PERFORMANCE-BASED EQUITY PRACTICES WITHIN LARGE BIOPHARMA

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Whether owed to regulatory and investor pressure, or simply a reflection of an increasingly sophisticated understanding of the relationship between company performance and executive pay program design, the use of performance-based long-term incentives (LTI) is on the rise. While initial adoption of performance-based equity has been the purview of larger and more mature companies (Fortune 500s), an emerging trend is evident in smaller and more nascent organizations seeking to drive results that yield value to all shareholders.

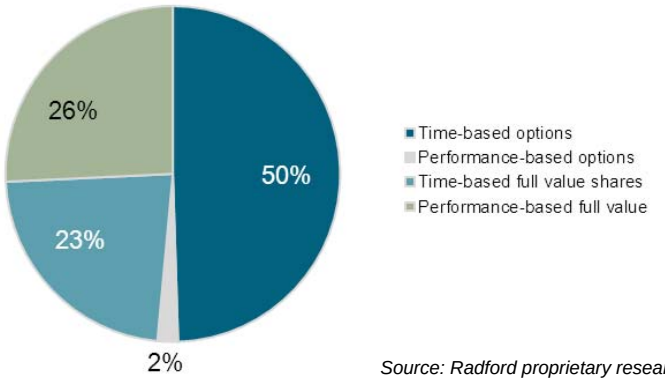
The applicability of performance-based equity across the broad spectrum of pre-commercial life sciences companies is a matter for debate, and subject to the specifics of a given company. While on the one hand, performance-based plans can be “shareholder friendly” and used to justify higher levels of equity delivery, they are typically effective only to the extent that companies have clear visibility into longer-term performance, a luxury that many pre-commercial, research-based life sciences companies do not have.

Within the industry, commercial and more established biotechnology/specialty pharmaceutical companies have begun to incorporate performance-based equity into their total rewards design, a trend that is expected to expand to companies across the industry as Compensation Committee’s seek better alignment between executive compensation and the events that drive value for shareholders. Radford’s White Paper examines the current trends in performance-based equity among larger biotechnology firms, provides an examination of the critical factors in adopting performance-based plans and presents Radford’s perspective on the issues that must be addressed to maximize the effectiveness of these plans within a total rewards strategy.

Current Practices Among Large Biopharmaceutical Companies

We get visibility into how some of the larger Biopharma companies are grappling with performance-based equity considerations by looking at current practices. Radford recently collected and analyzed data related to equity practices at the 30 largest biopharma companies in the US (as ranked by market capitalization), which showed that adoption of performance-based LTI vehicles is prevalent among this group and is pervasive as a key vehicle for delivering LTI compensation. About 60% of companies in the study reported that they used some form of performance-based equity (almost exclusively for named executive officers), representing nearly 40% of the overall LTI value delivered, at the median.

Figure 1: LTI Vehicle Distribution Among Top 30 Biopharma's with Performance-Based Plans



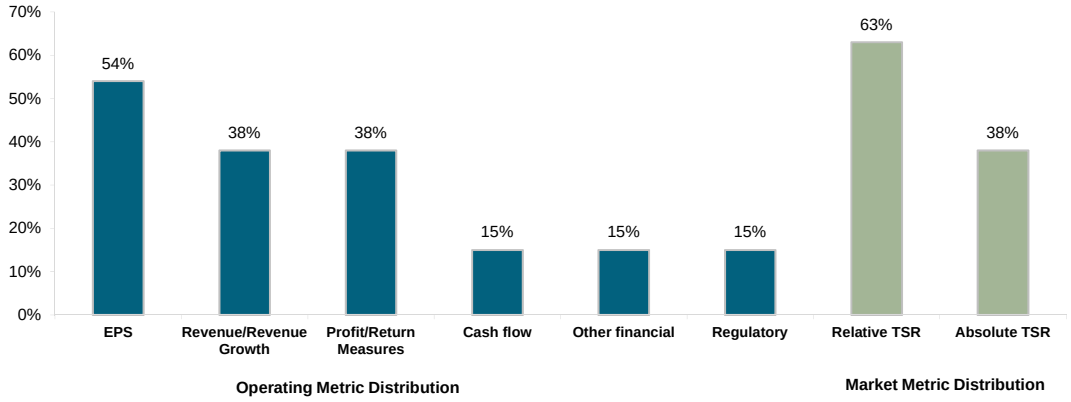
Source: Radford proprietary research.

However, we also note that performance-based equity remains a single tool within a diversified portfolio. About one-tenth of companies in the study used only one equity vehicle, while about 47% used two vehicles, and 43% used three vehicles.

One core design element is the selection of performance metrics that create a direct line between the results achieved and the increase in share price for investors. Metrics selection practices are split, with some companies using operating metrics that align to outcomes under the direct control of management, while others rely on market metrics such as Total Shareholder Return (TSR), which rewards only improvements in stock price or enterprise value. In some instances, companies rely on both metrics, recognizing that the achievement of key business milestones may or may not lead to immediate improvements in share price, although they reflect value creating-events that may reduce the risk to the business. Most companies (about 76%) evaluate performance based partially or solely on operating metrics, such as revenue, profit and cash flow, with earnings per share (EPS) the most prevalent of those. (See Figure 2). Meanwhile, market-based metrics, relative and absolute total shareholder return (TSR), are used by just under half of the companies in the study.

A slight majority of companies (52%) rely on just one metric and the other 48% are divided between using two or three or more metrics reflecting the complexity and inter-relatedness of short-and long-term investment decisions on value creation.

Figure 2: Performance Metric Prevalence: Top 30 Biopharma



Source: Radford proprietary research.

As would be expected, there is a relationship between the performance period duration and whether additional vesting is required to trigger the award (see Figure 3). The most prevalent performance period is three years with awards cliff vesting upon achievement. This is reflective of mid-term or longer-term product cycles, the introduction of new products and a focus on sustainable performance. Shorter performance periods, such as one-year, we find often contain additional time-based vesting restrictions for retention purposes. This may also include the immediate vesting of a portion of the award upon the achievement of the specific performance metrics. Our research does indicate that companies using a one-year performance period more often will mirror the metrics in their short-term incentive plan potentially raising questions on the link between short- and long-term measures that drive improved valuations. (This could have the effect of "paying twice" for the same performance outcome; however, the downside potential of this effect can also be mitigated in the goal-setting process and the migration to multi-year performance periods in the future).

On the other hand, awards with three- or more-year performance periods will typically vest in interim tranches to recognize the intermediate milestones that yield value to shareholders. This practice we found to be rare, which is an unexpected discovery for an industry that takes 10 to 12 years to bring a product from discovery to commercial success.

Figure 3: Performance Equity Vesting Practices: Top 30 Biopharma

Performance Period	Market Prevalence	Typical Vesting Schedule
More than Two Years up to Three Years	65%	Cliff vesting upon achievement
One Year or Less	18%	Additional vesting upon achievement (most fully vest within three-four years once earned)
More than Three Years	12%	Cliff vesting upon achievement or milestone vesting during the performance period
More than One Year and up to Two Years	6%	Cliff vesting upon achievement

Source: Radford proprietary research.

Equity Vehicle Types

There are three fundamental types of equity instruments used in a performance-based equity plan: Performance Share Units, Market Stock Units and Performance Stock Options.

Performance Share (Unit): A performance share unit is defined as a grant of restricted stock (full- value share) predicated on the achievement of performance conditions. Awards are tied to internal operating (such as revenue) or financial market metrics (such as stock price) over a period of time. Performance may be measured or be evaluated based upon achievement of absolute performance goals or performance relative to a set of companies/peers or a broader market index that represents the overall success of the market.

Given the recent economic downturn, many companies are open to the idea of considering performance shares conditioned on market conditions – namely stock price. However, we see differing opinions on relative performance plans vs. absolute performance measurement as the logical tension between management and shareholder expectations.

One of the advantages of relative TSR plans is that they insulate executives from externalities they cannot control, such as macroeconomic shifts. Because they do not require a particular stock price to be determined in advance, they are not at risk of constituting a disincentive during down markets. This advantage is also one of their key drawbacks, because this design facet can potentially reward executives who fail to meet operational goals while the company's stock price nonetheless outperforms that of its peers due to conditions

outside of the influence of the performance of the company. Another key drawback to a relative TSR plan is complexities involved in determining a “relative group or peer group” since the group of companies that an investor might view as relevant may not be the same group used for setting pay levels. Generally speaking, companies will want to look beyond the set of peers they’ve identified as labor and/or market competitors to include companies within the industry that have similar stock price movement patterns akin to their own.

In contrast, plans based on absolute stock price performance are subject to the vagaries of stock price movement for reasons outside of the company’s specific operational performance. While this has the benefit of being easy to communicate and of aligning pay to the expectations of analyst and investors, it does tend to enforce a short-term and narrow perspective on driving share price, potentially to the exclusion of sound investment decision-making and laying the groundwork for longer-term value creation which is a requirement in the bio pharma/speciality pharma industry due to prolonged product cycles.

Operational performance share plans grant units of stock based on the achievement of operational metrics (such as revenue) over a set period of time. In some instances companies may introduce a stock price multiplier or floor price requirement, to increase or decrease the award payout based on shareholder return from the date of grant.

Market Stock Unit: A market stock unit is defined as a grant of restricted stock with the sliding payout scale based on absolute stock price performance compared to the original grant date. A minimum grant of shares may, or may not, be guaranteed regardless of actual performance with the opportunity to earn up to target or higher award level, based on increased stock price performance from the grant date to the vest date.

Market stock units have the advantage of aligning participants with shareholders by adjusting the award size based on share price performance or TSR. They also provide some balancing of countervailing risk by delivering a baseline or minimum grant regardless of performance for services rendered. This could be considered a merit or demerit of the design, depending on your perspective. See Figure 5 for payouts based on different scenarios:

Figure 5: Payout Scenarios for Market Share Units

	Scenario 1 (appreciation)	Scenario 2 (depreciation)
Target MSU Award (A)	10,000	10,000
Stock Price at Grant (B)	$10.00	$10.00
Stock Price at Vest (C)	$15.00	$5.00
Payout Ratio (C/B)	150%	50%
Shares Earned at Vest (AxC/B)	15,000	5,000

Performance Stock Option: A performance stock option is defined as a grant of stock options that is predicated on the achievement of performance conditions to vest in the award. All of the design considerations outlined in the Performance Share Plan would apply to this vehicle as well. Once the award is earned, the stock price must exceed the strike prices for the participant to realize value from the award. While some companies use this vehicle, the award can have a lower perceived value to the extent performance milestones were achieved, but

the share price falls below the strike price. That said, they can also offer added leverage when performance goals are met and the share price responds accordingly.

Defining a Plan Design: Key Issues and Process Steps

There are several key, and relatively universally applicable, issues companies encounter when considering performance-based plans:

- *Developing clarity on the intent of the program*: Is the program meant to be a one-time solution to address a transient issue, or a part of a longer-term plan philosophy?

- *Determining who participates in the program*: Who participates in the program, which is based on the roles that impact the decisions and/ or metrics under the plan?

- *Determining the appropriate mix for long-term incentives:* What is the mix of equity instruments to motivate investment, near- and long-term decision making and which vehicles reinforce the risk/reward goals of the plan?

- *Determining the appropriate metrics and if absolute or relative performance is appropriate*. Each approach carries its own pros and cons. Absolute metrics tend to be best suited to surpassing specific, and broadly understood, hurdles (e.g., FDA approval). However, they may not be correlated to the external influences on stock price (e.g., economic and investor sentiment). Relative goals account for these external influences, but they expose companies to the risk of paying executives for performance or milestones that may not yield actual increases in share price.

Generally speaking, performance-based LTI plans are most effective when approached slowly and methodically. In other words, given the long history most companies have with time-based programs, the introduction of performance-based plans should start off gradually and apply to a discrete population (e.g., the executive team or specific in-tact project teams with a singular focus), before moving to a broad participant base . This approach both allows executives the opportunity to adjust to the new plans, and provides the organization a chance to determine which plan approach, mix of vehicles, and metrics are best suited to the organization. This aspect of the plan may also represent just a portion of the overall equity plan to also provide a hedge against having set the appropriate goals for plan participates.

Once the participant pool is determined, companies should look next at metrics: how many and which types are suitable to drive company performance. Generally speaking, we recommend one or two metrics; focusing on financial metrics has its obvious merits, but non-financial goals are also effective when centered around “transformational” events particularly those that sustain a robust pipeline.

At this point companies will need to determine whether the measurement of achievement against those goals will be done on absolute or relative terms, and whether they use operating or market-based measures. If measures will be relative, peer group selection to assess relative performance must also be done at this phase. As is in the case in all of performance plan design considerations, there are no one-size-fits all answers. Modeling various scenarios is typically critical at this stage to understand how the award would have been paid out based on historical performance. Once the above is determined, next performance and payouts must be defined, and finally the weighting and interdependence of the metrics must be determined.

Recap

Though used to a growing extent by a high percentage of large more established, commercial biopharma organizations (which we expect to continue to evolve to other companies in the industry), it is important to note that performance-based equity is not likely to work for all pre-commercial companies, and more volatile life sciences companies. Companies (of any size) should carefully consider the relative pros and cons inherent in the approach, as follows:

Pros	Cons
> Shareholder friendly providing clearer pay-for-performance linkage > Increases executive focus on metrics critical to long term and sustained increase in shareholder value > Shares not counted against burn rate until actually earned (if awards are not issued up front) > Can facilitate higher levels of long-term value delivery based on performance (over stock options)	> Must reserve shares at maximum in the equity plan > Potential retention issue if performance targets are not achieved or they reflect all or nothing rewards > Increased pressure on determining “right” metrics and reasonable goals > Implementation issues for companies accustomed to time-based awards > Milestone results may not yield increases in shareholder value (e.g., increased share price)

This list of “cons” may be reason enough for many life sciences companies to stick with time-based designs. However, for other smaller companies in the sector, the experience of biopharmas that have already adopted these plans can be instructive. The investor environment is calling for greater alignment between executive compensation and increases in shareholder value leading companies to re-evaluate the effectiveness of all aspects of compensation, especially performance based incentives in the form of cash and equity or long-term compensation.

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