Using Incentive Plan Design to Support Strategic and Transformational Change

Maximizing the linkage of business strategy with motivational and talent needs by resisting homogenization

By: John R. Sinkular and Ira T. Kay

Summary

Incentive plans lie at the heart of the executive pay program, driving and rewarding business strategy execution. This approach has brought great economic success to the clear majority of companies. The typical annual incentive plan and long-term incentive (LTI) mix of multiple award types can capture most regular core performance metrics. A more contemporary design approach may provide significant focus and urgency regarding a company's strategic transformation, shifting business strategy, or competitive advantage in attracting and retaining talent.

As we near the ninth year of Say on Pay (SOP) votes, most companies now apply robust tools to design and administer executive pay. Multiple internal and external perspectives are typically considered when setting target pay opportunities and mix, selecting incentive metrics, and ensuring realized pay over the long term is aligned with performance. This disciplined process can embolden companies to "fight back" on executive pay practice homogenization and apply more than the market typical or proxy-advisor-guided practices. [1] Instead, unique or emerging design practices can maximize the connection between the executive pay program, business strategy, and talent objectives.

Key Takeaways

- *Market typical or best practices have a place in certain elements of the executive pay program.*
- *However, companies with strong pay design and administration processes should feel confident to explore alternative approaches that may better drive the business strategy and meet key talent needs.*
- *New or critical performance goals may be lost in the typical incentive design or not assigned the necessary level of urgency or focus, particularly in a strategic transformation.*
- *In certain situations, a milestone-type incentive plan (e.g., achieving a new level of profitability) may better serve a company than trying to fit new metrics into an existing annual or long-term incentive plans.*
- *In the end, companies should use the design and administration practices that the Committee and management believe will best drive long-term shareholder value.*

[1] John R. Sinkular and Ira Kay. "Resisting Homogenization of the Executive Pay Program – Update Motivating the Executive Team While Satisfying Shareholders and Achieving Successful Say on Pay Votes." Pay Governance. October 13, 2016. http://paygovernance.com/resisting-homogenization-of-the-executive-pay-program-update-motivating-the-executive-team-while-satisfying-shareholders-and-achieving-successful-say-on-pay-votes/.

Providing a creative or highly differentiated executive pay program is not advised for every company. There may be concerns regarding the proxy disclosure implications, target pay opportunity comparisons, or proxy advisor firm perceptions. While companies may be criticized, compelling business and talent opportunities may be worth “fighting” for. With a strong rationale tied clearly to the articulated business strategy, companies can often develop a compelling fact base for creating a highly energized pay program distinct from prior company/peer approaches. In using a new or redesigned pay program, companies should thoroughly analyze key tradeoffs, proxy disclosure implications, and payout and financial / stock price performance sensitivities, including performance scenarios in which significant value, or no value, would be realized.

Below, we highlight several pay elements that may warrant reevaluation — either as an additive component or a carveout / redesign — to enhance how the company’s executive pay program aligns to its business strategy and talent needs. We then close with a summary of key considerations when contemplating these more creative or emerging executive pay program design practices. Please note that particularly care should be applied if these approaches are used for the chief and named executive officers (CEO and NEOs) due to external optics and SOP votes; as such, these strategies may be more viable for other executives.

Executive Pay Program Design Elements that May Warrant a New Approach

Below we summarize six areas that may warrant consideration for companies seeking to provide stronger strategic transformation linkage or otherwise improve the pay package’s perceived value and energy, as summarized on the following pages.

1. Pay Strategy

In setting target pay opportunities, companies can incorporate wider flexibility (managing to an *on average* market pay positioning rather than individual or *de facto* caps) to assist in attracting, motivating, and retaining key talent.

Current Market Practice	Potential Alternatives
• *De facto* cap at market median for the annual target pay opportunities • While most companies administer target pay within a competitive range (e.g., ±10% of market median on average), company comfort levels vary in going above the high end of the range	• Retain the administration of pay within a competitive range but incorporate wider latitude in setting target pay levels. For example, provide higher target pay positioning for top talent or mission critical positions, particularly if salaries are set, on average, at the lower end of the competitive range with target incentive award multiples at the high end or somewhat above the competitive range. • Set regular annualized target pay within the competitive range and allow for periodic special incentive opportunities (see below). However, it is critical to consider the proxy SCT pay disclosure in the year of grant.

2. Incentive Awards

In developing the incentive grant strategy, companies can “take a step back” to determine if the current market typical approach best meets its needs. This could include creating a separate milestone-based incentive plan (if there are critical goals that don’t easily fit into the traditional one- and three-year performance plan cycles) or providing more equity accumulation opportunities to accelerate the management team’s ability to earn company stock.

Current Market Typical	Potential Alternatives
• Typical mix of annual cash and LTI awards • Annual incentive opportunity is for results over 12 months and, if earned, paid in cash • Time-based awards vest over three to five years • Long-term performance share / cash plans use three-year goals and pay earned awards thereafter.	• Use milestone incentive plans, which do not have a time boundary, on a periodic basis (or layer in the grant over several years if the milestones have a longer expected duration). For example, a milestone incentive plan may be used to provide a dedicated incentive for achieving an annual earnings run rate or profitably deliver on new product sales within 5 years, rather than a traditional one- or three-year performance period. • Provide an annual incentive opportunity in the form of performance-based stock options or shares. • Grant “career shares,” which are stock units paid after retirement with the vesting that may occur in three to five years after the grant. • Allow opportunity to “purchase” stock options or full-value equity with earned cash incentives (e.g., pre-tax management stock purchase plan which may include a company match).

3. Long-Term Award Types and Mix

For LTIs, companies can evaluate if alternative grant mixes would better align to a transformative strategy or other special situations.

Case Study #1 – Career Shares to Assist with Retention and Mandate Long-Term Ownership

- *A company desired to provide executives with retirement benefits beyond the qualified plans; after considering traditional designs, the company decided that a stock-based plan would be best.*
- *Career shares may be granted annually (there is no preset formula). While shares vest after three years, the stock units must be retained until after retirement.*

Current Market Typical	Potential Alternatives
• Typical mix of two or three award types • LTI grant mix is fixed for many years	• Vary the LTI grant mix within defined parameters. For example, for a new business strategy or new senior hire, use a heavier weighting of stock options and performance shares (e.g., an equal mix); in regular years, use a mix of performance shares, stock options, and restricted stock units. • Instead of a portfolio of award types, grant one award type and rotate each year (e.g., performance shares the first year, restricted stock units the second year, stock options the third year, and then repeat the cycle).

4. Stock Price as the Key Performance Measure

Companies should determine the appropriate role of stock price performance as an explicit performance measure, including the role of absolute stock price (stock options or absolute total shareholder return [TSR]) and whether TSR as a relative measure should be an independent metric or modifier.[2]

Current Market Typical	Potential Alternatives
• TSR is used as a relative performance measure and used as an independent metric • Stock options are used by nearly 60% of industrial companies and have an average weighting near 25%	• Use TSR as a relative performance modifier to payouts determined based on multi-year financial performance. • Increase the role of stock options to assign a higher weighting (if currently in the regular grant mix) or introduce it as an award type in the annual grant mix. • Use absolute TSR as a performance plan measure.

Case Study #2 – Special Stock Price (Absolute TSR) 3-Year Grant to Align to Business Transformation

- *A company desired to provide executives with direct alignment to TSR milestones to be achieved within a three-year period, reflecting a significant change in business strategy and leadership.*
- *Senior officers were granted a three-year grant (i.e., no new regular equity awards for three years) primarily denominated in performance-contingent performance shares that could only be earned for achieving preset absolute stock price goals.*

5. Long-Term Performance Plan Assessment Periods

There are situations when the duration of a key financial goal may not fit in the market's typical three-year structure (e.g., critical business strategy goals for a time frame other than three years or goals that are nearly impossible to set over multiple years).

[2] See Viewpoint 2018, Relative Performance Is Important But Should It Be an Incentive Metric?

Current Market Typical	Potential Alternatives
• Use three-year goals and pay earned awards shortly thereafter (vesting and performance assessment periods are approximately the same)	• Separate the performance assessment and vesting periods. For example, if a one- or two-year performance assessment period is used, require additional vesting of two to three years. • Another approach is to allow for accelerating award payments if a goal is achieved sooner than the stated performance period.

Case Study #3 – Traditional Business Evolving to Drive E-Commerce

- *Significant change to stock incentive design to focus management team on transformation*
- *Size of pool of stock grants linked to strategic and transformational objectives.*

6. LTI Grant Frequency

There may be some situations (e.g., critical new hire, transformative long-term strategic goals, new start-up) in which large up-front grants may align to the business strategy and talent needs more so than the typical annual grant approach. However, doing this requires great care.

Current Market Typical	Potential Alternatives
• Annual grants in the first quarter with a mix of performance-contingent and time vesting award opportunities	• Award large up-front ("performance contract" or mega) grants that are all / heavily performance-contingent. Tesla is a recent, prominent example: the CEO is granted stock options expected to cover 10 years of awards that can vest for achieving both milestones and market cap goals. *Note: This approach requires great care due to the proxy-disclosed value in the year of grant.* • Make year-end LTI grants based on an assessment of the current and recent years' results and other considerations; this is a flexibility that could be applied following the elimination of the 162(m) performance-based pay exception (although other governance factors and investor optics should be considered).

Case Study #4 – Milestone Incentive Award Opportunity

- *An emerging company desired to provide an equity grant covering many years of LTI award opportunities (i.e., until all the milestones were achieved).*
- *Milestones were set based on the business strategy to achieve product development, manufacturing, and sales volume goals.*

Closing

Deviating from the homogenized, perceived best, or market-typical practices requires careful consideration and thoughtfulness. In contemplating new or emerging executive pay practices, companies should carefully deliberate and only make changes for compelling reasons and with a full understanding of the range of potential outcomes and proxy CD&A and SCT disclosure implications. As such, it is critical to conduct rigorous performance and incentive payout analyses on potential outcomes to fully understand the design implications and tradeoffs and to then create the appropriate safeguards to avoid unintended consequences. Depending on the situation and contemplated design changes, particularly the target award opportunities, companies should determine if the new approach is viable for the CEO and other NEOs. In the end, companies should design their executive pay program to best achieve the business strategy and meet talent needs while strongly aligning long-term pay with performance.

This Viewpoint is intended to inform Compensation Committees, executives, and compensation professionals about developments that may affect their companies; it should not be relied on as providing specific company advice or as a substitute for legal, accounting, or other professional advice.

General questions about this Viewpoint can be directed to John Sinkular at john.sinkular@paygovernance.com or Ira Kay at ira.kay@paygovernance.com.