

# Executive Compensation

## Bulletin

### Long-Term Incentives — The Continuing Shift to Performance-Based Awards

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As the largest component of the typical executive compensation package, long-term incentive (LTI) awards play an important role in motivating executives to achieve their organizations' key strategic and financial goals. LTIs make up 65% of the average CEO's total direct compensation and play a pivotal role in retaining executives and aligning their interests with those of shareholders and other stakeholders. Long-term compensation programs are also becoming more complex as they incorporate more performance-based elements, making goal setting and payout calibration increasingly important aspects of incentive design efforts.

To gain insights into the changing landscape of LTI programs, Towers Watson's Executive Compensation Resources unit reviewed the characteristics of LTI programs disclosed in proxy statements of *Fortune* 500 companies between 2011 and 2013. This article provides an overview of the regular LTI programs in place at these companies, excluding special awards, one-time awards and grants associated with hiring or promotion.

The most significant changes observed over this three-year period were:

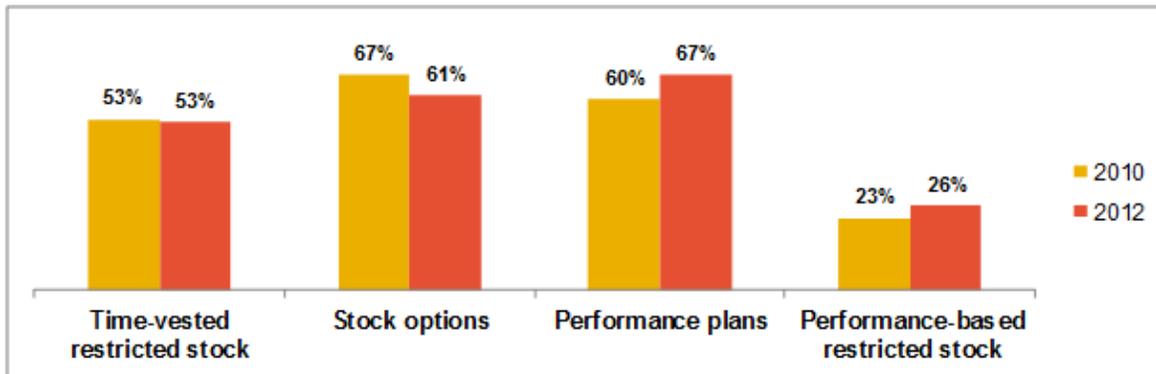
- **An increase in performance-based awards.** The percentage of companies granting performance plan awards increased from 60% to 67%, while the percentage of companies granting performance-based restricted stock increased from 23% to 26%.
- **A continuing decline in stock option awards.** The percentage of companies granting stock options in the last three years decreased from 67% to 61%, continuing the trend of the past decade or so since the advent of stock option expensing.
- **Continued market alignment in performance metric selection.** Total shareholder return (TSR) continues to be the most prevalent metric for performance plan awards, with a 45% prevalence in 2012.

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## Long-Term Award Prevalence

Our analysis breaks LTI awards down into four categories: time-vested restricted stock and restricted stock units (TVRS), stock options and appreciation-based awards (SO), performance plan (PP) awards and performance-based restricted stock (PBRs).<sup>1</sup> While the popularity of options and other appreciation awards has fallen in recent years, the growing popularity of performance-based awards, as well as increased diversification in the executive LTI mix, has more than offset this drop. *Figure 1* shows the shifts in LTI vehicle prevalence over the last three years.

**Figure 1. Prevalence of LTI vehicles at *Fortune* 500 companies**

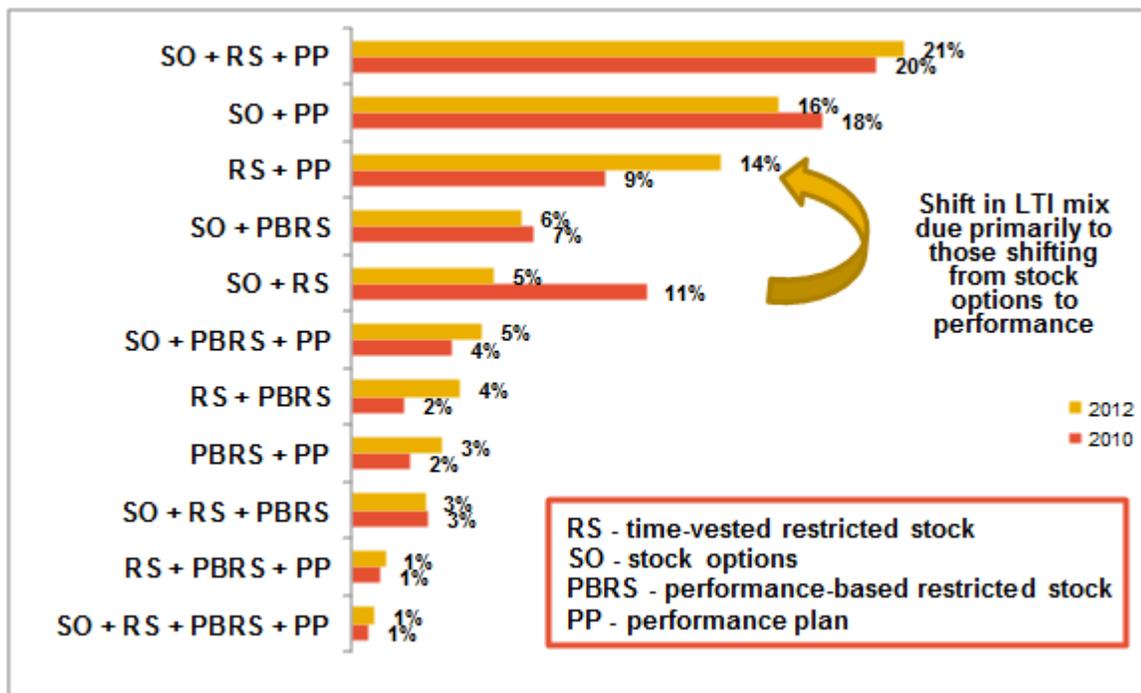


The number of LTI vehicles that companies are granting has increased in recent years, and the mix of those awards has grown more diverse. The percentage of companies granting only one form of LTI award has fallen by more than three percentage points, to 17%, which is matched by a corresponding three-percentage-point gain in companies granting three forms of awards (to 30% in 2012). Of the companies granting only one form of LTI award, the largest declines were in those granting only options (which fell from 5% to 4%) or restricted shares (which fell from 7% to 4%). These declines have been balanced by marked gains in the prevalence of LTI mixes that include performance-linked awards, which increased from 75% to 83% over the period. These shifts suggest two noteworthy trends: movement toward more diversified LTI mixes consisting of multiple types of vehicles and movement toward LTI mixes that include performance-linked awards. (See *Figure 2*, next page, for a breakdown of the LTI mix in the *Fortune* 500.)

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<sup>1</sup> PP awards are earned based on performance over a defined period. Final payout (adjusted for performance) does not occur until the end of the performance period. PBRs awards are earned over the course of a vesting period, with portions earned at various intervals during the period.

**Figure 2. LTI mix in Fortune 500 companies**



### Little Change in Restricted Stock and Option Design

The design of restricted stock and stock option awards has remained fairly stable over the past several years. Since 2010, more than 86% of companies granting restricted stock awards did so with vesting periods of three to four years, and the proportion granting awards that vest ratably has outpaced those granting awards that vest all at once (cliff schedule) by a two-to-one margin.

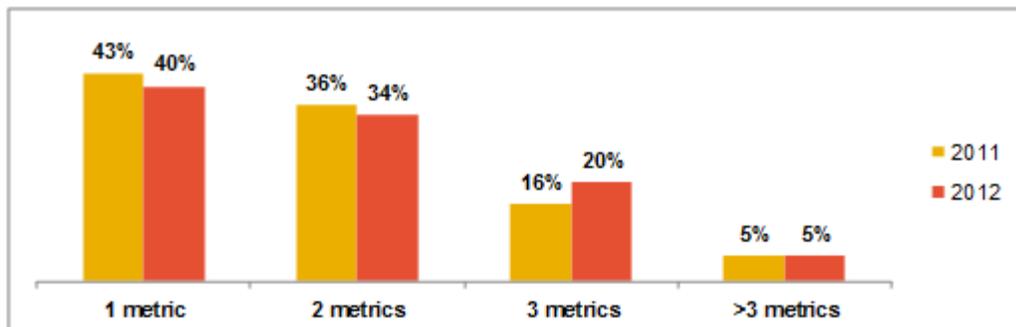
Among companies granting option awards, 89% made grants that vested over three to four years, and the vast majority (91%) awarded options with ratable vesting schedules. Most option grants (77%) had a 10-year term, while the remainder granted option awards with shorter exercise periods, typically five or seven years.

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### Performance-Based Awards Continue to Evolve

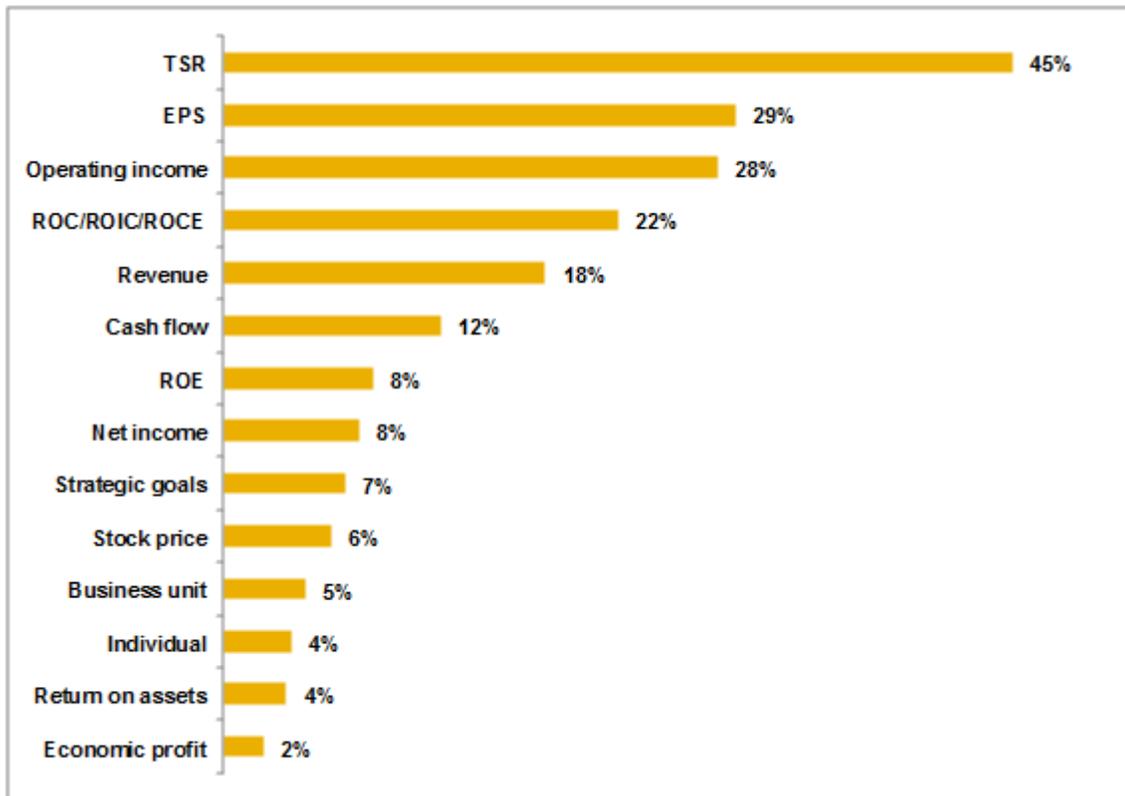
Although performance plan awards based entirely on a single metric are still the most common, their prevalence has fallen over the last year. The growing prevalence of awards incorporating three metrics corresponded with a similar drop in prevalence of plans measured by only one or two metrics (Figure 3).

**Figure 3. Prevalence in the number of performance plan metrics per award**



TSR, already the most prevalent metric in 2011, increased its prevalence by five percentage points and is now used by 45% of companies that grant performance-based awards (Figure 4). Other financial metrics, including earnings per share (EPS), operating income, return on capital/invested capital/capital employed (ROC/ROIC/ROCE), cash flow, return on equity (ROE) and net income saw lesser gains. Measures based on economic profit and strategic goals declined in prevalence over the period.

**Figure 4. Long-term performance metric prevalence (2012)\***



\*Figures total more than 100% because companies use multiple metrics in their LTI plans.

While TSR is the most common metric attached to long-term performance awards, use of this metric doesn't automatically put a company in line with best practices. Not only can the measurement of TSR differ between companies and awards (e.g., absolute versus relative TSR), but how the metric is weighted, the specific performance targets, payout ranges, the selection of peer groups and the specific function of TSR will also play a large role in determining the efficacy of the final award.

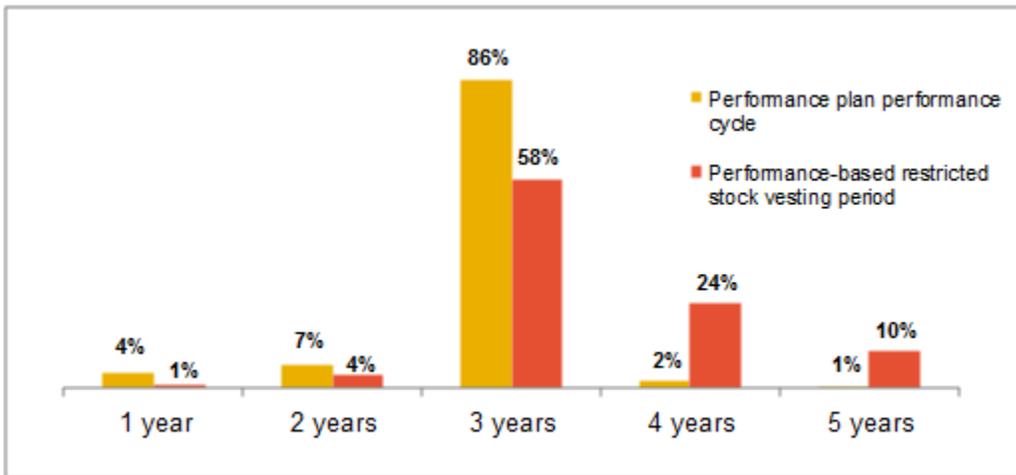
Industry practices also have a large influence on which metrics will provide the strongest links between executive pay and company performance. While 85% of companies in the energy and utilities industry use TSR as a metric for their performance awards, only 32% of health care companies do. Conversely, ROE, which has a 2% prevalence among IT and telecommunications companies, has a 42% prevalence among financial companies. As the prevalence and weighting of performance-based awards increases, it's more important than ever to understand both the specific and general industry trends. Only through careful observation of the changing landscape can companies ensure that their long-term plans are well designed, not only for the current year, but for the years to come.

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Keeping with the long-term nature of these awards, performance plan awards and performance-based restricted stock are typically earned over several years. While the vast majority of performance plan awards are earned at the end of a three-year performance cycle, vesting of performance-based restricted stock awards can tend to skew toward longer periods (although, here again, three years is the most common). *Figure 5* shows common performance cycles and vesting periods for performance plan awards and performance-based restricted stock awards, respectively.

While performance plans measure and pay for performance over the full-performance cycle, performance measurement for performance-based restricted stock frequently differs from the vesting schedule attached to the awards. In fact, 62% of performance-based restricted stock awards measure performance over a one-year period, with additional time/vesting required before the full award may be earned. These awards are commonly structured to qualify for the performance-based exemption under Section 162(m) of the Internal Revenue Code.

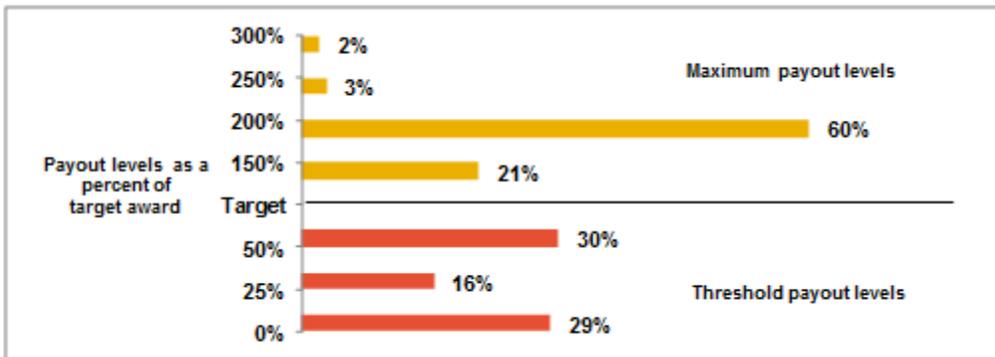
**Figure 5. Performance cycles and vesting periods for performance-based awards**



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Performance plan awards pay out in a range from threshold to maximum, depending on company performance (*Figure 6*). The threshold and maximum points prevent any payouts when performance has been too low and prevent windfall payouts when performance is unexpectedly high.

**Figure 6. Performance plan threshold and maximum payout percentage prevalence\***



\*Amounts do not add up to 100% because only the most prevalent payout levels are shown.

While the percentage of companies using the three most prevalent maximum points has not changed significantly in the last year, the percentage of companies using the three most prevalent threshold points has fallen by five percentage points, from 80% to 75%. The payout range of the total award is

ultimately a reflection of the payout ranges of each of the metrics that apply to the award. While the maximum payout will be quite stable, because adding or removing metrics will not have an impact on the cumulative maximum, the threshold payout can change a greatly based on the number of metrics involved. For example, if a performance plan award was based entirely on TSR, with a 50%–200% payout range, and is adjusted to be based equally on EPS and TSR, each with a 50%–200% payout range, the overall payout range will change to 25%–200%. The decline in usage of the most prevalent threshold points reflects that companies are adding more metrics to their performance plan awards. As the number of metrics and the range of weightings increases, the standardization in selection of threshold points decreases.

## Bottom Line

Long-term incentive compensation is among the most important components of an executive compensation package. Not only does it represent the majority of the value, but its long-term focus and inherent role in retention make it one of the most important compensation vehicles that companies have at their disposal. In the last three years, the key trends in long-term compensation have been toward greater diversification of both LTI vehicles and performance metrics. While these overall trends are important to note, the critical issue is whether a company's long-term incentive plan supports its long-term talent and business goals.

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