The Past and Future of Performance Plans …on Both Sides of the Pond

Peter Boreham
Hay Group (UK)

Fred Whittlesey
Hay Group (US)
Our discussion today

- Terminology
  - Proliferation of “performance” and “unlabeled” plans
- Past in the US and UK
- The Recent Past: 2009
- Ongoing Issues with Performance Plans
- Emerging Issues with Performance Plans
- Why the Future May be Different
  - Multiple dynamics in play
- Designing a performance plan
  - Doing relative TSR well
Performance Plan Terminology

- Performance plans vs. performance shares
  - Measurement and settlement
- Performance features
  - Applied to full-value shares or options
- Impact of performance on vesting
  - Contingency or acceleration
- Denomination
  - Shares or dollars
- Settlement
  - Shares or cash or discretion or choice
Performance Plan Terminology

- Performance shares
- Performance-based restricted stock
- Performance-based RSUs
- PARSAP/TARSAP
- Performance units
- Cash LTI
- Premium-priced options
- Indexed options
- Performance-vested options
Why We’re Different…or Not

- “Culture of excess” and “stars” in US?
- More egalitarian culture in Europe (especially outside UK)
- Parts of Europe suspicious of share price increase as a performance measure
- Stock option performance features in Europe
  - Makes performance plans look less risky vs. options in US
- US shareholder acceptance of RS/RSU 2004-2008
- Power of institutional shareholder vs. proxy advisors
  - Market dominance of ABI vs. RMG influence
- Treatment of below-target performance
  - Rewards reduced or foregone?
The Past (US)

- Emerged during flat stock market 1968-1982
  - "Not getting credit in the stock price for value creation"
- FAS123R and IFRS2 leveled the playing field
  - Grant date fair value accounting
- "Options are the problem" fueled move to shares/units
  - Enron, Breeden report, financial crisis
- Norms outside the US during continued globalization
  - If they can do it, why can’t we?
- Hybrid designs to deal with challenges
  - Goal-setting, performance measurement
The Recent Past (US)

- **Shorter performance periods**
  - 3-to-5 years shortened to 1-to-3 years
- **Hybrid time and performance designs emerge**
  - 1 year followed by 2 years of time vesting
- **Relative TSR plans remove goal-setting challenges**
  - But peer group and index selection challenges emerge
- **Performance measures proliferate**
  - Discretionary features – in plan design and after-the-fact
Then the corporate governance people in institutional investors “spoiled everything”
- No vesting for below median TSR
- Performance hurdles on options as tough as for shares
- Therefore option plans began to die-out in mid 00s
  > Exacerbated by IFRS2
In the beginning there were options….

…. but some people got a “free ride”

- Introduction of simple, easy-to-achieve EPS growth performance hurdles on options to avoid gains from rising market / sector ratings etc.

And then designs became more sophisticated

- Performance share plans based on relative TSR
  > Note – the aim at the time was not to reward relative performance but rather to avoid “payments for luck”
- Run alongside options, now with tougher EPS conditions
Plan types (FT-SE350, source IDS)

- 95% have performance share plans
- Only 20% currently giving option grants for top executives
  > More for smaller companies
  > Approx 40% give options below top executive level
- Around 50% have bonus deferral into shares
- In 25% of cases the deferred bonus is “matched”
- Plans typically have 3 year cliff vesting and contingent hurdles
- No time-vested RSUs

The most common performance measures by far are EPS growth and relative TSR

Performance conditions are often not well tailored to company strategy or sector
Ongoing Issues in Performance Plans

- **Performance target disclosure**
  - “Competitive harm” argument in US but continued SEC pressure
  - “Answer” in Europe is consistent % increase targets

- **Legal issues escalate with broader participation**
  - Labor law (outside the US)
  - Taxation

- **Misalignment between performance measurement and vesting periods**
  - Contingent performance conditions work better with cliff vesting
Emerging Issues in Performance Plans

- **Modifications**
  - Resetting, discretionary adjustments, cancellations

- **Clawbacks**

- **Termination provisions**
  - US IRC 162(m)

- **Extension below the executive level**
  - Line-of-sight argument (what about stock options?)
  - Participants see fair value disclosure vs. stock options

- **Total cost of plan operation**
  - Legal, valuation, administration, tax compliance
  - Internal staff time and outside advisor fees
Emerging Issues in Performance Plans

Measurement

- Peer group and index definition and interpretation
  - Attrition
  - Distortion of outcomes due to takeover speculation/premium
- Changes in business from M&A, divestitures
- Payouts vs. target
- Safety net design
  - Either/or performance targets and “extensions”
  - Likely to be rejected as investors become more involved
- Market volatility
  - Creates spurious variations in absolute and relative TSR with single-date performance-period begin/end
Emerging Issues in Performance Plans

Strategy

- Risk incentive concerns
  - Same issue with annual plans but more pay at risk
- Loss of company-wide alignment achieved with all-employee option plans
  - Although LTI purpose is arguably different at lower levels
- Big company “solutions” forced on smaller companies without “problems”
  - Concern for small and midcap technology and life sciences companies – having to import a different design than exported
  - Danger of a one-size-fits all approach being encouraged by investors and proxy advisers
What is the performance emphasis?

- **Increase in shareholder value**
  - Businesses that are growing or in turnaround

- **Relative change in shareholder value**
  - External benchmark of value created/preserved by management
  - Useful if business is cyclical or heavily impacted by outside factors
  - Rewards superior performance in falling market
  - Hard for participants to track performance

- **Long-term financial performance**
  - Easy for participants to understand
  - More relevant than share price-based measure below top team
  - No guarantee of strong link to shareholder value creation
  - Difficult to set realistic multi-year targets
Designing a performance plan

Combining performance hurdles & plan type

- Reward management for doing a good job
  - Shares with relative TSR hurdle

- Reward delivery of long-term financial performance
  - Shares / cash with EPS/ROI hurdle

- Reward delivery of the strategy
  - Shares / cash with milestone-based hurdles

- Reward share price growth that is not driven by “luck”
  - Options with EPS/ROI and/or relative TSR hurdle

- Reward share price growth in excess of a threshold
  - Shares / options with absolute TSR hurdle
  - Premium options
Designing a performance plan

Choosing a TSR peer group

✿ Investor-focused approach
  – What are the obvious alternative equity investments?

✿ Assessing management performance
  – Which businesses face similar economic, market, regulatory and operational challenges?

✿ Pragmatic approach
  – Which sectors correlate well or badly?

✿ Ineffective approach?
  – Companies of the same size regardless of sector

✿ The criteria for picking a TSR peer group are different to those for picking a benchmarking peer group
Designing a performance plan

Using median / average TSR as a threshold

- Has become “best practice” in Europe
- But in reality is a dysfunctional design
  - Performance differential between 49th and 50th percentile is trivial but makes a big difference to reward
  - Performance differential between 1st and 49th percentile is vast but makes no difference to reward

- Why operate a plan that has a 50% chance of paying nothing?
  - Understand overall STI and LTI mix

- Better to use a lower threshold
  - E.g., 30th or 40th percentile or median minus x%
Designing a performance plan

Detailed design considerations for TSR

- Ranking or % outperformance of a benchmark?
  - Ranking can over/under reward marginal differences
  - % outperformance works in a smaller group but requires target-setting

- Weighting the comparator group
  - May use index weighted by relevance
  - Ranking with most important comparators counting double/treble

- Details
  - Local or consistent currency for international groups
  - Averaging period for start/end share price
  - Treatment of companies leaving the comparator group
### What does the future hold in the US?

#### More Use?
- Continued increase in power of shareholders
  - Changes in voting
  - Investors drove introduction of performance plans in the UK
- Say-on-pay
  - Gives investors another “weapon”
- No-growth/low-growth equity markets and volatility
  - Pay delivery vs. expense
- Maturing of heaviest equity users – sectors and companies

#### Less Use?
- Skepticism over goal-setting and payouts vs. target
- No-growth/low-growth equity markets: exec payout without shareholder return
- Increasing concerns about total cost of operation
  - Administration, legal, tax, compliance, disclosure
- Performance conditions reduce value to participant and thus push up award size
Contact Information

✦ Peter Boreham
  - +44 20 7856 7146 office
  - +44 7884 110 640 mobile
  - peter.boreham@haygroup.com

✦ Fred Whittlesey
  - +1 206.780-5547 office
  - +1 206.388-9068 mobile
  - fred.whittlesey@haygroup.com
# Appendix: Performance Plans and Risk

<table>
<thead>
<tr>
<th>CATEGORY OF RISK</th>
<th>SOURCE OF RISK</th>
<th>SOURCES OF RISK FROM PERFORMANCE PLANS</th>
</tr>
</thead>
</table>
| Strategic        | • Business strategy or model erosion  
                  • Competitor actions or new entrants  
                  • Customer changes  
                  • Performance measurement and target disclosure  
                  • Move away from appreciation vehicles – signal to market about stock price growth? |
| Financial        | • Market  
                  • Liquidity  
                  • Financing – credit and equity  
                  • Currency fluctuation  
                  • Quarterly adjustments to accruals  
                  • Expense without payout for TSR plans |
| Operational      | • Internal processes  
                  • People (performance, fraud)  
                  • Systems  
                  • External events  
                  • Overly aggressive goals  
                  • Performance measures not aligned with value creation |
| Compliance       | • Regulatory  
                  • Civil  
                  • Criminal  
                  • Labor Law |
| Reputational     | • Customers and suppliers  
                  • Employees  
                  • Investors and lenders  
                  • Media  
                  • Payouts disconnected from shareholder return  
                  • Bigger awards to compensate for hurdles? |