POST-PANDEMIC LTI DESIGN TRENDS

The challenge of goal-setting amid volatility has compensation committees rethinking long-term incentive pay practices.

SUPPLY CHAIN DISRUPTIONS, inflation, regulatory change, a labor market upheaval—in these uncertain times, any number of factors can all too easily have an outsize impact on performance-based pay. Many companies learned that the hard way when carefully calculated three-year goalposts became obsolete overnight during the pandemic, says Eric Henken, a managing director at FW Cook.

"A lot of companies faced a scenario where they had multiple in-flight long-term incentive plans that were going to pay at zero," he says. "Obviously, that was not only de-motivational to the participants but also exposed the company to retention risks. Suddenly, performance-based LTIs were going to provide very little value to participants, opening some companies up to having top talent poached by those less disrupted by the pandemic."

DE-RISKING LTI DESIGN

For comp committees, unexpected pandemic pay outcomes underscored the importance of adjusting plan design to mitigate risk. "The overarching theme is that balance in plan design—not relying on a single performance metric, a single long-term incentive grant type—is critical," says Henken.

Large companies appear to be taking heed by exploring a variety of plan adjustments. FW Cook's recent study of compensation programs at the largest 250 public companies by market cap showed that while total shareholder return (TSR) remains the most common incentive pay performance metric, used by 72 percent of the top 250 companies, fewer are employing it as a sole performance metric.

"There's an understanding that while relative TSR creates direct linkage with shareholders and is well understood and well received by external organizations, it can provide limited line of sight to stock price outcomes for participants," explains Henken. "That's particularly true in industries that lack a large number of relevant comparator organizations due to consolidation, such as airlines and large banks. Having to use a broad index as a comparator reduces the relevance of the metric."

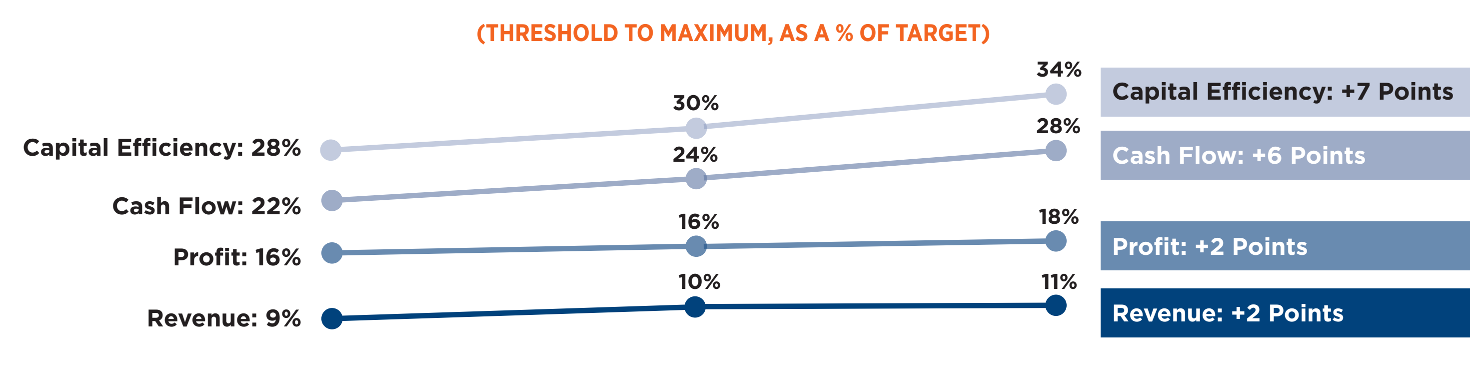
Since the pandemic, prevalence of TSR as a modifier of payouts based on other metrics has grown by 50 percent, with companies seeking to de-emphasize its weighting on overall payouts. "Companies using TSR in their award designs are increasingly doing that in conjunction with at least one other performance metric, such as profit, capital efficiency or revenue," says Alec Lentz, a principal at FW Cook. "They're looking to de-risk the overall program by making it more diversified and incorporating more levers into the compensation program."

GETTING GOAL-SETTING RIGHT

Economic uncertainty is also complicating goal-setting, as companies struggle with the forecasting necessary to ensure that performance targets for metrics like revenue, capital efficiency, earnings per share and EBITDA will be relevant and motivating two and three years into the future. To account for the possibility of external factors impacting performance, many companies are widening goal widths, or the distance between the minimum performance required for any payout at all and the performance required for maximum payout, for every type of financial performance metric. (See chart, "Change

Change in Median Performance Metric Goal Width from 2021 to 2023

Performance goal widths have expanded in recent years due to continued market uncertainty and challenging operating environments.



Source: 2023 Top 250 Report, FW Cook

in Median Performance Goal Width.")

"Since best practice is to widen goals symmetrically on both sides, one unintended consequence of that is it becomes more difficult to achieve the maximum payout," notes Henken. "But a lot of companies are willing to accept that tradeoff because risks related to a 0 percent payout in one of these plans are much greater than sacrificing a bit of upside potential."

Comp committees should be mindful of ensuring that widened goal ranges track with external guidance being provided to investors, adds Lentz, who notes that a high payout at the end of the three-year period during which a company missed its stated expectations could trigger scrutiny.

PICKING PERFORMANCE PERIODS

The vast majority of companies (89 percent) continue to base LTIs on performance over three years, and multi-year, end-to-end measurement periods also remain the preference of proxy advisors and investors. However, 12 percent of the top 250 companies use annual performance periods, which is 50 percent more than in 2019, signifying movement toward managing the impact of uncertainty on incentive pay.

"Increasingly, I'm seeing large companies consider measuring performance in annual increments so that strong performance in years one and two can somewhat buttress really poor performance in year three to still provide some modest payout," explains Henken.

"One interesting way of doing that is to set a one-year financial performance goal, which is much more predictable than a three-year goal, and then layer a three-year relative TSR modifier on top," adds Lentz. "The bulk of the earnout is determined by the one-year financial goal, but it looks like a three-year performance award in the proxy because of the three-year TSR performance period, and nothing vests until three years after the date of the grant."

Another approach entails annual goal resetting, where a company sets an annual growth rate goal for a given metric at the beginning of the three-year period. Each year's performance is then measured against actual performance in the year prior. "It passes muster externally as a three-year program because you're setting goals at the beginning of the performance period, but it provides a bit more flexibility for the results to adapt to changing business conditions during the three-year period," says Henken.

"Companies considering such an approach or using annual performance goals should plan to include a robust explanation of how the pay program is linked with performance in their proxy CD&A, as such designs can be scrutinized more than the typical three-year end-to-end awards," adds Lentz.

"THE OVERARCHING THEME IS THAT BALANCE IN PLAN DESIGN—NOT RELYING ON A SINGLE PERFORMANCE METRIC, A SINGLE LONG-TERM INCENTIVE GRANT TYPE—IS CRITICAL."

—Eric Henken, FW Cook

A MIX OF MULTIPLES

Despite shifts in the compensation landscape, most of the top 250 companies (86 percent) continue to use multiple long-term incentive grant types. Performance-based awards remain by far the most commonly used grant type, in use at 94 percent of companies typically for at least 50 percent of the award mix, consistent with the stated preference of proxy advisors.

"However, you still see companies using multiple grant types and not allocating too much of the mix to any single one," says Henken. "There's an understanding that if you go too high on the performance share units, it ratchets up the risk and the reliance on the goal-setting process."

While the number of companies using stock options/SAR awards held steady at 52 percent since 2019, use of restricted stock grants increased by 4 percentage points to 69 percent. Henken attributes the bump to the stability that RSUs introduce to the mix. "Time-based restricted stock units provide a foundational element of the program that helps create long-term retention linkages and weather potential macroeconomic uncertainty that might make the performance share units harder to obtain," he explains. Both grant types typically vest over three years on a ratable schedule.

TAKEAWAYS FROM THE TOP 250

The compensation plan design trends observed among the top 250 companies underscore the need to mitigate risk in the face of ongoing volatility. However, companies should take a cautious and thoughtful approach when pursuing changes to pay practices. "Long-term incentive pay design really needs to be customized for each company," says Lentz. "It can't be driven off of peer data, where you just introduce the most prevalent metric or grant type being used by your peers or in your industry."

"You shouldn't rush through a wholesale redesign," he says. "Ideally, it is a one-year process to review the efficacy of the current program, diligently review alternatives including consideration of pros and cons, and land on a new approach that has buy-in from all stakeholders. There are a lot of internal and external implications that need to be considered before everyone can be confident that it's the right thing to do."

For more information about compensation trends among top 250 public companies, visit fwcook.com/2023-Top250.

Eric Henken, a managing director at FW Cook, specializes in working with compensation committees to develop executive compensation programs.

Alec Lentz, a principal at FW Cook, advises companies on executive compensation practices and design, and related considerations, including proxy disclosure.