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Manna from Heaven: The Complexity and Confusion with LTIPs

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"Our long-term incentive plan is like manna from heaven." –CEO Fortune 500 Company

Companies spend millions of dollars each year on long-term incentive plans (LTIPs). They are the cornerstone of US executive pay, often representing 50% to 80% of the pay package, and are intended to align pay and performance, as well as to influence executive behavior and focus.

Unfortunately, most LTIPs are not well-understood—neither by the executive participants nor the compensation committees responsible for plan governance. And perhaps even more concerning, participants often have a feeling that incentive plan outcomes are out of their control. The plans are in fact viewed like "manna from heaven" which is not helpful in executing a strategic business plan. Companies can improve the performance of their LTIPs in two ways: simpler LTIP design and better communication.

Why are LTIPs so opaque and feel remote to participants?

1. Complex LTIP Designs with No Line-of-Sight

Many long-term incentive plans have little or no line-of-sight, meaning it is unclear to the plan participant exactly how they can directly influence results. LTIPs are also complex with multiple types of incentives, varying performance metrics, and multiple time horizons, and companies often "over-engineer" them which further exacerbates the complexity problem.

- Overlapping LTIP performance periods: Around 90% of these plans have a three-year performance period with a new performance period commencing each year. Thus, at any one time, there are as many as three LTIP performance plan periods running concurrently. Monitoring these plans is like watching three games at once with no scoreboard.
- Complex performance metrics: Some companies select performance metrics that are overly complex. This is caused by seeking a metric that has technical precision but is not widely understood by participants. In addition, some companies change the performance metrics from period to period which exacerbates the problem. If stakeholders cannot explain the plan measures on the back of a cocktail napkin, then the plan is too complicated.
- Relative total shareholder return (rTSR): Another contributing factor to poor plan understanding has been the rise of rTSR plans. While rTSR plans are a form of results-sharing and pay alignment, they are not effective *incentive* plans because they provide no line-of-sight and communicate nothing about business strategy and key value drivers. These LTIPs leave executives with the perception that they are holding a lottery ticket with pay-offs completely outside of their control.

2. Poor LTIP Communication

Most companies don't do a great job of communicating LTIPs. They invest millions of dollars year after year in LTIP opportunities but invest next to nothing in the internal communication of those plans. It is generally assumed that executives—and committee members—are "smart and will figure it all out." In case of a public company, often the only LTIP communication is in the proxy statement and for a private company: nothing.

Almost all LTIP communications speak to the grant and the payout. In essence, the company says, "Congratulations! Here is your LTIP award. We will get back to you in the future with your check." The subsequent grant communication is often just the legal agreement outlining the award. Typically, there is no discussion about how the earned incentive is connected to the business and how one might impact the performance metrics for future incentives. Further, there are rarely any updates or progress reports during the performance period, leaving participants and the committee in the dark until the time of the payout.

So, how can companies take the mystery out of LTIPS and increase the return on investment?

1. Simplify LTIP Plan Design

We are all well served by the KISS principle: "Keep It Simple Stupid." Incentive plan metrics and scorecards should be kept as clean and streamlined as possible. There is an old axiom in incentive compensation design which says that a well understood metric that is "generally correct" is a much better incentive than a technically precise metric that is not understood. Further, it should be clear to all stakeholders why this metric is a top priority for the company.

Companies using rTSR plans should review the objectives and the weight for this portion of the plan. Given the limited ability of participants to impact rTSR, many companies are now limiting the rTSR portion of LTIP to 15% to 25% of the total LTIP opportunity.

Despite the complexity, most companies will continue to use annual grants and overlapping performance periods. Thus, it is imperative that companies provide regular progress reports on outstanding awards so that everyone knows the score.

2. Improve LTIP Communication

An investment of more time spent communicating LTIPs will pay off in the long-term. There are several natural touchpoints that can vastly improve communication:

- New plan: Why are we offering this plan? How does it align with business needs?
- Grant/award: What is the opportunity? What are the key metrics? How can management impact their award?
- Progress report: How are we doing for this performance period? What is the score and why?
- Payout: What is the final payout? Why did we perform the way we did under the plan?

If executives understand the incentive plans better, then the plans are more likely to influence executive behavior and focus. And, if the compensation committee understands the plan better, then the committee can provide stronger plan governance and monitoring.

These plans can then be truly viewed as team and individual challenges that can be influenced instead of games of chance. It's win-win.

About the Author

David Seitz is a managing director at Pearl Meyer. He has over 30 years' experience in executive compensation consulting and particular expertise in long-term incentive plan design. Additional areas of concentration include total compensation strategy, incentive performance metrics, executive retirement, and global compensation, among others.

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