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Long-Term Incentive Plan Design Fundamentals

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This is the fifth in a series covering Executive Compensation Essentials—a resource for every board, compensation committee, and management team.

Long-term incentives are often the largest component of executive compensation, and they can also be the most complex. Whereas other pay elements often have a single objective, the objectives for long-term incentives are multi-faceted and include market competitiveness, performance alignment, shareholder alignment, and retention.

In this fifth installment of our Executive Compensation Essentials series, we turn our attention to designing an effective long-term incentive program (LTIP). Building on our previous discussions on pay philosophy, peer group development, the total compensation framework, and short-term incentives, this article explores how an effective LTIP requires a deep understanding of the company's strategy, business outlook, and primary objectives for the program.

Basic Award Types

The primary types of long-term incentive awards for public companies are Restricted Stock Units (RSUs), Stock Options, and Performance Stock Units (PSUs). Each award type can be viewed as having a slightly different *primary* objective within the overall long-term incentive program:

Award Type	Primary Objective
RSUs	Retention
Stock Options	Shareholder Alignment
PSUs	Performance Alignment

Because each award type has its own primary objective, companies often use them in combination to achieve their specific goals. Privately held companies often use cash-based incentive arrangements that mimic these equity currencies (e.g., Phantom Stock instead of RSUs, Phantom Stock Appreciation Units instead of Stock Options, and Cash LTIPs instead of PSUs).

Selecting the Optimal Mix of Award Types

There are various factors that should be considered when selecting the award mix:

- **Program Objectives**—The award mix should reflect the primary goals of the program, which can differ by eligibility level. For example, the objectives for higher-level participants may emphasize performance and shareholder alignment, whereas the objectives for lower-level participants may favor retention.
- **Life-Cycle Stage/Business Outlook**—Pre-IPO companies often favor the high-risk/high-reward nature of stock options, whereas mature public companies often favor the stability and performance linkage of RSUs and PSUs. In general, stock options are more appropriate for companies with higher stock price growth expectations.
- **Goal-Setting Visibility**—Companies in highly cyclical industries or companies regularly and materially impacted by external events may find it difficult to set multi-year financial targets. This can make the use of PSUs challenging, unless relying on relative metrics like relative TSR (total shareholder return).
- **Market Practice**—Although less impactful, having similar types of long-term incentives as key competitors can aid in the attraction and retention of talent. However, if your program design is anchored by the above considerations, you should be able to describe the reason for and benefit of deviation from market practice.
- **Proxy Advisory Firm Views**—A final consideration is the views of proxy advisory firms. One of the more influential firms currently does not consider stock options to be "performance-based" and prefers programs where at least 50% of the grant mix for the CEO is "performance-based." This has led some companies to adopt a grant mix that is at least 50% PSUs for the CEO.

Vesting Schedules and Performance Periods

RSUs and Stock Options generally have *time-based vesting*. Vesting practices can differ materially by industry and life-cycle stage. Early-stage companies often have shorter and/or more frequent vesting periods (e.g., 2-year quarterly vesting). Later-stage companies often have longer and less frequent vesting periods (e.g., 4-year annual vesting). Where retention is one of the primary objectives of the program, some companies will use either cliff vesting (e.g.,100% vests after year 3) or back-loaded vesting (e.g., 25% in year 1, 25% in year 2, and 50% in year 3). This is more likely to apply to RSUs (full value awards) than options (incremental value awards).

PSUs have *performance-based vesting*, and the most prevalent performance period is 3 years. However, there are hybrid designs where the program:

- Has a 1-year performance period followed by a 2-year time-based vesting period; or
- Use an average of three 1-year goals to determine the payout at the end of 3 years.

These hybrid designs, which are often used by companies with significant multi-year goal-setting challenges for their selected metrics, have been criticized by the proxy advisor firms as not being "long-term." The following are alternative strategies for dealing with poor goal-setting visibility:

- **Wider Performance Range**—Having wider spread between Threshold and Maximum performance, for example 75–125% of target instead of 90–110% of target.
- **"Strike Zone" Around Target**—Establishing a flat portion of the payout curve around target, for example 1% above and 1% below target yields a 100% payout.
- **"Self-Adjusting" Targets**—Setting a 1-year goal AND a growth rate for subsequent

years, where the growth rate is then applied to the prior year actual performance (results in the 3-year goal being automatically raised or lowered based on actual performance in the first 2 years of the 3-year performance period.

Equity Award Termination Provisions

An often-overlooked element of long-term incentive plan design is what happens to the awards in the event of various termination events. Although we won't cover all the details in this article, it is important to think through what should happen to RSUs, Options, and PSUs in the event of Death, Disability, Termination without Cause, Retirement, and Change-in-Control. For example, the Retirement provision requires balancing allowing people to retire when they're ready (as opposed to staying longer to secure vesting) but not encouraging people to retire while they are making substantive contributions to the company's success. This requires a thoughtful approach to both the Retirement Definition and the Retirement Provision.

There's no "one-size-fits-all" solution

An effective long-term incentive plan design reflects your company's unique strategy, performance outlook, and talent requirements. When designed effectively, the long-term incentive plan will (a) attract and retain the talent needed to execute the company's strategy, and (b) create strong alignment between executive compensation, company performance, and shareholder returns.

About the Author

Greg Stoeckel is a managing director and consulting team leader at Pearl Meyer. In his management role, he oversees a team of senior compensation consultants in the execution of the firm's growth strategy and in the development of consultants at various stages in their careers. In his consulting role, Greg is a senior advisor to compensation committees and executives on all aspects of executive and non-employee director compensation.

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