ISSUE 2013-9
NOVEMBER 26, 2013

Meridian Client Update

Stress-Testing: So Many Questions to Answer

More than just a popular governance buzz word, "stress-testing" incentive compensation designs provides valuable information for compensation committees and management alike. Stress testing incentive compensation helps organizations understand the relationship between the compensable performance range and business results and identify problems in the incentive plan design—an imbalance in the value sharing, windfalls or inappropriately harsh cliffs/payouts for the level of business performance achieved.

Art *and* Science

While stress testing involves calculation and financial analysis, it is the assessment of the results that brings insight to the process. Stress testing helps compensation committees to answer critical questions:

- Are the outcomes along the entire performance curve reasonable? Is it too generous or expensive?
- What do the results tell us about the plan design and performance scale? Will the plan encourage the right behavior?
- Is the upside significant enough to retain and motivate talented executives?
- Are results aligned with our strategy?
- What will shareholders think when they read our proxy and learn about the pay associated with these results? Will we be comfortable responding to a question at the board meeting or AGM?

The real purpose of stress testing is to use numeric analysis and sound design principles to help the compensation committee apply its professional business judgment.

How to Stress-Test Your Incentive Plans:

Short-Term Incentives:

Annual plans are the easiest to test as they have a short time frame for assumptions about individual and corporate performance. Depending on the number of performance metrics, this can be a fairly straight forward and mathematical exercise. It is usually easiest to start with target performance and determine the costs and benefits. This answers the question how much performance does the company require for a given compensation cost? The compensation committee can then consider if the cost is reasonable relative to earnings, returns, improvements (e.g., margin) or other key metrics.

Once costs and benefits at target performance are clearly understood, stress testing should move to the "what if" part of the analysis. In testing the upside, you want to understand the value of the incremental award, relative to the performance required to earn that award (incremental cost/benefit). Is the sharing of the value created appropriately matched to the effort and risk? Correspondingly, in testing the downside, the key question is whether the "penalty" associated with underperformance is reasonable relative to the lower performance result? The answers will change with the nature of the performance metrics utilized, level of stretch in the targets and the reward scale (or payout curve). In stress testing, costs may be shown as a percentage of earnings, to focus on the sharing of value. You may recall from our previous client update that annual incentives are often expected to payout within +/- 50% of target four out of five years or about 80% of the time.

Long-Term Incentives:

Testing the long-term incentive plan is more complex. Today, most companies use equity-based awards that vest over three or four years. In order to stress test these plans (costs and outcomes), you have to build a model with reasonable expectations for share price change. Determining what assumptions are reasonable is a key part of the exercise.

While the process for testing a long-term plan is similar to the process used for a short-term plan, the following additional questions should be considered.

- What is the relationship between award value and value created (i.e., increased market capitalization)? This illustrates the level of sharing between plan participants and shareholders.
- What is the balance between vested and unvested value? This shows retention value at a point in time.
- What if share price growth is higher or lower than expectations? How does the payment of dividends affect the analysis? What is the potential for a significant or sudden drop or spike in share price and what impact would that have?

Companies with performance share units also have to model reasonable performance assumptions including, for relative performance plans, assumptions about the performance of peer companies.

Do We Have The Right Metrics and Targets?

When developing incentive compensation plans, organizations put a great deal of thought and effort into the selection of the "best" performance metrics. As there is rarely one perfect metric that captures the full breadth of company performance, most business plans and strategies include a mix of targeted, immediate initiatives and results that are measurable to varying degrees.

Stress testing can create good discussion about the validity of selected metrics, or reinforce their appropriateness. Even when the metrics are fine, the results can still be troubling. This may be an indicator that the targets (or threshold or maximum levels) may not be properly aligned. Stress testing allows the organization to see if changing the performance levels, or broadening or narrowing the brackets between threshold and target, and target and maximum appropriately changes the outcome to produce a better overall result.

Practical Application

While stress testing improves plan design, reduces surprises and allows the compensation committee to understand the stress points in performance and payouts; it does not guarantee a perfect result. Plan design cannot respond to every nuance in a changing business environment; compensation committee discretion and judgment remains important. However, the demonstrated benefits of stress testing are recognized by governance advocates who expect stress testing of incentive compensation plans to be a routine part of good compensation governance practice.

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