

viewpoint

EXECUTIVE COMPENSATION

Last year was a landmark in executive compensation due to significant changes in compensation practices driven by legislative, economic and governance influences.

Watson Wyatt Worldwide tracks such changes with its annual *Automotive Industry Executive and Stock Compensation* research study, which gauges compensation activity among suppliers, dealers and the aftermarket. Dominic Andwan, an executive compensation consultant at Watson Wyatt, discusses the results of the latest study.

What happened to executive compensation last year?

We found that executive compensation, which was flat or decreased from 2000 to 2001, increased in the auto industry in 2002 across all elements of pay, especially salaries and bonuses.

However, most of the increases merely recovered ground lost in 2001, when bonus payments fell 67%. Long-term incentives, both grant values and actual gains, increased in 2002.

Why the jump in bonuses in 2002?

At the end of 2001, the country was struggling with the events of 9/11 and a weak economy. Most OEMs and suppliers forecast reduced vehicle sales in 2002. But by the end of last year, industry incentives caused sales to surge, and the industry ended up with its fourth-best sales year ever.

Since bonuses had been indexed to the more conservative budgets, they were higher than expected, even though profits as a whole continued to deteriorate.

Auto dealer groups did well compared to other executive groups, primarily because of consolidation within that sector.

Do you track executive compensation for OEMs?

General Motors Corp. and Ford Motor Co. are included in our U.S.-focus industry database. We do not segment out the OEM sector in the provided survey results since most of the OEMs, as non-U.S. companies, do not release their data to the public.

What drives the size of compensation increases?

Many factors influence the amount of pay provided.

Organization size is one, and salary level is another. Organizational performance is a key component—for example, profitability and return to shareholder—is often more reflected in annual and long-term incentives.

Unless you look at a specific company's practices, it can be difficult to attribute industry pay changes to any one event.

What trends are influencing executive compensation?

Stock option accounting will be a major change factor in coming years. There were seven prominent auto industry companies that voluntarily expensed their stock options last year: GM, Ford, Lear, Johnson Controls, ArvinMeritor, Paccar and Visteon.

It appears likely that, by 2005, FASB will mandate that all companies must expense their options. Once that happens, companies will be reexamining their plans to see how to minimize controllable expense and maximize the value of long-term incentives as well as performance alignment.

What will that mean for stock options?

We believe the future of stock options will include fewer grants and share allotments, fewer people eligible for stock options, reduce term for options, longer vesting periods and an overall increase in performance contingencies.

Does that mean companies will move to alternatives to stock options?

Yes, and the auto industry is leading the shift. Historically about 90% of companies in all industries used stock options, many as their exclusive long-term incentive. Today about 40% of auto industry companies have shifted to offering restricted stock and cash-based long-term incentives—twice the level of two years ago.

Are executives exercising stock options?

More are doing so and for greater gains. About 30% of auto industry executives exercised stock options last year for an average gain of \$1 million. In 2001, only 20% of them did so, and the average gain was \$850,000.

This year's Watson Wyatt Automotive Industry Executive and Stock Compensation research study will be available on June 16. For details, please contact Vicki at (248) 358-7918 or vicki.kozlowski@watsonwyatt.com.