Performance Awards:

3 Truths...
and a Lie?

As Performance Awards play an even more significant role in compensation, we continue to evaluate their importance in the ever-changing equity landscape.

Fidelity Stock Plan Services and **ClearBridge Compensation Group** have teamed up for the third time to assess the **alignment between Performance Awards and company performance**.

With access to data on Performance Award payouts and company grant practices, we took a close look at which factors impact the pay-for-performance relationship and whether an **ideal mix of equity vehicles exists**.

Our findings resemble a popular icebreaker game called "2 truths and a lie."

Our research revealed what we're calling "3 Truths," as well as an often-repeated statement in the equity compensation industry – the "Lie."

3 "Truths" about Performance Awards . . .

#1: Payouts and company performance are directionally aligned, but still imperfect.

Performance Awards continue to align with company performance to a certain extent. Approximately two-thirds of awards were in line with performance, measured as either Total Shareholder Return (TSR)[1] or Earnings Per Share growth (EPS) (68% pay-for-performance alignment for TSR, compared to 62% alignment for EPS).

#2: Metrics DO matter.

TSR performance demonstrates the strongest relationship between payouts and performance (68%), while revenue performance shows the weakest relationship (51%).

#3: LTI vehicle mix may be related to company performance results.

High-performing companies tend to include Performance Awards and/or Stock Options in their long-term incentive (LTI) mix more often than low-performing companies (92% vs. 81%).

…and a "Lie?"

Stock Options are not a "performance" vehicle.

Despite predictions of their eventual demise after FAS123(R) (now ASC 718) – and opinions from institutional shareholders that Stock Options are not performance-based – Stock Options continue to be an enduring choice, providing direct alignment with shareholder value creation, so they may be worth another look.

[1] Total shareholder return (TSR) is defined as stock price appreciation, including reinvestment of dividends.

Beyond Performance Awards

Our research confirmed that Performance Awards continue to directionally align with performance, as measured in our research by TSR or EPS – regardless of the actual metric(s) used for the Performance Awards. However, with only approximately two-thirds of companies aligned, the **use of Performance Awards is not the silver bullet** in achieving pay-for-performance.

We therefore looked beyond the use of Performance Awards and examined the **mix of LTI vehicles companies use**. Several observations stood out, such as the fact that high-performing companies are more likely to include Performance Awards and/or Stock Options in their mix of equity vehicles than low-performing companies.

Is there an OPTIMAL grant mix?

To better understand Performance Awards, we looked deeper into the grant mix companies use, how their mix has changed over the past couple of years, and whether there is an **ideal mix of equity vehicles** that companies should grant.

Research Methodology at a Glance

Performance Award data was collected from Fidelity Stock Plan Services and analyzed by ClearBridge Compensation Group for 200 Fidelity clients with share-based Performance Awards that had performance periods of one year or more. The total number of participants in these plans ranged from 1 to 5,692, with an average of 168 participants.

200 clients

To analyze the pay-and-performance relationship, we used 594 Performance Award payouts spanning a period of eight years (2008–2015), compared to a company's performance measure relative to performance of the S&P 500® Index.

594 payouts

For purposes of analyzing the grant mixes used by companies, ClearBridge analyzed company grant mix data provided by Fidelity Stock Plan Services for 304 clients with five years' worth of grant practices to look at how their mixes changed over time.

304 clients

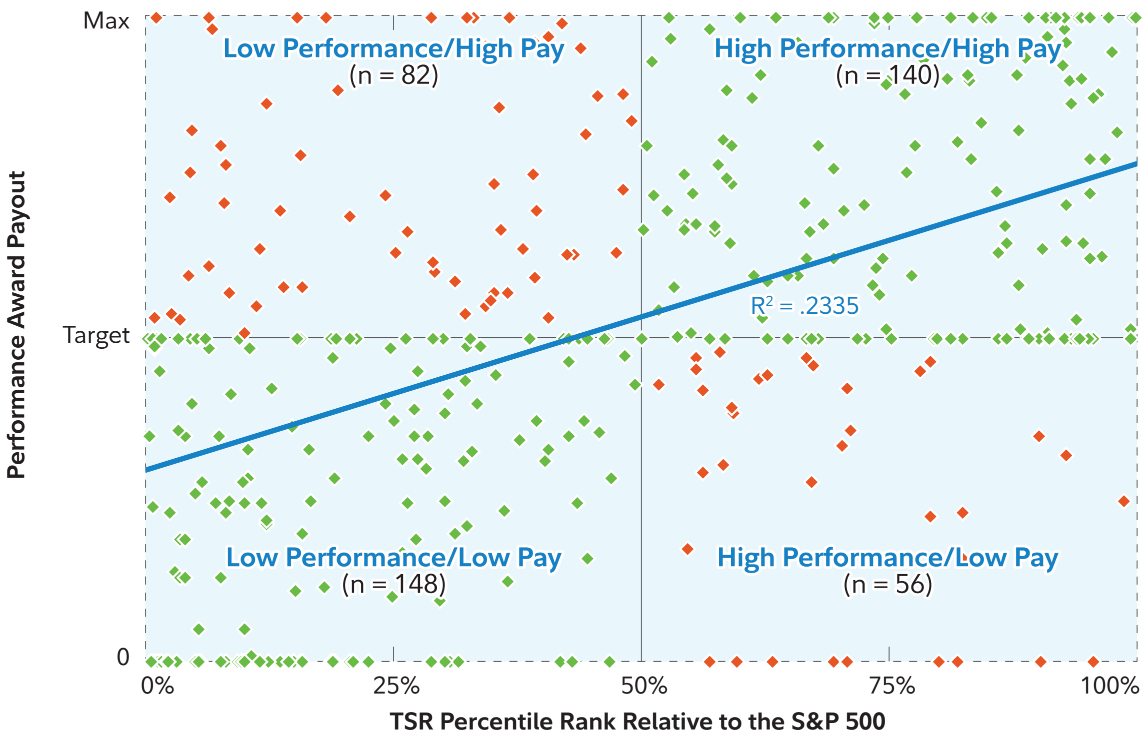
Additional detail on methodology can be found in the Appendix.

Truth #1:

Payouts and company performance are directionally aligned, but still imperfect.

When Performance Award payouts were compared against each company's TSR performance versus the S&P 500, 288 of 426 observations (68%) fell within the upper right and lower left quadrants, indicating that there was general alignment between payouts and relative TSR performance (see Exhibit 1). Furthermore, and similar to the results of our 2014 study, the pay-for-performance alignment was stronger between relatively high-performing companies (71%) than between low-performing companies (64%).

Exhibit 1 – TSR Performance versus S&P 500 (N=426)



Pay-for-Performance Alignment: Total Shareholder Return (TSR)

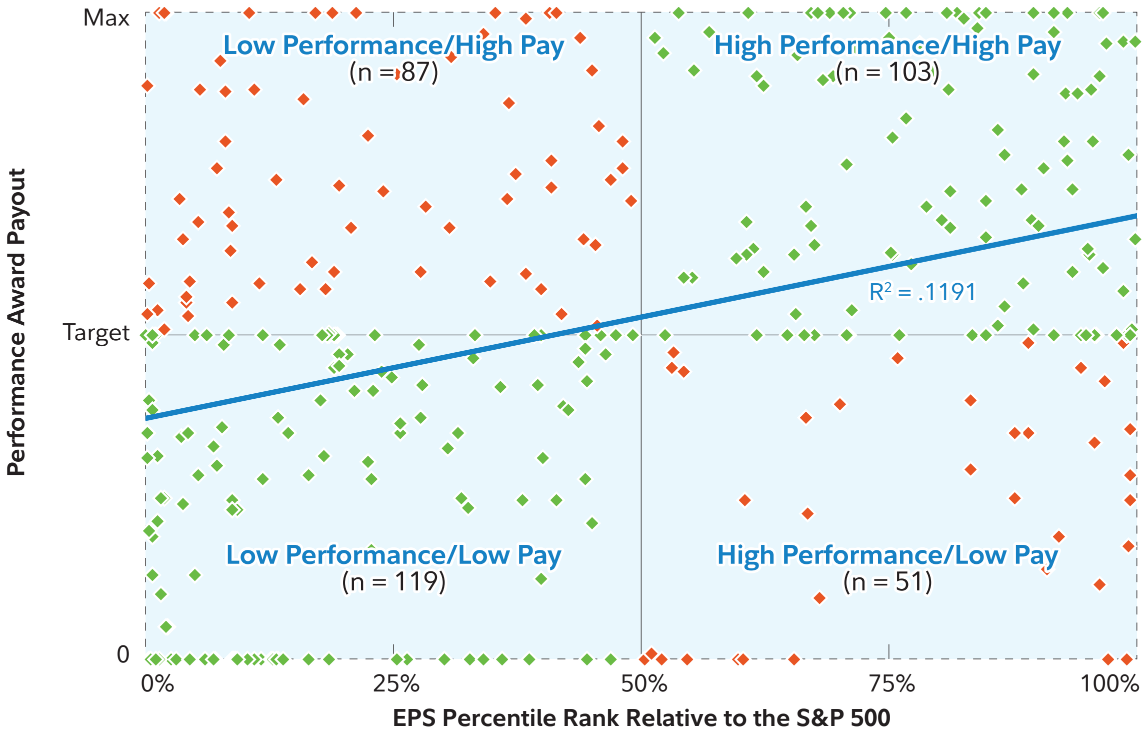
68%

32%

...Truth #1:

We replicated the Performance Awards analysis for EPS growth performance versus the S&P 500 and found similar results. 222 of 360 observations (62%) were pay-for-performance aligned, and once again the high-performing companies' payouts were more aligned with performance than low-performing companies.

Exhibit 2 – EPS Performance versus S&P 500 (N=360)



Pay-for-Performance Alignment: Earnings per Share (EPS) Growth

62%

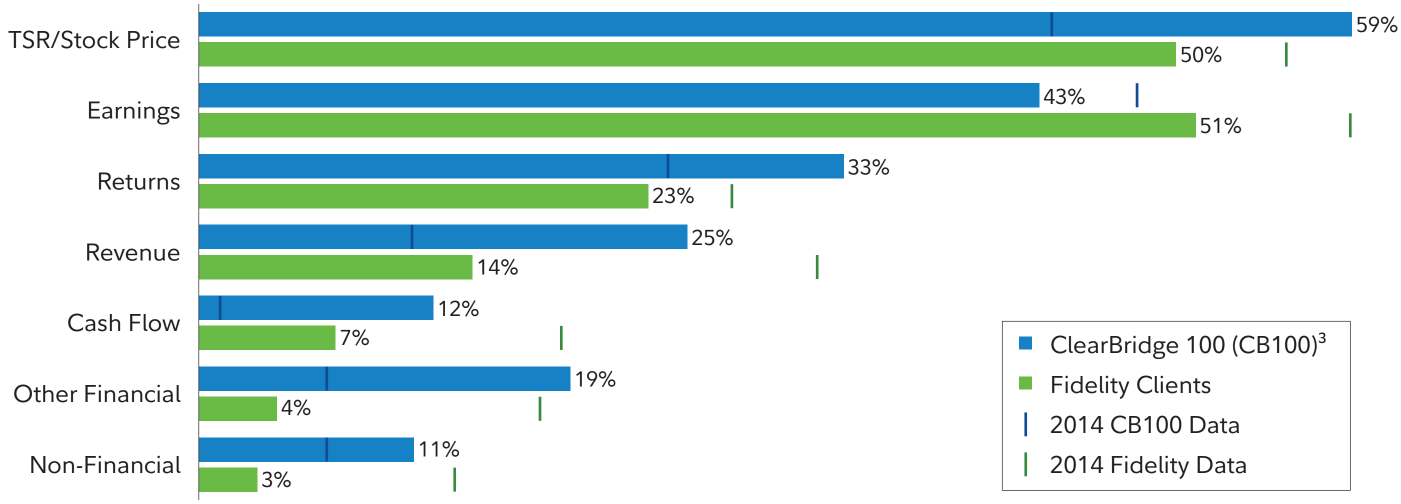
38%

Truth #2:

Metrics *DO* matter.

TSR and earnings continue to be the most commonly used performance measures in LTI plans.

Exhibit 3 – Prevalence of Performance Measure by Company[2]



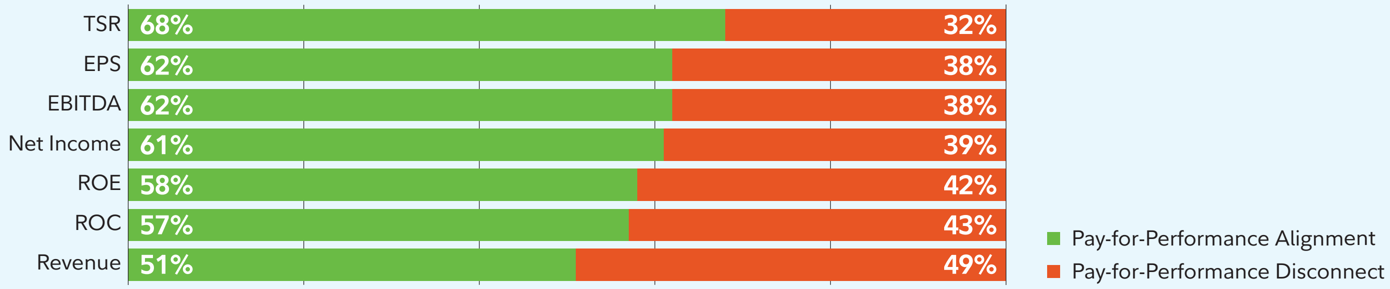
TSR plans tend to be measured on a relative basis (88% of companies), while financial-based measures tend to be measured on an absolute basis (92%).

Companies often use multiple financial metrics (42%) to assess performance and to balance growth and efficiency, as using a single metric can incentivize risky behavior. While companies use different metrics that best reflect their goals, some metrics appear to result in a stronger pay-for-performance alignment than others (regardless of actual performance measures used in companies' plans).

Relative Strength of Alignment

Companies' TSR performance has the strongest alignment with payouts, while revenue has the weakest, as shown in Exhibit 4.

Exhibit 4 – Relationship Between Pay and Relative Performance



[2] Note that the percentages add up to more than 100% given that companies may use more than a single metric.

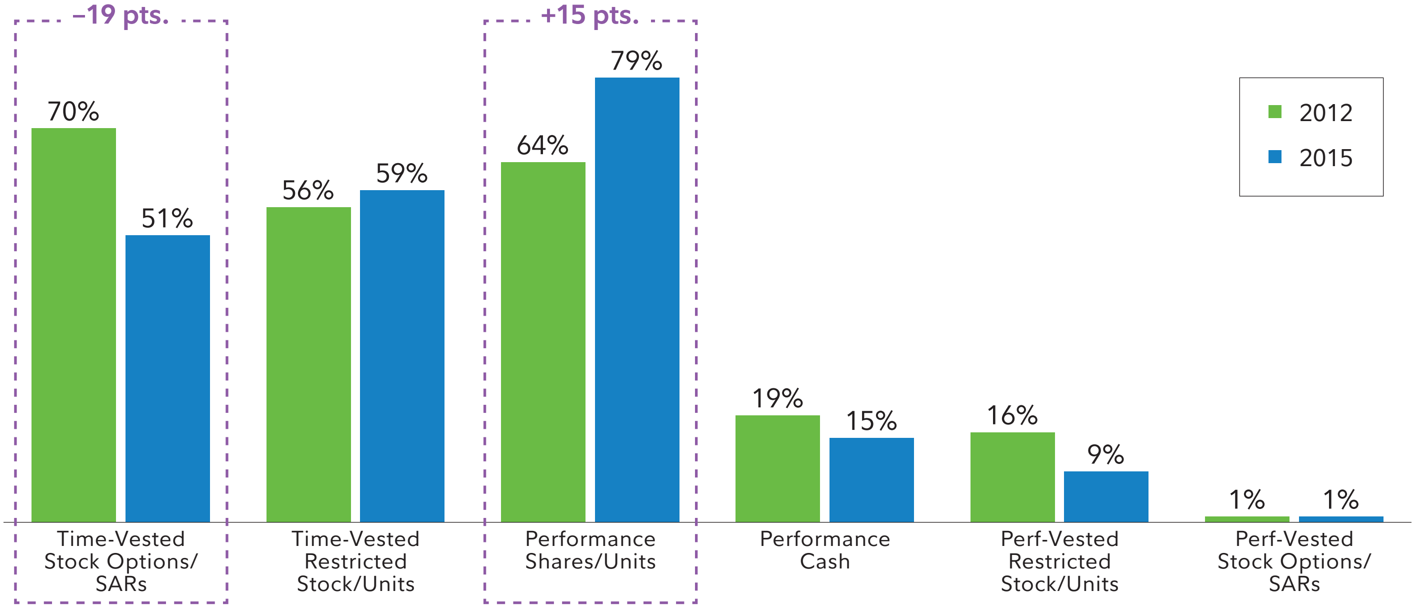
[3] The ClearBridge 100 Report presents findings on annual incentive plan and long-term incentive plan design practices for executives.

Truth #3:

LTI vehicle mix may be related to company performance results.

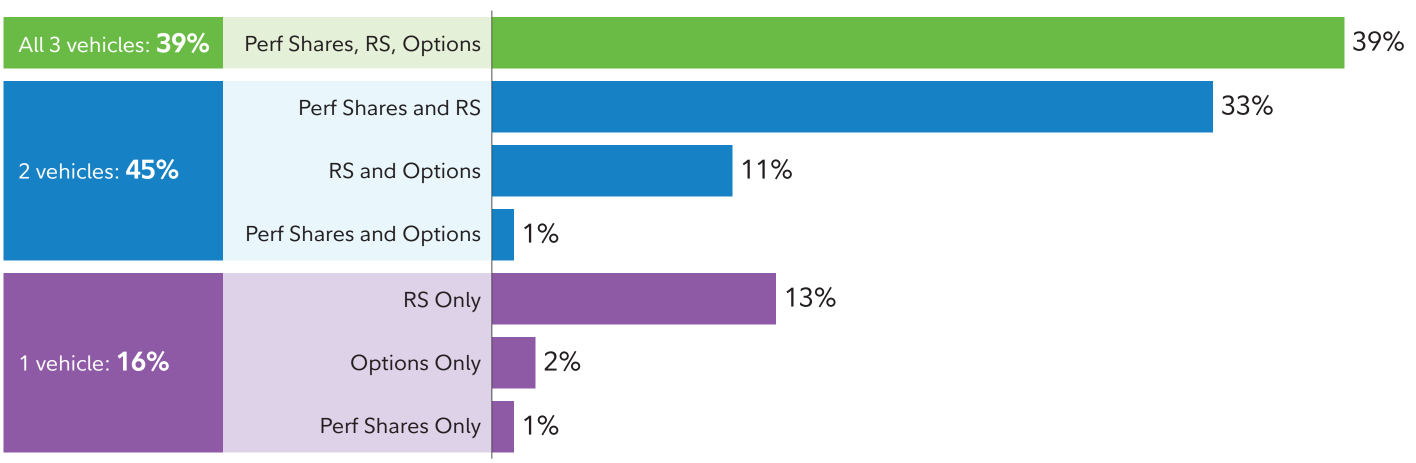
With two-thirds of Performance Award payouts directionally aligned with performance, it is not surprising that the number of companies adopting Performance Awards in recent years has continued to grow (see Exhibit 5 below).

Exhibit 5 – Prevalence of LTI Vehicles



However, the importance of other equity vehicles, such as Restricted Shares or Stock Options, should not be overlooked. In fact, as shown in Exhibit 6, 73% of companies granting Performance Awards do so in combination with one or more other LTI vehicles.

Exhibit 6 – Combination of LTI Vehicles



…Truth #3:

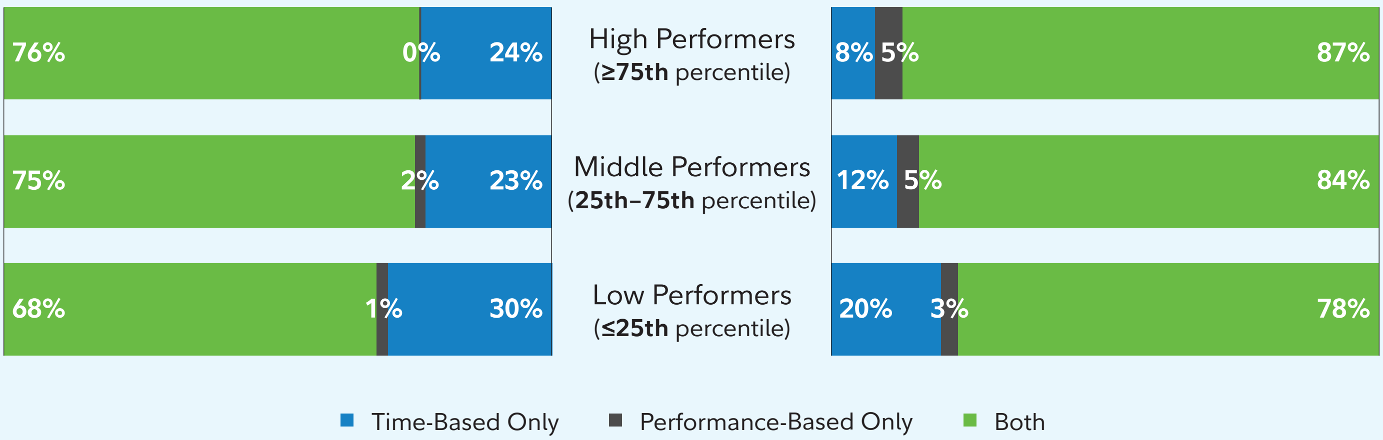
A deeper look indicates that high-performing companies use performance-based shares more often than low-performing companies, who tend to use time-based awards more often.

Stock Options fall in the gray zone, as time-based awards typically include Stock Options, but an argument can be made for Stock Options to be considered performance-based, given that the stock price needs to appreciate for the recipient to realize any value. When Stock Options are considered performance-based, an even larger percentage of high-performing companies use performance-based awards (Exhibit 7 versus Exhibit 8).

Are Stock Options truly time-based? Or, are they really performance-based?

Exhibit 7 – Equity Mix by Company Performance Level with Stock Options Treated as Time-Based

Exhibit 8 – Equity Mix by Company Performance Level with Stock Options Treated as Performance-Based



Percentages may not add up to 100% due to rounding.

The difference in grant mix may be due to high-performing companies perceiving the upside opportunities inherent in Performance Awards and Stock Options to outweigh the downside risks. In contrast, low-performing companies, which are often challenged with setting realistic long-range goals and struggle with meeting attraction and retention objectives, opt for the relative certainty associated with Restricted Shares.

and a *Lie?*

Stock Options are not a "performance" vehicle.

It's no lie – the demise of Stock Options has been predicted since FAS123(R) (now ASC 718), and institutional investors may not consider Stock Options to be performance vehicles. But, perhaps the time has come to reconsider them.

As the data show, the increased use of Performance Awards over the years corresponds with a decline in the use of Stock Options. However, Stock Options continue to be an enduring choice over other equity vehicles. Stock Options have direct alignment with shareholder value creation and can provide leveraged upside opportunity (since more Stock Options are granted for every Restricted Share).

***52%* of companies still use Stock Options**

These advantages can prove particularly beneficial for high-growth companies or companies undergoing a turnaround. For example, private equity portfolio companies often rely on upfront or periodic Stock Option grants to drive shareholder value creation and deliver significant upside reward.

A down economy and regulation changes have prompted many companies to shift away from Stock Options, but perhaps it is time to reconsider the benefits they can offer.

Conclusion

Overall, Performance Award payouts continue to align directionally with company performance.

Nevertheless, companies still rely on a mixed portfolio of vehicles to deliver their LTI program. While data show that high-performing companies use performance-based shares and low-performing companies use time-based awards, the classic "chicken or the egg" question comes to mind:

> *Do companies perform well or poorly based on the LTI vehicles they grant, or do they choose which LTI vehicles to grant based on their performance?*

Performance Awards appear to achieve the pay-and-performance alignment companies strive for – and shareholders expect. However, Performance Awards are no panacea for creating alignment, and instead, it may be a combination of LTI vehicles that is truly most effective.

Contact your Fidelity Stock Plan Services representative or Yonat Assayag (YAssayag@clearbridgecomp.com) at ClearBridge Compensation Group for more detailed information.

Appendix: Research Methodology

ClearBridge analyzed Performance Award data collected from Fidelity Stock Plan Services for 200 clients that had share-based Performance Awards with performance periods of one year or more. The total number of participants in these plans ranged from 1 to 5,692, with an average of 168 plan participants. Additional research statistics are provided in Exhibit 9.

Exhibit 9: Key Statistics Among Companies with a Performance Plan (# of Companies, n = 200)

Number of employees	**<2.5K** 30	**2.5K–10K** 49	**10K–25K** 48	**25K–100K** 48	**>100K** 14
Market capitalization	**<$1B** 15	**$1B–$5B** 85	**$5B–$10B** 31	**$10B–$25B** 33	**>$25B** 21
% of employees receiving Performance Award	**<1%** 122	**1%–5%** 45	**5%–10%** 14	**10%–15%** 4	**>15%** 4
Performance period years*	**1 year** 40%	**2 years** 27%	**3 years** 73%	**4 years** 6%	**5 years** 3%

Totals do not add to 200 due to availability of data.

For purposes of analyzing the grant mixes used by companies, ClearBridge analyzed company grant mix data provided by Fidelity Stock Plan Services for 304 clients, with five years' worth of grant practices to look at how their grant mix changed over time.

Exhibit 10: Key Statistics Among Companies that Grant Equity (# of Companies, n = 304)

Number of employees	**<2.5K** 53	**2.5K–10K** 88	**10K–25K** 71	**25K–100K** 67	**>100K** 18
Market capitalization	**<$1B** 26	**$1B–$5B** 98	**$5B–$10B** 52	**$10B–$25B** 61	**>$25B** 52

Totals do not add to 304 due to availability of data.

* As companies may utilize multiple plans with different performance period lengths, percentages do not add up to 100%. Two companies in the study are currently not publicly traded.

Appendix: Analyzing the Pay-and-Performance Relationship

We analyzed 594 Performance Award payouts spanning a period of eight years (2008–2015). These payouts were compared to a company's performance measure relative to performance of the S&P 500 Index.

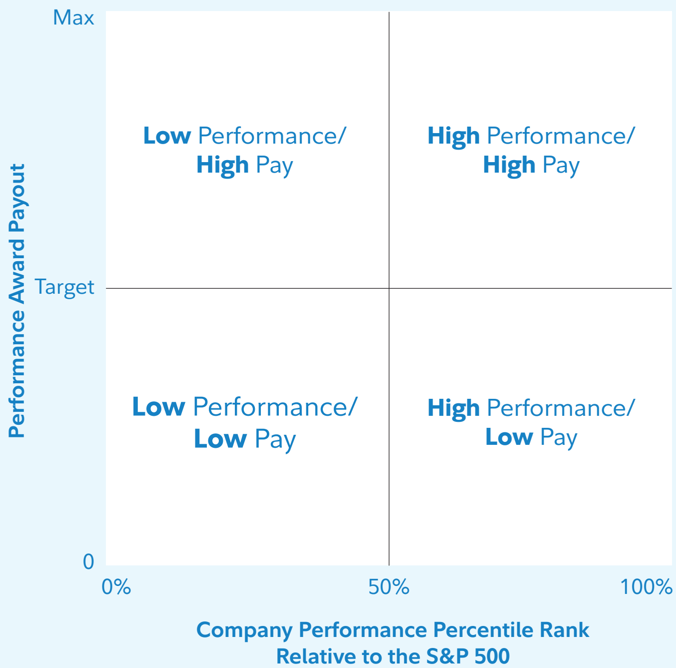
Specific performance measures analyzed include:

- Revenue Growth
- Return on Capital (ROC)
- Return on Equity (ROE)
- Net Income Growth
- Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) growth
- Earnings per Share (EPS) growth
- Total Shareholder Return (TSR)

The relationship was analyzed over the same period as that of the Performance Award measurement period. For example, the payout for a Performance Award with a three-year performance measurement period ending on December 31, 2015, was compared with a company's performance relative to the S&P 500 for the same three-year period ending on December 31, 2015.

Each Performance Award payout – ranging from a zero payout to a maximum payout under the plan – and the company's corresponding performance ranking relative to the S&P 500 was plotted on a pay/performance scale. The pay/performance scale was divided into four quadrants reflective of the pay-and-performance alignment (see Exhibit 11).

Exhibit 11: Pay/Performance Alignment Graph (Breakdown of Quadrants)



Performance Award payouts in the upper right quadrant (High Performance/High Pay) or lower left quadrant (Low Performance/Low Pay) are considered to be aligned with a company's relative performance. Payouts in either the upper left or bottom right quadrants represent a possible disconnect between pay and relative performance.

In addition to observing where the data fell, regression analyses were performed to assess the strength of the statistical correlation between payouts and relative performance.

821666.1.1