February 27, 2024

Performance-Based Equity Program Check-Up: Relative TSR Design Trends and Practices

Pressure from shareholders and institutional investor advisory groups to include stock performance metrics in incentive compensation plans, balanced with demand for a simple, yet durable approach to performance-based equity, has led to continued interest in programs that measure relative total shareholder return ("TSR"). Over the past few years, some of the core design parameters have evolved to strengthen the alignment of executive pay and performance while other terms have remained the same. Most notably, software companies lead in adopting these enhancements among the technology industry sectors.

Key changes include:

- **Bar raised on performance levels required for target and maximum payouts (i.e., above 50th percentile at target and above 75th percentile at max)**
- **Payout caps added for negative absolute TSR**
- **Adjustment in measurement approaches**

Other program terms have remained stable in new and existing plans:

- **Use of broad market indices as comparator benchmarks**
- **Longer performance periods than used for financial and operational metrics (e.g., cumulative 3 years)**

To ensure your relative TSR program remains aligned with market, this Alert highlights notable trends and key practices among our technology industry client base and the 103 technology industry companies in Compensia's July 2023 Tech 200 Database that awarded executives performance-based stock units ("PSUs") that included a relative TSR metric.

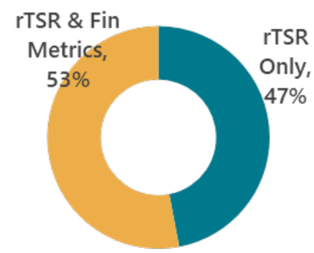
Background on Relative TSR PSUs

Relative TSR PSUs are simply RSUs that vest based on a company's change in stock price, plus dividends (if applicable) paid, over a pre-established performance period, measured against an appropriate index/peer group.

Why Companies Grant Relative TSR PSUs
✓ Captures investor's opportunity cost of investing in Company relative to the broader sector/ market
✓ Less sensitive to broad stock market fluctuations than options (since performance is relative)
✓ Provides a link to shareholder value creation
✓ Does not require setting long-term financial goals
✓ Avoids redundancy with bonus program goals
Reasons to Consider Not Granting
✕ May reward executives even if company does not meet financial/operational performance goals
✕ Comparator companies/index may be difficult to define
✕ Determining accounting grant value is somewhat more complex/less advantageous than for other vehicles
— Accounting expense is not generally reversible
— Design could drive accounting cost significantly higher or lower than target value

While these PSUs provide direct alignment with shareholders with respect to stock price returns, they are often supplemented with PSUs earned based on financial, operational or strategic metrics, as well as time-based vesting options or RSUs.

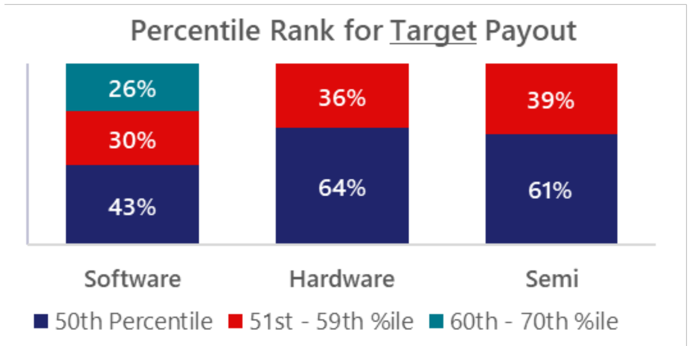
- **~64% of technology industry companies granting PSUs include a relative TSR metric**

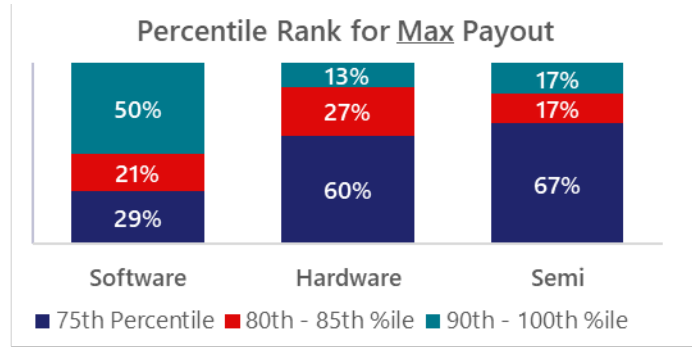


Where both relative TSR and financial metrics are weighted components of the plan formula (85% of the companies including both types of metrics), TSR accounts for, on average, 45% of the payout. The other 15% of companies use relative TSR results as a modifier to adjust payouts determined using financial or absolute stock price metrics, generally +/- 25 percentage points. No company eliminated a relative TSR metric for the current year, while 10 companies introduced relative TSR PSUs for the first time.

Performance Levels

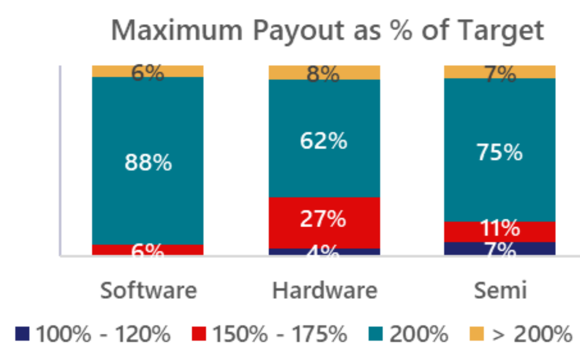
- **~50% of software companies require TSR above the median of the index for target payout (e.g., 55th – 60th percentile) and at or above the 90th percentile for maximum payout**
- **Other industries are slower to adopt more rigorous performance requirements**





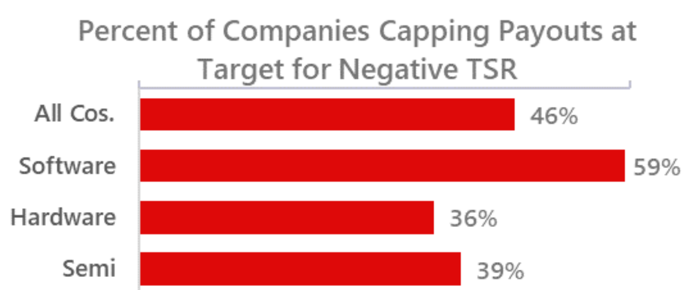
Performance requirements are becoming more rigorous, with companies raising the bar from the standard structure of setting threshold payout at the 25th percentile, target payout at the median/ 50th percentile and maximum payout at the 75th percentile.

In response to ISS' and Glass Lewis' belief that companies should "outperform the index" to earn target level awards, and Compensation Committees' desires to strengthen the alignment between pay and performance, there has been a 70% increase in the number of companies targeting higher percentiles. Hardware and semiconductor industries are slower to embrace this trend; however, these industries provide for less upside payout opportunities. Among software companies, 94% set the maximum payout at or above 200% of target, as compared to 69% of hardware industry companies and 82% of semiconductor industry companies. Threshold payout for achieving 25th percentile TSR remains most common (70% - 80% among all industry sectors).



Payout Cap for Negative Absolute TSR

- **Nearly 50% of companies cap payouts at target if absolute TSR is negative**



Capping payouts at target for negative absolute TSR is viewed favorably by advisory groups, serves as a risk mitigator and strengthens the alignment of plan payouts with company shareholders.

Measurement Approach

- **Percentile Rank remains most common measurement approach (70%)**
- **Rise in the number of companies considering or implementing a Percentage Points vs. Index (25%) or Points vs. Median measurement approach (5%)**

Each of these approaches comes with tradeoffs in terms of understandability and alignment. Three approaches used to determine relative TSR PSU payouts include:

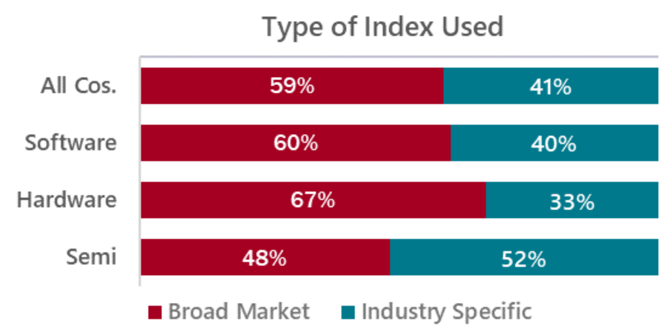
Approach	Advantages	Disadvantages
Percentile Rank vs. Index *Company's percentile rank against the individual index constituents*	▲ Easiest to explain to participants ▲ More direct "pay for performance" link as the actual percentile performance required for payout is known ▲ Avoids potential impact of more heavily weighted index components	▼ Percentile performance rank could be wide or narrow depending on constituents ▼ Difficult to track and measure performance without assistance of 3rd party vendor ▼ More difficult to scale down payout / capture a wide range of performance (plans typically designed to pay above the 25th percentile)
Points vs. Index *Outperformance or underperformance against overall Index*	▲ Easiest to track performance ▲ Generally results in lower accounting valuation ▲ Does not require addressing M&A	▼ Pay and performance outcomes more difficult to explain and not aligned in all markets ▼ May be significantly influenced by heavily weighted constituents ▼ Challenging to set payout curve
Points vs. Median *Outperformance or underperformance against the median TSR of the index constituents*	▲ Balances setting target performance equal to the index TSR that may be significantly influenced by more heavily weighted constituents, with the flexibility to set the range (i.e., within X% points of the index median)	▼ Not a common design ▼ More complicated to explain ▼ Difficult to track and measure performance without assistance of 3rd party vendor

With select indices becoming increasingly weighted toward a small group of highly-valued companies (i.e., top 10 constituents represent 30% of the S&P 500; Apple, Microsoft, Amazon, NVIDIA, Alphabet and Meta represent 40% of the NASDAQ), more companies are questioning the impact of using a percentile rank approach on the plan outcomes.

Comparator Index

- **90% of companies use an independently-constituted index vs. a custom peer group, most often a broad market industry**

A market index supports a transparent process, eases program communication and reduces year-over-year plan design changes. Despite shareholder requests to tailor the relative TSR benchmark to an industry or line-of-business focused index, most software and hardware companies continue to use the S&P 500 or Russell 2000/3000.



Performance Periods

- **68% of companies measure performance over a cumulative 3-year period with all earned shares vesting upon award determination**

Multiple performance periods are most often used at recently public companies or those adopting relative TSR PSUs for the first time. An overlapping 1-, 2- and 3-year performance period approach, all measured from the same starting point, is most common. In calculating TSR, an averaging period of between 30 and 90 days at the beginning and end of the performance period is typical practice to mitigate the impact of price volatility on outcomes.

Need Assistance?

Compensia has extensive experience in helping companies design performance-based equity programs aligned with the pay program objectives, market practices and shareholder preferences. If you would like assistance in reviewing your existing programs, developing a new performance-based equity program, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact **Jodie Dane at 415.462.1985 or jdane@compensia.com.**

About Compensia

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