Aon Hewitt
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The Link Between Employee Communication and Equity Plan Performance

The results of our 2015 PeerTracker Client Survey reveal an increase in communication to employees on Relative TSR performance-based plans and actual performance.

For long-term observers of compensation and corporate governance trends, the inevitable march of shareholder interests over the last 15 to 20 years is an amazing sight to behold. Moving mostly at a moderate pace, but punctuated by fierce bursts of activity like the advent of stock option expensing and say-on-pay voting, the consideration of shareholder interests in the design and communication of compensation programs is now significant, if not central. This is especially true when requesting shareholder support for new equity incentive plans or developing pay programs for executive officers.

A natural outcome of this march is increased reliance on performance-based equity awards, followed by the rising use of market-based metrics like stock price targets and total shareholder return (TSR). However, and somewhat paradoxically, these pay programs, which are often developed to more clearly link pay and performance, are commonly viewed as complex to design and challenging to communicate to employees.

For example, a typical performance-based equity award with a relative TSR metric is difficult to value (both from a day-to-day user and accounting perspective), may involve fluctuating stock prices for anywhere between 20 and 500 peer companies, and usually uses some formula-driven system to manage plan leverage (i.e., minimum and maximum payout outcomes). While the basic premise of these plans is straight-forward, actual plan mechanics can involve hundreds of moving pieces and some fairly advanced mathematics. As a result, communication is critically important and an ongoing struggle.

Communication pitfalls are a serious concern as the prevalence of performance-based equity awards rises. A number of methods for effectively communicating plan conditions and performance factors to employees have emerged. However, most approaches center on intensive, face-to-face sessions when plans are launched. These sessions commonly create a surge of initial energy, which fades over time— especially when performance periods stretch to three years in length.

Responding to communications challenges around the use of performance-based equity awards is a large reason why our team initially developed the *PeerTracker* platform in 2008. In addition to assisting clients with plan tracking and financial reporting, *PeerTracker* opens the door to real-time communication of corporate performance levels and in-progress/final award outcomes. Yet, despite significant progress among our client base, a number of important communications-related questions remain open for debate. Some of these fundamental questions include:

- How wide is the communications gap between plan designers and award recipients?
- What communication methods are most effective for driving improved business performance?
- How significant is the role of communication in driving performance outcomes?
- Do investments in communication ultimately make a difference?

Building the 2015 *PeerTracker* Client Survey

Against this backdrop of issues, Aon Hewitt's Equity Services team initiated our second annual *PeerTracker* Client Survey in June 2015. We polled more than 180 clients with active *PeerTracker* subscriptions to learn more about how they communicate and track performance-based equity plans.

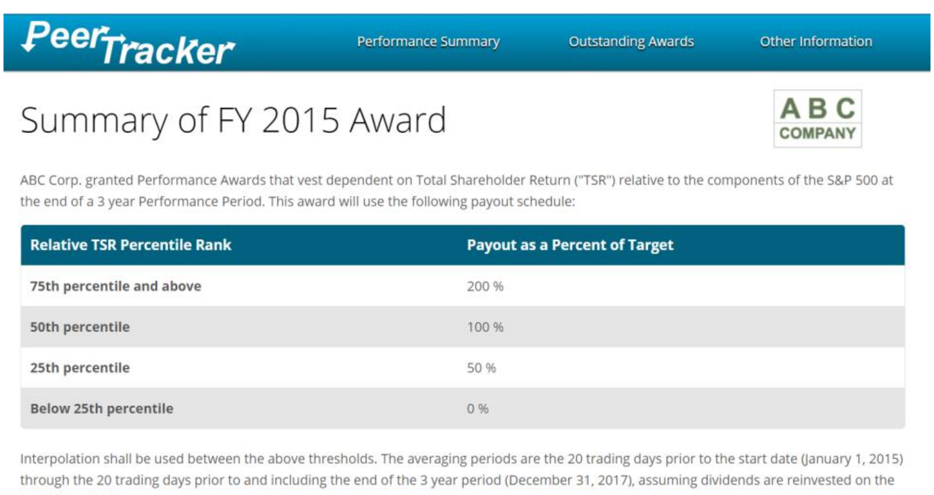
Most importantly, our survey explored how communication impacts overall plan effectiveness. Key issues examined by the survey include: (1) award recipient satisfaction with plan explanations; (2) the frequency of plan communication; and (3) plan design complexity.

Responses to the survey were then cross-referenced with each company's actual performance results based on data in *PeerTracker*. In total, information from more than 800 completed and ongoing performance periods (as of October 2015) was included in our analysis.

Without numerous years of data, covering both up and down market cycles, we believe it is premature to draw decisive conclusions about links between plan communication and performance results. However, with this being the second year of our study, the data we continue to collect certainly suggests effective communication has a positive impact on performance plan outcomes.

Issue #1: Satisfaction with Plan Explanations

For most companies with a performance-based equity plan, the logical starting point for an effective communications strategy is a clear and concise explanation of plan design. As such, a portion of every *PeerTracker* website is dedicated to this very issue (see product image below).


PeerTracker   Performance Summary   Outstanding Awards   Other Information

Summary of FY 2015 Award

ABC Corp. granted Performance Awards that vest dependent on Total Shareholder Return ("TSR") relative to the components of the S&P 500 at the end of a 3 year Performance Period. This award will use the following payout schedule:

Relative TSR Percentile Rank	Payout as a Percent of Target
75th percentile and above	200 %
50th percentile	100 %
25th percentile	50 %
Below 25th percentile	0 %

Interpolation shall be used between the above thresholds. The averaging periods are the 20 trading days prior to the start date (January 1, 2015) through the 20 trading days prior to and including the end of the 3 year period (December 31, 2017), assuming dividends are reinvested on the Ex-Dividend Date.

Of course, creating a plan explanation and measuring its effectiveness are separate issues. To address the topic of potential communication gaps, we asked clients who share *PeerTracker* websites directly with plan participants to answer the following question: Please rate your plan participants' overall reaction to the plan explanation.

When answering this question, every survey recipient was asked to choose from the menu of responses listed below:

- Very Satisfied – meaning participants have a very positive reaction to the plan explanation, by understanding the design, reasons for the plan, and how performance would be measured clearly.
- Satisfied – meaning participants have a positive reaction to the plan explanation, by understanding the overall design and intentions, but may not be entirely clear on specific aspects and details.
- Neutral – meaning participants do not really react to the plan explanation, indicating that understanding could be satisfactory or quite limited.
- Unsatisfied – meaning participants have a negative reaction to the plan explanation, by illustrating a lack of understanding of the design and intentions.
- Very Unsatisfied – meaning participants have a very negative reaction to the plan explanation, by demonstrating no understanding of the design and complete disregard for the award in general.

In aggregate, nearly 96% of survey respondents were either satisfied or very satisfied with how award recipients reacted to plan explanations, a 15% increase from our 2014 *PeerTracker* Client Survey. Obviously, measuring satisfaction levels is a subjective matter, so we decided to dig deeper.

To introduce greater objectivity into our analysis, we compared how companies actually performed relative to perceived satisfaction levels. While average performance outcomes for Very Satisfied respondents increased by about 15% over last year, the performance of Satisfied and Neutral respondents did not vary greatly from the 2014 survey. As the table below illustrates, actual performance outcomes become increasingly positive as plan explanation satisfaction levels rise:

Responses	Very Satisfied	Satisfied	Neutral	Unsatisfied	Very Unsatisfied	n=Total
Companies	15	13	1	0	0	
Average Percentile Rank	73%	55%	44%	n/a	n/a	29
Average Payout	134%	95%	73%	n/a	n/a	

Anecdotally, we also observed that companies falling into the Very Satisfied camp spent more time customizing the plan explanation sections of their *PeerTracker* websites. This year we measured the connections between specific investments in communication and plan outcomes. Those results are illustrated below.

Responses	High Investment in Communication	Low Investment in Communication	n=Total
Companies	28	27	55
Average Percentile Rank	71%	47%	
Average Payout	119%	81%	

As you can see, companies that reported spending more time customizing their plan explanations had higher than average percentile rank and average payout. While we are unable to conclude that larger investments in plan explanations result in stronger performance, the linkage illustrated above suggests companies that focus on plan comprehension will, on average, benefit from their efforts.

Issue #2: Frequency of Plan Communication

Aon Hewitt's 2015 Employee Engagement Survey found that companies with high levels of employee engagement perform better than companies with average or low levels of employee engagement. The same survey also points to frequent and consistent two-way communication as a key driver of engagement globally, along with factors like pay, career opportunities and recognition.

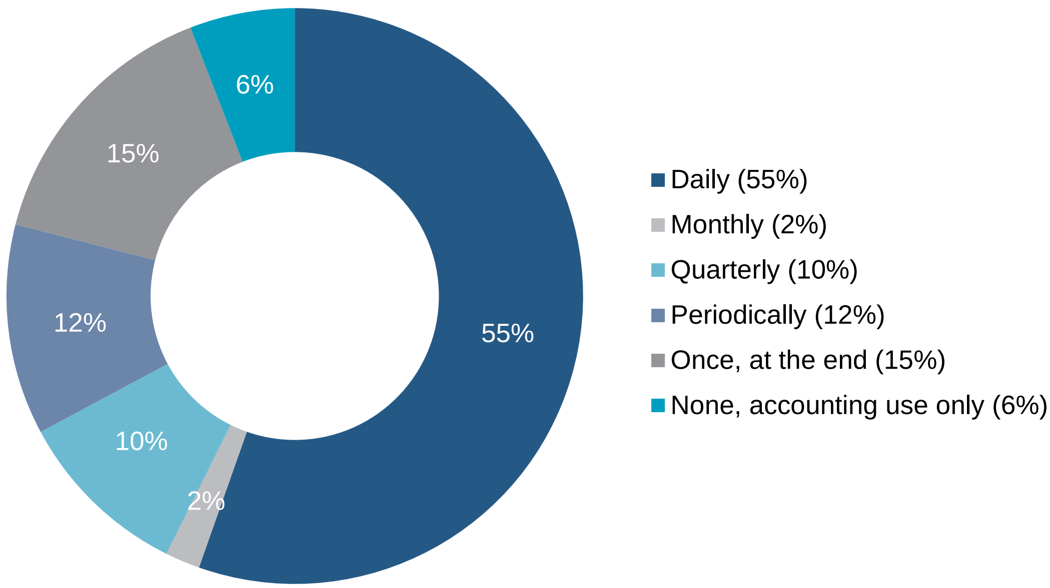
It stands to reason that similar forces are in play when it comes to performance-based equity plans. In theory, when award recipients have a clear understanding for where corporate performance is trending, they will either be more encouraged to sustain strong performance or more motivated to improve weak performance. Frequent communication drives improved comprehension, which in turn drives higher engagement. To begin assessing this theory, we asked *PeerTracker* clients to answer the following question: At what frequency do you share current performance achievement with plan participants?

Companies that communicate performance levels daily or that publish *PeerTracker* website links for employees to see at any time were grouped into the "daily" category. All other responses were categorized as follows:

- Monthly
- Quarterly
- Periodically (less than quarterly at management discretion)
- Once (only at the end of the performance period)
- Never (*PeerTracker* strictly used for accounting purposes)

Once the data was tallied, we discovered that 55% of companies provide daily (i.e., real-time) performance updates, or at least give employees the ability to check performance daily. In fact, there was an increase in all communication frequencies compared to our 2014 survey, except for communication that happens periodically or once at the end of the performance period. A large number of companies, 21%, communicate once a year or less (including never).

Communication Frequency to Award Recipients



More broadly, we categorized survey respondents into two camps: those who communicated frequently (quarterly or more often), and those that communicated infrequently (one time per year or less). Periodic communicators (12% of those polled) are excluded from these camps because it was deemed to be too subjective to estimate what periodic meant in every case.

Focusing on the two core groups of companies defined above, we next turned to the issue of plan performance, seeking to uncover potential performance disconnects between companies with frequent vs. infrequent rates of communication. As expected, differences emerged.

The following chart displays the percentile rank performance boost and subsequent upward swing in payout levels enjoyed by companies with more frequent rates of communication to award holders.

Frequency	Frequent	Infrequent	n=Total
Companies	37	18	55
Average Percentile Rank	72%	50%	
Average Payout	110%	89%	

Compared to last year, companies with infrequent communication experienced a decrease of nearly 10% in both average percentile rank and average payout, while companies with frequent communication experienced a 10% increase in average percentile rank. As is the case throughout this study, it's always possible that other forces could be influencing the data, including varied payout schedules and varied plan complexity. Nevertheless, this analysis seems to further suggest that increased communication rates can improve performance.

Issue #3: Plan Design Complexity

Given the results observed above, it certainly looks like communication practices have an influence on performance achievement. However, another important factor could play a major role: plan design complexity. Presumably, less complex plans will be easier to communicate and make it easier for plan participants to intuitively see the links between their behavior, corporate performance and payment outcomes. To test this theory, we developed a rating system to assess plan complexity across every available plan in our survey cohort. These ratings include:

- Low Complexity – meaning basic market-based plans, including market stock units (MSUs) and component percentile rank plans.
- Moderate Complexity – meaning basic market-based plans with one complex design feature, including total value caps, multiple tranches, internal metrics or complex TSR methodologies (e.g., volume-weighted average prices).
- High Complexity – meaning plans with two or more complex design features, usually including two or more the complex features described above.

Based on our internal ratings system, 62% of plans were classified as “Low Complexity”, 28% were classified as “Moderate Complexity” and 10% were classified as “High Complexity”. When compared to the 2014 survey, we noticed a decrease of 15% in plans classified as High Complexity and an increase of 18% for plans classified as Low Complexity.

After comparing our three complexity ratings to actual performance results, another important trend emerged. Plans with less complexity yielded higher performance levels. Specifically, plans with the “Low Complexity” classification yielded average payouts of almost 136% of target, while plans with “High Complexity” ratings had average payouts of 90% of target. In fact, per the chart below, performance levels rose consistently from high to moderate to low complexity plans.

Importantly, we believe this finding is more robust than some of our earlier data, as the sample size is larger, raising the statistical significance for each rating category. Although there are much fewer “High Complexity” plans, we still expect the relationship to hold.

Complexity	Low	Moderate	High
Plan Count	125	57	19
Average Percentile Rank	77%	60%	54%
Average Payout	129%	104%	94%

Of note, a number of companies included in our analysis have multiple plans. On a company level, 43% of companies had plans classified as Low Complexity, 41% had plans classified as Moderate Complexity and 16% had plans classified as High Complexity. We ran our analysis at the plan level to avoid integrating performance results across plans at the same company that might have different complexity levels and/or performance periods.

Taking the Next Step

Based on the full set of 2015 survey results observed above, several performance trends are apparent. To start, there is a noticeable difference between performance results when plan participants are more or less satisfied with plan explanations; as satisfaction levels rise, so too does plan performance. Additionally, companies who communicate performance results more frequently experienced higher performance achievement. Finally, plans with less complexity, which are presumably easier to communicate, yield better performance outcomes. Together, these findings point to the powerful role effective communication likely plays in performance-based equity results.

Despite these trends, we believe further study is needed. There is a difference between communication for the sake of communication and high-quality communication. There can also be many other variables at play. For example, companies with strong plan explanations, frequent performance updates, and simple plan design might be taking a more proactive and simplified approach because they have good news to share. These same companies might also be performing better because they have better overall management— where quality communication is one of many positive outcomes of good leadership. In future years, as our study continues to evolve, we plan to study these additional issues. For example, we can observe how often Low Complexity plans are communicated, and so on. Still, we find there is significant meaning in the association between effective communication and better performance.

Looking to the future, Aon Hewitt's Equity Services practice plans to perform this analysis again in 2016 to monitor the relationship between plan communication and performance outcomes over a long-term period.

To learn more about the Equity Services team at Aon, visit our website: radford.com/home/valuation. To speak with a member of our compensation consulting group, please write to consulting@radford.com.

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