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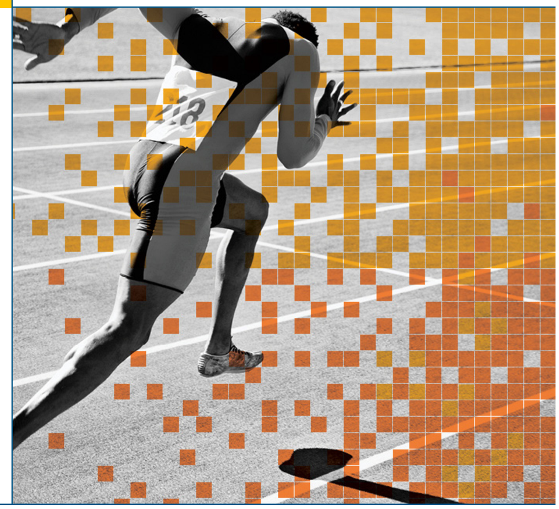

# Should You Rethink Your Use of Performance Share Units?

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While many of the practices discussed are, and should remain, prominent components of pay programs, shifting investor preferences and macroeconomic challenges make this a good time for compensation committees to review their current programs and ensure they're still the best option to drive both pay-for-performance alignment and long-term value creation. In this article, we take a comprehensive, thought-provoking look at areas of the executive pay status quo to explore why they became industry standards, how you can determine if they're right for your organization, and several alternative models that are emerging.

## Re-Thinking the Status Quo

While Performance Share Units (PSUs) have existed for decades, their popularity surged following the 2005 requirement to expense stock options at fair value. Spurred by proxy advisor preferences, companies began implementing PSUs along with traditional options, attracted by their flexibility in leveraging pay delivery and presumed pay-for-performance alignment. More recently, a number of companies have replaced options entirely with PSUs to focus more on financial measures executives can control, while still balancing against shareholder value creation.

Executive pay has grown rapidly over the last decade, and much of that growth has come in the form of PSUs. According to our Pulse on Pay report, PSUs were granted to 95% of S&P 500 CEOs last year and now make up 60% of the average S&P 500 CEO's long-term incentive (LTI) plan mix, up from 44% in 2012. There is a strong rationale behind this growth: when pay programs incentivize executives to focus on long-term shareholder value, they work exceptionally well. Performance-based vehicles are powerful tools in compensation committees' arsenals.

As PSU prevalence grows, however, companies are running up against several challenges that threaten to undermine true pay-for-performance practices if not carefully monitored. In addition, some influential investors have begun to question standardized PSU programs. Given recent guidance from Institutional Shareholder Services (ISS), compensation committees now have some latitude to re-examine whether their PSU programs live up to their full potential.

## Specific Goal-Setting Challenges May Hinder PSU Effectiveness

One of investors' perceived issues with PSUs is the challenge of setting accurate multi-year performance goals, especially amid today's sustained macroeconomic and geopolitical volatility. When the future is murky or rapidly changing, multi-year goal setting can be particularly difficult for some companies.

In addition, not all situations lend themselves to long-term goal-setting, even if volatility subsides. High-growth and/or cutting-edge companies may also face difficulties forecasting three-year financial targets with accuracy. Similarly, companies undergoing significant investment phases that will impact specific financial metrics, or those expecting downward revision to financial performance, may struggle to set goals that remain meaningful throughout performance periods.

Finally, overly rigorous goal setting can also introduce retention risks. Compensation committees find themselves walking a precarious line between setting challenging yet achievable goals. Miss the mark with overly aggressive targets, and executives face low holdings and realized pay, potentially dampening motivation and causing unwanted attrition. Set goals too conservatively, and companies face "over payouts" that draw criticism from proxy advisors and shareholders.

This confluence of goal-setting challenges is forcing companies to take a fresh look at their PSU programs and investigate the ways in which PSUs mesh with the overall business strategy.

## Questions to Help Effectively Evaluate Your PSU Programss

Compensation committees can benefit from asking themselves several critical questions about their pay programs and strategic goals to help ensure PSU programs are functioning as intended:

- **Do standard financial goals best capture our company's strategic priorities?** While revenue and earnings metrics may work for an established company in a mature industry, conventional metrics might hamper long-term growth for a younger company focused on market share expansion or customer acquisition.
- **Do performance-based metrics encourage the behavior we want from our leadership team?** If PSU metrics create unintended consequences or fail to motivate desired behaviors, the program may be undermining, rather than supporting, company objectives.
- **Does a focus on 3-year performance goals directly align with our business cycles?** For example, given the time horizon and the intensive capital required to develop accretive infrastructure in the oil industry, one leading company, which does not grant PSUs, built its incentive plan around 10-year-vesting RSUs (half vests after five years, the rest after ten). The company implemented the program over twenty years ago and still uses it today. They believe this approach better focuses the executive team on long-term success rather than on shorter-term performance goals.

Just because the answer is "no" to one or more of these questions doesn't necessarily mean a company should eliminate PSUs from a pay program. Asking these questions can highlight areas where pay-for-performance may be misaligned or where considering a different approach may lead to stronger incentive plans.

## Alternative Approaches to PSU-Heavy Pay Programs

Committees have several options for addressing PSU limitations without running afoul of investor desire for performance-based pay packages.

- **Relative goals in place of absolute targets** can help address forecasting challenges while maintaining performance orientation. Annual revenue growth relative to a peer set, for example, maintains competitive focus without requiring precise, absolute predictions.
- **Increased RSU or options weighting to create more modest PSU mixes** (such as 25% rather than 50% of the equity grant) can reduce overreliance on PSUs while maintaining some performance-based component. Replacing PSUs with a lower, equivalent value of RSUs can even reduce pay relative to peers while improving pay delivery certainty—a combination that may resonate with both executives and shareholders concerned about pay levels. As we discussed in our article on moving past PSUs, companies can merge this approach with longer vesting to further enhance the long-term alignment with shareholders.
- **Shorter performance periods, with extended time-based vesting,** may offer committees a middle ground. These come in different flavors and are most effective when aligned with key milestones within the business cycle. For example, a two-year performance period may be better if a company's business cycles are shorter. Alternatively, a company could implement one-year performance periods with a three-year modifier, multiple one-year periods, or overlapping measurement windows (e.g., one-, two-, and three-year periods). The intention of these methods is to recognize that timelines for business outcomes may differ. These different approaches allow PSUs to maintain a long-term perspective while improving (or reducing the sensitivity to) goal-setting accuracy. Note, however, that shareholders are often less receptive to shortened periods.

Some of these approaches may still trigger scrutiny from proxy advisors. Therefore, it's important companies provide a thorough rationale in their proxy statements about why they made specific changes. A compelling rationale should be rooted in the company's strategic priorities and talent needs.

## Reexamining PSU Programs Allows Committees to Embrace Strategic Flexibility

None of this is to say that PSUs can, or should, disappear from pay mixes. PSUs, like any tool, work best when they fit the specific circumstances and strategic needs of the organization. Rather than defaulting to industry practice, committees may want to evaluate whether their current approach truly aligns with their company's strategic priorities and business realities. As always, the goal of a strong pay program is not to eliminate accountability or performance orientation, but to ensure that compensation practices inspire and enhance long-term value creation. ■

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