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Why Give Front-Loaded Equity? How One-Time Multiyear Performance Awards Can Revitalize a Pay Plan

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When Actavis PLC (now Allergan Inc.) compensation committee members voted in 2014 to award the company's named executive officers (NEOs) with a front-loaded long-term equity incentive, they had a convincing rationale (Actavis 2015). The company was in the midst of executing a new transformational strategy focused on growth, as well as absorbing the recent $28 billion acquisition of Forest Laboratories Inc. The complex and multifaceted strategy would take several years to execute, so the new compensation plan aimed to focus executives on just one set of goals for the next three years.

The long-term incentive — and the strategy — was a big bet. Executives would forgo annual equity awards for three years. But if they delivered the transformation and achieved an annual total shareholder return (TSR) of at least 10%, they would earn awards ranging from a grant-date fair value of $5.6 million to $34.5 million — the top figure for CEO Brent Saunders. The equity, in the form of performance stock units and options, would fully vest in 2019.

Front-loaded awards typically lump into one sum the expected value of grants that will be made over the ensuing three to five years. Instead of an annual grant schedule, the full award is made upfront (see Figure 1). Oftentimes, companies will design these awards to have a higher-than-normal risk profile as well, but that isn't always the case.

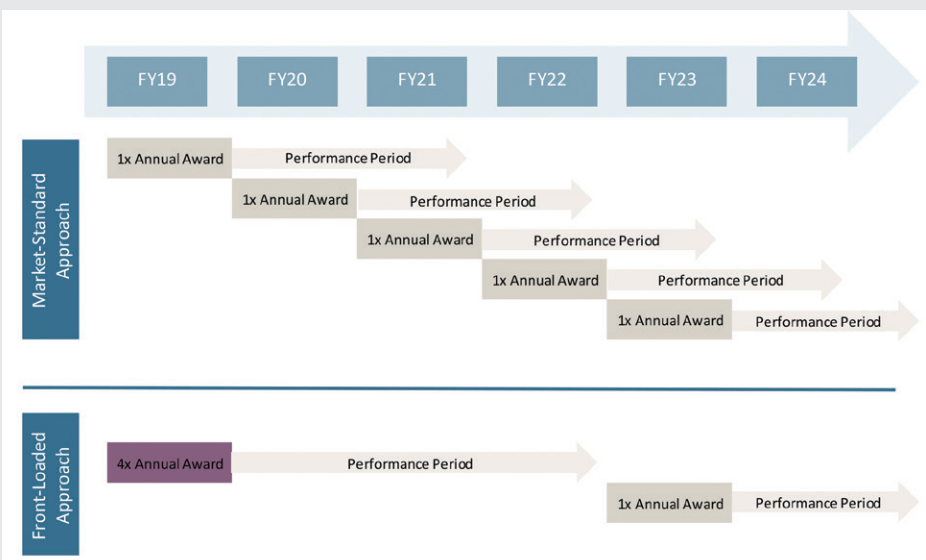
HIGH-PROFILE FRONT-LOADED AWARDS HAVE BEEN IN THE NEWS

There have been a number of recent grants of front-loaded awards that have received attention. Among the most noteworthy were those given to Oracle Corp. founder Larry Ellison and three other top executives (Oracle 2018). Each received large front-loaded incentive packages in 2018 intended to motivate them to drive the software company's transition to a cloud-based enterprise. After five years, Ellison and the co-CEOs could each earn more than 17 million options, valued in excess of $100 million at grant.

The Tesla Inc. compensation committee meanwhile awarded CEO Elon Musk a grant of more than 20 million options in 2018 that vest in 12 tranches, with the intention of not awarding him any guaranteed compensation (base salary, cash bonus or time-based equity) during the 10-year performance period (Tesla 2019). Musk must meet one aggressive performance milestone after another. He earns the maximum reward only if he increases company revenue by a staggering $160 billion and market capitalization by a sensational $600 billion — more than Facebook's market capitalization at the time of grant.

The Ellison and Musk awards — big news owing to the executives' celebrity and the grant sizes — brought the merit of front-loaded long-term incentive designs

FIGURE 1 Market-Standard and Front-Loaded Approaches



Source: Authors

into question. When, why, and how should compensation committees use them? In what situations, in other words, would a compensation committee want to replace traditional, annual long-term equity grants with big-bet front-loaded grants?

Companies ranging from Apple Inc. to Broadcom Inc. to Qualcomm Inc. to Valeant Pharmaceuticals International Inc. (renamed Bausch Health in 2018) have tested the waters. At Actavis, the compensation committee reasoned that the awards would focus executives on one set of goals that emphasized performance in the critical first years following the Forest Laboratories merger (Actavis 2015). The awards were also intended to aid executive retention and preserve the company's entrepreneurial culture.

Although the high-profile examples receive most of the press, companies of all sizes use front-loaded awards.

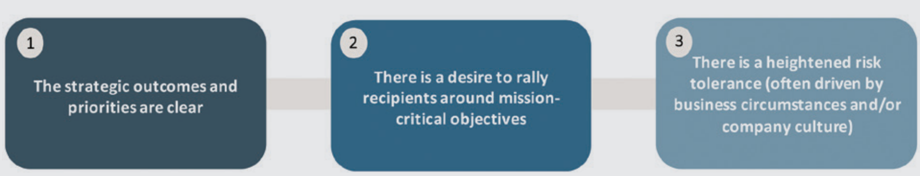
FRONT-LOADED AWARDS CAN BE A POWERFUL INCENTIVE TO DRIVE DESIRED BEHAVIORS

Front-loaded equity awards are not perfect for every situation, but they can provide an appealing alternative to the traditional approach. Today's market-standard designs provide balanced, diversified incentives that work well for most scenarios and most companies. However, the reality is that annual grants, overlapping cycles and three-year performance periods are suboptimum for some situations. First, the overlapping nature of the awards and annual resetting of goals can lead to a less performance-sensitive program and payouts that, over time, revert to target. Second, the multiple layers of goals and measures can dilute the incentive power of the program.

Front-loaded equity awards can provide a compelling alternative to the market-standard approach, especially for situations that meet the three criteria noted in Figure 2.

Front-loaded awards have the benefit of galvanizing executives around one set of clear objectives and creating more upside aligned with a company's mission-critical strategic imperatives. That's why front-loaded awards are more commonly used by private equity firms, companies undergoing a turnaround or transformation and companies undertaking a big-bet strategy.

FIGURE 2 When to Use Front-Loaded Awards



Source: Authors

In situations where there are wholesale shifts in a company's strategy or an urgency to energize the program, compensation committees should be asking whether there is a role for front-loaded awards. Take for example:

- A brick-and-mortar retail company that needs to step outside of its comfort zone to tackle the challenge of aligning with the digital age and create a seamless omnichannel shopping experience for its customers, or risk becoming obsolete.
- An automobile manufacturer facing tremendous headwinds and years of poor performance that needs to take risks to execute its turnaround strategy.
- A profitable industrial business facing shrinking demand for its primary product that needs to expand into different markets or face a certain, steady decline.
- A technology business with inestimable upside if it can beat its competition to market and gain a first-mover advantage.

CAUTIOUSLY USE FRONT-LOADED AWARDS

What are potential risks posed by front-loaded awards? What are the possible unintended consequences? Front-loaded awards are not for the faint of heart. They introduce more risk into the pay program and do not always play out as intended. At Actavis, executives ended up earning only 44% of their target payout even though the board acknowledged that the final payout did not reflect management's success in operating the business (Allergan 2018).

The first risk is triggering a broken incentive cycle, a performance period with no payout at all. Front-loaded awards magnify this risk because unlike traditional programs, they do not have the diversity of goals found in overlapping, annual grants.

Broken cycles can hurt morale and retention power, leaving executives with "nothing to play for" and making them easier targets for poaching from competitors. The impact can be particularly damaging if participants learn early in the performance period that no payout is likely. Furthermore, it can be challenging to re-stake executives following front-loaded awards without risking a shareholder revolt. These risks can be mitigated if executives have high stock ownership and/or large amounts of unvested equity from previous grants.

A second risk is that front-loaded awards, when they extend out several years, can constrain the company in making a strategic pivot to respond to market changes. This is a critical issue in today's economy, where the ability to react to new entrants, external disruptions and new market opportunities is key to long-term viability. The front-loaded program could then have a perverse hangover effect, creating an incentive to continue executing on the original strategy when the best thing for the company is to pivot.

A third risk is that the dialed-up risk/reward profile of front-loaded awards could spur executives to take more risks that could have an adverse effect on the company. With fewer grants over longer periods, executives have more at stake, are usually measured against fewer objectives during those periods and often receive full payouts only if they meet stretch performance goals. So long as the plan remains in place, executives will presumably remain focused on making the big bet pay off. The temptation could arise to cut corners or neglect other priorities.

Consider then-Valeant Pharmaceuticals International Inc. (now Bausch Health Cos. Inc.) in 2015. The NEOs received front-loaded equity grants payable at the end of five years (Valeant 2016). To reap the maximum reward of up to five times the target number of shares, the executive team would have had to boost its compounded annual total shareholder return (TSR) by at least 50%, equal to a share price of $1,181.81 — more than eight times the grant price of $140. The executives had a great start. The CEO had the prospect of a payout of 2.25 million shares valued at $2.66 billion. But the company then got caught up in financial misreporting and questionable distribution practices. The smell of scandal and investigations from Congress and the U.S. Securities and Exchange Commission (SEC) deflated the stock, which has since traded under $30.

Some critics of Valeant thought the 2015 pay plan — which both Institutional Shareholder Services (ISS) and Glass Lewis & Co. LLC recommended a vote against — deserved some of the blame. Under the plan, if the executives did not deliver aggressive stock-price growth, they would get no long-term incentive payout at all, which may have reinforced a growth-at-all-costs mentality. Of course, no incentive plan deserves all the blame, but big bets can set the stage where risky and undesired behaviors are more likely.

A fourth risk is that front-loaded awards attract extra scrutiny from the investing community. Although proxy advisers do not automatically vote against front-loaded awards, they scrutinize them much more intensely, as do shareholders. Are the larger grant values justified? Do the awards align with shareholder interests? Do the awards have compelling rationale? When the rationale and alignment are not clearly explained and disclosed, companies are more likely to receive lukewarm or negative say-on-pay votes.

Those negative votes are especially likely when awards appear excessive — as did the front-loaded award given in 2017 to Broadcom Ltd. CEO Hock Tan, valued at nearly $100 million at grant (Broadcom Ltd.). Both ISS and Glass Lewis recommended a vote against the plan, regardless that the award was tied to shareholder return, required outperforming at least half of the Standard & Poor's 500 and that the company clearly stated that Tan would not receive new equity grants until 2021. Shareholders gave the company a weak 62.3% affirmative on the pay plan during its say-on-pay vote.

THOUGHTFUL DESIGN IS REQUIRED TO GET FRONT-LOADED AWARDS RIGHT

Boards should consider six design principles when considering a front-loaded award. (See Figure 3.) These principles can materially mitigate potential risks, ensure strong alignment with shareholders and optimize the effectiveness of

FIGURE 3 Six Principles for Effective Front-Loaded Awards

Source: Authors

front-loaded awards. Not all of the principles will be relevant for every situation or business context. However, the more principles companies are able to incorporate, the greater the likelihood of a durable and effective design.

Most companies focus on the design aspects of the award, carefully thinking through appropriate metrics, performance periods, vesting schedules and goals. However, compensation committees often overlook critical internal and external communications.

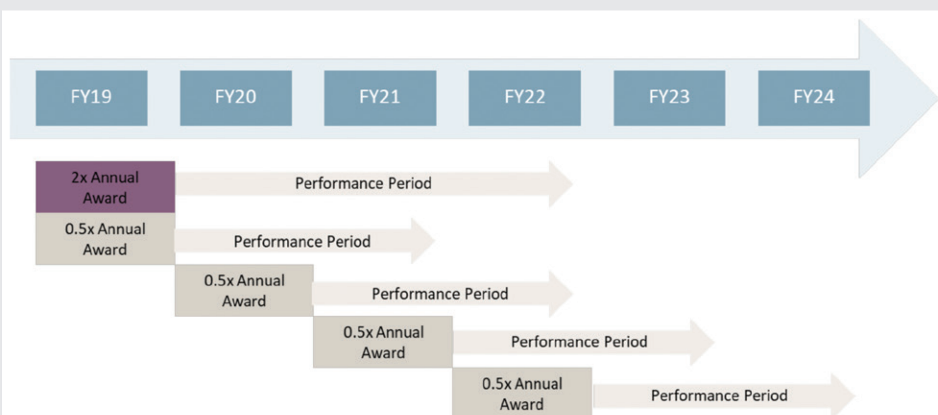
HYBRID APPROACHES CAN BE EFFECTIVE

Front-loaded awards may not fit every context or situation. Even if companies meet the three criteria listed in Figure 2, boards may be hesitant to take on the risks that could result from front-loaded awards. An alternative is to adopt a hybrid approach: make a smaller one-time front-loaded award and maintain the regular annual ongoing program. (See Figure 4.) Though smaller, the front-loaded award will still have many of the same retention and incentive benefits, but the ongoing annual program reduces the risks of broken cycles and retention gaps.

In 2017, Scotts Miracle-Gro Co. granted front-loaded performance awards to its NEOs referred to as project focus awards (PFAs) (Scotts 2018). The company had recently implemented a new strategy to respond to the shifting market. Project Focus called for an evaluation of the current asset portfolio designed to maximize the value of its non-core assets in order to concentrate its focus on its core lawn and garden businesses. The project also prioritized cash-generating activities to fund investment in key growth initiatives and return cash to shareholders. The PFAs were designed to align management's decision making in support of the financial objectives of the company's strategic initiatives. The PFAs would pay out based on cumulative non-Generally Accepted Accounting Principles (GAAP) free cash flow and calculated investor return over the five-year performance period. During this timeframe, the NEOs would also continue to receive time-based restricted stock units, but at a reduced level compared to recent annual grant levels to account for the front-loaded PFAs.

From the compensation committee's perspective, the one-time grant provided a critical performance-based vehicle to further reinforce the importance of the go-forward strategy at a critical time for the company. The partial front-loading also mitigated some of the risks of a fully front-loaded award. Most importantly, it allowed the compensation committee to continue to layer on annual equity grants,

FIGURE 4 A Hybrid Approach of Carving Out a Front-Loaded Award from Future Equity Grants



Source: Authors

which mitigated the potential impact of a broken cycle and the resulting gaps in retention and incentive power. The lower annual equity grant values in the first year also likely helped to reduce external scrutiny of the program.

CONCLUSION

No compensation plan is perfect. While sticking with the status quo may feel like the safest route, compensation committees should consider whether a full or partial front-loaded award could help address concerns with the effectiveness of the market-standard approach and better align with the long-term business strategy. Front-loaded awards, in the right situations and when designed thoughtfully, can offer a potent way to drive executives to execute on aspirational goals and focus on key strategies needed to ensure the company's success.

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