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Knowing When and How to Adopt Performance Share Units

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Performance-based equity is considered the gold standard by most investors for aligning executive pay and performance. Yet design complexities cause many small and midcap life sciences companies to delay the adoption of performance stock units (PSUs) until later stages in the company's development. Two recurring questions come up when we discuss performance equity with our clients. First, when is the right time to seriously consider PSUs? And second, how should the awards be designed given what they know about their business and talent needs?

Performance-Based Equity: Timing is Everything

The stakes are higher with performance-based equity as compared to cash compensation. While executives can typically earn more than the target number of shares for strong performance, they can also earn nothing if goals are not met. Life sciences companies have also been known to tie the vesting of performance-based equity to a future binary event, making those grants even riskier "all or nothing" propositions. It's therefore not surprising that most companies in the industry go to great lengths to ensure that the timing in the company's lifecycle is just right for granting PSUs.

In our experience, one factor which seems to trigger serious consideration of performance equity is when a company is exiting "Emerging Growth Company" (EGC) status. Many life sciences companies that have gone public within the last five years qualify as EGCs. This is a key designation which not only permits scaled-back Securities and Exchange Commission (SEC) disclosures—including forgoing a Compensation Discussion & Analysis (CD&A) in the annual proxy statement—but also exempts companies from holding an annual non-binding shareholder vote on executive compensation, commonly called "say-on-pay."

These lesser requirements mean that companies share less in terms of their current compensation practices, and investors have less opportunity to understand the company's approach to compensation and lack the ability to make their voices heard through the say-on-pay vote. Things change once a company exceeds certain financial thresholds or has been public for more than five years and therefore loses its EGC status. Inevitably, calls from investors to grant performance equity to strengthen the link between pay and performance, and to drive greater accountability within the executive team, will get louder. In turn, companies seeking to be responsive to these kinds of concerns will find themselves discussing performance-based equity.

A second important factor related to timing is a company's financial situation. Often, performance equity is designed to measure financial performance over a multi-year period, and so some degree of accuracy with respect to financial forecasting is necessary to set goals. In an industry that is no stranger to volatility, even goal-setting over relatively short periods such as one or two years can be challenging, let alone the three years which is considered the ideal performance period length by most investors. Life sciences companies beginning commercial operations, or those with revenue streams that are becoming more predictable, are therefore likely to be good candidates for the adoption of PSUs.

PSU Design: The Devil is in the Details

While it's hard to argue with the potential for PSUs to strengthen the alignment between corporate performance and compensation paid to the executive team, such a statement can seem trite to companies adopting them for the first time. There are a variety of practical challenges associated with granting performance equity, including the aforementioned ability to set reliable goals over a multi-year period. Indeed, such is the difficulty in setting multi-year goals, that some companies will compromise by using one- or two-year performance periods, with an additional year or two of time-based vesting to make the awards truly "long-term." While not ideal, these quasi-PSU plans are still better than sole reliance on time-based awards.

In addition to the time horizon issue, companies adopting PSUs must also contend with choosing the right metrics to measure performance. Traditionally, investors have preferred financial metrics since growth in revenue or profit more intuitively translates to growth in shareholder value. Financial metrics are also more tangible, with expectations regularly communicated to investors. In some instances it may be appropriate to include long-term non-financial goals, such as certain strategic objectives, but these goals will ideally have a clear link to a value-driving event.

In addition to financial and non-financial, a third metric category is shareholder return metrics, which are popular in the investment community since they directly measure relative or total returns on investment. However, while they emphasize the alignment between compensation and the shareholder experience, they are not as effective for driving the right behaviors since so much of share price is sentiment-driven. From an incentive standpoint, performance metrics over which executives have control are much more useful tools.

A final practical challenge with implementing PSUs is the transition away from time-based equity, which often vests in regular installments (typically either annually, quarterly, or monthly), to awards which may not fully vest for three years. From an employee perspective, this change in vesting creates a "lumpiness" in compensation which, all else equal, is likely to be perceived as a takeaway. The payout leverage in PSUs, often up to 200% of the target awards size, may help mitigate this concern, but perhaps not entirely. Therefore, companies will need to carefully think through their transition alternatives.

In Conclusion

The right time to introduce PSUs isn't always obvious. Certainly, when biopharmas begin commercial operations, and other life sciences business see more predictability in their revenues or earnings, compensation committees should be having conversations with their management teams and advisors to assess the feasibility of a PSU plan. In any event, it's important to not rush the design phase, nor feel pressured into granting PSUs prematurely. Most companies spend several months discussing metrics, goals, vesting, participation, leverage, and various factors related to performance-based equity before finally moving forward and this preparation time is worth the wait.

About the Author

Rob is a managing director with Pearl Meyer with over 12 years of experience in executive compensation and finance. He serves as a trusted advisor to boards and senior management at public and private firms across North America. He specializes in working with emerging and high growth companies that are pursuing or have recently completed a transaction, such as an IPO or deSPAC. He often works with clients to help them prepare for an IPO and in the design of equity programs across each stage in their lifecycle, including pre-and-post IPO. Rob works with companies in all industries, but he has in-depth knowledge and expertise in designing compensations strategies for organizations in technology, fintech, green tech, and life science/biotech.

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