INCENTIVE PLAN PRACTICES
ALIGNING EXECUTIVE PAY WITH PERFORMANCE

May 2015
Dear Clients, Colleagues & Friends,

We are pleased to present the Incentive Plan Practices report in collaboration with Main Data Group. Paying executives for performance is not a new concept. Companies have been following this mantra for years as evidenced by the surge in usage of performance-vested long-term incentive awards in response to shareholder demands for explicit links between pay and performance. However, companies continue to be subject to increasing pressure from shareholders and other stakeholders with respect to the metrics and level of performance for which top executives are paid. As the scrutiny of executive compensation has grown, so too has the complexity of the incentive programs.

While this type of data is often the subject of analysis for the largest U.S. issuers, we rarely see information gathered and analyzed for mid-size companies (revenues from $1 to $5 billion). With the assistance of Main Data Group’s analytical tools, this project was born out of the desire to evaluate how these companies designed incentive programs to motivate, reward and retain CEOs, while aligning pay with performance as disclosed in 2014 proxy statements. With further support from Main Data Group, we will be following up in the fall with a special report covering incentive plan practices and trends observed during the 2015 proxy season.

We invite you to review the study and share it with your colleagues. Should you have any questions or comments while reviewing this information, we hope you won’t hesitate to continue the dialogue by contacting us.

Regards,

Steven Hall & Partners
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Based on access to data supplied by Main Data Group, Steven Hall & Partners recently completed a study of incentive compensation programs at over 800 companies with revenues between $1 and $5 billion in the United States utilizing data from 2014 proxy statements (covering fiscal year ends from December 31, 2013 through September 30, 2014). Our study found that:

- **Fixed vs. Variable Compensation**
  - CEO compensation is overwhelmingly incentive-based
    - Target compensation is 85% variable and only 15% fixed (i.e. base salary)

- **Short-Term Incentives**
  - Median annual incentive targets for CEOs equaled approximately 100% of base salary
    - Typical leverage provides the ability to earn half of the bonus at threshold performance levels and 200% for maximum achievement
  - 87% of the companies studied used at least one metric related to earnings
    - Median weight of earnings metric equaled 50%
  - Plans most commonly used three performance metrics

- **Long-Term Incentives**
  - Annual grants of long-term incentive awards are almost universal practice
    - 95% of companies granted long-term incentive awards to the CEO
  - 67% of companies granted performance-vested awards
    - Performance-vested awards comprised the largest portion of long-term compensation as measured by dollar value
    - The two most popular performance metrics are earnings and stock price performance, primarily measured using relative total shareholder return (TSR)
  - While the trend towards performance-vested awards continues unabated, use of time-vested awards remains widespread. Over three-quarters of the study companies utilize more than one vehicle in their long-term incentive program.
    - 75% of companies granted time-vested restricted stock
    - 54% of companies granted stock options/SARs
Criteria for Selecting Companies

For this study, we utilized the Main Data Group Snapshot Data™ executive compensation platform to analyze companies that are publicly traded on US-based securities exchanges with revenues between $1 billion and $5 billion. A total of 839 companies met these criteria. The median revenue for the study companies was $2 billion, with a median market capitalization of $3 billion.

GICS Industry Groupings

The breakdown of study companies according to GICS Industry Groups is as follows:

<table>
<thead>
<tr>
<th>GICS Industry Group</th>
<th>Number of Companies</th>
<th>% of Total</th>
<th>Median ($ Millions)</th>
<th>Median Total Shareholder Return</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Revenue</td>
<td>Market Cap</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>155</td>
<td>18%</td>
<td>$2,323</td>
<td>$2,617</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>46</td>
<td>5%</td>
<td>$2,734</td>
<td>$2,360</td>
</tr>
<tr>
<td>Energy</td>
<td>76</td>
<td>9%</td>
<td>$1,991</td>
<td>$2,471</td>
</tr>
<tr>
<td>Financials</td>
<td>119</td>
<td>14%</td>
<td>$2,065</td>
<td>$4,715</td>
</tr>
<tr>
<td>Health Care</td>
<td>60</td>
<td>7%</td>
<td>$2,075</td>
<td>$4,730</td>
</tr>
<tr>
<td>Industrials</td>
<td>163</td>
<td>19%</td>
<td>$2,156</td>
<td>$2,689</td>
</tr>
<tr>
<td>Information Technology</td>
<td>111</td>
<td>13%</td>
<td>$2,132</td>
<td>$4,347</td>
</tr>
<tr>
<td>Materials</td>
<td>64</td>
<td>8%</td>
<td>$1,943</td>
<td>$1,954</td>
</tr>
<tr>
<td>Telecommunication Services</td>
<td>8</td>
<td>1%</td>
<td>$2,785</td>
<td>$2,777</td>
</tr>
<tr>
<td>Utilities</td>
<td>37</td>
<td>4%</td>
<td>$2,371</td>
<td>$3,283</td>
</tr>
<tr>
<td>Total Sample</td>
<td>839</td>
<td></td>
<td>$2,136</td>
<td>$3,149</td>
</tr>
</tbody>
</table>
Fixed vs. Variable

As part of the continuing effort on the part of Boards to align pay with performance, 85% of CEO pay at the study companies consisted of variable incentive compensation. Not surprisingly, given the interest in focusing on long-term growth, tightly aligning executives’ interests with those of shareholders and retaining key executives, long-term incentives make up the vast majority of the variable pay.

For the purposes of this study, fixed compensation consists of salary only and variable compensation includes annual bonus as well as all long-term cash and equity awards.

Target Pay Mix by Compensation Vehicle

The single largest component of target CEO compensation is long-term performance-vested awards (26%), followed by annual incentives, time-vested restricted stock and stock options/SARs which each comprise about 20% of total target compensation. This reflects a strong belief that the interests of executives should be clearly aligned with the long-term interests of shareholders, and is reflective of the increasing push by Boards to deliver more compensation in the form of long-term performance-vested awards.
**Short-Term Incentives**

**Annual Incentive Targets**

Median annual bonus target for CEOs was approximately $922,500, which equaled 101% of base salary among the companies studied. Target bonus opportunities have remained largely constant over the past few years, as the primary focus has been on selecting meaningful performance metrics and assessing the rigor of those goals.

**Target Annual Incentive Dollar Value and as a Percentage of Base Salary**

<table>
<thead>
<tr>
<th>Target Annual Incentive</th>
<th>Annual Incentive Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dollar Value</td>
<td>% of Salary</td>
</tr>
<tr>
<td>Average</td>
<td>$1,090,058</td>
</tr>
<tr>
<td><strong>Median</strong></td>
<td><strong>$922,501</strong></td>
</tr>
<tr>
<td>25th Percentile</td>
<td>$700,000</td>
</tr>
<tr>
<td>75th Percentile</td>
<td>$1,200,000</td>
</tr>
</tbody>
</table>

**Leverage**

Median threshold bonus for CEOs in the group equaled 50% of target payout and maximum equaled 200% of target payout. Here too, we have observed little variation in the basic leverage profile over the past several years, and it was rare to find maximums below 150% or above 250% of target payouts. We find that the Board’s focus has been directed at ensuring that the leverage profile is reasonably set compared to threshold and maximum performance targets, likely in order to discourage excessive risk-taking.

**Annual Incentives Ranges as a Percentage of Target and Base Salary**

<table>
<thead>
<tr>
<th>Annual Incentive Range</th>
<th>Annual Incentive Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>As a % of Target</td>
<td>Threshold</td>
</tr>
<tr>
<td>As a % of Salary</td>
<td>Threshold</td>
</tr>
<tr>
<td>Average</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Median</strong></td>
<td><strong>50%</strong></td>
</tr>
<tr>
<td>25th Percentile</td>
<td>25%</td>
</tr>
<tr>
<td>75th Percentile</td>
<td>50%</td>
</tr>
</tbody>
</table>
CEO Performance Metrics

CEO bonuses are typically based on more than one performance metric, with the most common number of metrics being three. In selecting the desired number of metrics, Boards must balance the desire to align pay with assessments of all relevant performance drivers with the fact that too many metrics can dilute the ability of an annual incentive program to focus executive attention and drive performance on critical performance measures.

# of Performance Metrics in CEO Annual Incentive Plan

- 1: 16%
- 2: 27%
- 3: 29%
- 4: 14%
- 5: 10%
- 6+: 4%
CEO Performance Metrics

Earnings were by far the most popular and highest weighted among all performance metrics observed in CEO annual incentive plans.

Among the companies studied:

- 87% of the companies studied used at least one metric related to earnings
  - Median weight of earnings metric equaled 50%

- Other common financial performance metrics included
  - Revenue – 36% of companies
  - Cash Flow – 24% of companies
  - Financial Returns (including ROE, ROC and ROA) – 21% of companies

- Slightly less than one-third of companies utilized individual performance criteria
  - Median individual performance weighting equaled 20%

- Strategic goals (19%) and safety measures (10%) were prevalent non-financial goals

- Metrics are almost universally expressed on an absolute basis (96%), with only 4% of study companies assessing annual goals on a relative basis

While we have observed an increased interest in expanding Board/Committee discretion in pay decisions, a very small portion of study companies (9%) currently disclose using discretion in setting the CEO’s bonus award. This likely has to do with challenges associated with assuring bonus awards qualify for tax deductibility under Section 162(m), as well as a strong bias against the use of discretion expressed by proxy advisory firms.
**SHORT-TERM INCENTIVES**

**CEO Performance Metrics**

- **CEO Performance Metric Prevalence**
  - Earnings: 87%
  - Revenue: 36%
  - Individual Performance: 32%
  - Cash Flow: 24%
  - Financial Returns: 21%
  - Other Financial Measures: 21%
  - Strategic Goals: 19%
  - Safety: 10%
  - Board Discretion: 9%
  - Expenses: 9%
  - Customer Satisfaction: 6%
  - Stock Performance: 4%
  - Other Non-Financial Measures: 2%

**Median CEO Performance Metric Weightings**

- Earnings: 50%
- Revenue: 28%
- Individual Performance: 20%
- Cash Flow: 25%
- Financial Returns: 31%
- Other Financial Measures: 25%
- Strategic Goals: 20%
- Safety: 17%
- Board Discretion: 20%
- Expenses: 20%
- Customer Satisfaction: 18%
- Stock Performance: 15%
- Other Non-Financial Measures: 25%
The structure of long-term compensation for public companies continues to evolve. In keeping with investor demands, the practice of granting only stock options and time-vested restricted stock awards has given way to granting a majority of equity in the form of performance-vested awards. Two-thirds of the companies studied grant performance-vested awards, which account for 40% of target long-term incentive compensation, on average. While the average value of time-vested restricted stock awards granted at the study companies is lower than the dollar value delivered in the form of performance-vested awards, restricted stock remains the most popular long-term incentive vehicle.

Vehicle Prevalence

Of the 839 companies studied, 95% (801) granted long-term incentive awards to their CEO. Among those granting long-term awards:

- 67% of companies granted performance-vested awards
- 75% of companies granted time-vested restricted stock
- 54% of companies granted option/SAR awards

Prevalence of Long-Term Incentive Vehicles
LONG-TERM INCENTIVES

Vehicle Mix

In our view, getting the mix of vehicles right is paramount. When properly designed, long-term incentive programs can help companies achieve different and complementary objectives. Among the companies studied, performance-vested awards represented the largest portion of long-term compensation, comprising 40% of target long-term incentive values for the CEO. The remainder of long-term compensation was delivered through time-vested restricted stock and stock options, representing 31% and 29% of long-term compensation, respectively.

Number of Vehicles

Over three-quarters of the study companies utilize more than one vehicle in their long-term incentive program. This reflects a balanced approach to accomplish multiple long-term objectives. For companies using two vehicles, the most common approach was to grant performance-vested awards in combination with time-vested restricted stock.
LONG-TERM INCENTIVES

Performance-Vested Awards

Performance-vested awards are the largest single component of target compensation for the majority of CEOs. A significant majority (68%) of study companies base the payout of these awards on performance over a three-year period. While programs often assess performance over a three-year period, one- and two-year performance periods often coupled with additional time-based vesting are a good alternative for companies with difficulty in accurately evaluating performance targets over a three-year period. Performance awards are settled in shares of company stock at an overwhelming majority of companies.

When compared to short-term incentive plans, long-term performance plans tend to have fewer performance metrics.

Among the companies granting performance-vested awards to CEOs:

- 68% use a three-year performance period to calculate the final amount paid out
- 83% payout performance-vested awards in stock
  - 8% in cash
  - 6% in a combination of both cash and stock
- Few companies (3%) grant performance-vested awards in the form of stock options

![Chart showing payout types and performance periods](chart.png)
Performance Metrics – Number and Prevalence

Among the companies analyzed, long-term performance plans typically incorporate one or two performance metrics. This is a notable difference from short-term plans where study companies were more likely to use three or more performance metrics.

The two most popular performance metrics are earnings and total shareholder return (TSR)/stock price performance. Financial returns are a distant third in terms of prevalence.

<table>
<thead>
<tr>
<th>CEO Long-Term Performance Metric Prevalence</th>
<th>49%</th>
<th>48%</th>
<th>28%</th>
<th>17%</th>
<th>16%</th>
<th>6%</th>
<th>4%</th>
<th>4%</th>
<th>1%</th>
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<tbody>
<tr>
<td>Earnings</td>
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<td>TSR/Stock Price</td>
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<td>Financial Returns</td>
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<td>Other Financial Measures</td>
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<td>Cash Flow</td>
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<tr>
<td>Other Non-Financial Measures</td>
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<tr>
<td>Strategic Goals</td>
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<tr>
<td>Customer Satisfaction</td>
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<td>Safety</td>
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Among the companies studied:

- 49% use earnings as a performance metric
  - 67% of these companies disclosed earnings are weighted 50% or greater for CEO long-term performance
- 48% use either TSR or stock price as a performance metric
  - Just over 50% of these companies disclosed they use TSR or stock price as the only performance metric
Performance Metrics – Absolute vs. Relative Goals

We found that the type of metric utilized has a significant impact on whether the goal is expressed on an absolute or relative basis. For financial performance goals such as earnings or financial returns, over 90% of companies measured metrics on an absolute basis. However, relative performance was the predominant measurement (81%) for stock price performance as companies typically evaluate TSR performance compared to a peer group or index.

While relative TSR is a very popular performance metric, there are some significant downsides to its use. Of most concern, the measure may be viewed by management as largely out of their control thereby limiting the motivational aspect of the award. Companies also often have difficulty in determining a comparable set of peer companies to measure itself against and use a broad-based market index as an alternative. In addition, TSR can penalize steady performers in favor of companies that are more volatile, particularly as TSR performance is often calculated on a single stock price measured at the beginning and end of the performance period.

In response to these challenges, we have observed an emerging trend in the design of performance-vested awards where relative TSR is used as a “gate” or “multiplier”, while the underlying award is earned based on an absolute financial performance metric. We believe that this type of hybrid design can provide an effective incentive for achieving both financial and stock price performance goals.
Time-Vested Restricted Stock Awards

Full value time-vested awards granted to CEOs had a median vesting period of three years with the majority of awards vesting in increments, or having "step" vesting. In our view, time-vested restricted stock serves as an important element of a balanced pay program providing a retention component while maintaining alignment with shareholders and focus on stock price performance over the longer term.

- 56% of awards granted with step vesting schedules
- 44% awards granted with cliff vesting schedules

![Vesting Type Diagram]

![Time Until Fully Vested Bar Chart]
**Long-Term Incentives**

**Time-Vested Stock Options/Stock Appreciation Rights (SARs)**

Stock options/SARs granted to CEOs in the study had:

- A median vesting period of three years
- Vast majority of awards granted with step vesting
  - 89% of options were granted with step vesting schedules
  - 11% of options were granted with cliff vesting schedules
- 70% of companies utilized an option term of ten years
  - Next most prevalent option term was 7 years (21%)

Option terms of less than 10 years are often utilized to reduce compensation expense and potential overhang.

- Median grant date fair value (calculated using an option pricing model, like Black-Scholes) disclosed by the companies equaled 33% of stock price on date of grant.
For companies contemplating modifications to their incentive programs, we offer the following thoughts for consideration:

**Follow the business plan** – Well-designed incentive plans should be aligned with your organization’s strategic plan in order to focus and reward executives for accomplishing objectives that will drive long-term shareholder value. The mix of vehicles and performance metrics selected should provide an appropriate and balanced focus on achievement of key strategic objectives and retention of executive talent.

**Periodically reconsider the program** – Incentive programs need not remain static over time. Instead, companies should periodically reevaluate programs to ensure that they continue to support the organization’s strategic objectives. Companies should periodically evaluate their mix to ensure that the program continues to make sense.

**Understand the ramifications of change** – If you are making substantial modifications to your incentive plans, make sure you understand all the legal and accounting ramifications of the changes. Nothing upsets executives, directors and shareholders more than surprises.

**Mitigate excessive risk-taking** – Make sure performance targets are attainable and fair to both executives and shareholders. Establish maximum performance goals and payout levels that will challenge executives, but won’t encourage them to take on excess risk. Performance metrics should also be thoughtfully selected to ensure that they are complementary with other goals used in both the short-term and long-term plans.

**Communication is paramount** – All stakeholders should understand how the plan works and what performance will drive payouts under the plan. Ascertaining the views of significant shareholders on essential program design issues is a key part of ongoing shareholder outreach. Additionally, regular communications to participants about the status of awards can go a long way towards ensuring continued focus on desired objectives and reinforcing the potential value of awards if performance goals are achieved.

**Do the right thing** – If your company faces a unique situation, the incentive plans should be reflective of and responsive to that situation. Don’t automatically shy away from vehicles or metrics that are unpopular with shareholder advisory services or governance experts if they support your specific strategic objectives. Make sure your shareholders understand the choice and why it ultimately aligns executive interests with theirs.
About Steven Hall & Partners

Steven Hall & Partners is an independent compensation consulting firm, specializing exclusively in the areas of executive compensation, board compensation, non-profit compensation and related governance issues. By focusing solely on this critical and complex segment of the human resources arena, we are able to provide our clients with the highest quality expertise and best counsel available on a practical basis. For more information, please visit www.shallpartners.com and follow us on Twitter @SHallPartners.

About Main Data

Main Data Group is a provider of high-resolution executive and board compensation data. We offer a robust cloud-based platform which streamlines peer comparison and executive compensation research for compensation professionals. Our breadth-of-data and ease-of-use go above and beyond. For more information, please visit www.maindatagroup.com. To learn more about Snapshot Data™ or to request a platform introduction, e-mail Main Data Group at information@maindatagroup.com or call us at (408) 776-1000 x114.

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