



IV. BUILDING A HIGH-RETURN LTI PACKAGE

CHOICE OF LTI VEHICLE DOES NOT DRIVE RETURNS

Compensation executives report that the choice of LTI vehicle is a major challenge for them. However, LTI vehicle choice has little direct impact on key employee outcomes—attraction, intent to stay, or effort. LTI vehicles assessed as part of this analysis were long-term cash awards, stock options, performance-vested stock, and restricted stock. LTI vehicle choice does not have a direct impact on employee outcomes because it is the components of each vehicle—such as target LTI payout in dollar terms, the probability of payout, what criteria determine awards, and the vesting schedule—rather than the vehicle itself, that drive employee preferences.

While the choice of LTI vehicle does not affect these employee outcomes, there are several other important organizational implications to consider when choosing LTI vehicles, such as the potential for share dilution, ease of employee communication, and alignment with shareholder interest.

CHOICE OF LTI VEHICLE DOES NOT DRIVE RETURNS

Though compensation executives find choosing the right LTI vehicle to be a major challenge...

...choice of LTI vehicle does not have a direct impact on intent to stay or effort

Maximum Impact of LTI Drivers

A CHALLENGE FOR MANY

“...that is a major challenge for organizations, determining the appropriate mix between their various LTI vehicles.”

Senior Manager
Equity Compensation
Financial Services
Company

“To maximize returns on LTI, we would really need to tailor the vehicle mix in a way much more to the individual.”

VP, Rewards
Equity Compensation
Retail Company

	Intent to Stay	Effort
LTI Vehicle	-	-

IMPLICATIONS FOR THE COMPENSATION EXECUTIVE

Don't change LTI vehicles specifically to improve intent to stay or effort. Focus choice of LTI vehicle on achieving other key business objectives such as potential for dilution, difficulty of explanation to employees, and aligning manager-shareholder interest.

Source: Compensation Roundtable research.

COMPENSATION ROUNDTABLE'S VEHICLE SELECTION GUIDE

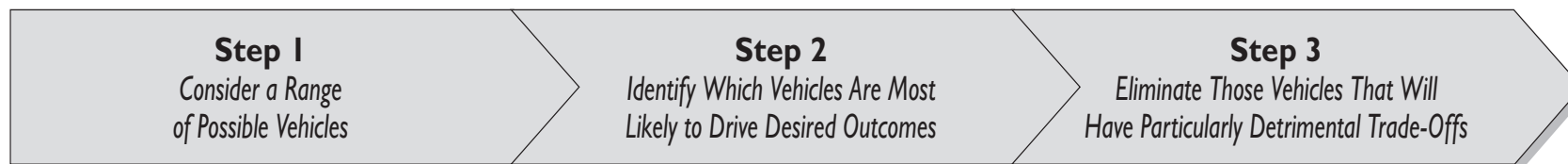
While choice of LTI vehicle does not have a direct impact on intent to stay or effort, there are other things to consider when selecting among LTI vehicles. Each vehicle offers some positive outcomes that need to be carefully weighed against potential trade-offs or undesirable effects. Compensation executives must evaluate the positive outcomes against trade-offs in light of their specific organizational context, electing vehicles that will drive the achievement of strategic business goals and limiting factors that would jeopardize the organization's ability to reach these goals.

Given the complexity of weighing the benefits and drawbacks of different LTI vehicles, the Roundtable has assembled a guide to some of the advantages and trade-offs of several LTI vehicles.



COMPENSATION ROUNDTABLE'S VEHICLE SELECTION GUIDE

While LTI vehicle choice does not directly impact intent to stay or effort, different vehicles offer other positive outcomes that should be weighed against potential undesirable effects



Potential Vehicles	Potential Positive Outcomes	Potential Trade-Offs
<ul style="list-style-type: none"> • Stock Options • Restricted Stock Units • Effort Units • Stock Appreciation Rights 	<ul style="list-style-type: none"> • Shareholder Alignment • Limited Dilution 	<ul style="list-style-type: none"> • Low Perceived Value • Difficult to Explain • High Cost • No Clear Pay-for-Effort Link

Source: Compensation Roundtable research.



COMPENSATION ROUNDTABLE'S VEHICLE SELECTION GUIDE

The table below provides key advantages and trade-offs of LTI vehicles to assist organizations in making a decision among them

Vehicle	Positive Outcomes	Trade-Offs
Stock Options	<ul style="list-style-type: none"> • Relatively easy for employees to understand • Contributes to the development of an ownership culture 	<ul style="list-style-type: none"> • In light of expensing rules, stock options may have high cost relative to perceived value by employees • Cost is not reversible if options are “under water” • This may have limited retention value since the stock has to appreciate before value is provided to employees, and there is no value if the stock declines in value from the date of the grant
Restricted Stock Units/ Restricted Stock	<ul style="list-style-type: none"> • For restricted stock, access to Section 83(b) election allows recipients to limit their taxes 	<ul style="list-style-type: none"> • This does not contribute to a link between pay and effort
Effort Units/ Effort Shares	<ul style="list-style-type: none"> • Relatively easy for employees to understand • Easier to communicate value of link to outcomes over which employee exercises some influence 	<ul style="list-style-type: none"> • It is hard for organizations to set measures and goals that are aligned with shareholder interest
Stock-Settled SARs/ Cash-Settled SARs	<ul style="list-style-type: none"> • Stock-settled SARs reduce the number of shares sold into the market to finance exercise transactions, thus limiting dilution • With cash-settled SARs, money is not required for employees to exercise for cash 	<ul style="list-style-type: none"> • This may have limited retention value since the stock must appreciate before value is provided to employees, and there is no value if the stock declines in value from the date of the grant

Source: Cook, Frederic W., “The 2006 Top 250”; National Center for Employee Ownership, “Beyond Stock Options”; Compensation Roundtable research.



COMPENSATION ROUNDTABLE'S VEHICLE SELECTION GUIDE

The table below provides key advantages and trade-offs of LTI vehicles to assist organizations in making a decision among them

Vehicle	Positive Outcomes	Trade-Offs
Modified Stock Options	<ul style="list-style-type: none"> • Balance a company's relative stock market effort against its absolute gains • Highly leveraged 	<ul style="list-style-type: none"> • Explaining the mechanics to employees can be complex
Phantom Stock	<ul style="list-style-type: none"> • Often good for start-ups and small businesses since it does not dilute the ownership rights of existing shareholders 	<ul style="list-style-type: none"> • This may not motivate employees since they do not gain true equity stake in the company
"Buy First" Stock Options	<ul style="list-style-type: none"> • Contributes to employee and shareholder alignment since it simulates the risk shareholders take when investing their personal wealth in the company 	<ul style="list-style-type: none"> • Employees may perceive this as simply a trade-off for a conventional bonus payment rather than a more valuable form of compensation
Premium-Priced Stock Options	<ul style="list-style-type: none"> • Aligns the LTI program with shareholder interest since using a stock option with an exercise price above the market price at grant allows shareholders to profit from stock price appreciation before employees 	<ul style="list-style-type: none"> • Employee perception of value can be low given that the options are "under water" at grant
Transferable Stock Options	<ul style="list-style-type: none"> • Since employees with vested stock options can sell them to institutional investors, the value of every option is more tangible for employees who have a choice of receiving immediate value or waiting for possible increased value over time 	<ul style="list-style-type: none"> • Reported costs will be increased since transferable stock options increase the expected life of options

Source: Cook, Frederic W., "The 2006 Top 250"; National Center for Employee Ownership, "Beyond Stock Options"; Compensation Roundtable research.

FOUR LTI COMPONENTS AFFECT EMPLOYEE OUTCOMES





Organizations face a number of choices when designing effective long-term incentive programs. Four elements of the LTI package—target amount, payout probability, vesting schedule, and criteria—have a direct impact on either intent to stay, discretionary effort, or both, requiring a decision on how each will be designed.

The greatest potential impact can be driven by LTI payout criteria. When organizations are able to set these criteria to the right levels, they can drive discretionary effort among LTI-eligible employees by as much as 14%.

FOUR LTI COMPONENTS AFFECT EMPLOYEE OUTCOMES

Choices organizations make for LTI targets, payout probability, vesting period, and criteria affect intent to stay, effort, or both

Maximum Impact of LTI Drivers*

	Intent to Stay	Effort
Target Amount 	13%	9%
Payout Probability 	5%	-
Vesting Schedule 	7%	-
Criteria 	-	14%

Among all LTI components, LTI criteria has the greatest potential impact on employee outcomes. Organizations that set LTI criteria to optimal levels can drive discretionary effort on the part of LTI-eligible employees by as much as 14%.

* Impact of LTI components measured for LTI-eligible employees.

Source: Compensation Roundtable research.

INCREASING LTI TARGET AMOUNTS DECREASES ROI

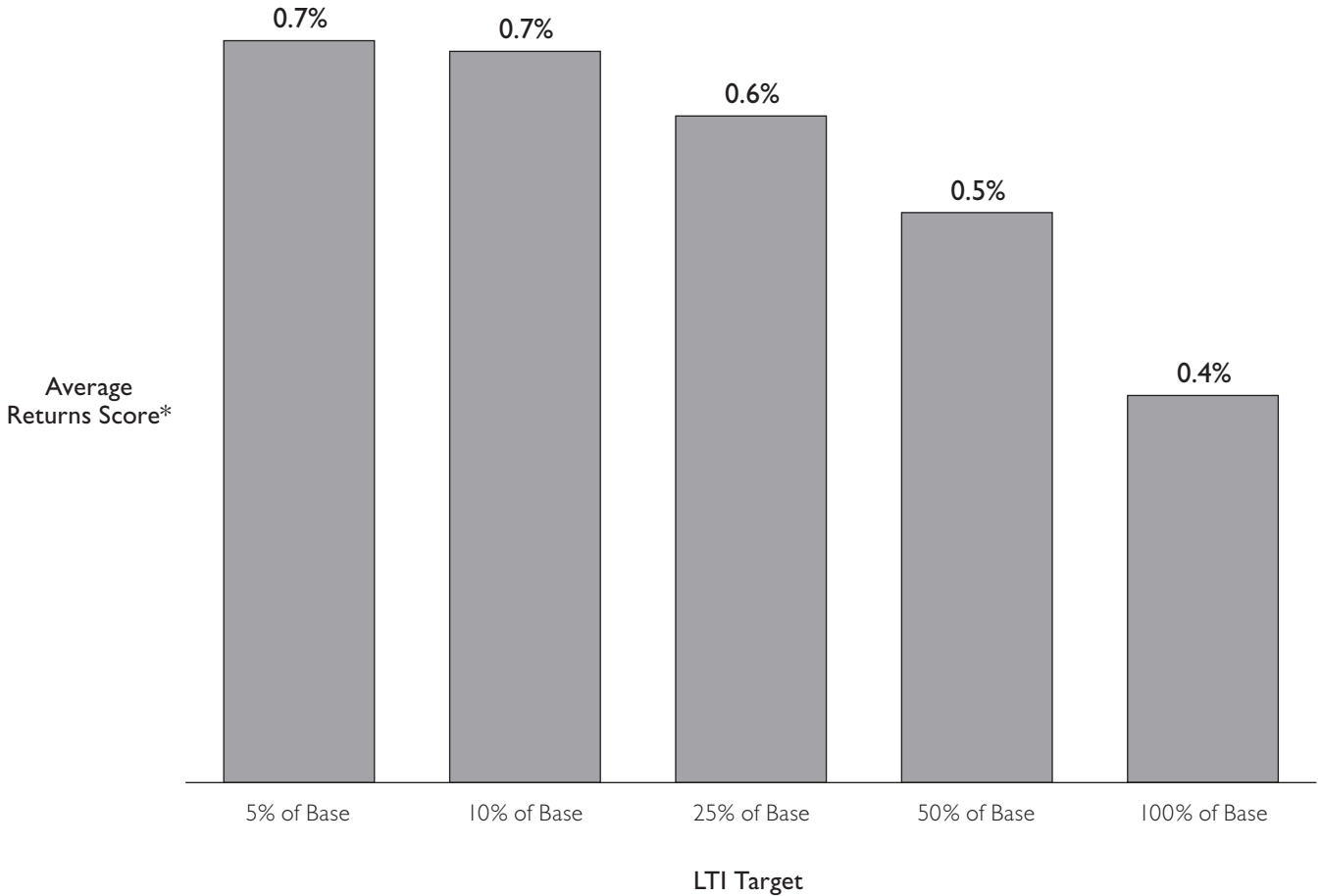
There are declining returns on investment as organizations increase LTI targets beyond 10% of base salary. This trend accelerates as target amounts grow. Average returns from an LTI target amount that is 100% of base salary are roughly half as much as returns from a target amount of between 5 and 10% of base salary.

Organizations are realizing the intended value of LTI programs to keep the best employees longer. LTI targets drive the intent to stay of the highest-performing employees about 12% more than for the average employee.

INCREASING LTI TARGET AMOUNTS DECREASES ROI

ROI consistently decreases as LTI target amounts are raised

Impact of LTI Target Amount on Returns



GREATER IMPACT FOR HIGH PERFORMERS
For any given LTI target level, organizations drive returns from high-performing employees 12% more than for the average employee.

* The average returns score is an average of the percent change in attraction, intent to stay, and effort caused by a plan design change per \$1,000 spent on design.

Source: Compensation Roundtable research.

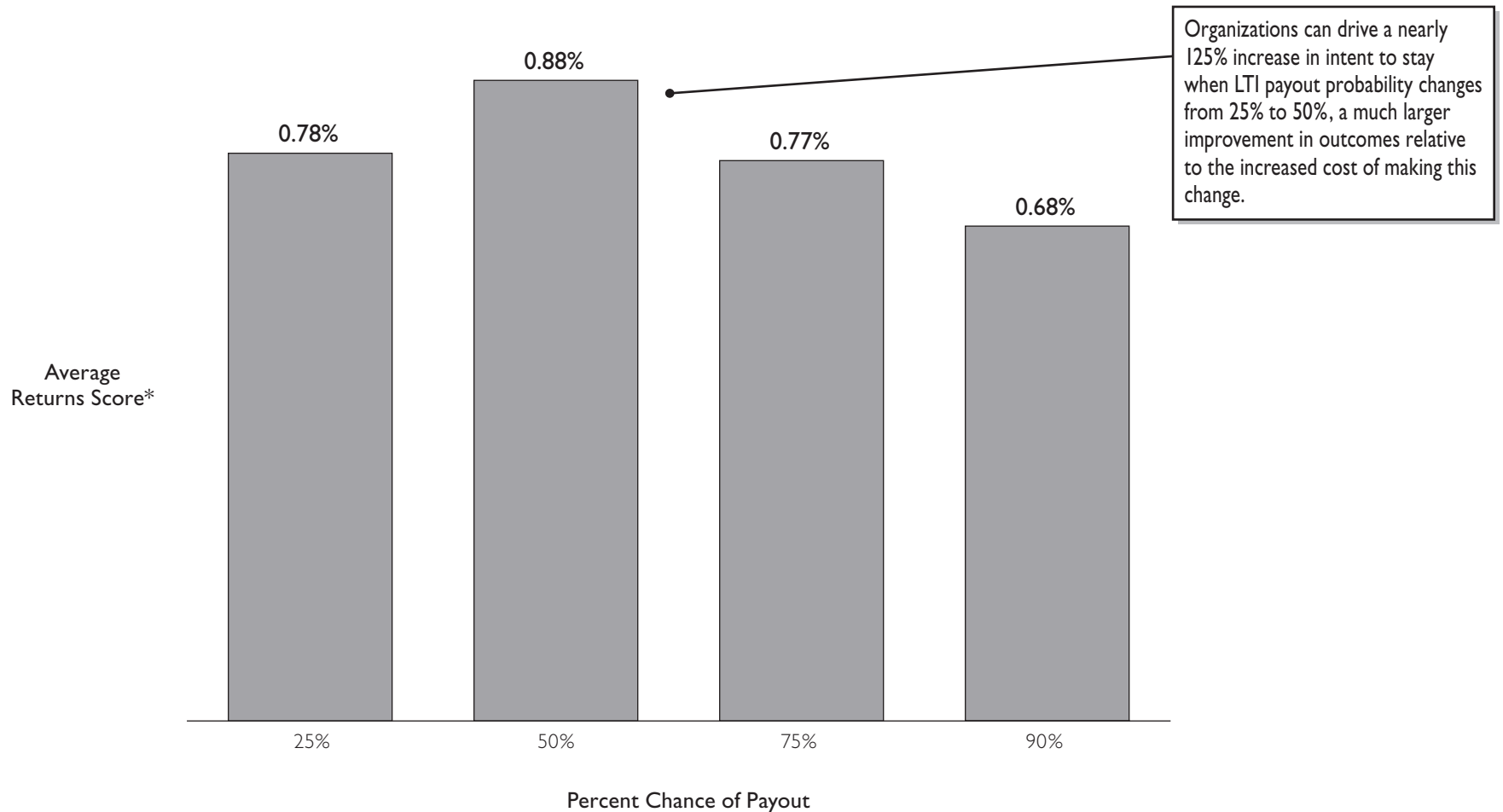
HIGHER LTI PAYOUT PROBABILITIES DECREASE RETURNS

The average organization will see declining returns to increasing LTI payment probabilities after roughly 50%, as costs begin to outweigh the increases in intent to stay that result from increasing probabilities. While costs jump considerably moving from a 25% payout probability to a 50% payout probability, in this case they are outweighed by a 125% increase in the impact on employee intent to stay by moving between these two levels.

HIGHER LTI PAYOUT PROBABILITIES DECREASE RETURNS

For most organizations, returns begin declining when LTI payout probability increases beyond 50%

Impact of LTI Payout Probability on Returns



* The average returns score is the percent change in attraction, intent to stay, and effort caused by a plan design element per \$1,000 spent on that design element.

Source: Compensation Roundtable research.

VESTING SCHEDULE MATTERS FOR SOME EMPLOYEE SEGMENTS

A large majority of organizations use a graduated schedule for their long-term incentives, meaning a schedule that vests a portion of the incentive value to the employee periodically until the full value is realized. Only 17% of organizations use a “cliff” schedule for their long-term incentives program, when the full value of the incentive vests to the employee at one time.

For most employees there is not a large difference in the impact of different vesting schedules on intent to stay. But for several segments large differences exist. On average, cliff schedules are more effective at retaining high performers, while graduated schedules are more impactful at retaining those in managerial roles.

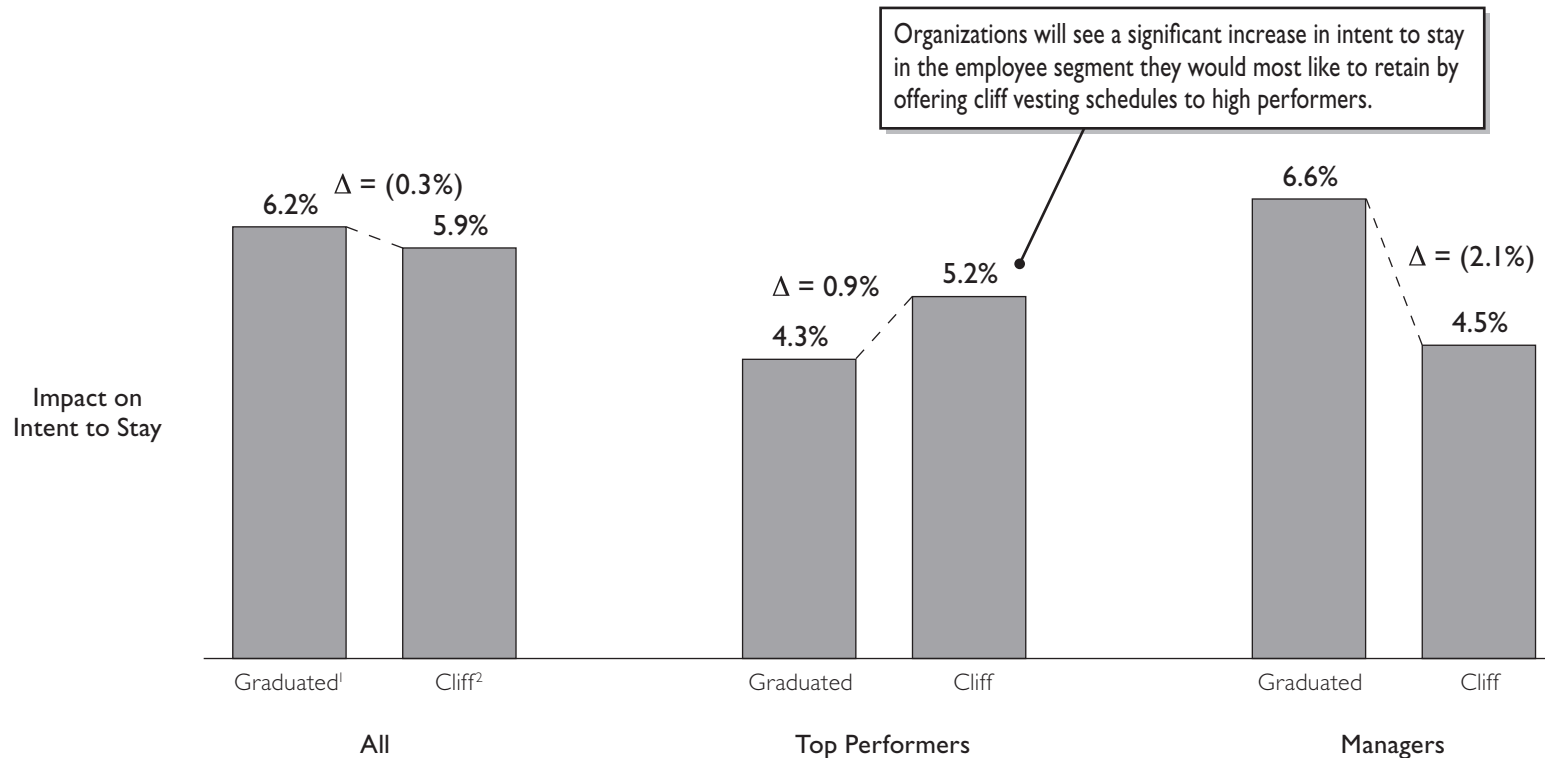
Assuming LTI targets and payout probabilities rise and fall with organizational performance, a cliff vesting schedule provides a greater payout relative to a graduated schedule when companies are performing better. High-performing employees may prefer a cliff schedule because they have greater expectations for company performance compared to their peers.

For organizations putting in place special LTI packages for high performers, these programs should be based on a cliff schedule even if the broad-based program is graduated.

VESTING SCHEDULE MATTERS FOR SOME EMPLOYEE SEGMENTS

Significant impact on intent to stay can be achieved by altering the LTI vesting schedule for certain groups

Impact of Vesting Schedule on Intent to Stay



VESTING SCHEDULE BENCHMARKS

Schedule	Percent Using
Graduated	83%
Cliff	17%

¹ Thirty-three percent of payout per year for three years.

² One-hundred percent of payout at the end of year three.

Source: Gaugos, Peter, "Paying for Effort: A Guide to Compensation Management, 2nd Edition," 192, Wiley Publishing, 2002; Compensation Roundtable research.

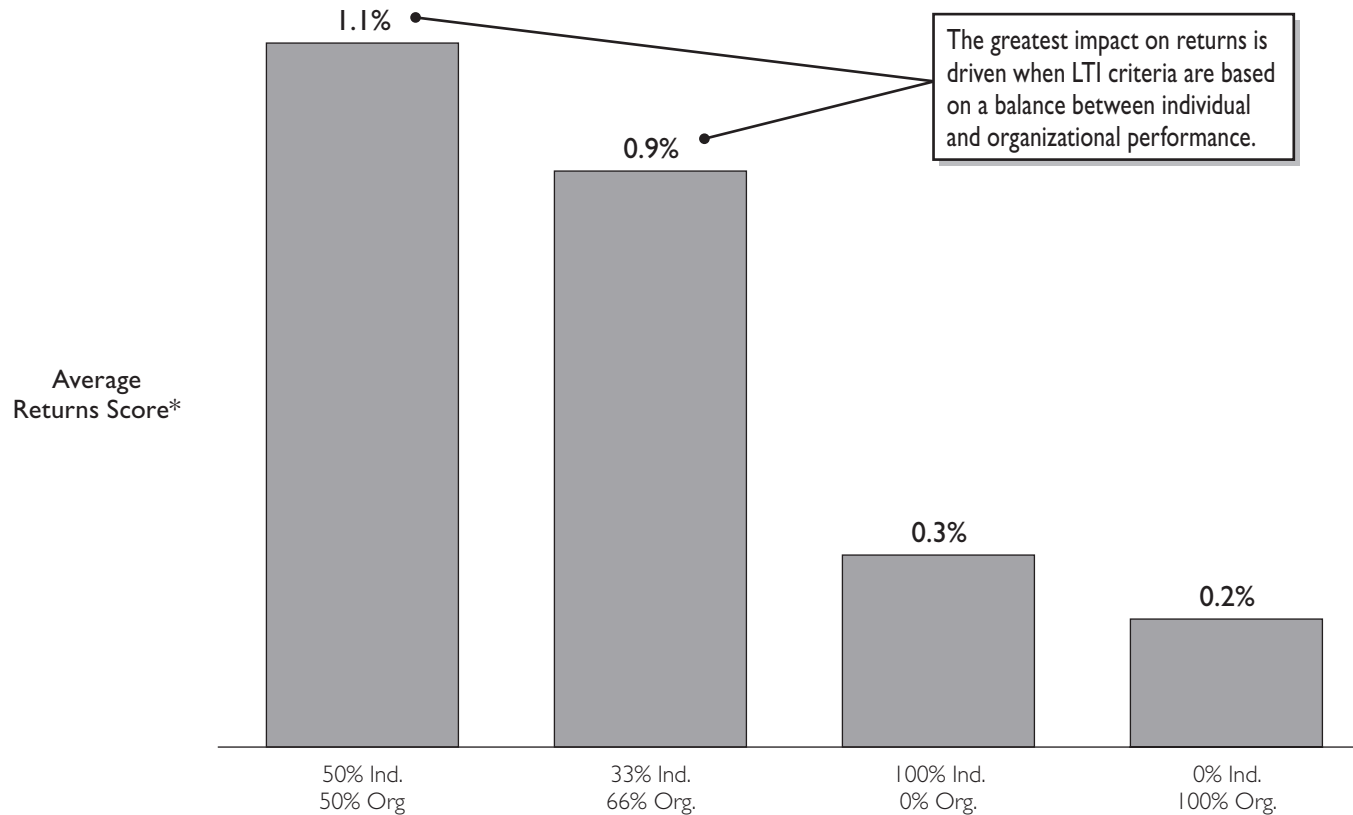
BALANCE INDIVIDUAL AND BROADER OBJECTIVES IN LTI CRITERIA

The LTI criteria that drive the highest returns balance individual effort with broader concerns (based on the performance of the organization as a whole, the business unit, or both). The greatest impact on returns comes from criteria that set the importance of individual goals to be worth between 33% and 50%. Employees want to know that their own efforts will have an impact on the long-term awards provided by their organization, but also value having some weight placed on organizational performance as a buffer. Balanced criteria drive returns at least three and a half times as much as those that are based 100% on either individual or business unit effort.

BALANCE INDIVIDUAL AND BROADER OBJECTIVES IN LTI CRITERIA

Individual performance is critical to setting the right LTI criteria, but it must be balanced by broader objectives to drive returns

Impact of LTI Criteria on Returns



* The average returns score is the percent change in attraction, intent to stay, and effort caused by a plan design element per \$1,000 spent on that design element.

Source: Compensation Roundtable research.

Marketing Materials

INTERESTED IN MORE ON THIS TOPIC?

Contact Our Member Support Center at:

E: EXBD_Support@executiveboard.com

P: +1-866-913-2632