



MANAGEMENT CONSULTING • INVESTMENT BANKING
for the ENGINEERING and CONSTRUCTION INDUSTRY

INCENTIVE COMPENSATION EFFECTIVENESS STUDY

THE 2013 U.S. CONSTRUCTION INDUSTRY INCENTIVE COMPENSATION SURVEY



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FMI's Incentive Compensation Effectiveness Study for 2013

Dear Construction Professional:

Incentive compensation is a huge investment! The challenge is ensuring your investment dollars are well-spent and you are getting the return on investment that you desire. The results of this incentive compensation survey reveal that the U.S. construction industry has an enormous opportunity to improve the effectiveness of current incentive compensation programs.

It can be challenging to create an incentive plan that supports your strategic objectives, motivates attainment of stretch goals, provides desired returns and behaviors, and yields results. FMI set out to answer some basic questions to find out what makes incentive compensation more effective in the eyes of top executives in the construction industry. It is apparent that doing nothing or paying discretionary bonuses is reactive and least effective for moving your company forward. This research article outlines seven critical issues, which are common practices in the industry that need to be addressed in order to improve the effectiveness of your incentive program.

Some key research findings are:

- Discretionary incentives that are offered by most construction companies are perceived as ineffective.
- Only 37% of construction companies use industry market data to ensure adequate incentives.
- Most construction companies are not using incentive compensation to support and reach key goals.

As we move forward, contractors in the labor management business must pay attention to their total rewards to attract and retain the best talent and realize the returns they desire.

I would like to thank all of you who have taken the time to participate in our incentive compensation survey and especially those who volunteered for the follow-up interview. My hope is that you use the seven best practices outlined in this article to help evaluate and assess your company's incentive compensation plan and find creative solutions to this big issue.

Sincerely,

A handwritten signature in black ink, appearing to read 'Radek Knesl', is positioned below the word 'Sincerely,'.

Radek Knesl
Consultant

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Introduction

The purpose of this survey is to evaluate the effectiveness of current incentive compensation practices commonly used in the U.S. construction industry.

When answering this survey, 22 percent of respondents requested an in-depth interview regarding their own incentive compensation program. As a result of the interviews, FMI can affirm that each company that offers incentive compensation has a unique plan to address its needs. There is no single best way to incentivize the workforce effectively. However, there are certain key elements which cause incentive compensation plans to be effective. The key elements of successful incentive compensation plans are outlined in this report.

The main problem with incentive compensation in the U.S. construction industry today is that it is predominantly discretionary. The majority of contractors (75% of all respondents to this survey) indicated that their incentive compensation is discretionary. Yet the feedback from some of the interviewees suggests that their employees would prefer to know what their bonus opportunities are in advance and what it takes to achieve them, if the incentive is to be effective. The construction industry is “not providing the carrot” by not effectively communicating the incentive opportunities to its workforce. The old “trust me” catchphrase is not effective in motivating employees to outperform. Although in some cases, the incentive is defined but still ineffective because it is not clearly communicated or understood, and/or the incentive is not significant enough to motivate the individuals.

It is encouraging to note that nearly half of the survey respondents offer incentives to all or a majority of their employees. That is significant, because empowered employees have a tremendous impact on company success. Some employees contribute more than others, and those with higher contributions should be rewarded accordingly through the incentive programs. Awarding the same bonus amount to people in the same positions is seen as unfair by the high performers and thus demotivating.

For the purposes of this survey, FMI did not provide a set of metrics for measuring incentive compensation effectiveness, nor review actual financial statements of respondents’ organizations to verify the stated outcomes were due to offering incentive. Since each plan is unique, the various reasons and expectations of companies offering incentive compensation differ and thus measure effectiveness in different ways. To compare trends across different metrics, the survey does not ask questions tailored to specific metrics, but instead asks for the respondent’s professional opinion as to what degree the incentive compensation has been effective. Furthermore, FMI recognizes the importance of safety in the construction industry. Many contractors use incentives to encourage and reward work done safely. We intentionally excluded safety but left room in the written portions of the survey to allow respondents to identify safety as one of the desired behaviors. We also excluded detailed analysis of incentive plans designed for executives and sales professionals, although we show the percentages of respondents offering these kinds of incentive plans. The focus of this study was the effectiveness of incentive compensation plans in general.

Survey Demographics

We emailed the survey to 5,636 top executives of various U.S. construction firms in early March 2013. FMI received 224 responses, or a 4% response rate. The respondents represent a mix of general contractors and subcontractors as well as geographic footprints and market sectors. Exhibits 1-5 summarize survey respondent demographics.

Exhibit 1: Firm Size in Terms of Total Number of Employees

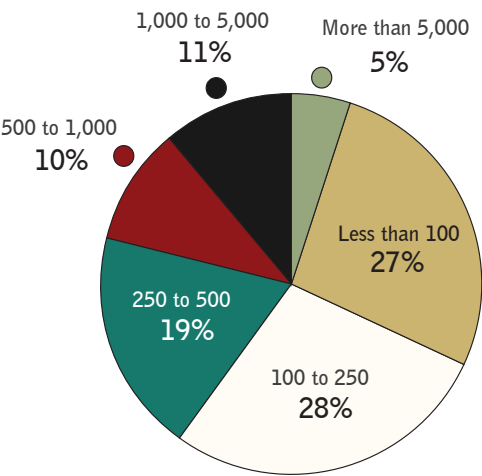


Exhibit 2: Firm Size by Annual Revenues

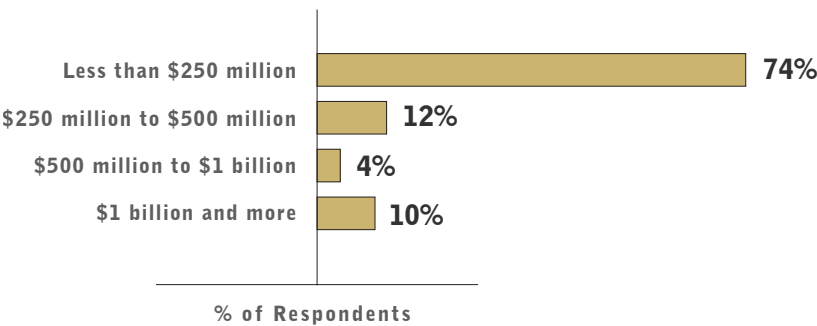
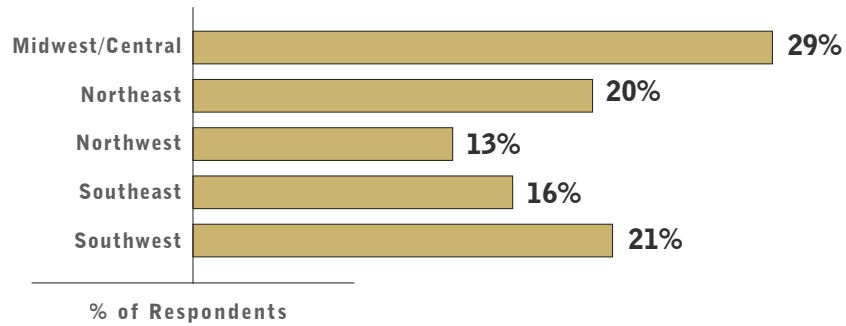
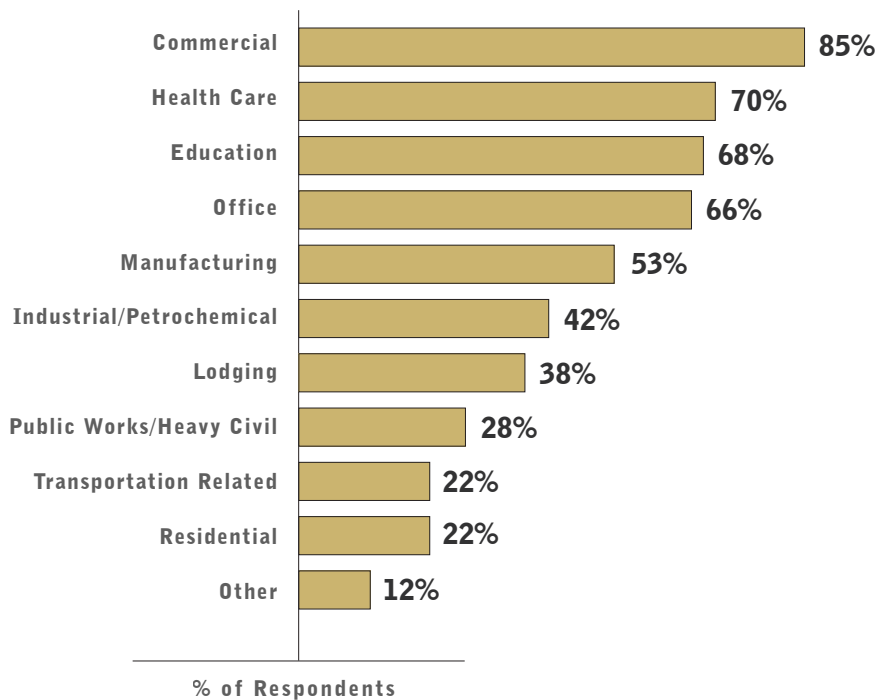
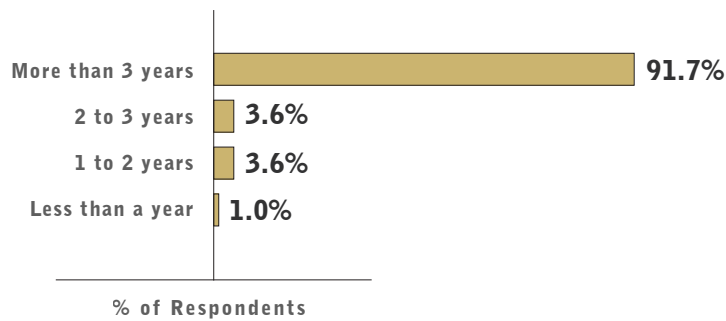


Exhibit 3: Location of Respondent's Firm Headquarters**Exhibit 4:** Market Sectors Served

In addition to understanding the demographics, we wanted to find out how many companies are adding incentive compensation to their total rewards besides identifying the proportion of participants having had an incentive program for more than three years. Nearly 92% of respondents have been offering incentive programs for more than three years, so their feedback is over a multiyear period. It appears that about 3.6% of construction companies add incentive compensation to their total rewards annually.

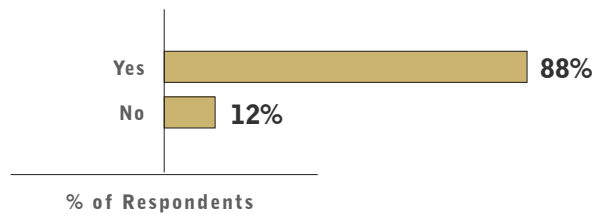
Exhibit 5: How long has your company had its existing incentive compensation plan in place?



Common Practices and the Effectiveness of Incentive Compensation in the US Construction Industry

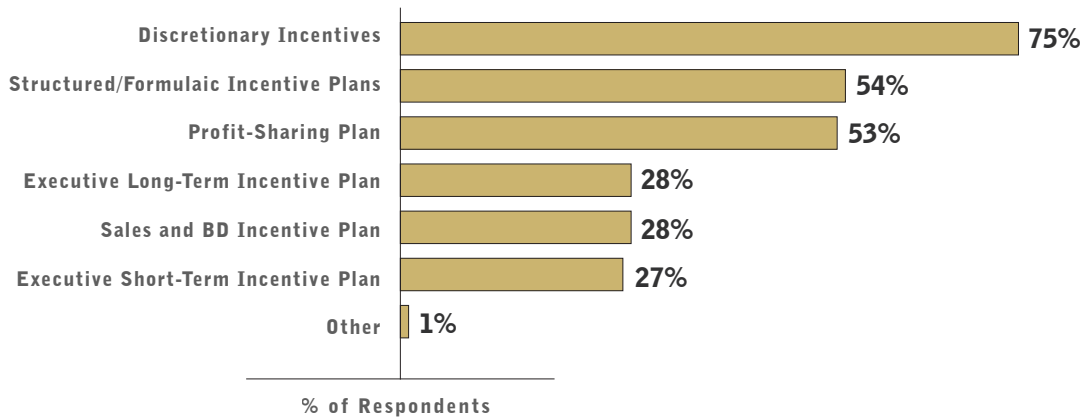
The first question we asked our respondents was whether they currently offer incentive compensation to their employees. Why? Because incentive compensation can be an effective tool for motivating employees to achieve their goals and improve overall performance. Eighty-eight percent of the respondents indicated that they currently offer incentive compensation to some or all of their employees. We can infer that approximately 88 out of every 100 construction companies in the United States reward some or all of their employees with additional compensation for achieving certain goals.

Exhibit 6: Percentage of construction firms offering incentive compensation



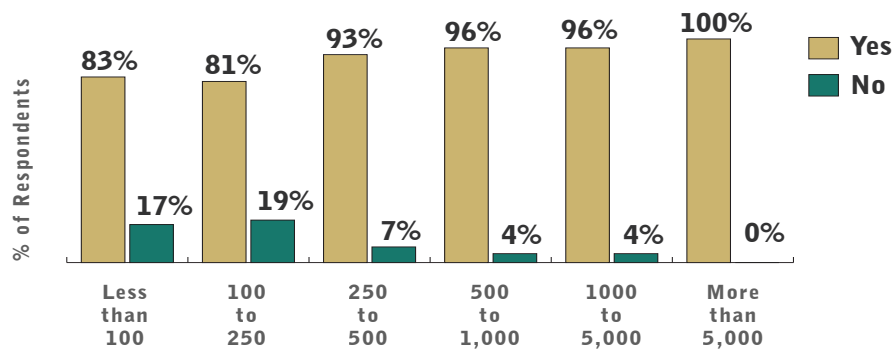
Of those contractors offering incentive compensation, the various types of incentives are displayed in Exhibit 7.

Exhibit 7: What kind of incentive compensation does your company currently offer to pay?



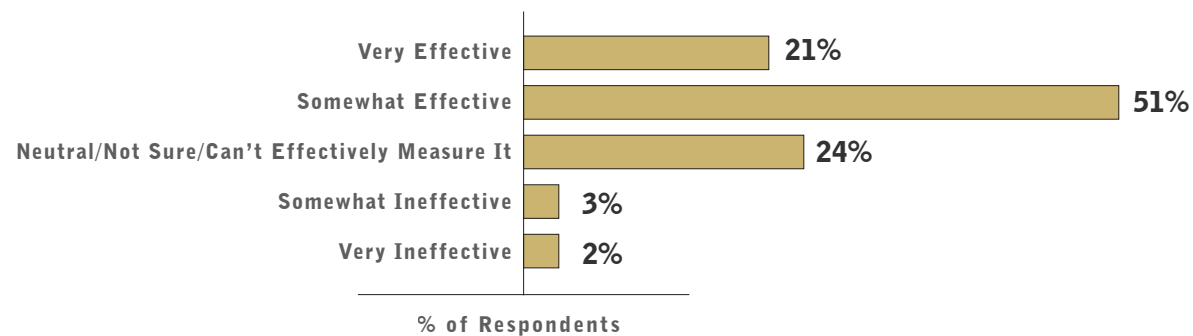
It is apparent (see Exhibit 8) that the larger the organization in terms of total number of employees, the greater the likelihood that the company is offering an incentive program to motivate its workforce.

Exhibit 8: Percentage of construction firms offering incentive compensation by workforce size



Although the majority of U.S. construction companies utilize incentive compensation, only 21% of the respondents indicate that their current incentive compensation programs are “very effective” in driving the desired behaviors and outcomes. Please see results of perceived incentive compensation effectiveness in Exhibit 9.

Exhibit 9: Level of effectiveness of the current general incentive compensation plan



It is important to understand why only 21% of the respondents find their incentive plans very effective. The intent of this report is to identify the key distinctions between common practices and the best practices, which appear to make the incentive plans “very effective” more often.

Slightly more than half of the respondents indicated that their plan is somewhat effective or partially successful, but the plan does not fully yield the desired results in terms of behaviors and outcomes. There are certain elements of incentive compensation that are critical to ensure the plan’s effectiveness.

FMI requested specific feedback regarding incentive compensation’s impact on company revenues, returns on investment, profits, productivity, efficiencies, employee retention and attracting new talent. The aggregate results are positive, but less than stellar. Please see Exhibit 10.

As indicated in Exhibit 10, incentive compensation is most effective for employee retention. Some 7.3% of the respondents noticed significant increases in employee retention because of their incentive compensation. Return on Investment and profits also increased significantly for 6.8% and 6.6% of the respondent firms respectively. However, the respondents indicated their incentive compensation plans are not as effective for improving their efficiencies and attracting new talent into their organizations. In other words, the respondents indicated that they are somewhat effective in attracting new talent into their respective organizations, but not solely because of their incentive compensation plans. Compare the results in Exhibit 11 versus the responses to attracting new talent into the organization due to incentive compensation per Exhibit 10.

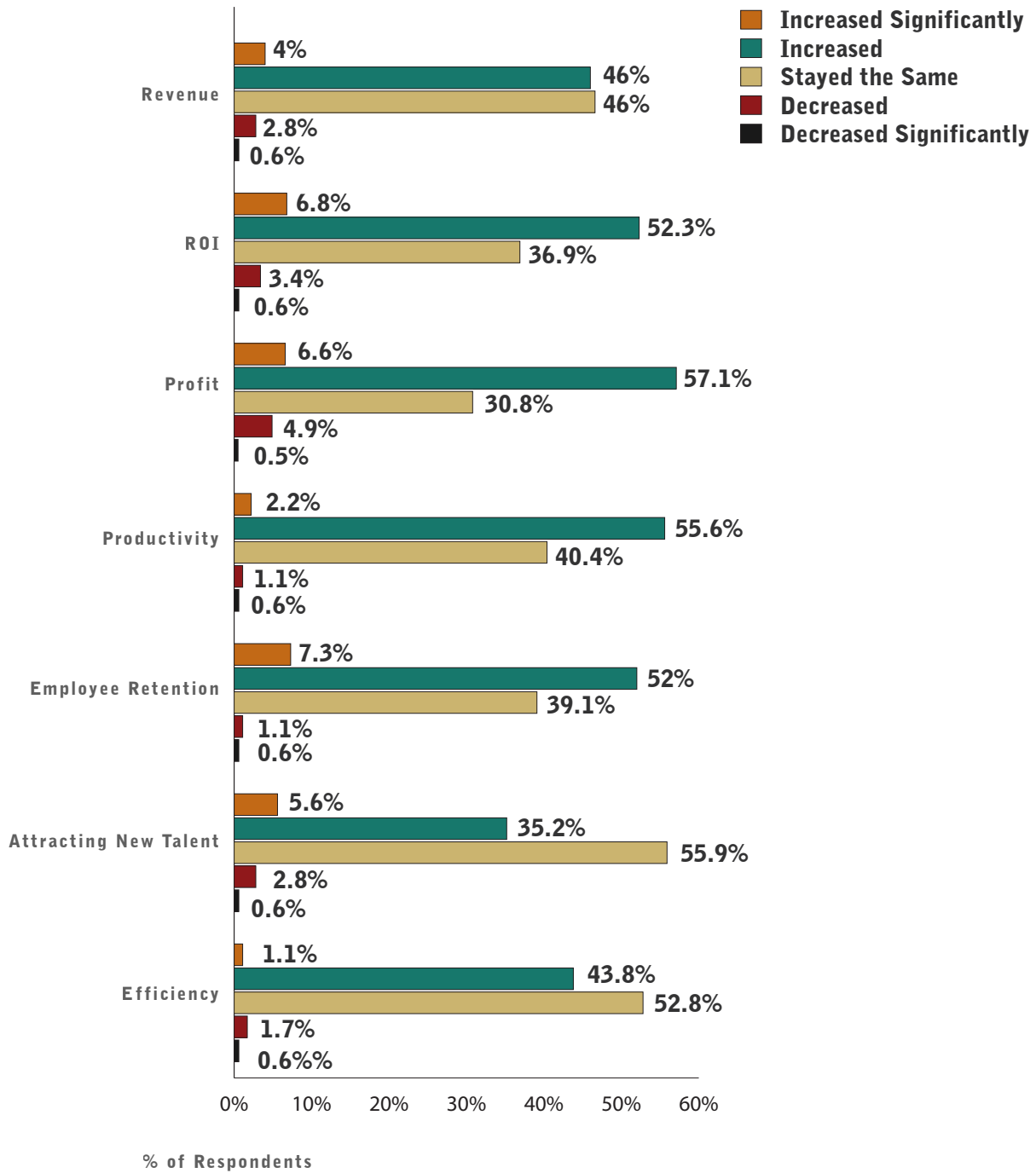
Exhibit 10: Impact of incentive compensation on desired outcomes

Exhibit 10 also shows clearly that the majority of the construction companies offering incentive compensation programs experience only modest improvements in desired results or no change at all. Let us examine what results construction companies expect from offering incentive compensation. The outcomes in Exhibit 12 indicate that most construction firms expect employee commitment to the success of the company, followed by the desire to reward those who contribute to such successes the most.

Exhibit 11: How effective has your company been at attracting new talent to your organization?

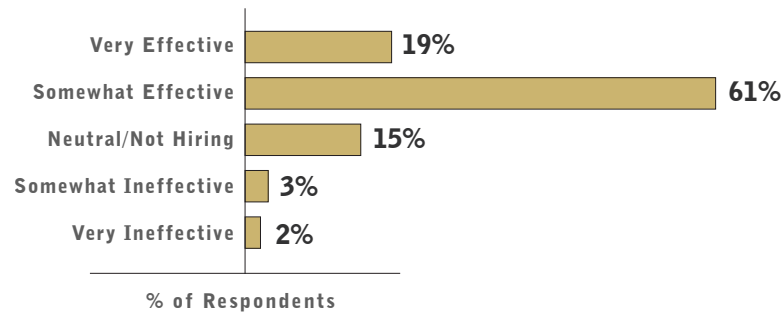
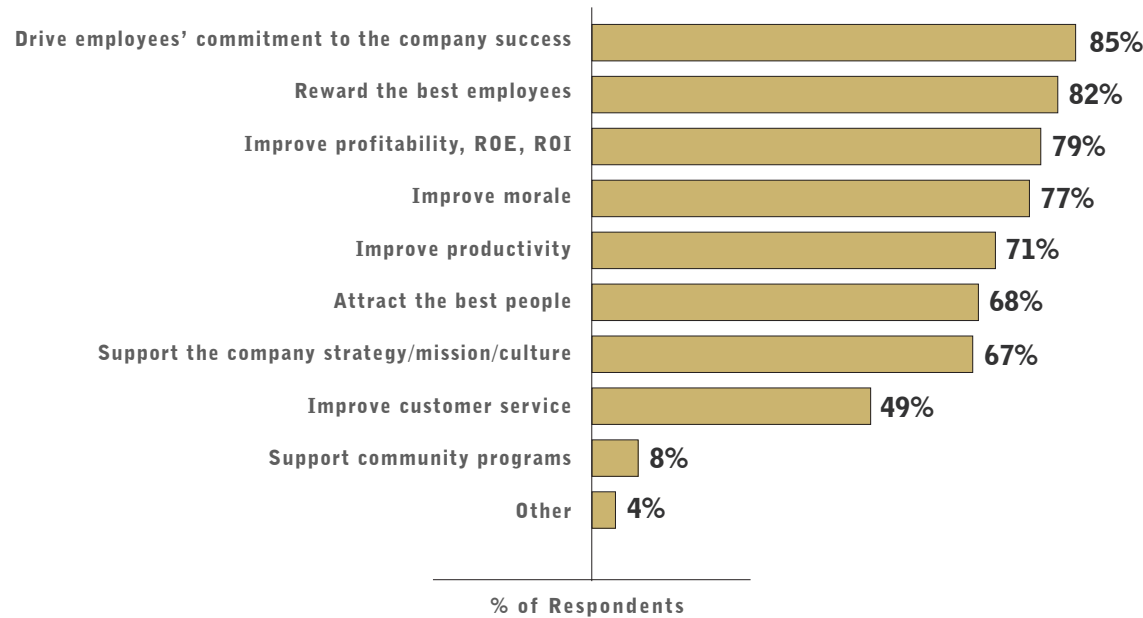
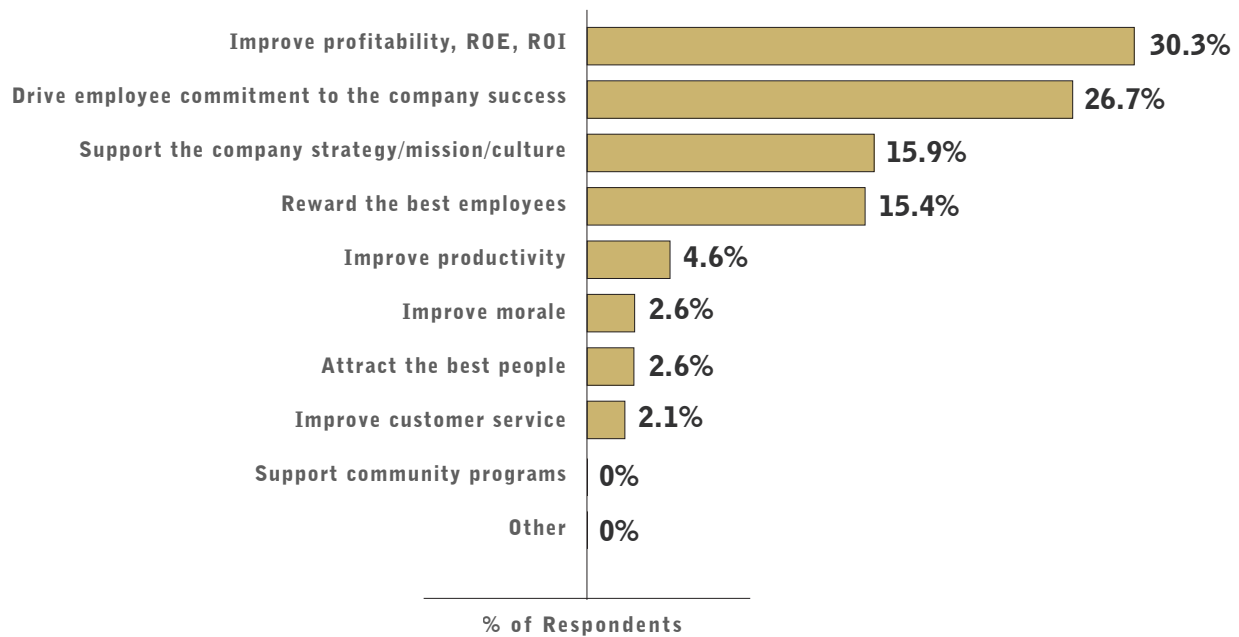


Exhibit 12: What results do you **expect** from your incentive compensation plan?



When we asked what result is most important in offering an incentive compensation program, we found that the majority of companies desire to improve profitability, followed by motivating employee commitment to the company success. Please see Exhibit 13 for details.

Exhibit 13: Of the above results, which one is **most important** to your incentive compensation program goals?



This implies that the owners are willing to pay extra for the attainment of stretch goals and improved performance; however, there has to be a positive return on the investment (incentive compensation) evident from it. Improving profitability is the primary reason for offering incentive compensation. Yet there are multiple other potential benefits in offering incentive compensation such as support of the company's strategic initiatives, rewarding talent in the organization, productivity improvements and morale boost. **Even though 49% of the respondents desire improved customer service, only 2.1% view incentivizing customer service as a priority.** In the follow-up interviews, we learned that many construction firms perceive customer feedback as satisfactory, yet most do not measure customer feedback on a consistent basis to use it as a measure for incentives.

Most Critical Issues With Common Practices vs. Best Practices

We identified the following seven most critical issues with common practices regarding incentive compensation from our survey sample.

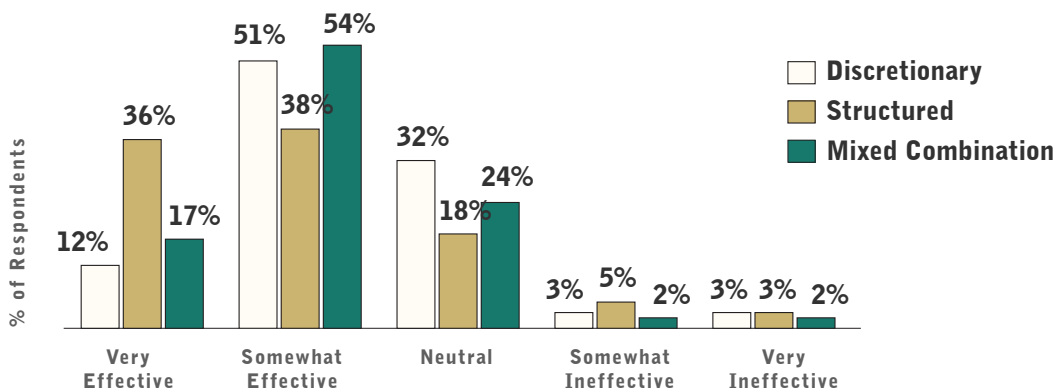
First Critical Issue — Discretionary vs. Structured

So why are there only 21% of the survey respondents in Exhibit 9 finding their incentive programs very effective? The **first critical issue** with incentive compensation plans commonly used in the U.S. construction industry is that they are **predominantly discretionary**. Seventy-five percent of the respondents indicate that their incentives are determined by senior management or owners’ discretion. In other words, senior management and/or the owners of the business decide what the incentives will be without any tangible reference to company performance, divisional contributions and/or individual achievements.

In a company with discretionary incentive pay, the employees do not see a clear link between increasing the incentive or extra pay and the improved levels of performance, which is not very motivating. In fact, participants in discretionary plans usually do not know what their bonus opportunities are. Many of the executives who currently offer discretionary bonuses admit to paying often the same amounts or small differentials in the incentive pay according to position of their employees, which high performers perceive as unfair and demotivating. In many cases, employees perceive discretionary incentive plans to be biased and often based on favoritism. Moreover, from the employee’s perspective, he or she does not know how to affect the amount of bonus.

To illustrate our point, we categorized the incentive plans into three distinct groups: 1. Plans that are purely discretionary, 2. Plans with only structured or formulaic measures, and 3. Plans that utilize a mixture or combination of structured and discretionary incentives for total incentive compensation payments. We also examined the correlation between plan effectiveness and structure of incentives offered. **The strictly formulaic incentive compensation plans are reported to be “very effective” three times more often than the incentive plans of companies that are completely discretionary.** An organization utilizing a combination of discretionary and formulaic incentives appears slightly more effective than completely discretionary incentives. Please consult the results in Exhibit 14.

Exhibit 14: Effectiveness of structured, mixed and discretionary incentives

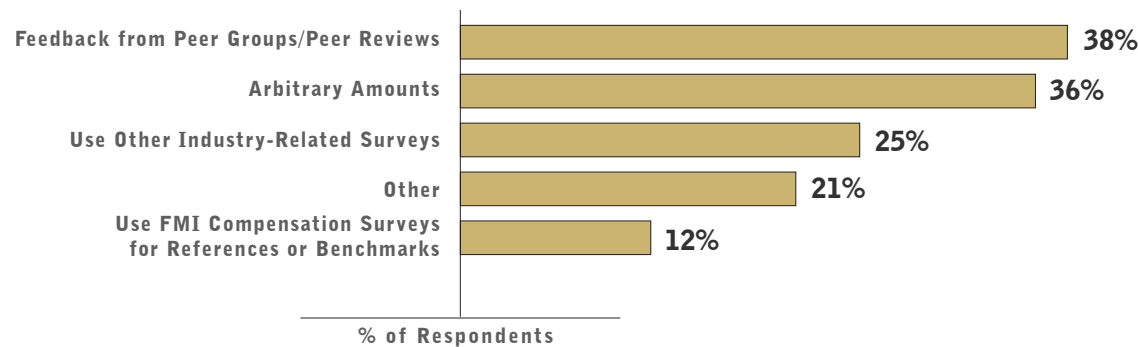


Best Practice: The executives of companies offering structured plans state that having a structured incentive plan is not only more fair to their participants, but also easier to administer if the incentives are awarded on results of data the company readily tracks and makes available for their employees. This survey reveals that those companies offering nondiscretionary structured plans report their incentive programs significantly more effective than those who offer only discretionary incentives or a combination of discretionary and structured incentives. Purely discretionary incentive programs appear to be the least effective in motivating employees toward better performance.

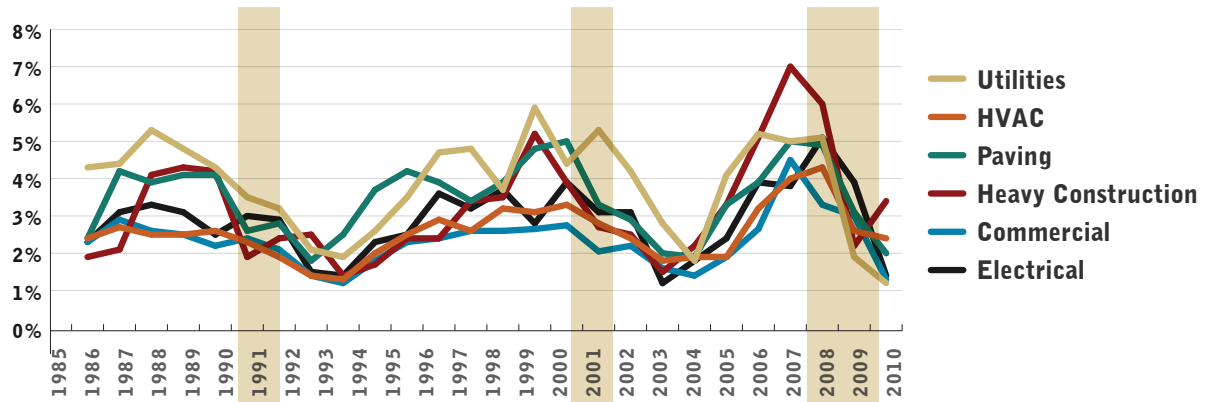
Second Critical Issue — Arbitrary Pay vs. Market Value

The second critical issue lies in determining the appropriate incentive amounts to motivate employees in various positions throughout the company. How do we best determine the appropriate amount of incentives to inspire our employees toward better performance? There is ample market data collected and available, but surprisingly few firms actually use industry-related surveys to determine base pay and incentive compensation. In this survey only 37% of the respondents indicated utilization of industry-related surveys, including the FMI compensation surveys, as references to assure the incentive opportunities offered are market-based and motivating.

Exhibit 15: How do you determine the appropriate incentive amounts?



Why is this so critical? Since the construction industry is labor-intensive with historically low profit margins, given the risks (See Exhibit 16), companies offering incentive pay need to be mindful of the cost of the incentive plan and whether they are achieving their set target profitability and performance levels. It is not uncommon for construction companies to pay thousands and even millions of dollars in incentives without reaching their target goals. This could easily have a negative impact on company profits.

Exhibit 16: Contractor profit before tax¹

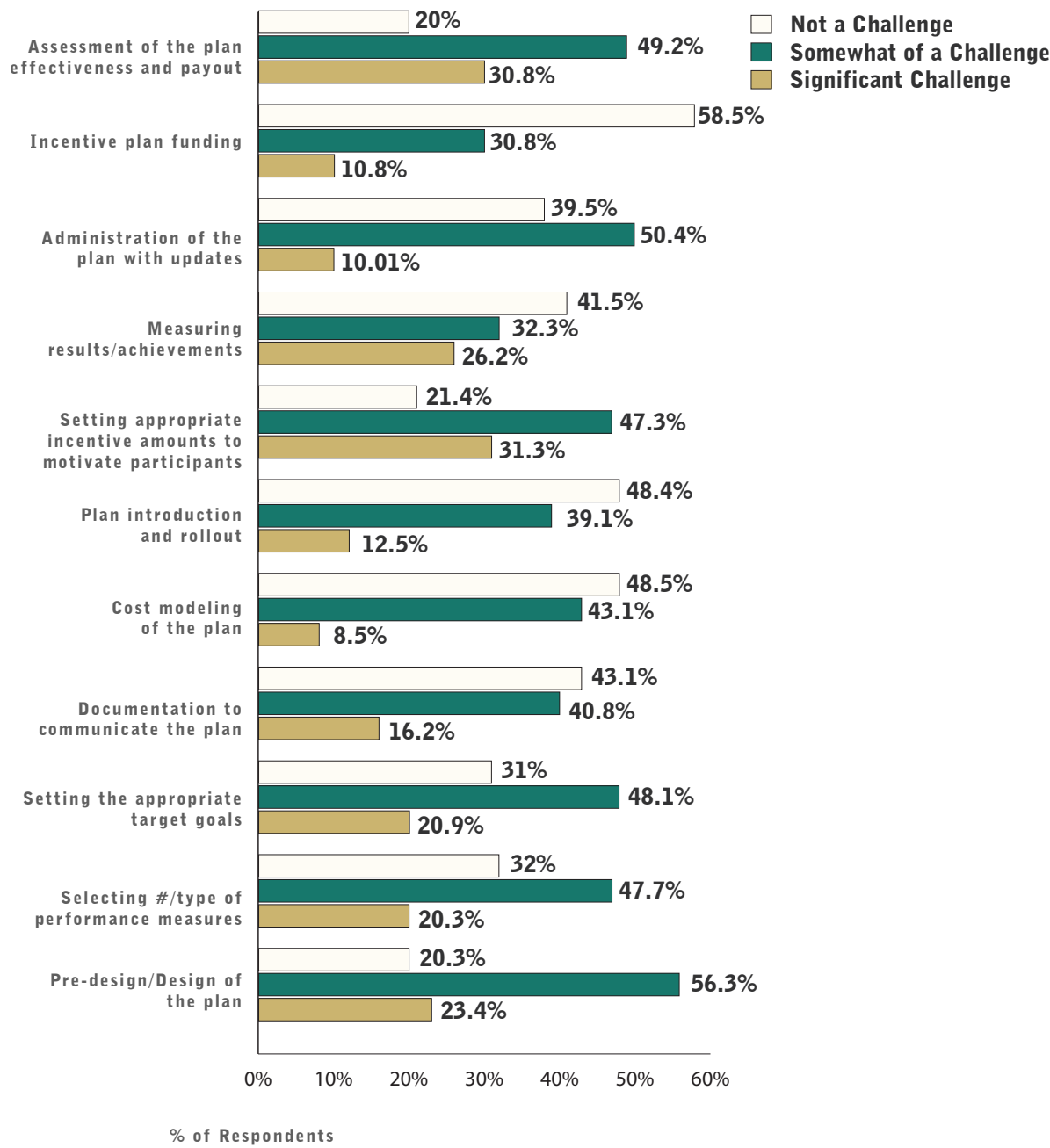
The real problem is that these companies arbitrarily decide what the incentives should be, while not ensuring that there is a return on their investment. **Thirty-six percent of respondent firms arbitrarily decide the incentive amounts to motivate their employees, so that amount of incentive pay is blind to the market.** Furthermore, 38% of respondents discuss with their peers (who may or may not get market data) appropriate amounts for incentivizing their employees. Consequently, nearly a third of the respondents utilizing structured plans identified setting the appropriate incentive amounts to motivate participants as the most challenging part of managing their incentive compensation program. Assessment of the incentive plan effectiveness was a close second in terms of challenges. Refer to Exhibit 17 for additional details.

During the follow-up interviews, we discovered that some of the companies utilizing uncapped formulas for incentivizing their employees suddenly found themselves paying incentives to operations personnel on projects that were bid at low or no profit margins during the recent Great Recession. This caused turmoil in their organizations, and owners realized significantly lower returns on equity and, in some cases, severe losses. Alternatively, some companies stopped paying bonuses and even put employees on furloughs, which had an adverse impact on morale and performance.

Overpaying employees does not necessarily make the employees sustainably happier or more satisfied, and it can make the company less competitive. Overpaying employees by tying the incentives to project profits makes it extremely difficult to move people from profitable jobs to projects with low gross profit margins and reduces cross-team cooperation. Conversely, underpaying employees makes it difficult to retain a quality workforce, and

¹ Source: Risk Management Associates, Philadelphia, Pa., Annual Statement Studies 1985-2009 Recession Periods are Shaded Red.

Exhibit 17: If you have a structured or formulaic plan, rate the following components in terms of plan management challenges.



it becomes difficult to attract new employees for future growth. Through FMI's compensation consulting practice, we found profitable construction companies, even in the \$1 billion in revenues and larger category, subscribing to compensation philosophies other than market base and market incentives. It is largely a result of not paying attention to the market rather than a deliberate intent. During the follow-up interviews, a number of respondents asked what are the best practices regarding merit increases, and our response depends on the company pay philosophy. However, we recommend beginning with market pricing to know the values of positions and then communicating the base and incentive opportunities to the employees.

There are generally three pay philosophies in the construction industry:

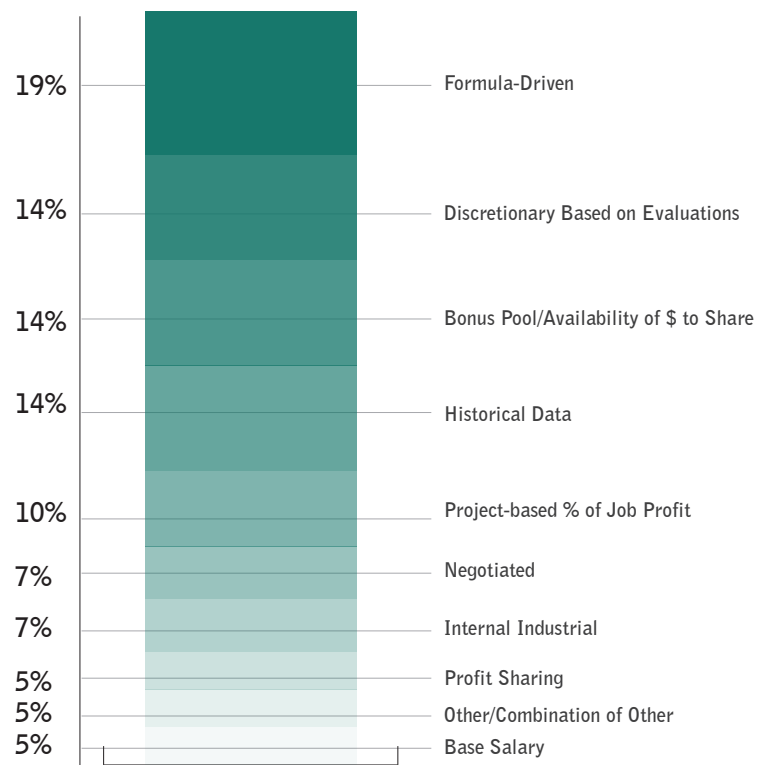
- a. Below-market base pay with above-market incentive pay
- b. Market base pay with market incentive pay
- c. Above-market base pay with below-market incentive pay

A construction company without a pay philosophy will not be able to articulate to its employees its philosophy, and may be overpaying marginal performers and unable to attract high performers. Paying market-base compensation and market incentives is by far the most preferred approach, but not common since it requires the appropriate data and understanding of what various job categories are worth in the marketplace.

In reality, the majority of construction firms do not know how competitive their total rewards packages are compared to others in the industry. As a result, many construction companies may not get a return on the various incentives and benefits offered and can be vulnerable to competitors poaching some of their high performers.

Finally, there are another 21% of the respondents indicating other methods for determining the appropriate amounts for incentivizing their employees. We asked them to describe their methods and received the following feedback, shown in Exhibit 18.

Exhibit 18: Other ways used to determine the appropriate bonus amounts



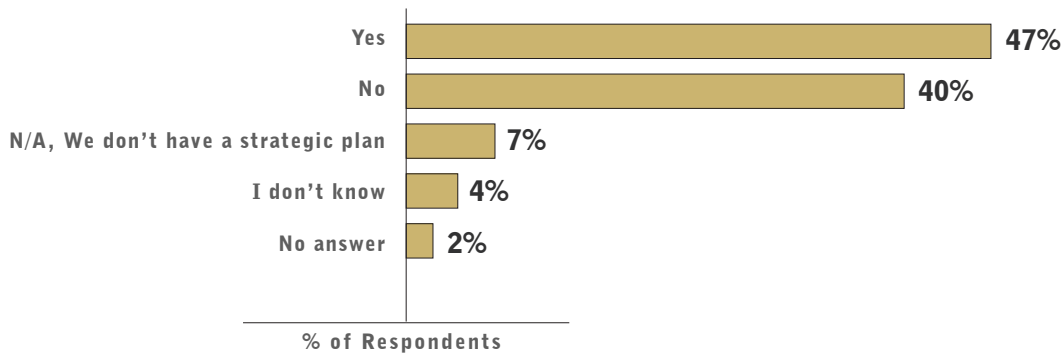
Best Practice: The compelling reason to use market data is to ensure that the incentives are competitive and meaningful for the participants, while the company can budget for the potential incentive payout, given certain levels of performance above and below target goals.

Third Critical Issue — Balanced Design Based on What Is Strategically Important

The third critical issue is that companies are not tying incentives to what is strategically important. Less than half (47%) of the respondents offer incentives to support and drive their companies' strategic initiatives. How can a company design an incentive compensation plan without articulating what is strategically important and why? Vagueness on what outcomes and behaviors are expected or desired, and thus rewarded with incentive pay, can lead to flawed designs of the incentive plans that will yield less than desirable results or induce unintended consequences such as silos.

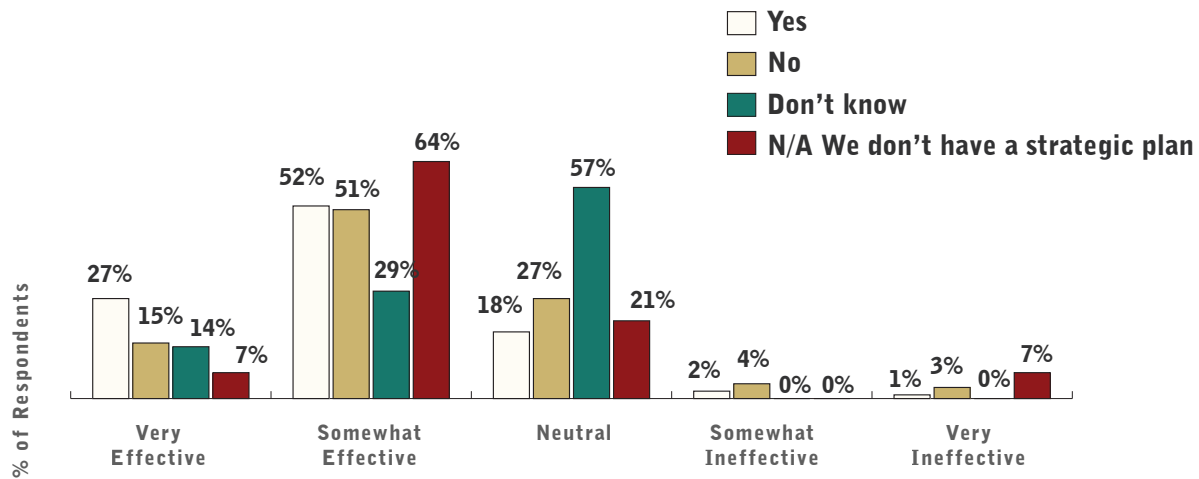
From FMI's consulting practice, we often see companies either tie all of the incentive to one measure or create a scorecard of too many measures to evaluate and reward performance. In the first case, it is all or nothing, and in the second case, there are so many variables that the employees can get confused about what to focus on.

Exhibit 19: Is your company's general incentive compensation tied to the strategic plan?



There is a clear pattern suggesting that those companies offering incentives to drive what is strategically important are reporting their incentive plans as "very effective" nearly four times more often than companies without a strategic plan. Conversely, companies without a strategic plan or those not tying their incentives to their strategic priorities report their plans "very ineffective" significantly more often than companies incentivizing strategic priorities. Please see Exhibit 20.

Exhibit 20: Impact on effectiveness of incentive plans by incentivizing strategic plan initiatives



This implies that companies without strategic plans or those that offer incentives that are not tied to the strategic plans have made their incentive programs the de facto strategic initiatives, because employees perceive important that which is incentivized.

Best Practice: Allocate a portion of the incentive to the overall success of the company while another portion of an employee's incentive depends on the individual's achievement of predetermined goals. Larger contractors that have multiple divisions or business units or regions may add a third component to incentivize the business unit or group performance. There is a science and an art to designing the incentive program to ensure that it is aligned with a company's strategic initiatives and rewards the desired outcomes and behaviors while minimizing the unintended consequences.

Fourth Critical Issue — Top-down versus Bottom-up Funding Mechanism

Although the majority of the survey respondents do not find funding their incentive programs challenging, as indicated in Exhibit 17, it is a **fourth critical issue** nonetheless. There are essentially two ways of funding the incentive programs. The first approach to funding is a top-down or more often called “bonus pool” approach that is commonly used in the U.S. construction industry whereby a company builds into its bids/contracts a bonus pool allocation and thus sets aside a sliver of the profits for bonuses. The three common problems with the bonus pool funding mechanism are:

1. The allocated bonus pool may be affected or reduced by potential challenges with a project.
2. The bonus pool is usually paid out to keep employees satisfied even if a division or entire company misses its goals and loses money.
3. The bonus pool is typically distributed in a discretionary manner, which is not conducive for companies to openly celebrate success.

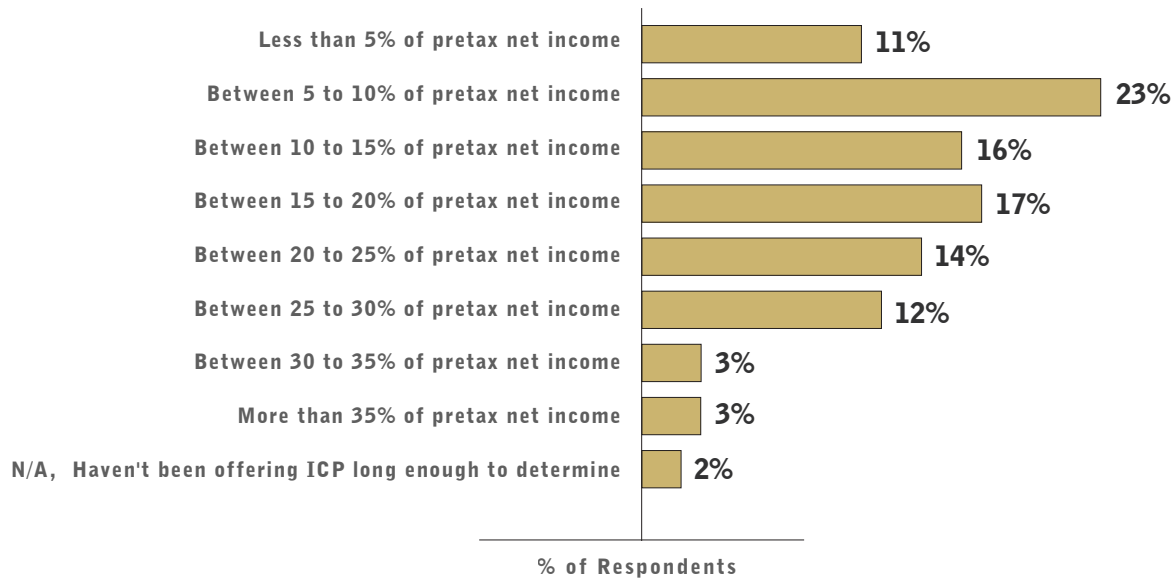
The second problem noted above with the bonus pool as a funding mechanism is that companies spend money on incentives even when they miss their goals. This seems to be a prevalent problem during recessionary economic periods as companies take on low-margin work just to stay busy, while their operations personnel are accustomed to getting a cut of the gross margin on jobs.

A less common, but more effective, funding mechanism is the bottom-up approach. This approach makes it easy for the person in charge of finance to begin with the end in mind. This way company owners decide the desired return on equity in the business or stock value per share of the company and plan from the bottom up to figure out their annual budgets. It is easy then to add the cost of the incentive plans at target performance to determine the appropriate goals for the entire organization, business units or divisions. Conversely, a company utilizing the bonus pool concept cannot predict how much money will flow into the bonus pool throughout the year and thus cannot define the potential incentive opportunity for the participating employees.

Utilizing the bottom-up approach helps the owners decide how much profit they wish to generate from the business and thus calculate minimum return on equity. By utilizing market data to set the appropriate incentive amounts for the positions being incentivized, a company can calculate the cost of the incentive plan at target performance, and add the cost of its bonus plan at target performance to the desired return on equity to easily figure out the goals for its incentive plan. This way the company offering the bottom-up approach to funding the incentive compensation plan can communicate the bonus opportunity for each individual participant in the plan.

We also asked how much is spent annually on the general incentives as a percentage range of pre-tax corporate net income. **U.S. construction companies pay out on average 15.67% of pretax net profit to their employees under their general incentive compensation plans.** Please refer to Exhibit 21 for details.

Exhibit 21: What percent of pretax net income do you spend on the general incentive compensation plan annually?



More important than knowing how much companies spend annually on incentive compensation is knowing the market values of the various positions a company is trying to incentivize and the market incentive amounts for those positions. The profitability of construction companies varies widely. Please see Exhibit 16. Since actual profits vary widely from company to company, we would recommend using market data to set the appropriate base and incentive pay rather than distributing 15% of a company's pretax profit.

The downside to utilizing the pool concept is that it is blind to the market, and potential overpayments can put a company at risk financially so that even if the company does not achieve its target goals, the company pays out from dollar one a portion of its profits in incentives, which may limit the owners' return on equity.

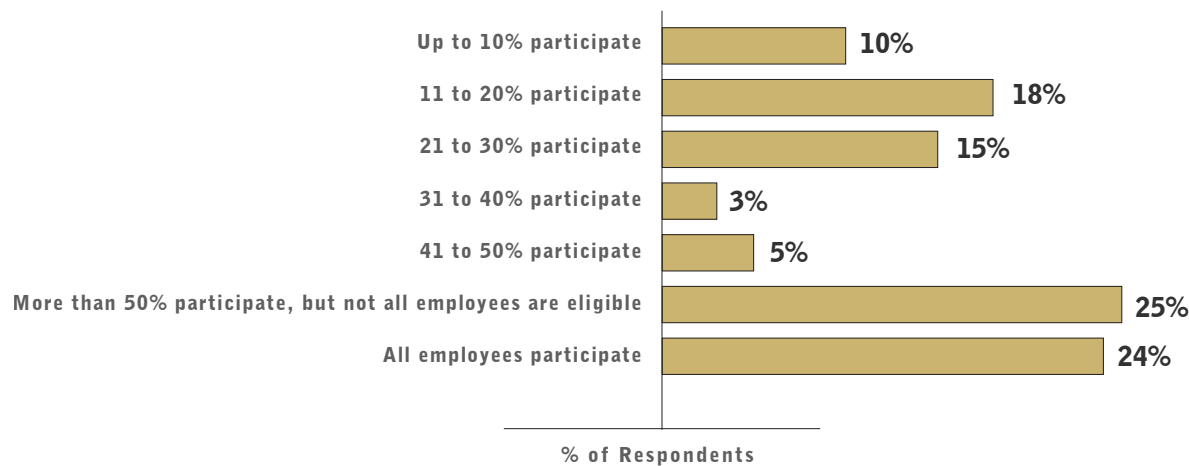
Best Practice: Companies using a bottom-up approach establish a fail-safe mechanism to ensure that the owners receive a certain return on their equity before incentives begin to pay out.

Fifth Critical Issue — Employee Empowerment

The fifth critical issue originates from employees not knowing how they contribute to the company's success coupled with lack of incentive opportunity for achieving goals. Although the construction industry desires to drive employee commitment to the company success (as indicated in Exhibit 12), the construction industry is not empowering the majority of the employees to excel and hold them accountable for their results. Only 49% of the respondents indicate providing opportunities to participate in incentive compensation to most or all of their employees. Please see Exhibit 22. That suggests that the other 51% of the respondents are not including and rewarding the majority or all of their employees with monetary incentives.

The argument against having a majority or all of the company's employees on an incentive compensation plan is the administrative burden of setting appropriate goals and administration of the program. Let us be clear. The incentive opportunities vary by position, and some employees may not achieve any of their goals and thus not receive any additional compensation; but **the issue is that many companies are not providing the incentive opportunity**. The incentive opportunities are usually stated in terms of a percentage of base salary to distinguish the levels of impact and contribution.

Exhibit 22: On average, what percent of your company's employees participate in the incentive compensation plan?



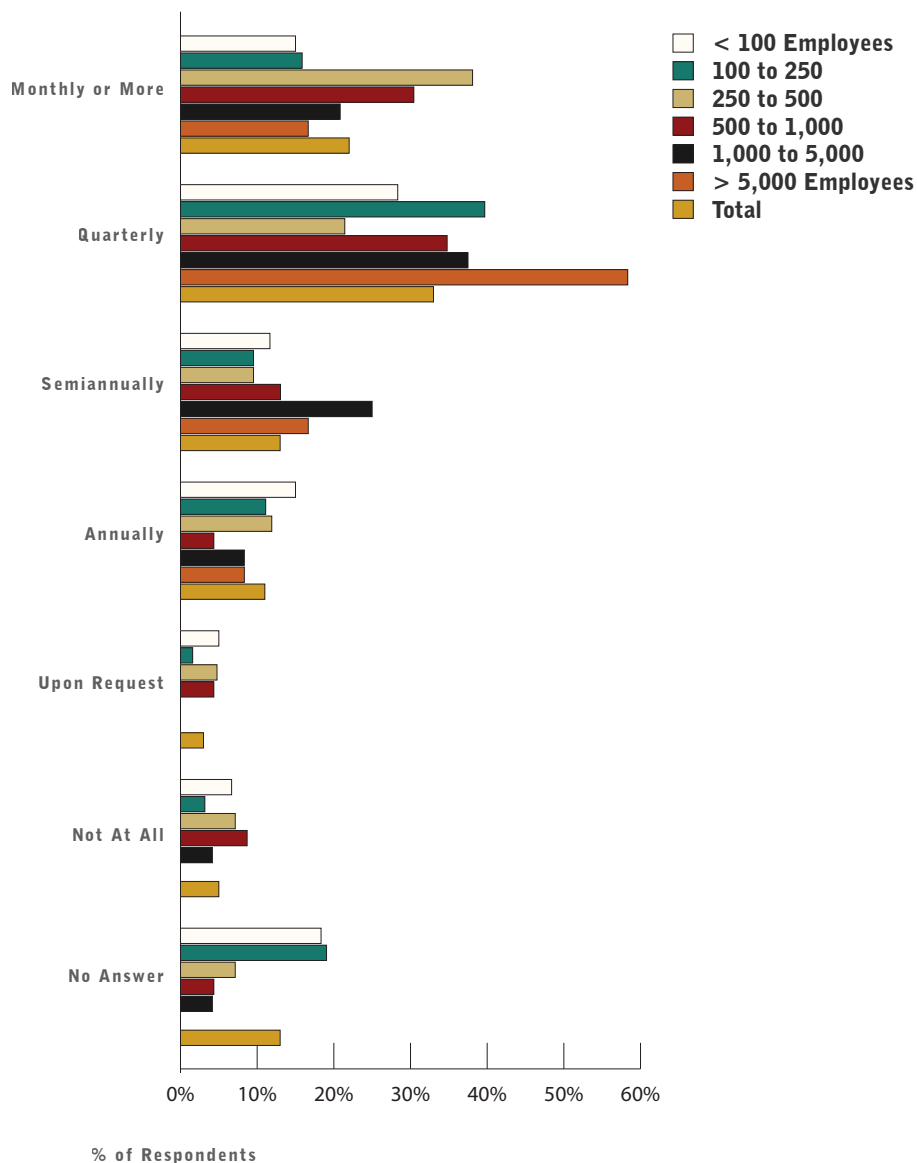
From our experience, companies have some champions, some employees that are disengaged and the majority that are somewhere in between on that scale. The incentive programs are usually most effective for those who are somewhere between top performance and disengagement. That is why it is important to include most, if not all, of your employees in the incentive program.

Best Practice: Involvement begets commitment. Providing an incentive opportunity to your employees will help them focus on what is important and support their commitment to company success that the vast majority of respondents desire. Incremental improvements of the majority of employees will have significantly more impact on the company success than incremental improvements of only a few employees.

Sixth Critical Issue — Communication and Transparency

The **sixth critical issue** is poor communication and lack of transparency. It appears that the vast majority of owners of privately held construction companies are resistant to sharing financial results of the business with their employees. We are not advocating full disclosure of the company financial information to the employees. However, if you want your employees to be excited about the incentive program, then they must understand what the goals are, how to measure success, and what is in it for them. Ideally, the incentive plan is co-created with input from participants in the plan, which helps not only in designing a fair and equitable incentive program, but also in driving the employee commitment and understanding of the plan.

Exhibit 23: Whithin your company, how often do you share progress reports or status updates regarding achievements to goals?





If the participants in an incentive program do not understand it or do not believe it to be fair and equitable, or perceive that the goals are far out of reach, then it is not going to be very effective in driving the desired results and behaviors. The survey results indicate that about 8% of the construction firms do not share information at all or only if requested by an employee. As we examine Exhibit 23 more closely, we notice that none of the companies with more than 5,000 employees falls into these categories. Similarly, all respondents representing the largest construction firms answered the communication question, but surprisingly 18% to 19% of respondents representing the smallest contractors in terms of size of their workforce did not answer the frequency of progress updates question. What does that say about the importance of communication? How can the organization celebrate success if it does not provide meaningful feedback about the company performance? It is encouraging to see that a third (33%) of all the companies are providing progress updates with respect to performance and goals on a quarterly basis. It appears that the largest contractors have found most success in providing **consistent quarterly status updates and progress-to-goals reports**.

Although communication can become more challenging as an organization grows, we see that the majority of organizations with workforces of 5,000 or more employees provide quarterly progress updates to their employees. Conversely, the smaller construction firms seem to struggle more with consistent progress updates or do not communicate at all. We can infer that the larger organizations seem to recognize the importance of consistent communication, which is one of the keys to more growth and success. Through good communication, employees see their value and contributions to the company's bottom line, which also helps to retain top talent. Retention of top talent may lead to increased profitability and sustained growth. Based on our consulting experience, **we consistently find a positive correlation between the level of communication and the level of satisfaction among the employees with pay and benefits**. This is especially evident in organizations with multiple divisions or regions where the pay and benefits are essentially the same, but the level of satisfaction with pay and benefits of those employees is always higher where there is more consistent and meaningful communication from management. **A higher level of transparency promotes an atmosphere of trust among the employees.**

Best Practice: Communicating quarterly progress is very important, but the critical part is providing meaningful information that the participants in an incentive plan can understand and use to improve their performance. Every employee should know how the organization is doing. If you do not provide consistent updates, people will talk and come to their own conclusions. A quarterly progress update, along with informal individual performance feedback, not only minimizes potential surprises, but also helps management develop and grow its direct reports.



Seventh Critical Issue — Clear and Measurable Stretch Goals/Objectives

The seventh critical issue is assigning goals and objectives that are not clearly measurable or even remotely attainable, and currently measured or tracked by the organization. This is the reason why in Exhibit 17, the second and third most challenging aspects of managing structured incentive programs are assessment of the incentive plan effectiveness and measuring results.

We found that the top-five most challenging aspects are:

1. Setting appropriate incentive amounts to motivate participants – 31.3% of respondents
2. Assessing the plan effectiveness and payout – 30.8% of respondents
3. Measuring results/achievements – 26.2% of respondents
4. Pre-designing/designing the plan – 23.4% of respondents
5. Setting the appropriate target goals – 20.9% of respondents

Only goals that can be tracked and measured should be included in the employees' incentive plans. The clear stretch goals are especially important to companies desiring rapid growth. This way a company can openly celebrate and reward the employees who take on the stretch goals. Occasionally, there may be an unforeseen circumstance that will create immense growth or contraction within a business, and therefore we always recommend that management retain the right to modify or adjust the company goals as necessary due to potential unpredictable events.

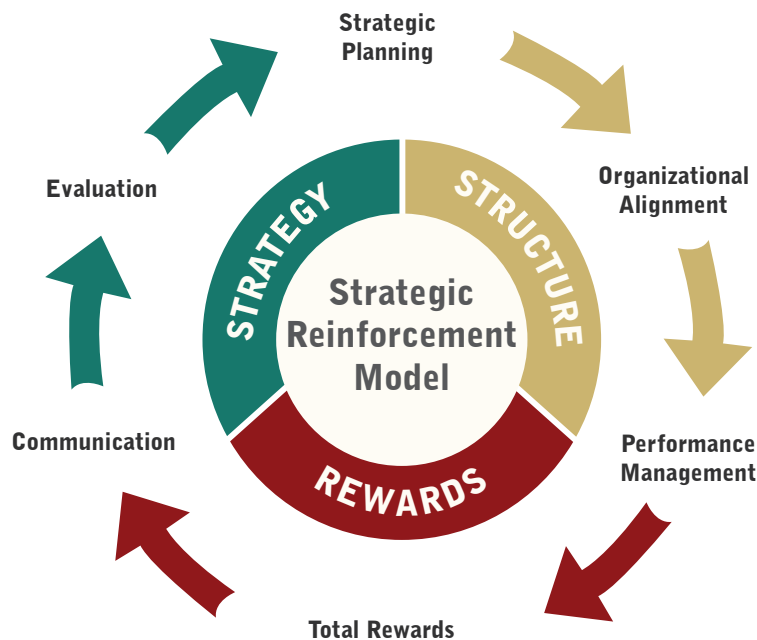
Best Practice: Establish stretch goals. By stretch goals we mean goals that are more than our best past performance, but not unattainable. The goals need to be clear and easily measured so they can be simply determined, “yes or no” on the achievement. Because it is extremely difficult to predict next year's performance and set appropriate corporate profitability goals, we recommend start to paying out at a threshold, where the company is not quite achieving target goals, but close enough to begin reduced payout. Achievement of the target goals (stretch goals) denotes 100% payout of the target incentive opportunity. Performance above target levels warrants accelerated or ramped-up incentives to reward outperformance up to the maximum payout, often referred to as a point of excellence. The stretch goals help advance company growth more deliberately.

This is not an exhaustive list of issues regarding incentive compensation, but rather a summary of the core issues that need to be addressed if you want your incentive program to be most effective.

How to Increase the Effectiveness of Your Incentive Compensation Plan

Beyond the results of this survey, FMI has learned from its consulting practice that the success of an incentive compensation program begins with designing a reward system that supports and rewards the achievement of strategically important initiatives. Begin with the end in mind when designing an incentive compensation plan. Determine what behaviors and outcomes are most important for the company's success.

Exhibit 24: Strategic Reinforcement Model



From your strategic planning, determine what is important and warrants paying incentives to be achieved. Design an incentive plan that is balanced to avoid unintended consequences. Limit discretion in the plan. Get market data to benchmark the appropriate base pay and incentives. Develop proforma financial statements to plan from the bottom up. Ensure there is adequate return on equity in the business before taxes and incentives. Cost model the projected payments of incentives at target performance. Set clear goals and objectives to avoid confusion and misunderstanding. Communicate the plan and provide quarterly progress updates to let the participants know how well the company is doing. Reconcile the achievements and pay out the incentives based on results. Assess the ROI and make adjustment for next year as needed.

Key Elements of Effective Incentive Compensation Plans

1. Designing the incentive compensation plan
 - a. Selecting the appropriate number and type of performance measures
 - b. Setting the appropriate target goals and performance standards
 - c. Balancing out the weights of the various incentive components
 - d. Determining eligibility and payment limitations
2. Benchmarking market data to set appropriate incentive amount to motivate employees
3. Cost modeling of the incentive plan
4. Documenting the incentive plan
5. Introducing the plan and communicating the incentive opportunity for each participant
6. Measuring the results
7. Providing periodic feedback/communication/transparency
8. Funding of the incentive plan from bottom up to make it sustainable
9. Assessing plan effectiveness
10. Updating/revising the incentive plan

Why and How Fast Should We Change Our Incentive Compensation?

Why do anything? If your incentive program is less than very effective, you might need to update your incentive compensation program. Consider this:

1. The majority of construction firms in the U.S. offer incentive programs, so if you do not, you are probably behind your competition. It is inevitable for your company to offer incentive compensation if you want to be competitive in bidding and winning work, but do it for the right reason. It does not have to be for profit only, but be sure you are getting what you want in return.
2. Turn lose/lose situation into a win/win opportunity. The incentive compensation will cost money. For some it may be millions of dollars, for others it may be thousands. But it is important to get it right, because it is a significant investment that is not “very effective” for 79% of U.S. construction companies.
3. Discretionary incentives are least likely to motivate employees.
4. Attract better people because you have a plan in writing as opposed to the old “trust me.”
5. You have to adequately measure it to get the cost benefit.
6. If you benchmark, you will be in a better negotiating position by showing the employees you know what the market pays and how you are willing to compensate them.
7. Per diems and mobility are becoming larger issues.
8. The plan needs to be fair.

How fast should you change your incentive compensation plan? It depends on what your company has in place, the state of the current plan and the company culture. Usually companies with discretionary incentives have an easier transition to a structured plan since there was not a formal plan before, but they must build trust and credibility into

the plan in the eyes of the participants. Those companies with existing plans that are ineffective and pay excessive incentives to employees for just showing up are often very difficult to change because the plan participants are not willing to let go of it.

Allow 90 to 120 days to transition from the legacy plan to a new strategically aligned and balanced incentive plan. Ideally, the incentive compensation plan should match your fiscal- or calendar-year cycle, so that you can report the progress to your employees accordingly. Through our consulting practice, we know that those companies attaching a clear purpose or goal to every change initiative find implementation easier. It seems that some companies however take on several change initiatives at once and then experience change overload where none is implemented well. Our suggestion is to create a checklist and take appropriate steps to implement the new incentive compensation plan. Again, communication is the key for the participants to understand why change is necessary and what will happen as a result of it.

Finally, anytime you modify a compensation plan, employees will have many questions. It is important to have positive and compelling answers for why the plan is changing. Involvement begets commitment, so it is our recommendation that you involve some of the employees in designing the incentive program not only to create net promoters of the incentive program, but also to stimulate feelings of empowerment and fairness of the new program. You will have to publish results even if it is in terms of percentages of achievement toward goals. The participants will need meaningful information to be engaged!

Concluding Thoughts

Incentive compensation is a huge investment for any company. Its goal should be to optimize its incentive outcomes so that it not only pays for itself, but it also provides an increased return on investment to the owners. In order to ensure that firms get an adequate return on their investment, an incentive plan must drive the right behaviors, while at the same time increase cooperation and productivity. Incentive compensation costs companies millions of dollars annually, and even for the smallest of contractors, the cost of incentive programs can rise to thousands of dollars. There are many moving parts, and it can be quite challenging for a firm to balance its incentive programs to get the desired financial outcomes and also the desired employee behaviors. It appears that the construction industry is mostly reactive regarding its incentive compensation practices. Strategic planning and forethought are largely missing during design and implementation of the incentive programs.

The results of this incentive compensation survey indicate that the U.S. construction industry has an enormous opportunity to improve the effectiveness of the incentives offered to employees for increasing return on their investment and driving the desired outcomes and behaviors. While some respondents have adopted what FMI views as incentive compensation's best practices, with the results of attaining and exceeding goals and improved profitability, it is clear that, even among those respondents, there is ample room for improvement. The environment is continually changing and so do the strategic initiatives of construction companies. Therefore, the incentive compensation programs will need to continuously evolve and incentivize toward what is important for continuing success.

Finally, some of the interviewees acknowledged that their issues do not necessarily go away by throwing money at them. The purpose of incentive compensation is to reinforce the desired results and behaviors. Employees are not solely motivated by money, but the incentives are one of the most effective tools a manager can use to reward the alignment of the goals, results and behaviors. Incentive compensation communicates that the organization recognizes and values the employees' additional contribution, believes in it and invests in it. It is about aligning the stretch goals and desired results with rewards. That requires having the five r's: right people in the right positions with right talents and skills attaining desirable results and being rewarded appropriately to make it sustainable.

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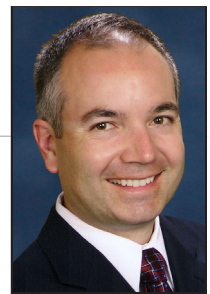


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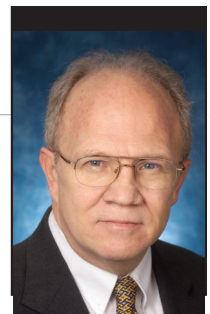


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About FMI

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- Mergers, Acquisitions and Financial Consulting†
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Founded by Dr. Emol A. Fails in 1953, FMI has professionals in offices across the U.S. We deliver innovative, customized solutions to contractors, construction materials producers, manufacturers and suppliers of building materials and equipment, owners and developers, engineers and architects, utilities and construction industry trade associations. FMI is an advisor you can count on to build and maintain a successful business, from your leadership to your site managers.

† Investment banking services provided by FMI Capital Advisors, Inc., a registered broker-dealer and wholly owned subsidiary of FMI.

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