Center On Executive Compensation

Setting Incentive Targets in a Time of Economic Volatility and Increased Uncertainty

As calendar-year companies and their boards prepare to finalize their long-term incentive awards, some have questioned their ability to set reasonable LTI targets given the uncertainty and potential volatility that may unfold over the coming months. Specifically, they are concerned about actual and potential public policy changes that could significantly impact the overall economy and/or their particular industries.

The Republican victories in the November election have created the potential for legislative and regulatory changes favorable to business, including tax cuts, regulatory relief and even fiscal stimulus. However, it is also possible that the change in control of the White House has created the potential for policy changes that could negatively impact corporate performance. Areas of uncertainty include changes in trade policy, the mid-term risk of accelerating inflation resulting from fiscal stimulus that in turn could drive higher labor and raw material costs, and even actions by the White House, Federal agencies and/or Congress targeting specific industries or companies.

Some companies may seek alternative design approaches to mitigate the risk of setting what may turn out to be overly aggressive or overly conservative long-term performance targets given the potential volatility that may result from such policies over the life of three-year long-term incentive grants. With that in mind, presented below are alternative approaches, and corresponding pros and cons of each approach, that companies may find helpful as they attempt to address the challenges of setting long-term incentive targets in an uncertain and potentially volatile business climate.

1. <u>Long-Term Performance Objectives Based on Annual Performance Goals</u>. As was observed during the financial crisis, companies may find it advantageous to simplify their long-term incentive design by setting one-year performance goals that determine the long-term award payout and require that such payouts be delivered in shares that vest over a multi-year period. By way of example, the 2017-2019 three-year performance award would be based on performance against the 2017 objectives but payout would be deferred into shares that vest at the end of 2019.
    a. <u>Advantages</u>: Eliminates the need to set multi-year performance objectives that may prove to be too easy or too difficult as a result of the uncertain impact of the new administration's policy actions. Such an approach would need to be coupled with clear disclosure as to the rationale for the temporary change in the structure of the awards. Retains a longer term focus by deferring the one-year payout into shares that still vest after three years.
    b. <u>Disadvantages</u>: Investors have historically been harshly critical of one-year goals in long-term plans, and it is uncertain if such criticism will be easily assuaged by company concerns over short-term volatility. It often helps if the company can explain that its rationale is clearly disclosed for the one-year targets and the duration of the temporary arrangement.

c. Other Considerations. Investors often express concern when there are duplicative annual and long-term incentive metrics and care should be taken to clearly explain why the performance metrics chosen are key to driving long-term performance and achievement of company strategy.

2. Relative Metrics to Index Performance. Another approach to mitigate volatility of the policy environment is to use relative metrics. This may include relative metrics that are specific to the company's industry, with the metrics compared to the company's peers, an industry index (if a specific industry is targeted). It may also include the use of a broader market index (such as the S&P 500 or Russell 3000) if policy changes that are more broadly applicable are included.

   a. Relative Metrics to Company Peers. In the event a particular policy change targets the company's industry, but not business generally, indexing long-term performance to the company's peers is an approach worth consideration.

      i. Advantages: This approach would help mitigate the chance that the company performance metrics would, given factors impacting its industry, turn out to have too much stretch or not enough stretch and thereby produce unintended incentive plan results. The use of relative measures may help to mitigate industry-specific influences by comparing the company's performance to other companies that may be similarly impacted by policy and economic influences.

      ii. Disadvantages: The design would need to guard against situations where the company outperforms its peers but TSR is still negative, thereby weakening the alignment with shareholders while rewarding the company's relative performance. To guard against this potential disconnect with shareholders, companies may want to consider limiting the maximum payout under a long-term incentive to some percent of target compensation (*e.g.*, 80% of targeted payout) when total shareholder return is negative over the three-year performance period. This has become a widely accepted practice.

   b. Relative TSR of a Broader Market Index. If policy changes have a broader impact across industries, companies may want to index long-term performance to a larger peer group, such as the S&P 500, S&P 1500 or Russell 3000.

      i. Advantage: Helps to mitigate general policy and economic influences that impact industries in general and equity markets.

      ii. Disadvantage: May not mitigate industry-specific impact as relative performance tends to regress to the mean the larger the performance group.

3. Board Discretion. We are hearing more frequently from investors a preference that Boards use discretion to adjust payouts if the performance under an incentive plan is not reflective of the intended pay for performance relationship of the awards. It is critical, however, that if the Board exercises its judgment in adjusting award payouts, the company must disclose factors upon which the decision was based. For example, in approving the incentive plan, the Board may determine in advance (and disclose) that it will set a particular range of performance (also known as a collar) within which it may exercise discretion to determine the appropriate payout and the specific contingences that would be considered with exercising such discretion. The use of Board discretion should be evenhandedly applied to increase or decrease payouts as circumstances warrant.

Economic uncertainty often generates concerns among companies and their boards about setting appropriate long-term incentive targets. There is no one approach that will work in all circumstances. However, it appears that investors are increasingly willing to entertain both indexing approaches and the use of Board discretion when accompanies by clear disclosure.