

Managing Executive Incentive Programs for Chemical Companies

Designing and managing effective compensation programs is challenging for chemical industry companies due to the highly cyclical and global nature of the business. This article offers some useful context and information for compensation committees and management teams of chemical companies to consider when designing and managing their executive pay programs. In particular, we cover key attributes of the industry and their impact on setting goals and designing incentives to help manage the impact of volatility resulting from:

- Commodity prices on feedstock supplies and product sales
- Macroeconomic trends on demand (domestic and global)
- Variability in currency exchange rates

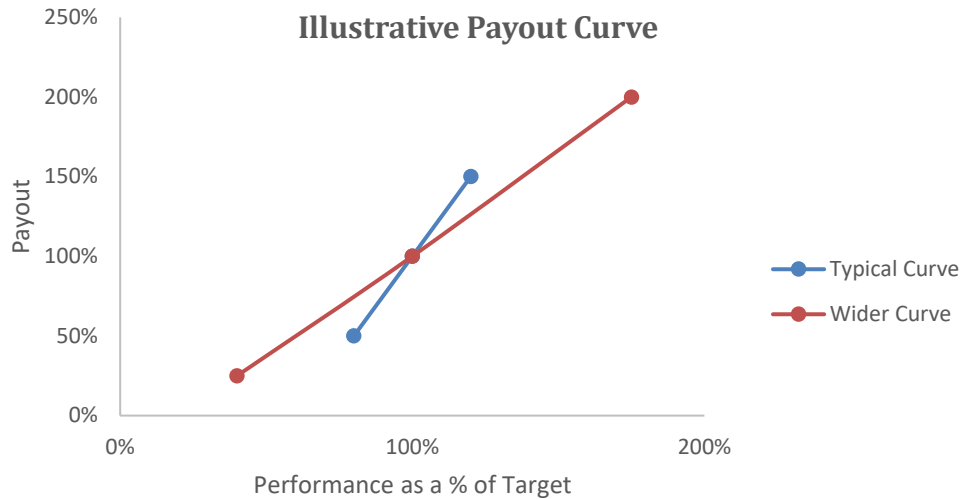
These factors drive volatility in business results over time. The chart below illustrates a performance distribution based on 10 years of 1-year EBITDA growth rates for 50 of the largest chemical companies in the United States. The top and bottom deciles highlight the industry's volatility.

One-Year EBITDA Growth Rates

Percentile	Chemical Industry	General Industry
90 th	65.8%	42.7%
75 th	20.0%	18.6%
50 th	5.1%	7.4%
25 th	-7.7%	-1.3%
10 th	-26.1%	-14.8%

This volatility places pressure on incentive plans to ensure management teams and employees are appropriately incentivized in a way that aligns pay outcomes with sustained performance. We have found the following approaches useful in our work with clients in the chemical industry:

- **Wider incentive performance and payout ranges:** we have worked with organizations to use wider payout ranges to allow participants to “get in the game” sooner, at lower (but defensible) levels of performance with a lower level of payout, but also providing for additional stretch in achieving and rewarding upside performance.



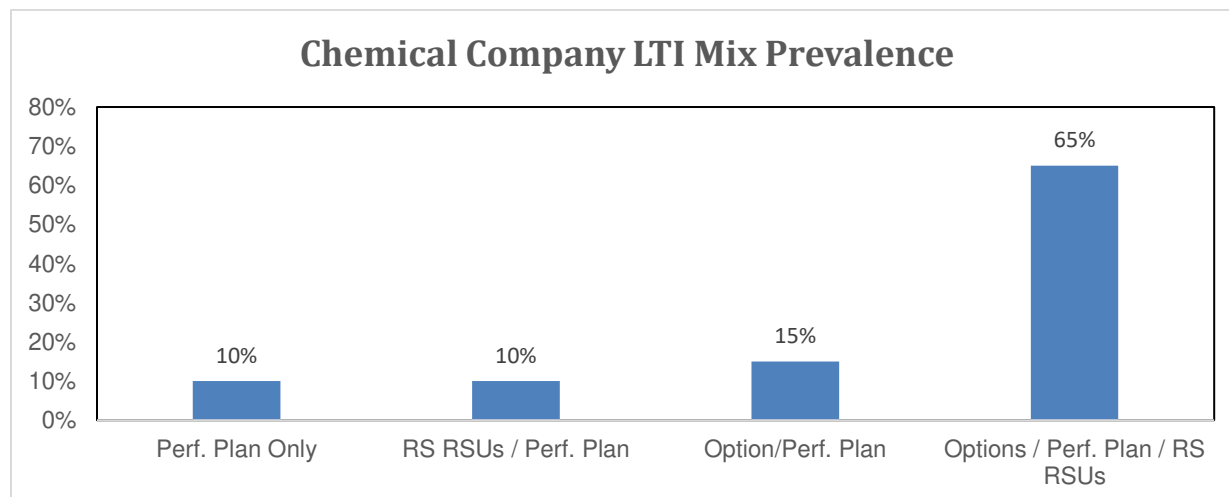
Most companies review peer practices and their own historical performance and establish leverage curves for each financial metric based on “market norms.” For example, companies often build earnings-based goals with threshold at 80% of target and maximum at 120% of target, while revenue goals often reflect a somewhat tighter 90%-110% range. The threshold often will correspond to a 50% payout while the maximum will correspond to 150% or 200%. However, we believe historical variability is an important consideration when setting performance curves, as greater variability often implies a need for a wider curve. If an 80/120 approach were used by chemical companies, given the volatility shown on the prior page, there would be too many years where results would be below threshold and above max.

Adjustments to the curve should generally be philosophically symmetrical to ensure fair outcomes – i.e., balance a lower threshold goal with a more challenging maximum goal. Note, however, that this may not always translate to numerically symmetrical curves. When “widening the curve,” we find that many companies consider lower thresholds for performance, while also reducing the payout threshold from 50% down to 25%-35%, or in some cases all the way to 0%. Similarly, for maximum, payouts can often range up to 250+% of target.

- Managing input cost uncertainty:** In some instances, companies may use one of the following approaches to manage variability in input costs. Although “no adjustment” is likely the simplest and cleanest approach, it can result in outcomes over time that do not align with true operational performance. We increasingly have discussions with compensation committees regarding methods to reflect uncertain business circumstances and volatility, as highlighted below.

Approach	Description	Considerations
Directly Price-Adjust Goals	<ul style="list-style-type: none"> Fixing costs to remain constant throughout the year, even as they fluctuate 	<ul style="list-style-type: none"> Protects employees from rising costs, but can be demotivating if cost declines Critical to apply symmetrically and consistently Can result in payouts that are not aligned from actual profitability Does not hold management accountable for managing expense
Goal Corridors	<ul style="list-style-type: none"> Allowing profitability to be impacted by variability in input cost only up to a certain degree (i.e. if cost is between X-Y, it flows directly through, but we cap at X and Y) 	<ul style="list-style-type: none"> Requires analysis around expected range of input costs and sensitivity at certain levels Complex design Sends message that employees are expected to manage input cost variability, but only to a certain degree
No Adjustment	<ul style="list-style-type: none"> Plan operates as is with no consideration for swings in input costs (“chips fall”) 	<ul style="list-style-type: none"> Simple and easy to understand Will likely result in significant volatility in payouts Places pressure on widening the goal-setting curve

- Portfolio LTI Strategy:** Another important mechanism to diversify incentives for cyclical companies is to use multiple LTI vehicles, often with multiple performance plan metrics. In a recent study of LTI awards at a sampling of publicly traded chemicals companies with revenues greater than \$1B, we found that 65% use all three LTI vehicles (stock options, performance-based awards and RS/RSUs). This is a greater proportion as compared to general industry, where only about 30%-40% of companies use all three vehicles.

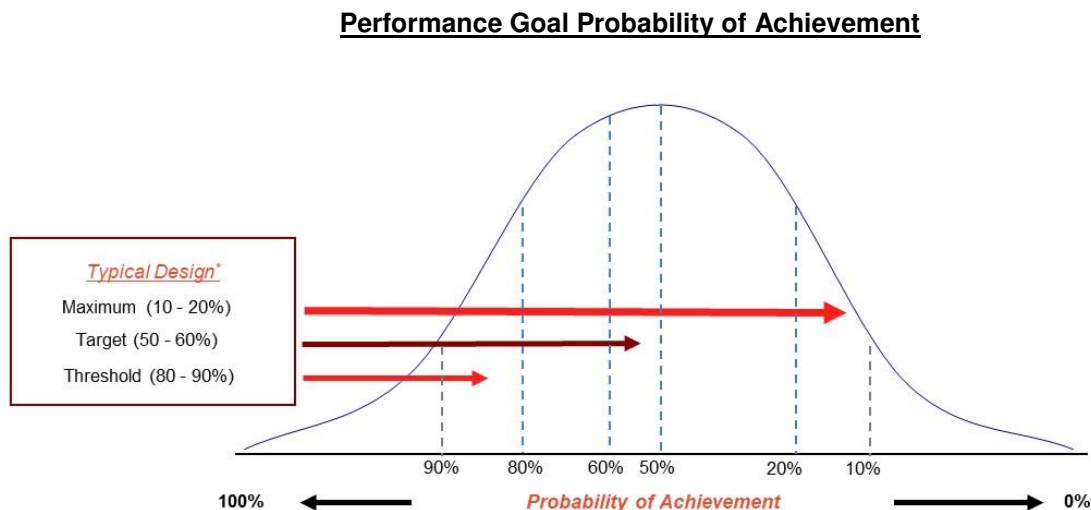


Using multiple LTI vehicles in combination allows the program to address multiple objectives:

- Stock options: direct shareholder alignment, long-term instrument across industry cycles
- RS/RSUs: stability and retention
- Performance Awards: long-term performance, line of sight and meets shareholder/advisor expectations

Although granting multiple LTI vehicles increases program complexity, chemical companies are increasingly awarding all three vehicles to help manage variability in results and explicitly address the distinct objectives of each vehicle while managing the uncertainty in the business.

- **Use of Discretion in Annual Incentive Plans:** A compensation committee's judgment during down cycles is critical to ensure appropriate outcomes for annual incentive plans. In situations where performance outcomes were far above or below expectations, committees may take into consideration the context and background associated with the outcome. They may also take into account historical pay outcomes and whether incentive plans have paid according to a normal expected distribution of outcomes. Typically, we expect a distribution that pays at least threshold 80%-90% of the time, targets 50%-60% of the time, and maximum 10%-20% of the time, as illustrated below.



The exercise of discretion to avoid unintended compensation results, can be a powerful tool for a compensation committee. This is particularly the case in the post-162(m) era where committees have more flexibility to align executive pay and company performance. We support the application of informed judgments and discretion in evaluating performance and determining annual bonus award payouts in unforeseen/limited circumstances. That said, it is important to follow a disciplined and structured process that lead to the ultimate pay decision, and include transparent disclosures of the rationale for the adjustments. The application of discretion to adjust annual incentive payouts should be viewed as a “last resort” to align pay outcomes with performance, and should be used judiciously. Discretion is generally not applied to long-term performance plans because of technical complexities associated with doing so and the long-term nature of awards.

Ultimately, each company should prioritize its business circumstances in considering ways to manage cyclicity and volatility. Institutional investors and proxy advisors have perspectives on how to best manage or adjust pay programs, but we advise clients that their internal business strategy, performance and context should be the primary drivers. It is important to consider the perspectives of external parties in making decisions so that compensation committees are not blindsided by a negative reaction or call out, or in extreme cases, a negative Say on Pay vote recommendation/outcome. Our role is to assist clients with navigating the complex environment and balancing the inputs of multiple stakeholders to make the best long-term decisions for the company.