New Trends in Award Designs and How They Impact YOU

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What to Expect When You are Expecting…Changes

Here's what we should expect in 2015

- Refinements to the 2014 awards
- Potential structural changes in award designs

New award designs can come with unique sets of risks. We encourage stock administration/accounting professionals to tune in to new trends in order to

1. ***foresee*** potential downstream risks
2. ***communicate*** *these risks to HR*
3. ***understand*** P&L implications
4. ***set expectations*** on the compensation cost
5. ***introduce*** refinements yielding better cost structure

How Things Used to Be

A recap of the evolution of the share-based compensation structures:

Restricted Stock	Options	Market Awards	Performance Awards
			
✓ Requires time-based service only ✓ The fair value of a dividend-protected RSU is the grant date stock price ✓ Easiest to implement ✓ Static accruals	✓ Requires time-based service only ✓ Inputs for the Black-Scholes formula need to be developed ✓ Easier to implement ✓ Static accruals	✓ Compares stock performance only ✓ Needs a *fair value* ✓ Better for relative targets ✓ Easier to forecast long-term ✓ Static accruals	✓ Internal and operational metrics ✓ Do <u>not</u> need a *fair value* ✓ Better for absolute targets ✓ Difficult to forecast long-term ✓ Variable accruals

How Things are Becoming

Awards are getting more and more innovative

- Award recipients are receiving a mix of different instruments
- Different types of awards are being combined together (such as hybrid awards)
- LTIP awards with short-terms targets are being developed

Stock Plan Admin/Accounting/ Valuation Risks

- Complex awards may not fit in well with administration systems
- Valuations often require sophisticated modeling

Say on Pay Risks

- Disconnects between proxy disclosures and actual outcomes can increase the say on pay risk
- ISS may view certain LTIP awards as an STIP masquerading as an LTIP

Communication Risks

- Novel award designs may not be intuitive at all; communication is the key
- *Too much* communication can cause paralysis, short-term thinking, or even backfire and disincentive performance

So, There's Good News, and Bad News

Market awards were hot over the past few years, but implementation risks abound

The effects of say-on-pay and growing influence of corporate governance groups like Institutional Shareholder Services (ISS) have made it tough for companies to rely exclusively on time-based awards

- One trend in award design in response has been the adoption of sophisticated award designs
- However, implementation of sophisticated award designs normally means unique challenges for executive compensation and corporate accounting professionals

Popular, incentivizing, link manager wealth to shareholder wealth

Lots of moving pieces creates unique implementation risks with design, reporting, and downstream tracking

Overview

1. **Fixed Value Awards**

2. **Hybrid Awards**

3. **Performance Period Variations**
   1. LTIP Market v. STIP Performance Conditions
   2. Multiple Performance Periods
   3. TSR Awards with a Five-year Period
   4. Awards with an Indefinite Term

4. **Payout Metrics Variations**
   1. Awards with Various Peer Groups
   2. Commodity-based Awards
   3. Capped Value Awards
   4. Dollar-denominated Awards

5. **Post-vest Holding Requirements**

Fixed Value vs. Fixed Shares Grants

- **A basic decision compensation committees face is whether to grant awards on a fixed value or fixed shares basis**
  - Fixed Value: total dollar value of award is set and the number of shares granted are backed into based on grant-date fair value
  - Fixed Shares: total number of shares awarded is set based on internal metrics/calculations, but the dollar value can change – potentially easier for participants to understand

Example:

Fixed Value	Decision to grant $1 million in awards (based on benchmarking), initially equal to 10,000 awards	$1 million remains the binding constraint, so that the awards issued either grows/declines	Accounting value: **$1MM**
Fixed Shares	Decision to grant 10,000 awards (based on benchmarking and assessment of value)	10,000 target awards remains fixed, but the value of this grant may grow/decline	Accounting value: **???**

Most companies have migrated to fixed value to manage cost and volatility of stock year over year

Ergo, How Do You Define Value?

- **Most companies have taken a philosophy of focusing on the grant value instead of the # of shares when determining competitive opportunity**

- **But for setting grant quantities, should the accounting value or face value of the stock be used?**

  - Face value = S = stock price at grant

    Pull stock price at grant

  - Accounting value = FV = fair value

    Use Monte Carlo simulation

- **Example (target $1MM fixed-value grant):**

Face Value	S = $100 Implied Shares = 10,000
Accounting Value	FV = $110 Implied Shares = 9,091

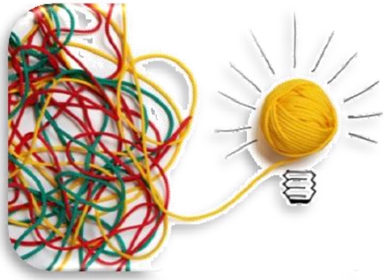
Two comments:

1. The math can work in the opposite (favorable) direction
2. What if a change was made at the last minute to fixed-shares? Then:
   10,000 shares * $110 = $1,100,000

Managing Disconnects Between Expectations and Outcomes

You've heard it before, let's say it again:

- The accounting value on a TSR award will not = stock face value
- For a fixed value granter, this may = participant grant quantity surprises
- For a flexible value granter, this may = CD&A disclosure surprises



Stock Administration and Finance can drive value in one or more ways:

Drive insight and transparency to avoid surprises	Enhance and optimize award design
▪ Run pro forma valuations 1, 2, and 3 months before the grant to gauge where the value is trending	▪ Model the difference between an outperformance and percentile ranking framework
▪ When the value exceeds the face value of the stock by > 10%, unpack the value and proactively explain the drivers of a higher valuation	▪ Model different award features (there's many): payout cap, absolute TSR provision, upside and downside, interpolation, etc.
▪ For any new award design, perform a backtest "as if" the award had been granted every year for the last 7 years	▪ Model multiple comparison groups

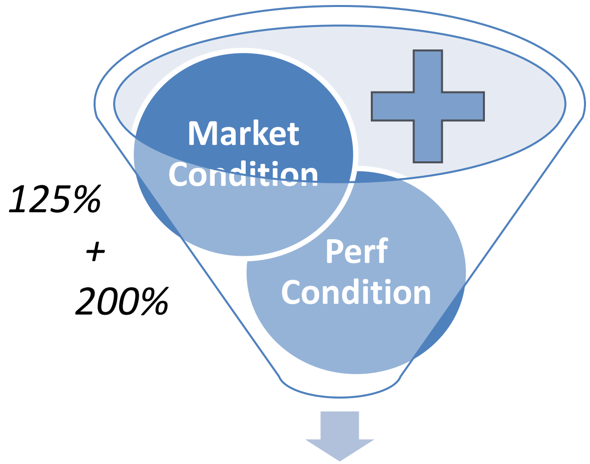
Hybrid Awards: Performance & Market

Hybrid awards

- A hybrid award that is gaining traction in the market: the performance *and* market award
- The payout is combined, and often you must hit multiple targets to receive payout
- These types of hybrid can lead to complicated downstream implications, depending on design

Additive Payout

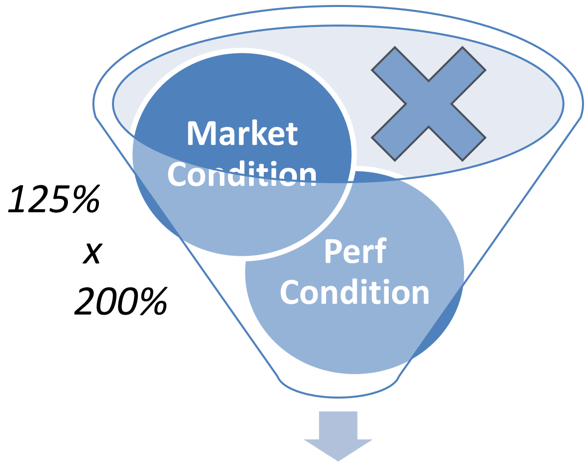
- Simpler fair value; may involve admin system complications



325% Additive Payout

Multiplicative Payout

- Modifier approach; may involve significant accounting and admin complications



250% Multiplicative Payout

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Hybrid Awards: Multiplicative Payout Discussion

Different Structures Explained

- Under the multiplicative payout calculation, the market condition multiplier is multiplied by the performance condition multiplier
- Standard structures:
  - Modifier approach

Performance Target	Payout	1-Year EPS		3-Year TSR Modifier	Relative TSR Percentile
Stretch	150%	$1.25		+50%	85th
Target	100%	$1.15		+0%	50th
Threshold	50%	$1.05		-25%	25th

  - Matrix approach

Net Income as a % of Target

TSR Ranking	< 70%	70%	100%	110%
> 80th	0.000	0.900	1.200	1.800
60th - 80th	0.000	0.825	1.100	1.650
40th - 59th	0.000	0.750	1.000	1.500
<40th	0.000	0.675	0.900	1.350

Why It Matters

- ❑ While a structure like this may deliver best of both worlds; or, may deliver excessive complexity and confusion
- ❑ Careful award communication becomes extra important
- ❑ Trickier accounting and reporting under matrix approach – be proactive

Potential Complications

- ✓ Bifurcation of the performance and market conditions may be necessary
- ✓ Multiple fair values if a cap on the overall payout exists
- ✓ Indefinite number of fair values

Performance Period Variations

- **Performance period variation is one of the common award design amendments we currently see**
  - While some of these changes can have a beneficial impact on the award design, others can create significant side effects

- **Some of the award designs with different performance period variations are presented below:**

LTIP v STIP

- You just can't get away from not being able to do long term performance awards
- It's hard to set realistic targets for performance conditions in the long-term

Multiple Performance Periods

FY15 → FY16 → FY17

- Multiple performance periods is a common design structure for relative TSR awards
- Some award designs with multiple performance periods can create significant complications in modeling

5-year Performance Periods

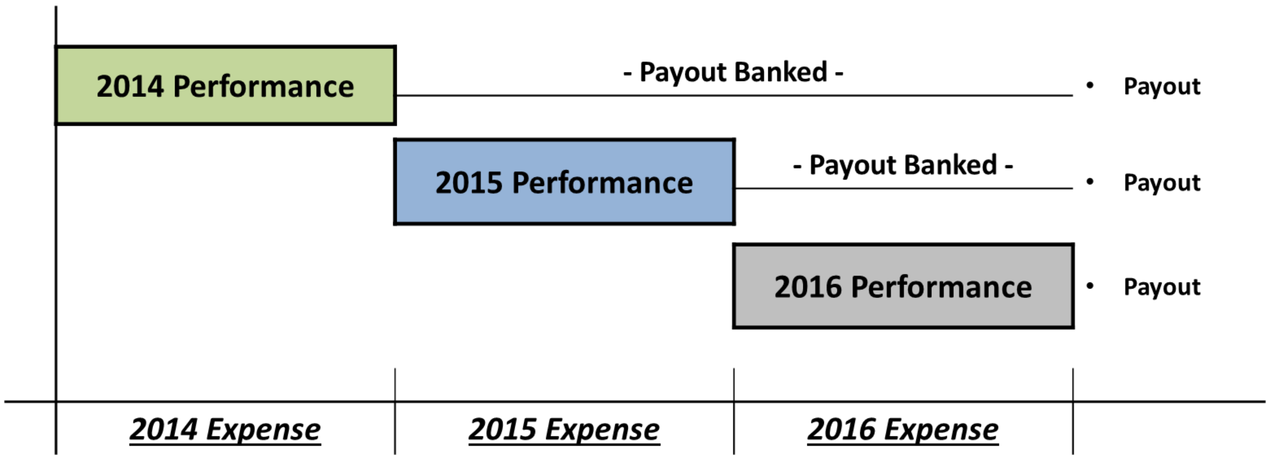
- Extending performance periods can be a great measure to capture long-term performance trajectory
- This award design, however, can be more suitable for C-suite executives

Indefinite Term

- Indefinite terms can create significant complications in modelling
- Inputs such as simulation term, volatility, risk-free rate needs to be developed carefully

LTIP Market v. STIP Performance Conditions

- A popular performance condition program design contains three tranches corresponding to successive one-year targets that get set at the beginning of each year.



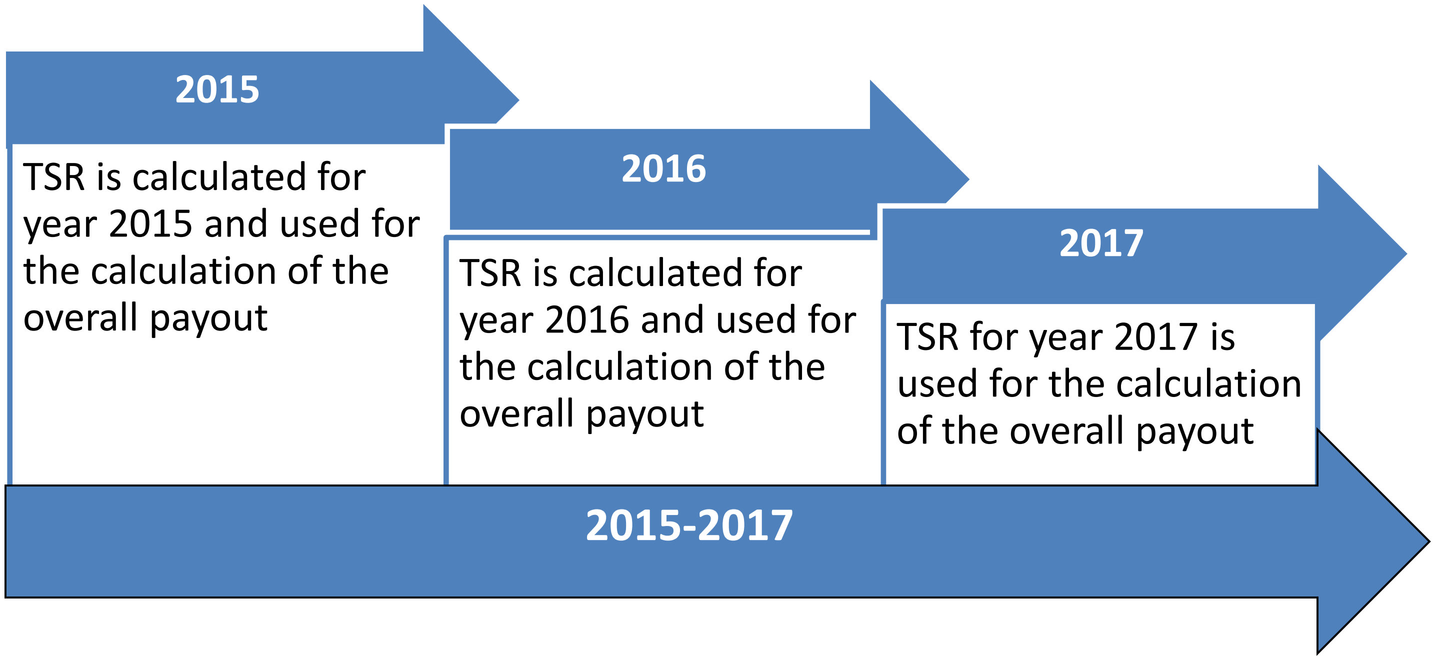
Description of the Structure

- ✓ There are three performance periods
- ✓ EPS target is fixed for the first tranche only
- ✓ EPS targets for tranches 2 and 3 will be determined at the beginning of the respective performance periods

Potential Complications

- ✓ Multiple tranches for the performance condition may result into significant administrative complications
- ✓ No accounting grant date
- ✓ Accounting expense recognition over a shorter period

Average'em Out!



Description of the Structure

- ✓ There are four performance periods
- ✓ TSR payout percentage is calculated for each performance period
- ✓ The final payout is the average of the payout percentages over each performance period, including the full performance cycle

Pros and Cons

- ✓ May result into complications in modelling
- ✓ Allows to smooth the effect of poor performance over the longer run
- ✓ Not clear is this structure adds more value compared to a simple three-year performance cycle

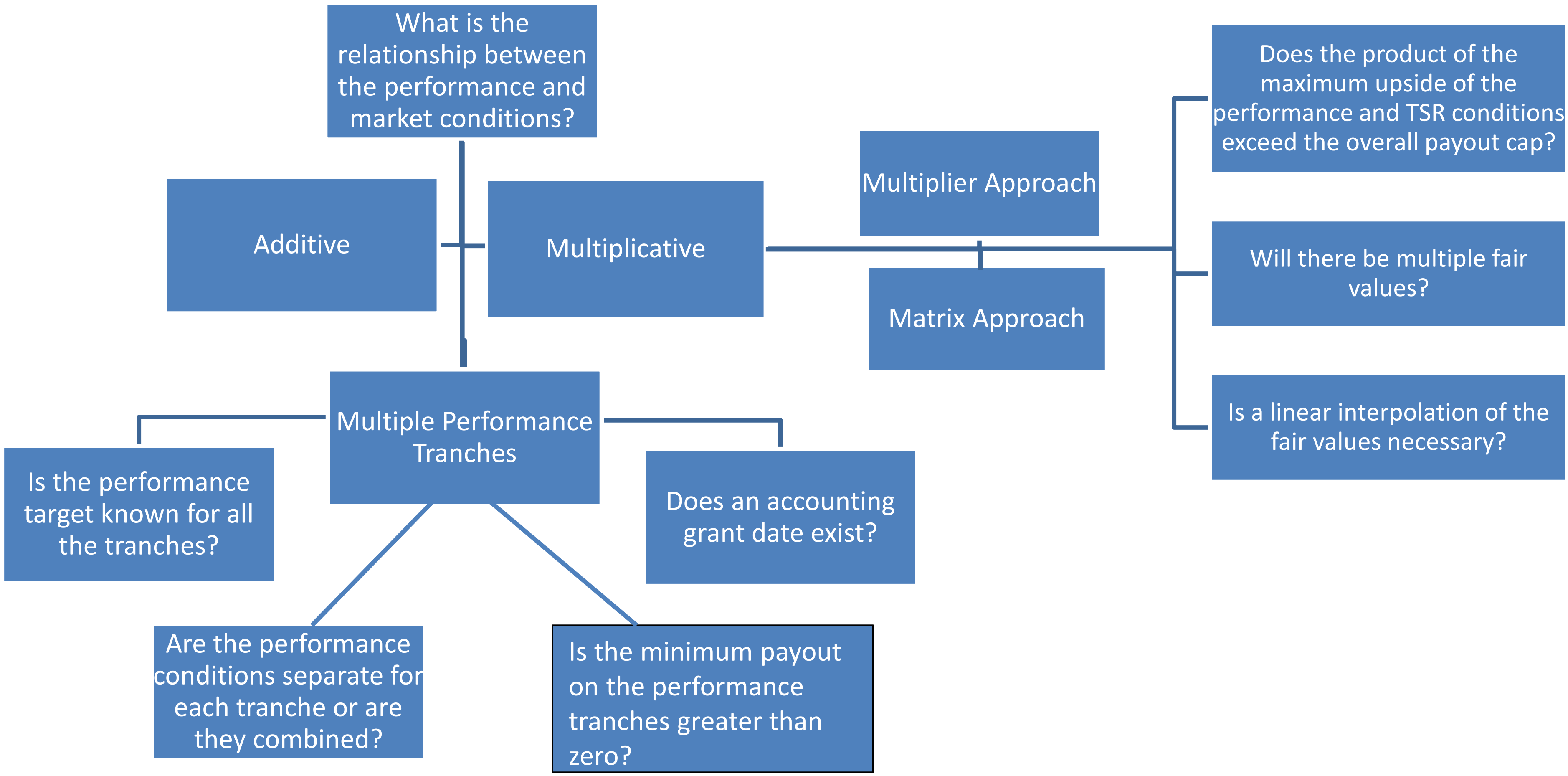
Bifurcation Impossible

- Sometimes, the payout structure combines the performance and market conditions together
- In this case, it is impossible to bifurcate these two conditions

Full Performance Cycle	• Average the average percentile rankings over the three-year performance period
Performance Periods 1, 2, and 3	• For each year, the average percentile of the company's all three metrics is ranked against the average of the peers
EPS Revenue TSR	• Three-year performance cycle • For each metric, compare the company's performance against peers

- No fair value of the TSR portion of the award can be performed without estimating the performance conditions
- This may, or may not have been the intent of the initial award design

What to Know When Designing Complex Awards?



Three-year v. Five-year Term

Criticism of **3-year** performance period

- Encourages short term goals and increased risk/volatility
- TSR awards are more sensitive to where the stock price is at a particular point in time

Arguments for a **5-year** performance period

- Allows to capture structural and systemic growth in the company's performance, and allows time for long-term strategies to bear fruit
- Downside: may potentially be too long of a restriction for many recipients

Awards with an Indefinite Term

Some awards now are coming with *indefinite* terms

- A valuation model with an indefinite term is not even worth trying!
- For a price-vested (rather than time-vested) award, there is no way to calculate a vesting time

Here's what we suggest

- Use 30 years (as a proxy for the simulation term)
- Available stock price history (especially for newly public companies) may not be used as a sole basis for the expected volatility assumption

Here's what you can expect to see

- The value of a price-vested RSU award with an indefinite term is comparable to the value of an RSU

Awards with Various Peer Groups

Peer Group Considerations by Type

Category		Peer Group Source	Considerations

Index	1	Broad market index (e.g. S&P 500)	• To compare relative performance of index ***constituents*** or index ***level***
			• Closed and semi-closed lists
			  • Drops from index—do we still measure against them?
			  • Entries into index—should they replace an initial peer?
			• **Beware:** the larger your peer group, the larger the administration burden

	2	Specialty market index	
Competitors	3	Competitors or close comparable firms	• M&A outside of peer group • M&A *within* peer group • Bankruptcy • Spin-off or industry exit by peer • **Beware:** the smaller the peer group, the higher the fluctuations in the hypothetical award payout on a quarterly basis

Commodity-based Awards

- **Some award designs pay out based on the company performance vs. commodities**
  - This is a common structure normally seen for mining, O&G companies

TOP 5 considerations

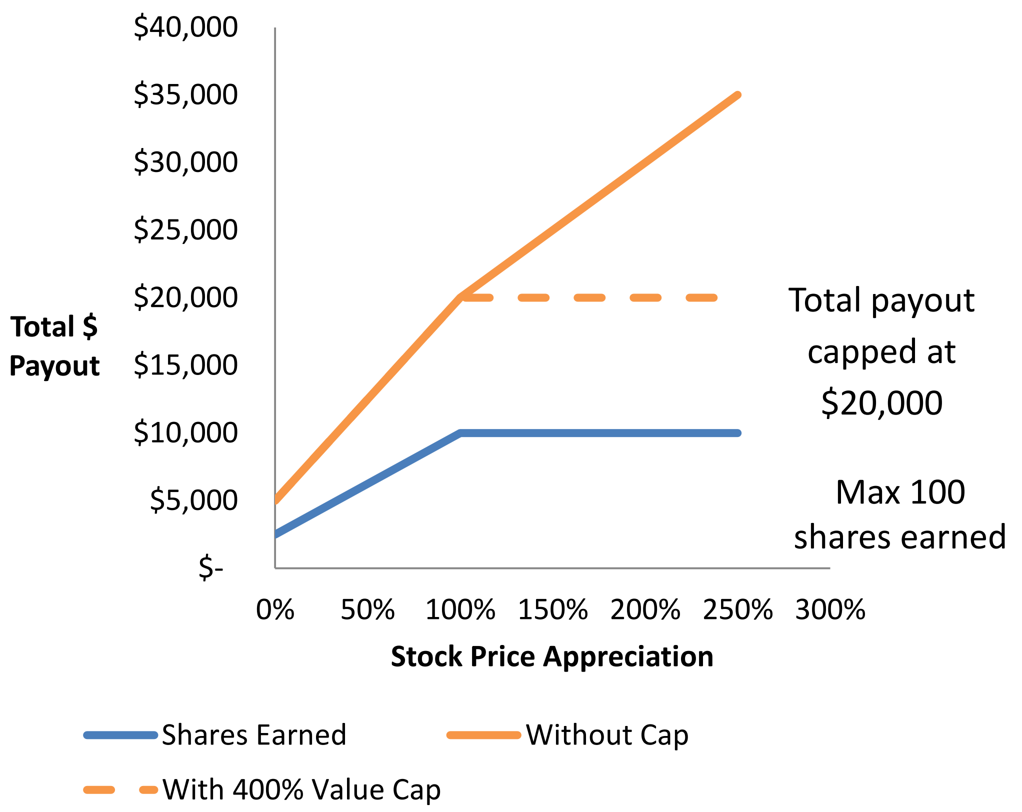
- Indexing against commodities requires liability treatment
- No specific accounting guidance on how to develop a fair value
- Information sources may be unavailable
- Commodities may be bundled in a basket
- Modelling is tricky

Capped Value Awards

Capped Value Awards: An Example

- 50 target shares, with payout range between 0% to 200% of target
- $100 closing stock price on the grant date
- Total payout capped at $20,000 (400% of the target shares and grant date stock price)

The chart on the right shows the difference in the total dollar payout earned by the recipient with and without a value cap, with varying stock price appreciation.



If a fixed-value granting policy exists, then any reduction to the per-unit award value allows more units to be granted for the same aggregate cost. From this perspective, efforts to lower the per-unit accounting cost of an award to be closer to the face value of the stock can be useful.

Dollar-Denominated Awards

Dollar-Denominated Awards: An Example

- An executive might be issued a target dollar value of $1,000,000, which is 2x her base salary
- This target dollar value will be scaled by 50% to 150% based on relative total shareholder return as compared to the constituents of the S&P 500

However, the award is equity settled, the final payout will be divided by the share price to determine the number of shares that will be issued.

CAUTION

Be prepared to explain to recipients why they are precluded from participating in share price appreciation.

A dollar-denominated award removes share price appreciation as a source of upside.

- When the company is outperforming, not only the payout multiplier is high, but also the share price is considerable high
- The benefit of this award is that it removes the “double leverage”
- There comes a point at which the recipient no longer benefits from stock price increases

Post-vest Holding Requirements

Post-vest Holding

- A requirement that shares must be held, even <u>after</u> vesting
- Some benefits, but may prove to be a very contentious issue

Vesting Period → Post-vest Holding

Hey!
What gives?

Some possible explanations…	***Explanation 1**: Easier to enforce* share *ownership* requirements
	***Explanation 2**: Easier to enforce clawbacks*
	***Explanation 3**: Governance groups (ISS, Glass Lewis) like them*
	***Explanation 4**: May result in lower fair value/expense*

Also…

1. Not many companies have adopted, and there aren't yet signs that this will be widespread
2. Not currently expected/appropriate below Section 16 officer level

Questions?

Speaker Information

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Narine Karakhanyan brings a diverse background in economics, finance, quantitative methods, and programming to the Equity Methods Valuation Services Group. In her current role as a Valuation Consultant, Narine assists companies with addressing ASC 718 compliance issues related to their employee stock option and market award valuations by providing leadership and support on custom valuation engagements. Prior to joining Equity Methods, Narine worked with HSBC Germany in the Securities Services / Custody division, arranging settlements of purchases and sales of securities and maintaining cash accounts. She also worked as a Research and Teaching Fellow at the University of Magdeburg in Germany, where she lectured undergraduates and conducted research in the Department of International Economics. Most recently, Narine served as a teaching instructor in the Department of Economics at Arizona State University. Narine holds a Bachelor of Economics degree with honors from the Yerevan State University in Armenia, an M.S. in Economics and Finance from the University of Magdeburg, and an M.S. in Economics from Arizona State University. Currently, Narine is a SAS Certified Base Programmer and is pursuing the Advanced Programmer Certification and Level II of the CFA candidacy exam. Narine enjoys traveling and speaks four languages.