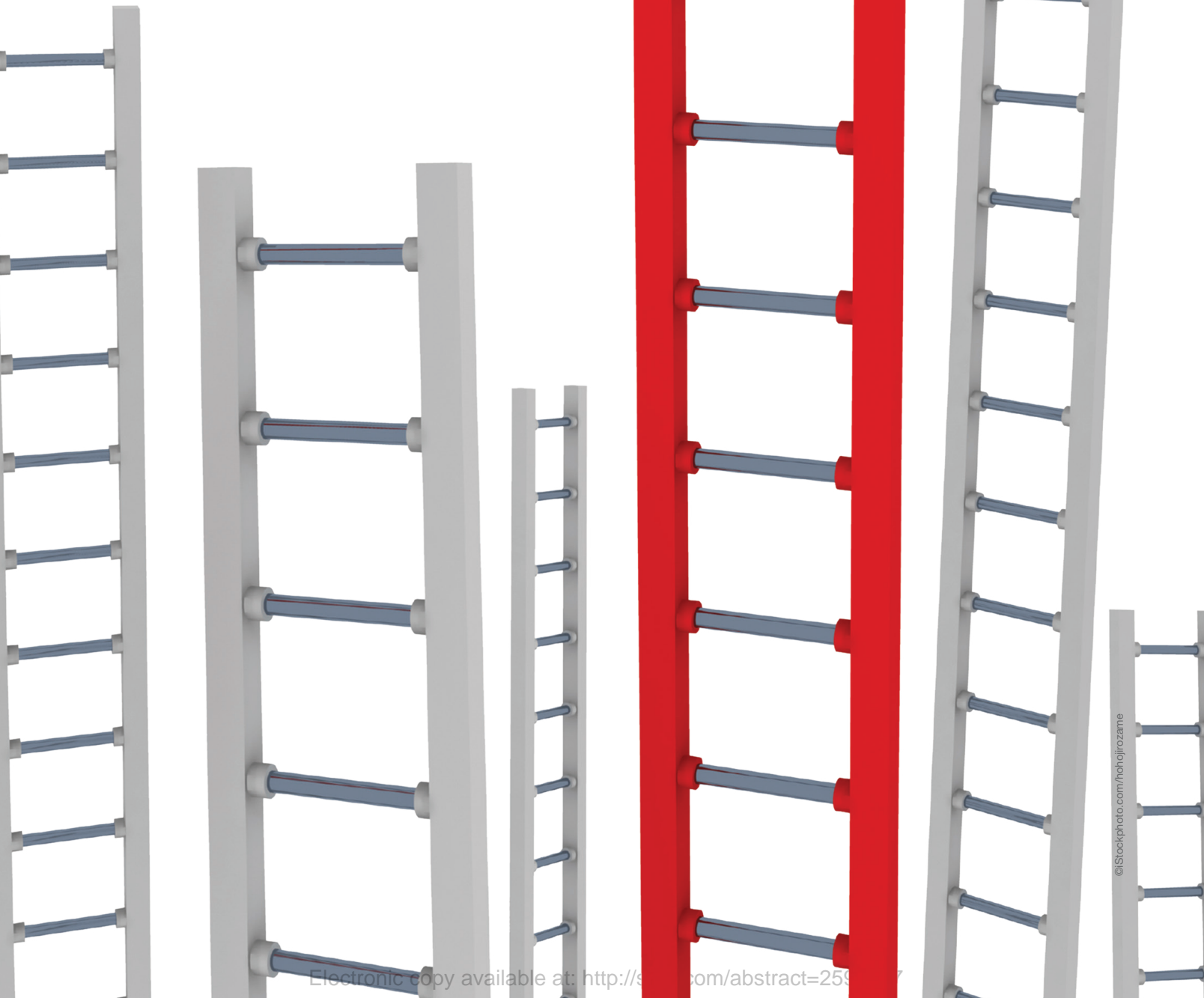


# HOW DOES YOUR LTI PROGRAM MEASURE UP?





## Updating Data from 2013, a New Survey Looks at Where We Are Now

Finding the right balance is key to your long-term incentive plan.

Companies continually search for the right performance measures to balance rewards with stock price. Although they are increasingly using total shareholder return (TSR) as one performance measure, they are reluctant to use it as the only one, given its drawbacks which are discussed later in this article. Other measures such as earnings per share and return on invested capital are more closely connected to stock-price performance. Companies also can use more fundamental measures that are factors in calculating earnings per share and return on invested capital, since they indirectly drive stock prices.

With say-on-pay legislation and the evolving standards of Institutional Shareholder Services Inc. (ISS) now

entrenched in the psyche of compensation committees, improving the disclosure of long-term incentive (LTI) plans should continue to be a priority for all public companies. Such disclosures should include the measures used, the values associated with those measures, and how they can be expected to drive performance.

To review trends in LTIs, particularly the underlying incentive design, Arthur J. Gallagher & Co. conducted its “Study of 2013 Short- and Long-Term Incentive Design Criterion Among Top 200 S&P 500 Companies.” The study, in its sixth year, surveys compensation data as disclosed in 2014 annual proxy statements for 200 of the largest U.S. companies.

By James Reda, David Schmidt and Kimberly Glass, Arthur J. Gallagher & Co.

Findings from the previous year's study were featured in *workspan* magazine's December 2013 edition, in the article, "How Does Your Long-Term Incentive Program Measure Up?"

That study found that the use of stock options had decreased and value had shifted to performance-based stock awards. More companies were linking pay with performance by using performance-based awards, and for the first time ever, performance-based awards made up 50 percent of the total LTI award.

This article updates how the same companies are structuring LTI programs one year later. It covers what has changed since findings were last published in *workspan*.

Figure 1 illustrates how four major trends in LTI design have changed from 2012 to 2013.

### LTI Plans Keep Becoming More Complex

The shift away from appreciation awards, such as stock options and stock appreciation rights, and toward performance awards, or those earned

based on achieving performance goals, continued in 2013. For the fourth consecutive year, grants of performance-based awards were more prevalent than grants of time-based appreciation awards, and the gap continues to grow. Since 2009, when the two were about even, performance-based awards have increased to 27 percentage points higher than stock options and stock appreciation rights (93 percent vs. 66 percent).

As they become more prevalent, LTI pay plans also are becoming more complex. The average number of performance measures being used has risen in lockstep with the use of performance-based awards over the past five years. This increase is occurring because of decisions to align pay with overall performance and to avoid placing too much weight on one measure.

Performance-based awards, which averaged 41 percent of the LTI mix in 2009, increased to 56 percent in 2013. On the other hand, stock options and stock appreciation rights, which

averaged 37 percent of the mix in 2009, now average just 26 percent.

The number of performance measures has increased steadily over the past five years. The shift away from using only one measure in a LTI plan continues, as the share of companies using two or more measures increased from 54 percent in 2009 to 72 percent in 2013. The average number of performance measures used increased to 2.2 measures per company in 2013, up from 1.7 measures in 2009. This is likely a response to U.S. Securities and Exchange Commission concerns about the risks associated with single performance measures, especially if the same measure is used in both short-term and LTI plans.

Figure 2 illustrates how performance measures have increased in line with performance-based awards.

The collective use of performance-based awards (performance shares or units, performance-based restricted stock, performance stock options, premium stock options and long-term cash plans) totaled 93 percent in 2013,

Figure 1 | 2012 vs. 2013 Gallagher Studies — Major Trends

#### Gallagher 2012 Study

#### Gallagher 2013 Study



Performance-based awards were at least **50 percent of the total LTI award value** for the first time ever.

The momentum continued in 2013 with the **average value of performance-based awards jumping to 56 percent** of the total long-term incentive award.



LTI programs continue to become **more complex and diverse**, with more companies granting at least two types of LTI awards. In addition, the number of performance measures being used in performance share or unit plans has increased, from an average of 1.6 in 2008 to 2.1 in 2012. The inclusion of relative measures has also increased during this time period.

The number of performance measures continues to increase, with an average of 2.2 measures seen in 2013. This is likely a response to Securities and Exchange Commission concerns about the risks associated with single performance measures, especially if the same measure is used in the annual incentive plan. **Companies using three or more measures have increased from 17 percent in 2009 to 32 percent in 2013.**



While stock options continue to be popular and part of the LTI mix, **performance-based awards have become a larger part of the LTI mix** (to the detriment of stock options).

**Performance-based awards continue to increase** in both prevalence and value with the opposite occurring for stock options/stock appreciation rights. As performance-based awards increased again in 2013, both time-based stock options and restricted stock or units declined three percentage points each.



**173 of 200 companies had a LTI plan in 2012.** Of these 173 companies, 58 percent used relative measures and 45 percent used relative total shareholder return (total shareholder return). At 45 percent, relative total shareholder return represented 79 percent of all relative measures used in 2012.

The number of companies with LTI plans increased from 173 to **185 (of 200)**, as say on pay has led to stronger pay-for-performance links. The number of companies using relative measures increased to 61 percent, with 49 percent using relative total shareholder return. At 49 percent, relative total shareholder return represented 81 percent of all relative measures used in 2013. We believe that this is due to Institutional Shareholder Services' use of total shareholder return to evaluate pay-for-performance alignment.

up from 76 percent in 2008. On the flip side, the prevalence of stock-option and stock appreciation rights grants, in total, has declined steadily from 82 percent in 2008 to 66 percent in 2013. (These figures exclude the two companies that made no LTI grants in 2013.)

The shift from appreciation awards to performance awards has been strong over the past two years, with the share of companies awarding stock options and stock appreciation rights dropping 9 percentage points and those making performance awards increasing 11 percentage points. This is attributed to the impact of say on pay and the influence of Institutional Shareholder Services (ISS), particularly its classification of time-based stock options as non-performance-based grants. Not surprisingly, the prevalence of time-based restricted stock or units also dropped in 2012 and 2013 after reaching a high in 2011.

Figure 3 illustrates the prevalence of grant types from 2008 to 2013.

### Performance Measures Mean Variety of Choices

Almost all companies use performance-based compensation to balance executive pay with corporate and individual performance. A fair balance can be struck between the goals of shareholders and senior management under the oversight of the board of directors, but

the task is not simple. Selecting performance measures and corresponding performance levels can be one of the most difficult aspects of designing an incentive compensation program.

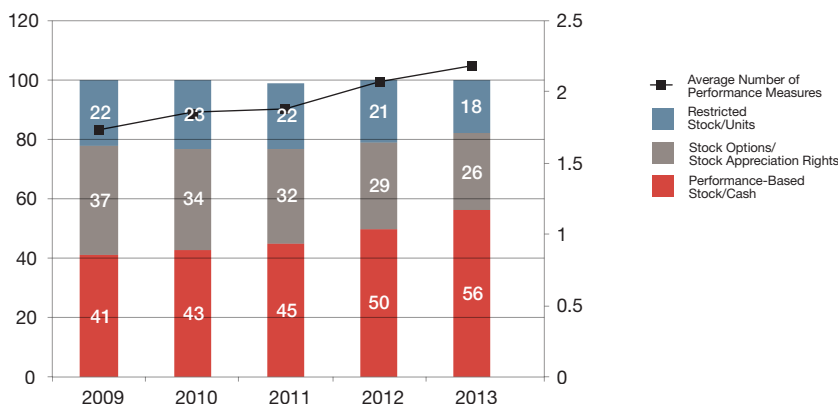
Goals should be reasonable and aligned with the business plan and investor communications. The threshold payout for an incentive plan also should be adjusted to be fair to both executives and shareholders.

Because the relationship between pay and performance is often complex, communicating the purpose and design details of the executive performance program is challenging. However, despite changing disclosure expectations and interpretations, the interest in pay-for-performance continues to grow and will remain a focus of the SEC, proxy advisers and shareholders.

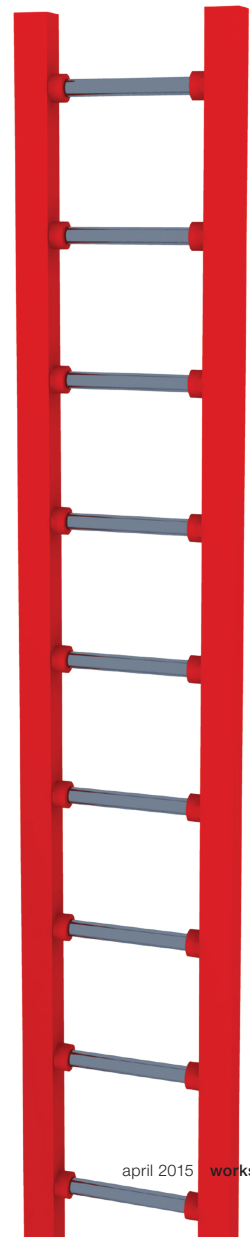
Performance can be measured against a fixed goal, such as an earnings target, and/or a relative goal, such as the performance of a peer group of companies or an index. LTI plans often use relative measures (used by 61 percent of companies in 2013) but short-term plans rarely include relative measures (used by 8 percent of companies in 2013). Performance measures also can be segregated into two main categories: market-based, such as stock price or total shareholder return, and financial-based, such as earnings per share, return on assets, and so on.

The interest in pay-for-performance continues to grow and will remain a focus of the SEC, proxy advisers and shareholders.

Figure 2 Long-Term Incentive Weights for Large Company CEOs vs. Complexity of Plans



Source: Gallagher 2013 Study



## 44% of the companies used a CAPITAL EFFICIENCY MEASURE IN 2013.



More companies use financial-based measures, but market-based measures are gaining ground. In 2013, 81 percent of companies used at least one financial-based measure, and 55 percent of companies used at least one market-based measure, which most often was total shareholder return.

Ideally, a balanced incentive program (including short- and long-term incentives) should include financial goals, stock-appreciation goals, absolute goals and relative goals. Thus, if the company does well against its business plan, but underperforms in its industry, the incentive payout will fairly reflect overall

performance. On the other hand, if a company does not hit its internal goals but outperforms its peers and/or the broader stock market, then some level of payout might be warranted.

The study found:

- Total shareholder return is the most commonly used performance measure in LTI plans. Some 55 percent of the firms used the measure in 2013, up from 51 percent in 2012 and 46 percent in 2011.
- Income-based measures are the second most commonly used measures. Some 53 percent of companies with LTI plans used at least one measure of income in 2013, up from 52 percent in 2012 and 50 percent in 2011. Of the income measures, earnings per share was used most often but has been declining, to 57 percent usage in 2013 from 62 percent in 2010.
- Some 44 percent of the companies used a capital efficiency measure in 2013, up from 31 percent in 2009. This category includes return on invested capital, return on equity, return on capital, return on net assets, economic profit and economic value added.
- The use of revenue measures decreased slightly to 18 percent in 2013, from a high of 21 percent in 2011.
- Cash flow measures were used at 13 percent of companies with performance plans in 2013. That usage has remained relatively flat over the last three years.
- The vast majority, 87 percent, of LTI plans includes the common design

Figure 3 | **Prevalence of Long-Term Incentives**

Grant Type	Percent of Companies Making Grants					
	2008	2009	2010	2011	2012	2013
<b>Appreciation Awards</b>	82%	76%	75%	74%	68%	66%
Stock Options	76%	71%	71%	71%	64%	62%
Stock Appreciation Rights	6%	5%	4%	4%	4%	4%
<b>Restricted Stock or Units</b>	48%	55%	57%	60%	55%	49%
<b>Any Type of Performance-Based Award</b>	76%	75%	77%	82%	88%	93%
Performance Shares or Units	55%	54%	60%	65%	72%	80%
Performance Restricted Stock or Units (performance hurdles)	11%	13%	11%	15%	13%	13%
Performance or Premium Stock Options	3%	3%	2%	2%	3%	4%
Long-Term Cash	20%	20%	18%	17%	16%	16%

Source: Gallagher 2013 Study

Figure 4 | **Performance Measures (Percent of Long-Term Incentive Plans)**

Performance Measure	2009	2010	2011	2012	2013
<b>Income:</b> EPS, net income, EBIT/EBITDA, operating income, pretax income	54%	55%	50%	52%	53%
<b>Total shareholder return:</b> Stock price appreciation plus dividends (relative and absolute), stock price	45%	45%	46%	51%	55%
<b>Capital efficiency:</b> Return on equity, return on assets, return on investment, return on capital, return on sales, economic value added	31%	41%	36%	40%	44%
<b>Revenue:</b> Revenue, revenue growth	14%	18%	21%	20%	18%
<b>Cash flow:</b> Cash flow, cash flow growth	13%	13%	14%	12%	13%

Source: Gallagher 2013 Study

of threshold, target or maximum performance and payout levels.

The remaining 13 percent incorporate performance through the use of a performance hurdle.

- Some 71 percent of performance periods reported covered three years. Usage of three-year periods has rebounded after falling from 70 percent in 2010 to 68 percent in 2012.

Figure 4 illustrates the use of performance measures as a percentage of LTI plans.

For a few reasons, the rise in performance-based plans has led to a consistently high use of relative total shareholder return as a performance measure. Overall, this measure is easy to use because it is based on one very important factor to shareholders (namely, the value of their holdings), and it is self-adjusting and not tied to budgetary or business condition concerns. Also, some institutional investors prefer relative TSR because it is the best indicator of the stock-specific investment of the investment sector. Typically, institutional investors first invest by sector and then by specific stock. Institutional investors who had alternative investment choices in a sector find it comforting that the LTIs will be paid out according to how well the stock pick turned out.

However, using relative total shareholder return has potential drawbacks compared to using company financial performance measures. The pitfalls of total shareholder return plans include:

- No line of sight to corporate performance. That is, participants in LTI plans do not see the direct link between their performance and stock price movement. This is compounded when the return is measured against that of a basket of companies.
- Outcomes can be at odds with long-term sustained performance.

# Financial studies have reinforced earnings per share AS THE BEST CORRELATION WITH STOCK PRICE PERFORMANCE.



- Small variations in calculation methodology can lead to significant differences in payouts.
- Total shareholder return is an end-to-end measure and therefore is subject to temporary stock price swings.
- Unfavorable accounting treatment.
  - Like stock option awards, relative total shareholder return plans are expensed whether or not the award is achieved.
  - The amount expensed usually is larger than the face value of the award, due to the stochastic nature of stock price movements and the upside potential (typically 150 percent to 200 percent of target). Financial-based measures such as earnings per share and return on invested capital are expensed.

To mitigate the drawbacks of relative total shareholder return performance, more companies are using the measure as a modifier to payouts, which are initially or maybe primarily based on financial goals such as earnings per share or return on invested capital. In 2013, 9 percent of companies used a modifier based on total shareholder return to adjust the final performance result. That

is an increase from the 5 percent of companies that used such a modifier in 2012 and 4 percent that used it in 2011. The authors expect this trend to continue.

As an earlier article has shown and financial studies have reinforced, earnings per share has the best correlation with stock price performance, and return on invested capital has the second-best correlation. However, these correlations differ among industries, and there are multiple definitions for return on invested capital. Return and invested capital are calculated numerous ways to adapt to various industries, and large stock buy-backs that have recently been commonplace might exaggerate the earnings-per-share performance. Even with these pitfalls, earnings per share and return on invested capital can be broken down into their underlying financial components and can be very helpful in providing an excellent target for senior management. For example, return on invested capital is simply operating margin (net income divided by sales) divided by capital turns (sales divided by invested capital).

Figure 5 illustrates how these measures affect stock price.

and shareholders will push incentive design to become even more complex and better representative of company performance. The authors expect this trend to continue, particularly with the continued pressure on companies due to “say-on-pay” votes.

LTI plan design should consider financial performance measures that drive stock performance and are in the line of sight of senior management. Management and shareholders alike will win, and the accounting expense will be aligned with the payouts derived from these plans. **WS**

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Figure 5 | Performance Drivers



## Conclusion

The design of LTI plans will continue to evolve, and it should. Over the past five years, these plans have become more complex and are focused on financial performance as well as general stock market performance. The quest of compensation committees to find the perfect formula that will be fair to managers

### resources plus

For more information, books and education related to this topic, log on to [www.worldatwork.org](http://www.worldatwork.org) and use any or all of these keywords:

- Long + term + incentives
- LTI
- LTI + design.