Creating Clarity in Incentive Strategy in an Uncertain Business Environment

A *Compensation Committee Series* Webinar

Presented by NACD and Pearl Meyer

August 18, 2022

Meet the Presenters

Gaurdie Banister
Board Member

- Former President & CEO, Aera Energy LLC (Shell and ExxonMobil JV)
- Current Corporate Board Memberships: Enbridge, Dow, Russell Reynolds Associates
- Past Corporate Board Memberships: Tyson Foods, Bristow Group, Marathon Oil

Joe McNeal
Managing Director
Pearl Meyer

- Executive compensation advisor to publicly-traded and private companies
- Depth of experience in Life Sciences & High Technology
- >15 years, early-stage start-ups, IPOs, SPACs, Fortune 500

Brett Herand
Principal
Pearl Meyer

- Executive compensation advisor to mid-market publicly-traded and private companies
- Depth of experience in old-line industries (manufacturing, insurance, distribution)
- >15 years, financial sponsors and their portfolio companies

Housekeeping

- Submit a question and receive your answer directly from the presenters, either during today's webinar or as a follow-up. You will also be opted-in to receive future executive compensation thought leadership from Pearl Meyer.
- Presentation slides are available today at www.pearlmeyer.com/creating-clarity and within the webinar console.
- The replay will be available early next week at www.nacdonline.org/webinars and www.pearlmeyer.com/creating-clarity.

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Agenda

- A summary of best practices related to short- and long-term incentive plan design in a volatile environment
- Important considerations related to stockholder engagement, public disclosure, and governance best practices
- Trends beginning to emerge ahead of the 2023 pay cycle

Where Have We Been…

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Longest bull market on record

Dodd Frank Act in response to Wall Street "greed"

Increased influence of proxy advisors and increased executive pay scrutiny

The rise of rTSR plans and other tools to enforce pay and performance alignment

Increased homogeneity in executive pay plans

COVID

Broad use of discretion and exceptions → begrudging acceptance by proxy advisors in 2021 → Elevated say-on-pay failure rates in 2022 → Where do we go from here?

Where Are We Now?

The economy is...

Robust	Headed for a Recession
✓ High job growth and job openings	× Fed's interest rate policy
✓ Corporate balance sheets are strong	× Consumer borrowing up
✓ Profit margins are high	× Consumer confidence down
✓ Inflation can only go down	× Elevated inflation persists
✓ Over-exuberance limited to tech sector primarily	× Bear-market stock prices
	× Geopolitical headwinds

Poll Question #1

Q: An unwinding of COVID-induced trends or a recession? How confident are you in the economy over the next 6-18 months?

1. Very confident
2. Somewhat confident
3. Neither confident nor pessimistic
4. Pessimistic
5. Very pessimistic

Creating Certainty when Uncertainty Reigns…

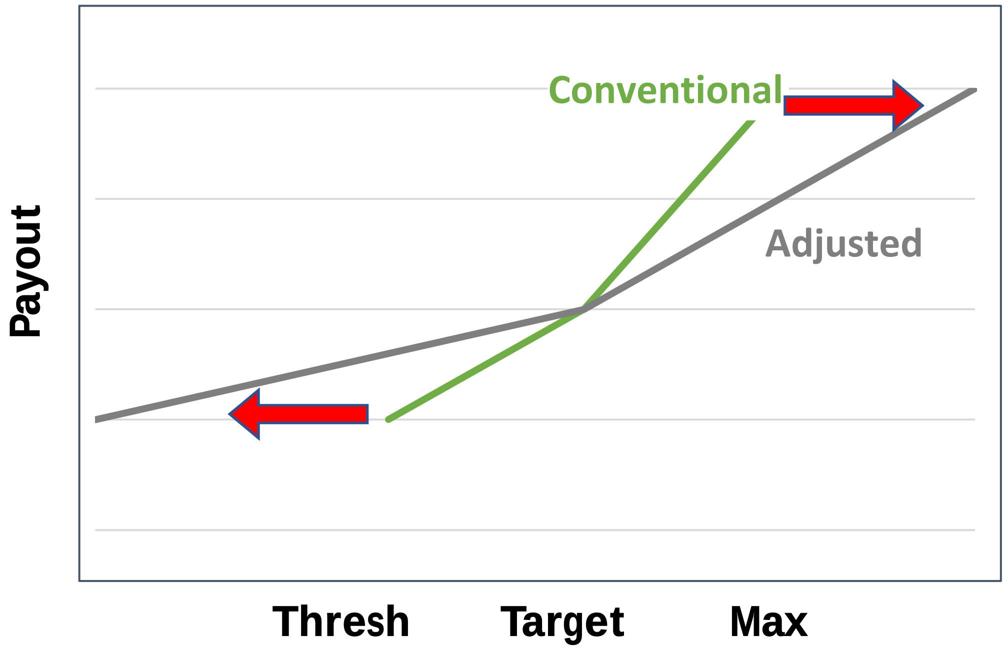
- As we look to 2023, companies are assessing strategies to manage and mitigate economic uncertainty in the context of pre-pandemic strategies and standards
- At the same time, companies must ensure that pay programs are aligned with evolving business strategies and meet evolving governance standards

Let’s look at strategies that companies can consider to balance these objectives and briefly review a few case studies

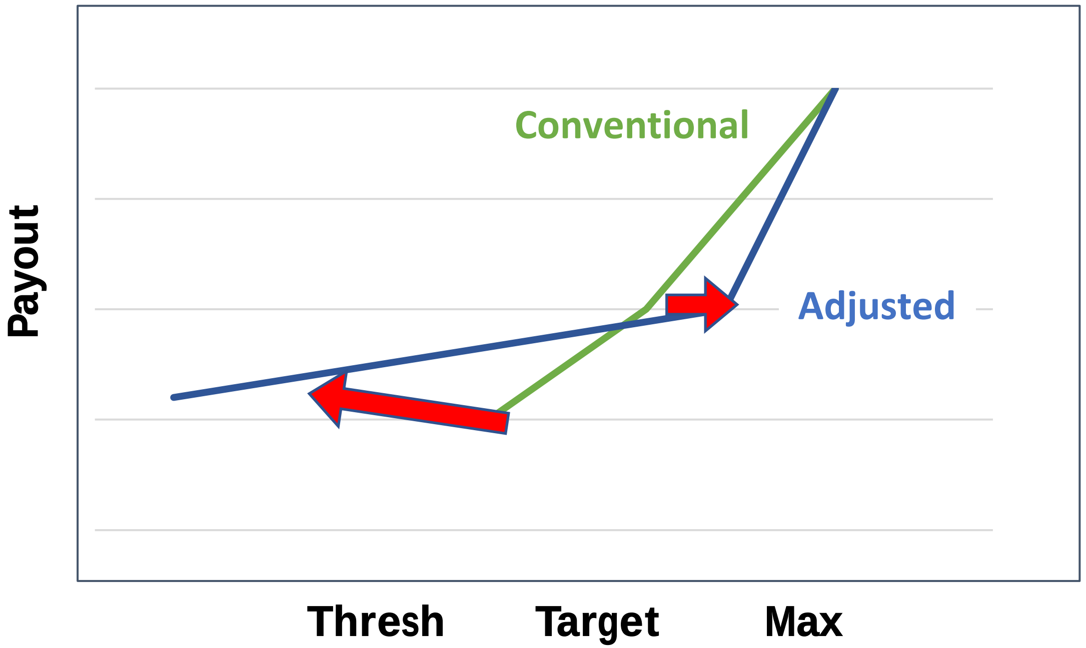
Simple, But Flexible and Effective

- Adjust payout lines to align with business risk and goal-setting philosophies & culture

Increased Downside Protection and Increased Upside Risk



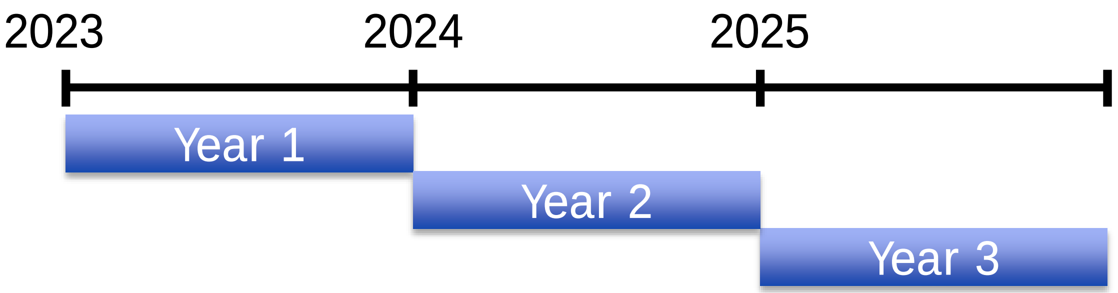
Increased Downside Protection and Stretch Targets



Build-as-You-Go LTI Strategy

- Setting 3-year performance goals for LTIPs can be challenging. Setting 3-year performance goals in times of increased uncertainty is even more difficult

- Instead of setting 3-year performance goals, consider a “Build-as-You-Go” strategy:
  - A series of 3 one-year goals
  - Goals established at the beginning of each year
  - 1/3 of the target award can be earned each year
  - Shares banked and fully-settled at end of 3rd year



- Potential challenges: Not a true three-year plan, disclosure challenges within compensation tables

Case Study: Build-as-You-Go LTI Strategy

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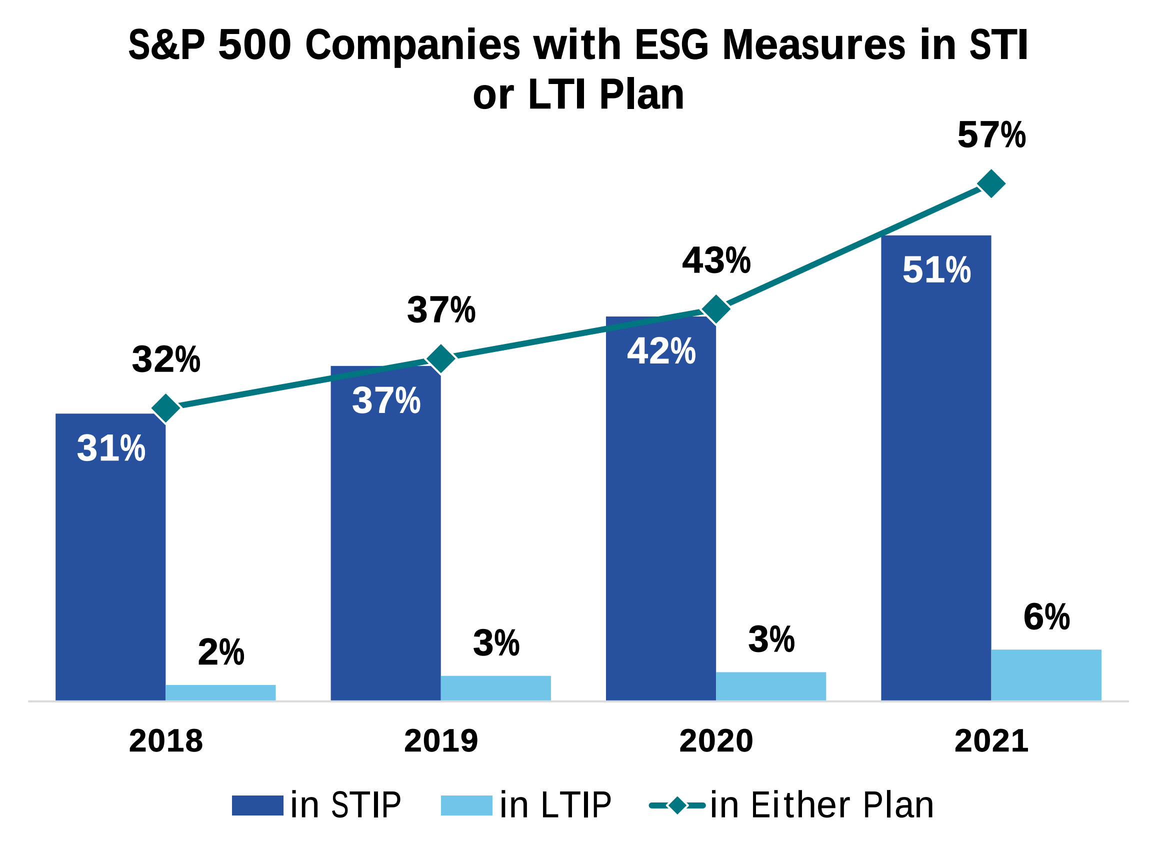
Situation

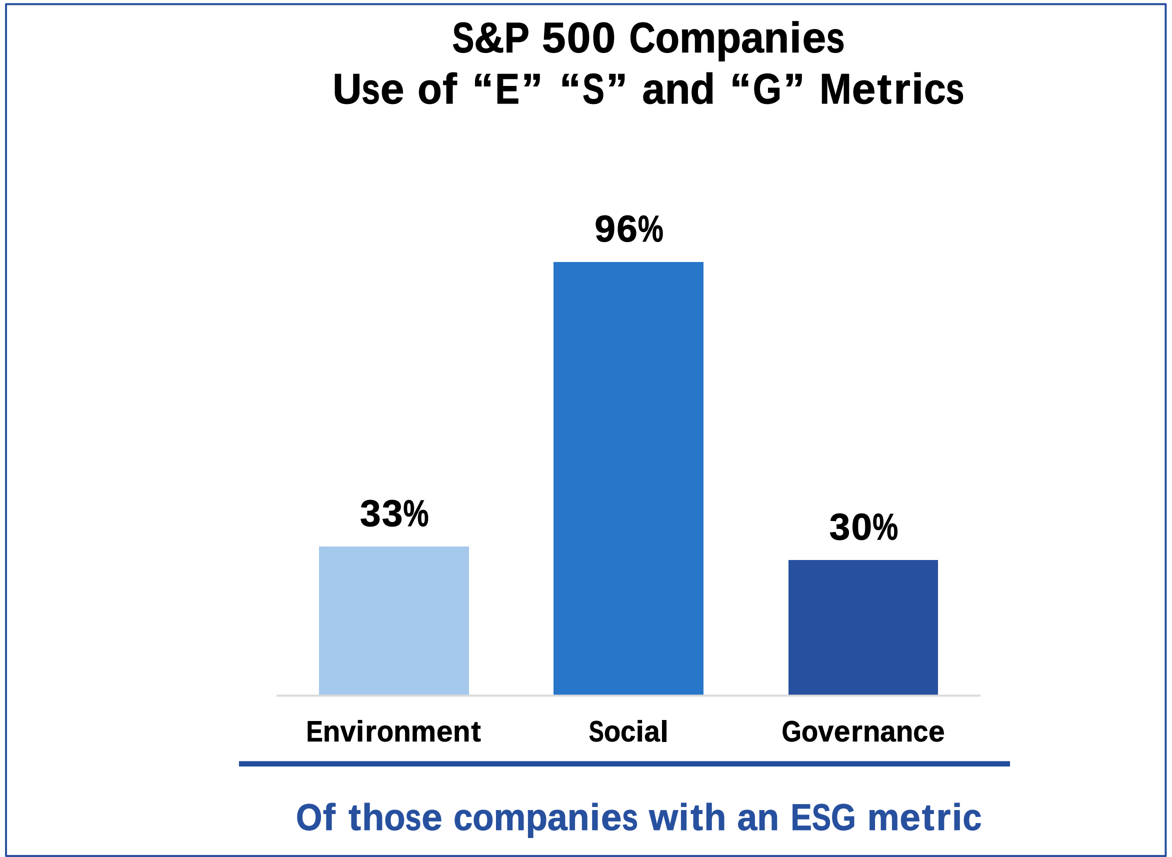
- Publicly-traded distributer with new, but experienced, management team
- Drop in stock price driven by reductions in profitability due to strategy mis-steps by prior management team
- LTI for Sr Management: Options, RSUs, 3-yr rTSR (lukewarm support by both new management and the committee for the 3-yr rTSR construct)
- 2-Year Stopgap: 3-yr rTSR plan replaced with 1-yr PSU plan with payout deferral (and STI metric overlap) to allow for thoughtful re-design of LTI strategy
- Passed say-on-pay despite "NO" vote recommendation (2 consecutive years)

Solution

- Option (25%), RSUs (25%) and PSUs (50%)
- Build-as-You-Go PSU plan tied to 1-year EPS goals (STI includes operating income and FCF)
- 3-year rTSR modifier (+/-20%) on aggregate number of shares earned
- Thoughtful disclosure strategy and shareholder engagement
- Proxy advisor support and strong say-on-pay vote
- Returned to a 3-year PSU plan (EPS) and retained rTSR modifier

The Expanding Performance Scorecard





Source: Main Data Group

Poll Question #2

Q: Where are you on the journey related to ESG links to incentive compensation at your company (if across companies, the company where you spend the most time)?

1. We have not discussed
2. We have discussed but have no plans to attach incentive pay to ESG
3. We have discussed and expect to attach incentive pay to ESG in the next few years
4. We already tie a portion of incentive to measures of ESG

Equity Mix Adjustments

- Replacing performance-based LTI with time-based LTI during periods of uncertainty

Company	Action	Say on Pay Result
Booking Holdings Inc.	▪ FY20: 100% RSUs from 100% PSUs ▪ FY21: 75% PSUs and 25% RSUs	Failed SOP for FY21
Fox Corporation	▪ FY21: RSUs to 50% of LTI from 25%	Passed SOP for FY21
Simon Property Group, Inc.	▪ FY20: 100% RSUs from 100% PSUs ▪ FY21: 15% RSUs and 85% PSUs	Passed SOP for FY20
Ulta Beauty, Inc.	▪ FY20: 50%/50% RSUs and options from balanced PSU/RSU/Option mix ▪ FY21: Pre-COVID balance mix	Passed SOP for FY20

Trying to Make it Acceptable to Investors

- ✓ Include some performance-based LTI
- ✓ Include commitment to re-introduce/increase performance-based equity in proxy disclosure
- ✓ Extended vesting/ownership requirements
- ✓ Retain majority performance-based LTI mix for CEO
- ✓ Soft goals

How New Disclosure Impacts Plan Design

- Final rules expected in October 2022 and may be required for 2023 proxy filing
  - Net income and TSR featured prominently; "company selected measure" likely to trigger much more debate and discussion
- Emphasis on actual pay vs. company performance – new mechanism for companies to reinforce how incentive programs track with shareholder value creation
  - May trigger pendulum shift towards heavier emphasis on TSR and TSR modifiers

Year	Summary Compensation Table Total for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for non-PEO NEOs	Average Compensation Actually Paid to non-PEO NEOs	Total Shareholder Return	Peer Group Total Shareholder Return*	Pre-Tax Net Income (Loss)	Net Income (Loss)	[Company-Selected Measure]*
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
Y1									
Y2									
Y3									
Y4*									
Y5*									

Shifts in Shareholder Engagement Standards May Impact Plan Design

Shifting Paradigm	Prominent Examples	Impact for Boards and Executive Teams
Proxy advisors (ISS in particular) elevating the threshold for companies to satisfy "board responsiveness" in the face of low or failing votes in prior year	• "Against" votes despite robust outreach – Xerox, Halliburton, Hologic • Shift in ISS viewpoint to move beyond sustained, meaningful outreach • Increasingly looking for actual changes to go-forward incentive plan design based on stockholder feedback	• Understanding shareholder pain points: Plan design, pay quantum, or both? • Do stakeholders have adequate visibility into company strategy to accurately opine on company incentives? • Carefully craft disclosure of shareholder outreach activities to narrow the exposure • Is there a need to more carefully "drive" the areas of feedback from stockholders during outreach sessions?

Return of Rigor and Discipline in Goal-Setting and Measurement

Flexibility in accommodating pandemic-induced uncertainty appears to be waning

- Stockholders preferring a return of rigorous performance goals and measurement processes despite volatility (inflationary pressure, geopolitical instability, supply chain pressures)
- Modifications were common FY20/FY21
- FY22 say-on-pay voting trends suggest stockholders are increasingly “over it”

Heavier reliance on relative performance goals

- Takes the angst out of the goal-setting process
- Requires a targeted index or comparator group which may be difficult to identify
- Utilizing TSR modifier which may offer more favorable accounting treatment

Incorporating ESG-related metrics into incentive plans

- Notable increase in prevalence of HR metrics (safety, diversity and inclusion, employee engagement, etc.)
- But are these goals inherently less volatile? While less subject to market dynamics, ESG metrics may be new to the corporate scorecard and could present tracking/measuring challenges

But Does Everyone Agree?

Norges Bank, the world's largest sovereign wealth fund (owns 1.4% of all global stock), takes the view that inclusion of performance conditions within long-term incentive plans is too complex over a multi-year horizon

Citing no meaningful correlation between executive pay and stockholder value creation, they propose a very different approach:

- "Substantial" portion of executive pay should be delivered via company stock that must be held for 5-10 years (including instances of resignation or retirement)
- Reduce corporate governance burden by eliminating performance conditions that do not clearly and empirically link to company strategy
- Majority of CEO pay should be settled in stock each year
- Total compensation "cap" should be established and disclosed at the beginning of each year
- Reduce/eliminate perks and post-retirement benefits that may interfere with a "locked-in" share vesting arrangement

Poll Question #3

Q: Is your compensation committee discussing different approaches to your executive incentive plans for next year?

1. We are making changes to the STI plan
2. We are making changes to the LTI plan
3. We are making changes to both STI and LTI
4. We are discussing changes but haven't made decisions yet
5. We have discussed changes, but plan to stick with our previous/current approach
6. We haven't discussed next year yet

What's On the Horizon for 2023

- Companies taking a "wait and see" approach on setting projected FY23 performance
  - Growth forecasts, macroeconomic factors still too difficult to predict
  - Current discussions more focused on additions/deletions to performance metrics within existing plans

- Move toward relative performance metrics
  - TSR performance vs. peers may push more companies to incorporate in LTI plans
  - Relative performance metrics beyond TSR

- Countervailing view on ESG investment thesis
  - Instances of significant disconnect between company performance and pay outcomes as companies cite ESG successes
  - Push for audited ESG disclosures to promote reliability and uniformity

Key Takeaways

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- If your board plans to "wait and see," be sure that these discussions are on agendas for meetings later in the fall. Even if decisions are happening later in the year than is typical, ensure the committee still has set timeframes to make goal-setting and plan design decisions
- Despite the upheaval, do take all of the market context into account, but make decisions based on a clear assessment of your own organization's market position, challenges, and opportunities

Questions

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