Pearl Meyer

ADVISOR BLOG

Relative Total Shareholder Return Caps, Collars, and Modifiers—Oh My!

Despite recent trends toward the differentiation of long-term performance plan design, with companies and investors seeking alternative or supplemental measures to pair with relative Total Shareholder Return (rTSR), rTSR remains by far the most common long-term incentive plan measure for named executive officers in US public companies. This is particularly true in the energy sector where over 85% of S&P 500 companies have an rTSR plan in place. And why not? I agree that rTSR isn't a strategic measure and it doesn't tell plan participants what they need to do to succeed. However, assuming you want to establish a performance-based long-term incentive program, basing payout on relative TSR performance has some clear advantages, particularly for companies in highly cyclical industries:

- Relative metrics buffer against industry cyclicality, providing opportunity for payout even in down cycles, and enforcing a threshold level of outperformance in up cycles
- Relative metrics reduce the internal wrangling and uncertainty that often comes with establishing multi-year financial performance goals
- TSR tracks shareholders' experience and is viewed as a "fair" measure
- Establishing a relative performance peer group is (a lot) easier for rTSR than it would be for a relative financial performance metric like ROIC or EPS growth

It is largely for these reasons that oil & gas companies turn so frequently to rTSR plans, although the fact that TSR is the sole performance metric for two of the four ISS pay-for-performance tests is also a key consideration for some compensation committees.

Cool—let's establish an rTSR plan and hit the gas!

Hang on! If you have adopted an rTSR plan with the proxy advisory firms in mind you should also be aware that a "plain vanilla" rTSR plan is no longer sufficient to earn a clean bill of health in your ISS or Glass Lewis proxy review. In reading over myriad advisory firm reports (I know—I should get out more), the most common concerns I see regarding rTSR plan design are:

- Target payout at median performance (i.e., goals are not sufficiently robust); and
- Lack of a modifier to limit payout when absolute TSR is negative.

Both of these concerns merit some discussion, but for now let's focus on that second concern: the lack of an absolute TSR modifier. The underlying rationale for the advisory firm position is that if shareholders are losing money, plan participants shouldn't be able to earn an above-target payout. Seems like a reasonable expectation on its face. In our experience, simply capping payouts at 100% for negative TSR is also unlikely to have a significant impact in the theoretical world of accounting valuation.

However, while accounting valuation is a helpful input, that's just one of many factors the compensation committee must weigh in the determination of plan design. In the real world where boards must also consider the impact on executive retention, motivation, and succession, adoption of a "simple cap" on an rTSR plan has the potential to create a distraction, significantly reducing the perceived value of rTSR awards among plan participants. This challenge is particularly acute in an industry like oil & gas where the percentage of companies experiencing negative TSR over a given three-year period has been between roughly 35% and 40% since 2000 (it varies by sector, but not much).

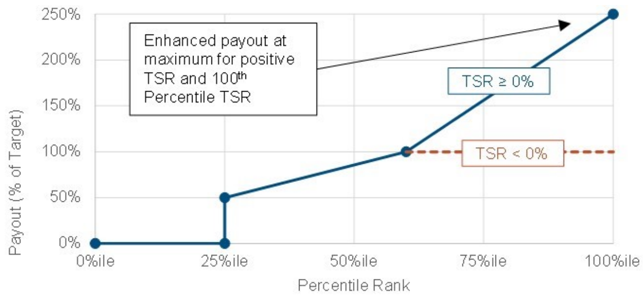
So before you dive head-first through more hoops to comply with another compensation "best practice," here are a few cautionary points to keep in mind:

- **Don't lose sight of what your rTSR plan is supposed to accomplish.** As noted above, there are some key advantages of an rTSR plan for companies in cyclical industry sectors. If you adopted an rTSR plan to have a performance-based vehicle that provides incentives to outperform in up cycles and down cycles, be careful about how many caps, collars, and matrices you apply to your plan. **Every time you layer on an adjustment factor you run the risk of getting further away from your original objective and you run the risk of diluting the incentive value of your plan.**
- **Share-settled plans already have an absolute modifier built in**. If you are concerned that above-target payouts in years of poor absolute performance sends the wrong message, you may already have an absolute modifier in your plan. If awards are denominated and settled in shares, the fair market value of individual shares earned will move with stock price and will impact the realized value at vesting. **Capping the number of shares earned in a down cycle penalizes plan participants twice for the same tough industry conditions.**
- **Absolute performance may already be captured elsewhere in your pay mix**. For the vast majority of companies with an rTSR plan, that plan is not operating in a vacuum. Most companies pay for absolute performance in the annual incentive plan,

> or with other long-term incentive devices. **I would be particularly leery of adding an absolute modifier if you grant stock options or if you already have another absolute performance metric in your long-term incentive program.**

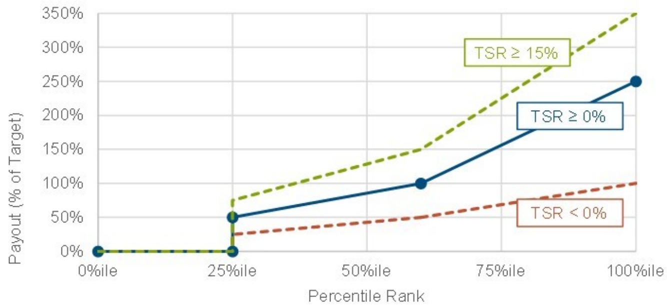
If you do decide you need to add a modifier due to investor pushback, advisory firm pressure, or because you simply think it's the right thing to do, there are still some additional alternatives to consider:

Cap: this approach typically applies a cap at 100% of target for any period where absolute TSR is negative. It's the simplest approach but perhaps the most unfair to plan participants. If your plan is equity-settled consider capping the *value* of the payout at the grant date value rather than capping the number of shares.



Collar: this approach adds some give and take to the simple cap approach, capping for negative TSR but guaranteeing some minimum payout if absolute TSR is sufficiently positive. A word of caution, however: the advisory firms may push back if they think the design of the plan provides for multiple bites at the apple (e.g., if you can earn target for sufficiently positive TSR independent of your relative standing).

Matrix: this is the most complex of our three general approaches, effectively establishing multiple payout curves that are dependent on which range you fall in for absolute TSR. The basic concept here is that awards may still go to zero even if you have significantly positive TSR, but if you hit on both absolute and relative TSR your payout could be much higher than typical.



Whatever you do, I would be careful not to get too cute. Don't try to create a plan that is all things to all people as you are likely to end up with significant compensation expense (not to mention time commitment) with little or no incentive value to show for it—a very expensive Rube Goldberg compensation scheme where no one is quite sure what they did to produce the desired outcome. Keep in mind that every change has implications for the expected value of the plan and the overall performance leverage of your pay program; it can turn into a never-ending game of Whack-a-Mole. And finally, don't forget you have other alternatives like moving away from rTSR to other measures of long-term performance or (GASP!) just going back to a straight diet of restricted shares and stock options. Now that's thinking outside the box.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Jose.

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