

The Design, Valuation, and Administration of Performance Equity Plans



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Introduction

Applebee's

- Largest casual dining concept – 1,800+ restaurants and 125,000+ associates
- 25% company-owned
75% franchised
- Public since 1989, NASDAQ (APPB)
- More information www.applebees.com

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Aon/Radford

- Full compensation consulting services
- Expertise
 - Traditional Stock Option Awards
 - Performance Awards and Market Conditions
 - Modifications of Equity Awards
- More information www.aon.com or www.radford.com

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Agenda

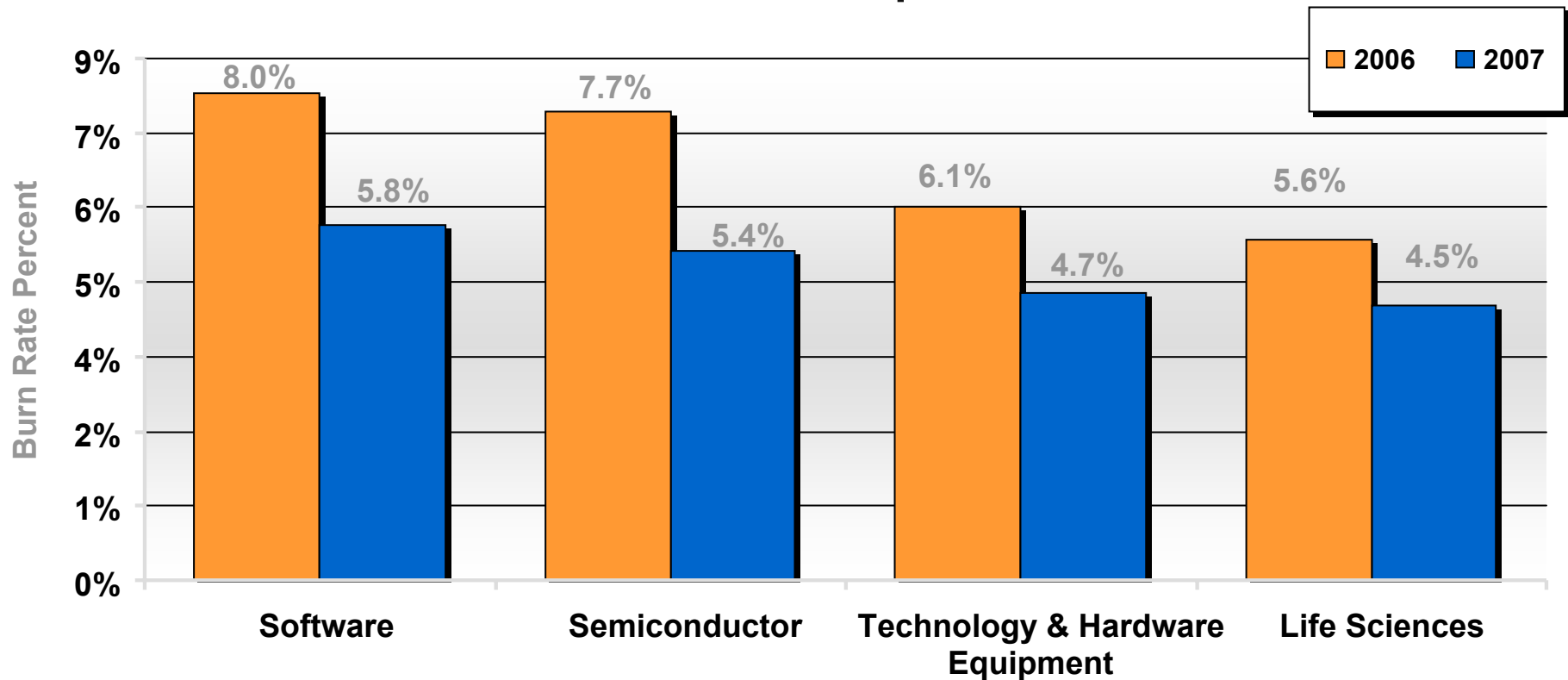
- **The Post FAS123R Landscape**
- **Applebee's Equity Compensation Strategy and Design**
- **Challenges of Administering Performance Equity Plans**

The Post-FAS 123R Landscape

- **The end of option “tyranny”**
 - **No longer one-size-fits-all**
 - **A majority of companies now use multiple vehicles**
 - **A significant minority (more than 25%) use performance requirements**
 - **According to Equilar, the most common Performance Metric is Total Shareholder Return**
- **Limited share pools**
- **The beginning of “my company” solutions**
 - **Old vehicles being rediscovered**
 - **New vehicles being born**
- **The need – find ways to make our shares “more valuable”**

The Evolving Market – We Need to Be More Creative in Using Shares

ISS 3-Year Average Gross Burn Rate Allowable Cap Russell 3000 Companies



Types of Equity Awards

- **Traditional Stock Options**
- **Stock Appreciation Rights**
 - **Settled in Shares**
 - **Settled in Cash**
- **Capped stock options**
- **Service Based Restricted Stock**
- **Performance Share Awards**
 - **Internal Performance Conditions**
 - **Market Conditions (Both Absolute and Relative Conditions)**
- **ESPP**

Typical Performance Awards

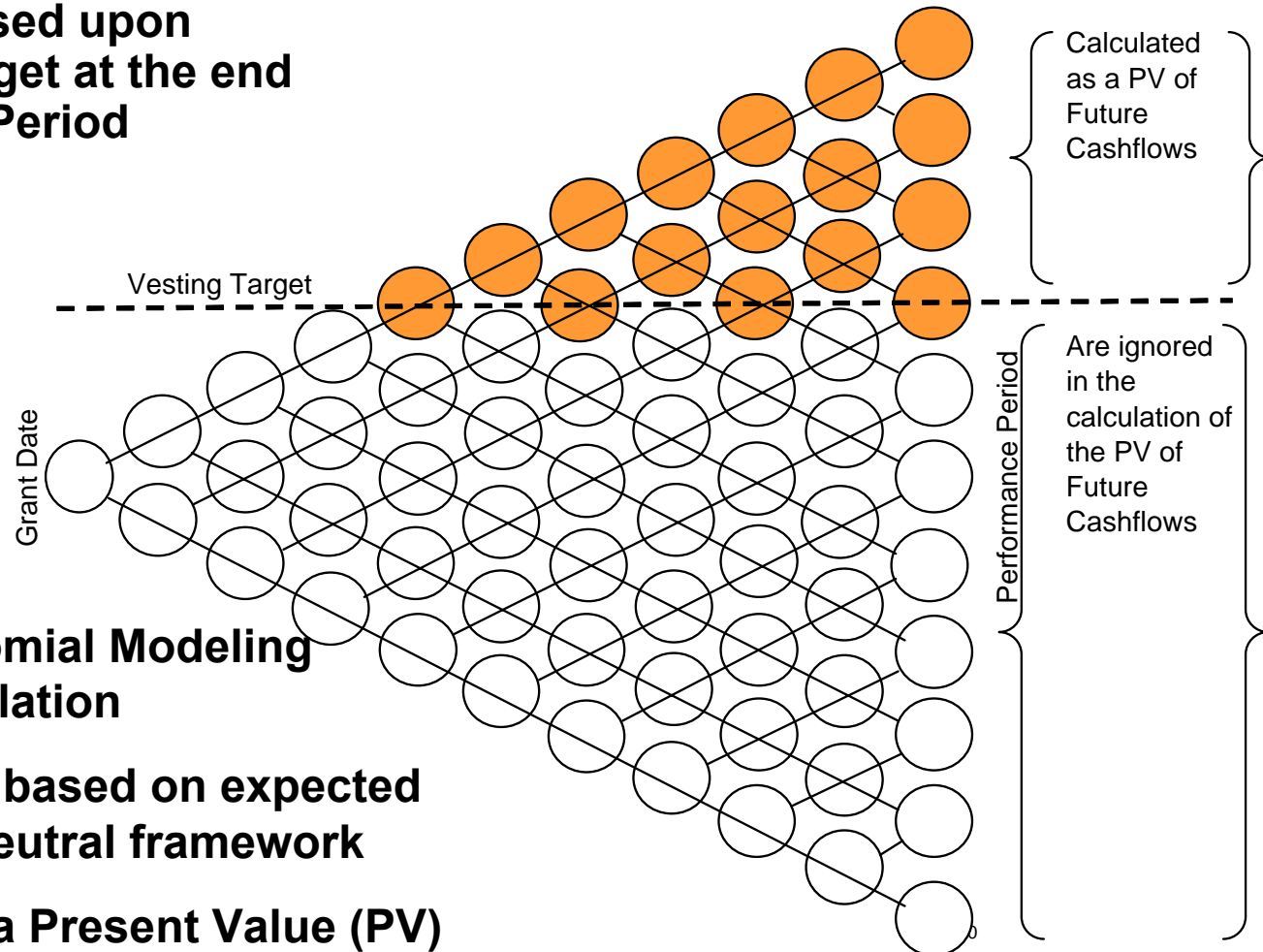
- Performance awards are becoming more prevalent in current FAS 123(R) environment
 - Prior FAS 123(R) had negative accounting consequences
 - Normally found with full value shares, since stock options are inherently a performance vehicle
 - Can be defined as *Performance Conditions* or *Market Conditions*
 - Performance Conditions
 - Typically based on internal metrics such as EBITDA, EPS, or revenue
 - Need to expense the actual number of awards that vest and reconcile
 - Market Conditions
 - Typically based on a fixed stock price or Total Shareholder Return (“TSR”)
 - May better align compensation delivered and shareholder return
 - Not permitted to reverse charge if market condition is not met

Common Types of Performance Plans with *Market Conditions*

- **Absolute Market Conditions**
 - Vesting contingent on reaching certain stock hurdles
 - Generally seen for top couple of executives
 - Influenced by general market movements
 - Creates a discount comparatively against FAS 123(R) charge of normal full value share absent the vesting hurdle
- **Relative Market Conditions**
 - Depending on percentile rank after performance period, a percentage of awards will vest
 - More broad based in distribution
 - Normalized against general market movements
 - Will not necessarily create a discount from original FAS 123(R) fair value if upside opportunities exist
 - Challenge of picking reliable peers

Absolute Market Conditions - Valuation

- Share only vests based upon reaching vesting target at the end of the Performance Period



- Requires either Binomial Modeling or Monte Carlo simulation
- Project stock prices based on expected volatility in Risk-Neutral framework
- Discounted back to a Present Value (PV)

Absolute Market Conditions – Sample Results

- The following charts depict the reduction in fair value of a hypothetical restricted share grant that contains a market condition. The market condition stipulates that the share only vests if reaching certain price levels at the end of the four-year performance period.
- Based on a 5% risk-free rate, and no dividend yield

		Vesting Hurdle					
		0.00%	5.00%	10.00%	15.00%	20.00%	25.00%
Volatility	20.00%	-27.56%	-32.46%	-37.47%	-42.35%	-47.12%	-51.92%
	30.00%	-29.26%	-32.50%	-35.96%	-39.26%	-42.43%	-45.48%
	40.00%	-28.55%	-31.04%	-33.40%	-35.80%	-38.01%	-40.58%
	50.00%	-26.97%	-28.84%	-30.74%	-32.76%	-34.49%	-36.55%
	60.00%	-24.87%	-27.19%	-28.75%	-29.75%	-31.57%	-32.73%
	70.00%	-22.59%	-24.42%	-25.69%	-26.15%	-27.93%	-28.15%
	80.00%	-20.84%	-21.30%	-22.50%	-24.60%	-24.41%	-25.91%

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Relative Market Conditions - Provisions

- Depending on percentile rank after performance period, a percentage of awards will vest
- Can provide upside opportunities (generally up to 200%) if outperform comparator companies
- Most common performance period is three years
- Recommend to have at least 20 comparators
 - What to do if somebody drops out (i.e. business combinations, changes in the Index, etc.)
- Generally see 20 day or greater averaging period

Relative Market Conditions - Example

Rank	Company	TSR	
1.	Peer Comparitor I	19.81%	200% vest if above the 75th Percentile
2.	Peer Comparitor C	19.21%	
3.	Peer Comparitor E	19.07%	
4.	Peer Comparitor J	18.04%	
5.	Peer Comparitor S	17.42%	
6.	Peer Comparitor N	16.39%	Number of awards vesting will be interpolated between 0% and 200% based upon actual percentile rank
7.	Peer Comparitor G	16.32%	
8.	Peer Comparitor Q	14.55%	
9.	Peer Comparitor L	14.43%	
10.	Peer Comparitor D	13.61%	
11.	Peer Comparitor K	12.77%	
12.	Peer Comparitor T	9.68%	
13.	Peer Comparitor O	7.27%	
14.	Peer Comparitor F	7.15%	
15.	Peer Comparitor H	6.09%	
16.	Peer Comparitor M	4.89%	0% vest if below the 25th Percentile
17.	Peer Comparitor B	4.64%	
18.	Peer Comparitor P	4.09%	
19.	Peer Comparitor R	3.82%	
20.	Peer Comparitor A	3.28%	
	Company	12.07%	
	Median	13.19%	
	Average	11.63%	
	Rank	12	
	Percent To Vest	85%	

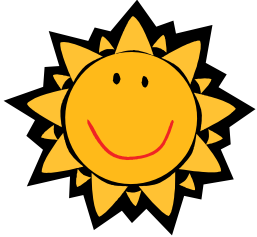
Relative Market Conditions - Valuation

- **Very challenging modeling techniques**
 - Requires Monte Carlo simulation
 - Generally done in a “risk-neutral” framework
 - Projects stock prices for company and each relative peer company, including the underlying correlation of stock prices in the projection
 - Projected stock prices are not only used for determination of expected awards to vest, in addition to the discounting of future cash flows

Relative Market Conditions – Recent Adopters

Market Conditions Company	Perf. Period	Index?	Number of Peers	Averaging Period	Number of BEndpoints	Maximum Bendpoint	50% Bendpoint	Filing Date
PG&E	3	No	12	30	3	200%	75%	12/22/2006
Lexington Realty Trust	5	No	N/A	N/A	N/A	N/A	N/A	1/3/2007
Equity Inns	3	NAREIT	15	N/A	N/A	150%	100%	1/5/2007
AMR Corporation	3	No	N/A	N/A	N/A	N/A	N/A	1/17/2007
Overseas Shipholding group	3	No	18	N/A	N/A	N/A	N/A	1/17/2007
Dow Jones	3	Publishing & Media	N/A	N/A	4	150%	100%	1/23/2007
Home Depot	3	S&P 500	500	N/A	3	300%	100%	1/24/2007
American Express	3	S&P 500	500	N/A	N/A	N/A	N/A	1/26/2007
Time Warner	3	S&P 500	500	N/A	N/A	200%	N/A	1/26/2007
Corn Products International	3	No	30	N/A	N/A	200%	N/A	1/29/2007
Nationwide Health Properties	3	NAREIT	15	N/A	N/A	200%	N/A	2/5/2007
Treehouse Foods	2.5	No	N/A	N/A	N/A	N/A	N/A	2/5/2007
Dollar Thrifty Automotive	3	Russell 2000	2000	N/A	N/A	N/A	N/A	2/6/2007
BearingPoint	3	S&P 500	500	20	N/A	250%	N/A	2/8/2007
Gilead Sciences	3	1EX Biotech Pharmaceutical Inc	N/A	N/A	N/A	200%	100%	2/9/2007
Hershey Foods	3	Peer group	N/A	N/A	N/A	250%	N/A	2/13/2007
Ameren Corporation	3	Utility Peer Group	N/A	N/A	N/A	200%	N/A	2/15/2007
Hubbell Corporation	3	S&P Midcap 400	400	N/A	7	200%	100%	2/15/2007
Strategic Hotels & Resort	1	Bloomberg Hotel REIT	N/A	N/A	N/A	200%	100%	2/20/2007
NewField Exploration	3	No	22	20	22	200%	140%	2/21/2007
MDU Resources	3	No	28	0	4	200%	100%	2/21/2007
IDEARC Inc.	3	Not well Disclosed	N/A	N/A	N/A	150%	N/A	2/22/2007
Nordstroms	3	Not Disclosed	N/A	30	8	125%	80%	2/26/2007
Northwest Natural Gas	3	No	10	90	10	200%	60%	2/27/2007
Allegheny Technologies	3	Not Disclosed	N/A	30	4	300%	100%	2/27/2007
Edison International	3	Philadelphia Utility Index	20	20	3	200%	100%	2/27/2007
AES Corporation	3	S&P 500	500	0	2	150%	75%	2/28/2007
International Flavors & Fragrances	3	S&P 500	500	20	N/A	N/A	N/A	3/12/2007
Glimcher Realty Trust	3	Other REITS	16	N/A	N/A	200%	N/A	3/14/2007
CBS Corporation	3	S&P 500	500	10	3	300%	100%	3/16/2007
Applebees	3	Bear Sterns Index	24	200	4	150%	50%	3/20/2007
Chevron Corporation	3	Not Disclosed	4	20	4	200%	N/A	4/3/2007
TXU Corporation	3	Electric Utilities Index	N/A	N/A	N/A	200%	N/A	4/5/2007
Average			291	38	6	203%	93%	
Median			28	20	4	200%	100%	

Applebee's Equity Compensation Strategy and Design



HOPES

- By putting all equity on a common playing field, we can allow choice and use vehicles that maximize ROI (perceived realized value)
- By removing onerous accounting treatment of performance vesting, we could begin using it as part of our LTI mix

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FEARS



- Expensing may reduce utilization of equity compensation below the executive level, making it uncompetitive for us to continue granting there
- Increasing complexity of valuation methods that produce different numbers creates more bureaucracy and administrative costs making cash a more attractive vehicle

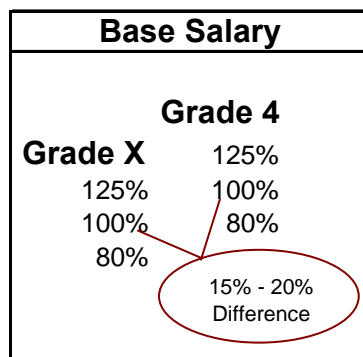
Applebee's Performance Equity Plans for 2007

- 1. Performance-Based Grants vs. Pure Grade-Based Grants**
- 2. Replace Cash LTI with Restricted Stock for GMs**
- 3. Performance-Vested Restricted Stock for Officers**
- 4. ESPP Redesign with Cash Match**

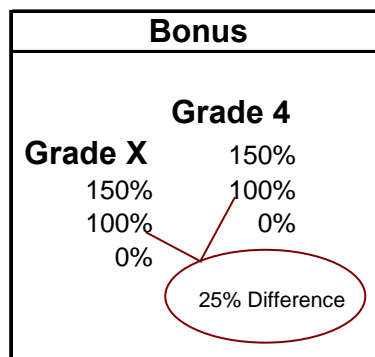
Performance-Based Grants vs. Pure Grade-Based Grants

Concepts

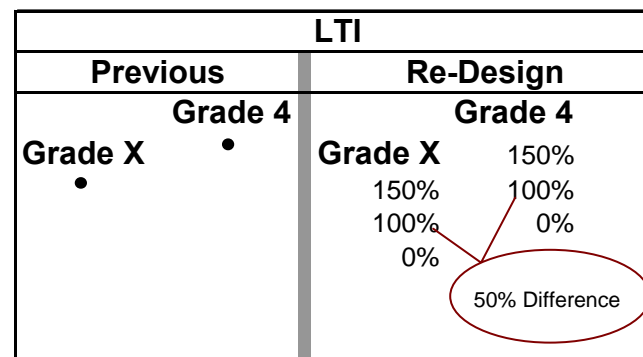
- Previously, grants were common by grade
- Doesn't make sense given all of the other flexibility in the compensation program



• 80%-85% Overlap



• 75% Overlap



• Zero Overlap

* 50% Overlap

Performance Grants vs. Pure Grade-Based Grants

Concepts (continued)

- Used overall performance rating as modifier of grant size

Performance Rating	% of Target Grant
O	1.5x
ME	1.25x
E or ND	1.0x
U	0

- “Key associate” awards to those not receiving quarterly grants – used restricted stock
- Allowed Equity Choice for grants at 3:1 ratio for SARs to RS

Performance Grants vs. Pure Grade-Based Grants

Execution

- Thought that tying ratings to grants may skew ratings --- did not see this overall
- Takeaways were rare, did not need “zero sum game” to find additional shares
- Budgeted 10% of total grant for performance basis (10% of population at 1.5x, 20% at 1.25x)
- Prepared personal letters for each high-performing recipient

Replace GM Cash LTI with Restricted Stock

Concepts – Previous Plan

- **Current plan was earned in Year 1, then held until beginning of Year 4 (two year cliff vest)**
- **No interest paid or performance modification of fund balance**
- **Expensed all in Year 1, with recapture for forfeiture**

Replace GM Cash LTI with Restricted Stock

Concepts – New Plan

- **New plan offered 4x the current overall payout, plus modification of value according to stock price (Upside without additional FAS123 expense)**
- **Used restricted stock grants with 4 year cliff vest, ranging from \$7,500 to \$25,000 face value for our restaurant GMs**
- **Cash LTI balance earned in previous years will pay out in the interim prior to vesting of first RS grant**

Replace GM Cash LTI with Restricted Stock

Concepts – New Plan (continued)

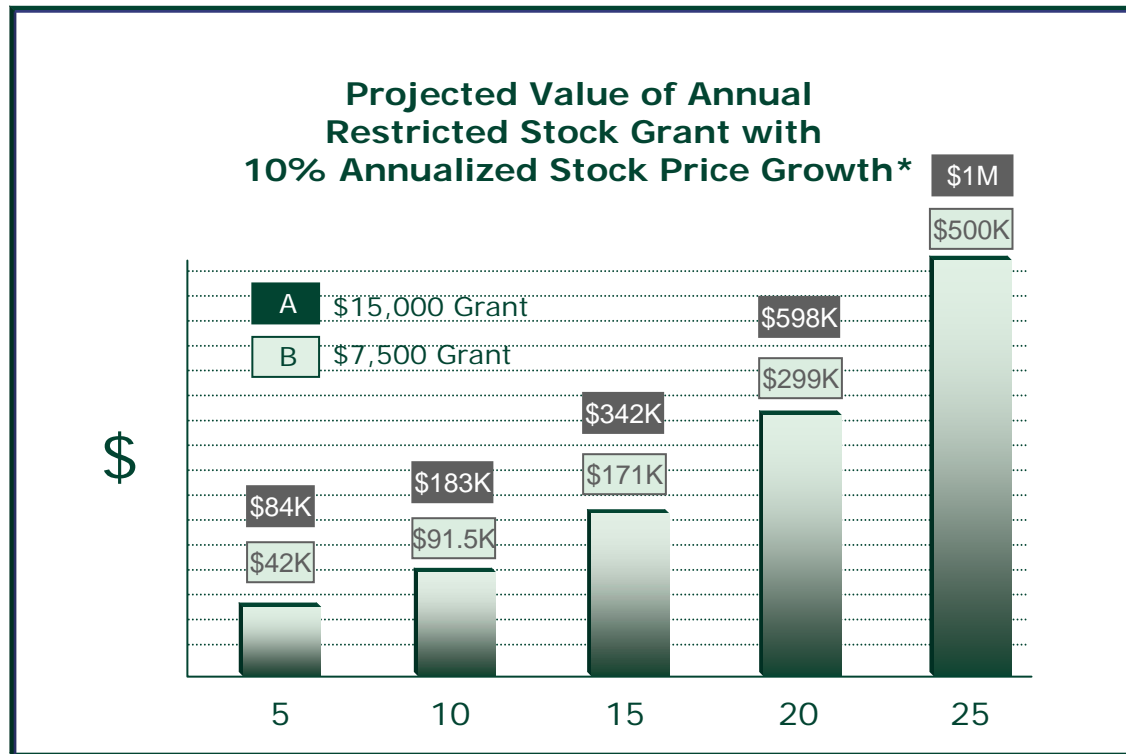
- Quarterly grant to a dollar target vs. number of shares protected the company from unexpected FAS123 costs due to stock price
- Timing of expense was very favorable, resulting in a permanent one-time shift toward later years

Fiscal Year	% Expense
Year 1	12.1%
Year 2	27.8%
Year 3	27.8%
Year 4	27.8%
Year 5	4.5%

Replace GM Cash LTI with Restricted Stock

Execution

- Concept of restricted stock unfamiliar to GMs, confused with stock options
- Higher grants for top 20% performers meant zero grants for bottom 20% performers - - appropriate but delicate to communicate
- Able to articulate strong wealth building potential in GM role:



* After regular income taxes on grants, net of long-term capital gains tax.

Performance-Vested Restricted Stock for Officers

Concept

- Use of RS is increasing in the market, and it is easier to understand and value than SARs
- We wanted to introduce a performance feature with both upside and downside, rather than simple time vesting, for a portion of executive grants
- Considered both market and performance features, but selected TSR as the best metric for Applebee's
- Determined a peer group relative basis for TSR was most appropriate

Performance Relative to Peer Group	% of RS Vesting *
≥P75	150%
Median	100%
P25	50%
<P25	0
* Prorate between anchors	

- Expense is fixed at grant, except for forfeiture

Performance-Vested Restricted Stock for Officers

Execution

- **FAS123 calculation is complex, essentially “handicapping” the likelihood of exceeding or underperforming the peer group**
- **Our quarterly grants magnify this, resulting in some unpredictability of expense**
- **Tracking to the peer group also takes work; a published index would be easier but may not be a very true comparison**
- **Using PVRS beyond the officer group would require education upfront and ongoing communication to avoid surprises**

Employee Stock Purchase Plan

Concept – Current Design

- **Stock ownership has long been an important part of Applebee's culture**
- **ESPP is offered to all associates - - full and part-time in corporate and restaurant locations**
- **Previous program was 15% discount with look-back, quarterly buys**
- **FAS123 presented \$1M in option expense for the program**

Employee Stock Purchase Plan

Concept – Current Design (continued)

- **Analysis showed that over 80 % of ESPP shares were being “flipped” prior to passing the two-year disqualifying disposition mark - - not the intended use of the program**
- **Safe Harbor design of 5% with no look-back would have been perceived as a harsh takeaway - - even by many associates not enrolled**

Employee Stock Purchase Plan

Concept – New Design

- **Used Safe Harbor for “free” 5% discount with no FAS123 expense**
- **Combined with a 15% cash match upon holding the shares for two years - - outside of the qualified plan**
- **look-back was eliminated - - more of a short-term focus not aligned with the spirit of the ESPP**
- **Face value of design (20% no look-back vs. 15% look-back) does not present a takeaway:**

Employee Stock Purchase Plan

ESPP Stock Price Examples

Assumes a 2 year hold	-10%		10%		20%		30%	
	Current	Proposed	Current	Proposed	Current	Proposed	Current	Proposed
Associate Contributions	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
Stock Price	\$20	\$20	\$20	\$20	\$20	\$20	\$20	\$20
Discount %	15%	5%	15%	5%	15%	5%	15%	5%
Purchase Price	\$17	\$19	\$17	\$19	\$17	\$19	\$17	\$19
Shares Purchased	58.82	52.63	58.82	52.63	58.82	52.63	58.82	52.63
Share Value	\$1,176	\$1,053	\$1,176	\$1,053	\$1,176	\$1,053	\$1,176	\$1,053
Future Stock Price	\$18	\$18	\$22	\$22	\$24	\$24	\$26	\$26
Future Share Value	\$1,059	\$947	\$1,294	\$1,158	\$1,412	\$1,263	\$1,529	\$1,368
15% Match (end of 2 years)	\$0	\$142	\$0	\$174	\$0	\$189	\$0	\$205
Total Value before Taxes	\$1,059	\$1,089	\$1,294	\$1,332	\$1,412	\$1,452	\$1,529	\$1,573
Tax Impact								
Ordinary Income @33%	\$19	\$47	\$58	\$75	\$58	\$80	\$58	\$85
Capital Gains (15%) Loss (33%)	\$0	(\$17)	\$18	\$16	\$35	\$32	\$53	\$47
Total Tax	\$19	\$29	\$76	\$91	\$94	\$111	\$111	\$132
Net Gain	\$40	\$60	\$218	\$241	\$318	\$341	\$418	\$441

- Expense impact is reduced through Safe Harbor, attrition and timing - - while offering equal reward to associates who use the plan as designed

Employee Stock Purchase Plan

Execution

- Recordkeeping is manual as this is a unique design, but that is manageable
- Required multiple forms of communication to associates
- Participation in first two quarters decreased 7% compared to prior plan

Summary of Applebee's Performance Equity Design Principles

- **Performance features can enhance ROI on equity compensation investment if they:**
 - Measure something people understand and believe in
 - Have symmetry in the upside and downside
- **Smart consideration of FAS123 expense and timing can be a source of P&L advantage in a world where all LTI vehicles are being expensed**
- **Attractiveness of larger equity grants offsets longer vesting or more difficult performance hurdles - - especially for top performers**
- **Many different equity designs produce the same financial impact - - choosing the right design reflects the organization's culture and character**

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