A High Risk, High Reward Pay Orientation

Can an aggressive pay-for-performance reorientation help businesses meet goals?

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A financial services firm with revenues in excess of $1 billion utilized a price-vested options approach with rigorous goals to align with the company's high-growth strategy.

The strategy was successful, and after the stock price nearly doubled by the end of the performance period, the CEO realized values in excess of 10 times what the value was when the options were granted to the executive.

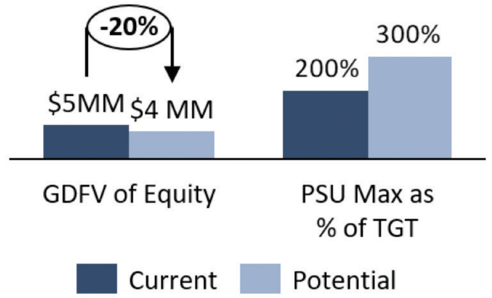
Introducing a "high-risk, high-reward" pay design that allows companies to provide outsized wealth creation opportunities for outsized performance.

This approach is appropriate for companies in varying contexts, whether in a distressed industry (e.g., oil and gas, retail), a turnaround situation, a private equity-backed high-growth firm, or just a firm with the goal of making pay for performance more prominent within the organization. Or perhaps reportable pay is too high. If so, a "high-risk, high-reward" plan can help cut the reportable grant date fair value of pay while offering an aggressive incentive to executives when performance is delivered longer-term.

Take, for example, the exploration and production sub-industry of the oil and gas sector. "Lower-for-longer" crude prices have forced a reassessment of pay levels to meet both proxy advisor and shareholder demands. How do you revitalize executive incentives in this context? Devise a plan to cut reportable pay while offering a significant upside to executives if performance goals are met; all the while maintaining a largely performance-based plan in the eyes of external stakeholders.

Consider three temporary approaches, employed separately or in combination, which can ease the pay squeeze that executives might otherwise feel.

1. Increase Performance-Share Leverage



Reduce grant date fair value (GDFV) and raise max upside

2. Introduce Performance Options

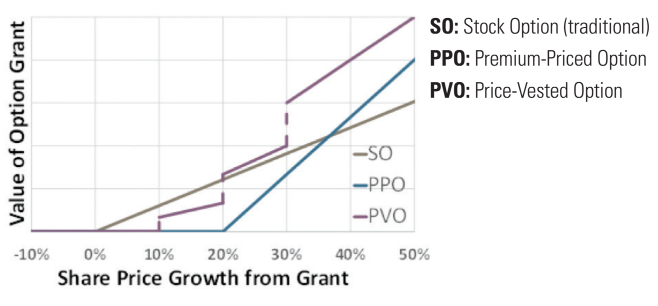
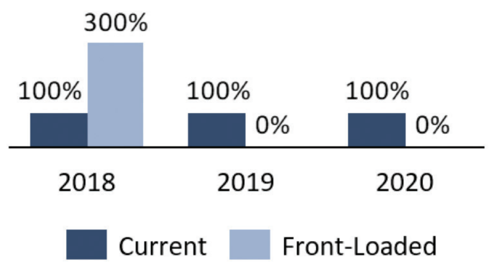


Figure 1. Reduce the grant date fair value of performance shares. Do so by decreasing the target while increasing the maximum payout. This is a simple tweak for companies already granting performance shares. Depending on Monte-Carlo valuation inputs (if using market-based measures), reportable pay can decline while preserving a performance-based design as measured by proxy advisors.

Figure 2. Introduce performance options. Leverage the opportunity for wealth creation tied to share price by using premium-priced options (i.e.,

3. Front-Load Awards



Front-load 3 years of annual awards

vesting at an exercise price above the grant price) or price-vested options (vesting at grant price with exercise prices set above grant/strike price). Both can be designed as performance-based in the eyes of proxy advisors. Neither pay for poor performance. Valuations (e.g., Black-Scholes, binomial), depend on share volatility and other inputs. Goals should be set aggressively, though not to discourage participants or harm retention.

Figure 3. Front-load the awards. Executives can be granted several years' worth of annual awards up-front. They would see no grants in subsequent years, until an end-of-period reset. Proxy advisors will criticize reportable pay in the first year, but will then ease off. In effect, you create "golden handcuffs," improving retention. On the downside, if performance goals aren't met, you're constrained in adjusting pay during interim years.

The upside of all these approaches is that, if you set the leverage, goals, and duration right, executives can earn much more than in normal annual cycles. However, if goals aren't met, payouts will be negligible, which is a retention risk towards the end of the cycle. That's why, as with all plans, weigh the pros and cons, finding the right approach to please investors while ensuring pay remains tied to powerful and transformational incentives. ■

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