

ADVANCING THE DIALOGUE

Want to align pay and performance? Grant fixed shares

INTRODUCTION

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Over the last few years, a lot of the discussion about aligning pay with performance for corporate executives has focused on the use of performance conditions for equity grants. The idea is that by tying the vesting of equity to explicit performance goals, executives will be held more accountable for results in order to “earn” a significant portion of their compensation.

However, in today’s environment, proxy advisors and many shareholders are often more concerned with the reported accounting value for equity incentives at grant rather than how much is actually earned by executives for performance. As a result, while performance share plans clearly have a role to play in executive compensation design, they are far from a panacea to address the pressure to improve pay for performance alignment.

Another Way to Align Pay with Performance

Is there another way to demonstrate alignment between pay and performance? Perhaps in addition to the use of performance shares?

SBCG’s analysis of pay for performance relationships indicates that simply granting the same number of shares each year to individual executives — rather than using a grant date target value — might result not only in more *perceived* alignment between pay and performance as measured on the grant date, but also in more *actual* alignment. The basis for the improved alignment associated with fixed share grants is fairly intuitive. By granting a constant percentage of the company’s market capitalization each year, the amount of gain realized by an executive (or group of executives) should directly track the change in value. Thus, actual pay and performance should be aligned.

WHAT’S THE BIG IDEA?

Consider determining equity awards for executives each year based on the number of shares rather than the grant date value:

- Better shareholder optics (grant values automatically adjust up and down with share prices)
- More real pay-for-performance alignment in volatile markets
- Easier for participants to understand
- Avoids issues with calibrating “grant date fair value” when making equity grants.

This alignment can be further enhanced by adjusting the share grants around this fixed target year-to-year based on recent performance; for example, tied to financial or share-price related goals and results for the company or individuals. Alternatively, a company can grant a fixed number of shares to executives as a group and change the allocation among the individuals in the group based on their personal contributions and performance.

For the purpose of this assessment, the specific vehicles being granted are not important—stock options, restricted shares, or performance shares can all be used. Rather, our focus is on how the number of shares granted is determined year-over-year and whether the value of the grant is taken into account when making individual awards (vehicle mix issues aside).

For example, the ‘traditional’ grant date value approach for deciding how many shares to grant might work as follows (shown as 100% full value shares for simplicity):

(000S EXCEPT PER SHARE DATA)	YEAR 1	YEAR 2	YEAR 3	YEAR 4
TARGET VALUE	\$3,000	\$3,250	\$3,500	\$3,750
STOCK PRICE	\$10.00	\$8.75	\$13.95	\$12.75
# SHARES	300	371	251	294

A fixed share grant alternative flips this around, targeting the same number of shares each year and allowing the grant value to vary with the share price:

(000S EXCEPT PER SHARE DATA)	YEAR 1	YEAR 2	YEAR 3	YEAR 4
TARGET # SHARES	300	300	300	300
STOCK PRICE	\$10.00	\$8.75	\$13.95	\$12.75
VALUE OF GRANT	\$3,000	\$2,625	\$4,185	\$3,825

So why is this more aligned with performance? Let’s start by looking at the external perspective, or how shareholders perceive the link between pay and performance.

External Perspectives

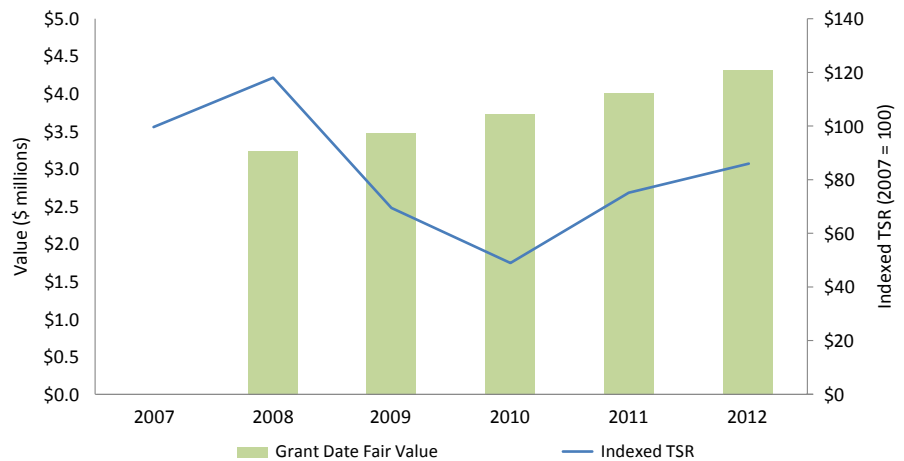
For many shareholders—and their proxy advisors—pay for performance alignment is defined primarily based on the “grant date fair value” (GDFV) of equity grants, rather than how much an executive actually earns when—or if—the shares eventually vest. The logic for this is that GDFV:

- Is reported on a consistent basis across companies;
- Has historically been the main basis for executive pay benchmarking and the determination of grants; and therefore
- Generally reflects the decision-making process of the Board (what they actually controlled in a given year).

Regardless of the limitations of the GDFV approach to evaluating equity, it seems likely that shareholders will continue to include the values reported in the proxy as at least one factor they consider when evaluating pay and performance alignment.

However, when targeting a specific value of equity, it becomes easy for the apparent alignment of pay and performance to become disconnected. For example, let’s take a branded consumer-products company with a highly volatile share price and assume that the Compensation Committee targets the median of peers for their CEO compensation. As the share price fluctuates each year, the Compensation Committee adjusts the number of shares granted to keep the GDFV of equity competitive with peers. In addition, assume the peers have become highly competitive for talent, driving up the annual value of compensation, and the Compensation Committee also believes that the fluctuation in share prices has more to do with macro-economic circumstances rather than the CEO’s individual performance. Thus, they feel compelled to provide at least a median pay package to the executive as measured on the grant date. As a result, the reported value of pay keeps going up while performance — as defined by Total Shareholder Return (TSR) — is often down year over year and over time, as shown in Figure 1.

Figure 1.
**Consumer Products Co. —
 Value-Based Equity Grant Model**



Now let’s take the same example, but assume instead that the Compensation Committee decided to fix the number of shares granted at the beginning of the five-year period (shares granted could also be adjusted for performance, but we have held the number constant for the sake of illustration). The reported results are shown in Figure 2. As the illustration shows, fixing the number of shares means that the reported value (GDFV) of equity fluctuates with the share price, resulting in much greater apparent alignment between pay and performance at any given period of time.

Figure 2.
**Consumer Products Co.—
 Fixed-Share Equity Grant Model**



The illustrations above have assumed that all grants are made on the last day of each year, fully aligning GDFV with fiscal year TSR. In the real world, there are timing issues that would need to be addressed to fully align the reported value of equity grants and the stock price performance, since today most companies grant equity early in the fiscal year while TSR performance is generally measured at year-end.

Actual Value

Perhaps more importantly, moving to a fixed share approach can also result in better alignment between *actual* value received by an executive and TSR performance. Let’s take, for example, the same consumer-products company discussed above and look at what happens to the “realizable value” of pay at the end of five years under the traditional value-based grant approach vs. fixed-share grants (see Figure 3.)

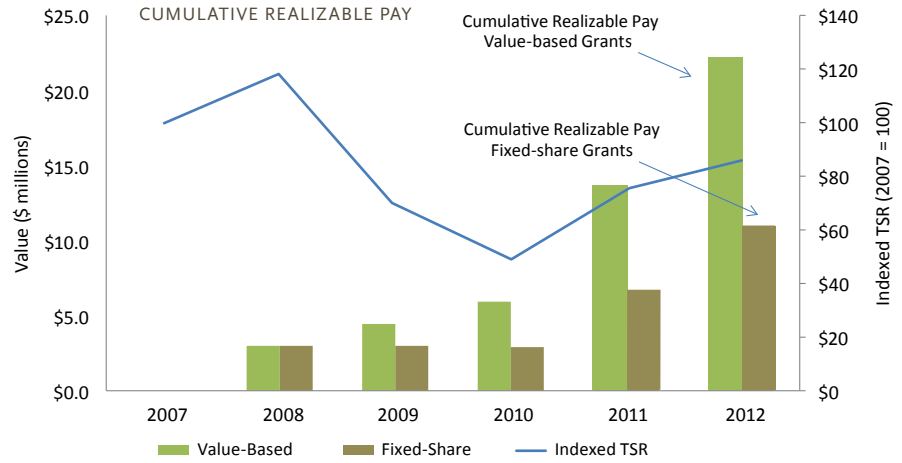
REALIZABLE PAY

There are many different ways to look at the issue of “actual” pay earned. For the purpose of the analyses in this discussion, we have defined “Realizable Pay” using the updated economic value of equity grants over a defined period of time, or specifically:

- Stock Options granted during the measurement period are valued using Black-Scholes on the last day of the period using the then current share price, the original strike price, and the remaining term of the option
- Restricted Shares are valued based on the share price on the last day of the measurement period
- Performance shares are for this purpose valued the same as restricted shares assuming the “target” number of shares will be earned

This approach is similar to measuring the embedded gains on stock options, except that the value of the remaining option term is included, rather than just what the option could be exercised for on a specific date. Each option granted during the period is valued as a premium-priced or discounted option using the Black-Scholes model and the stock price on the measurement date, so that underwater options are still considered worth something.

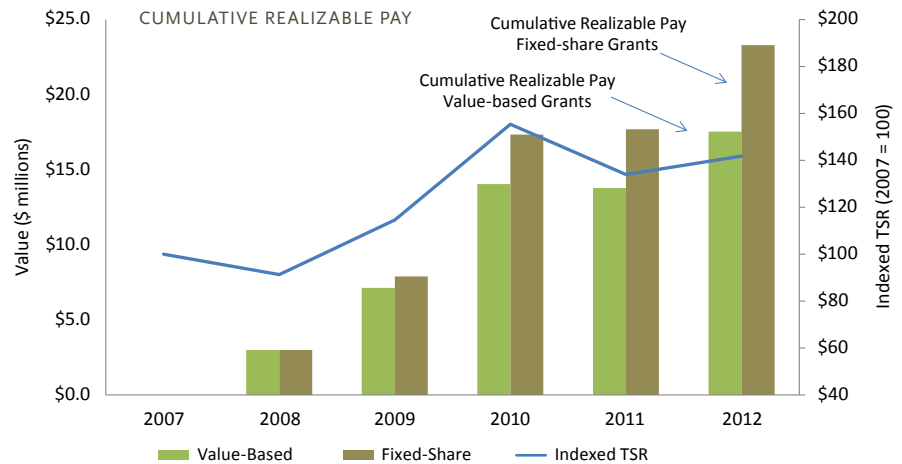
Figure 3.
Consumer Products Co.—
Comparison of Models



As this demonstrates, the cumulative value earned over time for the CEO receiving value-based grants can exceed the values for a CEO receiving a fixed share grant by a significant amount, even if the share price is meaningfully lower at the end of the period as compared to the beginning. This outcome is the result of pay for volatility rather than pay for sustained performance. When the stock price is sharply down, a larger number of shares need to be provided to maintain a target level of value-based grants, and these grants can result in significant payouts when the share price recovers, even if that recovery is only partial, as shown in this real-world example.

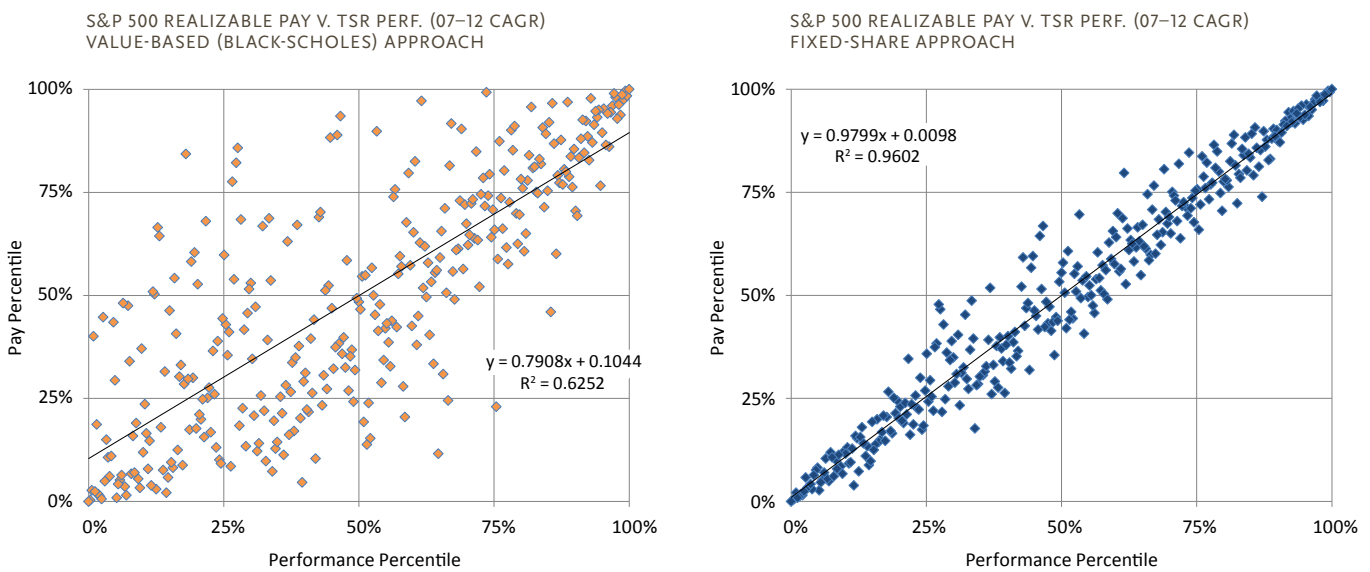
This “pay for volatility” is *always* a feature of equity awards that target a given value of stock awards. And it can cut both ways, either under- or over-rewarding an executive for performance, as shown in the example below (Figure 4.) for a company with sustained share price increases:

Figure 4.
Increasing Share Prices—
Comparison of Models



We tested this same comparison of value-based grants vs. fixed-share grants across the S&P 500 companies over the last decade and the results were astounding—**especially during periods of high market volatility (e.g., 2007–2012)**. The realizable pay for a CEO at the end of the period would be **significantly** more aligned with TSR performance if all the companies had fixed the number of shares granted at the beginning of the period rather than trying to adjust for a target “value” each year.¹ (see Figure 5.)

Figure 5. Comparison of Value-Based and Fixed-Share Models—S&P 500



We tested this result over multiple five-year periods and using different mixes of stock options and full-value shares, and the result was always the same—in aggregate and over time, a fixed share grant approach is *always* more aligned with TSR performance than a value-based approach. The difference is most compelling in periods of extreme volatility—and in practice many Compensation Committees would likely moderate the results of a pure “Black-Scholes” model in such circumstances—but the difference persists throughout all of the iterations we tested.

Other Considerations

While conceptually compelling, the idea of fixing the number of shares and giving executives more or less the same number each year is not without its problems. Some issues that would need to be considered include:

- How do we calibrate the “starting” number of shares in a way that is fair to shareholders and executives?
- Are we willing to accept the potential for very high reported values in the proxy if our share price performs well?

¹ For the purpose of this analysis, we assumed a constant pay package for each CEO based on a \$5 million “target” annual value of equity and a 50% stock option/50% full-value share pay mix. We then varied the number of shares granted and end of period realizable value for each company based on actual stock price performance of each S&P 500 constituent. Analysis includes all of the constant S&P 500 constituents over the past 10 years and excludes financial services companies.

- What about the fluctuations in total cost of the program from year to year? How do we manage?
- At what point should the number of shares be reset? 100,000 shares might be perfectly reasonable for a \$50 stock but not for a \$500 stock
- What about the timing of grants to align the reported value with year-end TSR performance? If we traditionally grant early in the year, how can we make a transition to late-in-the-year grants?
- As we grow, how do we handle the increased dilution from new executives and employees? Should we fix an absolute dilution limit? If so, how do we manage the reduction in individual grants as new employees are added to the pool?
- Or alternatively, how do we recognize in later stages of company evolution, share values are likely higher and less risk is assumed than by early stage employees and therefore a smaller percentage of the company (and fewer shares for individual executives) are warranted?
- How do we prevent the plan from becoming an entitlement rather than an incentive for performance?

In practice, most companies are likely to use something of a hybrid between the traditional value-based approach to granting equity and a fixed share approach, which focuses more on dilution than value. Indeed, we have worked with many companies that start with “how many shares did we grant last year” first—adjusted for the performance of the company over the last year—and only then test the implications for “how much is this worth” compared to market and peers.

In Summary

While not for every company, a fixed-share or dilution-based model for granting equity may make more sense than a target value approach in some cases. This is particularly true for companies in highly volatile markets, where standard valuation approaches for equity incentives may not work very well, and where adjusting the number of shares each year can further magnify the outcomes and generate “pay for volatility” rather than pay for performance.

The benefits of this approach are:

- Easy to understand and communicate to participants and shareholders
- Reported grant-date values can be more aligned with performance in the short-term
- Actual values will be more aligned with performance in the long-term

There are many details that need to be assessed to implement such a program in practice—and there are other, less radical, approaches which can help achieve some of the same objectives (e.g., using average prices over a longer term to calibrate the value of grants)—but the idea of sharing a fixed portion of the ownership with management each year has its benefits and is worth consideration for some companies.

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