A Better Way to Align Pay, Performance

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In recent years, a lot of discussion about aligning pay with performance for corporate executives has focused on the use of performance conditions for equity grants. The idea is that by tying the vesting of equity to explicit performance goals, executives will be held more accountable for results in order to "earn" the major share of their compensation.

However, in today's environment, proxy advisors and many shareholders are often more concerned with the reported accounting value for equity incentives at grant rather than how much is actually earned by executives for performance. As a result, while performance share plans clearly have a role to play in executive compensation design, they are far from a panacea to address the pressure to improve pay for performance alignment.

Another Way to Align Pay with Performance

Is there another way to demonstrate alignment between pay and performance in addition to the use of performance shares? Perhaps.

SBCG's extensive analysis of pay for performance relationships indicates that simply granting the same number of shares each year to individual executives — rather than using a grant date target value — might result not only in more perceived alignment between pay and performance as measured on the grant date, but also in more actual alignment. The basis for the improved alignment associated with fixed share grants we believe is fairly intuitive. By granting a constant percentage of the company's market capitalization each year, the amount of gain realized by an executive (or group of executives) should directly track the change in value of that market capitalization. Thus, actual pay and performance should be aligned.

Let's take a look at the external and internal (perceived vs. actual) perspectives in more detail.

External Perspective

For many shareholders — and their proxy advisors — pay-for-performance alignment is defined primarily based on the "grant date fair value" (GDFV) of equity grants, rather than how much an executive actually earns when, or if, the shares eventually vest. The logic for this is that GDFV:

- Is reported on a consistent basis across companies;
- Has historically been the main basis for executive pay benchmarking and the determination of grants; and therefore
- Generally reflects the decision-making process of the Board (what they actually controlled in a given year)

Regardless of the limitations of the GDFV approach to evaluating equity, it seems likely that shareholders will continue to include the values reported in the proxy as at least one factor they consider when evaluating pay and performance alignment.

However, when targeting a specific value of equity, it becomes easy for the apparent alignment of pay and performance to become disconnected. For example, let's take a company with a highly volatile share price and assume that the compensation committee targets the median of peers for their CEO compensation. As the share price fluctuates each year, the compensation committee adjusts the number of shares granted to keep the GDFV of equity competitive with peers. If the market rate of pay for the peers goes up each year (and the company follows suit), the reported value of pay keeps going up while performance — as defined by Total Shareholder Return (TSR) — is often down year over year and over time.

Now let's take the same example, but assume instead that the compensation committee decided to fix the number of shares granted at the beginning of the five-year period. Under this approach, fixing the number of shares means that the reported value (GDFV) of equity fluctuates with the share price (rather than increasing year over year with market), resulting in much greater apparent alignment between pay and performance at any given period of time.

Actual Value

Perhaps more importantly, moving to a fixed share approach can also result in better alignment between actual value received by an executive and TSR performance. Let's take, for example, the same consumer-products company discussed above and assess what happens to the "realizable value" of pay at the end of five years under the traditional value-based grant approach vs. fixed-share grants. Our analysis shows that the cumulative value earned over time for the CEO receiving value-based grants can exceed the values for a CEO receiving a fixed share grant by a significant amount, even if the share price is meaningfully lower at the end of the period as compared to the beginning. This outcome is the result of pay for volatility rather than pay for sustained performance. When the stock price is sharply down, a larger number of shares need to be provided to maintain a target level of value-based grants, and these grants can result in significant payouts when the share price recovers, even if that recovery is only partial, as shown in this real-world example.

This "pay for volatility" is always a feature of equity awards that target a given value of stock awards. And it can cut both ways, either under- or over-rewarding an executive for performance.

We tested this same comparison of value-based grants vs. fixed-share grants across the S&P 500 companies over the last decade and the results were astounding — especially during periods of high market volatility (e.g., 2008–2012). The realizable pay for a CEO at the end of the period would be significantly more aligned with TSR performance if all the companies had fixed the number of shares granted at the beginning of the period rather than trying to adjust for a target "value" each year — the correlation (R-squared) was close to 96% for the fixed share

approach vs. 62% for the value based approach over the 2008–2012 period, for example.

We tested this result over multiple five-year periods and using different mixes of stock options and full-value shares, and the result was always the same — in aggregate and over time, a fixed share grant approach is always more aligned with TSR performance than a value-based approach. The difference is most compelling in periods of extreme volatility — and in practice many Compensation Committees would likely moderate the results of a pure "Black-Scholes" model in such circumstances — but the difference persists throughout all of the iterations we tested.

In Summary

While not for every company, a fixed-share or dilution-based model for granting equity may make more sense than a "target" value approach in some cases. This is particularly true for companies in highly volatile markets, where standard valuation approaches for equity incentives may not work very well, and where adjusting the number of shares each year can further magnify the outcomes and generate "pay for volatility" rather than "pay for performance."

The benefits of this approach are:

- Easy to understand and communicate to participants and shareholders
- Reported grant-date values can be more aligned with performance in the short-term
- Actual values will be more aligned with performance in the long-term

There are many details that need to be assessed to implement such a program in practice — and there are other, less radical, approaches which can help achieve some of the same objectives (e.g., using average prices over a longer term to calibrate the value of grants) — but the idea of sharing a fixed portion of the ownership with management each year has its benefits and is worth consideration for some companies.

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