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When Do Performance Options Make Sense?

INTRODUCTION

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Many executive compensation observers have suggested that performance options — standard stock options with one or more additional performance conditions — will become a more significant and prevalent long-term incentive vehicle over the next several years. This viewpoint is driven by the perspective espoused by proxy advisors (e.g., ISS and Glass Lewis) and some shareholders that time-vested options are not "performance-based" because the opportunity is earned over time regardless of performance and the ultimate value delivered[1]. The argument follows that since performance-based equity is a superior incentive to time-based, options with performance conditions to be earned must be "better" than time-vested options. These observers expect the use of performance-based options to grow just as performance shares grew alongside or as a replacement to time-vested restricted share awards.

The countervailing view is that time-vested options are already performance-based. Their direct tie to share price appreciation matches the overriding measure of performance used by proxy advisors and many shareholders. We believe this viewpoint is held by many Compensation Committees and executives at companies that still provide options as a

[1] Note that the discussion of defining "performance-based" pay is a broader topic than we address in this article.

WHAT'S THE BIG IDEA?

Performance options are not a perfect tool to reinforce shareholder alignment. However, there are scenarios where the "double-jeopardy" of performance options is appropriate and valuable.

- Turnarounds and open-field growth opportunities are best suited for "offensive" use of performance options, where additional hurdles make sense to ensure or maximize results.
- Defensive use of performance options may be a reality when areas of significant shareholder concern must be addressed.

component of pay. From this perspective, subjecting options to additional performance conditions subjects the recipient to "double-jeopardy" — that two conditions must be met for the recipient to realize value from an award. Indeed, 2012 data to date shows that the use of performance options in the S&P 500 has not increased materially — see sidebar for S&P 500 companies that used performance options for Named Executive Officers in 2011.

S&P 500 Companies Granting Performance Options to Named Executive Officers in 2011

ALL NEOs

- C.H. Robinson Worldwide
- EMC
- Hudson City Bancorp
- JDS Uniphase
- Time Warner Cable
- Chipotle Mexican Grill
- Hewlett-Packard

CEO ONLY

- Advanced Micro Devices
- Eastman Chemical
- Lockheed Martin
- Motorola Mobility Holdings
- Motorola Solutions

Our perspective is that performance options can be highly effective, but in limited scenarios and for specific purposes. We have categorized their potential use as either "offensive" or "defensive". Offensive scenarios are where a highly-leveraged opportunity is provided to capitalize on specific performance imperatives, such as maximizing growth opportunities or executing a turnaround. Defensive scenarios are those where stock options are still considered an appropriate and effective vehicle to drive executive performance, but significant external pressure exists from shareholders about the form or magnitude of incentives and performance conditions are implemented to reinforce alignment with shareholders.

What is a Performance Option?

A performance option is simply a stock option with additional performance conditions that must be achieved for the option to vest or become exercisable. In a sense, this creates two performance conditions for the option — the stock price has to appreciate for the option to be worth anything and then the performance condition has to be achieved before the option can be "earned" or exercised.

Table 1. **Performance Option Accounting and Disclosure Treatment**

	PRICE-BASED *(i.e., "Market" conditions)*	FINANCIAL CONDITION
Example	Stock price hurdle, premium priced option, relative TSR	Financial measures (revenue growth, earnings growth, return on capital), operational objectives
Accounting	• Total expense fixed at grant and is not trued up for actual value delivered • Typically results in a lower grant date value than a plain-vanilla option • Monte Carlo or binomial valuation to determine grant date value	• Initial expense based on expectation for number of options to be earned • Final expense equals number of options earned times per-option grant date fair value • Can result in a lower value at time of grant but value trued up each quarter based on expected number of options to be earned
Disclosure	Grant date value disclosed in the Summary Compensation Table and Grants of Plan-Based Awards Table at grant	

In the limited number of instances that we observe performance options, the performance condition is either a stock price hurdle or a financial goal, such as revenue or earnings growth. The accounting requirements for a performance option vary depending on the performance measure (as shown in Table 1), but the proxy disclosure requirements are the same for any type of performance condition.

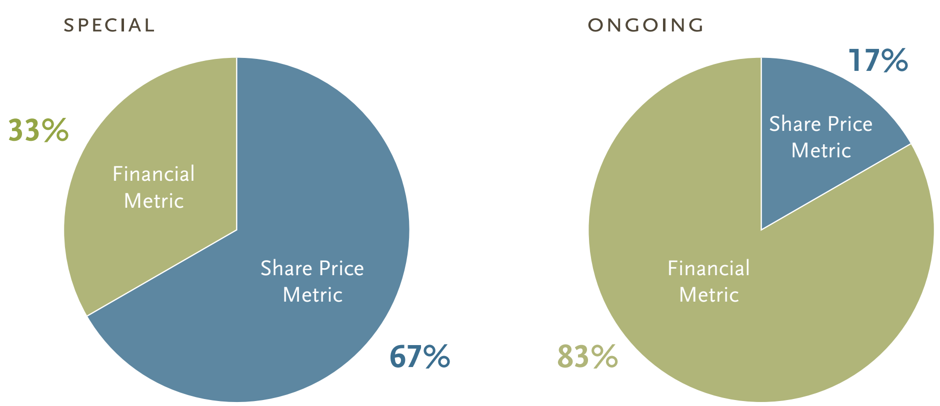
The additional performance requirement may lower the accounting value of the option, so the reported value of a performance option grant can be lower, or more options may be granted to deliver the same grant date fair value as time-based options. So, adding performance conditions can be used to increase the leverage of an option plan for an equivalent accounting value. The downside is that if goals are set too aggressively, performance options can either lead to inappropriate risk-taking behavior or become ineffective at motivating performance if the goals are seen as unattainable.

How Do Companies Use Them?

We identified only 12 S&P 500 companies that used performance options in 2011. Of these 12:

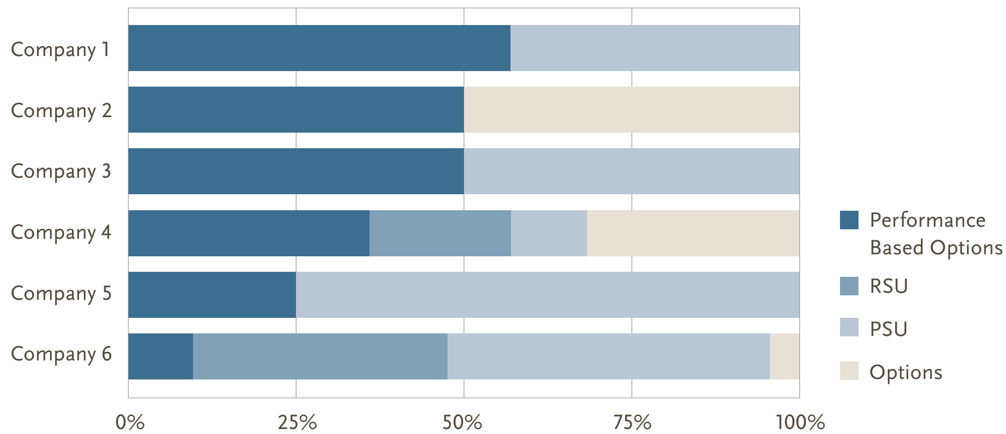
- 6 were described as one-time awards, and 6 as ongoing programs (per proxy disclosure)
- 5 of 6 one-time awards were granted to the CEO only
- All 6 of the ongoing programs were granted to all NEOs
- Performance conditions for special awards were more often share price based, and for ongoing awards almost always financial or operational

Figure 1. **Performance Measures — Special and Ongoing Awards**



Every one of the 12 companies used another equity vehicle in conjunction with performance options – time-based options, time-based RSUs, or performance shares. Performance options represented at least 50% of 2011 equity compensation at 3 of the companies that noted “regular” awards, as disclosed in the Grants of Plan Based Awards Table of the proxy.

Figure 2 **Performance Options % of Total Long-Term Incentive Grant Value**



When Do Performance Options Make Sense?

Despite the limited use of performance options today, there are circumstances where the additional conditions make sense. We have categorized these into "Defensive" and "Offensive" rationales in Table 2.

An example of Defensive use would be at company with an option-heavy compensation program that receives a significant "no" vote percentage on Say on Pay. Such a company might consider adding performance conditions to the stock options for the CEO in order to "get credit" for alignment with shareholders.

A more strategic, and in our view a more effective, use of performance options would be in a company on a turnaround or with a significant strategic growth opportunity, when objective long-term performance goals can indicate that the opportunity is being exploited, then the additional leverage may make sense. While public company use is limited, we often observe performance options in private equity transactions. These options are typically based on achieving financial or liquidity milestones. The concentrated group of investors with more explicit return expectations and timeframes enhance the shareholder alignment created by performance options.

Table 2. **Defensive and Offensive Use of Performance Options**

	DEFENSIVE	OFFENSIVE
Potential Circumstances	• Responding to a low Say on Pay vote or potential low vote • Investor concern with lack of pay and performance alignment	• Special program, e.g., new hire, transaction-related award • Galvanize executives around a specific corporate goal • Deliver highly leveraged pay opportunity
Characteristics	• Performance requirement aligned with investor expectations • Similar number of shares granted compared to "regular" option grant	• Stretch performance requirement • Often more shares awarded for a specific accounting cost, recognizing more difficult goal

In either case, we believe it is often effective to balance performance options with other vehicles given the riskiness of the award and the difficulty setting long-term goals. This avoids the potential for excess risk taking that can occur if a company puts all its “eggs in one basket” from an incentive plan standpoint and sets overly aggressive goals.

We also note that it is often possible to achieve many of the objectives listed in Table 2 using performance shares rather than options, which may be another key reason that performance options have not become more prevalent. Using performance options in place of performance shares clearly creates a program more leveraged to share price, but in most cases, we believe that highly leveraged and more risky programs created with performance options are not necessary, and as a result most companies opt for a more risk-averse approach to performance-based compensation.

In Summary

Performance options can be highly effective incentive tools, but in very limited circumstances. They can be used defensively, which is less effective but sometimes necessary. The more effective use is strategic and focused on very specific goals and objectives. These are often transformational achievements, such as capitalizing on a new major growth area or executing a turnaround in a distressed company.

Some of the factors that should be considered when evaluating the use of performance options include:

- What is our objective in adding performance conditions (defensive or offensive)?
- What metrics are important and can we set meaningful goals?
- What happens if we are too aggressive or business conditions change?
- Are we comfortable with the risk-reward implications?
- What other vehicles could be used to achieve our objectives?

If used appropriately, performance options can be an effective vehicle for demonstrating and motivating performance, but there are very specific circumstances in which they are most useful. Despite external pressure to maximize “performance-based” compensation, the prevalence of performance options is likely to remain limited.

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