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Equity compensation in distressed industries

Presentation to Texas GEO chapter

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Notice

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What will we cover…distressed industries

Industry Environment Issues

Impact on Executive Compensation

Retention Model

Alternative Designs

Distressed industries

Strong agreement among investors – 2016 Industries in distress

- — Energy – 86%
- — Retail – 46%
- — Health Care/Medical – 24%
- — Education – 22%
- — Municipalities – 18%

Characteristics of distress	Possible outcomes
— Low Interest Rates & Access to Capital — Broad Global Slowdown — Oversupply	— Bankruptcy — Restructuring — Asset liquidation — Reductions in executive compensation — High turnover among executives

Source: Energy, Retail, Healthcare and Education Facing the Most Distress, AlixPartners Restructuring Survey; January 6, 2016.

Recent headlines

While the Oil & Gas industry is starting to rebound, recent history reminds us of the challenging environment.

Oil prices fall sharply on Oversupply Concerns
WSJ – March 14, 2016

Commodity Price Plunge Puts Pressure on Local Governments
Oil & Gas Journal – May 30, 2016

The Oil Industry Got Together and Agreed Things May Never Get Better
Bloomberg – February 2, 2016

Big Oil Groups Raise Net Debt by a Third
Financial Times – May 29, 2016

KPMG: Price Volatility Driving Energy Business Model Changes
KPMG Global Energy Institute May 30, 2016

US Oil Industry Bankruptcy Wave Nears size of Telecom Bust
Reuters – May 4, 2016

Analysts Just Aren't Buying Oil Rally
WSJ – April 28, 2016

MarketWatch: Crude Prices Retreat After Briefly Eclipsing $50/Barrel
Oil & Gas Journal – May 27, 2016

Why evaluate distressed industries?

Most industries experience some form of slow down

Evaluate how down market could impact organization

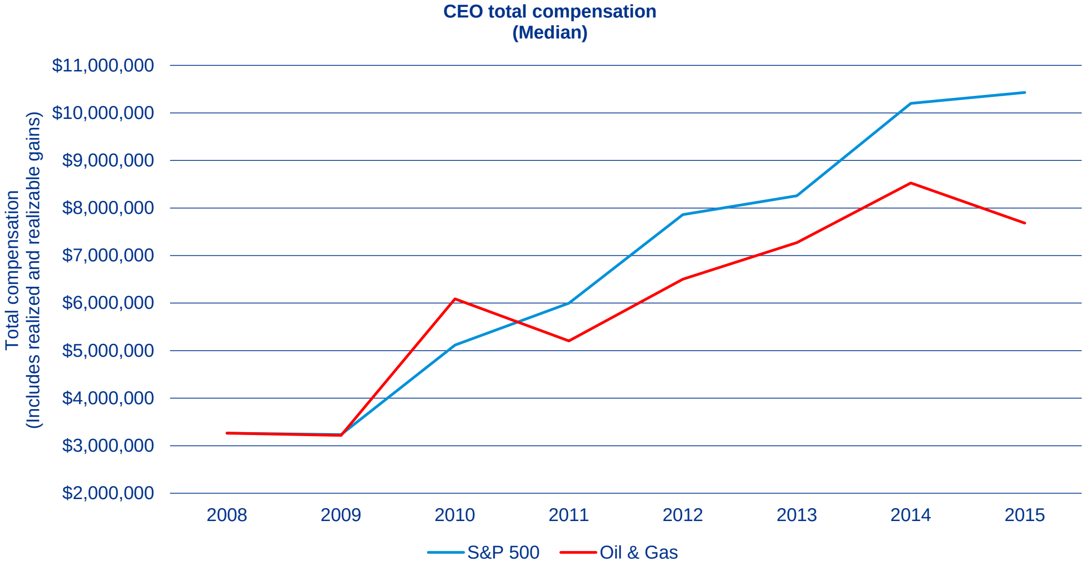
— Cost Control Priorities
— Employee Morale
— Compensation
— Retention Risks (Real or Assumed)

Develop contingency plans

— Employee Communications
— Cost Management
— Managing Retention Risk
— Compensation Structure & Levels
  - Cash
  - Equity

Total compensation over time

Since 2008, CEO Compensation has increased for the S&P 500, but Oil & Gas has lagged with a clear change in 2014.



Source: S&P Capital IQ.

Impact of oil prices on executive bonuses

Change in Total Compensation (reflecting Realized and Realizable gains) can be driven in large part by increases in stock price.

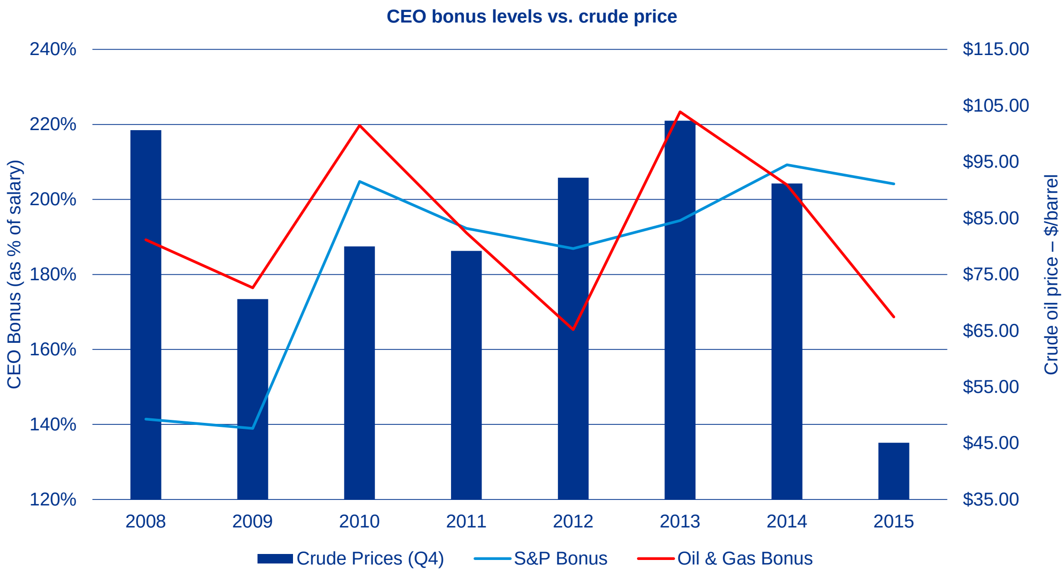
As with any industry, external factors impact stock price – in the case of Oil & Gas, prices have been impacted by:

- Over-supply
- Slower Growth
- Limited investment.

To illustrate the relationship between incentives and Crude Oil prices, consider CEO bonus levels (expressed as a percent of salary) for the S&P 500 and Oil & Gas industry.

Impact of oil prices on executive bonuses (continued)

As expected, Crude Oil prices have a stronger relationship with annual incentive levels in the Oil & Gas industry than in the S&P 500.



Source: S&P Capital IQ.

Challenges for the oil & gas industry

Incentives have historically been important factors in the Oil & Gas industry and should therefore consider:

— Low payouts may not (necessarily) reflect management impact.

— Limited incentive payouts can be de-motivating.

— Alternative approach is to have mechanism to recognize the impact of management apart from factors beyond their control – Oil Prices.

— Strive to provide strong message of positive impact.

— Absent these mechanisms and messages, companies increase their retention risk for the management population.

Retention risk

However, experience suggests these common responses:

- Cost Cutting (of Operations)
- Limited (or no) Compensation Increases/payouts
- Reductions in Staff

This experience suggests:

- Retention risk has limited focus in a down market
- Business performance should be considered as an element of managing retention risk

The following model examines the context of retention risk

Retention risk model

Distressed industry

Performance can have a significant impact on retention risk – particularly in a distressed industry.

Relative performance
Peer comparison, Performance vs. Budget, etc.

Absolute performance
Share price targets, annual fixed financial improvement

Absolute performance \ Relative performance	Low	High
High	**Poor sector performance** **Shareholders could have done better** **Modest Retention Risk**	**Strong overall performance** **Rewards align with retention objectives** **Limited Retention Risk**
Low	**Poor overall performance** **Shareholders Lose** **High Retention Risk (from Executive's perspective)**	**Strong sector performance** **Shareholders Win within Sector** **High Retention Risk**

Source: KPMG LLP

Assessing retention risk

- Shareholders had better returns had they invested elsewhere within this sector
- Executives have done more with shareholder capital than others in their sector
- Management performance is strong given market conditions
- Recruiters focus here – strong management results (relative), but limited compensation due to poor absolute performance

Source: KPMG LLP

In this context, companies examine alternative means
of delivering equity compensation and managing retention risk

Alternative designs

Mitigating retention risk

Front loading equity

Modify annual Restricted Share grants by reallocating a slightly higher share amount to earlier years

Potential Advantages

- *Grant equity sooner to weather down market*
- *Lower grant price with greater upside – received earlier than normal cycle*

Potential Disadvantages

- *Continued retention risk in absence of turnaround*
- *Relies on share price growth*

Relative performance to peers

Award shares based on performance levels against peer companies

Potential Advantages

- *Seen positively by proxy advisory firms*
- *Rewards for management efficiency.*

Potential Disadvantages

- *Challenge to construct peer group*
- *May have poor optics in light of poor absolute performance*

Index against price

Performance goals are adjusted based on factors beyond management's control (e.g., Oil Prices)

Potential Advantages

- Isolates management performance
- Provides a means of managing retention risk

Potential Disadvantages

- Developing a reasonable Index
- May have poor optics in light of poor absolute performance

Front loading equity

Front loading grants with modest increase in shares results in higher award value, delivered earlier than normal cycle – assuming share price moves upward.

Front loading grants

Illustration – All Values are Hypothetical

Share Price	$50.00
Annual Share Value Award	$150,000
Number of Shares	3,000

	2017	2018	2019	2020	2021
Share Price	$50.00	$60.00	$66.00	$69.30	$72.77
% Growth		20%	10%	5%	5%

	2017	2018	2019	2020	2021
Share Price	$50.00	$60.00	$66.00	$69.30	$72.77
% Growth		20%	10%	5%	5%

Normal grant cycle					
Year of grant					
2017	3,000				
2018		3,000			
2019			3,000		
Total Shares Granted				9,000	
Value/End of Cycle			$198,000	$207,900	$218,295
Total Value				**$624,195**	

Front loaded grants					
Year of grant					
2017	5,000				
2018		2,250			
2019			2,250		
				9,500	
			$330,000	$155,925	$163,721
				$649,646	

Relative performance to peers

Relative Plans are common, but may not be recognized for their retentive value – rewarding for sector performance independent of absolute performance.

Relative performance vs. peers

Illustration – All Values are Hypothetical
Measure: Total Shareholder Return (TSR)

Share Price	$50.00
Annual Share Value Award	$150,000
Number of Shares	3,000

Performance schedule	
%ile ranking	**Award multiple**
75th %ile and above	200%
50th %ile	100%
25th %ile	50%
Below 25th %ile	0%

Values between levels are interpolated.

TSR of peer group	
Company	**Return**
A	45%
B	42%
C	39%
D	36%
E	33%
Acme Oil Co.	32%
F	30%
G	27%
H	24%
I	21%
J	18%
K	15%
L	12%
M	9%
N	6%
O	3%
P	0%
Q	-3%
R	-6%
S	-9%
T	-12%
U	-15%
V	-18%
W	-21%
X	-24%
Y	-27%
Z	-30%

Acme's TSR	
Acme's %ile ranking	**Award multiple**
81%	**200%**
Resulting Shares	6,000
Price at End of Period	$72.00
Value of Award	$432,000

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Index against price

Applying an adjustment for significant swings in price (for Crude), can enable share awards to be isolated from factors outside of management's control.

Index against price

Illustration – All Values are Hypothetical

Share Price	$50.00
Annual Share Value Award	$150,000
Number of Shares	3,000

Budgeted Net Income Goal ($B) **$1.50**

	Market performance (% change in crude)				
	-20%	-10%	0%	10%	20%
Adjustment to Goal	50%	75%	100%	125%	150%
Adjusted Goal ($B)	$0.75	$1.13	$1.50	$1.88	$2.25
Actual Performance ($B)	$1.08	$1.08	$1.08	$1.08	$1.08
Percent of Adjusted Goal	144%	96%	72%	58%	48%
Share Grant	4,350	2,850	2,400	1,800	0

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Summary

Because of current conditions, CEO total direct compensation in Oil & Gas lags general industry when considering the impact of realized and realizable gains in equity compensation.

Not surprisingly, there is a relationship between Oil prices ($ Crude per Barrel) and incentive levels in the Oil & Gas industry.

In addition to cost control efforts, companies in a distressed industry should not lose sight of executive retention risk.

Retention risk is increased when absolute performance (e.g., stock price) is low and relative performance (e.g., peer group comparison) is high.

Three alternative incentive structures can serve as a starting point to examine equity compensation as a means to manage retention risk:

— Front Loaded Equity

— Relative Performance to Peers

— Index Against Price.

Questions?

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