Creating more effective incentives

By Hardeep Plahe

The beginning of the year is a time that we look at what has and hasn't worked in the past ... and what we would like to achieve in the New Year and beyond.

First, in the business context, we need to be clear about what success looks like and how it is going to be measured. Second, we need to work on incentivising both our employees and business partners in helping us to achieve the success we've planned for.

This is not a piece about the "dos and don'ts" of employee incentive programmes, fee structures or contractual clauses that you might employ to incentivise your business partners. It is much broader than that.

Whatever business you are in, your financial success will be driven by creating buyers for the product or service you are selling. I use the word "create" because unless you create buyers for your product or service, you're relying on chance. Alternatively, to put it another way, to create a "want" in others for what you are selling, just like Steve Jobs created a "want" for the iPhone a decade ago.

Successful business leaders understand and value this need to create "wants" which is why, on average, 10 per cent of revenues are spent on marketing. Marketing must start with the end in mind — a clear idea of the success that one wishes to achieve — in order to bear fruit. Effective marketing teams know this and will place importance upon crafting and honing the company's messages and its campaigns accordingly.

Businesses not only rely on buyers of products and services, they also rely on their employees "buying into" the tasks with which they have been entrusted. They rely on their investors and financiers "buying into" the business plan put forward by management and not "pulling the plug" at the first sign of difficulty. They rely on their suppliers "buying into" a long term business relationship instead of looking at the latest purchase order.

Without these other stakeholders, there would be no product or service to sell — or certainly not one envisioned by its management.

Incentives

Wouldn't it be odd if the creation of "wants" in these other stakeholders was left to chance? Wouldn't it be odd if a business did not carefully plan the "want" that it wished to create in its employees, investors, financiers, suppliers and other business partners in the same way as its marketing team plans an effective and targeted promotional campaign?

Wouldn't it be odder still if the "wants" that were created in these stakeholders did not align with, or worse still, ran counter to the specific goals of the business?

And yet it is not uncommon for agreements to be concluded, policies to be put in place and relationships to be handled in a way that generate problems for the business.

Incentives can be positive or negative — the classic "carrot and the stick" — and take both monetary and non-monetary form.

Certain employee behaviour, for example, can be driven by promises of greater remuneration or bonuses (a positive monetary incentive), earning a greater sense of importance from praise and respect (a positive non-monetary incentive), the fear of demotion (a negative monetary incentive) and the dread of criticism (a negative non-monetary incentive).

Investor and supplier behaviour can likewise be driven by positive and negative monetary and non-monetary incentives. For example, expectations of returns (a positive monetary incentive), or being part of something important such as a new technology or a “halo project”, which is necessarily one that will yield a direct monetary return (a positive non-monetary incentive).

Appraisals

However, it is not the type of incentive that is key but whether the incentive is in fact “fit for purpose”. Does it drive the type of behaviour it is designed for or is it having an unintended effect?

For example, if the business goal is to increase collaboration and referral of work between business divisions in an effort to bolster overall revenues, employees must be incentivised to do so.

Management may decide that year-end appraisals should recognise and give high praise for those that have referred work (a positive non-monetary incentive). However, if employees find that their remuneration and bonuses are based only on the work they have done (and not on the work they have referred), they will unlikely refer work and collaborate in the future however much praise they get. Here, there is a disconnect between the behaviour that management wishes to create and the incentives that are employed.

Private equity firms are often past masters at creating incentives to maximise their investment returns. For example, significant bonuses (payable on a successful sale) are promised to a portfolio company’s management team to help the PE firm achieve the highest possible exit price within a 3-5-year investment time horizon.

The same incentives would not be appropriate for a trading group which measures “success” differently. For example, the trading group will often take a longer-term view and be more willing to make significant investment in R&D which may not pay off for a decade or more.

So are your incentives fit for purpose?

The writer is a Partner at Gibson Dunn & Crutcher LLP.