Relative Total Shareholder Return Plans: The Low-Hanging Fruit of Optimal Performance-Based Equity Design

Introduction

The most prevalent equity incentive vehicle in use today is still the stock option, particularly in the technology and life sciences sectors. However, options have been under great scrutiny in recent years. Backdating investigations, debate over accounting treatments, underwater option repricings and outsized executive grants have all brought this equity vehicle into the harsh spotlight. Option proponents argue they remain the most effective and motivational incentive for high-growth and high-potential companies, but pressure from detractors has lead to increased use of time-vested restricted stock in lieu of options.

Each of the equity vehicles in our traditional toolkit has major flaws

Still, however, restricted stock is no panacea. Shareholders have correctly identified a lack of performance linkage with restricted stock – an award that will always deliver value as long as the recipient does not quit or get terminated, and the company remains viable. In response, we have seen increasing use of performance shares to address this shareholder concern. As organizations begin feathering performance shares into their vehicle mix, many are coming to realize the difficulty associated with setting multi-year performance goals in a volatile business environment.

Where does this leave senior leadership and compensation planning professionals today? Each of the equity vehicles in our traditional toolkit has major – some would say fatal – flaws:

Figure 1

Equity Vehicle	Major Flaw(s)
Stock Options	> Highly sensitive to strike price and exercise timing (may encourage short-term decision making) > Vulnerable to falling underwater creating morale and retention issues > May deliver value during general market upswings and not as a result of specific company performance
Time-Vested Restricted Stock (or Units)	> Delivers value with minimal linkage to performance – vests whether or not the company is successful
Performance Shares (or Units)	> Entirely dependent on ability to set reasonable multi-year performance goals > Unless performance metrics are publicly available GAAP disclosures, determination of payout is a “black box” process to most shareholders > Complexity of design often make them difficult to explain to participants, decreasing their incentive motivation

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However, there is an equity vehicle gaining popularity in the US that demonstrates the most promise in mitigating these common major flaws. Relative Total Shareholder Return (TSR) plans are a type of performance-based equity award that links payout to the company's stock price return vs. a set of comparator companies. Carefully designed, a Relative TSR plan:

> Places less focus on short-term stock price swing than traditional stock options by requiring sustained performance over time (e.g., 30-90 day average stock price)

> Cannot fall underwater like traditional stock options (if stock price falls faster than comparators' in a down market, payout is reduced – however, a minimum value can be preserved for retention purposes)

Relative TSR plans can mitigate the major flaws associated with other equity vehicles

> Provides strong pay-for-performance linkage through the requirement to match or beat comparator companies' stock returns

> Does not depend on ability to set long-term operational or financial goals

> Uses publicly-available daily stock price closes – entirely transparent metrics for participants and shareholders alike, simplifying administration and removing any subjectivity in measuring performance

> Carries favorable fixed grant date accounting under Topic 718 (formerly FAS 123(R)), which does not require cumulative accounting changes based on the number of shares that actually are earned, therefore making expense recognition level and predictable

There is one critical challenge with Relative TSR program design: establishing the peer group. While it is important to have some logical consistency with other publicly disclosed peer groups (e.g., the CD&A group used for named executive officer compensation assessment), the Relative TSR comparators don't have to be identical. Companies that are not confident in using a closely defined group such as the CD&A peers can address this challenge by choosing a broader index of comparator companies to represent the more diversified portfolio of their typical investor. Because stock price is easy to track and analyze, very large comparator indices (e.g., S&P 100, Russell 3000) are possible with Relative TSR whereas they are administratively impracticable with other operational/financial metrics.[1]

Example

The following example illustrates a sample Relative TSR plan, demonstrating how the awards mitigate many of the flaws associated with stock options and time-based restricted stock.

Figure 2

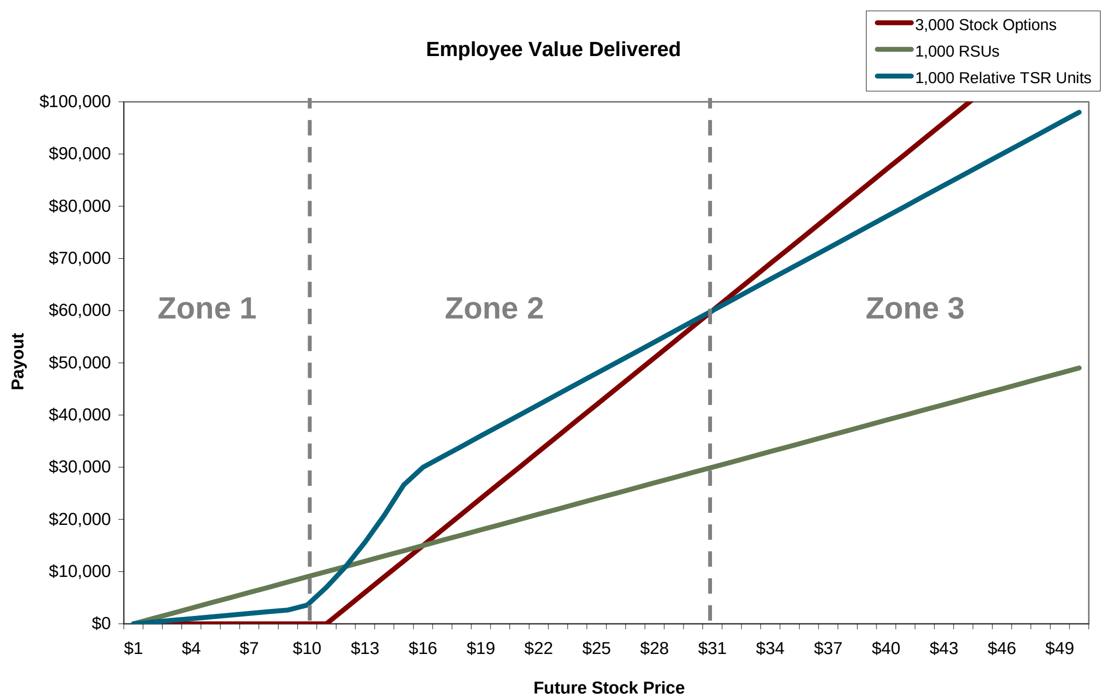
Sample Relative TSR Award Payout Schedule	Awards Earned Upon Vesting
MAXIMUM: 33% Above Comparator Group Median	**200%**
For every 1% in above Comparator Group median, **payouts increase by 3% of target**	
Comparator Group Median TSR + 1%	103%
TARGET: Comparator Group Median TSR	**100%**
Comparator Group Median TSR - 1%	97%
For every 1% below Comparator Group median, **payouts decrease by 3% of target**	
MINIMUM: 22% Below Comparator Group Median	**33%**

Figure 2 outlines a design that uses a Comparator Group's (CG) median TSR as the baseline. If the Company matches CG median, the target number of shares are earned (or vested). For every one percentage point the Company exceeds the CG median TSR, an additional 3% of target shares are earned. The maximum payout is 200% of target, meaning that the cap kicks in once the Company exceeds CG median TSR by 33 percentage points. Conversely, for every percentage point below the CG median, 3% of the target number of shares are taken away. The minimum payout floor is 33% percent of target, meaning no matter how badly the company performs, at least 1/3 of the award will vest at the end of the performance period. For the sake of simplicity, the performance period is a one-year cliff in this example.[2]

Figure 3 outlines the value delivered to an employee holding 3,000 traditional stock options, 1,000 time-based restricted stock units (RSUs) or 1,000 Relative TSR units.[3]

All three vehicles are assumed to be granted when the Company's stock is trading at $10.00. Stock options have the greatest leverage if the Company's stock price appreciates after grant, as demonstrated by the steep red line in Figure 3. RSUs, illustrated with the green line, don't have as much upside leverage as the options; however, they maintain significant value when the Company's stock price depreciates below $10.00, whereas the options fall underwater and are often considered worthless by participants.

Figure 3



The blue line in Figure 3 is the payout curve for our Relative TSR units (assuming the CG median TSR is 10% annually). Dividing the chart into three “zones” enables us to discuss the advantages of Relative TSR over the other two vehicles.

- Zone 1 – Downside
  - Provides performance-based retention value when options otherwise fall underwater
  - Avoids RSUs’ straight-lined “giveaway” often criticized by shareholders
- Zone 2– Reasonable Upside
  - Greater upside leverage than RSUs
  - Similar to or greater upside than options
- Zone 3 – Outlying Upside
  - Greater leverage than RSUs
  - Tempers what is often criticized by shareholders as “windfall” gains from options
  - Does not excessively reward risk, as the outlying upside returns are less leveraged compared to stock options

Historic Research

Radford has developed models to test how Relative TSR would have stacked up had they been in place in the recent past

Radford has developed historic models to test just how Relative TSR plans would have stacked up against options or RSUs had they been in place in the recent past. We assessed each vehicle from two different perspectives:

- Compensation Delivery (employee perspective) – calculates the amount of value delivered to the award recipient (often called “paper gain”)
- Expense Efficiency (company perspective) – calculates the ratio of compensation delivered to the employee vs. the Topic 718 accounting cost. A ratio below 100% represents less value delivered to employees than the cost to the company. A ratio above 100% represents more value delivered than costs accrued to the company.

The following table labeled Figure 4 outlines the assumptions used in our research methodology.

Figure 4

Assumption	Approach
Equity Vehicles Studied	> Stock Options > Restricted Stock Units > Relative TSR Units
Grant Dates	> Five grants made on January 1 of 2000 through 2005
Comparator Group	> S&P 100 companies (each company was studied against the remaining 99 for Relative TSRs)
Option Exercise Behavior	> The options are assumed to be exercised at the midpoint of the vesting date and the contractual term (assumed to be 10 years), for a weighted expected life of 6.25 years (a common assumption for financial reporting purposes).[4] > RSUs and Relative TSR units assumed held for the same period as options
Relative TSR Design	> Same design as outlined in Figure 2 above
Award Size	> 3,000 stock options > 1,000 RSUs (a 3:1 ratio to options)[3] > 1,000 Relative TSR Units (a 3:1 ratio to options)[3]

Relative TSR is a less volatile and more predictable compensation vehicle

Figure 5 outlines the result of our historic research for each equity vehicle. The ranking is done on a company-by-company basis. For example, if at Company ABC we found that stock options would have delivered $100,000 over the five years studied, RSUs delivered $80,000 and Relative TSRs delivered $120,000, the rankings would be: Relative TSR #1, Stock Options #2 and RSUs #3. We then calculate the average rankings to display in Figure 5.

Figure 5

	Compensation Delivered			Expense Efficiency Ratio		
	Median Result	Standard Deviation	Average Ranking Among Vehicles at Each Company - 1 (best) to 3 (worst)	Median Result	Standard Deviation	Average Ranking Among Vehicles at Each Company - 1 (best) to 3 (worst)
Stock Options	$43,484	$205,354	2.5	87%	411%	2.2
RS/ RSUs	$61,189	$71,125	2.3	115%	46%	2.2
Relative TSR Units	$109,413	$122,635	1.9	142%	82%	1.6

Shaded cells represent best result in each category of assessment.

We find that for both compensation delivery and expense efficiency, not only do Relative TSR units have the best average ranking, but they also show the highest compensation delivery and expense efficiency. Relative TSR also has the second lowest standard deviations, meaning it is a less volatile and more predictable compensation vehicle than traditional options – a characteristic that both HR and Finance professionals can appreciate.[5]

Conclusion

There is much potential for Relative TSR to replace broad-based equity programs – not just executive award packages

We have demonstrated in this Radford Review that a well-designed Relative TSR program can both (1) mitigate the most troublesome flaws with traditional equity vehicles, and (2) provide better compensation delivery and expense efficiency. While we have witnessed a marked increase in the use of Relative TSR among US companies over the last two years, the vast majority have limited their application to the senior executive levels. We believe that there is much more potential for Relative TSR to incorporate broad-based participants at every organizational level.

As more organizations explore Relative TSR we will find that the chief challenges are peer group selection, administration and employee communication. Radford has developed analytics and solutions to these challenges including proprietary, sophisticated statistical analyses to assess the quality of peer groups and daily trackers to communicate performance vs. peers to plan participants in real time. Visit our web portal at www.RelativeTSR.com for more information as well as additional white papers.

Footnotes

For more information on the footnotes below or any of the information presented in this white paper, please visit www.RelativeTSR.com or contact a Radford consultant (contact information below).

[1] A more in-depth discussion of peer group selection as well as information on Radford's PeerPicker statistical analysis of peer group stock price correlations are available on www.RelativeTSR.com

[2] Note this is only one example design. The use of a payout floor, the length of the performance period and the baseline definition of CG median are all design decisions that can vary from one program to the next. We chose this example because it is fairly representative of common approaches and is simple to illustrate.

[3] A 3:1 ratio between options and RSUs or options and Relative TSR Units is a common exchange rate used to compare each vehicle. However, this exchange ratio can vary from company to company. It is also important to note that accounting fair values may not be the same for RSUs and Relative TSR Units. RSUs are typically valued at 100% of the face value of the stock whereas Relative TSR Units may exceed face value depending on the design of the program.

[4] Other methods of exercise were considered for this analysis: options assumed to be exercised immediately upon vesting, options assumed to be exercised at the high stock price, and options assumed to be exercised at the full contractual term. We do not believe that any of the alternative exercise assumptions represent a realistic long-term assumption about exercise behavior.

[5] The same models used in the historic research cited in this Radford Review can also analyze your company's actual historic performance vs. peers under Relative TSR program scenarios.

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