CAPflash
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Long-term Incentive Plans with Relative Performance Measurements

■ By **Matt Vnuk, Shaun Bisman** and **Chelsea Carter**

The financial crisis of 2008, the resulting economic downturn, and an uneven recovery including significant international uncertainty have made setting meaningful multi-year performance goals difficult for many companies. One way to address this issue while still holding executives accountable for long-term company results is the use of relative performance plans, where payout of a long-term incentive (cash, shares or units) is tied to pre-determined performance levels measured against a benchmark group of companies.

The financial crisis of 2008, the resulting economic downturn, and an uneven recovery including significant international uncertainty have made setting meaningful multi-year performance goals difficult for many companies.

This leads to a number of questions, such as:

1. How is the benchmark group of companies defined?
2. What metric is used most often to measure relative performance?
3. What level of performance should equate to maximum, target and/or minimum payouts?
4. What other considerations should be taken into account when designing these programs?

This *CAPFlash* tracks companies' response to these questions through our proprietary research database. Each year, Compensation Advisory Partners ("CAP") reviews proxy disclosures for a cross-industry sample of Fortune 250 companies. In 2011, our study included 111 companies, with 26 companies, or 24% of our sample, incorporating relative performance measurement into their long-term incentive program as a primary performance measure. An additional 7 companies, or 6% of our sample, incorporate relative performance measurement into their long-term incentive program through the use of a modifier.

How is the Benchmark Group of Companies Defined?

For relative performance measurement in long-term incentive ("LTI") plans, the benchmark group of companies that performance is most often compared to is the executive compensation peer group. We found that 45% of companies measure pay and performance against a consistent group of companies. As shown below, just over half of companies take a different approach. For example, 42% of companies measure performance against an index that differs from the group of companies used to benchmark compensation levels.

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Comparator Groups Used to Measure Relative Performance	No. of Cos.	% of Cos. n=33
Compensation Peer Group	15	45%
General Industry Index (e.g., S&P 500)	9	27%
Industry Specific Group (Non-Compensation)	6	18%
Industry Specific Index	5	15%
Subset of Compensation Peer Group	1	3%

Note: Percentages add up to greater than 100% due to companies using multiple comparator groups.

Some companies use more than one comparator group. For example: AT&T measures performance relative to the Dow Jones Industrial Average constituents as well as a group of 11 domestic and global telecommunications companies. Intel measures relative Total Shareholder Return ("TSR") against its executive compensation peer group as well as against the S&P 100; and Northrop Grumman measures relative TSR against a group of leading U.S. and European aerospace and defense companies and the S&P Industrials Index.

Companies tend to use industry peer groups or indices when economic factors have a unique impact on the industry. Companies that use a broader market group, such as a general industry index like the S&P 500, believe that companies compete broadly for investor dollars. They may also operate in industries with a small number of players, making it difficult to identify peers in the same industry.

What Metric is Used Most Often to Measure Long-Term Relative Performance?

As shown below, relative performance plans most often measure company TSR. While EPS is the second most common metric used, it is only used by 15% of companies studied and is typically given less weight than TSR in a relative long-term performance plan.

Relative Financial Metrics Used in Long-Term Incentive Plans

	Relative Metric		
	TSR	EPS	Other
Overall Prevalence	73%	15%	23%
Most Prevalent Weighting Given To Relative Metric	100%	50%	100%

Note: Excludes companies with TSR used as a modifier (n=7). Percentages do not add up to 100% due to certain companies using multiple relative metrics.

Some companies use more than one measure of relative performance. PNC Financial Services (EPS & ROCE) is one example and MetLife (TSR & EPS) is another. Approximately half of the companies studied (52%) combine relative metrics with absolute financial metrics in long-term performance plans. The most prevalent metric used to measure absolute financial performance, alongside a relative performance metric, is EPS.

What Level of Performance Should Equate to Maximum, Target or Minimum Payouts?

The chart below shows that the relative performance benchmarks used for maximum, target and/or minimum payouts of relative long-term performance plans vary by company. The most common approach is to set threshold, target and maximum payouts at the 25th, 50th and 75th percentiles compared to peers, as highlighted below:

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Relative Long-Term Incentive Plan Performance Percentiles

Threshold (RELATIVE POSITION)	Prevalence	Target (RELATIVE POSITION)	Prevalence	Max (RELATIVE POSITION)	Prevalence
10^{th} %ile	6%	40^{th} %ile	5%	75^{th} %ile	33%
20^{th} %ile[1]	29%	45^{th} %ile	5%	80^{th} %ile	22%
25^{th} %ile	29%	50^{th} %ile	68%	85^{th} %ile	11%
30^{th} %ile	6%	55^{th} %ile	12%	90^{th} %ile	6%
35^{th} %ile	24%	60^{th} %ile	5%	95^{th} %ile	6%
40^{th} %ile	6%	65^{th} %ile	5%	100^{th} %ile	22%

Note: In cases where a rank approach is uses, percentile was interpolated.

Companies use two approaches to define relative market positioning: either "percentile" or "rank." As shown below, the percentile approach is most common. Examples of companies that use a ranking system include Motorola Solutions, Pfizer and Target. Examples of companies that use a percentile system include Lockheed Martin, Chubb and Express Scripts.

Relative Long-Term Incentive Plan Payout Measurement

	Payout Based On	
	Percentile	Rank
Number of Companies	17	10
Prevalence	63%	37%

Note: Excludes companies (n=6) that do not specifically disclose basis for relative long-term performance plan payout.

Leverage is another feature of long-term performance plans. Plans must define what percentage of the target opportunity threshold or maximum performance will yield. The chart below describes the leverage in relative performance plans among the companies in our study. It is most common for threshold performance to result in a payout of 50% of target, and for maximum performance to result in a payout of 200% of target.

Relative Long-Term Incentive Plan Payouts

Threshold (AS % OF TARGET)	Prevalence	Max (AS % OF TARGET)	Prevalence
15%	9%	120%	4%
20%	5%	125%	4%
25%	22%	150%	8%
30%	9%	200%	80%
35%	14%	250%	4%
40%	5%		
50%	31%		
60%	5%		

Note: Percents have been rounded to nearest 5%.

1 For companies that set threshold performance/payout at the 20th percentile, maximum performance/payout is typically set above the 75th percentile.

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What Other Considerations Should Be Taken into Account When Designing These Programs?

Accounting Implications

When determining what long-term incentive design to implement, it is important to consider accounting implications. If the award is denominated and paid in cash, then it requires mark-to-market accounting where the charge is generally "trued up" to the value of the final payout. A share-based award that utilizes a financial metric has a somewhat similar treatment, where the accounting charge is trued up for the number of shares earned, but the equity value is fixed at grant. Differently, for a share-based award that uses a market-based metric (such as TSR) the accounting charge is fixed on the grant date and the expense does not change to reflect the final payout. While some view this design feature as a positive as it avoids "volatile" period-to-period accounting, others are uncomfortable with the fact that the charge cannot be reversed if performance is below threshold and a payout does not occur.

A properly designed modifier approach (where the primary award determinant is an internal financial metric) is an alternative for companies not wanting to have a "fixed charge" while still utilizing a market-based relative metric. In this case, if internal financial goals are not met, there is no expense as the impact of the market condition was considered and locked in as part of the grant-date fair value per share. The final total expense equals the grant-date fair value per share times the number of shares earned under the EPS goal. Thus, total expense is trued up for the outcome of the performance condition – but not for the outcome of the market condition, which was incorporated in the grant date value per share.

Important: Before selecting a specific go-forward design for your unique circumstance, we recommend that you confirm accounting treatment for all designs under considerations with outside advisors.

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Discretion

Relative performance plans help reduce the need for discretionary adjustments to performance goals, which is often viewed as a positive feature of these plans. However, attraction / retention issues can occur when relative performance plans do not pay out. Annual grants with overlapping performance cycles are a common way of maintaining motivational impact, even when performance is down in one or two years. While not seen frequently, we have observed some companies attempt to solve for these issues by using alternative approaches. Some approaches include:

- Providing an added opportunity to earn an award if a financial metric (such as EPS) exceeds a predetermined level of absolute performance;
- Adjusting earned awards down by a small amount if absolute results do not reflect improvement;
- Limiting payout based on relative TSR to no higher than target if a company has negative TSR while it is outperforming its benchmark group; or
- Guaranteeing a minimum payout (threshold).

In most cases, annual grants are the approach that makes the most sense, since it clearly aligns with shareholder interests.

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TSR Modifier

Of the 33 companies studied with relative performance plans, 7 companies or 21%, incorporate relative financial performance into their LTI program using a TSR modifier. These companies' LTI plans are measured against absolute metrics and then a TSR modifier is used to adjust the payout up or down. Companies with plans that incorporate a TSR modifier measure relative TSR performance against a variety of benchmarks.

Comparator Groups Used to Measure Relative Performance	No. of Cos.	% of Cos. n=7
Compensation Peer Group	3	43%
General Industry Index	3	43%
Industry Specific Index	1	14%

A TSR modifier typically applies in all cases. However, some companies intend for a TSR modifier to only operate in "fringe" situations where absolute performance results differ substantially from relative performance. For example, a modifier could function so that if relative three-year TSR is in the bottom quartile, the performance share payout will be reduced by 25%. Conversely, if relative three-year TSR is in the top quartile, the performance share payout will be increased by 25%.

Views of Proxy Advisory Firms are Important

Glass Lewis recently wrote that: "[the] sole use of absolute metrics under long-term incentive plans is inappropriate as they may reflect economic factors or industry-wide trends beyond the control of executives on individual performance." This statement seems to indicate that they believe incorporating a relative measure into a long-term incentive plan can provide balance. Likely under a similar premise, ISS reviews both relative and absolute performance as part of its pay-for-performance analysis (specifically focused on TSR). Therefore, support of proxy advisory firms is another reason to consider relative performance measurement.

Conclusion

When designing long-term incentives, we recommend that companies start by defining their objectives (business, employee and shareholder), and then assess their ability to set long-term goals. When companies determine that a relative performance metric could help management drive performance, these plans should be considered. In the current Say on Pay environment, a properly calibrated relative long-term performance plan is one way to say: "we only pay above target for outperformance."

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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.