

The Value of Equity Compensation: Delivering on the Best of Intentions

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Many publicly traded companies deliver equity-based compensation to their executives on an annual (or bi-annual) basis after a fairly intense “packaging” process. Among other steps, this process may include a competitive assessment against a select group of peers, decisions regarding what levels of compensation are appropriate at certain performance levels (if granting performance shares), and calculations regarding dilution and expense. This painstakingly packaged award is then delivered to the executive with the intention of providing the “right” level of compensation for the “right” level of performance.

Mission accomplished! Or is it?

A shipping service can easily measure its success in delivering packages: The package arrives on time with contents undisturbed. There may be a tracking number and insurance on the value of the contents in case the package is lost or damaged.

In the world of equity compensation delivery, we may know when the equity package is due to “ship” and we can even state the intended value of its contents on that day, but do we know if the intended contents are there upon arrival? What about one, two, or three years later?

In this *InsightOut*, the first in a new series about Equity EffectivenessSM, we:

- Explore methodologies for measuring the value delivered from equity grants over time
- Address the question of “value”, but in the context of a holistic approach to ensure that various stakeholders (employees, the corporation, and shareholders) maintain a positive perception of their equity program(s).
- Outline how one company found a way to track equity effectiveness after the proverbial “equity delivery truck” had pulled away.

DEFINING EQUITY EFFECTIVENESS

Defining and measuring the effectiveness of an equity program is not a simple task. The reasons for even having an equity program may vary within and across organizations, from executive retention (large in-the-money unvested awards) to competitive necessity (everyone else is doing it) to capital accumulation (another form of retirement). The underlying intention, however, is to deliver value in some fashion.

Even so, many companies don’t formally or regularly assess whether the equity program has been an effective value proposition after the grant. Historically, compensation professionals and compensation committee members have been myopically focused on delivering the “correct” equity value to executives on the date it is granted based on one year’s worth of data. Their attention has been on positioning

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long-term incentive awards relative to a stated peer group. They have given little consideration to the value actually received or the company's return on its prior investments. It has not been a common practice — as it is in annual cash incentive programs — to test how much of the intended value of an equity grant was actually delivered versus the contribution the recipient made to the company's performance.

However, due to increased scrutiny of equity usage by both proxy advisors and shareholders, companies are starting to examine their equity programs more closely. Companies are now seeking to understand and demonstrate how "intended value" of equity relates to the "actual value" delivered to executives.

REDEFINING EQUITY EFFECTIVENESS

Recently we assisted a company that sought to understand the effectiveness of its equity program — more specifically, to determine the relationship between the "intended value" and "actual value" of grants made to its Chief Executive Officer (CEO) over time. This \$1 billion technology company had a strong track record of financial performance coupled with a highly volatile stock price. The company's equity program had a clear linkage between pay and performance with 67 percent of the total target long-term incentive (LTI) being delivered in performance shares and the remainder in stock options.

Although a competitive market study showed that *target* total compensation was in line with the market, there was a growing perception that the actual compensation being delivered through the equity program was low considering the company's performance in relation to its peers. To understand this disconnect, the company requested a review of actual value delivered in the equity programs versus the intended value at time of grant. The result of this comparison is the "Value Delivery Ratio."

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Acknowledging that many variables impact our understanding of equity value, such as vesting schedules, comparative timeframe, and the financial model used to value grants, we worked with the company to develop the following process:

- Collected three full years of equity grant data for the CEOs of the peer group companies
- Treated all time-based grants as if they were fully vested
- For performance grants, used only those actually earned for completed periods

Terminology and Calculations:

- *Intended Value on Date of Grant* is the value disclosed in the proxy within the Grants of Plan-Based Awards table. For most companies, valuation of stock options is based on the Black-Scholes methodology and valuation of full-value grants is based on number of shares granted multiplied by stock price on date of grant. Awards that are contingent upon performance conditions are valued differently depending on the types of performance conditions being used, but are a function of the value of the stock and the likelihood and expected distribution of awards. Only performance grants with a performance period beginning and ending within the three years were used in this calculation.

While this methodology, especially for stock options, may not be a true reflection of the value a company intends for its executive to realize, it is currently the only insight into valuation currently required in public filings.

- *Actual Value Delivered* is the value of the grant as of the last day of the three-year period:
 - Stock option grants calculated as:
(Stock Price on 12/31/09 – Grant Strike Price) x (Number of Shares Granted).
 - Time-based full-value share grants calculated as:
(Stock Price on 12/31/09 x Number of Shares Granted)
 - Performance shares calculated as:
(Stock Price on 12/31/09 x Number of Shares Earned)
- *Value Delivery Ratio* is calculated as:
(Actual Value Delivered ÷ Intended Value on Date of Grant)

Results:

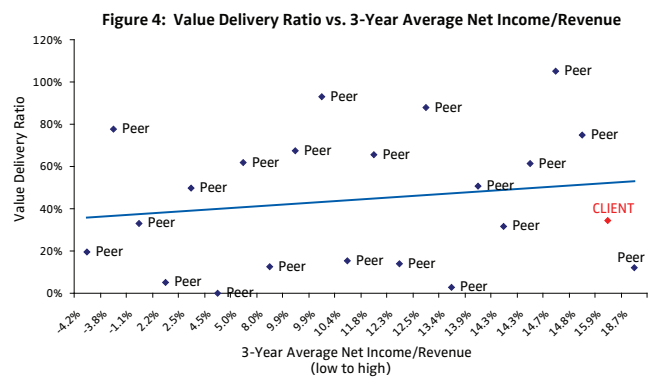
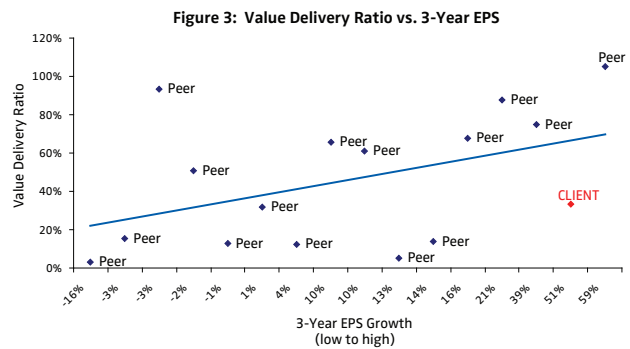
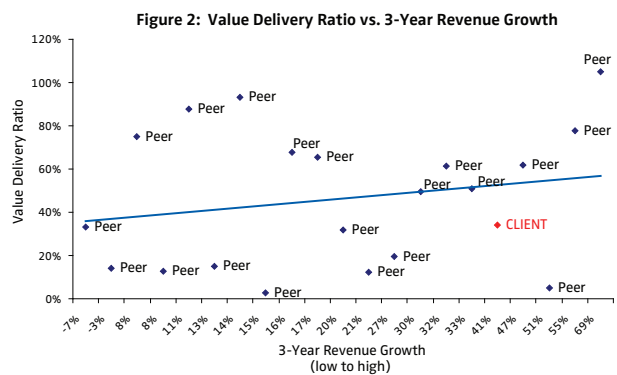
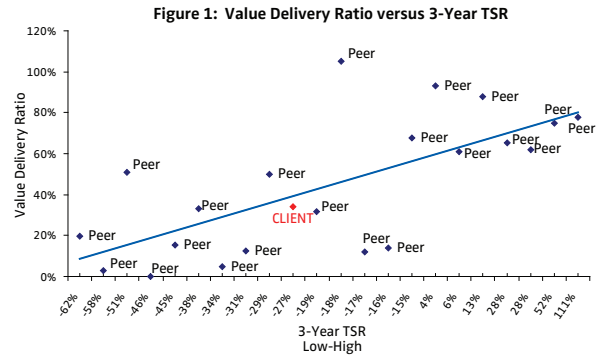
The company's Value Delivery Ratio for all CEO equity grants (including stock options) made within the last three years was approximately 35 percent, while the median of the peer group was closer to 50 percent.

This was a result of two factors: The company's stock price was non-responsive over much of the measurement period and they had a highly leveraged performance share program with stretch goals at target. These two factors combined to create an environment wherein the company's performance share targets were not fully achieved over the three years. This situation began to explain the negative perception of the equity program.

Next we sought to understand the link between the Value Delivery Ratio and the relative performance of the company against its stated peers. We plotted the relationship between the Value Delivery Ratio and four financial metrics found in the company's various incentive plans: total shareholder return (TSR), earnings per share (EPS), net income as a percent of revenue, and revenue growth. We used a three year period to determine if the company's Value Delivery Ratio was in line with its pay-for-performance in comparison to that of its peers.

Figures 1 through 4 plot the four metrics versus Value Delivery Ratios for the company and peer companies. Each point on the scatter-plot indicates the location of a peer company's Value Delivery Ratio against a financial metric. The solid line represents the trend line or "line of best fit" between the two variables.

The company's performance on all but one of the financial metrics (TSR) was better than the median of its peers. If the company's equity program truly promoted the company's pay-for-performance compensation philosophy, we would expect the Value Delivery Ratio to exceed the median of peers as well. With a Value Delivery Ratio at 35 percent, this was not the case. The CEO had, in fact, delivered on performance, but the equity plan had not delivered in kind, at least from the perspective of several relevant performance standards.



Plan Design Insights

This analysis provided empirical evidence that the plan was not providing commensurate incentives for results critical to achievement of the company's established financial imperatives. Correspondingly, this provided the company with the evidence it needed to consider a refinement to its long-term incentive plan and performance targets going forward. We were able to assist the company in working through the following issues with the company's compensation committee as it looked to design a more meaningful plan:

1. Are the targets established for our plan(s) more challenging than peers? If so, what implications does that have for the perceived risk profile of the plan? Do we know what potential risks are inherent to the executives achieving them?
2. Would the stakeholders of this plan be better served with a relative performance share plan rather than one with absolute targets? For example, if a relative EPS target had been used, the plan would have paid out near the company's maximum due to its high level of EPS performance against its peers (Figure 2).
3. What balance of performance shares, restricted shares, and options will provide the maximum incentive and reward to executives, as well as align with company and shareholder interests?

Regardless of the methodology used to examine the effectiveness of a company's equity program, the exercise is essential as companies seek to improve the return on their equity investment.

Alternative Methodologies

Companies might choose to test different hypotheses. For example, one alternative is to assess the value of an equity grant at each vesting tranche to get a more detailed look at the value available to executives at time of vest. The complexities of vesting schedules over multiple grants, multiple years, and multiple companies could make comparisons with other companies difficult and time consuming. However, this methodology provides a more "realistic" view for some companies, especially those with highly volatile stock.

Looking at different periods of time (two years, five years, or even longer) could provide a more focused or broader view of the effectiveness of a company's equity program over time.

Finally, updating financial data to the most recent quarter with 10-Qs, then supplementing proxy equity data with executive Form 4 filings, would provide a more current ("year to date") number. However, the volatility that existed in 2008 and 2009 can easily produce skewed results or results that are very different across timeframes — though the Value Delivery Ratio may not be impacted, as company results are also likely skewed by this market.

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Further Considerations for Plan Designers

Understanding the effectiveness of your company's equity plan — in promoting a compensation philosophy and in motivating employees — is a challenging but valuable endeavor for both shareholder approval and executive motivation and retention.

Prior to your next grant delivery cycle, consider the following:

1. Are your targets appropriate based on your performance relative to your peers?
2. At the outset, how does the "intended value" of the award relate to the value the company wants to deliver to its executive(s)?

3. How does the company formally evaluate the level of difficulty of achieving specified payout levels under the plan? How difficult is it for executives to attain the intended value of the award?
4. What is the level of risk you are asking your executives to take if the intended value of your plan is difficult to achieve?
5. What wealth, if any, has been built for your executives over time and how does that relate to the wealth delivered to shareholders over the same timeframe?
6. What would your Value Delivery Ratio be over the last three years under the same analysis? How would it change your plan design for the next grant cycle?

For questions regarding this article or for more information about Equity Effectiveness, contact any one of the authors.

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