Post #62: In-Flight Long Term Incentives—What, if Anything, Should Energy Companies be Doing?

From Chris Medland, Partner, Toronto, Ontario

The energy industry has some particular challenges with long-term incentives (LTI):

- **Multi-year equity value decline:** Many energy companies entered 2020 with multiple years of underwater stock options and equity awards tracking well below their original grant date value.
- **New shocks to the system:** COVID-19 has exacerbated the long term supply and demand imbalance and driven energy share prices down even further—For most companies, this happened just after 2020 LTI was awarded, significantly eroding 2020 LTI value.
- **Uncertain future:** Unlike many other industries, the path to share price recovery seems neither clear nor quick.

Against this backdrop, companies will feel significant investor pressure not to take action to restore lost value or offset under-performance against stated objectives. Energy investors have already cautioned against breaking the alignment between executive pay and their own investment returns.

There are two particular areas of focus for outstanding (in flight) long term incentives (LTI):

1. **Lower underlying equity values:** The significant loss in equity value driven by the sharp decline in energy company share prices due to COVID-19.
2. **Unachievable performance goals:** The likely failure to vest performance stock or PSUs because absolute performance targets are not achieved, further reducing LTI values and retention glue. For many energy companies, this comes just as they have put a “toe in the water” with long term absolute measures in addition to relative total shareholder return (r-TSR).

While very real concerns, what to do with in-flight LTI is an issue that, for most companies, will be on the agenda for Q4, rather than now. Even when we get to the late fall, there will be a lot more “don’ts” than “dos” for in-flight LTI.

What not to do

Despite the catastrophic impact of COVID-19, layered on to longer standing equity issues, there are a number of things that we expect companies to avoid, in order to maintain the value alignment mandated by investors:

- ✗ Don’t rush to a new strategy now
- ✗ Don’t reprice stock options
- ✗ Don’t provide compensation for value lost due to share price decline
- ✗ Don’t adjust relative TSR measures
- ✗ Don’t adjust full-year 2020 results for all in flight awards (at least not all this year)
- ✗ Don’t expect a consistent approach between adjustments made to annual and long term plan measures; the investor pressure to maintain alignment with shareholders may drive a different approach to LTI

What we do expect to see at energy companies considering any adjustment to LTI are the following:

- ✓ Exercise restraint—expect significantly more criticism (both from proxy advisors and investors) for adjustments to LTI, than to annual incentives
- ✓ Wait until Q4, 2020 to address absolute performance for 2018—2020 awards (if at all)
- ✓ Wait until 2021 (and later) to adjust later awards—even though the year being adjusted is 2020 for all three in-flight awards
- ✓ Use new, ordinary course LTI as the primary vehicle to address eroded LTI value, but manage dilution and burn rates cautiously

What this really means is that the only area where we are likely to see consideration of explicit adjustment is to absolute financial performance benchmarks, and perhaps only to the remaining portions of the performance period.

Those companies that have an absolute financial measure (currently not more than 25% of companies), have a typical weighting of PSUs (~50-60%) with a relatively low weighting to absolute financial measures (10-25%). This means that any adjustment is at the margin—impacting only 5 to 15% of LTI, so this won't solve the LTI value issue, but may add an important sense of fairness for plan participants.

We expect companies to give this issue more thought as we move towards Q4. Any potential actions would likely focus on limiting the impact of FY2020, so it does not overwhelm the other two years of the performance period. This may include evaluating each years' performance separately and averaging the results (assuming that FY 2020 will be a 0 in this formulation).

While the erosion of LTI value is a significant issue, particularly to management teams, there are no risk-free, short-term solutions to the problem. A wait and see approach—at least until year end—seems the best course of action, particularly given the long-term nature of LTI and its expected focus on alignment with shareholder experience.

Archived copies of previous Energy Insights can be found at www.meridiancp.com/insights/energy.