It’s All Relative: A Primer on Implementing Relative Financial Metrics in Your LTIP

The one-two punch from COVID-19 and the March 2020 oil shock is a reminder of how vulnerable company profitability and growth prospects can be to “exogenous shocks.” Indeed, the last decade of relatively steady run-ups in security prices is more of an outlier. Over long historical periods, volatility and turbulence are recurring themes.

That’s why relative metrics, at least in some capacity, belong in virtually every long-term incentive plan (LTIP). A long string of research[1] shows how relative metrics filter out external shocks that shatter the relationship between individual performance and pay. Target Corporation made the switch during the recession of 2008, explaining that:

> The decision to move to relative measures for PSU payouts is intended to ensure that our compensation performance metrics include not only performance against our own internal absolute benchmarks, but also performance relative to that of our competitors. Absolute measures that were used in the past could be greatly skewed by a rapid downturn or upturn in the economy, rather than reflecting executives' ability to drive performance under those conditions.

The most common relative metric is relative total shareholder return (rTSR), which approximately 60% of companies use. But if you talk to a hundred CEOs and compensation committees, not all will conclude it’s right for them. Fortunately, rTSR isn’t the only option. Essentially any financial metric can be converted into a relative form; think relative EPS growth, relative revenue growth, or relative return on invested capital (ROIC).

From rTSR to Relative Financial Metrics

So how did rTSR end up being so widely used? One reason is that rTSR makes it easy to compare a panel of companies—every public company has a readily available stock price, and stock returns are simple to calculate and compare.

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[1] This research, in fact, has been steadily accumulating for decades. Early research began in the 1980s from Bengt Holmstrom, Michael Jensen, and William Meckling, often focusing on the classic principal-agent question. Widely cited research from the 1990s and 2000s includes John Core and Wayne Guay, “When Contracts Require Risk-Averse Executives to Hold Equity: Implications for Option Valuation and Relative Performance Evaluation,” SSRN Electronic Journal, 2001. More recent research includes work by Mary Ellen Carter, Chris Ittner, and Sarah Zechman, “Explicit relative performance evaluation in performance-vested equity grants,” Review of Accounting Studies, 2009.

In contrast, while every company has reported revenue, earnings, and profitability data, comparisons can be tricky due to diverse accounting conventions, different fiscal year dates, and other anomalies. But there are certainly ways to overcome these hurdles, much in the same way there are inherent kinks in an rTSR award that need to be thoughtfully addressed in the design phase. More on this later. First, let's look at some of the unique benefits of relative financial metrics:

- Unlike rTSR, relative financial metrics are far less sensitive to the starting and ending points selected in the design (rTSR's starting point is usually a trailing stock price instead of a trailing fiscal year of sustained performance).

- Relative financial metrics provide greater line of sight than a stock price metric since they relate to operational measures like revenue and earnings. This is in contrast to TSR, in which company fundamentals are intermixed with macro factors and the whims of investors.

- Relative financial metrics, as with rTSR, sidestep the major difficulty of setting performance goals in an unpredictable economic climate.

- Unlike rTSR, relative financial metrics allow expense to be reversed in the event there is not a payout or a payout below target. Of course, this also means there can be true-ups in expense if performance exceeds target.

We continue to like the specific benefits of rTSR and expect to see it become more prevalent. However, 2020 may be the breakout year for relative financial metrics. They appeared for the first time during the last recession and although their use has grown steadily, the benefits of relative metrics really shine during periods of economic turbulence.

Tips and Best Practices with Relative Financial Metrics

We've worked with companies across industries and firm circumstances to implement relative financial metrics. Here are the key steps—along with some potential pitfalls to avoid.

1. **Metric selection**. Consider what metric(s) are relevant to your firm and industry. Common measures include revenue growth, EPS, gross margin, and ROIC. The specific metric that works best for your standalone financials might give anomalous results once extrapolated across your comparison group, making it necessary to back-test multiple scenarios.

2. **Minding the GAAP.** Relative financial metrics are most easily implemented using as-reported GAAP results, which is not how most companies talk about their own

performance to investors (adjusted non-GAAP metrics tend to dominate these conversations). If you're interested in applying adjustments and using non-GAAP performance for a relative financial metric, be sure you can successfully do this for each peer firm. For example, a simple non-GAAP adjustment to exclude currency fluctuations requires each peer firm to consistently disclose constant currency revenue, which may not be the case.

3. **Peer group selection**. As with rTSR, peer group selection is critical to the effectiveness of a relative award. For instance, while the S&P 500 peer group might fit as a "broad market" comparison for stock returns, it may be less appropriate for a metric like profit margin that is heterogenous across sectors. At the same time, the peer group needs to be large enough that it isn't overly influenced by individual firm events and anomalies.

4. **Performance comparison**. Develop an appropriate way to compare companies on an apples-to-apples basis. This seems simple, but it's easy to get wrong with many financial metrics. With TSR, you never have to worry about stock prices starting or ending below zero, and a stock moving from a penny to a dollar may be a near miracle. On the other hand, for EPS, these things happen frequently—such as EPS moving from $0.04 to $0.12 (a 300% increase)!

   Other conventions, like using absolute rather than percentage changes, can give an unfair structural edge to certain stocks. An example of this would be stable or mature firms that are struggling to grow but have a cash cow business generating steady results. When we assist clients, we perform extensive back-testing and what-if forecasting of several different possibilities to make sure the definitions and conventions are comprehensive and reasonable.

5. **Payout structure**. With rTSR awards, the default payout framework has been a percentile ranking where the TSRs of the constituents are compared and ranked on a percentile basis. Even with rTSR, we find companies are too quick to fall back on this without considering the main alternative, which is measuring over or under-performance against a baseline (e.g., linking the payout to excess performance over the median peer). Be sure to model both a percentile rank and an outperformance payout construct when looking at a relative financial metric.

6. **Combination with other metrics**. For many companies, a hybrid award combining two metrics opens a world of possibilities. A hot trend with rTSR is to apply it as a modifier instead of as a standalone metric. As you explore relative financial metrics, address the pros and cons of making the metric a modifier or standalone component. Also consider how it should interact with other relative or absolute metrics in the LTIP.

7. **Timing readiness and limitations**. Unlike with rTSR, we can't go to the internet and track daily revenue, earnings, etc., since these are only disclosed in quarterly and annual

filings. Different fiscal years and filing deadlines make it more difficult to compare firms in a timely manner. This sometimes means that payout certification needs to wait longer than it would under traditional metrics or that data must be omitted. Logistical issues aside, fiscal year differences alone can cause results to be less comparable when seasonality is known to exist in a business.

When we assist companies, we spend time looking at the different ways of handling fiscal year differences to ensure there are reasonable assumptions being made and no surprises at the end.

8. **Peer group delistings and corporate events**. As with rTSR metrics, assume that events will happen to your peer group over the next three years. Some firms may go bankrupt, others may merge or get acquired, and still others may be the acquirers. In this issue brief, we discuss peer group changes as they relate to rTSR, but the principles all apply cleanly to relative financial metrics as well.

9. **Education**. As a new award structure for most companies, recipients will need extra education. Absent a solid understanding, even the best awards will become a black box or a lottery ticket, leading to disengagement and a lack of incentive. Pull out all the stops to make sure participants understand the new structure, from brochures to townhalls to one-on-ones or small group learning sessions.

   A key component of education is post-grant tracking and keeping senior management, the compensation committee, and award recipients apprised of how the award is faring. We automate these calculations in AwardTraq to provide on-demand access. This ability to check award progress frequently is vital to the total rewards function and many companies even allow their participants to have the same type of access to information.

10. **Understand the accounting**. Under ASC 718, rTSR metrics are market conditions but relative financial metrics are performance conditions. Therefore, with financial metrics the grant-date fair value will be locked in at the time of grant, but accruals will vary in response to the probable performance outcome identified each period. For EPS purposes where the units granted are treated as contingently issuable shares, the realized outcome at each quarter-end must be used. The tracking process noted above will be essential to developing both accounting amounts.

Wrap-Up and Action Items

A hallmark of effective compensation is ensuring a tight link between inputs (effort) and outputs (pay). When that link is perceived to be broken or just nebulous, the value of the incentive contract falls and loses its strategic muster. This is why buyout packages in talent acquisitions are often structured at prices far below the realizable pay value of the outstanding equity that the executive candidate holds. Effective LTIPs use thoughtful incentive design and robust communication to tighten the perceived link between pay and performance.

Our contention is that relative metrics can help tighten the perceived link between pay and performance—generally, but especially during turbulent economic climates. Rarely should the LTIP be entirely relative in nature. Adding even one relative metric—or inserting a relative metric as a modifier—can yield important diversification and insulation against exogenous market shocks. Relative TSR will remain popular, but when it doesn't fit the circumstances, make sure to consider relative financial metrics.

As we've discussed, relative financial metrics introduce their own flavors of complexity that need to be carefully evaluated during the upfront design process. As we support clients through these efforts, we perform considerable backtesting and forward-testing using what-if scenario modeling. Backtests reveal how the award design would have fared historically had it been in use. What-if forecasts use scenarios to flex how the award may behave under different potential future states of nature. Collectively, they make the design construct more tangible to stakeholders and give a feel for how the award is likely to function in practice.

This gives rise to an iterative, but robust, award design process. When we assist clients, we start with a handful of constructs—flexing peer groups, performance metrics, calculation conventions, etc.—and run hypothetical results through the models. Next, we review the results and ask if they're intuitive and align with long-run shareholder value creation, which tends to prompt further tweaks to the design. Although there's no crystal ball as to what will ultimately happen in the future, the abundance of available data and modeling tools lends considerable clarity to any recommendation in front of senior management and the committee.

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