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In the UK and US, Performance Share Plans Appear Due for a Makeover

Some firms are trading in their performance shares in favor of restricted stock with longer vesting and holding periods as critics say performance plans have become overly complicated.

Starting in the early 2000s, performance share units (PSUs) became the dominant equity vehicle for long-term incentives in the United Kingdom (UK), and have since exploded in popularity in many other parts of Europe and the United States (US). Their proliferation is driven by investor pressure for greater linkages between pay and performance, which is reinforced by the introduction of Say-on-Pay voting and by proxy advisory firm voting policies.

However, the wheels are starting to come loose for some companies that jumped on the PSU bandwagon. In the past couple of years, boards, management teams, and even shareholders and their advisors, are starting to question whether performance plans have become too complicated and if they truly motivate the right kinds of behaviors that drive sustained long-term performance.

A Push for More Diverse Metrics

Most performance share plans focus on measures of corporate performance that have high line-of-sight for investors but, arguably, are not always in the control of executives. The most common metrics used for PSUs are relative total shareholder return (TSR) or absolute TSR, with operating metrics, such as earnings per share (EPS) or revenue as secondary modifiers. When PSUs became more popular in the US, most large companies used relative TSR as the dominant or sole metric. The result is increased homogenization of executive incentive plans and many companies now feel inhibited in their ability to tailor compensation plans to suit their unique strategies.

The popularity of relative TSR is not all surprising: Not only is TSR preferred by many shareholders, it has an advantage over other measurements because you can more easily benchmark to an appropriate peer group or the components of a stock index and more easily set and disclose targets.

Yet, in the past year, the reins are beginning to loosen. For the first time, a dominant proxy advisory firm, Institutional Shareholder Services (ISS), now considers alternative performance metrics in their qualitative analysis of pay-for-performance for US companies (see our article *ISS Adds Metrics to Qualitative Say-on-Pay Screening, But Not All Industries Will Benefit* for more details). And in the UK and the rest of Europe, where PSUs were popular much earlier than in the US, we see a more diverse range of metrics being used.

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Changes Are Already Afoot in the UK

Unlike the US, PSUs have become more common for employees below the executive level in the UK. Recently, that's led more people to question whether these plans make sense for less senior roles that may not have great line-of-sight into performance outcomes, particularly TSR.

The highly influential Investment Association Executive Remuneration Working Group's **report** on rebuilding trust in executive pay concluded that long-term incentives have become too complicated and have contributed to poor alignment between executives, shareholders and the company— sometimes leading to levels of remuneration that are difficult to justify. They are calling on companies to consider simpler alternatives to PSUs. One common alternative floated around by both companies and some investor groups is switching from PSUs to smaller awards of restricted stock granted with longer vesting or holding periods and increased shareholding guidelines. Typically, in order for investors to support a switch to restricted stock, a reduction in maximum award levels of at least 50% is required.

So far, most plan changes are occurring below the executive level where RSUs are relatively easy to implement without shareholder approval. Still, a handful of companies have been successful in convincing shareholders that RSUs are more appropriate than PSUs for executives (typically the CEO and CFO). Of course, not all investors are convinced that this would represent a positive change and companies that have tried to make a move from PSUs to RSUs for their executives have found there is still a lack of consensus among shareholders on whether PSUs, RSUs or other alternatives are more appropriate.

The Royal Bank of Scotland (RBS) stands out as one of the few companies that successfully switched from PSUs to RSUs this year. The company's new variable pay plan replaced both cash bonuses and long-term incentives with a single plan under which awards of shares will be granted based on the prior year's performance. These shares then vest in tranches between three and seven years after grant. ISS was critical of RBS' new plan, saying it produced a "greater certainty of outcome." However, the change was aligned with the highly restrictive regulatory requirements on variable pay put in place by RBS' regulators and received strong support from the UK government, which owns more than 70% of the shares in RBS. The plan also garnered support from other large investors, including giant Norwegian pension fund Norges Bank Investment Management. In the end, the new pay plan passed with 96% support.

Despite the success of RBS, other companies have not had nearly as much support. A number of UK companies abandoned proposals to replace PSUs or put the proposals to a shareholder pay vote only to have it voted down. Only five known UK companies were successful in introducing an alternative long-term incentive plan to PSUs for executives this year.

A few common themes emerge from looking at the success of these five companies, which may provide guidance for future companies that want to replace their PSUs at the executive level. These include:

- A clear link between the use of restricted stock and the company's strategy
- Significant (at least 50%) reduction in maximum award levels
- Lengthening of vesting and holding periods to five years or more

- Ability for the remuneration committee to make “malus” adjustments during the vesting period
- Increased shareholding guidelines for executives

Will Movement in the UK Foreshadow Changes in the US?

Adopting alternatives to performance-based share plans is not an idea that has garnered much support, or even attention, from US shareholders relative to the UK market. However, as with other corporate governance movements, changes in Western Europe often predate trends in the US. For example, Say-on-Pay voting began in the UK before institutional shareholders in the US campaigned for its inclusion in the Dodd-Frank Act. Not only do many UK and US-based shareholders share similar corporate governance values, institutional investors in these markets are increasingly holding stock in cross-border companies and have influence on global governance practices.

In the US, the discussion around PSUs is focused more on plan design and debating whether relative TSR should be the dominant metric, as opposed to questioning whether PSUs should be the dominant equity vehicle in long-term incentive plans. Our research on long-term incentive plans at technology and life sciences companies finds scant differences in the financial performance of companies with TSR-based performance plans and those without performance plans or with operating metrics only. There are two likely explanations for this: TSR is either outside of the control of the CEO or CEOs are unsure of the specific actions needed to increase performance.

However, there are a few instances of US companies rethinking their traditional performance share plans. This year, the semiconductor company Applied Materials swapped its relative TSR-based PSUs for a combination of PSUs and RSUs with three-year vesting. The new PSUs are tied to non-GAAP adjusted operating margin and three-year average market share goals. Similarly, in 2016, the mid-sized software firm Calix made the switch from relative TSR to PSUs with operating metrics and two additional years of vesting. With the change, the board said management had more ability to control performance outcomes.

There are some US-based companies that never really embraced PSUs when the trend took off. Google and Wayfair, as well as others, have RSUs with longer holding periods emphasizing long-term ownership and acting as owners of the company versus short-term stewardship— akin to the growing movement in the UK. Nonetheless, the US market still has a very strong connection to PSUs that is only starting to erode or morph into simpler and more focused operating metric-based plans.

Next Steps

In both the UK and US, the environment for introducing alternative plans like restricted stock for executives is challenging. There is growing consensus that having PSUs below the executive level may not be appropriate, particularly if the metrics are overly complicated or don’t offer good line of sight. As a result, we see large numbers of companies replacing PSUs with restricted stock for less senior employees in the UK.

It remains to be seen what will happen at the executive level in a widespread fashion. While the example of RBS provides hope for organizations that want to move away from PSUs, there is an uphill battle to convince shareholders and outside advisors. (Of course, plenty of companies still embrace PSUs and believe they are a good fit for their organization.)

Wherever the discussion on performance-based incentive plans goes from here, it is certain to be of particular interest to technology and life sciences companies whose compensation practices are heavily influenced by equity awards and where the typical three-year long-term incentive performance plan cycle is often seen as too long to establish meaningful goals.

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