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. Long-Term Performance Objectives Based on Annual Performance Goals. 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. Advantages: 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. It also retains a longer-term focus by deferring the one-year payout into shares that still vest after three years.
    b. Disadvantages: 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.

    a. Advantages: Board discretion can be applied to increase or decrease compensation as the circumstances warrant. Where a collar exists, stakeholders have a reference point for Board decisionmaking. Board discretion also allows Boards to address unexpected or contextual factors that may result in an overly generous or unreasonably low payout, given the performance provided.

    b. Disadvantages: Exercise of positive discretion can put the Board at odds with certain stakeholders. Discretion may be opposed by investors who are more focused on formulaic pay arrangements.

As companies explore alternative approaches to addressing potential unintended consequences of setting performance targets and determining incentive arrangements in periods of uncertainty, the mix of long-term incentives or the leverage in the payout schedule for various levels of performance may be adjusted. Examples of alternative design considerations include following:

4. Use of Overlapping Award Cycle to Adjust Future Performance Incentives. The degree to which award/performance cycles are overlapping provides a natural approach to mitigating the risk by allowing companies to adjust the performance objectives for a new long-term incentive award cycle each year. As opposed to end-to-end award/performance cycles (*e.g.*, granting awards for a three-year cycle and waiting to grant a new award until the end of the current three-year period), overlapping annual awards provides the opportunity to adjust objectives based on annual swings in the economic context within which the company operates. If awards are not granted on an annual overlapping cycle this would be an area to consider for mitigating future risk in setting performance objectives.

    a. Advantage. Overlapping awards allow company to revise the performance objectives each year for changes in the business or economic climate.

    b. Disadvantage. Having multiple awards with differing terms outstanding at the same time may create communications challenges for the company.

5. Revisiting the Mix of Long-Term Incentives. During periods of uncertainty it may be advisable to revisit the mix of long-term incentives to provide enhanced

retention of talent and to mitigate potential uncertainty. Currently, the most common mix of long-term incentives consist of performance-based stock (roughly 55% of the total award), stock options (24%) and restricted stock (21%), according to FW Cook report of award practices among the large US-based companies.[1] To help mitigate the risk of target setting in periods of uncertainty, the mix may be altered to place more emphasis on the longer exercise period corresponding to stock option awards or to increase the emphasis on restricted stock as a way to enhance retention.

a. Advantages. Revisiting the mix of pay can mitigate the risk of talent drain where circumstances warrant. Changing the mix can also help mitigate uncertainty until longer term targets can be set.

b. Disadvantages. Changes in the mix must be accompanied by clear disclosure explaining the context. Failure to clearly explain the changes can lead to criticism by certain stakeholders or proxy advisors seeking consistency.

6. Flatten the Payout Curve. Within the design of performance awards, making the payout schedule flatter to dampen the impact of under or over-achievement of goals or to bracket payout opportunities for different levels of performance (*e.g.*, 95% to 105% of goals produces a 100% payout of targeted incentives, 90% to 94% results in a 95% payout, etc.) may help to guard against unintended windfalls or shortfalls due to the difficulty of setting multi-year performance objectives.

   a. Advantages. Mitigates the effect of overachievement of goals by paying a lower amount for a higher level of performance. Mitigates the effect of underachievement by providing a longer payout curve thus guarding against shortfalls.

   b. Disadvantages. In times of lower performance, may generate criticism by some stakeholders who seek a lower payout amount for the same performance. In times of very good performance, may create concern by executives that payouts were lower than warranted by performance.

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 and every approach involves tradeoffs. However, it appears that investors are increasingly willing to entertain both design changes and the use of Board discretion when accompanies by clear disclosure. Thus, companies should be aware of, and explore the options that make the most sense for their particular situations.

[1] FW Cook, 2016 Top 250 Report, http://www.fwcook.com/content/documents/publications/12-19-16_FWC_2016_Top_250_Final.pdf.