

Executive SERPs: Is It Time For A Performance-Based Alternative?

Performance-based SERPs have been discussed off and on for many years, but usually within the framework of a modified benefit (e.g., a variable funding for the pension benefit)...

What we are suggesting is an entirely different approach...

Supplemental Executive Retirement Plans (SERPs) have been a standard practice for many companies. For some companies, they are a way to replace retirement benefits that would be lost by executives and other highly paid employees because of limitations imposed on qualified retirement plans (e.g., compensation over the IRC maximum, excluded income such as bonuses and deferred compensation). For others, they have become an important benefit to attract mid-career hires, who are walking away from unvested benefits at their current employers, and also to retain longer service employees. According to recent surveys, over 70% of U.S. corporations with annual revenue of \$1 billion or more have SERPs. Even though SERPs are fairly common, there are several converging factors that may lead many companies and compensation committees to consider alternatives to a traditional SERP:

- New SEC disclosure requirements will put a spotlight on the magnitude and cost of SERP benefits for executives.
- Many companies are facing pressures, including from the new pension law, to cut back or eliminate traditional defined benefit pension plans for rank and file employees as well as executives.
- Shareholder advocacy groups continue to push for more long-term alignment between executive pay and performance, and SERPs represent fixed pay.

THE PERFORMANCE-BASED ALTERNATIVE

Overview

In response to these factors, some companies are starting to consider performance-based alternatives to SERPs. We have been working with companies on an approach where a grant of restricted stock units (RSUs) with very long-term vesting is made, coupled with dividend equivalents, to provide value commensurate with that of the SERP being replaced, provided that expected stock price growth levels and dividend yields are achieved. An adjustment can also be made to reflect the inherently riskier nature of stock versus the guaranteed SERP benefit. For dividend-paying companies, dividend equivalents are invested in additional RSUs. The performance feature kicks in if stock price appreciation and dividends are above or below expected performance. The result is a more shareholder responsive retirement solution.

If a company demonstrates reasonable stock price appreciation and dividend yields (e.g., in line with long-term U.S. stock market annualized total shareholder returns of about 10%) for a period of ten years or more,¹ a relatively small grant of RSUs made today can mirror the value delivered by a traditional SERP.

¹ Shorter periods (e.g., five to seven years) can also work for companies with relatively high dividend yields or high stock price growth.

Advantages of the Proposed Approach

The use of a performance-based alternative using RSUs has three primary advantages over a traditional SERP.

1. Greater Alignment with Stock Performance/Shareholder Returns

Unlike a traditional SERP, the ultimate value of a performance-based SERP is strongly aligned with the returns realized by shareholders. Assuming the initial grant is properly calibrated to reflect acceptable stock price growth levels and dividend yields, the RSUs will deliver value in line with the SERP; however, if the company's performance over the remaining tenure of the executive is below expected levels, then the value of the RSUs at retirement would be less than what a SERP would have provided. On the other hand, if the company performs better than expected, the value to the executive upon retirement would be higher. Because the RSUs are essentially a long-term ownership stake they put executives' "skin in the game" with upside opportunity and real downside risk. Lastly, the increased tie to stock performance could also provide a positive signal to the market of the Board's and management team's confidence in the company.

2. Considerably Lower Accounting Cost

A performance-based SERP using RSUs would likely result in a lower accounting cost than a traditional SERP. The accounting for RSUs under FAS 123R would reflect the grant date value of the RSUs; that is, the number of RSUs multiplied by the grant date stock price (and potentially with a further reduction based on the inability to sell vested instruments prior to retirement as per FAS 123R). There would be no additional accounting charge for the dividend equivalents that are reinvested provided that they are not paid out until the original grant has vested. Depending on a company's circumstances, the cost savings from implementing a performance-based SERP using RSUs could range from 20% to 75% of a traditional SERP.

3. Potential for Upside

Unlike a SERP which provides a fixed benefit, RSUs have the potential for significant upside if the company performs well. An effective management team thus stands to benefit more if they perform well. Conversely, if performance is subpar, gains would be less.

Key Design Issues

Initial Awards: Grants should be set to provide a similar value to participants if expectations for stock price growth, dividend yield, etc. are met; however, appropriate adjustments should be made to reflect the difference in risk of a stock-based program versus a guaranteed payment. For example, expected stock performance can be set based on meeting or exceeding the historic stock performance of the company, the long-term performance of relevant peers, and/or an external index such as the S&P 500.

Supplemental Awards: Supplemental grants could be made in the case of promotions to provide an additional retirement benefit (similar to what the executive would have received under a SERP due to increased compensation).

Vesting: Similar to the SERP benefit it is replacing, vesting of the grant and its reinvested dividend equivalents starts when the executive approaches early retirement age (e.g., age 55), and finishes when the executive attains normal retirement age (e.g., age 65). Although vesting could be distributed evenly (e.g., 10% per year from age 55 to 65), we prefer, like in many SERPS, to have vesting weighted more heavily after age 60 (e.g., 8% per year from age 55 to 59, then 12% per year from age 60 to 65).

Tax deductibility under 162(m): 162(m) should not be an issue since shares will only be delivered following retirement (i.e., when the recipient is not eligible to be a named executive officer).

Death, disability and termination provisions not associated with a change-in-control: Could be set to trigger vesting or payments that traditional SERPs provide under similar situations.

Change-in-control: Could accelerate vesting for some part of the RSUs, or all, depending on the circumstances. Unlike traditional SERPs, which sometimes provide additional credit under a change-in-control, any benefit enhancement under this arrangement would be provided as a result of the "change-in-control premium" (i.e., a run-up in the stock price).

Security: The performance-based alternative is marginally less secure than a traditional SERP in the event of bankruptcy in that executives with a traditional SERP would have to get in line with other employees and creditors to receive any benefit, while in the case of a performance-based SERP, they would receive shares that would likely be worthless.

WHEN TO CONSIDER THE PERFORMANCE-BASED ALTERNATIVE

More Suitable Situations

- Companies under pressure to reduce the costs of retirement plans.
 - ▶ In conjunction with freezing or discontinuing a SERP, a grant of RSUs could be used to provide the portion of retirement benefit foregone, most likely at a lower cost.
- Companies where executive ownership levels are low.
 - ▶ A performance-based SERP can quickly provide a material ownership stake, albeit a contingent one. Because of its illiquidity, it can provide long-term upside and downside risk for key executives.
- As a supplement to a traditional SERP, for mid-career/late-career hires where the executive leaves substantial retirement value on the table at his or her former employer.
- Rather than providing additional years of service credit, which could be costly to the company, a grant of RSUs could be made to cover the value left behind, with vesting to correspond to retirement age.

Less Suitable Situations

- A turnaround situation, where the company's long-term prospects or ultimate survival is uncertain.
 - ▶ Executives are likely to view RSUs with long vesting as too risky (a SERP might not be perceived as favorably either, if the ability to pay it is greatly at risk).
- Companies where a large percentage of the executives are close to retirement, particularly if the company pays small or no dividends.
 - ▶ The time period may be too short to offset the risk of hitting a downturn in the economic cycle.
- Companies with limited availability of full value shares in their employee equity plans.
 - ▶ In such situations, RSU grants could hasten the need to return to shareholders to approve new authorizations (e.g., ahead of a promised schedule).

- ▶ A company in this situation could go to shareholders to get special authorization for this program, but this would probably make more sense if the company was offering to freeze or discontinue its SERP benefit in exchange for making these grants, and could demonstrate cost savings to shareholders if they approved the new program.
- Companies where direct compensation opportunities are already generous or above market and an enhanced retirement benefit is not warranted.

Impact of New SEC Compensation Disclosure Rules

For the year in which the initial grant is made, the number of RSUs and their grant date value would be disclosed in the *Summary Compensation Table*. Dividend equivalents would not be disclosed at in the *Summary Compensation Table*. Information about the award, including its year-end value, would continue to be reported in the accompanying tables until retirement.

Conclusion

Although the performance-based alternative may not fit all companies, we believe it will work in many cases to provide a more shareholder friendly way to offer supplemental retirement benefits for executives and other highly paid employees. This is especially important given the increased scrutiny of executive pay and benefits and the desire for greater alignment of executive and shareholder interests.

As with any strategically aligned executive or management compensation program, the successful design and implementation of a SERP alternative such as this one requires attention to program objectives, compensation philosophy, inherent risk of the delivery vehicle and the situational context in which the company is operating.

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ABOUT SEMLER BROSSY CONSULTING GROUP

Since its founding in 2001, Semler Brossy Consulting Group (SBCG) has been helping clients navigate the complex world of executive compensation in order to effect superior strategy execution. Today, eight Principals lead our client engagements nationwide across a wide array of industries, including financial services, healthcare, consumer products, technology, manufacturing, retail, and professional services.

We provide expert advice to Boards and management teams on all aspects of executive compensation from performance measurement to annual and long-term incentive design to executive benefits to director pay. As one of the largest independent executive compensation consulting firms in the United States, we take a holistic approach to pay — one that considers a company's overall business strategy, organizational reality, competitive environment, shareholder needs, executive talent profile and leadership and governance. We are particularly adept

at helping management and Boards through significant changes such as mergers, acquisitions, spin-offs, IPO, turnarounds, strategic redirections, CEO/executive succession and conflict resolution.

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Illustrative Example

Using RSUs Instead of a SERP to Provide an Executive Retirement Benefit

Consider the case of two companies, Company A and Company B, both of which have an annual dividend yield of 1.5%, and one, Company A, which has an expected long-term total annualized return to shareholders of 10%, and the other, Company B, with an expected return of 13%. Each company has a 50 year old executive and a 55 year old executive that it wants to provide a \$500,000 annual retirement benefit at age 65.

In a conventional SERP, for each executive the present value of a lump sum benefit at age 65 would be \$5.1 million, and the total accounting cost if the lump sum is taken upon retirement at age 65 would also be \$5.1 million (spread over 15 years for the age 50 executive and 10 years for the age 55 executive). If, instead of a conventional SERP, each company provided RSUs with dividend equivalents reinvested to age 65, the savings in accounting costs would be substantial.

- For the 50 year old, who has 15 years to age 65 and thus 15 years for the compounding of annual returns, the savings would range from \$3.8 million at Company A to \$4.3 million at Company B, or about 75% to 85% of the SERP cost.
- For the 55 year old, who has 10 years to age 65, the savings would range from \$3.1 million at Company A to \$3.6 million at Company B, or about 60% to 70% of the SERP cost.

Conventional SERP vs. RSUs with Re-Invested Dividend Equivalents (\$MM except # of shares)

Annual Benefit at Age 65 = \$500,000
Present Value of Lump Sum Benefit at Age 65 = \$5.1 MM
Assumed Company Dividend Yield = 1.5%

	Current Age of Executive	Expected Annualized Return ¹	RSUs – Grant Date		RSUs – Age 65		Total Accounting Cost		RSU Cost Savings	
			# RSUs ²	Value of RSUs	# RSUs ³	Value of RSUs	RSUs ⁴	SERP ⁵	Amount	As % of SERP Cost
Company A	50	10.0%	60,550	\$1.2	75,796	\$5.1	\$1.2	\$5.1	\$3.8	76%
	55	10.0%	97,550	\$2.0	113,305	\$5.1	\$2.0	\$5.1	\$3.1	61%
Company B	50	13.0%	40,450	\$0.8	50,635	\$5.1	\$0.8	\$5.1	\$4.3	84%
	55	13.0%	74,550	\$1.5	86,590	\$5.1	\$1.5	\$5.1	\$3.6	71%

* Based on discount rate of 6.0% and 1994 Uninsured Pensioners-male (post-retirement) mortality rates.

¹ Includes stock price growth and a 1.5% dividend yield.

² Assumes grant date stock price of \$20.

³ Includes RSUs resulting from re-investment of dividend equivalents.

⁴ # of RSUs initially granted times the grant date stock price (spread over the vesting period).

⁵ Per FAS 87, spread over 10 or 15 years, as appropriate, until age 65.

The value of the dividend equivalents accruing each year for the RSUs, to be disclosed under the proposed SEC rules, would be relatively small for either of these executives at either of the companies, even in the final year before retirement.

**Estimated Value of Annual Dividend Equivalents to be Disclosed in Summary Compensation Table
Assumed Company Dividend Yield = 1.5% and Grant Date Stock Price = \$20**

	Current Age of Executive	Expected Annualized Return ¹	First Year (\$000s)	Last Year Before Retirement (\$000s)
			Year 1	Year 10 or 15
Company A	50	10.0%	\$19.2	\$73.0 Yr 15
	55	10.0%	\$31.0	\$73.0 Yr 10
Company B	50	13.0%	\$19.5	\$108.2 Yr 15
	55	13.0%	\$31.5	\$94.6 Yr 10

¹ Includes stock price growth and a 1.5% dividend yield.