How to Design the Right Performance-Based Incentive Plan for Your Organization

David Bixby, Pearl Meyer
Nathan O’Connor, Equity Methods
Shane Tucker, Vinson & Elkins
What Issues Should We Consider?

I. The placement of performance awards in the mix
   • What is the problem we are trying to address?
   • What performance designs and metrics can be used?
     – Time-Based vs. Market vs. Operational Performance
     – TSR, EBITDA, ROIC, and Revenue Growth…other metrics?
     – Form of payment…cash versus equity

II. Goal setting and calibrating payout opportunity
   • Setting challenging but achievable goals

III. Avoiding key risks with performance awards
Executives want more value, shareholders want more performance, and the comp committee just wants everybody to be happy....

- **Executives**
  - “We’ll be in serious trouble if we lose this executive team”
  - “Grant me more given the low line of sight you’re giving me”
  - “Our performance is stellar given our starting point – don’t you dare compare us to Peer ABC”

- **Compensation Committee**

- **Proxy Advisors/Shareholders**
  - “Our say on pay is trending below 90% - we can’t let that happen”
  - “Your pay for performance isn’t where it needs to be”
  - “Why should you payout when we’re not – we want to see more TSR”
Award Design Process – What To Expect

• Preparation and planning begins long before the actual grant date
• Planning process has many objectives:
  • Evaluate new best practices
  • Create ongoing improvements in incentives and retention
  • Avoid cost over-runs (leading to pay-for-performance surprises) or deflated grant quantities (leading to participant frustration)
  • Energize executives amidst war for talent

YOU especially have a unique ability to influence this objective!

Plan often begins up to 6 months before the grant date

ASSUMED GRANT DATE: March 1

AWARD PLANNING

COMP COMMITTEE MEETING

AWARD VALUE-CHANGING EVENTS & CIRCUMSTANCES

GRANT DATE

PERFORMANCE PERIOD
(TRACKING/ASSESSMENT)

Sept - Nov

Nov

Nov - Mar

Planning often begins up to 6 months before the grant date
A recap of the main differences between market awards and performance awards:

<table>
<thead>
<tr>
<th>Market Awards</th>
<th>(Acct.) Performance Awards</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Compares stock performance only</td>
<td>✓ Internal and operational metrics</td>
</tr>
<tr>
<td>(e.g. stock price, or relative return)</td>
<td>(accounting, strategic, etc.)</td>
</tr>
<tr>
<td>✓ Needs a <em>fair value</em></td>
<td>✓ Do <em>not</em> need a <em>fair value</em></td>
</tr>
<tr>
<td>✓ Better for relative targets</td>
<td>✓ Better for absolute targets</td>
</tr>
<tr>
<td>✓ Easier to forecast long-term</td>
<td>✓ Difficult to forecast long-term</td>
</tr>
<tr>
<td>✓ Static accruals</td>
<td>✓ Variable accruals</td>
</tr>
</tbody>
</table>

These differences lead to different risks in the planning process. Also keep in mind: often recipients view these two awards types as indistinguishable.
## Picking The Right Measure

<table>
<thead>
<tr>
<th>Category</th>
<th>Common Measures</th>
<th>Typical Benchmark</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
</table>
| MARKET BASED          | TSR                              | Relative or Absolute   | • Key yardstick shareholders  
• Easier to set performance standards                              | • Poor line of sight  
• Requires meaningful peer group                                         |
|                       | Stock Price                      |                        |                                                                                                                |                                                                                                   |
| CAPITAL EFFICIENCY    | Return on Capital                | Relative or Absolute   | • Popular with shareholders  
• Can be compared to peers                                             | • Harder to track versus peers than TSR                                               |
|                       | Value Added (EVA)                | Absolute               | • Truest measure of “Value Creation” by management                                                            | • Difficult to set goals  
• Can incent reduced capital spending                                         |
| QUANTITY OF PROFITS   | EPS                              | Absolute               | • Good line of sight  
• Works during both times of growth and times of stability (or decline)                                       | • Difficult to set longer-term goals  
• Does not account for capital usage                                           |
|                       | Operating Profit (EBITDA)        | Absolute               | • Same as EPS  
• Allows comparison across bus. units                                                                 | • Same as EPS                                                                         |
| OPERATIONS            | Safety, Environmental, Cost      | Absolute               | • Emphasizes importance of non-financial measures                                                              | • May be more appropriately measured on an annual basis                                      |
|                       | Control, Customer Service Rating |                        |                                                                                                                |                                                                                                   |
| STRATEGIC MILESTONES  | Strategic Goals / Scorecard      | Absolute               | • Can change the organizational trajectory toward key long-term goals                                          | • Can be difficult to administer  
• Harder to sell externally  
• All milestones may not appear relevant to all participants                   |

Of course...your choice does not need to be mutually exclusive...
Overview of Key TSR Levers

1. **TSR Measurement Price Window**
   - **Affect on Fair Value:**
     - Stronger effect on fair value from beginning price window than ending window
     - 20-day window common for beginning and end

2. **Separate Grant and Performance Start Date**
   - **Affect on Fair Value:**
     - Common to align performance start date with fiscal year beginning
     - Grant date will typically postdate (e.g., February or March)

3. **Selection of Comparison Group**
   - **Affect on Fair Value:**
     - Choice between an Index and group of companies
     - Effect amplified when performance period start date precedes grant date

4. **Specification of Payout Function**
   - **Affect on Fair Value:**
     - Minimum payout percentage
     - Maximum payout percentage
     - Intermediary cliffs / slope / convexity

5. **Cap on Total Value Delivered**
   - **Affect on Fair Value:**
     - Limit on shares delivered AND total value
     - Penalizes for material stock appreciation, but allows more units to be granted

6. **Absolute TSR Hurdle/Check**
   - **Affect on Fair Value:**
     - In addition to Relative TSR, reference Absolute TSR
     - Reduces fair value, but allows more units to be granted

7. **Equity vs. Cash Vehicle**
   - **Affect on Fair Value:**
     - Depending on share reserves and overhang, awards may be paid in cash instead of stock
     - Introduces variable accounting

8. **Combination with Performance Condition**
   - **Affect on Fair Value:**
     - Independent or interdependent
     - Bifurcated or combined award

None
## Award Currency: How to Pay Out?

<table>
<thead>
<tr>
<th>Cash Denominated</th>
<th>Equity Denominated</th>
<th>Equity Denominated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Settled</td>
<td>Equity Settled</td>
<td>Cash Settled</td>
</tr>
<tr>
<td>(performance cash)</td>
<td>(performance shares)</td>
<td>(phantom units)</td>
</tr>
</tbody>
</table>

- **Cash Denominated Cash Settled (performance cash):**
  - Controls dilution
  - Less volatility in potential payout (particularly valuable on down-side)
  - Provides ready currency at vesting without selling shares
  - Disclosure can line up better with performance outcomes

- **Equity Denominated Equity Settled (performance shares):**
  - Directly aligned with shareholders
  - Conserves cash
  - Multiplier effect on realized pay during strong performance periods
  - Fixed accounting (usually)

- **Equity Denominated Cash Settled (phantom units):**
  - Maintains alignment with shareholders
  - Conserves shares
  - Diversifies payout portfolio

**BUT:**
- Variable accounting
- Less direct alignment with shareholders
- REQUIRES CASH!

## Advantages and challenges for all approaches...

- Burns through shares
- No cash available at vesting to cover taxes
- Grant date value counts toward advisory firm analysis regardless of payout

**BUT:**
- Still requires cash
- Variable accounting
- Can create uncapped payout obligation
- Grant date value still applies for advisory firm evaluations
Goal Setting
Goal Setting is “Easy” for Relative TSR, Hard for Accounting Metrics

### Relative TSR

<table>
<thead>
<tr>
<th>Goal Level</th>
<th>Percentile Rank</th>
<th>Payout</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stretch</td>
<td>&gt;75&lt;sup&gt;th&lt;/sup&gt;</td>
<td>200%</td>
</tr>
<tr>
<td>Target</td>
<td>50&lt;sup&gt;th&lt;/sup&gt;</td>
<td>100%</td>
</tr>
<tr>
<td>Threshold</td>
<td>&lt;25&lt;sup&gt;th&lt;/sup&gt;</td>
<td>0%</td>
</tr>
</tbody>
</table>

- Setting goals for performance and payout levels on a relative performance award is relatively easy
- Philosophically decide how high you want to set the bar (model different scenarios if unsure), and you’re done
- The compensation committee can cleanly verify that high payouts correspond to stretch outcomes

### Absolute Operational Metrics

<table>
<thead>
<tr>
<th>Goal Level</th>
<th>EPS Growth</th>
<th>Payout</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stretch</td>
<td>&gt;12%</td>
<td>200%</td>
</tr>
<tr>
<td>Target</td>
<td>10%</td>
<td>100%</td>
</tr>
<tr>
<td>Threshold</td>
<td>&lt;8%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Here’s what compensation committees are saying when presented operational targets:

“Prove to me that achieving 12% EPS growth is really only a stretch goal that’s 20% likely. How do I know it’s not actually a pretty realistic outcome?”
### Setting Supportable Goals

<table>
<thead>
<tr>
<th>How it works</th>
<th>Market</th>
<th>Peer Inference</th>
<th>Bottom-Up</th>
<th>Distribution Fitting</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>▪ Base targets off analyst consensus expectations</td>
<td>▪ Analyze peer proxy payout data to see relative premium and discount given to stretch and threshold targets, respectively</td>
<td>▪ Link goals to internal business group expectations and organizational capabilities</td>
<td>▪ Build probability distribution from company and peer historical data</td>
</tr>
<tr>
<td></td>
<td>▪ Apply discount and premium to back into threshold and stretch targets</td>
<td></td>
<td></td>
<td>▪ Infer threshold, target, and stretch levels from distribution</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Challenges</th>
<th>Market</th>
<th>Peer Inference</th>
<th>Bottom-Up</th>
<th>Distribution Fitting</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>▪ Threshold and stretch goals difficult to set</td>
<td>▪ Assumes effective peer goal</td>
<td>▪ Potential bias from padding/competing incentives</td>
<td>▪ May not align with internal business expectations</td>
</tr>
<tr>
<td></td>
<td>▪ May not align with internal business expectations</td>
<td>▪ May not align with internal business expectations</td>
<td>▪ Not market-based</td>
<td></td>
</tr>
</tbody>
</table>
## Performance Standards

<table>
<thead>
<tr>
<th>Performance Level</th>
<th>Description</th>
<th>Guideline Likelihood of Achievement</th>
<th>Common Relative Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Threshold</td>
<td>Minimum acceptable level of performance</td>
<td>Should achieve this level of performance at least eight out of every 10 years</td>
<td>25&lt;sup&gt;th&lt;/sup&gt; – 40&lt;sup&gt;th&lt;/sup&gt; percentile</td>
</tr>
<tr>
<td>Target</td>
<td>“Expected” level of performance with some stretch</td>
<td>Should achieve this level of performance at least 5 or 6 out of every ten years</td>
<td>50&lt;sup&gt;th&lt;/sup&gt; – 60&lt;sup&gt;th&lt;/sup&gt; percentile</td>
</tr>
<tr>
<td>Maximum</td>
<td>Outstanding achievement corresponding to maximum payout</td>
<td>Should achieve this level of performance once or twice within any ten year period</td>
<td>75&lt;sup&gt;th&lt;/sup&gt; – 100&lt;sup&gt;th&lt;/sup&gt; percentile</td>
</tr>
</tbody>
</table>
Goal Setting Approach

Step 1: Pick the right metric for your objectives
- **Input** (revenue, strategic objective) vs. **output** (TSR)
- **Leading** (bookings) vs. **lagging** (ROIC)
- **Correlation with stock price** (link to shareholder value)
- **Correlation with other metrics** (eliminate redundancy)

Step 2: Set rigorous, supportable goals
- **Baseline**
- **Corroborate**
- **Finalize**

- Internal forecasts/FP&A
- Historical data
- Simulation models
- Analyst estimates

<table>
<thead>
<tr>
<th>Threshold</th>
<th>Target</th>
<th>Stretch</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2.96</td>
<td>$3.20</td>
<td>$3.44</td>
</tr>
</tbody>
</table>

**Graph:**
- Three-Year Cumulative EPS
- Percent
- Cumulative Percent

**Steps:**
1. Pick the right metric for your objectives
2. Set rigorous, supportable goals
Calibrating Payout And Performance

• Of course – be sure to calibrate your payout to the required level of performance
  • Plans often pay out 25% to 50% at threshold and 150% to 200% at maximum
  • However, how steep or flat your payout line is will ultimately depend upon how challenging your goals are (or aren’t)
  • Conversely, the difficulty of your goal-setting should account for how aggressively you position your pay opportunities

• And all of these have implications for the reported value of the awards
Oh...and About External Optics

• Beware generic “best practices” but avoid pitfalls where you can
  • Will our performance goals look challenging externally?
  • Should award payouts be capped for negative TSR?
  • What impact will changes have on reported value?
  • What can we do to balance those considerations while still being fair to participants?
Avoiding Key Design Risks
Section 409A of the Internal Revenue Code

- Section 409A imposes strict timing rules for deferral elections, distributions, and funding of nonqualified deferred compensation
  - Failure to comply with section 409A results in current income inclusion and 20% additional tax plus interest tax
Section 409A of the Internal Revenue Code

- However, if properly designed, performance awards will be exempt from section 409A (via the “short term deferral” exemption)
- If awards cannot be exempt they can be designed to comply with section 409A
SEC Issues

• Form 8-K reporting may be required when establishing new awards

• Performance awards may not be derivative securities and, therefore, may not be reportable for Form 4 purposes until settlement

• Consider proxy statement (or Form 10-K) disclosure issues

• Consider share counting issues under Form S-8
TSR Award Implementation Issues

• TSR plans in particular are not intuitive; the key is in the communication
  • Repeatedly we hear from top executives that no-one understands or appreciates the potential value in the performance LTI plan...including themselves
• Communicating how the awards are tracking can be helpful
  • Challenging for participants to track relative performance ... “I know our stock is up....but not sure if it’s beating others”
  • But, beware of the problems of too much communication—can cause paralysis, short-term thinking, or even backfire and disincentive performance
TSR Award Implementation Issues

• Administration
  • Performance tracking. For market awards, and especially relative TSR awards, this can be a complex and daunting task. Tracking delisted companies over time can be tricky. International peers come with another set of challenges

• Details in award design
  • Open/closed peer lists, dividend protection, payout provisions to handle business combinations

• Accounting/valuation
  • Complex awards may not fit in well with administration systems
  • Valuations often require sophisticated modeling
Accounting Performance Conditions
Implementation Issues

**Strategy Side—the future is foggy**

- **Relative performance targets**
  One hand—relative performance targets are great, because then it will be easier to set long-term targets (remember: payouts based on relative metrics are less sensitive to broad market shocks)
  - On the other hand—how exactly do it?
    - Relative EPS for example is very sensitive to one-off events

- **Internal performance targets**

**Implementation Side—the road is winding**

- **Communication**
  - Challenging for participants to track relative performance ... “I know our stock is up...but not sure if its beating others”

- **Accounting**
  - Variable accounting applies
  - Relative performance targets

- **Explain**
Problematic or Non-existent Variable Definitions

- Ambiguous or non-existent variable definitions blur payoff calculations
- Can create litigation risk in the future!
- Be sure to double-check that any calculation examples are consistent with the language describing the calculation
- 162(m) implications
Sections 162(m) & 280G

- The elimination of the performance based compensation exemption removes a number of regulatory limitations in the administration of awards
- Does not eliminate 162(m) compliance concerns if grandfathering is available
- Performance awards vesting upon a change of control have a higher value for 280G “golden parachute” calculations
Compensation Disclosures

• Make sure you get maximum credit externally for all your hard work

• Clearly enunciate performance goals and outcomes

• Don’t get dinged for “lack of transparency”

• Talk about realized/realizable pay versus grant-date pay to stress pay and performance alignment (especially if your plan hasn’t paid out)
Final Thoughts

• There are many reasons to consider adding a performance-based long-term incentive plan...and almost as many reasons not to

• Performance plans can address shareholder concerns about pay for performance and the Board’s desire to align with “best practices”

• They can also help drive management performance toward achievement of key long-term success measures

• However, if not properly designed they can add unhelpful complexity to a pay program that already has all the right moving parts
Speaker Contact Info

David Bixby
Managing Director
Pearl Meyer
david.bixby@pearlmeyer.com

Nathan O’Connor
Managing Director
Equity Methods
nathan.oconnor@equitymethods.com

Shane Tucker
Partner
Vinson & Elkins LLP
stucker@velaw.com