CAPflash

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2010 Proxy Season – Annual and Long-term Incentive Plan Performance Metrics and Vehicles

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Introduction

As a follow-up to the June and July 2010 CAPFlashes (Issues #7 and #9) Compensation Advisory Partners ("CAP") presents its final study from 2010 proxy disclosures on annual and long-term incentive practices for our research group of Fortune 500 companies. We reviewed incentive plan metrics in aggregate and by industry group, as well as long-term incentive practices within the aggregate group. Our study covers 85 companies, representing seven industry groups: Consumer Products, Financial Services, Health Care, Insurance, Pharmaceuticals, Retail, and Technology.

Annual Incentive Plan Metrics

In our June 25, 2010 CAPflash, we noted that the most frequently reported modification in 2010 CD&As was changing performance metrics used to fund annual incentive awards (reported by 15 companies, or 44% of the 34 companies making annual incentive plan changes).

The chart below shows that for all industry groups, the two most common metrics used in annual incentive plan funding are Revenue/Revenue Growth and various measures of earnings, such as Operating Income, EBIT or EPS. In four of the six industry groups, the most prevalent metric used is Revenue/ Revenue Growth. Among Insurance and Healthcare companies, Operating Income and EPS, respectively, are the most prevalent metrics. Strategic goals are used by 67% of the Pharmaceutical companies. Return metrics are rarely used as key funding criteria. ROIC is one of the top metrics in the Healthcare industry, but other industry groups do not commonly use return measures. Excluding financial services companies, 60 companies (82% of 73 companies) use more than one metric to fund annual incentives.

The chart summarizes the three most prevalent metrics used in each industry group:

Industry	No. of Cos.	Annual Incentive Funding - Most Prevalent Metrics Used		
		#1	#2	#3
Consumer Goods		Rev. / Rev. Growth	EPS	Operating Income
# of Cos.	13	9	8	7
% of Cos.		69%	62%	54%
Healthcare		EPS	Operating Income	ROIC
# of Cos.	11	4	4	2
% of Cos.		36%	36%	18%
Insurance		Operating Income	Operating Income EPS	Operating Income ROE
# of Cos.	12	9	6	6
% of Cos.		75%	50%	50%

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Industry	No. of Cos.	Annual Incentive Funding - Most Prevalent Metrics Used		
		#1	#2	#3
Pharmaceuticals		Rev. / Rev. Growth	EPS	Strategic Goals
# of Cos.	12	10	10	8
% of Cos.		83%	83%	67%
Retail		Rev. / Rev. Growth	EBIT/ EBITDA	Operating Income
# of Cos.	10	3	3	2
% of Cos.		30%	30%	20%
Technology		Rev. / Rev. Growth	Operating Income	Cash Flow
# of Cos.	15	10	5	4
% of Cos.		67%	33%	27%
All Industry Groups		Rev. / Rev. Growth	Operating Income	EPS
# of Cos.	85	39	28	23
% of Cos.		46%	33%	27%

Note: Excludes financial services companies due to limited disclosure related to TARP participation/ restrictions. Four companies use a non-GAAP EPS metric.

As financial services companies increasingly come out of TARP, we expect their bonus pool funding to be linked to company profitability and performance expressed in bottom-line metrics as well as risk and capital adequacy metrics. In addition to financial services, many companies are making efforts in their plan design to offset any potential inappropriate risk taking by focusing on metrics used, time horizons, deferrals and performance sensitivities.

Long-Term Incentive Vehicles

In our June CAPflash, we found that the biggest change reported by companies with regard to long-term incentive practices was the mix of award vehicles.

Stock options are the most prevalent LTI vehicle used among the 85 companies studied, used by 62 companies (or 73%). Both Time Based Restricted Stock ("TBRS") and Long-term Performance Plans ("LTIPs") are also frequently seen, used by 53 and 51 companies, respectively (62% and 60%).

Here is the breakdown of overall LTI vehicle prevalence:

Long-Term Incentive Vehicle Prevalence	No. of Cos.	% of Cos. (n=85)
Stock Options	62	73%
Time-Based Restricted Stock (TBRS)	53	62%
LTIP	51	60%
Performance-Based Restricted Stock (PBRS)	31	36%
Performance-Based Stock Options (PBSO)	5	6%

Note: Percentages do not add up to 100% due to multiple responses.

As companies continue to make changes to LTI programs they are balancing time-based equity with performance-based equity. Of the 85 companies, 48 use two LTI vehicles in their executive program (56%), 20 use three vehicles (24%), 17 use one vehicle (20%). The two most prevalent vehicle combinations used are:

- 2 vehicles: stock options and LTIP/or PBRS, used by 24 companies (28% of 85 companies), and
- 3 vehicles: stock options, TBRS and LTIP/or PBRS, used by 20 companies (24% of 85 companies)

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Below is the breakdown of the combination of LTI vehicles awarded:

Combination of LTI Vehicles Used		
# of LTI Vehicles Granted	**No. of Cos.**	**% of Cos. (n=85)**
2 Vehicles (Options, LTIP/PBRS)	24	28%
2 Vehicles (Options, RS)	13	15%
2 Vehicles (TBRS, LTIP/PBRS)	11	13%
3 Vehicles (Options, RS, LTIP/PBRS)	20	24%
1 Vehicle (LTIP/ PBRS)	8	9%
1 Vehicle (TBRS)	5	6%
1 Vehicle (Options)	4	5%

We expect the use of performance-based LTI to continue to increase, modestly, in 2011 and beyond. Stock options will continue to be a part of the LTI mix, but with less emphasis. As the economy stabilizes and recovers, we also expect to see less time-based restricted stock granted at senior executive levels.

Performance-Based Long-Term Incentive Metrics

Of the 65 companies that use an LTIP or Performance Based Restricted Stock or Options, 27 companies use EPS (42%) and 23 companies use Relative TSR (35%) as metrics. We have seen a slight uptick in the use of Relative TSR, given its simplicity and clarity of measurement in a volatile market. Due to the difficultly in goal setting, companies continue to recalibrate performance metrics.

The breakdown of the most prevalent performance based LTI metrics used is as follows:

LTIP / PBRS / PBSO Metric	No. of Cos.	% of Cos. (n=65)
EPS	27	42%
Relative TSR	23	35%
Revenue / Revenue Growth	14	22%
ROC / ROE	13	20%
Cash Flow	7	11%
Operating Income	6	9%

Note: Percentages do not add up to 100% due to multiple responses.

Further, of those companies using EPS and Relative TSR, they are most common in certain industries:

- EPS is common in healthcare, consumer goods, pharmaceutical companies
- Relative TSR is common in technology, consumer goods, pharmaceutical companies

Of the companies that use an LTIP or PBRS, 52 companies (83%) pay out in stock.

LTIP / PBRS Payout	No. of Cos.	% of Cos. (n=63)
Stock	52	83%
Cash	25	40%
Both (Stock and Cash)	5	8%

Note: Percentages do not add up to 100% due to multiple responses.

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Other Long-Term Incentive Provisions

Consistent with broad market norms we also found that a three year time frame for performance measurement and or vesting is common:

- Among the companies that use an LTIP/PBRS, the most common performance period is 3 years (86% of those providing)
- 37% of companies granting stock options use 3 year installment vesting
- 36% of companies granting time based RS use a 3 year vesting period, with cliff vesting somewhat more prevalent than installment vesting

Conclusions

Companies are continuing to evaluate and modify executive annual incentive and long-term incentive plans. We expect to see continued modest shifts in LTI programs, as companies continue to evaluate the appropriateness of specific LTI vehicles in light of the recovering market, accounting cost vs. employees' perceived value, and overall pay strategy. The increased emphasis on performance-based compensation will prevail through 2011 as shareholders continue to demand clear alignment between pay and performance.

Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.