



Executive Incentive Plans: How Leading Companies Pay for Performance

Featuring Commentary from:



Executive Incentive Plans: How Leading Companies Pay for Performance

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Effective executive compensation programs aim to align executive pay with measures of company performance, and a well-designed incentive plan achieves this alignment through a rigorous process, including the selection and weighting of performance metrics.

This report identifies incentive plan metrics for CEOs, CFOs and other NEOs in the S&P 500 to provide a broader scope of both annual cash incentive plans and long-term incentive plans. Beyond performance metrics for long-term incentive plans, performance periods assigned to those awards reveal how these companies measure long-term success.

While higher-level data on the inclusion of specific performance metrics and periods is useful, plan designers require additional details to craft plans ready to withstand scrutiny and volatility in the marketplace. To illustrate these broad trends more completely, the report then takes a deep dive on long-term incentive plan design for CEOs in the S&P 100. Plan details such as the weight assigned to specific performance metrics, as well as performance goal and award payout ranges, show how public companies balance incentives meant to drive both financial and operational strategy with shareholder value. Narrow performance ranges, for example, leverage a wider spectrum of payouts, thus motivating executives to improve performance—even if only by small increments.

E*TRADE Commentary

Shareholders, especially institutional investors and advisors, are increasingly interested in how executive compensation is aligned with overall business performance. This has influenced executive compensation design, driving an increased adoption of performance equity plans.

In 2007, fewer than 23% of CEOs in the S&P 500 had long-term performance grants included in their equity compensation mix¹. By 2014, nearly 70% of companies in the S&P 500 granted performance equity². This significant increase in performance-based equity vehicles over the past several years aligns with the SEC's adoption of Say on Pay in 2011.

Methodology

For this report, Equilar examined the prevalence of performance metrics and performance periods for annual cash incentives and long-term incentives of CEOs, CFOs and other NEOs at S&P 500 companies over the last four fiscal years. Years were defined as fiscal year ends between August 1st and July 31st. Equilar also analyzed the most recently disclosed long-term incentive plans for CEOs in the S&P 100 index. The data collected for this detailed study includes performance metrics and their weightings, performance ranges as a percentage of target performance, and payout ranges as a percentage of target payout. Analysis for both the S&P 500 and S&P 100 study was conducted on a “by award” basis, and data reflects the percentage or number of awards befitting the category.

Incentive Plan Metrics for S&P 500 Executives

When companies choose measures of business success, or performance metrics, executives gain line-of-sight into the levers they must pull to reach strategic goals while creating long-term value for shareholders. Historically, the changes in choice of metrics for executive performance awards show how companies have evolved the way they incentivize their leadership at various levels of their organizations.

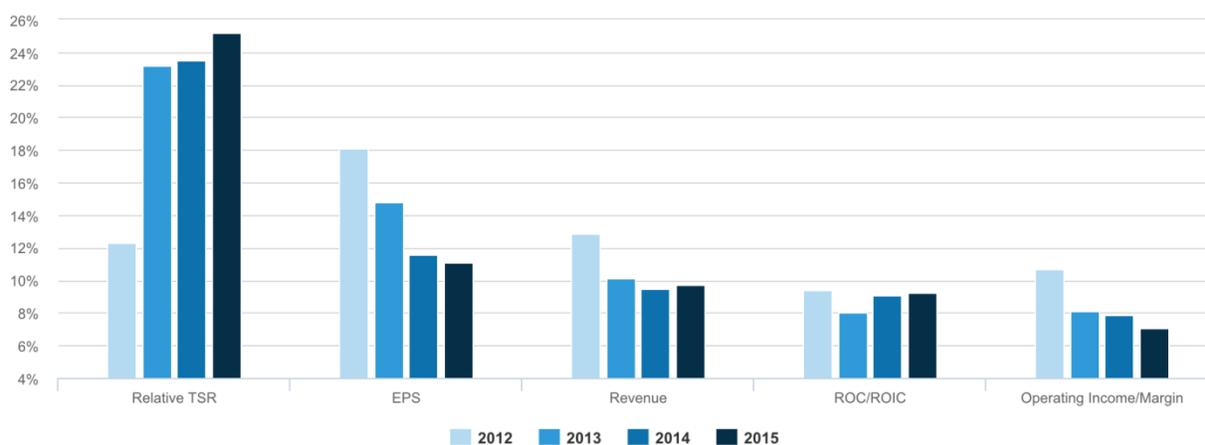
Long-Term Incentive Award Performance Metrics

Long-term incentive plans (LTIPs) leverage metrics to motivate executives to work towards a company's long-term growth and quality goals. Over the past four years, relative TSR (rTSR), EPS, return on capital or invested capital (ROC/ROIC), revenue and

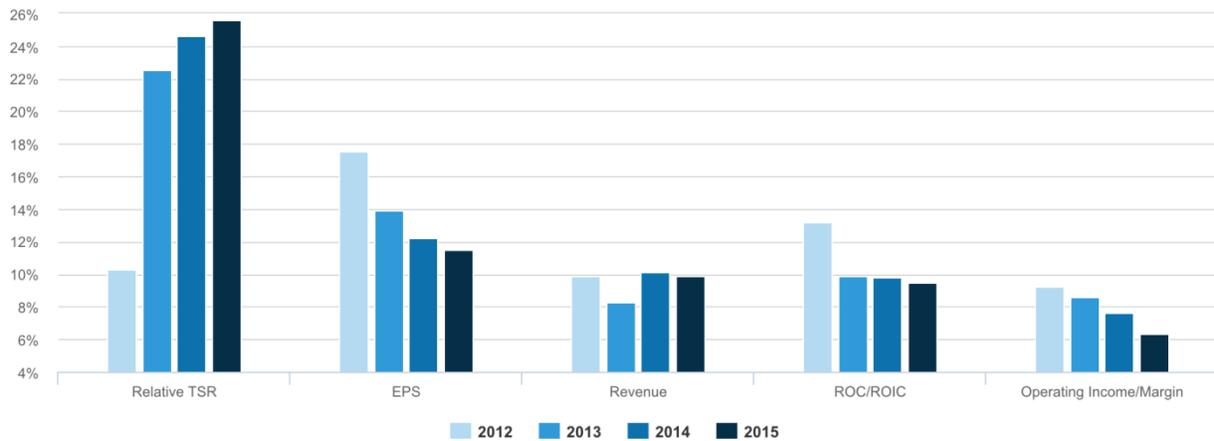
operating income/margin have been consistently the five most popular performance metrics linked to the long-term incentive awards of executives in the S&P 500.

Overall, there has been a distinct trend toward the use of rTSR for all executives. For example, in 2015, 25.2% of CEO incentive awards utilized rTSR as a metric, compared to 12.3% in 2012. Meanwhile, EPS and revenue fell significantly in that same year and continued to trail off. For example, 18.1% of CEO incentive awards utilized EPS in 2012, and that figure dipped to 11.1% in 2015. Notably, though only a part of 3% to 4% of executive incentive awards, EBITDA (earnings before interest, taxes, depreciation and amortization) was the other metric besides rTSR that has seen a consistent uptick over the past four years.

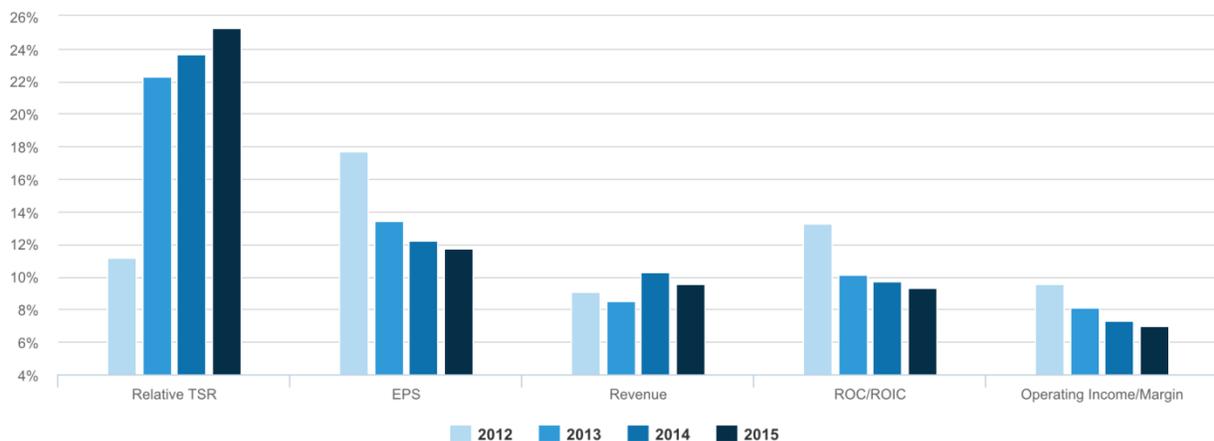
CEO Long-Term Incentive Award Performance Metrics, S&P 500



CFO Long-Term Incentive Award Performance Metrics, S&P 500



Other NEOs Long-Term Incentive Award Performance Metrics, S&P 500

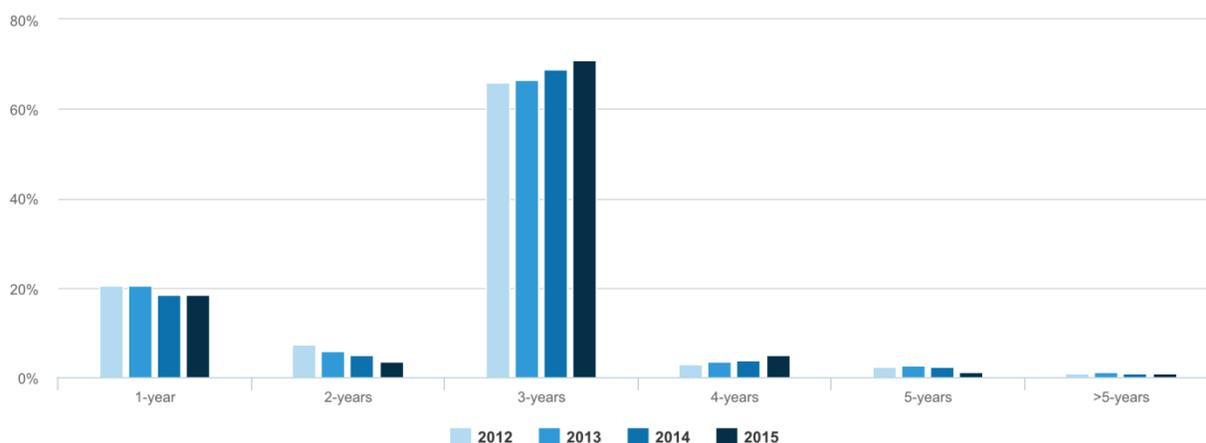


Long-Term Incentive Award Performance Periods

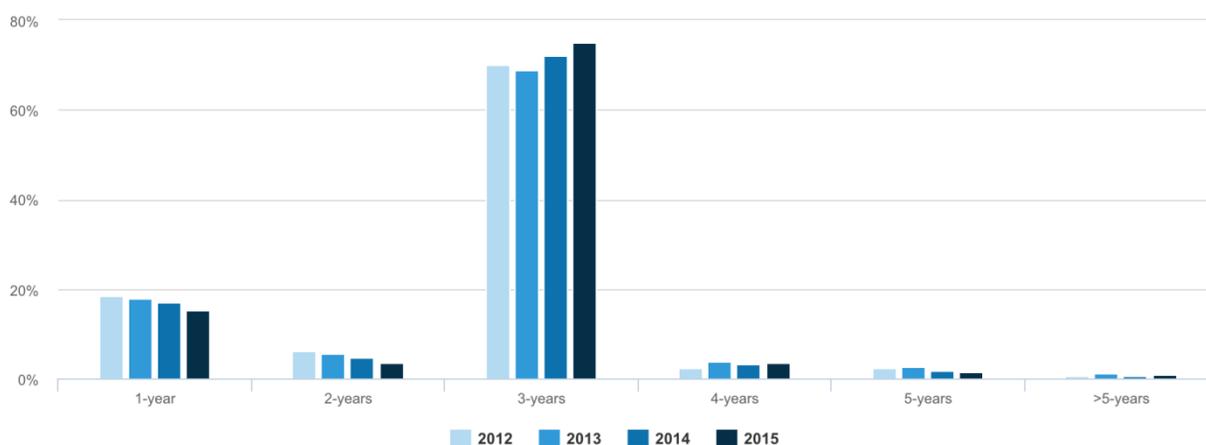
Performance periods define the length of time over which a performance metric will be measured, and those metrics are linked to the payout of long-term and equity incentive awards. Performance periods typically range from one to 10 years based on individual company business models. Some companies look to more aggressively align executive performance with shorter term goals, while others choose longer performance periods necessary for sustained company growth.

When ideal balance is achieved, performance periods are long enough to motivate longer-term thinking while not so remote as to stagnate performance incentives in the immediate term. As a result, three- and four-year performance periods have gained more traction since 2012, with three-year periods by far the most common. In 2015, three-year periods were attached to long-term incentive awards 70.8% of the time for CEOs in the S&P 500, 75.0% of the time for CFOs and 75.0% of the time for all other NEOs. Approximately 1% of S&P 500 performance periods were longer than five years across the study period.

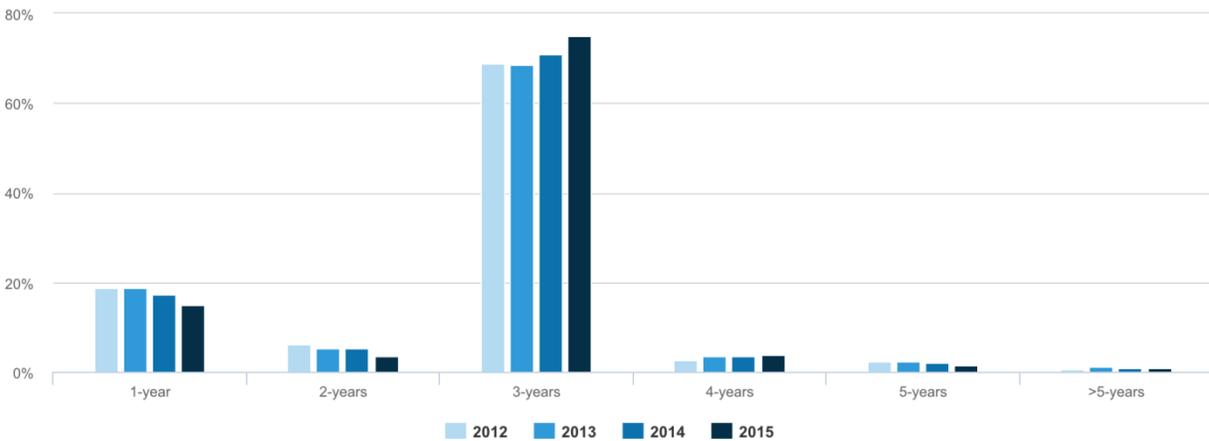
CEO Long-Term Incentive Award Performance Periods, S&P 500



CFO Long-Term Incentive Award Performance Periods, S&P 500



Other NEOs Long-Term Incentive Award Performance Periods, S&P 500



E*TRADE Commentary

Year over year, three-year performance periods continue to be the most common as evidenced based on the data shown here. Many companies are getting creative by layering multipliers for milestones reached before specific dates, or by delivering partial earned shares on vest dates within the three-year performance period in order to encourage earlier results while still promoting executive retention.

Annual Cash Bonus Award Performance Metrics

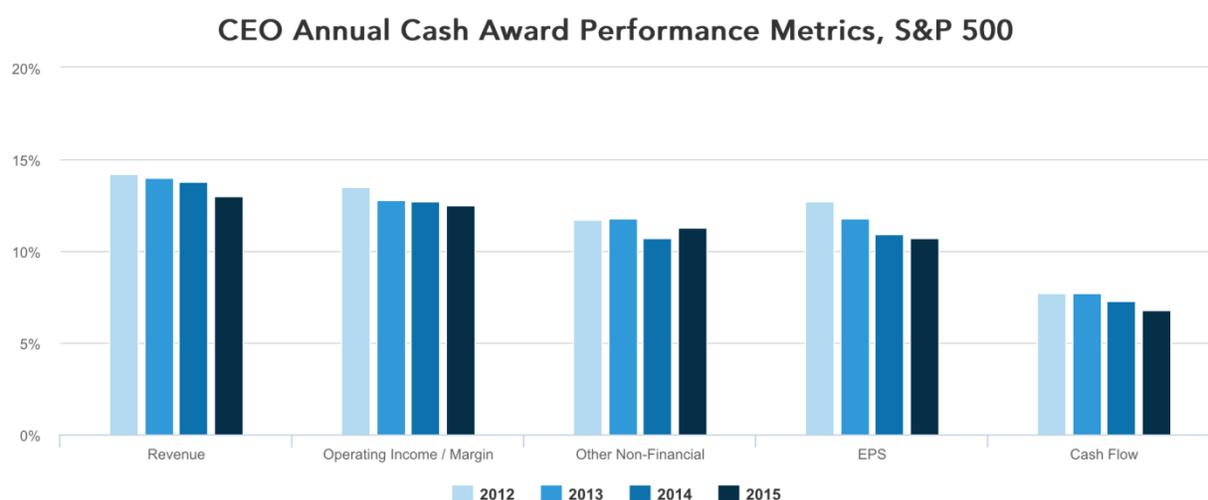
In addition to long-term incentives, executives also often receive short-term cash incentive awards based on fulfilling certain performance goals. The performance metrics for short-term awards can differ from those assigned to long-term awards, depending on the performance periods for long-term awards and business strategies of specific companies.

Overall, short-term performance metrics are more widely distributed than long-term incentive plan metrics. Revenue, operating income and earnings per share (EPS) were the three most common financial metrics among annual cash incentive awards for

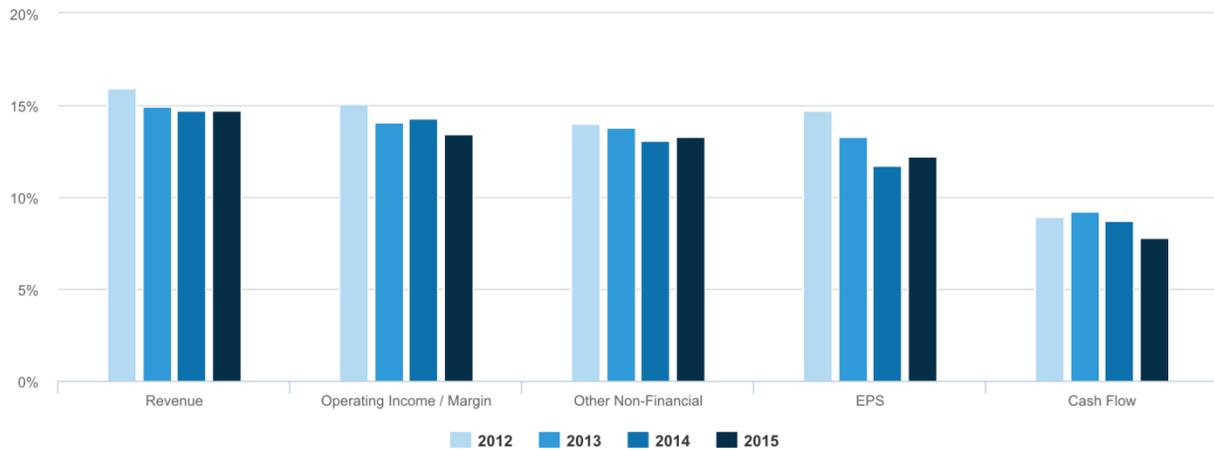
executives in the S&P 500. In 2015, the most common short-term incentive metric was revenue, attached to 13.0% of awards for CEOs, 14.7% for CFOs and 15.2% for other NEOs.

For CEOs and CFOs, the most popular metrics have waned in popularity over the years, and have been partially replaced by less common metrics such as cost/cost ratio, industry specific metrics, measures of safety, divisional performance and EBITDA. Of the less popular metrics, cost/cost ratio among CFOs was the only metric to appear more than 6% of the time for any executive awards, attached to 7.7% of short-term incentive awards for finance chiefs.

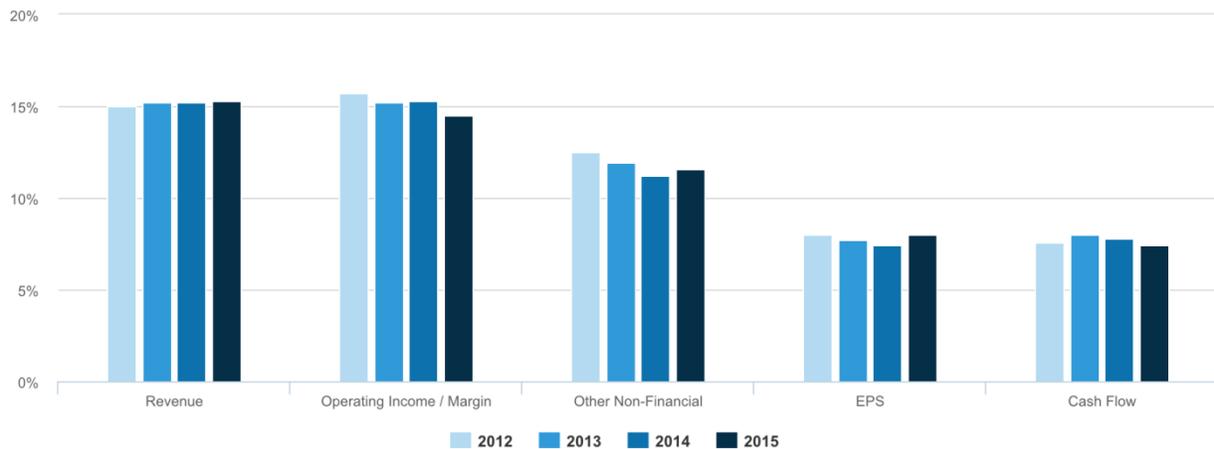
CEOs and CFOs are more likely than their other NEO counterparts to be measured by other non-financial metrics, which can include measures of leadership, productivity, quality of services, and product and workforce diversity. Overall, there is still a tendency to align bonuses for executives with company financial performance, likely because this aligns with the creation of longer-term shareholder value. However, these financial metrics are increasingly paired with non-financial metrics to encapsulate company performance.



CFO Annual Cash Award Performance Metrics, S&P 500



Other NEOs Annual Cash Award Performance Metrics, S&P 500



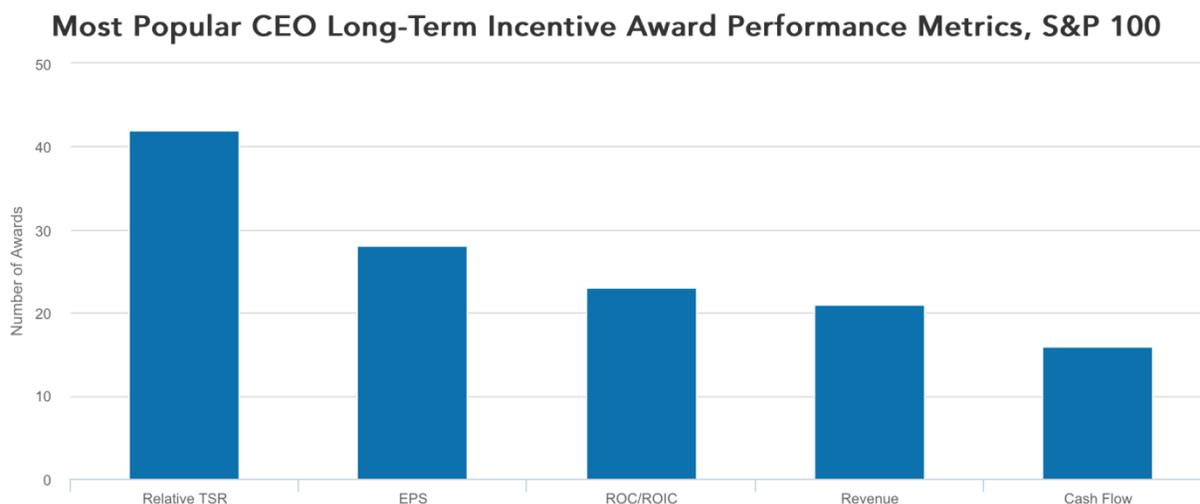
Long-Term Incentive Plan Details for S&P 100 CEOs

Beyond the decision to use specific performance metrics, incentive plan designers must consider additional details to achieve pay and performance alignment. In a deep dive on the most recently disclosed long-term incentive plans for CEOs in the S&P 100, Equilar went beyond the basic inclusion of performance metrics and analyzed the influence of metrics and performance goals on payouts of performance awards. In doing so, the study aims to uncover how leading companies achieve their pay-for-performance objectives.

Performance Metric Weightings

Companies commonly assign multiple performance metrics for the payout of one incentive award. For example, assigning a measure of sales (revenue) and of profit (EPS) to a single award aims to motivate an executive to focus on both top- and bottom-line growth. In these cases, plan designers assign weightings to individual metrics, with greater weight translating to larger influence on the payout.

In the most recently reported fiscal year, relative TSR, EPS, return on capital or invested capital (ROC/ROIC), revenue and cash flow were the most popular performance metrics for long-term incentive awards to S&P 100 CEOs. Relative TSR was by far the most often used, assigned to more than 40 performance awards. Each of the other most popular metrics appeared more than 15 times, where no other metrics appeared more than 10 times.

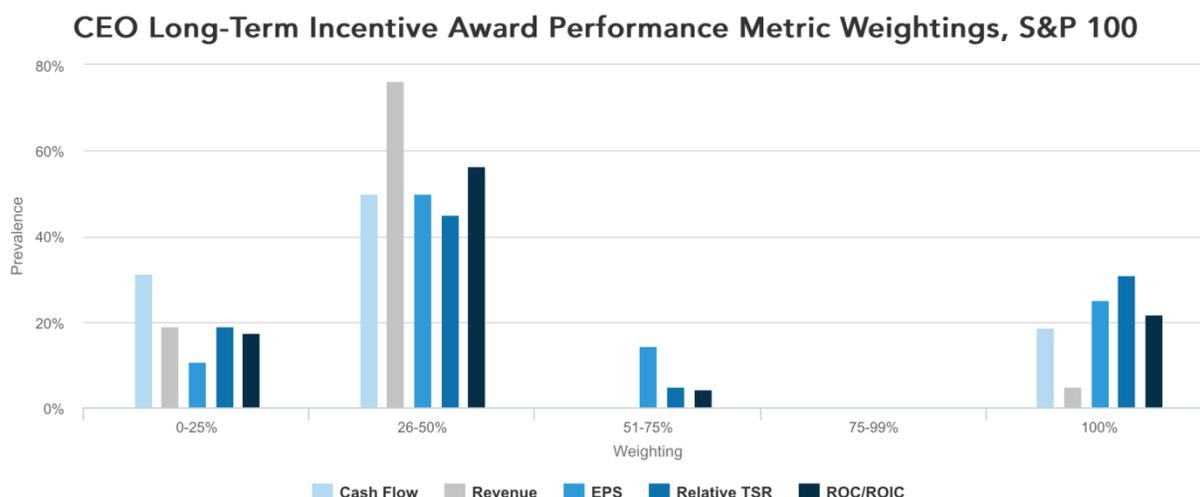


Popularity does not correlate directly to weighting. The most popular financial metrics attached to long-term incentive awards for CEOs in the S&P 100—cash flow, revenue, EPS, and return on capital or invested capital (ROC/ROIC)—were typically weighted less than 50% in 2015.

Relative TSR was the most popular metric in terms of prevalence but was weighted

less than 25% for about one in five of the CEO incentive awards when it was included. Awards that measure TSR to partially determine payouts, yet do not depend solely on TSR to encapsulate performance, provide incentive to deliver both strong financial or operational performance—critical elements of strategic achievement—and value to shareholders—a fundamental concern of proxy advisors and shareholders.

Along with being highly popular, relative TSR was also the most likely to account for 100% weighting, in nearly one out of every three awards to which it was assigned. Revenue was weighted between 26% and 50% most often of any metric in the study—76.2% of the time. Most prevalent on the low-end, cash flow was assigned a weighting in the bottom quartile 31.3% of the time.



E*TRADE Commentary

Typically, a company’s board of directors, specifically the compensation committee, tries to align executive pay with the company’s strategy and to the performance metrics valued by its shareholders, which supports our observation that companies often include several metrics across a single performance grant.

The consistency of some metrics and similar weighting across different plans speaks to

several possible factors: consistent interpretation of what stockholders value, ease of measurement, and performance equity participants' ability to understand and influence the measurement.

The complexity of administering and accounting for the performance awards appears to rarely influence the overall design of the plan or impact the rate of plan design changes year-on-year. As specific corporate strategies vary and may even change from one year to the next in the same company, individual metrics attached to the long-term performance incentives mirror these shifts and variations.

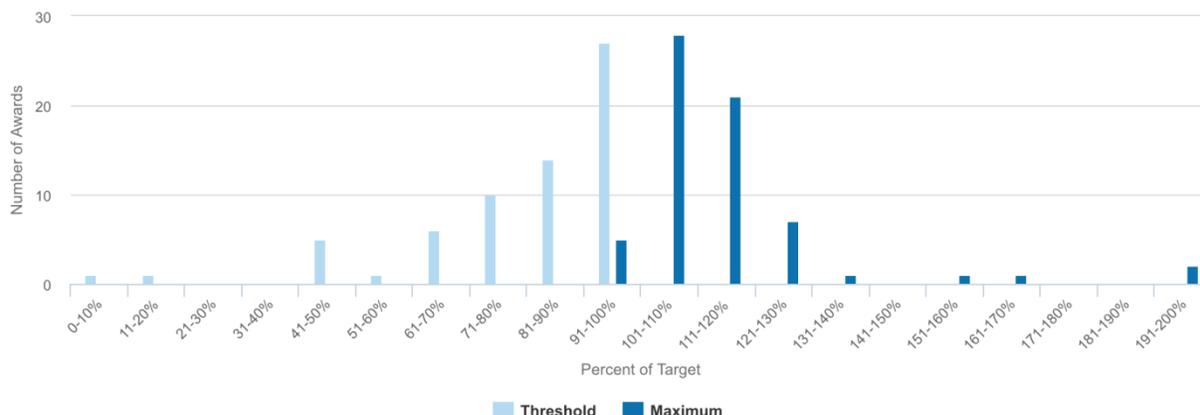
Performance Ranges

Performance ranges set expectations for the degree to which executives will receive and maximize their payouts. The connection between set performance goals—or targets—and award payouts creates the link between pay and performance. These types of incentive plans inevitably result in portions of executive pay being “at risk,” or variable, meaning that poor performance can result in little or no payout compared to target amounts.

Among CEO performance awards in the study, performance thresholds—or the minimum performance that results in the payout of an award—for long-term incentives were largely above 80% of target performance in 2015. Of the 65 awards that included reported threshold performance, 51 were between 80% and 100%, meaning that in order for these executives to receive any payout, the company would have to hit at least 80% of its target performance goal. The largest grouping of performance thresholds occurred even higher, between 91% and 100%.

Maximums, or the point beyond which higher payouts are no longer achieved, occurred largely in the 101% to 120% of target performance range. Of the awards that included reported maximums, 49 fell within this range, meaning that executives would receive the largest possible award if the company achieved 101% to 120% of target performance.

CEO Long-Term Incentive Award Performance Ranges as % of Target Performance, S&P 100

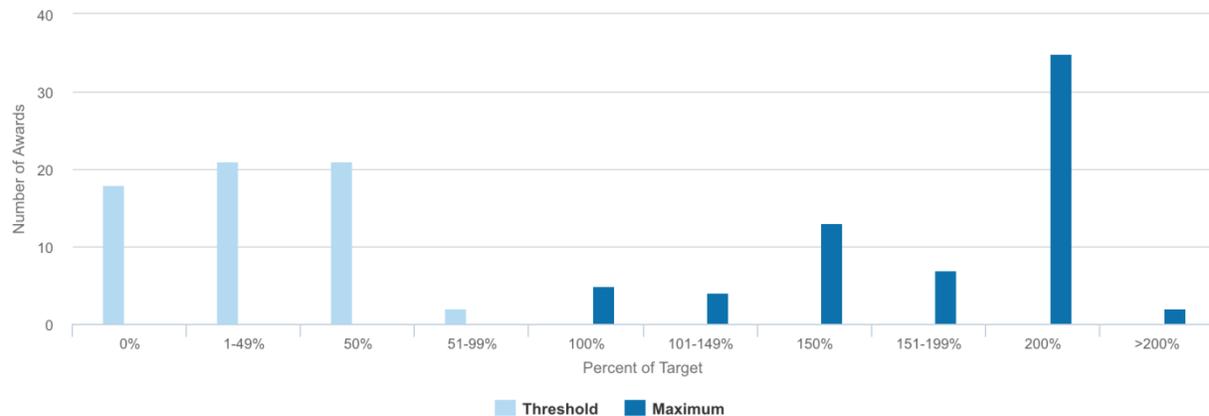


Payout Ranges

Award payout ranges as a percentage of target amounts were much wider than performance ranges, indicating that incentive plans leverage small, incremental change in performance into larger changes in award payouts. The most popular threshold as a percentage of target payout for long-term incentives of CEOs in the S&P 100 was 50% in 2015, and the risk of earning 0% of the target award was not uncommon. In other words, if a company did not reach its threshold for company performance, most executives were eligible for at most half of their target payout, and frequently nothing at all.

Maximum payout was most typically capped at 200% of target, with more than half of the awards in the study topping out at twice the target amount. The largest maximum in the study was 300% of target.

CEO Long-Term Incentive Award Payout Ranges as % of Target Payout, S&P 100



As an example of how these work in tandem, in its 2015 proxy ([filed 03/30/15, p. 37](#)), American Express displayed payout and performance ranges together to show how performance over the previous three years resulted in a payout. Executives at the company received 102.8% of the target award when the company exceeded the 3-year average return on equity target of 25%.

E*TRADE Commentary

As highlighted in Equilar's study, performance ranges, in relation to payout ranges, communicate the importance of specific deliverables to the grant recipients. Performance ranges are typically set so that overachievement is very difficult, but underachieving is relatively easy. This is why we see payouts increase quickly with over-performance.

It's also important to note there are many factors that play into a company's consideration when designing payout performance goals. Not only will a company consider past performance and forecast estimates in relation to their peer groups, but also they may weigh industry and market trends, the economic climate, their competitive environment, as well as the regulatory and compliance landscape. This is all done while staying mindful they are ultimately trying to drive shareholder value and ensure executive retention and motivation.

For these reasons, the challenge of setting annual performance goals can be complicated as companies attempt to achieve the proper balance between overachieving metrics and missing the payout ranges all together.

PLEASE READ THE IMPORTANT DISCLOSURES BELOW

¹ "Performance Awards: Trends, Challenges & Equity Edge[®]," E*TRADE Financial Corporate Services, Inc. Equilar Inc., and Hay Group White Paper, 2009.

² "2015 Equity Trends Report," Equilar Inc. featuring commentary from E*TRADE Financial Corporate Services, Inc. , 2015.

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