The Return of Cash Long-Term Incentives

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Bottom Line	Use of cash long-term incentive plans has increased across a broad spectrum of companies.
Subjects	Market Data, Performance Cycles, Measures and Award Curves, Cash Plans in Total LTI Strategy

Executive Summary

The attention given to equity-based compensation plans in recent years – driven by changes in accounting, tax, and disclosure rules and fueled by shareholder concerns – has resulted in cash compensation arrangements being pushed to a secondary position in the headlines. But as many companies have agonized over choices between stock options and restricted stock, experimented with adding performance features to grants, and reconsidered the role of equity in compensation strategy, cash long-term incentive plans have increased in use in some unexpected places.

This trend is a bit counterintuitive. There has been great concern over non-cash compensation expense resulting from accounting rule changes for equity-based compensation and widespread efforts to manage that expense through both reducing the amount awarded and revising valuation techniques used to compute the associated expense. Yet companies of varying size, industry, and maturity are pursuing a long-term incentive strategy that includes a cash component. These plans are a radical departure from the norm of equity-based plans that are linked directly to share value, paid in shares, and incur a fixed noncash expense measured at the grant date.

Performance periods range from one year to five, with some complex hybrid designs, but the three-year cycle is most prevalent.

Twenty-nine percent of the companies are using two performance measures, most commonly a profitability measure (e.g., EPS) combined with a return measure (e.g., ROIC).

Though the replacement of stock-based pay with cash helps manage share dilution, the ultimate financial impact can be even greater.

The Research

Using the SEC filing data for 6,079 companies available through our custom research capability, we identified 191 companies with cash long-term incentive (LTI) programs. While this small percentage hardly represents a new market norm, 75% of these companies have more than $1 billion in annual revenue indicating that most of the companies are among the largest 1,000 companies. These plans now exist in approximately 15% of this class of firms, approaching the prevalence among the Fortune 200. This “big company” practice has trickled down to mid-sized companies, and even those under $1 billion in revenue, in this era of shifting toward performance-based programs. The number of newly-implemented plans in 2006 and 2007 indicates it may be the beginning of a still broader trend.

The Data

Unlike many compensation trends that are clustered in certain industry sectors (e.g., all-employee stock options in small and mid-sized technology companies) or among companies of similar size (e.g., supplemental executive retirement plans in Fortune 100 companies), the use of cash LTI plans is spread across a remarkably broad universe of companies.

Cash LTI plans originally appeared in larger mature companies with limited upside potential in the stock price, the resources for goal-setting and administration of multi-year performance based plans, and the cash available to settle those awards when due.

Contrary to this history, the current population of companies with cash LTI plans ranges from those with under 2,000 employees and over 400,000 employees; under $1 billion and over $100 billion in annual revenue; and under $1 billion to over $250 billion in market capitalization.

	Number of Employees	Annual Revenue (mm)	Market Cap (mm)
75th percentile	33,000	$10,960	$11,709
Average	34,256	$11,042	$13,143
Median	13,100	$3,310	$2,577
25th percentile	3,581	$1,091	$790

Virtually every industry sector is represented by this practice – manufacturing, financial services, technology, retail, utilities, healthcare, pharmaceuticals and biotechnology, and media. Firms of all types and sizes have begun experimenting with cash-based long-term incentive programs to supplement, but not replace, their equity-based plans.

Just as the design features of performance-based equity programs have proliferated (see Insight Issue 2, The New Era of Equity Compensation: Performance Plans) the cash LTI programs do not conform to a norm. We cannot report what the "typical" plan looks like, but there are a few emerging plan design trends.

Performance Periods

The traditional time period for long-term incentive programs has been three to five years. The increasing volatility and faster change of pace of the business environment has created more difficulty in establishing durable multi-year goals. While companies are using performance periods ranging from one year to five, with some complex hybrid designs, one plan design dominates: the three-year cycle with payment at the end of the performance period (74% of companies). Next most common are those with a one-year or two-year performance period (14% of companies) followed by a one- to three-year time-based vesting period.

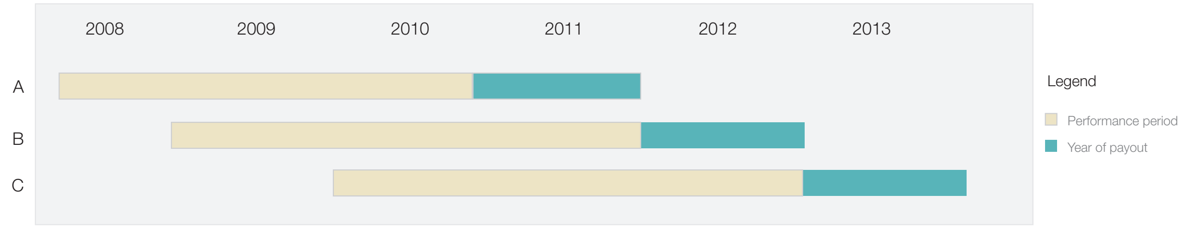
Performance Period (yrs)	Number of Companies	Percent of Companies	Additional Time Vesting
1	16	8%	100%
2	12	6%	8%
3	142	74%	6%
4	8	4%	13%
5	2	1%	0%
Other	11	6%	9%

All of the companies with a one-year performance period have a time-based vesting element following the performance measurement period. Many companies have adopted this design to take advantage of an opportunity to preserve the tax deductibility as a "performance-based" plan even though most of the plan period is not performance-based. This design also allows companies with a limited ability to set multi-year goals and create a multi-year plan from single-year goals, realizing a similar retention power but lacking the ongoing link to company performance. A few plans do continue to vary the award amount during the time-based period creating a complex plan that is difficult to describe succinctly.

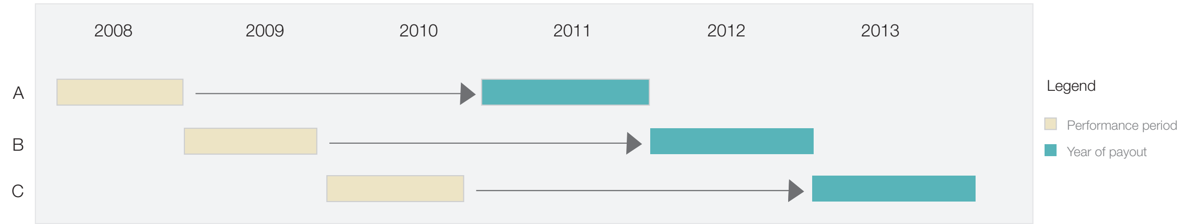
Performance Cycles

Sixty percent of the companies with Cash LTI plans have overlapping performance cycles, most all of them initiated annually. Eleven percent of the companies have a single performance cycle with a new one commencing afterwards. Many companies did not specify the nature of the interaction among performance cycles; the majority of these have recently implemented cash LTI plans and the company did not disclose and perhaps has not yet decided how the structure will evolve. The overlapping structure reflects the typical long-term incentive program design for stock options, restricted stock, and performance shares and ensures that a continuing unvested and/or performance-contingent opportunity is in place each year.

This approach creates another opportunity with Cash LTIs, which typically have no link to share price, by allowing the company to evolve performance measures year to year. This presents the danger of measurement conflict, however, and must be carefully thought through. For example, if the performance measurement in year 1 is based on revenue growth then the measure in year 2 is focused on return on capital the decision-makers may be faced with the conflicting messages of "you are rewarded for growth" but "spending to grow may be penalized." Clever balancing of these, integrated with equity incentives, can provide an effective structure if the complexity doesn't outweigh the performance message.



The one-year performance periods with subsequent time-based vesting, in addition to reducing the need for multiyear goal-setting, can minimize the risk of goal conflict and complexity while supporting longer-term alignment and retention objectives.



Performance Measures

It is both difficult and misleading to discuss the prevalence and use of various performance measures in long-term incentive plans. Fifty-five percent of the companies are using a single measure and this is often, but by no means a majority practice, total shareholder return versus a peer group or industry index ("Peer TSR"). Peer TSR is used as the single or one of multiple measures by 26% of the companies.

Twenty-nine percent of the companies are using two performance measures, most commonly a profitability measure (e.g., earnings per share, EPS) combined with a return measure (e.g., return on invested capital, ROIC). The remaining 16% of companies are using three or four measures or provided disclosure of plan details that made it difficult to confirm the plan's performance measures.

Performance Award Curves

Award opportunity levels are typically expressed as a percent of target. The maximum award payable under most plans is 200% of target; 49% of companies cap awards at this level. Above and below that, plans pay a maximum ranging from 100% of target (no upside beyond the target level of payment) to over 500% of target.

The threshold award level – the amount earned if the minimum performance level is achieved – is typically 50% (36% of companies) but varies from no threshold being disclosed to a purported threshold of 100% of target. We expect companies will be encouraged to provide clearer disclosure of the range of possible awards in future disclosures.

The Role of Cash Plans in Total LTI Strategy

Just as the increased use of restricted stock units and performance shares has not heralded the discontinuation of stock option grants, few of the companies with cash LTI plans have abandoned equity-based compensation. Companies continue to evolve portfolio-based approaches to long-term incentives, and the increasing prevalence of Cash LTI plans is another manifestation of this experimentation. We are observing an emerging norm of companies of all sizes using two or three types of long-term incentive awards in any given year.

Cash LTI plans have a number of characteristics that complement equity-based program features as they:

- Partially or fully insulate executives from market volatility and/or industry and macroeconomic factors that may render stock options worthless and threaten retention ability. This may be particularly acute while a company implements a change in strategic direction with a multi-year results horizon.
- Provide cash distributions for a portion of LTI earnings when stock-based awards may be “tied up” in meeting accumulation goals for stock ownership guidelines and retention policies.
- Allow reallocation of some LTI costs to manage share dilution in companies with sufficient cash but pressure from shareholders to reduce run rates to a level that will not provide for competitive LTI awards.

Despite these advantages, it is important to understand the multiple facets of plan cost. This research shows that companies of varying size, industry, and maturity are using a long-term incentive plan that results in a cash expense that is variable. Though the replacement of stock-based pay with cash helps manage share dilution the ultimate financial impact can be even greater. Under current accounting rules, stock-based pay holds the potential for both a fixed expense and an expense that is far less than actual compensation delivered - although there also is potential for expense recognition in absence of any compensation delivery at all. While cash plans avoid this latter situation of expense without pay, any pay will have a dollar-for-dollar expense associated with it.

From a governance perspective, as shareholders continue to push for alignment of pay and shareholder returns and as the financial markets continue to move away from focus on accrual-based measures such as net income and EPS and toward cash-based measures we may see a short lifespan of the Cash LTI trend.

This may be exacerbated by use of performance measures that have no clear link to shareholder value, performance targets set too low resulting in high or maximum payouts during times of depressed share prices, and payout when combined with large annual incentive payouts create a perception of “too much cash” for a single year. In the current governance, disclosure, and media environments it takes only a few incidents of large payouts in absence of value creation for a practice to come under attack as yet another “pay for failure” scheme.

Takeaway

It is important to remember that the initiation and revision of a certain type of LTI plan may be occurring in the context of other changes in stock option grant cycles, full-value award grant timing, and other changes in the overall LTI structure. We cannot assume that a single year's grant structure is part of a static program. Many of the companies using cash LTI awards did so for the first time last year.

During the past few years as equity compensation practices have been challenged, revisited and restructured, companies of all types and sizes have explored alternatives to stock options. The great diversity, and complexity, of Cash LTI program design shows the opportunity these plans provide in tailoring long-term incentive pay to a company's particular business and financial strategies and represent the other end of the LTI spectrum from simple stock option grants with time-based vesting.

We have seen some trends quickly come and go, such as the use of RSUs for top officers, which spread quickly only to receive challenges from shareholders demanding performance contingencies on the "free shares." As companies evaluate Cash LTIs as an alternative for delivering long-term performance-based pay to executives, they should remember that the transparency of plan design resulting from current disclosure requirements may generate challenges to significant cash payouts based on performance measures that may not correlate to shareholder value creation.

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