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the case for **PERFORMANCE SHARES**

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Total rewards professionals

are beginning to see many companies, large and small, include performance shares as a major component of their long-term (LTI) programs.

Performance shares and performance units are tied to one or more performance measures and typically are driven by performance over a three-year period, with the range usually between two and five years. Achievement of performance goals is paid in stock in the case of performance shares and cash or stock in the case of performance units.

In most instances, the number of shares or dollars received depends on performance surrounding the target goal. Most plans allow for *some* payout for below-target performance, but generally only when performance is at least 80 percent of target. Similarly, most plans provide for additional shares or cash for above-target performance.

Performance shares are at the top of the list on a cost-to-value basis, especially if goals feature achievability and growth.

Key benefits to the company and employee include the following:

- Links to company performance and key drivers of company success
- Eliminates the vagaries of stock-market performance (could be a positive or a negative but creates uncertainty in any case)
- Contributes to executive ownership

- Provides shareholder- and investor-friendly option with a pay-for-performance link
- Provides potential for receiving more stock at higher-than-grant values
- Offers value once shares are received, as long as the company is solvent
- Satisfies 162(m) conditions.

Cost advantages include the following:

- Complete reversal of compensation expense for company if threshold performance-based goals are not met
- Potential for discounted value at grant date for performance shares linked in part or in whole to a market condition
- Fixed accounting based on grant-date fair value
- Lower stock dilution as compared to stock options.

QUICK LOOK

- Performance shares are at the top of the list on a cost-to-value basis, especially if goals feature achievability and growth.
- If performance criteria are tied to a performance condition such as achievement of return on investment (ROI) or sales-growth targets, failure to achieve such a condition results in a complete reversal of compensation costs.
- One potential issue regarding performance shares is the difficulty in establishing goals that are achievable and that present somewhat of a stretch.

The Pay-for-Performance Link

A clear advantage of performance shares and performance units over other stock incentives is the natural link to performance. Most plans are configured in a way that above-target performance will pay out in a higher-than-target number of shares. Or, if performance falls short of target performance, the number of shares paid out will be less than target or zero if performance is significantly below target.

Stock plans approved by shareholders that provide performance shares or performance units also include specific information on the array of metrics surrounding them. This ensures that performance shares and performance units qualify as performance-based compensation under 162(m), and are therefore a deductible expense.

Fixed Accounting

Compensation costs for all stock-based plans, including performance shares, are based on the fair value at the grant date and are fixed either on a per-share basis or on an absolute basis (for market-based performance shares). This is a significant benefit over prior accounting guidelines governing performance shares where share-price changes were a factor in determining year-to-year cost of the plan — variable accounting applied. However, the actual cost of performance shares with performance conditions will vary based on performance against goals and the actual number of shares received, as well as forfeitures, especially as a result of terminations.

Companies granting performance shares with performance conditions must make judgments regarding the likely perform-

ance to be achieved and the number of shares to be paid at the end of the performance period. The actual number of shares delivered in a performance-share plan generally will be different from the target number of shares granted. Performance that exceeds expectations will result in more shares delivered than the plan/target. Performance below expectations will have the opposite effect. Consequently, the tracking of performance can either increase or decrease compensation cost. If the company is certain that over-or under-target performance is likely to occur, it is necessary to change compensation costs expected over the vesting period.

Estimates of forfeitures might vary from initial estimates made at the grant date, and therefore could require a different expectation and forecast over the vesting period. Consequently,

Long-term Incentives

LTI Vehicle	FAS 123(R) Measurement Approach	Key Employee Tax Issue	Key Advantage	Key Disadvantage
NQSOs	Fixed: grant-date fair value ¹	Ordinary income tax at exercise	Determine taxable event, upside potential	Potential underwater, highly dilutive
ISOs	Fixed: grant-date fair value	Capital gains tax at sale	Capital gains, upside potential	No company tax deduction, ISO rules
Stock SARs	Fixed: grant-date fair value	Ordinary income tax at exercise	Limits dilution, upside potential	Potential underwater
Restricted Stock	Fixed: grant-date face value ²	Ordinary income when vested	Retention, no cost to employee	Pay tax when vested, not 162(m) qualified
Restricted Stock Units (paid in stock)	Fixed: grant-date face value	Ordinary income when delivered	Flexibility, can include performance	Flexibility subject to 409A rules
Performance Shares	Fixed/variable: stock price fixed, shares adjusted ³	Ordinary income when vested	Additional shares and higher stock price	Performance measures set
Performance Units (paid in cash)	Variable: adjusted until paid ⁴	Ordinary income when vested	Receive cash, diversify	Cash flow, variable accounting

¹ Fair value based on an option-pricing model, such as Black-Scholes

² Face value equals stock price on grant date

³ Stock Price fixed on grant date; shares are variable until measurement period is complete

⁴ Mark-to-market accounting until award is paid

while the unit value is constant, based on the grant-date value, the quantity of shares is variable. Forfeitures reduce compensation costs. This applies to all stock-based LTI vehicles.

Performance units are similar to performance shares, but instead of paying in stock, they typically are paid in cash and are therefore categorized as liabilities according to FAS 123(R), rather than as share-based pay transactions. Consequently, performance units are subject to variable accounting and must be recorded as a mark-to-market expense each quarter.

Expense Reversal and Discount Features

Another key cost benefit of performance shares and performance units with performance conditions is the reversal of expense if conditions are not met. Specifically, if performance criteria are tied to a performance condition such as achievement of return on investment (ROI) or sales-growth targets, failure to achieve such a condition results in a complete reversal of compensation costs.

A performance condition is defined as a condition affecting the vesting (or exercisability), exercise price or other pertinent factors used in determining the fair value of an award that relates to an employee rendering service for an explicitly or implicitly specified period of time and achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities). This would not include total shareholder return (TSR) or stock-price growth.

If performance criteria are tied to market conditions, reversal of compensation costs is not permitted. However, using path-dependent models like Monte Carlo, it is possible to calculate a discount factor for performance shares or performance units linked to

TSR or other stock-price variables. Based on the author's recent experiences, it would not be unusual to realize a discount of 30 percent to 40 percent off full value. This discount would be based on a combination of stock valuation using Black-Scholes or some other option-valuation model and a risk assessment or probability based on achieving either an absolute or a relative target. While expenses cannot be reversed if the goals are not met, this design is worthy of consideration if goals are achievable with good upside potential. Unlike performance shares with performance conditions, exceeding targets that result in additional shares earned will not increase compensation expense, as the likelihood of these occurrences would be accounted for in the Monte Carlo simulations.

Stock Dilution

Even though Institutional Shareholder Services (ISS) de-emphasizes traditional stock-dilution measures in favor of shareholder-value transfer — the dollar amount of shareholders' equity flowing out of the company to employees and directors — many important institutional investors continue to place a high degree of emphasis on stock dilution. Institutions placing less emphasis on ISS recommendations and dilution definitions include California Public Employee Retirement System, Capital Group, Fidelity Investments, Legg Mason and TIAA-CREFF.

Performance shares are considered full-value shares and are valued at about two-to-three times that of stock options. Therefore, on a value basis, significantly fewer shares are granted as compared to stock options. Consequently the impact on stock dilution is much lower for performance shares than for stock options, and is viewed more favorably by many institutional investors.

FIGURE 1: PERFORMANCE MATRIX

Revenue	EBITDA	\$30m	\$35m	\$40m	\$50m
\$100m	50%	75%	100%	125%	150%
\$125m	75%	100%	125%	150%	175%
\$150m	100%	125%	150%	175%	200%
\$175m	125%	150%	175%	200%	

Setting Goals

One potential issue regarding performance shares is the difficulty in establishing goals that are achievable and that present somewhat of a stretch. Because most companies develop three-year strategic and financial plans, developing goals should not represent a major obstacle. There are generally two types of goals that can be employed — absolute and relative. Examples of absolute goals are internal goals such as earnings per share, net income, revenue growth, etc. Relative goals are those that compare a company-specific measure with the same measure for an appropriate peer or industry group. Relative goals often are used in conjunction with TSR, which is strongly influenced by stock-price changes and overall market trends. Just as a rising tide lifts all boats, using an absolute TSR will reflect market movements and management effectiveness. A relative TSR measure neutralizes market movements and emphasizes specific company performance relative to the market. So if relative TSR increases (TSR for company X increases faster than the company X peer-group collective TSR), it would signal that management has outperformed its comparative market.

Figure 1 shows a simple linear example of a performance matrix that is comprised of two absolute goals — EBITDA and revenue. The percentages represent the payout relative to various combinations of performance.

A Winning Formula

The advantages of performance shares are numerous. They are designed to motivate and reward extraordinary performance, have a relative low impact on stock dilution and have fixed-cost accounting based on fair value at grant date. In addition, share costs can be completely reversed if performance-based targets are not achieved. Even in the case of market-based performance shares, compensation costs can be

relatively low as a result of risk-related price discounts. For these reasons a gradual shift from plain-vanilla stock options to performance-based grants is expected over the next few years. **WS**

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