

The New Era of Equity Compensation Design: Performance Plans

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| Bottom Line | The growing use of performance plans as a supplement to stock options in long-term incentive programs adds significant complexity to the data collection, analysis, and valuation necessary for conducting competitive assessments of pay. |
| Subjects | Executive compensation, market analysis, benchmarking, performance plans, performance shares, performance measures. |

Executive Summary

Comprehensive changes in the regulatory and governance environment surrounding equity-based compensation have resulted in a diversity of practices not fully reported in survey data and media coverage. While some headlines portray a world in which stock options have been abandoned for restricted stock, greater scrutiny reveals a much more complex structure of grant types and provisions being used for both executive grants and all-employee programs. The most notable change is the widespread introduction of performance-based plans with a wide variety of features. Understanding the nuances of competitive practice is essential for conducting meaningful competitive assessments and making plan design decisions.

The Issues

Over the past four years, changes in accounting rules, tax regulations, disclosure requirements, corporate governance standards and investor expectations have converged to create a sea change in equity compensation design. Firms of all sizes and in all industry sectors are changing their equity compensation strategies. Contrary to sometimes misleading headlines, companies have not abandoned stock options and replaced them with other types of equity grants. Most of the change is occurring among small and mid-sized firms which are looking more like their Fortune 500 industry peers and granting combinations of stock options, restricted stock and units, performance shares, and long-term cash incentive awards.

The changes are not only in the types of grants made but in the grant provisions – shorter option terms, a variety of vesting schedules, addition of performance criteria, and the combining of time-based and performance-based features. These changes have occurred in executive compensation programs as well as in all-employee plans.

Over the past few decades the structure of equity compensation programs was highly consistent among companies of similar industry and size, but equity plan design is no longer correlated with these factors. While five years ago we would find, for example, that virtually all small and mid-sized software companies used only stock options with ten-year terms and four-year vesting schedules, the diversity of practice among those same companies today is remarkable, illustrated in the contrasting examples below:

| Company Code | Revenue (billions) | SO Grant | SO Vesting | RS Grant | RS Vesting | PS Grant | PS Perf Period |
|--------------|--------------------|----------|------------|----------|------------|----------|----------------|
| A | \$2.58 | √ | 4 yr | | | √ | 1 yr |
| B | \$2.67 | √ | 2 yr | √ | 4 yr | √ | 1 yr & 2 yr |

SO = Stock Option
 RS = Restricted Stock
 PS = Performance Share

Understanding the variety of practices among one's peer companies is the first step in assessing pay levels and practices. Unlike the days in which calculations of "salary plus bonus plus options" allowed an apples-to-apples comparison of pay, today's fruit cocktail programs require closer scrutiny and more diligent analysis.

The increasing prevalence of performance-based equity grants represents the latest challenge in assessing market pay levels.

The various combinations of performance periods, performance measures, integration of performance and time vesting, and other features have resulted in almost every plan being unique.

Half of the companies granting performance shares combine an initial performance-based period with a subsequent time-based vesting schedule.

The Research

We reviewed equity compensation data for the Named Executive Officers (NEOs) – the “top five” reported in the proxy statement – in the ten largest companies, as measured by market capitalization, in eight segments of the technology sector. This sector has been the most sensitive to the impact of myriad rule changes and environmental shifts. Thus, we would expect the most change and innovation here.

| Industry Segment | Average Market Cap (billions) | Average Revenue (millions) |
|--------------------------|-------------------------------|----------------------------|
| Communications Equipment | \$21.3 | \$8,275 |
| Computer Hardware | \$22.8 | \$15,002 |
| Computer Networks | \$2.8 | \$1,123 |
| Computer Peripherals | \$33.8 | \$13,602 |
| Computer Services | \$6.7 | \$6,032 |
| Computer Storage Devices | \$9.1 | \$4,105 |
| Semiconductors | \$32.3 | \$7,476 |
| Software & Programming | \$53.2 | \$9,057 |
| Total Group | \$22.8 | \$8,083.9 |

While our sample represents larger – and in many cases more mature, lower-growth – companies smaller firms often look to the industry leaders and these trends will likely influence practices at firms of all sizes.

Using CompAnalyst Executive™, we gathered data on long-term incentive compensation awards made during the most recent fiscal year at these firms and long-term incentive awards from previous years still vesting and/or being earned. These two datasets provide us with insight into the multi-year grant patterns essential to understanding executive long-term incentive practices.

Prevalence, Value, and Mix

The structure of equity awards to executives in the technology sector has changed substantially from the options-only model of years ago, however options continue to be a core element.

| Industry Segment | Granted to One or More NEOs in Last Fiscal Year | | | |
|--------------------------|---|------------------|--------------------|------------|
| | Stock Options | Restricted Stock | Performance Shares | No Grants |
| Communications Equipment | 100% | 50% | 40% | 30% |
| Computer Hardware | 90% | 60% | 30% | 50% |
| Computer Networks | 70% | 50% | 20% | 70% |
| Computer Peripherals | 70% | 60% | 20% | 20% |
| Computer Services | 60% | 60% | 40% | 50% |
| Computer Storage Devices | 70% | 70% | 10% | 50% |
| Semiconductors | 100% | 60% | 20% | 30% |
| Software & Programming | 90% | 50% | 10% | 50% |
| Total Group | 80% | 58% | 26% | 44% |

- In the last fiscal year (LFY), only **20% of the companies made no stock option award** to any of the NEOs while 58% granted a combination of options and one or two other vehicles.
- The most significant trend: **69% of companies made full-value grants** (restricted stock, units, and/or performance shares) to one or more NEOs in the LFY. That is an extraordinary change in practice from a few years ago in this sector.
- Another important point: **44% of the NEOs in these 80 companies received no long-term incentive award** in the LFY, but most have outstanding awards from previous years, highlighting the need for a multi-year perspective on executive pay.

The Emergence of Performance Plans

The big news here, of course, is the rapid spread of performance plans in this sector; 26% reported new awards in the LFY.

- It is important to note that companies whose most recent proxy filing was prior to the effective date of the new SEC disclosure rules were required under the “old rules” to show performance share grants in the “Restricted Stock” column of the Summary Compensation Table, with a footnote discussing the performance features. Some reports tracked only the numbers in the table, leading to an overstatement of the prevalence of restricted stock awards and an understatement of performance share grants.

The bigger news is the diversity of plan design for these performance-based awards. The unique combinations of performance periods, performance measures, integration of performance and time vesting, and other features have resulted in almost every plan being truly unique.

| Company Code | Performance Period (yrs) | Subsequent Time Vesting (yrs) | Performance Measure(s) |
|--------------|--------------------------|-------------------------------|--|
| C | 1 | 4 | Operating income |
| D | 2 | 0 | Net revenue, operating income |
| E | 1 & 3 | 0 | Adjusted cash flow from operations, revenue growth |
| F | 1 & 2 | 2 | Share price |

- The performance period for these plans ranges from one to five years. This introduces the need to understand variation in practices, given the anomaly of a one-year period being represented as a “long-term” incentive.
- Further complicating the analysis is the growing use of plans with one-year or two-year performance periods followed by a multi-year, time-based vesting period. About half of the companies granting performance shares combine an initial performance-based period with a subsequent time-based vesting schedule, creating a hybrid performance share/restricted stock program.
- Approximately half of the companies use a single performance measure while the others use two or more performance measures as the basis for determining award payouts.
- The variety of performance measures ranges from traditional accounting measures (revenue, net income, EPS) to more progressive financial measures (free cash flow) to market-based measures (total shareholder return, share price).

Recommendations

Answering the seemingly simple question of “how much does that position pay?” has become enormously complex, particularly for executive positions. For NEOs in public companies we have immediate access to raw data and the opportunity to develop a detailed understanding of granting practices which can give us insight into the anomalies we find in other survey data sources.

Beyond the data, however, companies and their advisers must adapt their analytical models to the continuing change in equity compensation practices as companies introduce previously unutilized types of pay vehicles and new design features on existing vehicles. Making sense of this information requires the following:

- 1. Confirm the grant type:** The rapid spread of multiple grant types and year-to-year changes in grant patterns requires going beyond the column-by-column prevalence data and understanding the mix and relative use of vehicles used. Next year the old rules/new rules challenge in proxy data reporting will not exist, but continued experimentation with grant design is likely.
- 2. Confirm the situation:** The presence of founders, those with significant ownership positions, new hires, and terminations further complicate the data as these individuals may receive grants that diverge from the norm or no grants at all. For nonexecutive positions as well, turnover continues to taint datasets that do not adequately identify new hire grants.
- 3. Confirm the details of the grant:** Knowing the type of award is not enough. Time periods, performance criteria, acceleration versus contingency features, minimum award guarantees, and payout caps are elements that have a significant effect on value. Simplistic treatment of a “share” at face value tells nothing about compensation value.
- 4. Develop a multi-year model:** We continue to see significant year-to-year variations in grant timing and patterns. A “zero” in a given year does not indicate that a company did not compensate with long-term incentive awards that year, and indicates the need to understand grants in previous years. As more companies grant restricted stock and performance shares with substantially differing vesting and performance periods, an annual view of pay has become irrelevant.

Takeaway

SEC filings provide data on grant values and accounting expense, neither of which reflect compensation value. Capturing the variation in the mix of stock options, restricted stock, performance shares, and long-term cash plans and combining that with annual cash compensation to understand total pay requires producing a dollar-denominated present value of pay. There is disagreement among financial professionals, compensation practitioners, and investors regarding the appropriate method for determining the compensation value of long-term incentive awards.

In the face of conflicting data disclosure and valuation methodologies, developing a meaningful conclusion about competitive pay levels and practices requires developing an analytical model of compensation value that is credible to the Compensation Committee of the Board of Directors. The increasing prevalence of performance plans represents the newest challenge in this process.

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