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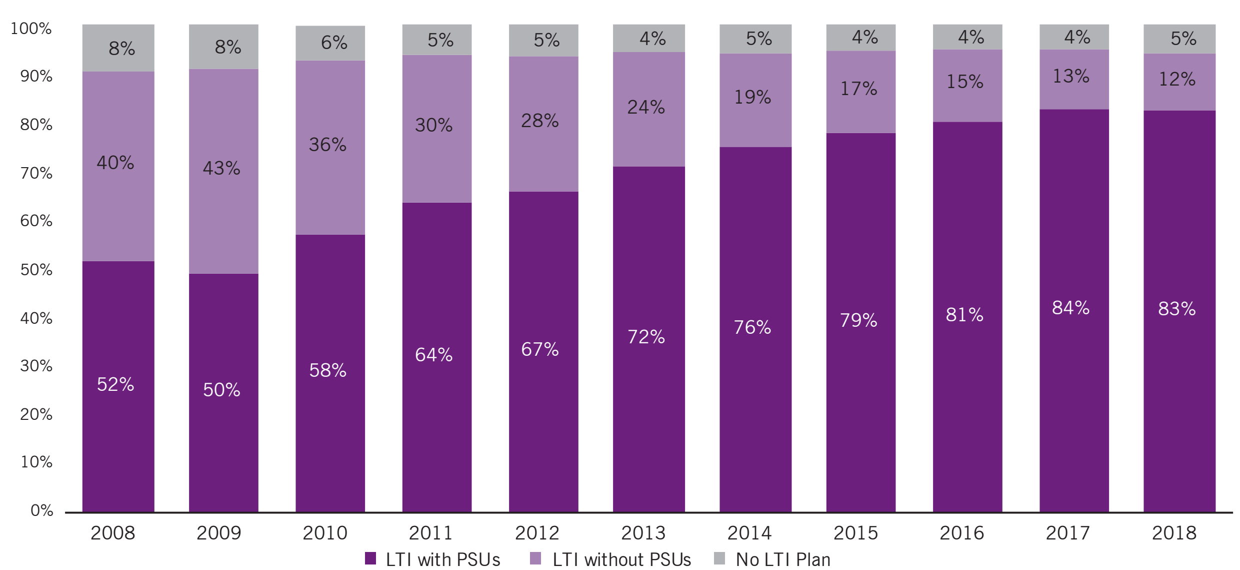
Are Performance Shares Shareholder Friendly?

by Marc Hodak, Farient Advisors

Since the early 2000s, executive compensation has experienced a secular shift toward performance shares[1]—equity awards whose vesting is based on performance as opposed to time or service. In the past, for example, an executive might have been granted mostly restricted stock units (RSUs) that would vest over a three-year period; they simply had to stick around to get all the shares. Today, an executive is more likely to be granted over half their awards in performance share units (PSUs) that vest at the end of three years; in such cases, the number of shares that actually vest can be more or less than the nominal grant, depending on how well the company performs during that period. Ten years ago, less than half of S&P 500 firms awarded PSUs. Today, as shown in Figure 1, over 80% of them do, and PSUs have become an increasingly larger percentage of the long-term incentive (LTI) mix within those companies.

Figure 1
Prevalence of PSUs in LTI Plans in the S&P 500



1 Shares with performance-based vesting are generally awarded as "performance share units," or PSUs. This article uses "performance shares," "performance share units," and "PSUs" interchangeably.

This growth in PSUs has been driven largely by the efforts of influential institutional investors and their proxy advisors to promote what they believe to be a more shareholder-friendly award than restricted stock or stock options, which these investors have taken to calling "non-performance based." However, investors are by no means in complete agreement about how pay for performance should be implemented in companies. Fissures have begun to appear in the general sentiment about performance shares.

Perhaps most notable, in 2017 the well-known Nordic sovereign wealth fund, Norges Bank, came out with a widely circulated white paper that declared a preference for share awards *without performance conditions*, arguing that the use of complex performance criteria does not necessarily enhance alignment between corporate managements and their shareholders. Other investors have recoiled at the increase in the sheer volume of pay disclosures, which have been largely driven by descriptions of performance share plans. In fact, PSUs have evolved to the point of presenting significant structural and economic problems that should cause more investors to rethink them.

Performance Shares Significantly Complicate LTI Plans

Time-based grants of restricted stock or stock options are easy; if the executive sticks around, the shares or options eventually vest. Notwithstanding their "non-performance" label, these types of equity awards can effectively align the interests of managers and shareholders by directly, transparently tying the personal net worth of the executives to the ups and downs of the stock price.

How effective is that alignment from the shareholder's perspective? Empirical studies have shown, with remarkable consistency, a significant positive relationship between management ownership of shares and the enhancement of shareholder value. Indeed, this is one of the most robust results in the peer-reviewed, corporate governance literature—one that has been replicated over several decades of scholarship covering many different nations and regulatory regimes.[2]

Compared to straight equity grants, performance shares introduce significant complexity into long-term incentives. To determine how many of the granted shares will vest, the plans must include performance measures and, for each measure, a scale of the portion of granted shares that vest across various performance levels, from threshold to target to maximum. These plans must be calibrated to yield rewards that make sense across the entire spectrum of possible performance outcomes. Further complicating matters, PSUs increasingly include additional "triggers" or "governors" designed to prevent unintended windfalls due to the uncertain relationship between accounting-based metrics, such as earnings or returns, and stock price over multiple years. Such complexity makes these plans much less transparent to even the plan participants, some of whom have dismissed them as "black box" reward mechanisms, thus casting considerable doubt on their actual incentive effect.

> "Whether their end-of-year goals were set one year ago or three years ago is immaterial to the short-term behavior that the plan can drive."

This complexity has also, not surprisingly, proved frustrating for investors trying to evaluate the plans. Working against investors' desire for "shareholder-friendly" incentive compensation plans, PSUs, with their exotic features in overlapping grant and performance periods, are often the most complicated parts of today's compensation disclosures. And since the inner workings of these plans are often poorly understood by internal as well as external stakeholders, it is almost impossible to explain counterintuitive pay results, even when such results were intended by the designers of the plan.

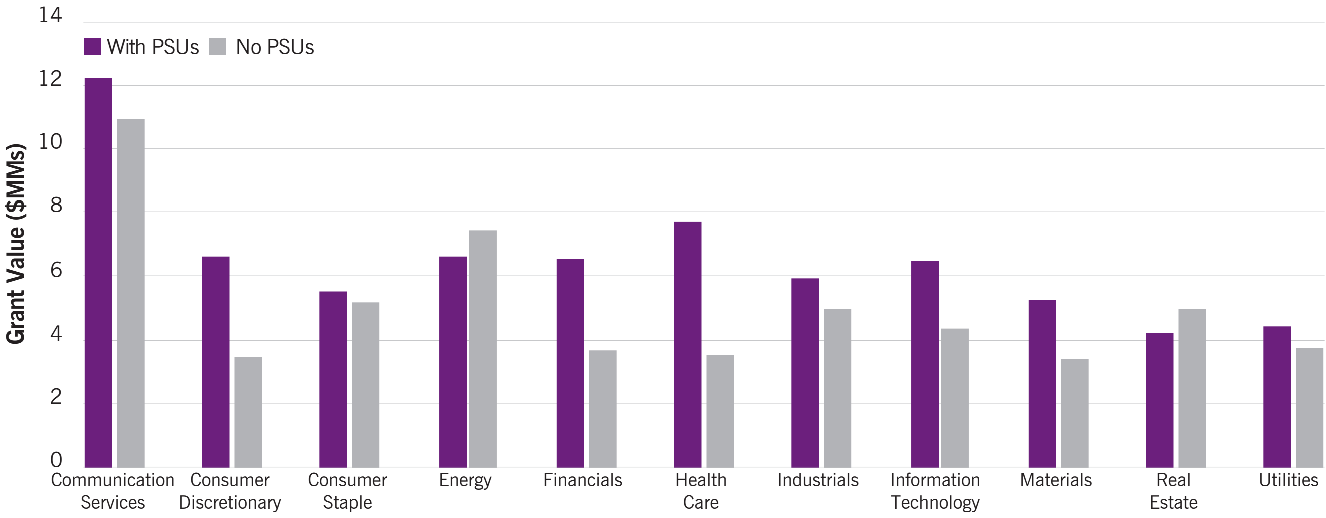
Performance Shares Turn Out to Be More Costly, Too

In a recent study, my Farient colleagues and I looked at LTI awards across S&P 500 firms containing significant PSUs versus those containing only RSUs or stock options for each year over the ten-year period from 2008 to 2017. During this period, CEOs who received a significant portion of their LTI awards in the form of PSUs were awarded median grant values that were roughly 35% higher than those for CEOs who received only restricted stock or stock options. Moreover, as can be seen in Figure 2, in nine out of eleven sectors, the grant date value of LTI awards that included PSUs was materially higher than for those getting only RSUs and stock options. In the case of the average company switching from "non-

2 McConnell, John J., and Henri Servaes, "Additional evidence on equity ownership and corporate value," *Journal of Financial Economics*, 27 (1990) pp. 595-612; de Miguel, Alberto, Julio Pindado, Chabela de la Torre, "Ownership structure and firm value: new evidence from Spain," *Strategic Management Journal*, Volume 25, Issue 2 (December 2004) pp. 1199-1207; Von Lilienfeld-Toal, Ulf and Stefan Ruenzi, "CEO Ownership, Stock Market Performance and Managerial Discretion," The *Journal of Finance*, Volume 69, Issue 3 (June 2014), pp. 1013-1050.

Figure 2

Median of Grant-Date Values of Equity in S&P 500 Firms from 2008-2017



performance" equity awards to PSUs over the last decade, the median CEO received an approximately 40% increase in the grant date value of their award.

The most likely explanation for this increase in grant date values should make perfect sense to any investor—namely, that performance shares create greater compensation risk than an equivalent value of time-based equity, especially RSUs, and no one should be expected to accept greater risk without the prospect of a greater reward. Furthermore, our firm's experience in developing offers for senior executives suggests that they almost invariably view RSUs as more valuable than an equivalent, nominal value of PSUs, especially in periods of volatility. PSUs can also feel riskier than options to managers in a period of rising stock prices, as historically granted options increasingly find themselves "in the money." Tellingly, over the last ten years, relatively higher-risk sectors such as Financials, Health Care, and Consumer Discretionary saw the largest cost differences in grant values for "performance" vs. "non-performance" share awards, while lower-risk sectors such as Utilities, Consumer Staples, and Real Estate have had the most comparable grant values.

In light of these findings, it seems ironic that many investors have supported the use of performance shares with the expectation that the growing use of PSUs would have the ultimate effect of *limiting*, not increasing, overall CEO pay. Instead, CEO pay has stubbornly grown alongside the increasing prevalence of performance shares, despite the greater scrutiny to which their pay has been subjected. Of course, many factors other than PSUs could be, and likely are, contributing to this effect—but the basic risk-reward imperative that comes with PSUs is also almost certainly a contributor.

Performance Shares Hurt Corporate Performance

Even if performance shares cost more, they may be worth it if they lead to better company performance. Given the proven benefits of management share ownership, it seems plausible that alignment may be improved by layering on performance conditions before allowing stock to vest. Not only would management have their personal wealth tied to the stock price by virtue of the change in value of whatever shares they end up with, but they would also have to have performed well to obtain those shares. This hypothesis is enhanced by the fact that managers see a more direct connection between their actions and the measures that often drive performance awards, such as earnings or revenue, than between their actions and the company's stock price.

Unfortunately, this theory runs up against another powerful strand of research into incentives: it is exceedingly difficult to find any relationship between the bonus rewards received by managers and value created for their shareholders. A number of reasons have been offered for why bonus plan outcomes correlate so poorly with shareholder value. A leading contender is that rewards based on a set of concrete metrics and goals to be achieved in a limited time introduce "short-termism" in management behavior. Knowing that the clock will strike midnight at the end of a plan year clearly focuses management on the particular metrics and goals being rewarded in that period. But, such focus also encourages less attention to potentially important things that are not being measured, or will not show up until after the plan year is over.

The existence and effects of "short-termism" have been documented in numerous studies. One much-cited Duke University survey of some 400 public company CFOs conducted in 2005 and repeated in 2013 included the question: Would you be willing to sacrifice economic value in order to hit an earnings target? Over three-fourths of the responding CFOs admitted that their companies would consider doing that. That, in a nutshell, is the inherent hazard of short-term plans.[3]

Since performance share plans are typically "long-term" plans, we might suppose that these effects would be much less relevant. However, managers don't distinguish short- from long-term plans based on how far into the future performance will be measured; they distinguish them based on the vintage of the goals for the coming year-end. Whether their end-of-year goals were set one year ago or three years ago is immaterial to the short-term behavior that the plan can drive.

This reality of managerial behavior brings up potentially important problems associated with short-term plans, while magnifying their likely effects:

The first is that long-term goals based on accounting results, such as earnings or return on capital, are likely to become stale as managers get nearer the end of the plan. More so than in annual plans, three-year plan targets are likely to be long-since achieved, or no longer achievable, well before the end of the performance period. Furthermore, any interim shift in the strategic landscape, which is highly likely within any three-year period, could make such goals no longer worth achieving. This would require the company either to renegotiate the goals, undermining the integrity of the plan, or to risk the rewards or penalties associated with meeting the goals of a plan that no longer drives shareholder value.

By contrast, share ownership is by its nature long-term and value-focused, and has no expiration date. And ownership without the added contingencies introduced by PSUs gives management the widest strategic range in pursuing opportunities as they arise. If managers have the opportunity to sacrifice some short-term earnings or returns in favor of significantly higher future earnings or returns, they will make the trade-off in favor of maximum value creation, consistent with the positive impact on their personal wealth. Performance shares can also provide that exposure, but with a significant dose of uncertainty about ownership. For example, if management is considering a major strategic investment just as a performance period is coming to an end, do we really want management to be weighing a near-certain 5% or 10% hit to the number of shares they may end up with due to the projected, negative effect of the investment on their PSU metrics against the expected, but eventual 2% or 3% gain in total shareholder returns (TSR) from going through with the investment?

So, the question arises: Which incentive effect dominates? Do the alignment benefits created by stock ownership, albeit at an uncertain level, outweigh the potential "short-termism" associated with the temporal bonus mechanism that determines the number of shares that one ends up with?

In a recent study, we looked at relative total shareholder returns (RTSR) during three-year periods over the last ten years for S&P 500 companies that awarded performance shares versus those that awarded solely "non-performance" equity. Notwithstanding the mix of stated preferences among investors, their market behavior spoke clearly. As shown in Figure 3, companies with PSU plans underperformed their sector peers, while companies making straight grants of restricted stock or options outperformed their sector peers in every three-year period we looked at.

What's more, the underperformance of PSU-laden plans and the outperformance of "non-performance" plans across this period were both statistically significant. In other words, "performance shares" don't appear to perform for shareholders.

What Investors Want

These findings challenge us to reinterpret "what investors want" since investor preferences have been the main driver of the shift towards performance shares.

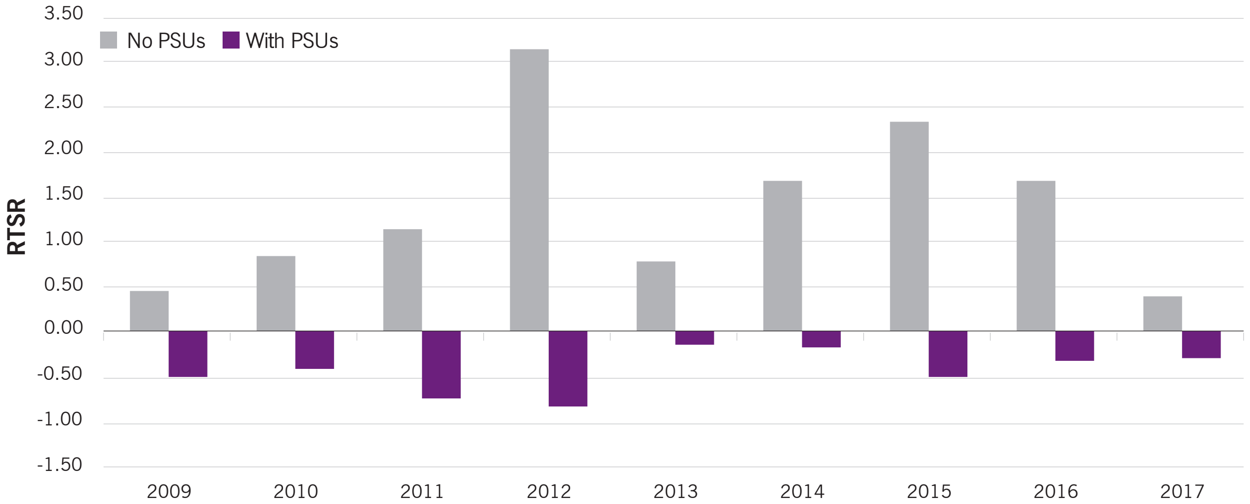
There continues to be a broad consensus in support of the basic idea of pay-for-performance for top executives. Boards and the executives themselves, as well as investors, generally agree with that principle. But how pay-for-performance manifests in incentive plans is open to a wide range of possibilities. Performance shares are one manifestation, and may well be the best choice for long-term incentives for certain companies—for example, those where performance metrics reliably capture changes in long-run corporate values. But the idea that companies should uniformly be implementing performance shares as their dominant LTI vehicle is likely to be counterproductive to the interests of those promoting them.

Unfortunately, knowing that PSUs may increase compensation cost and hurt performance does not absolve companies from having to reckon with "what investors want," especially

3 Graham, John, Campbell Harvey, and Shiva Rajgopal, (2005), "The economic implications of corporate financial reporting," *The Journal of Accounting and Economics* 40 (1-3):3-73.

Figure 3

Three-Year TSR Relative to Sector Peers for S&P 500 Firms



Note: Companies "With PSUs" awarded at least 20% of their long-term incentives in performance shares. "No PSUs" firms awarded only restricted stock or stock options (or a combination) without performance conditions.

as distilled by their proxy advisors. As long as ISS and Glass-Lewis continue indiscriminately to endorse and push all companies to make the majority of their LTI awards "performance-based," boards will continue to implement PSUs on an ever-growing scale.

Boards can, and some do, push back against "best practices" that don't line up with their sense of what is best for *their* companies. But given the business model of proxy advisors and the influence they wield over public companies, the trend towards performance shares is unlikely to be arrested without pressure from more large investors re-evaluating what is truly shareholder friendly when it comes to LTI plans. In light of the evidence of how performance shares are actually affecting corporate performance, it may be time for more investors to join the growing backlash in their ranks against PSUs, and to begin communicating a more nuanced view and expectation of their adoption by companies in their portfolios. It may also be time for proxy advisors to look at the evidence on PSUs and shareholder value in shaping their standards, and adjust their advice accordingly.

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