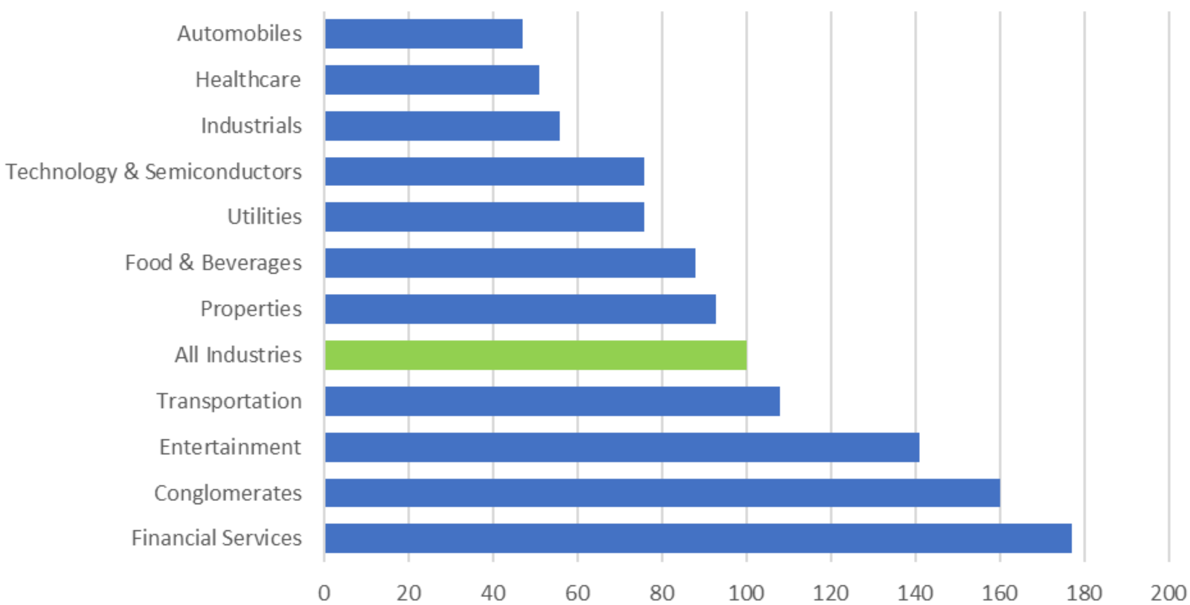
Source: Directors Remuneration Report for Listed Companies in Hong Kong, Comptify Analytics above USD 6.5 billion, constituting a lot of blue-chips in the Hong Kong stock exchange (see Chart 1 and Chart 2).

At mega-sized corporations, executive packages are relatively small as compared to the total value of company. If the CEO manages to grow a USD 100 billion corporation by 1%, he is generating USD 10 billion each year and it can be seen as a bargain if his remuneration is USD 10 million. Thus, shareholders may rather pay generously for a performing executive, be it by effort or luck, than risk to switch for a "cheaper" alternative at market run rate. It explains why CEO's guaranteed cash, being a proxy of executives' as a whole, accelerates along with size for larger companies. Nonetheless, this argument should have a limit and it is by no means easy to locate where it lies.

Some industries or companies pay their executives higher than others due to the stage of development and profitability among other factors (see Chart 3). The high-pay sectors in stock exchange for Hong Kong are Entertainment (+41% vs all-industry's average), Conglomerates (+60%) and Financial Services (+77%). The lower end includes Industrials (-44%), Healthcare (-49%) and Automobiles (-53%).

The benchmark group for executives can be extensive. For example, the role for CEOs is quite homogenous – To oversee business strategies and activities, organisation operations, profit and loss, legal compliance and so on. A well-versed CEO in one corporation is believed to be capable of managing a wide range of corporations effectively. It implies that since company management

Chart 3: Index of Guaranteed Cash for CEO in Companies with Market Cap > USD 1.3b (All Industries = 100)



Source: Directors Remuneration Report for Listed Companies in Hong Kong, Comptify Analytics skills are deemed universal, pay benchmarking needs to be cross-industry with companies of varied sizes to reveal the potential cost of talents in multiple categories for executive retention.

Benchmark group for executives can be extensive: Cross-industry and varied sizes

The Pointer Method

In benchmarking, a conventional practice is to refer to the market median (i.e. 50th Percentile) as an anchor for pay comparison. Nonetheless, not every firm is a median company hence not every executive has a median standing in the market. Besides that, as the number of executives is very limited (e.g. only one CEO in a company), it is advisable to build a critical mass of companies in the benchmark group so as to attain satisfactory level of data stability. In view of that, we have introduced an improved way of executive benchmarking, called the "Pointer Method".

The Pointer Method increases accuracy by using a dynamic benchmarking percentile (the Pointer) with reference to the company size positioning among the benchmark group. Table 1 illustrates how it works – A property company's revenue is USD 250.0 million per year and the size is at 72nd percentile among the selected peer companies. Based on the Pointer Method, the market reference point for pay benchmarking would be 72nd percentile, at which guaranteed cash is USD 380,962 but not the median, USD 179,346. This approach offers a fine-tuned pricing for an above-median company and avoids underpaying the CEO at merely median and vice versa.

"Cautionary Notes"

It is worth a rethink if "Pay for Position" is always and everywhere a guiding principle in executive compensation management – It may be sound for positions inside the organisation "body" but not the "head". For human brain, it is said to be the most complex structure in the universe. It holds true for executive jobs in the business world.

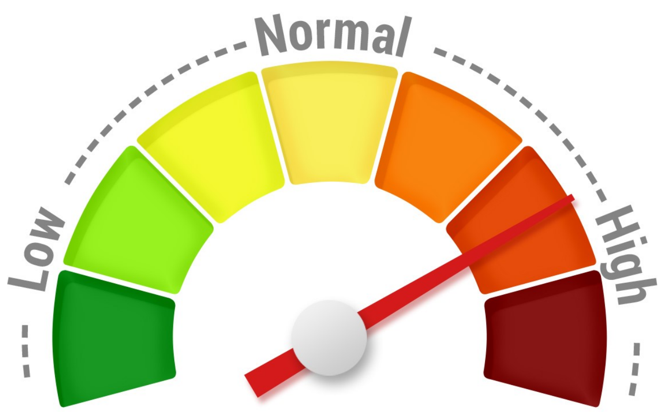


Table 1: The Pointer Method Illustration

Position: CEO
Industry: Properties
Market Cap: Small
No. of Companies: 18

Annualized in USD	P10	P25	P50	P72	P90
				Pointer	
Revenue (Million)	8.6	42.1	137.8	323.6	563.8
Net Profit (Million)	-20.4	0.9	15.6	38.6	70.4
Market Cap (Million)	143.7	166.4	202.2	**250.0**	286.4
# of Employees	61	252	864	2,555	5,563
Guaranteed Cash	38,840	81,080	179,346	**380,962**	561,436
Total Cash	46,333	116,923	223,526	532,115	838,718
Total Direct Compensation	49,302	128,141	253,846	604,744	1,045,590
Total Remuneration	50,301	130,641	252,885	626,154	1,046,513

Source: Directors Remuneration Report for Listed Companies in Hong Kong, Comptify Analytics

Commodity usually comes at a consented market price between buyers and sellers. It can be openly traded in the exchange with expectation of guaranteed settlement. Positions which sell manpower, e.g. blue-collar workers, are kind of commodities in the HR market. A perfect jobholder for such position would properly deliver all the roles and responsibilities stated in the job description, making the person almost equivalent to the position. Pricing a manpower position should be a stress-free one as long as there is compensation survey data in place.

However, executives are knowledge workers. Although the job itself might be easily defined, the actual value creation could have a huge difference from person to person and one may shape the job rather than the opposite. Also, the leveraged value by an executive's knowledge, skills and business connections can vary widely by situations. For example, a head of retail business who knows everything inside-out, e.g. customer behaviour, operations, logistics, lease negotiation, hiring, could help a foreign brand to set foot on a new territory which could create greater value as compared to running day-to-day for a local business with organic growth.

> To exercise judgement and sensitivity to determine executive compensation

Executive market is far from uniform, no matter on supply (employee) or demand side (employer), and is inefficient, i.e.

the market rate is unable to price in all related factors available. It makes pricing executives a dreadfully challenging task.

The board, HR and/or C&B consultants are required to exercise judgement and sensitivity to determine the level of executive compensation, not yet mentioning all complications stemmed from its technical design for driving the desired set of behaviours.

Learn More

Comptify Analytics offers professional support to HR and remuneration committees on designing and reviewing executive packages. We also provide up-to-date market data through Directors Remuneration Report annually. Please contact us for more details.

About the Authors

Mr. Vincent Fung is a Managing Consultant who heads up consulting business for multiple industries in Asia Pacific for Comptify Analytics ("CA"). Prior to that, Vincent worked in and was the Consulting Lead for Mercer-HRBS, a company acquired by Mercer in 2015, for more than 12 years. With background of information engineer, he has taken charge of initiatives for HR technology application and innovation throughout his career. He was appointed regularly by a number of public companies for directors remuneration advisory, including a blue-chip company listed in Hong Kong Stock Exchange

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Mr. Bandrick Pang worked for Mercer-HRBS (previously known as "HRBS") for around 8 years before joining Comptify Analytics ("CA"). He was the Industry Lead for Luxury Retail and Lifestyle Retail for Asia as well as Practice Head for Directors' Remuneration Services for Hong Kong Listed Companies. He oversaw key activities in consulting projects, information services and business development. He holds a Bachelor Degree of Business Administration with a first-class honor focusing on information system management and data mining.

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