

Why Relative TSR Trumps Options

Comp committees can craft equity incentives that avoid options' many downsides

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Boards have long been aware of the downside of stock options. They pay out only in a healthy stock market, their value can be affected by broad market movements, and their image has been tarnished by backdating scandals and repricing.

Now, as pay for performance tops shareholders' list of hot topics, options' stature has diminished to the point where ISS no longer considers them to be a form of performance-based compensation.

For these and other reasons, options' role in executive compensation programs has been diminishing. Yet many companies are loath to do away with options altogether, because of their inherent link with shareholder value creation and their unlimited upside potential for executives.

Now there's a way for compensation committees to craft equity incentives that do a better job than options of rewarding management's performance for stockholders, while avoiding the downside of options.

Such plans award shares based on total shareholder return (TSR). The change in stock price during the measurement period, plus dividends, is divided by stock price at the beginning of the period. TSR is the ultimate measure of long-term corporate performance for shareholders.

Companies can identify management's role in delivering this performance by comparing their TSR with

that of companies in a peer group. This allows compensation committees to account for the impact of economic conditions and other outside forces, because such factors tend to affect the entire peer group, helping or hindering each company's performance. Thus, a relative-TSR plan can create a level playing field for performance assessment.

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Of course, not every company has a robust peer group. Good candidates for relative-TSR plans are those with 15 or more competitors, or companies that can properly be benchmarked against a broad grouping like the S&P 500 or the Russell 3000.

Because the shares earned are themselves subject to market forces, such plans align executives' financial interests with those of shareholders while taking into account changes in stock value.

Replacing stock options with a relative-TSR plan can solve various problems that options create. For one thing, these plans satisfy the demands of critics such as ISS, because payouts depend on a pre-set metric.

For another, they can be highly motivating for executives frustrated by the market's potential to submerge options and keep them underwater for years. Free from worry that the stock market will zero out

the spreads of their unexercised options, executives can stay focused on outcomes that are more within their control.

Such plans also can mimic options' inherent leverage by delivering from 0% to 200% of the target number of shares, depending on performance. They can reward executives at high-performance companies just as handsomely as options.

At companies that make regular progress reports, and where executives believe that the peer group is appropriate for their business, such plans can pique executives' interest in what it might take to beat the competition.

Companies can best realize the benefits of these plans by focusing on their percentile rank in TSR (amid the peer group) during overlapping three-year performance periods, and using cliff vesting to encourage retention.

Relative-TSR plans also appeal to human resources departments, because they make it far easier to explain to executives how comp committees arrived at the number of shares actually granted than was the case with options. Another benefit over options: These plans tend to use fewer shares from shareholder-approved pools than options.

Using relative-TSR plans can be an effective way to align executives' long-term interests with those of shareholders while focusing on executives' contributions to corporate performance. They can help companies attract and retain the kind of executive talent that shareholders demand. ■