Differentiating Equity Grants: The Dilution Solution

Fred Whittlesey and Kiran Sahota
Buck Consultants

Over the past five years, a litany of changes in accounting rules, tax law, proxy disclosure rules, institutional shareholder and proxy advisor policies, government regulation, and capital markets have caused many companies to rethink their equity compensation strategies and programs. Companies previously relying on stock options as their sole long-term incentive vehicle have explored the use of restricted stock, restricted stock units, performance shares, and long-term cash incentive plans. Pressure to reduce dilution has led to reductions in plan participation as well as frequency and size of grants.

During this evolution, the primary focus has been on the financial impact: accounting expense, tax effects, cash flow, dilution, and value transfer. This, and a parallel focus on governance issues, has driven equity compensation practices without balanced attention to strategic and behavioral considerations. As a result, there is a growing concern that the core purposes of equity compensation have been compromised:

- Linking shareholder value creation and managerial decision-making
- Creating employee ownership to transform corporate culture and align all employees' work effort
- Driving day-to-day work behavior by employees having a financial position in the enterprise

External Forces Create Internal Pressures

Efforts to reduce usage, stemming from dilution concerns, have reduced the perceived effectiveness of equity compensation and, in turn, put pressure on managerial decision-making processes that drive the allocation of equity to employees. Performance management, succession planning and overall talent management strategies are being revisited as the allocation of equity is now reliant on systems previously used for only minor salary increase differentiation and subjective adjustments to formula-driven incentive plans. Now a significant – and sometimes the only – capital accumulation program is subject to systems and practices that may be based on questionable criteria and flawed individual differentiation practices, raising the stakes for all concerned.

Because equity compensation is a core corporate governance issue, companies should apply the same rigor to the allocation of pay that they require of other capital allocation initiatives in the corporation (i.e. capital investment, issuance of debt and equity instruments, and supply chain relationships). A $500 million dollar expenditure for equity compensation must be subject to the same decision discipline imposed on actions of comparable financial scale. Yet allocation of equity pay is often subject to criteria like "Director-level and above," "Grade 10 and above," and "Performance rating of 3.5 or better." The new corporate governance and economic environments dictate that this be improved.

To improve the effectiveness of equity compensation, organizations must reconsider how some core human capital management processes – performance management, succession planning, and overall talent management – can support equity compensation decisions and restore the potential that equity compensation holds for improving organization performance. Doing so requires an understanding of the changes that have created this challenge.

In the Beginning

The roots of equity compensation, and still the core of many programs today, are stock option grants based on job-related factors with little or no individual differentiation. Many organizations have grant guidelines, similar in concept to salary ranges with minimum, target, and maximum grant levels, but often little differentiation occurs within those ranges.

This lack of differentiation is consistent with the "group performance" nature of stock options -- the collective effort of all employees creates value reflected in stock price appreciation. It is difficult to attribute incremental contributions to such a comprehensive performance metric, so delivering award potential based on job level, modified by time-based vesting, seemed appropriate. It was, in most companies a single, unified process with relatively simple rules. This process has become fragmented and ineffective due to a series of changes.

Change #1: Reduction in Run Rates

The first notable change in equity compensation usage was a result of the reduction in run rates – the number of stock options or shares, expressed as a percent of outstanding shares issued in a given year to employees. Shareholders increasingly voiced dissatisfaction with high run rates and the resulting dilution at a time when companies were anticipating changes in accounting rules and resulting stock-based compensation expense on the income statement. These two concerns combined to cause many companies to reduce the amount of equity being issued to employees – but execution became the challenge.

An across-the board reduction had all of the problems inherent in any across-the-board pay action – equally penalizing the best performers and poorest performers – with the added negative perception of a take-away.

Enter Differentiation

Differentiation seemed a better answer as there were many aspects of granting patterns that needed to improve notwithstanding run rate pressures. The question was "differentiate how?" and two primary themes emerged:

- Title-based differentiation. – The most common cutoff point is the murky "Director Level" or comparable pay grade-based organizational layer. Buck's 2008 Global Long-Term Incentive Survey ("GLTI Survey") reports that equity participation at this level is consistent with that of C-level and VP-level executives with a significant drop-off at the next managerial level. Though the Director title is considered by many to be a loosely-defined and inconsistently applied title across organizations, it seems to have emerged as an accepted criterion.

- Performance-based differentiation – For many entrepreneurial companies with a simple pay model – base salary and stock options – differentiating option grants was the first time they needed to make decisions about allocating pay based on performance. Given that performance appraisal systems are seen as flawed in a significant proportion of organizations – as evidenced by the number of "special adjustments" needed just after the completion of the annual cycle – use of these systems for allocating something so culturally and financially significant is often resisted. While some differentiation occurs on base salary increases, the relatively minor role of salary compared to stock options in many firms heightened the difficulty and risk of using a flawed system for such a significant form of pay.

Although eligibility for new hire and annual/focal grants has been limited in some companies to certain job levels and/or performance levels, many of these same organizations make retention grants, promotion grants, recognition grants, and/or patent grants thereby increasing the "leakage" in an otherwise constrained system. The prevalence of "special" awards is surprisingly high in many companies. The GLTI Survey data indicate that these "miscellaneous grants" are at an all-time high comprising 17% of the value of all awards made last year, and rivaling the magnitude of new hire grants.

Change #2: Restricted Stock and RSUs

As more companies entered a maturing phase, stock options became a less lucrative form of compensation. Combined with market volatility - options had little or no value - and the associated accounting expense, the cost-benefit relationship was turned on its head. Restricted Stock Units (RSUs) provided some minimal "guaranteed" value, rather than just upside based on company performance, and equity began looking more like base salary.

This heightened the attention to distribution of equity as full-value awards typically accounted for a fraction of the number of options that would have been granted. Combined with across-the-board reductions in use of equity, more companies began to question whether these new “smaller” grants were worth the trouble. This frequently led to more exclusions at the lower end of the organization as the sole cutback strategy.

Change #3: Cash Incentives

Continued pressure on run rates raised another possibility – the use of cash rather than stock. Many organizations have ample cash reserves at a time of shareholder pressure on dilution from employee equity plans, so cash alternatives are back on the table. As macroeconomic pressures increase the attractiveness of cash to lower-level exempt and nonexempt employees, these alternatives are further explored. Once cash becomes a possible long-term incentive alternative, performance management is again tested as stock price is eliminated from the equation and “line of sight” – the perceived impact of individual effort on the performance results – leads to the inclusion of an individual performance factor. It is somewhat telling that the inclusion of individual performance in a long-term incentive program may be facilitated by a move away from equity to cash compensation, as it indicates a cultural movement away from market-oriented group performance to individual measurement.

Change #4: The Market Downturn

The significant decline in share prices in most industry sectors has added another dynamic. Addressing underwater equity – out-of-the-money options, RSUs with drastically diminished value, and performance plans with now-unattainable targets – leads to a discussion of modifications. Modifications include option exchange programs, option repricing, and performance goal resetting. Because the vast majority of outstanding equity awards are options – the GLTI Survey reports that 63% of shares granted were stock options – option exchanges and repricings are the topic of the day.

Option exchanges are an effective solution for many companies, but the overarching problem remains: an across-the-board repair of previously-granted awards precludes the ability to differentiate.

The workforce decisions that organizations must make in the current economy further highlight the need for more effective and integrated talent management strategies to help contain cost and accelerate growth. The economic conditions have generated a greater leadership interest in areas of employee engagement, high performer retention…and differentiation.

Performance Management

Human resource strategists are generally pleased to see a renewed focus on performance management, whatever the source. Decades of research confirm both that organizations with effective performance management systems outperform those without, and that the majority of organizations are dissatisfied with their current systems. Then why have these systems not been fixed? In many cases, HR systems may not be the issue because business results do not come from HR systems but rather the underlying talent management processes.

Performance management as typically defined – a process of establishing performance expectations, assessing outcomes against those expectations, and delivering pay based on that – is difficult and in many culturally controversial, a combination that facilitates avoidance. We believe there are methods with demonstrated track records that optimize the key goals of performance management – communication, behavioral change, value creation, and a sound basis for resource allocation.

But the use of individual performance evaluation as a basis for equity grants means that the “past” becomes the basis for pay in the “future” and creates a temporal paradox. A model that considers past, present, and future will allocate equity compensation more effectively and goes beyond the traditional notions of performance management.

Which Pay for Which Performance?

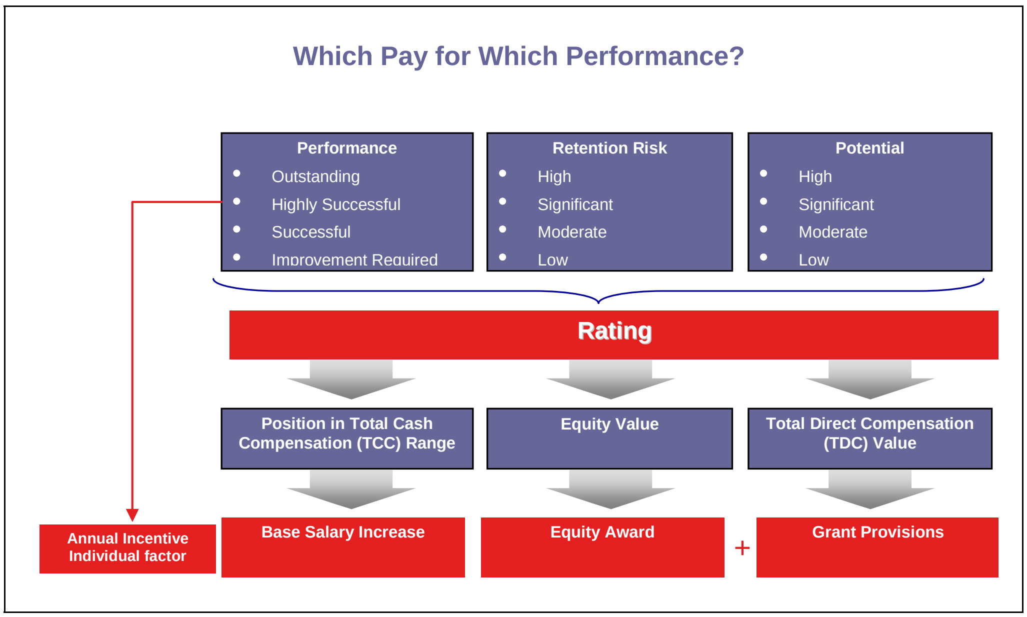
Effective differentiation requires considering the “*past, present*, and *future*” of each employee’s performance and allocating a form of pay and provisions for that form of pay that address the incumbent’s unique status within the three criteria.

- *Past* - Performance: Contribution to the success of the enterprise over the most recent measurement period. This may be possible with the existing performance evaluation system or may require a related and parallel rating or ranking process

.
- *Present* - Retention Risk: The need to retain the individual in their current role to avoid replacement and transition costs that in total may exceed the incumbent's current annual pay, regardless of past performance. Of the three factors this may be the one for which no organizational systems or procedures exist and may require the most subjective judgment.

- *Future* - Potential: The long-term value to the organization of the individual in current and future roles, regardless of past performance and retention risk. An effective succession planning system can provide input to this assessment. Absent such, this may require a second subjective input.

These assessments may result in the awarding of a salary increase, an annual incentive payment, and/or an equity grant but in many organizations the equity will be disproportionately more valuable than the other two forms of pay.



Equity Compensation Portfolio Review

Finally, an equity compensation portfolio review must overlay the decision process due to the multi-year and cumulative nature of equity compensation. An individual's past, present, and future pay from equity compensation is an aggregated result of grant history, individual financial decisions (option exercises, liquidation of shares), and share price performance. The continued practice of new hire grants that are two or three times the size of subsequent awards affects the leverage from the differentiation process for the first few years of tenure.

Because of the complex portfolio of incumbents' equity, the review should also consider their portfolio value and the vesting status of those awards, under various price scenarios. The interaction of past, present, and future value potential with past, present, and future behavioral factors highlights the need for a diligent approach to equity allocation.

> Employee A, a superstar Engineering Director, is still 50% unvested in her equity and received options at some very favorable strike prices plus a large performance grant of RSUs last year. Her unvested gains are well above targeted gain levels and the retention power of existing grants is strong. She receives no equity award this year.

A comprehensive approach to differentiate equity awards, based on the factors discussed, leads to individual grants that may vary in terms of:

- Type of award (options, restricted shares, performance shares, multi-year cash bonus)
- Amount
- Vesting (number of years, incremental or cliff, time-based only or performance-accelerated)
- Performance features (acceleration or contingency; company, unit, or individual)

Employee B, an Engineering Director in the position for only one year, is struggling to make the change from individual contributor. His performance was below standard this past year but is managing a critical product development area and the VP of Engineering believes he can be mentored and should be given one more year to demonstrate he can be effective in the new role. His promotional option grant from last year is still unvested but is underwater and B made a comment that he'd be better off taking a nonmanagement engineering job across the street. B receives an RSU grant with 3-year cliff vesting.

While this approach adds complexity to both the managerial decision-making process and the grant administration process, the current corporate governance environment dictates the need to accommodate this complexity. Further, in business enterprises where human capital is the primary source of value, the allocation process deserves as much analytical and decision support as any physical asset or financial instrument decision.

Employee C is a "meets expectations" performer as an Engineering Director, a solid "B Player" with a relatively low unvested portfolio value. The VP is somewhat frustrated by C's silo mentality with his group which doesn't participate and contribute to the broader engineering effort. They meet their product milestones but are not integrating and sharing technology. C receives a grant of performance shares contingent on a 3-year goal of revenue growth from new company products introduced between 1/1/09 and 1/1/11.

Conclusion

Behavioral differentiation with a multi-year portfolio-based methodology requires a management culture and measurement orientation that not all companies will find feasible. But companies facing dilution constraints and pay governance challenges will find that improving the ROI of their equity awards mandates a more sophisticated approach. Integrating performance management, succession planning, talent management measurement, and equity delivery will improve the return on all four human capital strategies.

HR departments and managers will often voice objections to a sophisticated approach like this. It's more complex; more time-consuming; and requires a degree of subjective assessment. Those three strikes often cause firms to allow inertia to keep them with a current and admittedly flawed system. Add to this the requirement that a manager may have to communicate to three incumbents who are the "same" by some criteria three very different equity awards (see sidebar) and there will be resistance. But the financial impact and governance implications of equity compensation require companies to advance their human capital management processes to support an effective equity compensation strategy.

Fred Whittlesey is a Principal and the West Region leader for Buck Consultants' compensation consulting practice, based in San Francisco. fred.whittlesey@buckconsultants.com

Kiran Sahota is a Consultant in Buck Consultants' Human Capital Management practice, based in San Francisco. navkiran.sahota@buckconsultants.com