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Five Steps to an Innovative Compensation Strategy

By Sal DiFonzo

How to develop a pay philosophy to guide your compensation strategy.

Merit increases for salaried construction professionals, excluding executives, were 3.7% in 2017, according to FMI's recent compensation research. What is interesting about this figure is that companies projected 3.1% for merit increases in 2017. Most years companies spend less than what they project. The reasons for this are many, including turnover and the fact that not everybody receives an increase every year. In fact, 63% of salaried construction professionals received a merit increase in 2017.

The reality that companies overspent on their merit projections indicates a competitive labor market. Hiring talented construction craftworkers, professionals and executives has never been more difficult. According to "FMI's 2017 Talent Development Survey," 89% of contractors are facing talent shortages, compared to 53% in 2013.

What can contractors do? Few companies have the time or resources to "build their own" through apprenticeship programs or co-ops. Most will need to retain their current employees and attempt to attract qualified new talent from the sparse labor pool. It will take innovating current compensation practices to improve competitiveness in the labor market.

Start With a Compensation Philosophy

To create a foundation for a sound compensation strategy, first define your organization's compensation philosophy. A thoughtful compensation philosophy will guide pay decisions consistently across the company. Here are some examples:

Market Base/Market Incentive

The most common strategy is to pay market-rate base wages or salaries and market-rate incentives. What is market? Broadly speaking, the market is the 25th to the 75th percentile of the labor market. Some companies specifically define market as the 50th percentile (where half of all companies pay less and half pay more).

Pro: It's the "Goldilocks" strategy of not too hot and not too cold.

Con: Top talent may not consider organizations with middle-of-the-road pay plans.

Low Base/High Incentive

The low-base/high-incentive philosophy ensures low fixed costs and pays outsized rewards to those individuals or teams that perform. Base salaries may be at the 25th percentile of the market, but incentives would target the 75th to 99th percentile of the market.

Pro: Philosophy attracts "risk/reward"-oriented employees who would like to earn high W-2 income.

Con: During a downturn, this approach can leave the company exposed to high turnover if it cannot pay outsized bonuses or any bonuses at all.

High Base/Low Incentive

High-base/low-incentive philosophies make it easier to attract employees and limit variability in compensation expenses. Base salaries may be at the 75th to 90th percentile of the market, and incentives may be either nonexistent or only at the 25th percentile of the market.

Pro: Job offer hit rates are higher with this philosophy.

Con: Limited variable pay opportunity may attract risk-averse employees or those who are looking for a more relaxed work environment.

There are multiple permutations of pay philosophies that combine these examples. Companies can also bifurcate the philosophy by level or by job. For example, FMI worked with a heavy civil client that developed a market compensation philosophy for all positions except for one job: project superintendent. The company decided to pay this critical role with a high-base/high-incentive opportunity due to a lack of skilled candidates with bridge-building credentials.

Because similar jobs receive pay in the same manner, a defined compensation philosophy that is consistent across the organization facilitates mobility of resources across job assignments. It eliminates the situation where one manager pays "whatever it takes" to recruit somebody versus another manager who might say "they need to earn it over time." Put simply, a common philosophy reduces compression issues. Compression occurs when a new hire makes significantly more than existing and seasoned incumbents. This means that a company with a market compensation philosophy wouldn't hire someone who is demanding a base salary at the 90th percentile of the market.

Strategically, a defined compensation philosophy translates the overall business strategy into action. It defines the talent the company seeks and determines who will be responsible for achieving the goals which derive from the business strategy.

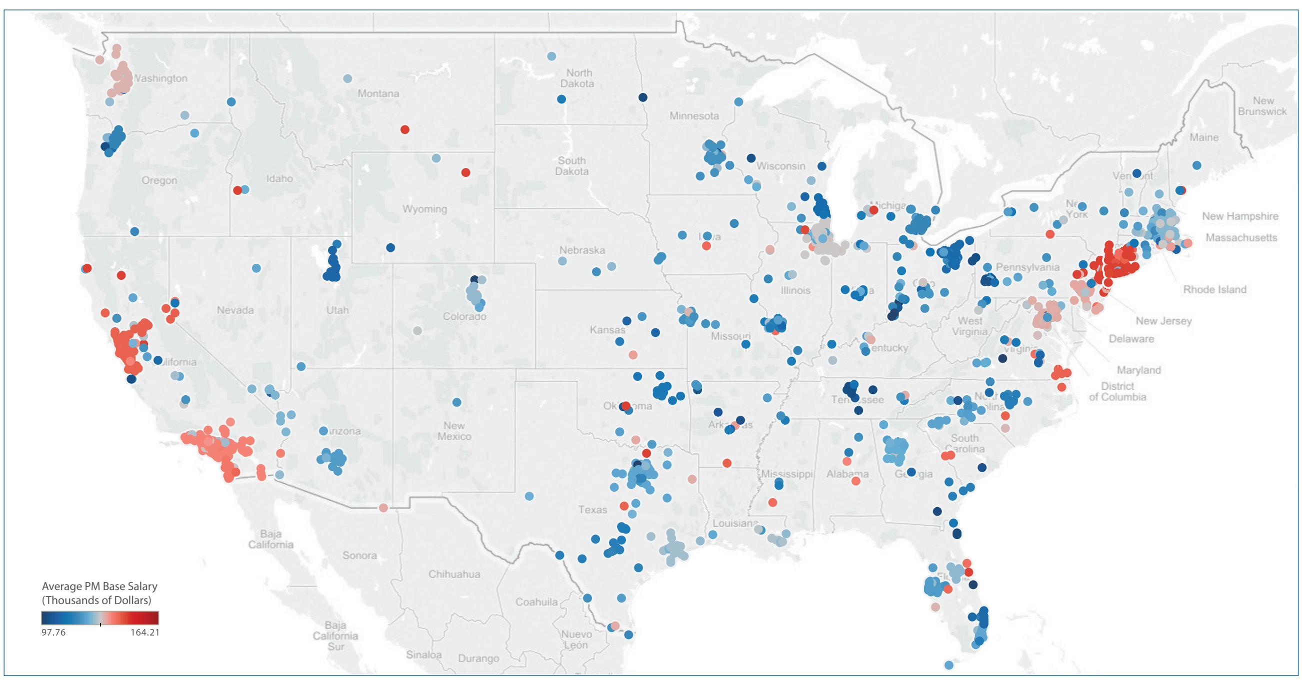
Use Data to Make Pay Decisions

Not many car buyers would walk into a showroom and pay full sticker price. Most buyers research invoice costs and markups through websites such as Kelley Blue Book, Edmunds or National Automotive Dealers Association (NADA). With informational power in hand, purchasers can ensure a fair deal.

It is surprising that "FMI's 2013 Incentive Compensation Study" revealed that only 25% of contractors use compensation surveys to research pay rates. Most executives rely on information from peers, competitors and recruiters. Accurate as it may seem, the small sample bias can lead to highly inaccurate and costly decisions.

Companies with advanced pay practices use industry-specific surveys to gather insightful market intelligence. These surveys typically contain payroll-sourced data parsed by geography and job (e.g., Exhibit 1). In construction, craft and construction professional labor markets are local, while executive labor markets are national.

Exhibit 1. Average Project Manager Pay (Thousands of Dollars)



Source: FMI Compensation Survey Data, 2015

Average base salary for project managers is shown at the city level and includes PM levels 1 through 5.

Convert to a Structured Plan

FMI's research also revealed that 75% of contractors have purely discretionary bonus plans. The problem is that these "trust me" plans are falling out of favor as discerning new entrants into the labor market are choosing to work for companies that have structured incentive plans. Structured plans answer the questions of how much one can earn and what it takes to earn it. Having a structured plan makes it easier to recruit against trust me plans. For more information on how to create a structured incentive plan, see "Designing Effective Incentive Compensation Plans."

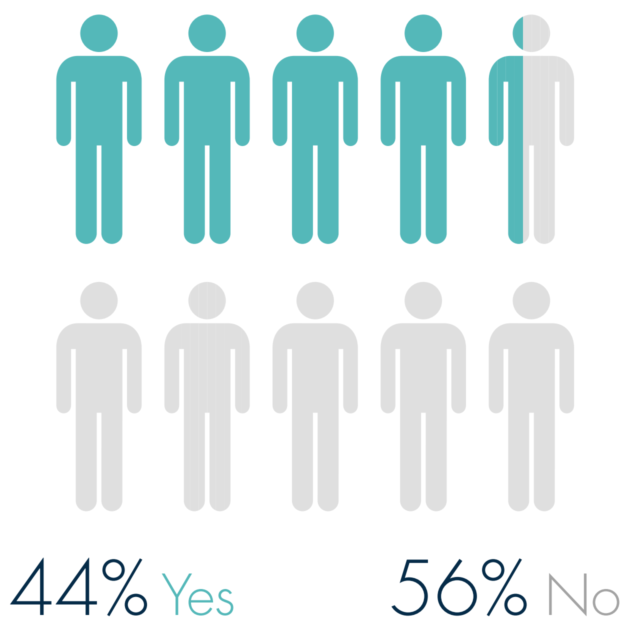
Leverage a Long-Term Incentive Plan for Executive Retention

A contractor may already distinguish itself by having a defined compensation philosophy to guide pay decisions, and the company may also offer a structured incentive plan—making recruiting easier as well as clarifying the relationship between pay and performance. What else can the company do to set itself apart from the competition? With only 44% of contractors having long-term incentive plans (according to "FMI's 2016 Incentive Compensation Study"), this compensation element aims to retain key talent (Exhibit 2).

Examples of long-term incentive plans include simple cash-based plans, stock, phantom stock as well as stock appreciation rights (SARs). In this widely privately held industry, synthetic equity programs like phantom stock are popular when owners (often families) choose not to offer actual equity.

These programs create "golden handcuffs" by taking annual awards and deferring payout, typically more than three years into the future. Balances build over time, making it very difficult for participants to leave. For more information on long-term incentive plans or non-qualified deferred compensation programs, please see "Looking to the future: How E&C firms can leverage long-term incentive plans."

Exhibit 2. Does your company have a long-term compensation plan?



Source: 2016 FMI Compensation Study

Set Your Plan in Action

Companies can avoid repeating a pattern of old practices by creating innovative remedies for each of these problem situations:

1. ***Problem:*** Allowing multiple compensation philosophies to exist within the organization can lead to inequities, compression and the reinforcement of siloed cultures.

   Remedy: During the strategic planning process, define a compensation philosophy that unites the company behind pay principles focused on the desired culture and talent pools.

2. ***Problem:*** Guessing or using anecdotal data to make pay decisions can lead to overpaying or underpaying errors.

   Remedy: Utilize available labor market data to make empirical—not uninformed or emotional—decisions.

3. ***Problem:*** Utilizing hackneyed, 100% discretionary pay plans that have no connection to established goals or outcomes.

   Remedy: Create a structured short-term or broad-based incentive plan that communicates the earnings opportunity and develop the performance measures that lead to successful outcomes. Link the goals to the business strategy. The result is easier recruiting, more motivated employees and improved financial or operational results.

4. ***Problem:*** Creating special deals for executives (to retain them) that are difficult to unwind.

   Remedy: Install a structured long-term incentive plan to retain key executives and high potentials. A long-term incentive program will create a competitive advantage and reduce the likelihood of losing key leadership that may defect to competitors (or form their own competitive firms).

The investment in an innovative compensation strategy will provide a return to the organization in both good and bad economic times. Getting started can be difficult, but once you build a solid pay philosophy—and incorporate it into your annual strategic and business planning process—the rewards will pay off well into the future.

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