Pearl Meyer

ARTICLE | FEB 2024 | NACD

To Maximize ROI, Equity May Need to Go Deeper

Aalap Shah

MANAGING DIRECTOR

The recent Delaware Chancery Court ruling that blocks a record multibillion-dollar equity award raises myriad corporate governance questions regarding the establishment of executive compensation arrangements.

One interesting question raised by this case is whether there are diminishing returns to granting incremental equity awards to an individual that is already a significant shareholder or that already has a significant amount of outstanding equity awards.

More broadly, this question has applicability to a company's overall equity allocation strategy in terms of whether there is a greater return on investment from a continuous focus on equity awards at the senior-most levels of an organization—or from extending equity grants more broadly throughout the company.

Analyzing the aforementioned case, the governance questions (and related learnings) are clear and compelling:

- Where is the full board's or independent directors' conflict of interest "line" drawn?
- What is the proper process when collaborating with management on designing a compensation program?
- What are the appropriate inputs to consider when sizing a compensation package (e.g., comparable market data, value of the individual or role to the organization, unvested and vested equity holdings, alignment with business objectives)?
- Have incentive goals been determined using a process that is not only transparent to the decision-makers and advisors, but also defensible externally?

As the court assessed the facts, perhaps the most far-reaching of the governance questions posed was why the CEO's pre-award equity stake was not fully considered. The court's query strikes at the heart of a few fundamental executive compensation questions boards should be discussing:

- Is there a point where additional equity to an individual with significant holdings results in diminishing returns?
- If so, what is considered "significant," and how is a company meant to reward an executive for continued engagement?
- Should the value of unvested equity holdings always be considered when determining future compensation or is that value for past performance and service?
- Would that equity, and its associated compensation expense, be better utilized as an engagement mechanism for other executives and employees?

The issue of whether incremental equity compensation drives the engagement of individuals that have equity ownership significantly above market norms is extremely nuanced. More broadly, the most pressing plan design question, once the governance questions are answered, is whether a different equity allocation strategy would unlock greater value creation for shareholders. There is no denying that CEOs and executives have the most direct line of sight to performance outcomes. However, given the interplay between goals associated with market value and financial goals that most companies adopt, actual achievement is predicated on the broader team executing. Shouldn't they feel like owners, too?

Another market-dominant player has recently been in the news and has doubled down on the idea that a team creates value for an organization and its shareholders. Borrowing structures typically reserved for corporate America's executive ranks and deploying them in the field, this retail company is offering bonus opportunities reaching two times the performance target and annual equity grants to its store managers. Clearly, the company believes that instituting a pay-for-performance mindset deeper in the organization drives accountability, fosters retention, and unlocks value creation.

The question for the broader director community is whether or not that approach can be replicated across sectors and if it is an appropriate direction for each individual organization. Some private equity-backed companies have answered that question in the affirmative and have extended equity participation deeper into their organizations. Additionally, the practice of issuing broad-based equity grants is commonplace in both the technology and life sciences sectors.

Although the logic of using broad-based equity grants to increase worker engagement is compelling, extending an equity program further down into the organization is not problem-free. The main questions to raise when considering such a move are:

- What would be the overall impact on share usage and stock-based compensation expense?
- How constrained is the current equity pool? How long will it last if the program is expanded?
- What is the right balance between cash and equity? How much leverage is appropriate versus steady income?
- Based on our current equity eligibility population, how quickly do employees sell shares or exercise options?
- If an employee stock purchase program is in place, what is the participation rate, and does it achieve goals around broad-based exposure?
- Does fostering an ownership mindset align with the company's organizational structure?
- What type of communication plan will be needed to educate employees on equity grants, including their potential wealth creation opportunities and the associated risks?

If, after doing the proper diligence, a broader equity program is cost prohibitive but the concept aligns with the company's values and strategic priorities, boards could consider the following strategies:

- Issue a one-time grant with a relatively long vesting schedule to current employees and an at-hire grant for any new employees to plant the seed of ownership. As the grant approaches being fully vested, another grant could be considered.
- Reserve a pool for high-potential individuals to periodically provide equity grants to non-equity eligible individuals.
- Provide an equity grant to individuals upon promotion along with other compensation

increases. It is important that grant issuance be an additive to any cash compensation increases to ensure employees see the wealth-creation potential.

Companies that take the time to challenge long-held assumptions about equity eligibility have the potential to unlock greater engagement and increase long-term shareholder value by providing an opportunity for all employees to share in the wealth that is created as a company successfully executes its strategy and realizes its growth potential.

About the Author

Aalap Shah is a managing director at Pearl Meyer. With more than 20 years of experience, Aalap advises public and privately held companies on executive compensation issues, with focus on pay governance, pay-for-performance alignment, and incentive plan design. Of particular interest is the intersection between business strategy, people strategy, and compensation strategy, believing alignment of all three is required to design effective programs.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.