

Can Your Long-Term Incentive Plan Become More Performance Based Again?

By Larry Schumer

A top responsibility for Compensation Committees is to ensure a strong linkage between executive compensation and company performance. Long-Term Incentive Plans (LTIPs) typically provide the largest component of senior executives' compensation, most often through one or more of three equity-based types: Stock Options, Restricted Stock, and Performance Shares.

This *InsightOut*tm assesses the relative strength of the linkages between company performance and each type of equity when included in an LTIP. It also:

- Makes the case for increasing usage of Performance Shares as a key component of LTIPs
- Provides data supporting the conclusion that this increase is, in fact, occurring; Buck Consultants' data focuses on practices in mid-size to large companies, those between \$500 million and \$5 billion in revenue
- Poses key design questions for Compensation Committees who are considering Performance Shares in their LTIPs

SCORING EQUITY-BASED LTIPs FROM A PERFORMANCE PERSPECTIVE

Buck believes that these three types of LTIPs incorporate the concept of performance to very different degrees.

Let's start with Stock Options. Options have earned a mixed reputation in the marketplace for various reasons, including:

- The multi-million-dollar gains executives received from exercising options granted over many years of a strong economy and bull market when a company's actual performance, although decent, could have — and, perhaps, should have — been stellar
- The backdating scandal
- The end of "no-cost options" brought about by FAS 123R

These factors prompted a move away from a predominance of Stock Options in LTIPs during the 1990s and in the early years of this decade to the much greater use of Restricted Stock in the last three to five years. However, we would still give Stock Options a "performance score" of B or B+ because they are an "appreciation-only vehicle." When granted, they have no intrinsic value and may never have value unless a company's financial performance raises its stock price.

We give Restricted Stock a low performance score of D because, as a time-based award, it rewards executives "for just sticking around." Even a stock price that drops 20 percent over the vesting period still provides 80 percent of the value for what was likely poor performance. However, if companies were to use only cliff vesting of restricted stock after three or four years, and Boards were to become more diligent about replacing lower performing CEOs and other senior executives, then we would increase the score from a D to a C+ or B-.

Clearly, there are reasons why the move from Stock Options to Restricted Stock that took place from 2002 through 2007 was a rational move. For one thing, a declining or flat stock market during some of those years made these full-value grants even more appealing to executives. The move also reduced dilution, which shareholders saw as a positive outcome. And, of course, the "great equalizer" of FAS 123R, which requires all equity programs to have a cost recognized through the income statement, was a major factor. However, we do believe that the pendulum had swung very far as many companies moved mostly or totally to Restricted Stock grants.

Of the three types, Performance Shares provide the strongest link to performance. They have been prevalent in the largest, more mature companies for many years. In recent years, they also have been appearing increasingly in the equity mix of LTIPs for mid-size companies. We give them a performance score of A because shares are earned only for attainment of specific financial goals set by the Board or Compensation Committee.

The most common Performance Share plan would be one that sets a target number of shares — let's use an example of 10,000 shares — that a CEO could earn for performance over a three-year period. This sample plan could have two metrics, each equally weighted and each with a specific target — Return on Equity (ROE) over three years targeted at 12 percent and Total Shareholder Return (TSR) over three years against a peer group at the 55th percentile. Chart One presents a complete example of how the formula would work given various outcomes under the two metrics. For instance, the CEO might earn no shares if the ROE were less than nine percent or 120 percent of the 5,000-share target if ROE were 14 percent.

THE DATA TRAIL LEADS TO MORE PERFORMANCE SHARES IN LTIPS

Recent data points to a strong trend toward greater use of performance-based equity plans in the form of Performance Shares. Let's look at company practices in 2006 and 2007 from three data sources.

First, Buck's client projects in 2007 often included a proxy analysis of the client's peer companies, looking at data mostly from 2006. In several different projects, in industries as diverse as technology and utilities, we saw Performance Share programs in 15 percent to 20 percent of the mid-size to large companies we looked at with revenues of \$500 million to \$5 billion.

Second, Buck's annual *Global Long-Term Incentive Survey* provides data on executive and non-executive incentive programs in 35 countries. The 2007 survey, based on data as of April 2007, found that just more than 30 percent of all respondents maintained such incentive programs. (The large majority of these 30 percent of companies used Performance Shares, but a few used options with performance conditions for vesting.) Interestingly, this is double the approximately 15 percent prevalence we found from our 2004 survey.

Chart One

ROE		TSR	
Value (Percent)	Percentage of Target Shares Earned	Value (Percentile against Peer Group)	Percentage of Target Shares Earned
Less than 9%	0%	Below 45th percentile	0%
Between 9% and 9.99%	50%	Between 45th and 49th percentile	50%
Between 10% and 11.99%	80%	Between 50th and 54th percentile	80%
Between 12% and 12.99%	100%	Between 55th and 59th percentile	100%
Between 13% and 14.99%	120%	Between 60th and 69th percentile	120%
15% and higher	150%	70th percentile and higher	150%

Third, to obtain as current a sample as possible, we analyzed 40 companies in our targeted range (\$500 million to \$5 billion in revenues) across industries with fiscal years ending September 30, 2007. These companies will have just filed their proxy statements in the first three months of 2008. Among these 40 companies, 35 percent used performance equity plans. Chart Two on page 3 also highlights the types of equity chosen by the 16 companies that used only one type and the 13 companies that used two types.

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Chart Two

Number of LTIP Types in the Plan		None	One	Two	Three
Percentage of the 40 Companies		13%	40%	32%	15%
Number of the 40 Companies Using One Type	16	Number of the 40 Companies Using Two Types		13	
Stock Options only	8	Stock Options and Restricted Stock		6	
Restricted Stock only	5	Stock Options and Performance Shares		3	
Performance Shares only	3	Restricted Stock and Performance Shares		4	

Clearly, these three data sources indicate a strong trend toward greater use of performance-based equity programs among mid-sized companies. We expect the prevalence of such programs to increase to well over 50 percent in the next two to three years.

CONSIDERING PERFORMANCE SHARES? IF SO, CONSIDER THIS

Although a detailed discussion of Performance Share plan design is beyond this article’s scope, those contemplating such a plan should consider the following key issues:

- *How many metrics should be used?* We suggest using only one or two so as not to diminish the importance of any metric used. The number of metrics used should be influenced by how large a percentage of the total LTIP opportunity is to come from Performance Shares.
- *Which metrics should be chosen?* The best course is to choose metric(s) that align most closely with the business strategy and stakeholder expectations. (Note that different types of metrics can result in different accounting treatment under FAS 123R.)

- *Should the company’s performance under the plan be compared at the end of the performance period to a peer group’s and/or the company’s own performance?* There is no right or wrong answer here. The basis for comparison should be established after an active dialogue between the Compensation Committee and CEO. If two metrics are used, we generally suggest a mix of comparisons — one relative to a peer group and the other company-specific — especially in the early years.
- *At what levels should the targets, threshold, and maximum performance levels be set?* Generally, we recommend steep grading lines (for instance, the relatively large increments between the target shares set in Chart One) to keep the performance intention strong. We know that fewer or more shares will be awarded based on performance, but it is also important to remember the self-adjusting nature of the value of Performance Shares. To the extent the performance measures are those underlying shareholder value creation, then performance below target would result in fewer lower-priced shares and performance above target would result in more higher-priced shares.
- *How long should the performance period be? If these are long-term plans, shouldn’t the performance period be three years?* In response to this observation, we hear CEOs saying that it is too difficult to set the achievable goals for a multi-year period because their businesses change too frequently. However, Compensation Committees need to push back on this argument because many of these executives are eligible to receive overlapping grants annually from the LTIP. Therefore, even if the company’s performance does not merit a grant payout to executives for one period, opportunities still exist for payouts from subsequent, overlapping grants. To address this point, Compensation Committees may want to propose:
 - Phasing into a three-year period by first using a two-year period
 - A hybrid arrangement composed of a two-year, or even one-year, performance period followed by additional years of vesting to maintain the “long-term feel”

- *What is the “appropriate” mix of equity types in an LTIP?*
Companies often use a combination of Stock Options, Restricted Stock, Performance Shares, and multi-year cash plans, especially in the early years of experimenting with a new type of plan. We suggest limiting the combination to two types, including Performance Shares. Also, Compensation Committees sometimes choose to start with Performance Shares making up less than half of the total incentive opportunity and then increasing that proportion over time.

As Compensation Committees consider the design issues surrounding their LTIPs, they must do something of a balancing act. On the one hand, they must represent the interests of shareholders, whose natural preference would be for the more rigorous and more performance-based behavior that Performance Shares promote. On the other hand, Compensation Committee members also know that shareholder interests include the retention and motivation of senior executives. These same executives often place a higher value on Restricted Stock, which has only time-based restrictions on receiving the value. Restricted Stock is often referred to as having “retentive value” and this can be interpreted to mean that it is better for or more valued by the recipient.

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CONCLUSION

The link between pay and performance is paramount in executive compensation plans. Compensation Committees are doing a better job of forging this link, as evidenced by the increasing use of Performance Shares and other performance-based LTIPs. Almost all Compensation Committees are at least discussing these issues. We are still in the early stages of this movement, but it is happening quickly. As it progresses, it will be interesting to see how performance plans evolve and whether they grow to be the dominant component of total LTIP opportunities for top executives.

ABOUT THE AUTHOR:

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