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How to Design Effective Total Shareholder Return Awards

Presentation for:
Executive Compensation Webinar Series
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Presentation by:
Anthony Eppert

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- Questions during this presentation
  - We encourage questions (even though your audio lines are muted)
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About Anthony "Tony" Eppert

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Anthony Eppert , Partner
Hunton Andrews Kurth LLP
Tel: +1.713.220.4276
Email: AnthonyEppert@HuntonAK.com

- Tony practices in the areas of executive compensation and employee benefits
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Upcoming 2020 & 2021 Webinars

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- Upcoming 2020 webinars:
  - Building a Compensatory Peer Group: A Step-by-Step Approach (11/12/2020)
  - Employment Taxes: The 101 Course (12/10/2020)

- 2021 webinars:
  - Upcoming Proxy Season: Compensatory Thoughts from ISS (Annual Program) (1/7/21)
  - Proxy Disclosure Tips on COVID-Related Compensation Decisions (2/11/21)
  - Executive Compensation Clawbacks: A Robust Analysis of Design Features (3/11/21)
  - Finding Value: How to Negotiate Compensatory Economic Drivers in a Change in Control Transaction (4/8/21)
  - Is a Global Employment Company the Solution to Help Manage Internationally Mobile Employees? (5/13/21)
  - Training Course on Designing an Equity Incentive Plan (6/10/21)
  - Training Course on Stock Option Awards and Stock Appreciation Rights (7/8/21)
  - Training Course on Restricted Stock and Restricted Stock Unit Awards (8/12/21)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/9/21)
  - How to Properly Hire and Fire an Executive Officer (10/14/21)
  - A Review of Unique Non-Employee Director Compensation Arrangements (11/11/21)
  - Thoughts on Maximizing the Deductibility of Compensatory Arrangements (12/9/21)

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Our Compensation Practice – What Sets Us Apart

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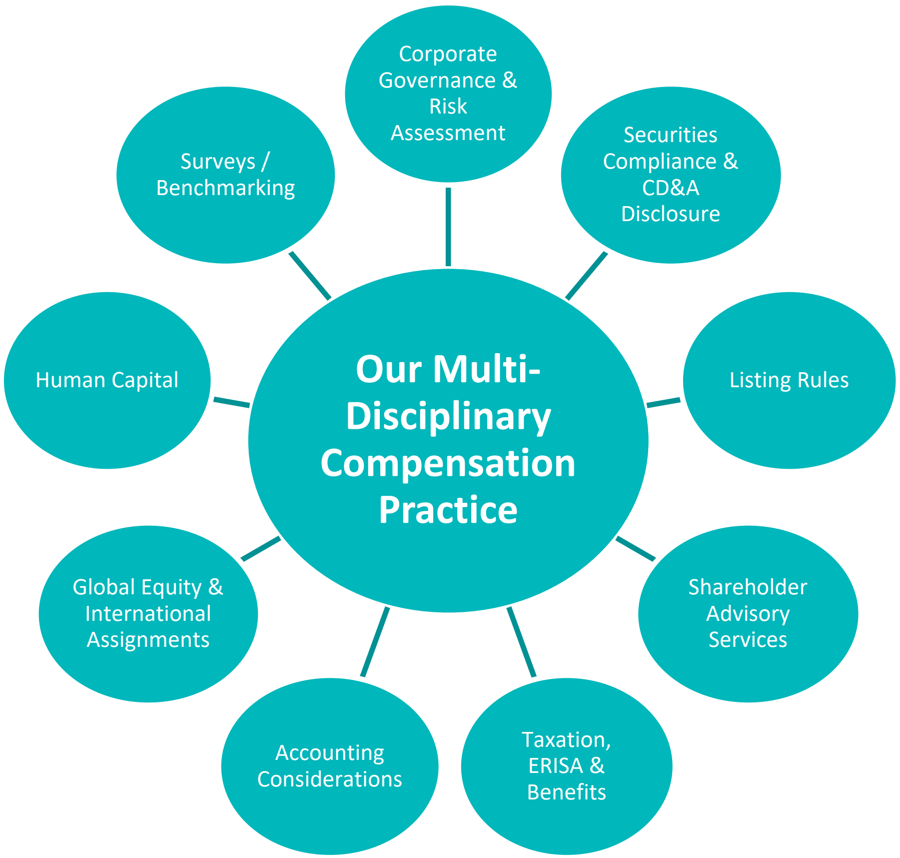
- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human Resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement "best practices"
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of this Presentation

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- The purpose of this presentation is to discuss design considerations for performance-based equity awards with a total shareholder return ("***TSR***") formula

- To that end, this presentation covers:
  - The pros and cons of TSR awards,
  - TSR trends and current market practices,
  - Design variables that significantly change how TSR awards perform and whether TSR awards payout,
  - How to pick an appropriate peer group for relative TSR designs,
  - Whether dollar-denominated awards should be converted using grant date stock price or grant date "fair value,"
  - Considerations when determining the appropriate measurement period,
  - Dividend reinvestments,
  - Rank v. outperformance designs, and
  - Whether payouts should be modified in negate shareholder return scenarios

Background

- TSR calculations are complex and, without sufficient background information, are apples to oranges when comparing a TSR program of one company to the TSR program of a member of such company's peer group

- Additionally, TSR calculations contain a number of design variables that can significantly change the overall design, including whether TSR awards perform properly or payout. For example, there are:
  - Absolute TSR designs, and
  - Relative TSR designs (*i.e.*, relative to the TSR of the peer group)

- For purposes of the following slides, and unless otherwise specifically indicated, use of the term TSR means relative TSR

Absolute TSR Formula

- TSR is simply stock price appreciation/depreciation, plus reinvestment of dividends, over a measurement period
  - Another way to look at it, is that TSR measures the return an investor would receive if he or she bought one share of common stock at the beginning of the measurement period, accumulated dividends during the measurement period, and then sold the common stock at the end of the measurement period

- An absolute TS formula is calculated as follows:

$$\text{TSR} = \frac{\text{Ending Price} - \text{Beginning Price} + \text{Dividends}}{\text{Beginning Price}}$$

- The payout is then determined as a function of the company's TSR compared to predetermined goals (*i.e.*, it is not compared to the TSR of the peer group)

Relative TSR Formula

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- A relative TSR program has the same math formula as an absolute TSR program, however, with a relative TSR program the payout is determined as a function of the company's TSR ranking/ration compared to the TSR ranking/ration of its peer group

- The following represents a hypothetical (though typical) relative TSR program:

	Relative TSR Rank	Payout %
Maximum:	75^{th} percentile	200%
Target:	50^{th} percentile	100%
Threshold:	25^{th} percentile	50%
Below:	Less than 25^{th} percentile	0%

- In the above example, if the company's TSR rank relative to its peer group is at the 25^{th} percentile, then the payout would be 50% of the target shares

Relative TSR Formula (cont.)

- The following steps are typically employed when computing relative TSR:
  - Calculate TSR for the company and each member of its peer group,
  - Determine the sequential rank/ratio for each company in the peer group according to its TSR performance, and
  - Determine the corresponding portion of the award that should vest or payout

Reasons “For” and “Against” a TSR Program

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- The following represent some of the reasons “For” adopting a TSR program:
  - Awards earned by the executives are commensurate with shareholder returns (i.e., a strong shareholder alignment)
  - TSR programs are viewed positively by shareholders and proxy advisory firms because payout are commensurate with shareholder return; and
  - Avoids having to annually set multi-year financial goals

Reasons “For” or “Against” a TSR Program (cont.)

- The following represent some of the reasons “Against” adopting a TSR program:
  - TSR is a reward program, not an incentive program, because stock price of the company and of the peer group companies is not within the control of the CEO or other executives (*i.e.*, a TSR program provides “no line of sight” to drive executive officer behavior, and to be an incentive, there needs to be a line of sight);
  - TSR is not a long-term value generator because it simply measures a change in stock price between two dates (in contrast, for example, growth in revenue and earning are long-term value generators);
  - The company has high volatility in its stock price and/or the company’s peer group has high stock price volatility (the latter applying when relative TSR is used);
  - Due to the Monte Carlo simulation modeling, relative TSR programs will typically result in higher values being disclosed in the proxy statement (*i.e.*, sometimes the values are higher than the grant date price); and
  - For share reserve calculations under shareholder-approved equity incentive plans, a TSR program “reserves” the maximum number of shares

Relative TSR – Peer Group

- Picking an appropriate peer group is the first major step to designing a relative TSR program. Should the company use:
  - A market stock index such as the S&P 500?
  - A specified peer group of companies?
  - Or a combination of the above two?

- The typical considerations in selecting peer group members apply, including:
  - Industry,
  - Revenue,
  - Market cap,
  - Earnings, and
  - Possibly geography

- In terms of the number of peer group members (assuming use of a specified peer group), a goal should be to use enough companies in order to prevent:
  - Significant changes from one rank or percentile to the next; and
  - Distortions due to bankruptcies, M&A events, liquidations, going private, etc.

Relative TSR – Peer Group (cont.)

- Generally, it is desirable to pick peer group companies that have strong correlation in stock price
- Addressing volatility, care should be taken to avoid matching a company with low volatility to a peer group containing high volatility (and vice versa)
- How should a relative TSR program address changes to members of the peer group of companies that occur during the measurement period due to bankruptcy, M&A activity or going private transactions?
  - Should it be fixed (*i.e.*, the number of peer group companies could then decrease over the measurement period due to, for example, an M&A event),
  - Prior to the end of the measurement period, should there be a determination as to how replacement peer group companies will be chosen (*e.g.*, use a stand-in dummy entity with TSR that is deemed equal to the average TSR of all remaining peers), or
  - Should the choosing of a replacement peer group member be left to the discretion of the compensation committee of the Board of Directors

Relative TSR – Calculation Number of Shares

- Typically, a compensation committee will have an initial dollar value to award to each executive, and such dollar value must then be converted into shares for purposes of creating a relative TSR award
  - Example: To continue to incentivize and retain the executive, the compensation committee is granting the executive a target TSR award equal to $100,000 as of the date of grant
  - The next step is to convert the $100,000 to a number of shares subject to the award

- The design issue is whether the $100,000 in the above example should be converted to shares on the basis of:
  - Grant date stock price, or
  - Grant date "fair value" (determined using a Monte Carlo valuation)

- The answer will likely depend on the driver, that is, whether the compensation committee is more concerned with:
  - The perceived value of the award to the executives, or
  - What value will be reported in the Summary Compensation Table

Relative TSR – Calculating Number of Shares (cont.)

- Grant date fair value will usually exceed the grant date stock price by a substantial percentage
  - This means a lesser number of shares could be subject to the award if the grant date fair value is used, and
  - A higher dollar could be disclosed in the Summary Compensation Table than was initially intended by the compensation committee if grant date fair value is used
- For example, assume the target grant value is $100,000 and the closing stock price on the date of grant is $20.00 per share
  - Use of the grant date stock price would produce the following: $100,000/$20.00 = 5,000 shares = $100,000 of initial perceived value
  - Use of the grant date fair value (assuming the estimated fair value is $25.000/share in this example) would produce the following: $100,000/$25.00 = 4,000 shares = $80,000 of initial perceived value

Relative TSR – Calculating Number of Shares (cont.)

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- And to help smooth the effect of stock price volatility that can arise due to the point-to-point measurement in the relative TSR calculation, an average stock price could be used (*e.g.*, average stock price over a 30-day period)
  - Which can help to alleviate concern that relative TSR payouts are influenced by market timing

Relative TSR – Measurement Periods

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- The measurement period is a point-to-point analysis with a beginning, a middle and an end
  - The starting point is important because companies with poor stock performance at the starting point have an advantage over peer group companies beginning the measurement period with strong performance
  - The middle does not matter and has no impact on the relative TSR calculation
  - The ending point is also important because the market generally places a higher priority on the future expectations of a company (as opposed to its current performance)

- In our experience, most companies use a 3-year measurement period, measured on a cumulative basis
  - And some companies will require a time-vesting component that begins at the end of the performance period

- Should there be any additional "kick the can"?
  - For example, if at the end of the 3-year measurement period the program does not produce an award, then the program could remain open and in place for one additional year (*i.e.*, one addition kick at the can)
  - And using this example, the measurement period during this additional year could be on a monthly or quarterly basis, or a one-time annual basis (*i.e.*, the design is flexible)

Relative TSR – Reinvested Dividends

- Though dividends are not required to be included in a relative TSR formula, inclusion of dividends paid during the measurement period is common (*i.e.*, shareholders received such gains

- Which date should be used for calculating the amount of a dividend?
  - The date the dividend was announced;
  - The "ex-dividend date"? This date is generally two days prior to the record date, and is the date that determines whether a shareholder will receive the dividend (*i.e.*, shareholders who bought the stock prior to the ex-dividend date will receive the dividend, and shareholders who bought the stock on or after the ex-dividend date will not receive the dividend);
  - The record date (*i.e.*, the date the list of shareholders of record is completed); or
  - The date the dividends are paid to shareholders of record

Relative TSR – Rank or Outperformance Design

- Description of a “rank design”
  - Most relative TSR programs are rank designs
  - This means that the relative TSR results of each peer group company are ranked in ascending order, then a percentile rank calculation is performed to determine where the company ranks in its peer group
- Description of an “outperformance design”
  - Payouts are determined by “how much” the company’s TSR outperformed the TSR calculation of its peer group members

Relative TSR – Determining Payouts

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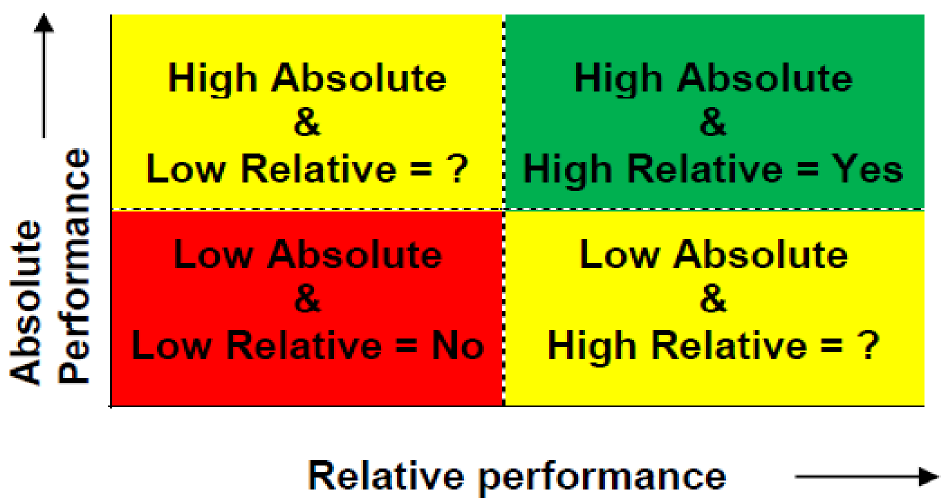
- This is straight forward, there is typically a:
  - Threshold target to get “any” award,
  - Target award, and
  - Maximum award

- In setting payouts, consider the compensation philosophy of the company
  - For example, if the company pays at the 40th percentile under its compensation philosophy, then target could be set at a 40% performance, which would result in a 100% payout

TSR Design – Determining Payouts – Negative Returns

- What happens when there is no alignment between absolute TSR and relative TSR? For example:
  - Should management be rewarded when absolute TSR is high, but relative TSR is low (*i.e*., a reward to reflect the gains realized by shareholders)?
  - Should management be rewarded when absolute TSR is low, but relative TSR is high (*i.e*., a reward to reflect outperformance of the peer group)



- Possible ways to address negative returns are on the next slide

TSR Design – Determine Payouts – Negative Returns (cont.)

- Possible ways to address negative returns:

- 1st – Eliminate any payouts when absolute TSR is negative over the performance period
  - Consider too whether this should work in the reverse, that is, to provide a payout when absolute TSR is high but relative TSR is low (*i.e.*, a reward to reflect the gains realized by the shareholders)

- 2nd – Cap the payout opportunity when absolute TSR is negative over the performance period
  - Such caps typically limit the payout to the target level
  - If applicable, the cap would apply irrespective of whether the relative TSR formula would have otherwise required a higher payout opportunity
  - Consider whether the cap should work in the reverse, to protect management in instances where absolute TSR is high but relative TSR is low (*i.e.*, a reward to reflect the gains realized by shareholders)

- 3rd – Have a formula modifier that downward adjusts the payout when the company has a negative return (i.*e*., similar in formula to an upward adjustment that would apply if the company had positive TSR)

TSR Design – Determining Payouts – Negative Returns (cont.)

- A common reason “for” addressing negative returns
  - Why should management be entitled to a payout for outperforming peers when shareholders lost money?

- A common reason “against” addressing negative returns
  - Management should be paid for outperforming peers because a shareholder’s loss could have been greater at a peer company
  - The existence of a possible elimination of payout, a cap or a formula modifier would decrease the “fair value” of the award, thus possibly increasing the number of shares subject to the award
    - A double edged sword because the result could be used as a “for”

TSR Designs – Determining Payouts - Examples

- The following is an example of a company that adjusts the relative TSR payout (*i.e.*, cutback or enhancement) based on absolute TSR

Absolute TSR	Muliplier
Less than 0%	50%
0% to 15%	100%
Greater than 15%	150%

- The following is an example of a company that uses absolute TSR to only enhance the relative TSR payout

Absolute TSR	Additional Payout
0% or Less	0%
4%	20%
16%	110%
25% or Greater	200%

TSR Design – Change in Control Provisions

- There are a number of TSR design issues to address a change in control transaction, including:
  - Ignore the actual performance through the change in control date, and pay awards at the target level;
  - Pay at the target level, but then pro rate the award to the date the change in control was consummated;
  - Maintain the status quo calculations, but shorten the measurement period until the change in control date; and
  - Same as the above, but pro rate the award to the date the change in control was consummated

TSR Design – Accounting – Reducing Expense

- Recently, some companies have been reducing the accounting expense associated with a TSR program by capping the amount of grain that can be recognized under the award
  - For example, the value of the payout would be capped at a multiple of the target award value (*e.g.*, 5x the target award value)

- Such a provision is unlikely to have practical consequences unless the company experiences extremely high growth
  - However, practically applied or not, it still should work to reduce the accounting expense associated with the TSR program

- Other designs that can help reduce accounting expenses include:
  - Limit the payout or reduce it to $0.00 when absolute TSR is negative,
  - Reduce any gap between the beginning of the measurement period and the actual grant date (*e.g.*, performance period begins January 1st, but grants are not effectuated until after the annual meeting in April)
    - All known information must be included in the fair value determination
    - This means that if performance begins before the grant date, then such performance during the gap period must be included in the fair value determination
    - For example, if the company outperforms its peers during the gap period, then grant date fair value will be higher because the Monte Carlo simulation will deem the company to outperform the peers after the grant date
    - And if the company underperforms during the gap period, then the grant date fair value will be lower

Don’t Forget Next Month’s Webinar

- Title:
  - Building a Compensatory Peer Group: A Step-by-Step Approach
- When:
  - 10:00 am to 11:00 am Central
  - November 12, 2020