Pearl Meyer

TRENDS & ISSUES

We Know Your Sector: Executive Compensation in Mid-Sized Software Companies

The software sector is characterized by an intense focus on growth, constantly evolving technology, protocols and regulations, and relatively rapid progress from initial idea and business development stages through revenue stream development. “First mover” status is important and strategic priorities shift quickly.

Compensation program design is optimized when it is tailored to sector-specific factors. While mid-sized software companies are by no means homogenous in their CEO pay program designs, they do tend to favor certain elements.

We undertook a study of publicly traded software companies that:

- Were NYSE or Nasdaq listed;
- Had annual meetings that included a say-on-pay ballot item in the 12-month period ending February 28, 2019;
- Had annual revenues between $200m and $1b for the fiscal year preceding this annual meeting;
- Had no CEO turnover during this time period; and
- Had non-founder CEOs.

We identified 16 companies that fit these criteria and isolated “high growth” and “low growth” subsets using 15% most recent fiscal year revenue growth as our cutoff (the eight high growth companies averaged 42% revenue growth while the eight low growth companies averaged 7%).

A Note on Table Stakes vs. Competitive Advantage

We are operating in an age of pay transparency. The information that follows is useful for understanding market norms within the sector and what factors may be driving these norms. But we believe this type of information represents “table stakes.” All committees can and should have ready access to this level of insight to inform their pay decisions.

April 2019

A seasoned consultant will help committees identify opportunities to deviate from market norms in a way that supports their company's specific business strategy and human capital management priorities. It is this conscious deviation from market norms that allows the executive compensation program to become a powerful catalyst for value creation and competitive advantage within an industry.

Data is no substitute for advice.

Key Takeaways

- CEO target pay opportunities emphasize equity over cash, and there is a significant spread for long-term incentive (LTI) grant value from company to company.
- A typical CEO bonus program includes a combination of top-line (revenues) and bottom line (profit) goals, with significant company-to-company variation in terms of the category of profit measured (earnings-per-share [EPS], earnings before interest and tax [EBIT], earnings before interest, tax, depreciation, and amortization [EBITDA]).
- There is little focus on non-financial measures as a separate performance category.
- A combination of time-vested restricted stock units (RSUs) and performance shares is the most common CEO LTI design, and—likely reflecting the proxy advisor perspective that they do not constitute "performance-based" pay—stock options are used by only one fourth of these companies.
- Half of the companies using performance shares rely on a short (less than three-years) performance period, and revenue growth (often used in conjunction with either EPS or operating income) is the most common performance measure.
- There are relatively high burn rates as compared to general industry.
- These companies are more likely to receive "Against" recommendations on say-on-pay than the broader Russell 3000.

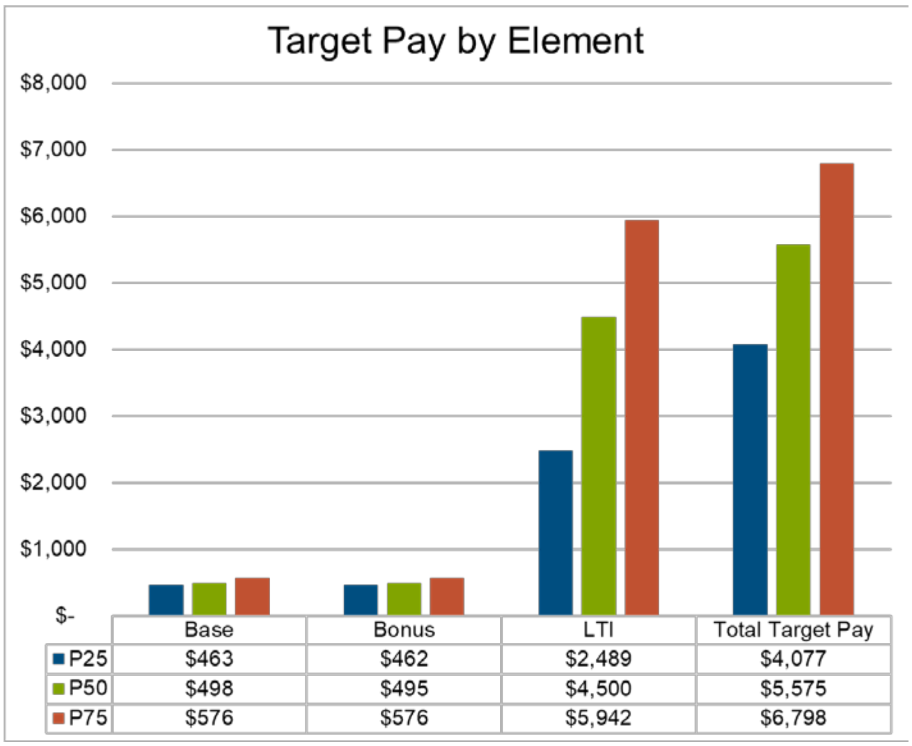
Looking Forward

- There is high likelihood of significant year-to-year swings in pay opportunities due to equity emphasis.
- Absent a significant economic downturn, we do not anticipate change to the fundamental pay mix.
- There is likely a slow evolution to carving out a portion of overall bonus opportunity for discretion.
- We anticipate increased emphasis on performance shares and possibly opportunistic usage of stock options in the event of economic downturn.
- Investor performance assessments tend to emphasize top line growth over capital efficiency, suggesting that these companies are unlikely to embrace economic value added (EVA)-related incentive plan measures.
- In the event of an economic downturn, we anticipate increased burn rates.
- It is critical in this sector to invest time and energy into ongoing shareholder engagement in order to mitigate the impact of proxy advisor recommendations that do not consider sector-specific nuance.

Referencing proxy data available from Main Data Group, we provide further detail relating to general pay practices, short-term and long-term incentive design for CEOs, as well as aggregate equity usage and say-on-pay support.

CEO General Pay Practices

Total Target Pay Opportunity



Key Takeaway

- Relatively little variation across companies for base salaries or target total cash, but significant spread for LTI grant value

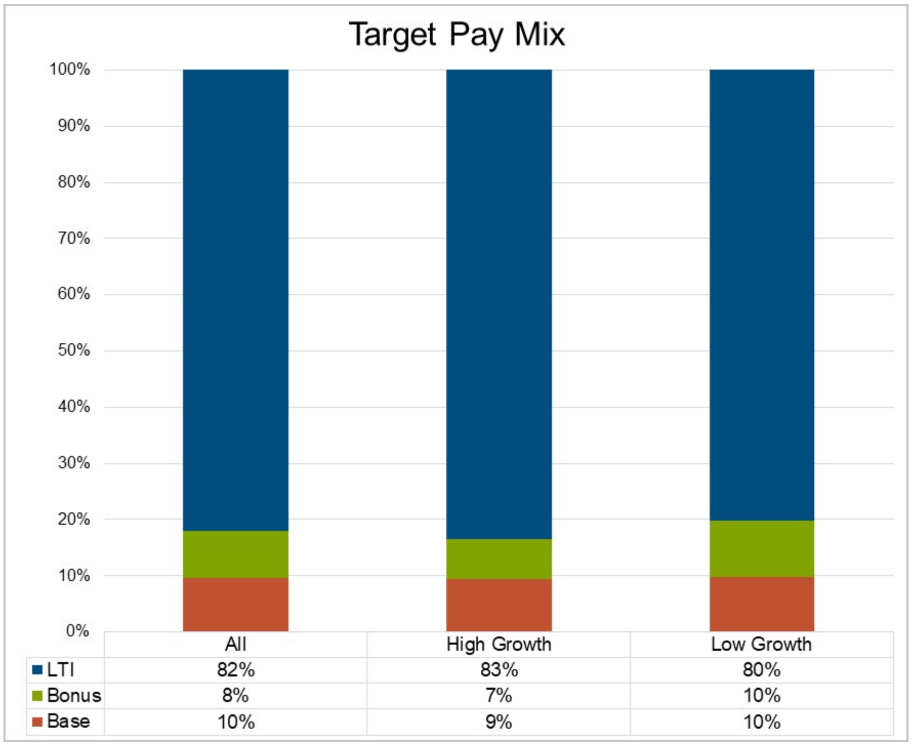
Do High Growth Companies Differ?

- No, remarkable consistency in pay opportunities between High Growth and Low Growth subsets across pay elements

Looking Forward?

- Heavy emphasis on equity compensation drives the dynamic such that year-to-year pay opportunities may swing significantly on a company-by-company basis to the extent share prices move meaningfully.

Pay Mix



Key Takeaway

- Strong emphasis on LTI

Do High Growth Companies Differ?

- No, remarkable consistency in pay mix between High Growth and Low Growth subsets across pay elements

Looking Forward?

- 162(m) tax reform may have a modest impact on salaries at larger companies who have seen $1m as an artificial cap—but this is generally not the case for mid-sized software.
- Absent significant economic downturn (which would drive down LTI opportunities as share prices plummeted), we do not anticipate any change to the fundamental pay mix dynamic in this sector.

CEO General Pay Practices

Plan Type

Key Takeaway

- Vast majority of companies (14/16) use goal-driven target awards (payouts determined by achievement relative to pre-determined performance targets); only two companies indicated awards were discretionary (although in each case financial results receive strong consideration in ultimate payout determination)

Do High Growth Companies Differ?
- Interestingly, both companies using discretionary programs were in the Low Growth subset

Looking Forward
- 162(m) tax reform provides greater opportunities for companies to exercise discretion.
- We anticipate slow evolution in this direction, with companies carving out a small portion of the overall opportunity (20% or less) for discretionary assessments of performance.
- Investors will demand clear disclosure on factors that informed these discretionary pay decisions.

Funding of Awards

Key Takeaways
- While 0-1.5x target is the most typical funding range, there are a wide variety of practices with respect to maximum awards, ranging from 1x target to a flat cap of $3m
- Only two companies indicate non-financial measures are a specific performance category

Do High Growth Companies Differ?
- Tend to have higher maximum award opportunities (2x target or above)
- Less likely to consider non-financial measures

Looking Forward
- Companies basing their incentives on something other than performance in financial statements may find it more difficult to convince shareholders they indeed link pay with performance.

Performance Measures

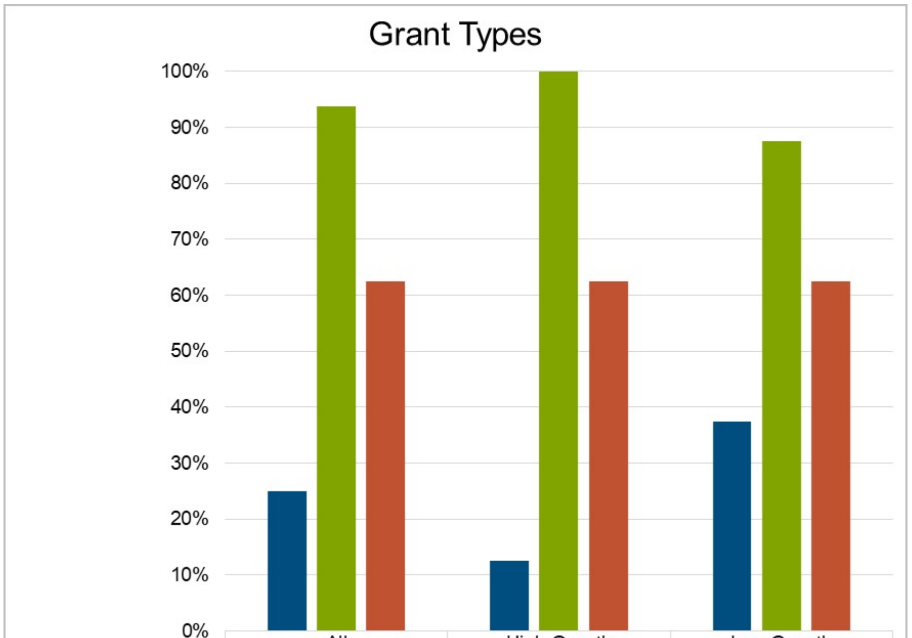
Key Takeaways
- Combination of top-line (revenues) and bottom-line (profit)
- Variety of profit measures in use (EPS, OI, EBITDA)
- None of these companies use the capital efficiency-focused measures of ROIC or EVA

Do High Growth Companies Differ?
- More likely to focus on EBITDA as profit measure rather than OI or EPS
- No greater emphasis on top-line measures than Low Growth subset

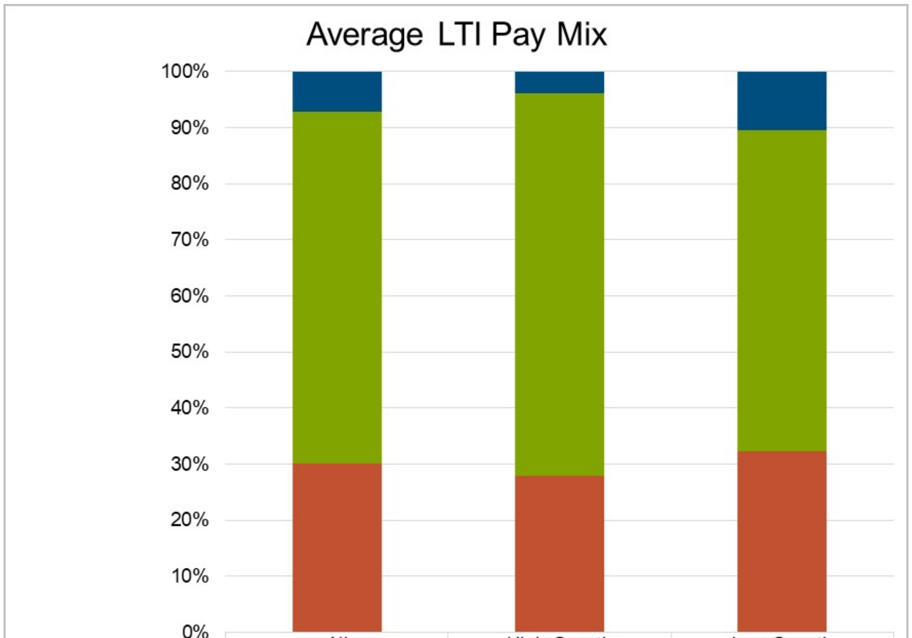
Looking Forward
- While some investor groups have indicated an appetite for sustainability and governance-related measures that go beyond financial statement performance, we anticipate that financial results will continue to dominate.

CEO Long-Term Incentive Design

Grant Types



	All	High Growth	Low Growth
Options	25%	13%	38%
RSAs/RSUs	94%	100%	88%
Performance Shares	63%	63%	63%



	All	High Growth	Low Growth
Options	7%	4%	10%
RSAs/RSUs	63%	68%	57%
Performance Shares	30%	28%	32%

Key Takeaways

- Most companies use a portfolio of awards, with a combination of time-vested RSAs or RSUs and performance shares the most typical approach
- Time-vested RSAs or RSUs account for the bulk of grant value

Do High Growth Companies Differ?

- Somewhat less likely to use stock options

Looking Forward

- Continued pressure from investors to demonstrate pay-for-performance may shift some emphasis away from time-vested RSAs/RSUs.
- While some companies have had success convincing investors that time-vested stock options are inherently performance-based, we anticipate decreased emphasis on time-vested RSAs/RSUs will translate into increased emphasis on performance shares.
- We may see opportunistic usage of stock options in a protracted downturn (this leveraged instrument becomes more attractive when there is an expected market recovery).

Vesting & Performance Metrics

Key Takeaways

- For time-based awards, typically a four-year graded vest
- Wide variety of performance share designs, but most common performance measure was revenue growth (often used in conjunction with a profit measure such as EPS or OI)
- In 50% of cases, companies used a performance period of less than three years but added subsequent time-based vesting to "earned" shares so that total vest was at least three years
- Where relative TSR was used as a measure (three companies), an established market index was referenced rather than a custom peer group

Do High Growth Companies Differ?

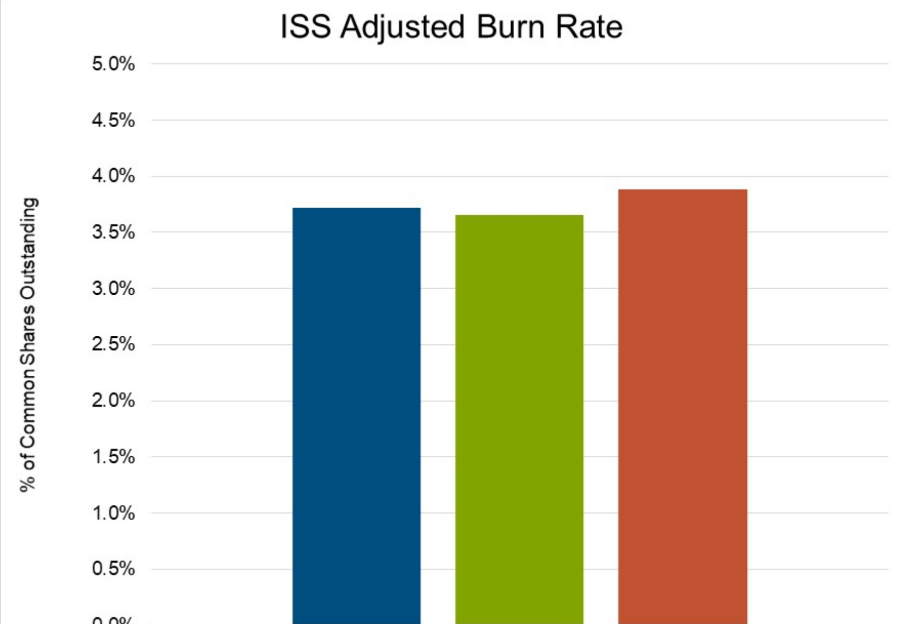
- More likely to provide upside opportunity of up to 200% of target for performance shares, whereas Low Growth subset was more likely to provide upside only to 150%

Looking Forward

- Many companies in this sector have relatively limited visibility into future performance and therefore use either shorter (less than three years) performance periods for performance shares or default to a relative TSR measurement that does not necessitate the kind of long-term goal-setting that can be problematic—as companies who are not currently using performance shares implement new programs, we anticipate they will opt with one of these approaches initially.
- Despite some renewed interest from proxy advisors in EVA-related performance assessments, we do not expect software companies to embrace EVA for incentive plan purposes.

Aggregate Equity Usage

Burn Types



	ISS-Adjusted Burn Rate
All	3.7%
High Growth	3.7%
Low Growth	3.9%

Key Takeaways

- While higher ISS-adjusted burn rates[1] than general industry, nowhere near the 5% - 6% that is common for small cap technology

Do High Growth Companies Differ?

- No, remarkably consistent

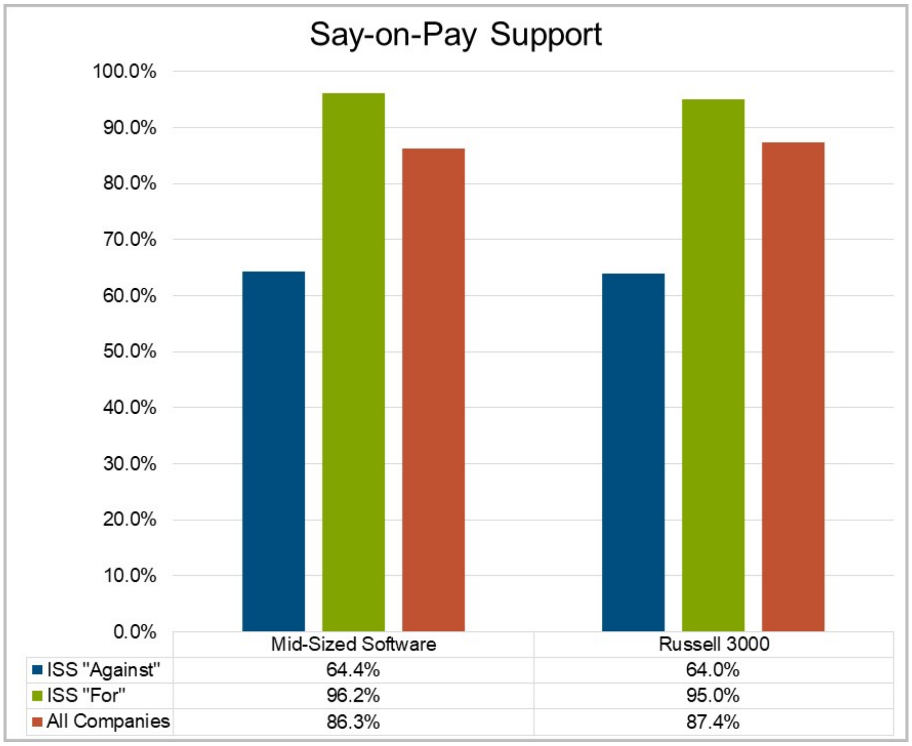
Looking Forward

- Over time, mature software companies tend to reduce equity spend as hiring activity levels off and eligibility for awards becomes more concentrated at management levels.
- In the event of a downturn, we would anticipate a short-term spike in burn rates due to the incremental impact of retention-focused awards and the dynamic of reduced value on a share-by-share basis.

[1]Shares granted (adjusted to option equivalents based on company stock price volatility) as a percentage of common shares outstanding

Say-on-Pay Support

Overall Support Levels



Key Takeaways

- Generally similar support as compared to the Russell 3000
- ISS is more likely to recommend “Against” these companies; 31% received “Against” recommendations vs. only 14% of the Russell 3000
- ISS “Against” recommendations have significant impact, with average support dropping 32% vs. when ISS recommends “For”

Do High Growth Companies Differ?

- No, other factors (overall pay levels, interpretation of pay-for-performance alignment, presence of shareholder irritants in program design) trump growth as a factor in say-on-pay support

Looking Forward

- Engagement with shareholders is critical in order to both build compensation programs that reflect investor priorities and communicate how the pay program is tailored to company-specific needs and challenges.
- Absent this type of engagement, the proxy advisor influence is heightened.

- Proxy advisor vote recommendation protocols tend to be punitive to sector-specific compensation designs such as emphasis on time-based equity and use of shorter performance periods for performance shares.
- Companies who invest more time and energy into ongoing shareholder engagement on compensation issues will have stronger say-on-pay support.

Companies included in the study:

8x8	LogMeIn
Alarm.Com Holdings, Inc.	Manhattan Associates
Aspen Technology	Monotype Imaging Holdings
Blackbaud	Paylocity Holding Corporation
Bottomline Technologies	Progress Software
Ebix	Qualys
Ellie Mae	SPS Commerce
FireEye	Tableau Software

Project Team

Dean Chaffee served as the project manager for this research and analysis. Analysts contributing to the report included Libbie Engels, Steven Grinsztein, Quinn Iuliano, and Elise Towers.

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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