



STEPS TO IMPLEMENTING PERFORMANCE metrics IN LTI PLANS

QUICK LOOK

- Metrics must be viewed by plan participants as relatively controlled, subject to their influence and achievable in order to align them with the company's performance priorities.
- A reasonable performance-based LTI plan is one that aligns shareholder returns and potential payouts with the organization's particular value proposition/business strategy.
- Performance-based LTI plans designed for a large, stable or mature organization may differ from those of a small, high-growth or changing organization.

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One of the biggest challenges for compensation professionals is building a performance-based long-term incentive (LTI) plan around meaningful, but achievable, performance goals that motivate participants and drive investor value. Well-designed, simple and easy-to-understand plans have proven highly effective in focusing an executive's performance over a longer-term period and, with the inclusion of vesting restrictions, are useful in promoting retention.

With the advent of mandatory stock option expensing, intense investor

pressure and the desire to link executive payouts to meaningful longer-term results, more companies are reassessing their equity strategies and the use of performance-based metrics.

This article discusses six key considerations in designing an effective and simple performance-based LTI plan. It includes special considerations for the needs of smaller firms, startups, rapidly changing businesses or other organizations that may have difficulty setting performance metrics over a longer-term period.



1 Pick Effective Performance Metrics

Effective performance metrics share two key characteristics: predictability and validity.

Metrics must be viewed by plan participants as relatively controlled, subject to their influence and achievable in order to align them with the company's performance priorities. Conversely, performance goals that are perceived as unrealistic or subject to factors outside the executive's control are unlikely to influence executive behavior or to be achieved. One way to assess predictability is by looking at the historic correlation between the company's share price and the proposed performance metric. The greater the long-term correlation between the performance metric and the company's stock price performance, the more predictable, and therefore appropriate it is for use in a performance-based plan.

A valid performance measure is one that has a meaningful correlation with both shareholder returns and the organization's particular value proposition, whether the latter involves driving revenue, profits, growth or new product development. Metrics also should be highly valued within both the organization and the industry. An effective performance-based LTI plan will closely focus on promoting such critical values over the midterm and longterm, rather than focus on short-term stock price growth. In some cases, companies are adopting performance metrics and terms to LTI plans that look very different from those of their peers, but are intended to address the organization's specific goals and strategies.

2 Select the Most Appropriate Time Frame

The typical performance-based LTI plan runs three years, with performance being measured at the end of the period.

The downside is that absolute goals rely heavily on effective planning and forecasting and also may create an incentive for executives to set lower goals to increase their chances of a payout.

A three-year time frame encourages a longer-term performance focus as well as retention. However, a three-year term requires the ability to identify longer-term goals with some precision, a process that may be fairly standard for large, stable or mature organizations.

The situation is different for smaller firms, high-growth companies and those likely to experience a major organizational change in the near future, such as a sale or acquisition. Faced with uncertainty about their long-range performance, they are likely to be more comfortable adopting a shorter horizon that allows them to pinpoint the kind of realistic and predictable goals most likely to drive executive behavior. As a way to add the long-term performance perspective favored by investors and encourage retention, those companies may incorporate a vesting period after the performance period is completed. Typically, companies in this situation might opt for a one-year performance period but also encourage a longer-term perspective through the use of graded vesting over the next two years.

3 Weigh Absolute versus Relative Performance Metrics

Absolute performance goals are specific targets against which future performance is measured. Typically linked to the company's business strategy, they are relatively easy to measure and communicate; are consistent with shareholder expectations of typical practices; and give plan participants a strong sense of control and influence. For example, a company might set an absolute goal of \$1 billion in revenue from a starting point of \$900 million, with achievement based on actual revenue at the conclusion of the performance period. The downside is that *absolute* goals rely heavily on effective planning and forecasting and also may create an incentive for executives to set lower goals to increase their chances of a payout.

In contrast, *relative* performance goals measure company performance against a group of peers or a company index. For example, a performance-based LTI plan might require performance in the first quartile relative to a group of 20 peer-group companies, based on revenue

growth for the performance period. Such comparative performance assessments tend to be motivational in both good years and bad, with the greater likelihood of payouts even in a down year aiding in retention. While suited to longer performance periods, relative metrics are more sensitive to changes in the composition of the comparator group or the alignment of different companies' fiscal year-end. Relative measures also can be more difficult to communicate to a broad-based population, while outcomes may be inconsistent with investor expectations, the company's cash flow or its ability to pay out the awards.

Generally speaking, companies that are facing significant change and prefer a performance-based LTI plan with a one-year performance period would be better off using absolute metrics, while a similar company facing significant change that is measuring results over two to three years may prefer relative performance measures.

4 Consider Cumulative versus Point-in-Time Metrics

Financial performance can be measured over a multiyear performance period based on either cumulative metrics or a specific point in time. Cumulative metrics require that specific goals be met in each plan year as well as at the end of the full performance period. They are a good approach for organizations that want to promote and pay out only for consistent financial performance. They offer the additional benefits of being predictable, fostering more consistent performance and aligning better with shareholder expectations. On the flip side, cumulative hurdles may be harder to achieve and to communicate to executives.

As shown in Figure 1, to meet a cumulative goal of 10 percent per year of operating income growth, a typical performance-based LTI plan might

FIGURE 1: LONG-TERM INCENTIVE PLAN USING CUMULATIVE METRICS

Operating Income (Year 0 = \$10 million)	Cumulative	
	Operating Income Target	Growth Over Prior Year
Prior-Year Performance	\$10 million	N/A
Year 1	\$11 million	10%
Year 2	\$12.1 million	10%
Year 3	\$13.3 million	10%
Target Performance Expectation	\$13.3 million	Cumulative Growth = 33%

Companies that are facing significant change and prefer a performance-based LTI plan with a one-year performance period would be better off using absolute metrics.

provide for a cumulative total compounded operating income growth of 33 percent that includes milestones of 10-percent cumulative growth through year one, 21 percent through year two and 33 percent through year three.

Point-in-time metrics only require that a company achieve a stated goal at the conclusion of the performance period. While easier to communicate, such measures tend to produce less consistent results and give participants less credit for performance in early years because they are focused on final results. They also are more susceptible to early windfalls and/or disasters and ultimately may be out of sync with shareholder expectations.

Using a point-in-time approach, the company described previously would meet its performance goal solely by

hitting 33 percent total operating income growth at the completion of the three-year performance period, with no annual milestones. (See Figure 2.)

5 Examine Consecutive versus Overlapping Performance Cycles

In a consecutive performance cycle — sometimes referred to as an end-to-end plan — a new cycle begins at the completion of the previous performance period. For example, if a plan initially runs from 2008 to 2010, the new plan would begin in 2011 and finish in 2013. This approach makes it easier to establish, administer and communicate performance goals and keeps participants focused on a single set of metrics at a time. On the down side, consecutive cycles allow less flexibility to add new hires to a plan midcycle and are more

susceptible to large swings in performance, making it difficult to motivate executives in a disaster scenario.

In an overlapping performance cycle, a new plan begins each year so that multiple plans are running simultaneously. For example, within a performance plan that begins in 2008 and ends in 2010, a new three-year plan would start each year. Overlapping performance periods allow goals to be adjusted annually with the start of a new plan and enable the company to add new hires each year. They also allow for more frequent executive recognition and rewards and can better promote retention. However, overlapping cycles present challenges in administration, communication and goal setting and, in some cases, can end up diluting participants' focus among different performance priorities.

For a company introducing a performance-based LTI plan, consecutive performance cycles can be a good start because they offer more opportunities to work out potential plan-design issues without starting a new plan each year. The organization can fairly easily switch to an overlapping cycle at any point, while a company that begins with an overlapping approach may have difficulty switching to a consecutive approach because there are multiple plans running simultaneously. However, larger and more sophisticated companies with a history of multiyear performance periods may be more inclined to use overlapping cycles.

6 Set Targets for a Performance/Payout Scale

An appropriate performance/payout scale generates specific payouts to executives for specific levels of performance, usually including threshold and maximum hurdles along with targeted performance. Target performance

FIGURE 2: LONG-TERM INCENTIVE PLAN USING POINT-IN-TIME METRICS


Operating Income (Year 0 = \$10 million)	Point-in-Time	
	Operating Income Target	Growth Over Prior Year
Prior-Year Performance	\$10 million	N/A
Year 1	N/A	N/A
Year 2	N/A	N/A
Year 3	N/A	N/A
Target Performance Expectation	\$13.3 million	Cumulative Growth = 33%

FIGURE 3: PERFORMANCE/PAYOUT SCALE BASED ON REVENUE AND EARNINGS PER SHARE

Grant Scale	Threshold	Target	Maximum
Revenue			
Performance	At 75% of Target	At 100% of Target	At 150% of Target
Payout Opportunity	50% Payout Opportunity	100% Payout Opportunity	200% Payout Opportunity
Earnings per Share (EPS)			
Performance	At 95% of Target	At 100% of Target	At 110% of Target
Payout Opportunity	70% Payout Opportunity	100% Payout Opportunity	150% Payout Opportunity

typically results in a 100-percent payout opportunity, with a 50-percent to 80-percent payout for threshold performance and a 125-percent to 300-percent payout for maximum performance. The performance/payout scale should be based on both the metric used (a threshold-to-maximum range for revenue will be broader than the same range for earnings per share) and the company's business strategy. Figure 3 outlines an example of a typical performance/payout scale based on revenue and earnings per share.

Conclusion

With careful consideration of designing a simple and easy-to-understand plan using these six central design themes, companies can structure a reasonable, well-balanced and highly effective performance-based LTI plan that addresses investor concerns while providing an effective incentive for executives to produce results. 

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