Checklist for Total Shareholder Return Incentive Plans

07 | 2015
workspan
The Magazine of WorldatWork®

Does your company's total shareholder return align with its business goals?

Today, one of the most significant debates in executive compensation circles centers on the merits of relative total shareholder return (TSR) as an incentive plan metric. On one side, proxy advisers and governance groups have championed relative TSR as a metric

By Mark Emanuel, Semler Brossy

Common Critiques of Relative TSR Plans

- Relative TSR plans lack line-of-sight for participants as point-in-time share price can be more sensitive to exogenous factors than traditional financial measures. Also, participants have no control over, and reduced visibility to, comparator performance.
- Relative TSR performance can become disconnected from absolute and/or relative financial performance during shorter, discrete periods.
- Consistent relative TSR outperformance is difficult to achieve over multiple periods, even for companies that are high-performers.
- The comparator group can introduce a variety of unintended consequences if not carefully considered

that — in theory — ensures executives are only rewarded when shareholders experience above-market returns. On the other side, a host of critics (including directors, executives and consultants alike) notes a number of challenges that — in practice — make relative TSR a difficult metric to use (see "Common Critiques of Relative TSR Plans").

One thing is clear, though: The use of relative TSR in long-term incentive (LTI) plans has exploded in recent years from nearly 30 percent of S&P 500 companies in 2010 to roughly 50 percent today. This trend has been, in part, a reaction to say on pay and the attendant rise in influence for the proxy advisers that champion relative TSR metrics. Many companies have — sometimes, begrudgingly — introduced relative TSR plans in response to, or in anticipation of, say-on-pay-related concerns. Our experience suggests that the introduction of a relative TSR plan is one of the most common changes made in response to a failed or low-majority say on pay vote result.

Although the trend to relative TSR has certainly been driven by these external factors, that does not mean there cannot be a meaningful and effective role for relative TSR plans in an incentive program. To do so, there simply needs to be clarity as to why relative TSR is being adopted and how it is being used.

Establish Clear Objectives

To maximize the effectiveness of a relative TSR plan, companies must first be able to enumerate the rationale for introducing the plan. We identify here three common objectives that may be served by a relative TSR plan:

- **Align pay with value creation that outpaces peers**. This ensures alignment of pay outcomes with the shareholder's experience. Typical for companies facing significant and uncontrollable market uncertainty where measurement of relative TSR may be more relevant than measurement of absolute financial performance, or companies facing changes in leadership or strategy that make the setting of absolute, financial goals exceedingly difficult.
- **Provide a balanced portfolio of incentives**. Common among mature, stable companies with a pay strategy that emphasizes balance across absolute and relative performance and multiple vehicles, metrics and timeframes.
- **Respond to governance pressures**. Common among companies that are responding to low say-on-pay support or those looking to adopt best practices championed by proxy advisers and "blue ribbon" governance panels to more explicitly align compensation with shareholder results.

Companies that wish to simply follow the market and adopt a relative TSR plan should do so at their own risk. At best, doing so risks creating an overall incentive program that lacks a coherent purpose and balance. At worst, blindly adopting a relative TSR plan has the potential to distract from the core objectives of the incentive program and create unintended consequences and behaviors.

Ensure Appropriate Design

Once clear on the plan's objectives, companies can begin to focus toward tailoring the design to serve the stated objective(s) in order to best complement the accompanying portfolio of incentives.

The process to translate the plan's objective(s) into program design is an exercise in calibrating the plan to the desired orientation as incentive or reward. At one end of the spectrum, relative TSR is used as an incentive — a carrot to prospectively drive and reward for outperformance. At the other, relative TSR is used as a reward — to retrospectively deliver pay commensurate with results and outcomes. Where the plan falls along the spectrum of incentive vs. reward is modified by how prominent the plan is within the context of the total incentive portfolio and the potential sensitivity of results to performance. A plan that represents the entirety of the LTI in a total pay mix that is weighted heavily to long-term pay, or with a greater sensitivity to results, will enhance a plan's orientation to incentive. A plan that represents only a modest portion of the total incentive portfolio with only modest performance leverage will attenuate the plan's orientation to reward.

A plan's design features must be tailored to achieve the desired orientation — incentive or reward. In this respect, there are four primary design considerations for relative TSR plans:

- What portion of the LTI mix will be tied to relative TSR?
- Will relative TSR be used as the singular measure, in combination with other metrics, or as a modifier to other metrics?
- How will plan payouts be calibrated to relative performance rankings?
- Who is the comparator group?

Weighting of Plan in LTI Mix

A majority of weighting within the total portfolio of LTI vehicles can magnify the incentive or reward orientation of the relative TSR plan by placing further prominence on the relative TSR metric. Similarly, a greater than typical weighting of LTI

Figure 1 | Illustrative Mapping of Common Objectives on the Incentive vs. Reward Spectrum

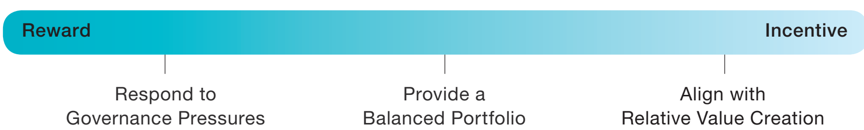

Figure 2 | Typical Design Characteristics of Relative TSR Plans, by Objective

Common Design Characteristics	RESPOND TO GOVERNANCE PRESSURES	PROVIDE A BALANCED PORTFOLIO	ALIGN WITH RELATIVE VALUE CREATION
Approx. % of LTI Mix	20-50% of LTI mix	33-50%	50-100%
Metric Selection	Relative TSR paired with 1-2 financial metrics May only be used as a modifier to financial metrics	Relative TSR paired with 1-2 financial metrics	Relative TSR is the singular metric
Goal-Setting/ Payout Leverage	50th P earns target; max payout for 75th P Reduced leverage (75-125%) May include a cap on payout if TSR is negative in absolute	50th P earns target; max payout for 75th P Typical leverage (50-150%)	50th P earns target; max payout for 80th P+ Enhanced leverage (0-200%) May include a cap on payout if TSR is negative in absolute
Comparator Group	Measured against a broad index (e.g., S&P 500)	Measured against industry index or benchmarking peers	Measured against benchmarking peers
Prevalence			
Approx. % of S&P 500 Relative TSR Plans	25-30%	20-25%	50-55%

A plan's design features must be tailored to achieve the desired orientation—incentive or reward.

in the total pay mix can achieve similar results by increasing (or decreasing) the plan's prominence.

Combination and Weighting of Metrics

The combination and weighting of the relative TSR metric (within the plan) also influence prominence by, again, having an impact on the notion of "dollars-at-risk" to relative TSR performance. A plan that uses relative TSR as the singular metric will have a greater prominence than one in which relative TSR is paired with one or two financial metrics. When relative TSR is used only as a modifier to financial performance, the prominence can be further reduced by narrowing the potential for relative TSR outcomes to have an impact on the ultimate value realized from a given award.

Calibration of Goals and Payout Leverage

While both the combination of metrics and the weighting of the plan are a measure of how prominent the relative TSR plan is within the context of the individual's total incentive opportunity, the calibration of the relative TSR goals and associated payout leverage is used to directly influence the incentive or reward orientation of the plan.

Greater orientation to incentive is associated with the following goal-setting approaches that increase the riskiness and leverage of a plan to motivate and drive outperformance:

- A requirement for above-median relative TSR to achieve a target (or even threshold) payout
- Significant payout leverage (e.g., up to a 200 percent payout for performance at the 90th percentile)
- The use of an absolute TSR cap to reduce or cap payouts if absolute TSR is negative.

Plans that require only median relative TSR performance to achieve a target payout and that have a more normative payout leverage (e.g., 0-150 percent of target) are associated with a greater reward orientation because they reduce the level of risk in the plan so as to become a vehicle for pay delivery of satisfactory performance. Note that the use of relative TSR as a modifier to core financial metrics (as noted above) often coincides with even further reduced leverage in which the payout may plus or minus be modified up to 25 percent.

Comparator Group Selection

The final lever for determining incentive vs. reward orientation is the choice of comparator group. Using a broader and larger group of companies, such as the S&P 500, as the comparator group generally has the effect of reducing the likelihood that the company will significantly outperform or significantly underperform the group. Of course, exceptions exist for countercyclical industries, but narrowing the comparator group to a specific industry index or, even further, to a select set of peers will generally increase the relative TSR plan's incentive orientation.

Companies that wish to get the most out of their relative TSR plan should first understand the objective the plan is intended to serve.

Conclusion

While the challenges associated with relative TSR, as a metric, are here to stay, so, too, are the forces that have made it a popular choice for issuers in recent years. Companies that wish to get the most out of their relative TSR plan should first understand the objective the plan is intended to serve. Second, companies should ensure the design of a plan supports and aligns with the desired level of prominence, incentive or reward orientation. ws

Mark Emanuel is senior consultant for Semler Brossy in Los Angeles. He can be reached at memanuel@semlerbrossy.com.

resources plus

For more information, books and education related to this topic, log on to **www.worldatwork.org** and use any or all of these keywords:

- Executive Compensation
- Shareholders
- Rewards.