Post #66: LTI Grants in a Volatile Environment

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The current stock market volatility creates challenges for oil & gas companies as they prepare for their annual long-term incentive (LTI) grants, often awarded in Q1. Large stock price swings can have a significant impact on both total share use and the recipients' perceived value of the awards.

Most public companies use a targeted Grant Value for each participant and divide the targeted Grant Value by a stock price (e.g., grant date price, multi-day average price) to determine how many shares to grant. The targeted Grant Value is often communicated to the participant as part of their total compensation package, in combination with base salary and annual bonus opportunity.

Many oil & gas companies have lost 25% to 50% or more of their market value in 2020. If a company's stock price is down 33% since the last LTI grant, the company would need to grant 50% more shares (or equivalents) today to maintain those prior dollar-based Grant Values.

With significant changes in stock price, should companies reconsider how to approach 2021 LTI grants?

Why do we use LTI Grant Value?

LTI Grant Values were developed as part of compensation surveys and became increasingly widespread following changes to accounting and disclosure rules in the mid-2000s. Originally, surveys needed a way of valuing non-cash awards to create a total compensation picture; enter LTI Grant Values. With stock options, this usually involved the Black-Scholes model, which was often subject to much cynicism about how accurately it valued employee stock options. As full-value awards (e.g., restricted stock and performance shares) became more common, surveys and companies began to use a Grant Value based on the grant date stock price.

The Grant Value (calculated using the grant date stock price) is also used in accounting for the equity awards. For equity-settled awards, the Grant Value is locked in on the grant date, resulting in fixed accounting. In the mid-2000s, disclosure rule changes required the use of the accounting value in proxy disclosures, which increased the visibility of Grant Values across companies. As a result, proxy advisors and shareholders use the Grant Value in their analysis of a company's compensation programs.

Flaws of LTI Grant Value

Because the Grant Value represents the value of the award at a particular snapshot in time, it may not accurately reflect the value of the award relative to either external benchmarks or historical benchmarks. Here is an example, based on recent E&P price performance and some assumptions about a continued improvement in early 2021.

E&P Company A grants stock annually in January, while E&P Company B grants stock annually in March. They both grant $1M to their CEO. Illustrative stock price performance below.

Here are the grants, assuming no change in grant value year to year.

	2020 Grant Value	2020 Price	2020 Shares	2021 Grant Value	2021 Price	2021 Shares
Company A CEO (January Grant)	$1,000,000	$40	25,000	$1,000,000	$21	47,619
Company B CEO (March Grant)	$1,000,000	$16	62,500	$1,000,000	$33	30,303

A few observations:

- Company A nearly doubled the number of shares in January 2021 to maintain the same value, whereas Company B granted half the shares in March 2021 than it did during the worst of the pandemic.
- In April 2021, Company A CEO's 2020 and 2021 grants are worth $1M and $1.9M, respectively. Company B CEO's 2020 and 2021 grants are worth $2.2M and $1.1M, respectively.
- For benchmarking purposes, both companies would have the exact same LTI Grant Value in both years. Does that make sense? Would all four of those grants feel the same to the participant?

Private Equity Model: Fixed Number of Shares or % of Market Cap

We have observed some companies (typically private equity backed) that use a fixed number of shares or a percentage of market cap to determine the LTI grant. Companies often use this approach upon emergence from a bankruptcy, IPO, or other significant event. However, it would not be typical for an ongoing program.

The primary challenge to a fixed number of shares in an ongoing program is that the Grant Value may deviate too significantly from reasonable compensation benchmarks. One example: several years ago Chipotle granted a fixed number of shares every year to their co-CEOs. As their stock price continued to increase, the Grant Values got so large (>$20M to each co-CEO) that they resulted in several years of ISS Against recommendations and low Say on Pay support.

Alternative Considerations

Grant Value benchmarks should continue to play a role in LTI decisions; both market Grant Value benchmarks and the individual's previous Grant Values provide helpful reference points. However, other considerations are also important, particularly with volatile stock prices. These might include:

- What timeframe (e.g., stock price, industry sentiment) do the LTI benchmarks represent? What has happened since that point?

- How have our circumstances changed since the last LTI grant? How many shares did participants receive last year?
- How do projected grants impact our burn rate and share usage? How does that compare to historical practice and external standards? Should we consider a cap on our overall burn rate as a percentage of shares outstanding?

Companies may consider strategies to limit the impact of volatility, such as burn rate caps or using a longer term average stock price to determine the number of shares. However, the most important strategy is judgment. Strict adherence to a fixed dollar value (or a fixed number of shares) doesn't always lead to an appropriate outcome, so judgment should play an important role in determining LTI grant sizes in volatile times.