Executive Long Term Incentives: Making the Jump to Market Stock Units

Historically, technology companies have relied heavily on stock options to deliver executive long-term incentives. Many entrepreneurs and investors view options as the ultimate "pay-for-performance" vehicle, and employees in Silicon Valley have become accustomed to receiving these awards regardless of their rank, tenure, or title. Recently, however, we've seen a notable decline in their use, including among smaller growth companies.

Executives, Compensation Committee members, and compensation professionals have all taken note of the following realities:

- Stock options are often less attractive after taking into consideration differences in the accounting cost and the employee's perceived value of the award
- Institutional Shareholder Services ("ISS"), the influential proxy advisory group, treats options less favorably than other award types in both its dilution and pay for performance analyses
- After two major stock market declines, companies prefer to limit the risk of slipping into underwater option problems
- Critics are increasingly vocal in their opposition to what they view as "windfall" gains based on market, rather than company-specific, performance

Taken together, we have come to observe that stock options are not always the best compensation vehicle despite their past prominence. Knowing this, while also facing today's more challenging economic and political environment, companies are wrestling with how to provide effective long-term incentives going forward. Questions that come up include: Do options still work? Are restricted stock unit awards ("RSUs") a better alternative? Should performance shares be introduced?

In this Thoughtful Pay Alert, we consider these issues and focus on alternative approaches to performance-based long-term incentives. In particular, we discuss the merits of equity vehicles with vesting linked to stock price performance. In our view, these awards are an under-utilized approach, but can be a highly effective tool for many technology companies.

Company Lifecycle and Compensation

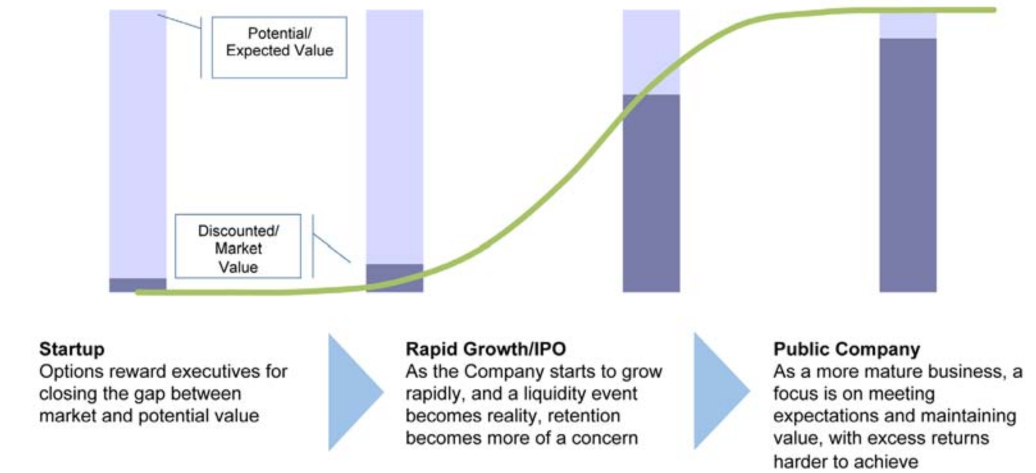
As a business evolves and matures, factors that impact compensation decision-making and plan design also change. For the early stage company, the focus is almost entirely inward. Performance milestones include raising capital, building a team, developing a compelling product or service, and generating the first dollar of revenue. As shown in Illustration I, start-up companies are notable for the significant discrepancy between the discounted market value of the company and the value investors place on the potential of the enterprise. Due to the substantial uncertainty regarding actual outcomes, investors will realize significant gains if the company's potential is realized; value creation is driven more by company-specific events than by market forces. In this environment, stock options reward executives explicitly for their success and strongly align management and investors.

Over time, and as the company reaches a more mature state, its investor profile changes and expectations shift. With greater transparency around strategy and performance, there is a greater emphasis on value preservation and delivering a competitive risk-return profile. In addition, ownership is likely to be widely dispersed and effective corporate governance – with an emphasis on independent board oversight and accountability to shareholders – is essential.

For these more mature companies, the value proposition has changed. As Illustration I highlights, the gap between market and potential value has narrowed due to more modest uncertainty regarding the viability of the company's product or strategy. In this case, the company's value is much more sensitive to general market movement and the executive team will contribute to excess risk-adjusted returns (alpha, among professional investors) only by exceeding expectations and beating the competition.

Executive Long Term Incentives (continued)

Illustration I
Company Lifecycle



It is for these organizations that stock options have the most notable flaws:

- Expected returns are modest compared to those of a start-up company, resulting in less meaningful motivation despite embedded leverage
- Market-driven fluctuations can unfairly reward or punish executives without accounting for "true" executive contribution
- In times of company-specific distress, when retention is most needed, options offer little reward for loyalty or motivation for future effort

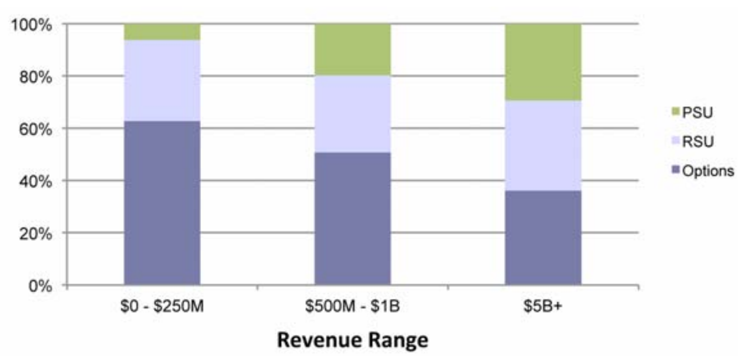
To address these issues, many companies – primarily larger firms, although we are seeing increased RSU use throughout the technology sector – have turned to RSUs. In many ways, RSUs are the flip side of stock options. They provide less leverage than options, but deliver value to recipients in almost any market condition. However, the very virtues of RSUs are also their shortcomings: their lack of leverage tempers the motivation incentives provided, and the use of service-based vesting leads to the (not wholly unfair) criticism that they can amount to "pay for pulse."

Balanced Incentives

A more balanced approach, and one that we recommend for many of our clients, is a portfolio of long-term incentives that incorporates stock options, RSUs, and performance shares. As shown in Illustration II, there is a clear trend among larger companies toward this incentive mix. Even among the smallest companies, 40% of long term incentive value is delivered in full value shares.

Performance shares attempt to strike a balance between stock options and RSUs. Essentially, these are shares of stock that are earned based on stock price or operating perfor-

Illustration II
Bay Area 150: Average Executive Equity Award Value



Executive Long Term Incentives (continued)

mance over a fixed period of time. To date, and as shown In Illustration III, most performance share programs have tied vesting to the achievement of financial metrics (for example, revenue, profit measures, etc.). However, we believe there are several disadvantages associated with this approach:

- The metrics may be redundant with a company's annual bonus plan
- The motivation/retention incentives may decline if goals are viewed as unattainable (in other words, performance share programs may be as fragile as stock options)
- Many companies find it difficult to establish multi-year operating targets
- Despite an assumption that operational performance will translate into shareholder value creation, the link is indirect
- These programs may trigger SEC disclosure obligations that may conflict with desired guidance to Wall Street and/or trigger competitive concerns

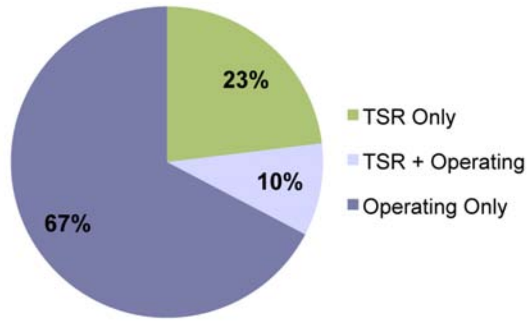
Market Stock Units

For these reasons, we find that many companies would benefit from incorporating Market Stock Units ("MSUs") into their executive incentive programs. Typically, an MSU is granted for a target number of shares, but the actual number of shares earned will fluctuate based on the company's stock price performance relative to an external benchmark (for example, peer group stock price performance, an industry-specific index, or broader index such as the Nasdaq) or based solely the company's own stock price performance. These two different types of awards may be referred to as either relative or absolute MSUs, respectively. We find that relative MSUs in particular possess several advantages over other equity vehicles:

- They are significantly less fragile than stock options and traditional performance shares, providing good motivation/retention incentives in both up and down markets
- The link to shareholder value creation/preservation is direct (performance against a bad business plan will not drive high levels of reward)
- Forecasting/goal setting is not required
- Stock option levels of leverage can be achieved

Illustration III

Bay Area 150: PSU Performance Metrics



As highlighted by Illustration IV, relative TSR shares can accommodate a broader range of performance outcomes by fluctuating with both absolute and relative performance.

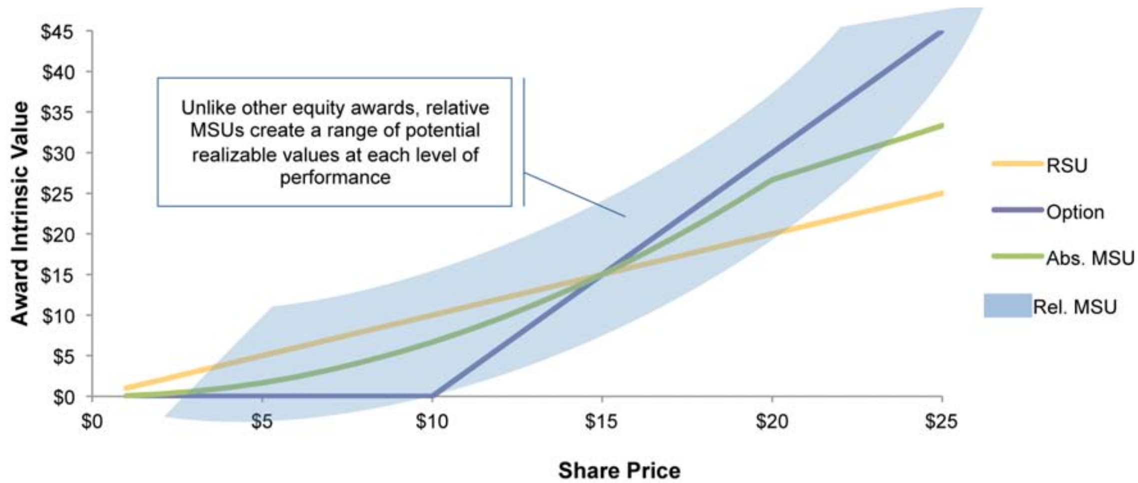
Despite their benefits, companies should recognize that MSUs come with some additional administrative complexities. In particular, the design process for MSUs is more intensive than it is for traditional stock option or RSU programs (though arguably less complex than traditional performance shares). Some of the features that require careful consideration include:

- Whether the performance benchmark will be a standard index (for example, Nasdaq, Russell 3000, etc.) or a custom peer group;
- Whether performance will be the company's rank among peers in the benchmark or the percentage by which performance is above or below the benchmark;
- The impact of such performance on the payout percentage, including whether there will be a minimum performance threshold;
- The maximum number of shares that can be earned; and
- How the awards will be treated in the event of various termination events or the achievement of full career/early retirement provisions.

While the hurdles we've pointed out are all solvable issues, they make clear that the modification of an executive long-term incentive program is a significant undertaking. We recommend that companies considering a change give themselves a long lead time to work through the design

Executive Long Term Incentives (continued)

Illustration IV
Equity Award Alternatives



carefully, ensure that key stakeholders are engaged and understand the program, and give internal personnel adequate opportunity to work with accountants, stock plan professionals, valuation experts, and others who will be critical to a successful transition.

Conclusion

In this Thoughtful Pay Alert, we discuss the advantages of MSUs when used in the proper setting. We believe that many companies would find them to be a valuable addition to their portfolio of executive long-term incentives. Over the longer term time horizon, executive compensation should be closely aligned with shareholder value creation. Over the short-term and mid-term time horizon, to accomplish that goal, companies are designing programs that: link the grant value of incentives to past performance; tie the future vesting of some portion of awards to future performance; fluctuate with both share price and operating performance; and incorporate a mix of equity vehicles to support the dual objectives of motivation and retention. In support of this goal, MSUs are a useful tool, but should be considered as one element of a balanced, thoughtful approach to executive total reward strategy.

About the Authors

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Need Assistance?

Compensia has had significant experience in advising technology and life science companies on designing performance-based incentive compensation programs. If you have any questions on implementing a performance-based incentive compensation program, please feel free to contact us. ■

Executive Long Term Incentives (continued)

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

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