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Designing PSUs That Work

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Equity strategies rarely remain static. They evolve as companies move from inception to the public markets and through different stages of clinical development, regulatory approval, commercial launch, and growth.

For many life sciences companies, that evolution follows a familiar path. Early programs are often built entirely around stock options. Over time, companies introduce time-based restricted stock units (RSUs), particularly as they mature and seek to broaden participation, compete for talent with more advanced companies, or reduce the share usage associated with an option-heavy program. Eventually, for many public companies, the question becomes whether performance stock units (PSUs) should become part of the annual equity program for executives.

Historically, this progression first became common among large, multinational commercial organizations. In part, the trend reflected the growing influence of proxy advisory firms during the 2010s and increasing pressure to demonstrate that a meaningful portion of executive equity compensation was explicitly linked to performance. ISS, in particular, did not consider conventional stock options to be performance-based awards.

Over time, the practice spread to smaller and earlier-stage companies as some investors similarly pushed for equity that would vest based on achieving specified performance goals.

Today, it is increasingly common for commercial-stage companies, and even some late-stage clinical companies, to consider introducing PSUs as part of the annual executive equity program. The challenge is not deciding whether performance-based equity is theoretically attractive. Instead, the real challenge is designing a program that actually works.

The Goal-Setting Challenge

Any company adopting performance-vesting equity must answer two fundamental questions:

1. What should performance be measured against?
2. How should the goals be set at levels that are meaningful but achievable?

For mature businesses with established financial models, revenue, earnings, or other financial metrics can provide a viable basis for PSU design. Even then, companies should consider whether the PSU metrics are sufficiently differentiated from those used in the annual incentive plan, either by using different measures or, at a minimum, evaluating performance over a longer period.

Some companies avoid company-specific goal setting altogether and adopt relative total shareholder return (rTSR) programs. These plans can be easier to administer because they eliminate the need to establish long-term operating goals several years in advance. The trade-off is that they do not drive behaviors in the same way as programs based on explicit goals that teams can work toward.

For many precommercial and early commercial life sciences companies, however, neither traditional financial metrics nor a purely market-based approach may be the best fit. Financial-based goals are not meaningful for pre-revenue companies. For early revenue-generating companies, financial goals can be particularly difficult to set at appropriate levels until they have developed sufficient forecasting capabilities. A forecast that appears reasonable at the time of grant can quickly become obsolete as clinical, regulatory, financing, or commercial circumstances change.

In those situations, linking PSUs to meaningful value-creating milestones can provide a more useful alternative. Clinical development, regulatory, commercial, or other strategic achievements can be tied directly to important inflection points in the company's progression and, if selected thoughtfully, can align executive rewards with outcomes that matter to shareholders.

Where companies can struggle is in determining how to build a structure that is sufficiently rigorous without becoming unnecessarily complicated.

A Simpler Framework for First-Time PSU Programs

Some mature commercial organizations use sophisticated PSU scorecards that evaluate a combination of scientific, development, regulatory, financial, and other strategic performance. These structures can work well, but they often take several award cycles to refine. Goal selection, weighting, measurement, and calibration can all become complicated, particularly when companies are trying to establish a sustainable framework that will work from year to year.

For companies implementing PSUs for the first time, a simpler approach can be more effective. One repeatable framework is to grant an opportunity to earn up to 150% of the

target number of PSUs based on achieving three binary performance milestones. Each milestone is worth 50% of the target award.

The basic structure is straightforward. Rather than creating a heavily weighted scorecard or attempting to establish multiple performance ranges around uncertain operating forecasts, the company selects three milestones that represent progressively greater levels of execution and value creation.

1. The first goal should be an outcome that is likely to be achieved and generally expected to occur within approximately 12–18 months. It should still represent an important business achievement, but it should also provide employees with a reasonable degree of confidence that at least one portion of the award can be earned.
2. The second goal should require stronger execution and a positive business outcome. It may be reasonably likely to occur, but it should not be assumed. Depending on the company's development stage, this type of milestone may generally be expected within approximately 24–36 months.
3. The third goal should represent a true stretch outcome—an achievement that could create meaningful shareholder value but that may not occur. This milestone may have a longer anticipated timeline, perhaps 36–48 months, and is what provides the outperformance opportunity in the PSU design.

Taken together, the three milestones progress from expected execution to stronger performance to a meaningful stretch outcome. The design is easy for participants to understand while still differentiating the performance level required to earn different portions of the award.

Why Achievability Matters

This calibration is particularly important when PSUs are first introduced. In many cases, the company is not increasing the total equity opportunity. Instead, it is converting a portion of what would otherwise have been granted as time-based RSUs into performance-based equity. If employees view the performance goals as unrealistic from the outset, the transition can feel like a reduction in compensation rather than an enhanced opportunity. That perception can undermine both the motivational and retention value of the program.

By contrast, if the first two milestones are designed to be reasonably achievable with successful execution, recipients can see a credible path to earning the awards. The structure can even provide an advantage relative to time-based RSUs. Because the PSUs vest when the applicable milestone is achieved, participants may earn a portion of the award sooner than they would have if the same number of shares had simply been subject to a standard time-based vesting schedule.

That distinction can be particularly helpful when introducing the program to executives. Performance-based equity should create meaningful accountability, but recipients must

also believe that performance can realistically translate into compensation value.

Put a Time Limit on the Goals

Another important feature is a defined performance window.

Under this framework, each of the three milestones must be achieved within four years of grant. If a milestone is not achieved during that period, the corresponding portion of the award is canceled. That expiration feature serves several purposes.

- It prevents older PSU awards from remaining outstanding indefinitely. Without a defined time limit, an award could theoretically vest years later when the achievement may no longer represent the same level of performance or shareholder value contemplated when the award was granted.
- It also reinforces the connection between performance and timing. In many development-stage companies, achieving a milestone is not enough. When the milestone occurs can be equally important. A clinical, regulatory, or commercial achievement that occurs years later than originally anticipated may not warrant the same reward.
- Canceled awards can return to the company's equity pool and become available to support future grants, subject to the terms of the applicable equity plan.

The result is a cleaner program in which each award cycle has a defined life, and participants understand both what needs to be achieved and by when.

The Hard Part Comes in Future Years

The basic framework is relatively simple to establish, but sustaining it over multiple years requires thoughtful evolution. The primary challenge for management and the compensation committee is identifying new and differentiated goals for each annual award cycle. Companies should avoid creating multiple outstanding PSU tranches that can all vest based on the same future achievement.

For example, if the completion of a particular clinical study is used as a stretch goal in one year's award, using completion of that same study as a more achievable goal in a subsequent year's grant can create overlapping payouts tied to a single event. Over time, this can weaken the connection between individual award cycles and the performance expected during each period.

As a result, the compensation committee should consider the PSU program as a multi-year framework rather than designing each grant in isolation. The company needs a sufficiently deep pipeline of potential milestones so that future awards can continue to reward distinct

achievements without repeatedly paying for the same outcome.

For some organizations, that challenge will ultimately lead to a more sophisticated PSU scorecard as the company matures. For others, a relatively simple milestone-based structure can remain effective for several years.

Keep the Design Understandable

A PSU program does not need to be complicated to create meaningful performance alignment. In fact, particularly when PSUs are first introduced, simplicity can be an advantage. Recipients should understand what they are being asked to achieve, how much of the award they can earn, and the timeframe in which performance must occur.

Most importantly, participants must believe that the goals are achievable. Performance-based equity that is viewed as unattainable will have limited motivational or retention value, no matter how well the design appears on paper.

A simple milestone-based framework can bridge the shift for companies moving from predominantly time-based equity toward a greater emphasis on performance. By combining achievable near-term objectives with more challenging longer-term outcomes, companies can introduce meaningful performance conditions without sacrificing the incentive and retention objectives that remain central to the equity program.

For life sciences companies, where long-term financial forecasting may remain difficult well into the company's development, thoughtfully selected milestones can provide a practical way to tie executive equity rewards to the creation of shareholder value.

About the Author

Matt advises life sciences and technology companies on executive compensation, specializing in benchmarking, incentive design, pay-for-performance alignment, security arrangements, and CD&A disclosure.

About Pearl Meyer

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