FMI QUARTERLY
ISSUE THREE
2017

Boost Your Bottom Line and Strategy With Incentive Compensation

By Mike Rose

How to align employee performance with corporate strategy to ensure that staff behaviors are consistent with the company's overall mission and vision.

A breakthrough idea may put you on the competitive map, but staying there requires good execution and perseverance. The problem is that too many companies are bad at both and wind up failing during the execution phase. According to research published by Harvard Business Review, "Employees at three out of every five companies rated their organization weak at execution."[1]

Successful strategy execution requires individual actions and behaviors at all levels of the organization to be linked and aligned with the overarching corporate strategy. In this article, we show how incentive compensation can be effective in driving and aligning employee behavior with broader organizational goals and objectives. This ultimately leads to better financial performance and successful strategy execution over time.

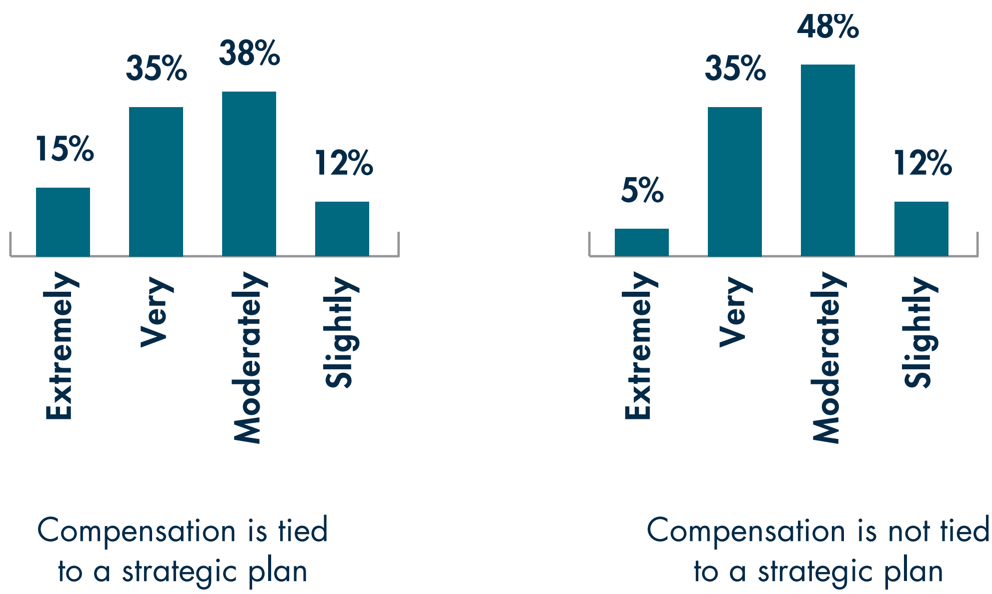
The Big Disconnect Between Strategy and Incentive Compensation Plans

In a recent FMI compensation survey, we found that nearly 30% of firms lack a strategy, and 57% of those that do have a strategy do not tie short-term incentives to their strategic plans. This is critical because firms that tie their incentives to strategy find their compensation plans extremely effective (three times more often than those

[1]Gary L. Neilson, Karla L. Martin and Elizabeth Powers. "The Secrets to Successful Strategy Execution." Harvard Business Review. June 2008.

that don't link their plans to strategy – see Exhibit 1). Consequently, by not tying incentive plans to strategy, there may be a significant missed opportunity to support and drive strategic initiatives through incentive plans that align employee behavior with the overarching company strategy.

Exhibit 1. Effectiveness of a short-term incentive program in achieving its objectives if compensation is/isn't tied to a strategic plan



Source: 2016 FMI Compensation Study

In our work with clients, we have found that structured incentive compensation can be an extremely effective tool in motivating employee behavior. A well-designed incentive compensation plan supports the alignment of employee performance with corporate strategy and helps ensure that staff behaviors are consistent with the company's overall mission and vision. This compensation approach also differentiates top performers and high potentials from other employees in a tangible manner, which supports long-term retention efforts for these critical staff members.

How to Set Real, Measurable Goals

Consider this: A construction firm decides to execute a strategy that is focused on growing new markets, increasing net profits and maintaining a strong safety record. The organization's culture is team-oriented but also relies strongly on individual contributors. Leadership intends to aggressively expand into new markets, increase sales by 50% and create a more sales-oriented culture.

Because net profit is a central objective of this new strategy, the compensation plan's corporate component must have a net profit measure (before taxes and incentives). In addition, each business unit has a revenue growth objective coupled with a net profit multiplier.

The following examples highlight what this could look like for three key positions:

Operations: Project Manager

Each project manager has three individual goals:

1. ***Margin Gain:*** +2% (averaged across all projects) over the plan year.
2. ***Safety:*** Specific required number of safety site visits and a safety discussion with each foreman.
3. ***Revenue:*** Revenue generated from new projects that the PM is currently managing.

Each project manager's specific goal may vary depending on the nature of the projects managed, his or her role on the project, experience and skill level. A margin gain goal keeps the project manager focused on increasing margin regardless of the estimated margin. This eliminates some of the issues associated with project-specific bonuses, namely, that they are subject to "gaming" (where project managers may desire high-margin projects, particularly if they receive a margin-based commission and avoid low-margin troubled projects). Focusing on a goal like margin gain removes these issues and provides management the flexibility to assign the best project manager needed for the job.

Business Development: Client Developer and Business Developer

A business growth focus requires professionals who are dedicated to identifying and closing new opportunities. Lead generation versus closing sales requires different skill sets associated with two separate roles: client developer and business developer. These two roles work closely together to form a cohesive sales unit.

Client Developer: Focuses on developing leads from new prospects.

> ***Goal: Individual lead generation.*** This includes a specified number of qualified new customer opportunities. Qualified opportunities result in a quote and may require management review.

Business Developer: Focuses on closing qualified leads from both new and current customers.

> ***Goal: Target sales at a specified gross margin (GM).*** This involves applying a commission to sales and adjusting with a GM multiplier that is based on the GM estimate. The commission steps up for sales above a target level or sales goal. For example, the target commission is 5% on sales, but can go up to 7.5% for GM greater than goal or is reduced to 2.5% for GM less than goal.

With the above goals in place, operations and business development work as a team; project managers develop leads from current customers while client developers generate leads from new accounts. These leads are then funneled to the business developer who ultimately closes the deals. This structure does not preclude the addition of other team members (e.g., estimators), but each must have a clearly defined role and goals that support the overarching organizational strategy.

The Power of Effective Incentives

Over the years, we have witnessed many examples of how effective compensation plans can make a real difference in overall corporate performance. Here are three examples:

Example 1. We worked with a mechanical contractor whose strategy emphasized safety, so the company leaders decided to incorporate safety into their compensation plan. As a result, the organization saw near-miss reporting increase by 1,500%, and its recordable rates, having been stuck in the 3.5-4.0 range, dropped by about 50%.

Example 2. In this case, one of our heavy civil contractor clients implemented a growth strategy that included expansion into new markets, with an emphasis on increasing net income. The incentive compensation plan motivated and aligned the branch managers through an 80% weight on corporate net income achievement (see red box in Exhibit 2). As a result, the organization accomplished 150% of its corporate goals at year-end and saw net profit jump from 5% to 7%.

Example 3. In another case, an equipment dealer was experiencing declining gross margin. The strategy called for taking market share from competitors. The compensation plan placed an emphasis on gross margin through a commission multiplier. A market share bonus was also included. In the first year of implementation, the declining trend in gross margin was reversed and increased by 2.31%.

How to Get Structured

Structured compensation plans are typically made up of three main components: corporate, business unit and individual. Each plan participant's incentive bonus is the sum of those components (i.e., corporate plus business unit plus individual) as shown in Exhibit 2.

Exhibit 2. Three Key Elements of a Structured Compensation Plan

When designing a structured compensation plan, it is important to focus on the following nine key areas:

1. **Define the Strategy:** Clearly articulate the strategic objectives and translate them into quantifiable objectives. For example, an organization may set out to enter new markets. To measure success in this endeavor, the company will specify an objective like "increase revenue by 50% at a net profit of 3%." Using clear and quantifiable objectives that apply across the organization serves as an excellent measure for the corporate and business unit components of the incentive compensation plan.

2. **Define the Compensation Philosophy:** To motivate behavior through the incentive plan, bonuses must be significant and competitive (i.e., at least at the 50th percentile), and particularly for high performers. As a result, it is important to access market data provided by reliable survey houses. Our research showed that having a compensation philosophy in place increased the effectiveness of short-term incentive programs significantly.

3. **Define Roles and Responsibilities:** A new organizational strategy may require new roles and responsibilities. For example, a strategy that focuses on aggressive revenue generation may include sales responsibilities for project managers. In addition, new roles may be required (e.g., client developers who focus on developing leads from new accounts).

4. **Balance the Design:** Each component in the compensation plan has a weight, and those weights add up to 100%; so properly weighting the plan depends on the organizational strategy and culture. For example, a strategy and culture that depend heavily on building successful teams may place more weight on the corporate and business unit components. On the other hand, a strategy that depends on highly motivated individual contributors may place more weight on the individual components.

5. **Align the Plan with Strategy:** Choose those measures for each component of the incentive compensation plan that align most closely with the strategic objectives. To keep things simple, most plans typically have only one measure for the corporate and business unit components. Invariably, but not always, net profit is the measure that directly aligns with strategy.

6. **Set Goals for the Individual Component:** Individual goals form a key element in the connection between strategy and behavior because they communicate what specific outcomes determine success. FMI's experience shows that the goals set at the individual level are critical to translating objectives into results-producing behaviors. Typically, three individual goals are set (although there may be more), and they should be SMART: specific, measurable, achievable, relevant and timely (achievable within a year). Creating too many goals, however, leads to a lack of focus.

7. **Communicate:** Communicating the organization's vision, strategy and compensation plan in a manner that shows the connection among all three ensures that employees understand how their individual contributions affect the overall pursuit of long-term objectives. This understanding is a key element in employee motivation. Effective communication starts with rolling out the plan clearly and explaining its objectives, mechanics and payout scenarios. Throughout the year, plan participants should receive feedback regarding progress toward their goals on a monthly basis (if possible) or each quarter (at a minimum). For participants who are falling short, managers should offer coaching and mentoring their reports on the types of activities and behaviors that will increase their progress toward goals. Goals and associated communication are key elements in reinforcing corporate objectives and ensuring plan effectiveness.

8. **Evaluate:** At the end of every fiscal year, perform an honest assessment of the strategy's and the compensation plan's effectiveness. Did the organization achieve its goals? How many goals, on average, did individuals achieve? If goals weren't achieved, what were the issues, and what kind of corrective action is required to get back on track?

9. **Consider a Long-Term Incentive Plan (LTIP) to Support the Strategy:** A long-term incentive plan (LTIP) is another effective tool for supporting retention and management succession objectives. An LTIP can also support the business strategy by driving long-term performance. For more information on LTIPs, check out "Looking to the Future: How E&C Firms Can Leverage Long-Term Incentive Plans."

Looking Ahead

For incentives to be highly effective, clarity and communication are imperative. Employees should know in advance what their bonus opportunities are, what it takes to achieve those targets, and how their efforts impact the organization's strategy.

Leaders embarking on a new strategy should consider the following questions:

1. Is the strategy clearly defined and translatable into specific metrics?
2. Do we have a well-defined compensation philosophy?
3. Do we require new roles and responsibilities to implement this strategy?
4. Does the compensation plan support the strategy?

A competitive pay strategy that addresses these questions in a comprehensive way, and that links back to broader corporate objectives, will serve as the very cornerstone of any good human capital investment approach now—and well into the future.

Mike Rose is a senior consultant and data services manager with FMI Compensation. Mike's work with clients includes assessment, design and implementation in the areas of company incentives, executive compensation, sales compensation and base pay strategies. He may be reached via email at ***mrose@fminet.com***.

About FMI

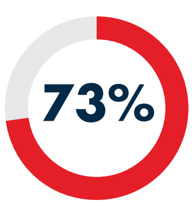
For over 60 years, FMI has been the leading **management consulting and investment banking** firm dedicated exclusively to **engineering and construction, infrastructure and the built environment**.

FMI serves all sectors of the industry as a trusted advisor. More than six decades of context, connections and insights lead to transformational outcomes for clients and the industry.

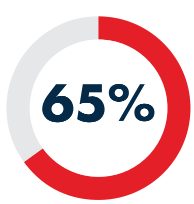
Sector Expertise

- A/E and Environmental
- General Contractors/CM
- Heavy Civil
- Industrial
- Specialty Trades
- Utility T&D
- Cleantech and Energy Services
- Construction Materials
- Building Products
- Oil and Gas
- Private Equity
- Owners

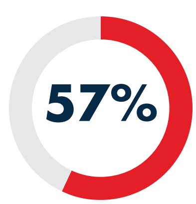
FMI Client Highlights



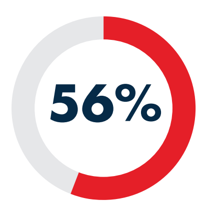
of the ENR **Top-400** LARGEST CONTRACTORS



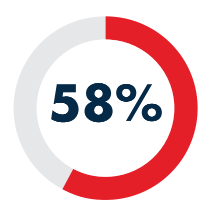
of the ENR **Top-200** SPECIALTY CONTRACTORS



of the ENR **Top-100** DESIGN FIRMS



of the ENR **Top-200** ENVIRONMENTAL FIRMS



of the ENR **Top-100** CM FOR FEE FIRMS

Industry Focus. Powerful Results.™

Denver
210 University Boulevard
Suite 800
Denver, CO 80206
303.377.4740

Houston
1301 McKinney Street
Suite 2000
Houston, TX 77010
713.936.5400

Phoenix
7639 East Pinnacle Peak Road
Suite 100
Scottsdale, AZ 85255
602.381.8108

Raleigh (headquarters)
5171 Glenwood Avenue
Suite 200
Raleigh, NC 27612
919.787.8400

Tampa
308 South Boulevard
Tampa, FL 33606
813.636.1364

FMI

www.fminet.com