

Octane-Driven Performance

Octane is the logical drug of choice for high-performance vehicles — but there’s a catch. High-octane gas costs significantly more, so filling up the minivan with super-unleaded is a waste of money. Nor does it make sense to tap high octane for a premium vehicle when its maximum performance will be negotiating stop-and-go traffic.

The same concept applies to adopting and designing high-performance executive incentive plans. This article explores three long-term incentive plan designs that can be tuned for very high levels of performance. These programs are not for the faint of heart. They can be very expensive when the desired level of performance is not achieved, and therefore should be reserved for the type of highly specialized business scenarios described below.

The Vehicle Line-Up

Companies today are confronted with a dizzying array of long-term incentive programs. Many are designed to accomplish multiple and sometimes conflicting goals, ranging from minimizing accounting charges and share use to motivating executives, making the plan more shareholder-friendly and

enhancing shareholder return. Often, companies will employ two or more vehicles to achieve conflicting goals, making design considerations even more complicated. To narrow the scope of this discussion, we will discuss each of three alternatives as a stand-alone design.

The high-performance line-up includes:

- A relative performance share plan that compares performance to relative total shareholder return (TSR). TSR consists of stock price appreciation, plus reinvested dividends.
- Premium-priced stock-settled stock appreciation rights (SSARs) that have shorter performance terms.
- A Short-Period Incentive (SPRINT) performance share plan based on absolute performance during a shorter measurement period.

Off The Line

From a shareholder and executive perspective, a performance share plan based on relative TSR can be highly attractive. The plan will deliver value regardless of the economic environment, as long as the company outperforms its peers. The reverse is also true — absolute strong results will

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QUICK LOOK

- ⇒ A total shareholder return plan will deliver value regardless of the economic environment, as long as the company outperforms its peers.
- ⇒ Stock-settled stock appreciation rights could use as few as half the shares that would be needed under the option program to deliver the same economic value to the executive.
- ⇒ A short period incentive plan is based on a three-year performance period, which is reasonable for a long-term plan and complements the one-year term of an annual incentive plan.



not result in high awards if the company is outperformed by the peer group.

Under a typical relative performance share plan, a target annual equity grant expressed in shares is assigned to each executive. The target level can increase or decrease, based on the three-year TSR of the company versus the peer group.

These plans can be tuned for performance, as illustrated in Figure 1. Regardless of the aggressiveness of the plan design, all four approaches pay out at target, as long as company performance is at the peer-group median. But the maximum and threshold awards will vary significantly.

Once tuned to the desired level of performance, the plan's performance and/or cost is reduced or enhanced by the addition of other long-term incentive vehicles. The racing fuel approach is very aggressive as a stand-alone plan, but much less so if it accounts for just 25 percent of the long-term incentive award, or is paired with a significant grant of time-vested restricted stock. In fact, relative TSR plans are often mated with one or two other equity vehicles, such as restricted stock or plain vanilla stock options.

Incorporating the entire long-term incentive grant into a relative TSR plan can backfire. A company's TSR could soundly beat the return on a broad index basis, but substantially

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lag peer companies' returns. In such cases, the plan may pay out zero or reduced awards, even though the company outperformed the average Fortune 500 company. While the plan would be performing as designed, the company might need to ramp up its recruiting efforts in anticipation of potentially higher turnover as a result. Conversely, the entire industry might suffer significant declines based on economic conditions. If the company outperforms its peers, there could be substantial payouts to executives in years when shareholders have lost significant value (the "best of the

worst" curse). Again, the plan would be working as intended, but the company nevertheless might find itself facing some very unhappy shareholders.

SSAR Performance

SSARs have the advantage of delivering the same economic value as stock options, but with fewer shares. Under an SSAR, the company would issue shares to the executives that represent only the in-the-money value of the pretax gain at option exercise. Depending on the circumstances, SSARs could use as few as half the shares that would be needed under the option

FIGURE 1: SHARES GRANTED AS A PERCENT OF TARGET

TSR Percentile Ranking Against Peer Group	Regular Gas	Regular Plus Gas	Premium Gas	Racing Fuel
85 th percentile and higher			200 percent max	250-300 percent max
75 th percentile	125 percent max	150 percent max	125-150	100-150
50 th percentile	100	100	75-100	50-75
25 th percentile	75	50	50	0-25
Below 25 th percentile	0	0	0	0

Source: Pearl Meyer & Partners

A company's TSR could soundly beat the return on a broad index basis, but substantially lag peer companies' returns.

program to deliver the same economic value to the executive. However, it should be noted that the methodology used by Institutional Shareholder Services (ISS) would assign the same number of shares to an SSAR grant as an option grant.

Now, we're still missing the SSAR supercharged performance element. The key to this design is to consider shorter terms for the SSARs grant, along with premium pricing — that is, a strike price above fair market value at the date of grant. This approach accomplishes several goals:

- A premium SSAR grant is more likely to be perceived as aligning pay and performance, since the stock price must increase beyond a threshold before there is any gain by the executive.
- A shorter term further enhances the performance focus, since the price appreciation must occur during a shorter period of time for the SSARs to become “in the money.”
- Depending on the design, the company may reduce FAS 123R accounting costs. Figure 2 on page 77 compares the grant date “fair value” (the FAS 123R

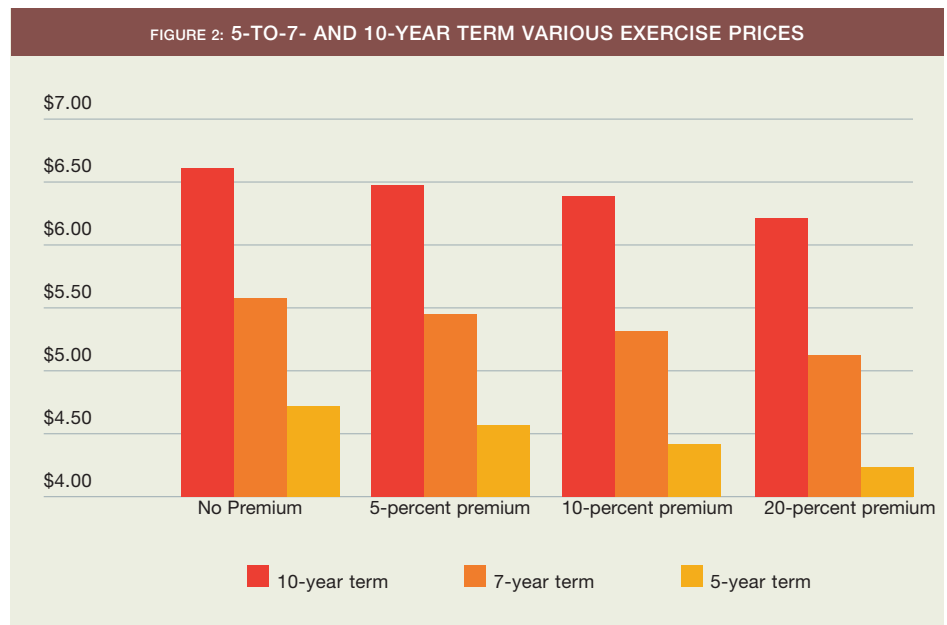


FIGURE 3: GRANT COMPARISON

Strike Price	Alternative 1		Alternative 2	
	Shares Issued	Grant Value	Shares Issued	Grant Value
Fair market	15,150	10,590	\$100,000	\$50,000
10% premium	0	6,740	\$0	\$30,000
20% premium	0	4,780	\$0	\$20,000
Total	15,150	22,110	\$100,000	\$100,000

Source: Pearl Meyer & Partners

expense) of an SSAR with a 10-year term issued at fair market value, versus SSARs issued with premium prices and shorter terms. It assumes a \$10 stock and 50 percent volatility. To make an extreme comparison, an SSAR issued at market (with a \$10 strike price) with a 10-year term would have a grant value of about \$6.60. If issued with a 20-percent premium strike price (\$12) and a five-year term, the grant value would drop to about \$4.20. Combining premium strike prices with shorter

performance terms offers some interesting design possibilities.

Let's assume a company wants to grant an executive an SSAR with a \$100,000 grant value. As shown in Figure 3 on page 77, such value could be provided through a traditional grant of 15,150 SSARs at fair market value with a 10-year term (alternative 1), or a performance-enhanced grant of SSARs with a five-year term and a mix of fair market and premium exercise prices (alternative 2).

Although the cost to the company would be the same for both designs, alternative 2 would deliver higher performance in two ways.

First, from the shareholder's perspective, providing about half the shares at premium exercise prices reinforces the pay-for-performance connection.

The full grant is not "in the money" unless the stock price appreciates more than 20 percent over a five-year term.

Second, from the executive's perspective, there is the potential for greater

FIGURE 4: EXECUTIVE GAIN



FIGURE 5: STOCK PRICE AT EXERCISE AND GAIN AT EXERCISE

		Stock price at exercise						
		\$10.00	\$11.00	\$12.00	\$12.34	\$15.26	\$16.60	\$20.00
10-yr CAGR		0.0 percent	1.0 percent	1.8 percent	2.1 percent	4.3 percent	5.2 percent	7.2 percent
5-yr CAGR		0.0 percent	1.9 percent	3.7 percent	4.3 percent	8.8 percent	10.7 percent	14.9 percent

		Gain at exercise						
		\$10.00	\$11.00	\$12.00	\$12.34	\$15.26	\$16.60	\$20.00
Alternative 1	15,150 \$10	\$0	\$15,150	\$30,300	\$35,481	\$ 79,690	\$100,000	\$151,500
Alternative 2	10,590 \$10	\$0	\$10,590	\$21,180	\$24,801	\$ 55,704	\$ 69,901	\$105,900
	6,740 \$11	\$0	\$0	\$ 6,740	\$9,045	\$ 28,713	\$ 37,748	\$ 60,660
	4,780 \$12	\$0	\$0	\$0	\$1,635	\$ 15,583	\$ 21,991	\$ 38,240
	22,110	\$0	\$10,590	\$27,920	\$35,481	\$100,000	\$129,640	\$204,800

Source: Pearl Meyer & Partners

CAGR = Compound Annual Growth Rate

value if stock price performance is strong.

As Figure 4 illustrates, if the stock price exceeds \$12.34, alternative 2 results in more realized value to the executive, even though more than half of the options are premium priced.

As shown in Figure 5, payouts will depend on an accelerating stock price. Consider the \$100,000 expense in our example. Under alternative 1, the executive will realize a gain that exceeds the company's cost as long as the stock price goes up at least 5.2 percent per year over the 10-year life of the option. In alternative 2, however, the stock price has to increase at least 8.8 percent per year for the executive to see a gain equal to the expense taken by the company. That means that if the stock price is stuck in bumper-to-bumper traffic, this design would not only consume more shares, but would result in a high cost for the value delivered. On the open road, however, this design kicks into overdrive. Paired with other long-term incentive vehicles, it takes on a pretty good shine.

Shorter Performance Periods for Consistent Performance

Performance share plans are increasingly popular. Most are based on three-year performance periods, which

A premium SSAR grant is more likely to be perceived as aligning pay and performance, since the stock price must increase beyond a threshold before there is any gain by the executive.

are reasonable for a long-term plan and complement the one-year term of an annual incentive plan. However, companies of late have been experiencing more difficulty setting reasonably achievable performance goals over a three-year period. For example, calendar-year companies set goals for their 2007-2009 long-term incentive plans at the end of 2006, when the economic environment was robust. By the second quarter of 2008, however, many economists declared the United States in a recession that is now widely expected to last well into 2009, rendering many of

those 2007-2009 targets unachievable despite management's best efforts. As a result, many compensation committees will end up having to decide at year-end whether to take action to retain executives if it seems clear there will not be payouts under the annual and long-term incentive plans.

Rather than the more typical three-year period, an enhanced performance share plan design might be built around one- or two-year performance periods. Some might object that such briefer time frames do not reflect real long-term performance. Because the shares

FIGURE 6: SHARES GRANTED AS A PERCENT OF TARGET

Performance Against Goals	Regular Gas	Regular Plus Gas	Premium Gas	Racing Fuel
150%			200% max	250% max
125%		150% max		
115%	125% max			
100%	100	100	100	100
85%	50 threshold			
75%		50 threshold		
50%			50 threshold	25 threshold

Source: Pearl Meyer & Partners

How Do the Three Designs Stack Up?

Performance Feature	Relative Performance		Short-Period Incentive		Test results
	Share Plan	Premium SSAR	(SPRINT)		
Interior fit and finish: management's perspective	4	4	4		<ul style="list-style-type: none"> All three designs will deliver substantial value through high performance, and will be positively received if management is bullish on the stock. Used as a stand-alone, these highly leveraged and fairly risky plans may not receive management support.
Exterior fit and finish: board/shareholder perspective	4	4	2		<ul style="list-style-type: none"> All three designs are likely to be viewed positively by shareholders from a pay-for-performance perspective. From a design perspective, boards and governance organizations typically embrace relative performance and premium SSARs/options, although the challenge will be calibrating payouts to performance. The shorter performance-period plan may not receive as much support. Relative performance and premium SSARs/options are generally perceived positively in disclosures.
Fuel consumption: share usage	4	1	4		Premium SSARs increase share consumption and deliver value only if stock prices rise. Because the ISS treats fair-market SSARs the same as premium SSARs, this is not the best design option if the plan is low on fuel or ISS approval is important.
Vertical acceleration: value creation	4	5	4		All three alternatives can be tuned to generate exceptional value if company performance appreciates rapidly.
Turbo lag: timing of value creation	2	1	3		All three designs, particularly premium SSARs, will not generate immediate value since value is contingent on significant stock price or performance increases. A supplemental grant of fair market SSARs or time-vested restricted stock can minimize turbo lag, but will make the plan more costly.
Lateral acceleration: coffee rides up the side of your cup during turns	5	2	2		Relative plans have high lateral acceleration levels since they take turns in the economy well. Absolute measures may come up woefully short around the turns in choppy economies, but have the ability to take the lead in straightaway (vertical) acceleration.
Endearing design: prevalence	2	2	2		These designs are unlikely to be beloved by the masses because they stray too far from prevalent practices. But they can serve the high-performance niche market very well as one element in an overall incentive program.
Staying in the race: retention	2	2	2		If performance lags expectations, these plans will not keep executives focused on the finish line. Rewards are strictly focused on high performance, particularly if the plan is tuned for racing fuel.
List price versus price with option packages: accounting cost	1	3	3		<p>Almost any plan can be designed to meet an accounting cost objective, if the aggregate value of the grant is reduced.</p> <ul style="list-style-type: none"> The relative performance share plan, which is based on total shareholder return (TSR), can be more costly since costs are not reversed if goals are not met. Plans that avoid TSR as a performance measure may end up with a lower long-term price tag.
Finish Line	28	24	26		

Generally speaking, high performance takes on different meanings depending on the view of the stakeholder.

would not vest for three to four years, however, the plan creates retention value and promotes a continued focus on stock price.

A simple performance share plan provides a grant of shares based on a one-year performance period. The award becomes 100 percent vested three years later. Similar to the relative TSR plan, this approach allows performance to be calibrated to a desired level (see Figure 6 on page 79). Performance is determined on an absolute basis, rather than being compared against a peer group or other relative measure.

As seen earlier, all four approaches would pay the target award if 100 percent of the target goal is achieved. Maximums and thresholds vary significantly across the four designs.

Calibrating award levels against performance should take into account important factors like industry volatility, industry pay practices, predictability of company operating results and the other long-term incentive plans in place.

This approach is the least aggressive of the three designs we're discussing.

But used as a stand-alone plan and calibrated at the racing-fuel level, it could leave a company stranded at the starting line if goal setting turns out to have been overly aggressive and awards are unlikely to be paid out.

Performance Roundup

Generally speaking, high performance takes on different meanings depending on the view of the stakeholder. To get a sense of how each of the three designs stack up, we road-tested and recorded performance levels. The results are summarized on page 80.

The Winners' Circle

No single design is likely to meet all of a company's objectives for a long-term incentive plan, but the concepts presented above can be incorporated into just about any long-term incentive design to provide an extra-high-powered incentive for executives to achieve the desired goals. 

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