

CAP is Fatally Flawed— the Best Inputs for Pay Versus Performance Analysis Continue to Hide in Plain Sight

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This year's proxy filings mark the first time that public companies have prepared the SEC's new Pay Versus Performance ("PvP") disclosure. The disclosure introduces Compensation Actually Paid ("CAP"), a complex interpretation of pay that adjusts Summary Compensation Table ("SCT") pay by principally "marking to market" the value of granted, outstanding, and vested equity awards within a fiscal year.

The commonly accepted view is that CAP directionally represents the change in equity holding power for an executive in a given year. However, CAP values are highly dependent on pay design, the timing of pay increases for an individual executive, stock price at the end of fiscal years, and other factors that are not immediately apparent when reviewing the disclosure. As a result, companies with similar total shareholder return ("TSR") performance over a defined timeframe can have divergent PvP outcomes that can be difficult to reconcile without a deeper understanding of the CAP methodology's idiosyncrasies.

The disclosure sheds light on specific elements of pay and performance but is not a substitute for time-tested approaches to assess a pay program's efficacy and alignment with performance over a multi-year time horizon. Board compensation committees should continue to rely on more robust benchmarking and outcome-based analyses to assess pay programs. Competitive pay benchmarking, incentive goal rigor analyses, and more traditional realizable pay analyses provide a more exhaustive set of tools to calibrate and assess pay and performance.

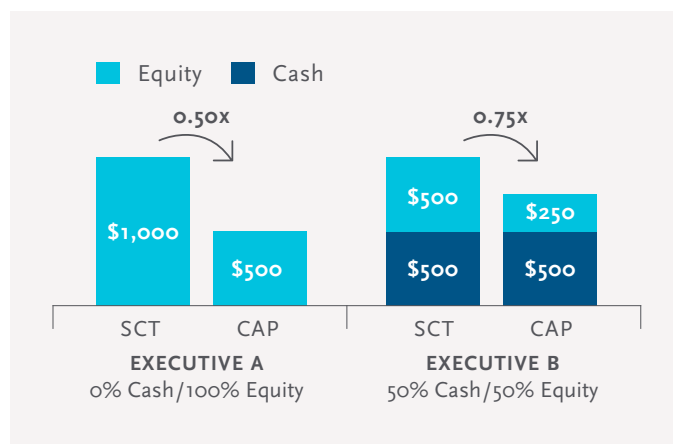


TAKEAWAY 1 Pay Design and Especially Equity Mix Greatly Influences CAP Sensitivity to TSR

CASH TO EQUITY MIX

CAP values are highly dependent upon the weighting of equity relative to cash in an executive's pay package. It is important to note that CAP reflects cash compensation as it is reported in the SCT, without reference to target cash bonus or prior year earnings. Thus, equity is the component of CAP that varies relative to SCT values. The example below shows two executives with different cash/equity pay mixes and the same single-year TSR (-50%) to illustrate this point.

CAP to SCT Ratios Under Different Pay Mixes



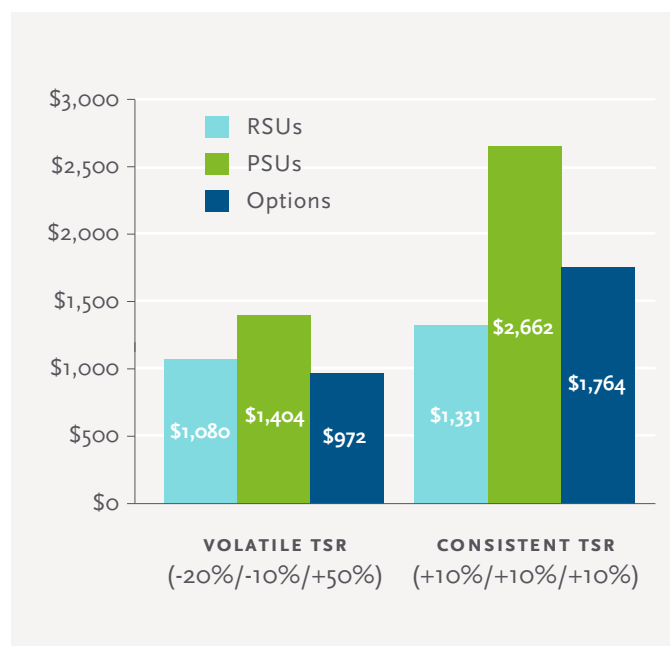
Pay philosophy and pay mix vary based on a company's industry, talent objectives, and growth stage (among other factors).

- Executive pay at a high-growth technology company might be heavily weighted to performance-based equity tied to stock price growth hurdles. The mix and leverage of that design can generate volatile CAP values in the PvP table.
- By comparison, an established technology company may grant more cash and deliver equity in the form of time-vested vehicles, which creates less volatility in the table.

EQUITY VEHICLE MIX

Differences in equity vehicle mix can also yield very different CAP outcomes under similar stock price scenarios. To illustrate, we compared the year-to-year CAP valuations of a \$1.0M equity grant using three different vehicles: time-vested stock awards (RSUs), performance-vested stock awards (PSUs), and stock options. We valued the vehicles in two stock price (TSR) scenarios: a period with inter-year TSR volatility and a consistent +10% TSR CAGR.

Cumulative CAP Values Under Different Stock Price Performance Scenarios¹



¹ Volatile TSR scenario assumes projected PSU performance of 75% at FYE1, 50% at FYE2 and 130% at FYE3 and Black-Scholes value for options of 40% at grant, 24% at FYE1, 16% at FYE2, and 36% at FYE3. Consistent TSR scenario assumes projected PSU performance of 150% at FYE1, 175% at FYE2, and 200% at FYE3 and Black-Scholes value for options of 40% at grant, 45% at FYE1, 50% at FYE2, and 53% at FYE3.

The charts demonstrate how CAP values can diverge for different equity vehicles under the same stock price scenarios.

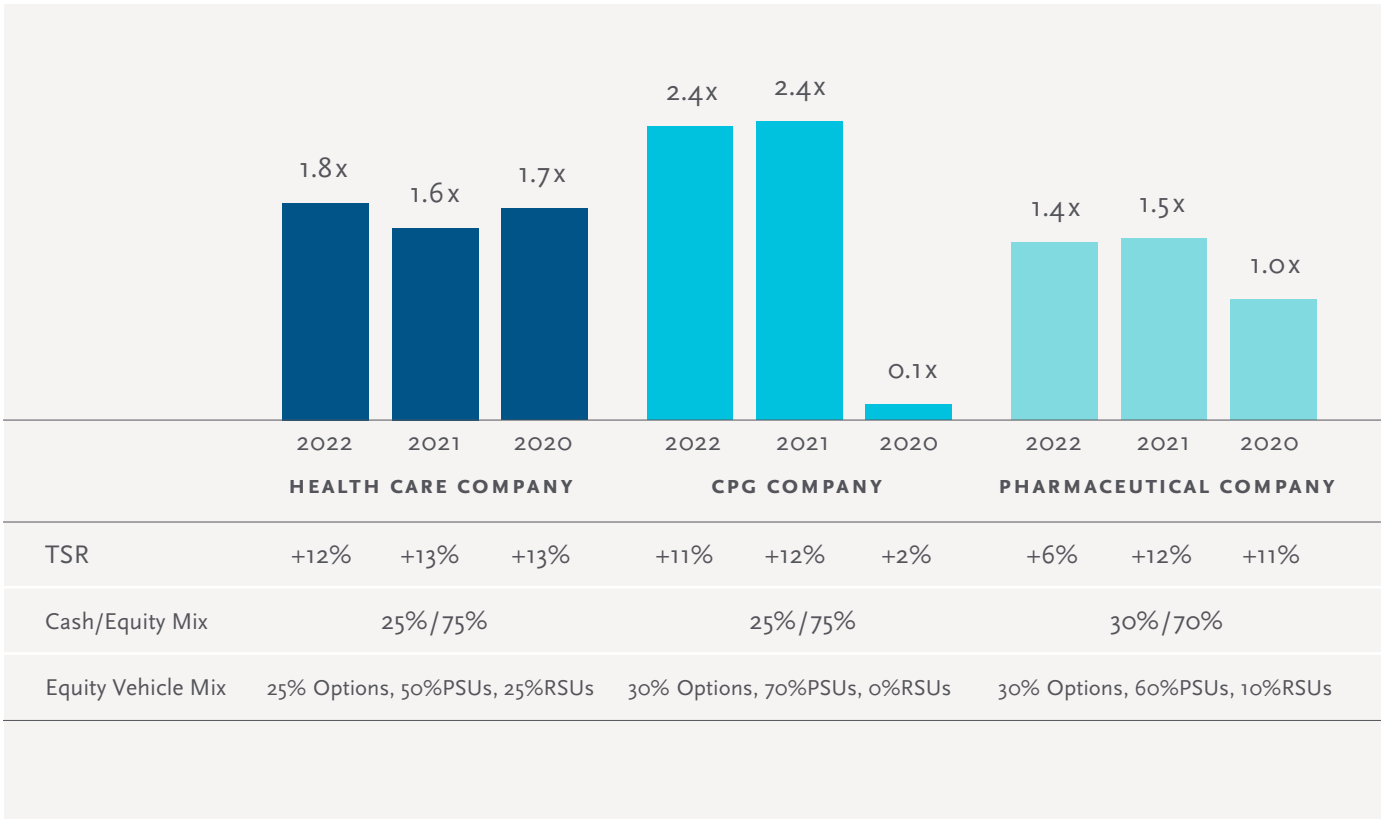
- **RSU** value simply moves 1:1 with stock price.
- **PSU** value tracks with stock price and, under the rules, the number of shares is adjusted at the end of each year based on the forecasted achievement of performance goals at that time. Companies typically establish a payout range of 0% to 200% of the “target” number of shares granted. The adjustments within that range serve as a multiplier—upward or downward, depending on performance—in the CAP calculation. Under this methodology, CAP values for PSUs are more volatile and can be difficult to interpret during periods of market volatility.

- **Stock option** value typically falls somewhere between that of an RSU and a PSU. It is closely tied to stock price but includes additional nuance from the Black-Scholes pricing methodology. The value may skew high or low during volatile trading periods given the importance of the exercise price and the higher number of underlying shares.

Application:
Three Real-World Case Studies

We examined three companies with similar TSR performance over the last three years to test this theoretical model in the real world. These examples show how the CAP calculation mechanics can cause companies with similar annual TSR profiles to have significantly different PvP outcomes.

CAP to SCT Ratios Among S&P 500 Companies with Similar 3-Year TSRs



The divergent PvP outcomes for these companies are explained by different design features for each of their programs, which are not clearly disclosed in the PvP table:

- 1. Cash/equity mix:** The Pharmaceutical company had the highest percentage of compensation delivered in cash, and cash is fixed in the CAP reconciliation of SCT. This contributed to more stable CAP values that were closer to 1.0x the SCT value when compared to the other companies.
- 2. Equity mix:** The CPG company had the highest degree of volatility in CAP values. Their equity mix had the highest weighting of PSUs and no RSUs. The performance-based vehicle adds volatility from the annual performance projections.
- 3. Achievement of performance goals:** The CPG company had the highest degree of volatility in CAP values. Their equity mix had the highest weighting of PSUs and no RSUs. The performance-based vehicle adds volatility from the annual performance projections.

TAKEAWAY 2 | Other Factors Limit the Disclosure's Effectiveness

The PvP disclosure methodology relies upon other inputs that may not reflect actual pay and performance dynamics or the compensation committee's intent with grants.

- 1. PvP disclosure overemphasizes the stock price at the start and end of the year.** The CAP calculation generally captures the change in equity from the start of a fiscal year to the end of the fiscal year (or at the point within a year where an award vests). Similarly, the CAP methodology adjusts outstanding PSU performance and option fair value assumptions based on forecasts at the end of the year. The point-to-point stock prices tell a simple story but do not reflect price fluctuations throughout the year when the shareholder experience could have been better

or worse. In particular, stock price swings around an annual grant date, vesting date, or the fiscal year end could yield very different CAP values at the end of the year that are not necessarily reflective of actual performance.

- 2. CAP comparisons within the table include several timing disconnects.** CAP values can include grants made in any number of years so long as a portion of those grants remains unvested. By comparison, the SCT values focus on the fair value of awards granted in that year. Additionally, financial and TSR performance horizons in the PvP table are fixed by the SEC and do not necessarily align with the timing of grants used to calculate CAP.
- 3. Changes to a pay program are not identifiable through the disclosure.** CAP values alone do not demonstrate the effect of pay progression or changes to pay structure. Pay changes may have an immediate impact on SCT values, but the relationship between pay and performance is obfuscated by the disclosure's definition.
- 4. Options are represented on an understated timeline.** Options are valued using Black-Scholes valuations, which can employ varying assumptions about the term of the option. This means that any growth (or loss) in stock price after the vesting date is not captured in the CAP calculation despite its impact on the economic value realized upon exercising the options.
- 5. CAP methodology does not pick up target versus actual bonus paid.** Cash is a fixed value in the CAP and SCT methodologies. The annual bonus can be a meaningful portion of variable compensation; however, the CAP methodology does not include any attempt to adjust or reconcile the difference between target and actual bonus values.
- 6. PvP disclosure does not account for the rigor of performance goal-setting.** The rigor of goals has a significant impact on PSU valuations, which can drive substantial changes in CAP calculations versus SCT values.

7. PVP disclosure lacks a consistent relative performance

comparison. Company TSR is measured against the indexed peer group TSR, which helps to understand relative performance. However, there is no consistency in peer groups across companies.

CONCLUSION

How Should Companies Use PVP Disclosure?

The disclosure is a helpful back-of-the-envelope snapshot of the change in equity holding power for the CEO in a given year. However, it is difficult to distill the complex notion of “pay versus performance” into a table that is both intuitive and comprehensive.

As such, we suggest that compensation committees continue to answer the following questions when assessing the reasonableness of pay and performance outcomes:

1. What was the overarching metric(s) of success over the timeframe analyzed, and how did the company perform on a relative basis against peers?
2. Were executive target pay opportunities competitive in terms of pay levels and pay mix?
3. Were incentive plan goals appropriately calibrated relative to internal budgets, external analyst expectations, and industry growth rates/benchmarks of success?

4. Were realizable pay opportunities appropriately aligned with performance against the “metric of success” over multiple time horizons (typically 3, 5, and 10 years)?

This multi-faceted approach to measuring pay for performance allows for a holistic analysis of inputs and outputs, and it also ensures that the compensation committee maintains a constant pulse on the efficacy of the pay program—including whether the program incentivizes performance against the right “metrics of success.”

External stakeholders can use the information provided in a company’s proxy statement to take a similar approach. The compensation tables provide complete information about equity awards, and the proxy Compensation Discussion and Analysis section provides information on goal-setting rigor, pay mix, incentive plan payouts, and a narrative description of why companies chose their pay designs. These pieces of information as a whole can provide a better picture of a program’s competitiveness, particularly against peer companies, and can help ground stakeholders in the broader story of performance that might otherwise be lost in the PVP table and its accompanying narrative. ■

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