

Long-Term Incentive (LTI) Compensation: The Basics

Introduction to Long-Term Incentive Plans (LTIPs)

[LTIPs](#) are structured reward systems aimed at motivating and retaining key employees over a time period greater than 12 months by aligning their rewards with the long-term goals of the company. LTIPs can be structured in a variety of ways and may include stock options (non-qualified stock options and incentive stock options), restricted stock, restricted stock units, performance shares, or other performance-based awards.

“LTIPs ensure that key stakeholders’ financial interests are aligned with the company’s success.”

The primary purposes of LTIPs are:

- **Retention of Key Talent:** Offering long-term rewards to retain crucial personnel.
- **Alignment of Interests:** Aligning the financial outcomes of shareholders with the pay outcomes of executives.
- **Performance Enhancement:** Driving better performance by motivating leadership behaviors for successful attainment of strategic and operational goals.

LTIPs can be a strategic tool to encourage a performance-driven culture and ensure talents are motivated to contribute to the company’s long-term success.

Role of LTIPs in Business

LTIPs are fundamental to business operations and long-term growth. They are crafted to align the objectives of the shareholders and the employees. Below we take a deeper look into the significant roles they play in a business:

Retention of High-Quality Talent

In the competitive corporate landscape, retaining top-tier talent is imperative for sustaining business growth and competitiveness. Among public companies, the use of LTIPs for executives is nearly a universal practice. LTIPs keep high-caliber professionals within the organization by providing them with a financial stake in the company’s long-term success which would be forfeited if they voluntarily depart the company. By offering substantial rewards contingent on long-term performance and tenure, LTIPs encourage key personnel to stay and contribute to the organization’s success over extended periods. This retention of expertise and experience is invaluable in maintaining a strong competitive position in the market.

Encourage Employee Loyalty

Employee loyalty is a critical asset for any organization. LTIPs nurture a culture of loyalty by establishing a direct linkage between the employees’ efforts and their long-term financial rewards. When employees see a clear pathway to significant financial gains through the company’s success, their allegiance to the organization is solidified. This loyalty results in reduced turnover rates, better team cohesion and a shared goal of enabling the long-term success of the company. Over time, this

culture of loyalty can significantly contribute to building a positive company reputation and working environment, which, in turn, attracts more high-quality talent.

Foster Long-Term Decision-Making

One of the central tenets of LTIPs is promoting a long-term outlook in decision-making among employees, particularly executives. By tying substantial rewards to long-term performance metrics, LTIPs dissuade short-termism and encourage decisions that favor long-term stability and growth. This long-term focus in decision-making is crucial in navigating the often-turbulent waters of the business world, ensuring that decisions taken today don't compromise the company's future.

Aligning Employees with Company Goals and Objectives

The alignment of employees with the broader company goals and objectives is a hallmark of successful organizations. LTIPs are specifically designed to achieve this alignment by correlating personal rewards with the achievement of strategic company goals and objectives. When individual success is tied to the company's success, a natural alignment of goals and objectives occurs. Employees, especially at the executive level, are motivated to work toward the strategic goals and objectives set by the company, as their personal financial success is directly tied to the achievement of these goals and objectives. This alignment fosters a collaborative environment where both individual and organizational goals and objectives drive the actions and decisions of the workforce.

Types of LTI Vehicles

LTI vehicles come in various forms, each with its own unique features and benefits. Unlike base salary, which provides immediate compensation for services, LTI vehicles are designed to reward employees over a longer term, often contingent on both individual and company performance. Below are some common types of LTI vehicles that are typically granted in addition to base salary and other forms of short-term compensation.

Stock Options

Stock Options provide employees the opportunity to purchase company stock at a fixed price at any time during a future exercise window of time. This stock option has no value if stock price does not increase. However, it becomes more valuable as the company's stock price increases, aligning the interests of employees and shareholders. Stock options provide a future potential for financial gain based on company stock price performance.

There are two primary types of stock options: incentive stock options (ISOs) and non-qualified stock options (NQSOs). ISOs meet the requirements of Section 423 of the Internal Revenue Code and have certain tax advantages for employees, provided certain rules are followed. While the majority of LTIPs provide for the ability to grant ISOs, very few companies actually grant ISOs given some of their disadvantages. As a result, the majority of stock options granted are NQSOs, stock options that do not qualify as ISOs.

Stock Appreciation Rights (SARs)

A SAR entitles an employee to the appreciation in value of a specified number of shares of employer stock over an "exercise price" or "grant price" over a specified period of time. When exercised, the appreciation is typically paid out in the form of shares of company stock. SARs act very much like stock

options except that an employee does not have to pay an exercise in order to exercise the SAR as they would with a stock option.

Restricted Stock

Restricted stock is an award of employer stock that is subject to vesting requirements and transferability restrictions (generally at no cost to the employee). Typically, restricted stock is granted with voting and dividend rights. Since restricted stock is an award of shares of company stock, it provides employees with an ownership stake in the company, better aligning employees with shareholders.

Restricted Stock Units (RSUs)

RSUs are commitments to grant a specific number of shares or the cash equivalent to employees at a future date. The value of RSUs directly correlates with the company's stock price, providing a clear incentive for employees to contribute to the company's success. Unlike base salary, RSUs create a longer-term retention and performance incentive, as they often vest over time and may also be tied to performance milestones.

Performance Shares and Units

Performance Shares and Units (PSUs) are awards contingent on meeting specified performance objectives over a multi-year period. The payout can vary based on the degree of achievement of these objectives. PSUs provide a direct link between the rewards offered to employees and the company's performance over a longer term (typically three years), emphasizing a focus on achieving strategic goals as opposed to the immediate rewards provided by a base salary.

LTIPs offer a structured approach to incentivize and retain key employees by aligning their financial interests with the long-term success of the company, distinguishing them significantly from base salaries and short-term bonuses, which do not typically foster a long-term outlook in employee performance and retention.

Performance Metrics for PSUs

The performance metrics chosen for these plans are vital as they drive the behavior of executives toward achieving the long-term goals of the organization. The following are some of the common performance metrics used in PSUs.

Total Shareholder Return (TSR)

[TSR](#) is a comprehensive metric that reflects the total returns provided to shareholders through capital appreciation and dividends over a specific period. It's often used as a performance metric in LTI plans to ensure that executives are working in the best interest of the shareholders. By focusing on TSR, executives are incentivized to enhance shareholder value by increasing the share price and ensuring regular dividend payouts.

In our most recent corporate governance and incentive design survey, Relative Total Shareholder Return (rTSR) continues to be the most prevalent (76%) metric in performance based LTI plans, with over 40% using it as a payout modifier versus a weighted component (61% prevalence). Read the full survey [here](#).

Following are statistics for the Meridian 200. All figures shown are as of the end of fiscal year 2021.

| | Revenues (\$M) | Market Value (\$M) | Employees | ROIC (3-Year) | Annualized TSR (3-Year) |
|-----------------------------|----------------|--------------------|-----------|---------------|-------------------------|
| 25 th Percentile | \$10,785 | \$17,959 | 16,375 | 5.2% | 7.0% |
| Median | \$18,367 | \$38,413 | 42,775 | 8.9% | 15.4% |
| 75 th Percentile | \$47,623 | \$102,694 | 92,438 | 14.0% | 25.2% |

Return Measures

Various return measures like Return on Equity (ROE), Return on Investment (ROI) and Return on Capital Employed (ROCE) are often used in LTI plans to assess the efficiency and profitability of the organization. These metrics help in evaluating how well the company is utilizing its resources to generate profits. By incorporating return measures in LTI plans, companies can encourage executives to optimize resource utilization and improve operational efficiency.

Earnings per Share (EPS)

[EPS](#) is a crucial metric that indicates the portion of a company’s profit allocated to each outstanding share of common stock. It’s a widely recognized measure of profitability and is often linked to executive compensation in LTI plans. By focusing on improving EPS, executives are encouraged to work toward enhancing the company’s profitability, which, in turn, could lead to higher shareholder value.

Establishing a Long-Term Incentive PPlan (LTIP)

Creating an LTIP requires a structured approach, beginning with a clear understanding of the company’s long-term goals and objectives and how the LTIP can support these goals and objectives. The process involves multiple steps, from goal setting to legal consultations, ensuring the LTIP aligns with both company objectives and regulatory requirements.

Identifying Company Goals

The first step in establishing an LTI program is identifying the long-term goals the company aims to achieve. These goals should reflect the company’s strategic goals and objectives, such as expanding market share, improving financial performance, or advancing innovative projects. The identified goals will serve as the foundation upon which the LTIP is built, ensuring that the plan will drive the behaviors and performance necessary to achieve these goals and objectives.

Setting Measurable Outcomes

Once the long-term goals are identified, it’s crucial to set measurable outcomes that can accurately reflect progress toward achieving these goals. Establishing clear, quantifiable metrics and corresponding goals provide a basis for evaluating performance and determining the extent to which the incentives are earned. These performance metrics in an LTIP typically focus on quantifiable financial measures such as revenue growth, profitability or stock price-based measures.



Technical Considerations

Technical considerations, such as legal, accounting and tax considerations, are vital when establishing an LTIP. It's essential to ensure that the plan complies with applicable laws, regulations and accounting standards. This includes securing necessary approvals from the board of directors and, in most cases dealing with grants of equity awards, i.e., LTI vehicles, the shareholders. Companies also need to consider tax implications for both the organization and the plan participants. Consulting with legal, accounting, securities, tax, and financial advisors is crucial in navigating the complex regulatory landscape surrounding LTIPs, ensuring compliance and minimizing risks.

The process of establishing an LTIP is a thorough one that necessitates a clear understanding of the company's long-term goals, setting measurable objectives and ensuring legal compliance. When done correctly, an LTIP can significantly contribute to aligning employee performance with the company's strategic objectives, driving long-term success and creating lasting shareholder value.

Managing and Tracking LTIPs

Effective management and continuous tracking of Long-Term Incentive Plans (LTIPs) are crucial to ensure they remain aligned with the company's goals and continue to drive desired behaviors and outcomes. Through systematic evaluation and leveraging technological solutions, companies can keep their LTIPs on track and maximize their benefits.

Performance Evaluation and Adjustments

Evaluating the performance of LTIPs involves assessing whether the established metrics are being met and whether the incentives are driving the intended outcomes. This evaluation should be a regular activity, preferably conducted annually or bi-annually, to allow for timely adjustments if needed. Metrics may need to be recalibrated, and incentive structures may need tweaking to remain aligned with evolving company objectives or market conditions. This iterative process ensures that the LTIP continues to serve its intended purpose over time.

Using Software for LTIP Management

With the increasing complexity of LTIPs, many companies are turning to specialized software solutions for managing and tracking these plans. Such software can automate much of the administrative workload, ensure accurate record-keeping and provide insightful analytics. They can track performance metrics in real time, calculate incentive payouts and generate reports that help in evaluating the effectiveness of the LTIP. Moreover, they can provide a transparent platform for communicating the plan's structure, progress and outcomes to participants, fostering a clearer understanding and engagement with the LTIP.

By combining regular performance evaluations with strong software solutions, companies can effectively manage and track their LTIPs. This will make sure they continue to align with organizational goals and deliver the intended benefits to both the company and the participating employees.

The Future of LTIPs

As dynamic entities, LTIPs are subject to evolution based on various external and internal factors. A glimpse into the foreseeable future reveals a few trends and influencing factors that could shape the landscape of LTIPs.

Impact of Economic Trends

Economic trends significantly impact the design and effectiveness of LTIPs. For instance, fluctuating market conditions, such as the rise and fall of stock prices, affect the real and perceived value of stock-based incentives. Inflation, interest, and tax rates also play a part in determining the attractiveness of deferred compensation plans. Moreover, global economic shifts and regulatory changes can lead to a reevaluation of LTIP structures to ensure compliance and alignment with new market realities.

Influences of Employee Expectations

The expectations and preferences of employees, especially the newer generations in the workforce, are gradually reshaping LTIPs. Employees are increasingly looking for more immediate rewards and clearer paths to ownership or profit-sharing. There's a growing interest in seeing a direct correlation between individual efforts, company performance, and personal rewards.

Moreover, the transparency in how LTIPs are structured and how rewards are calculated is becoming a crucial factor for employee satisfaction and trust. As a result, companies might take advantage of technology to create more transparent and interactive platforms that allow employees to track and project their LTIP earnings.

The adaptability of LTIPs to these and other future trends will be crucial for maintaining their efficacy as tools for aligning employee and company objectives, attracting top talent, and promoting a culture of long-term strategic thinking and ownership.

Final Thoughts

LTIPs stand as a pivotal component in the strategic toolkit of modern businesses, offering a structured pathway to align the ambitions of a company with the financial and professional aspirations of its executives and key personnel.

The landscape of LTIPs is set to be influenced by broader economic trends and the shifting expectations of a new generation of employees and investors. The utilization of technology for better transparency and management, and the adaptability to economic fluctuations are among the factors that will define the future relevance and effectiveness of LTIPs.

As companies merge into a future marked by rapid technological advancements and changing workforce dynamics, the thoughtful design, diligent management and adaptive evolution of LTIPs will remain central to cultivating a motivated, loyal and high-performing team geared toward long-term success.

Meridian Can Help

Meridian Compensation Partners can help you determine the best LTIP and LTI vehicles to adopt as you re-evaluate your LTI program to ensure it helps support your organization's strategic and operational goals and objectives. Each organization should consider its LTI alternatives and performance metrics specifically to support its goals and objectives, and Meridian can help determine which LTI vehicles, performance metrics, and designs make the most sense for your organization.