Determining Equity Grant Sizes In the Volatile COVID-19 Environment

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This Viewpoint is one in a series of ongoing articles Pay Governance will be publishing regarding the impact of COVID-19 on compensation programs. All of our Viewpoints can be found on our website at www.paygovernance.com.

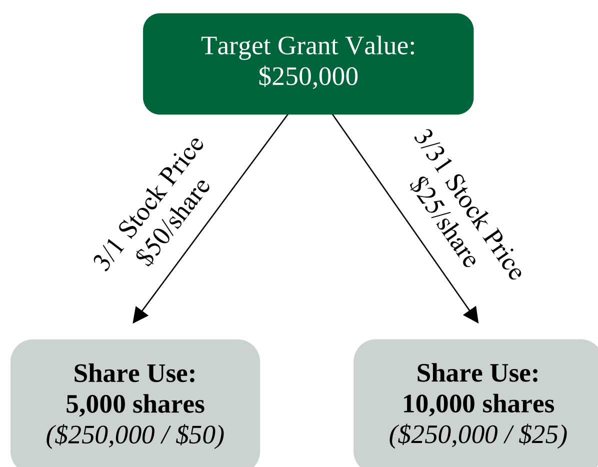
Introduction

While so many of us have been forced to quickly adapt to new daily routines, the near- and longer-term implications of COVID-19 for global business practices and governance are only beginning to take shape. The underlying governance and design of executive pay programs are likely to endure, but when it comes to how these programs are administered, we believe that some adjustments may be needed in response to a very different financial and economic environment.

Given the timing of COVID-19, the range of implications and their relative urgency will vary with company circumstances. In the executive pay space, one issue many companies will face relates to calibrating equity awards in an environment with substantially depressed and volatile equity markets. Specifically, most companies typically start the award calibration process with a targeted dollar value for each participant and proceed to determine the number of units to grant based on the current stock price and other factors. Below we illustrate the process using a target grant value of $250,000 delivered in restricted stock units (RSUs) at an assumed 3/1 stock price of $50 and compare it with the same calibration using a 3/31 price of $25.

For example, for a grant of RSUs, a company will divide a targeted dollar value of $250,000 by the company's closing share price on the date of grant (e.g., $50/share) in order to determine a grant of 5,000 RSUs ($250,000/$50).

However, a not unrealistic share price decline of -50% in the past 30 days (to $25 in this example) suggests that *the company would need twice as many shares to deliver the same targeted dollar value* ($250,000/$25 = 10,000 RSUs).



For most companies, using this historical approach — combined with the recent collapse in share prices — would create an untenable situation for a variety of reasons including the expected impact on burn rate, dilution and share reserve life, and possible proxy advisor and shareholder reactions.

Given the varying degrees of urgency in addressing the topic, this Viewpoint will start the discussion to highlight a variety of circumstances, considerations, and alternative approaches for companies to consider and discuss in the near-term. In the coming weeks, we will continue researching these issues and consulting with our clients in order to find creative solutions to a variety of circumstances. We will publish a future Viewpoint on this topic including a summary of current/recent market practices and our related observations.

Near-Term Equity Award Calibration Circumstances

As a starting point, this issue is not new: companies faced similar circumstances in making 2009 equity awards following the equity market collapse in late 2008 and early 2009. However, we are in a unique executive pay environment — one which is much more heavily scrutinized with annual quantitative and qualitative reviews by proxy advisors as well as shareholder oversight in an annual Say on Pay vote which did not exist following the 2008 financial crisis.

For companies with a calendar fiscal year, employee equity awards are commonly granted between late-January and early- to mid-March. For many of these companies, annual equity grants have already been awarded using traditional approaches based on a variety of contemporary factors, including available market compensation data, share prices on (or prior to) the date of grant, performance, and internal equity. As a result, calendar-year executives and Compensation Committees may think that, at least in the immediate term, the issue of equity award calibration is largely behind them.

While we realize many companies with a calendar fiscal year end likely issued their annual grants in Q1, many management teams and Compensation Committees will face the challenge of determining appropriate equity award sizes under one or more of the following scenarios:

Annual Equity Grants

- Companies that make annual executive equity awards between April and June.
- Companies that are about to make non-employee director awards (typically made at/around the time of an annual meeting in late-April to mid-June).
- Companies that delayed grants normally made in Q1 due to market or other circumstances.
- Companies with off-calendar fiscal years that normally grant later in the calendar year.

Other Equity Grants

- New hire awards (periodic or as needed).
- Promotional awards (periodic or as needed).
- Retention or other special awards (if under consideration).

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Considerations for Calibrating Equity Awards in the COVID-19 Environment

As executives and Compensation Committees evaluate their individual circumstances, there are several internal and external considerations that must be balanced, discussed, and decided upon:

Issue	Description
Internal Issues	
Consistency	Companies should strive to ensure COVID-19's timing does not create significant differences between grant recipient groups driven solely by how the transactions have been scheduled (e.g., if executive awards were made in Q1 but non-executive director awards are planned for May/June). This issue could also have external implications in the form of shareholder and proxy advisor reactions.
Share Use and Dilution	Resulting annual share use ("burn rate") and dilution levels should not be excessive nor indifferent to shareholder/proxy advisor expectations — dilution is further exacerbated where stock options are deeply out-of-the-money and may be expected to remain outstanding without the opportunity for exercise for an extended period.
Share Plan Reserve Life	The impact of increased share use will have direct implications for share plan reserve life and the timing to seek shareholder approval for a new share reserve.
Plan Limits	With the potential to use more shares for individual awards, companies should ensure resulting grants conform to all applicable share plan award limits (e.g., the maximum number of shares to an individual executive or director per year).
External Issues	
Proxy Advisor Perspectives	Current Institutional Shareholder Services (ISS) policies clearly articulate that companies should respond to declining company performance with reduced executive pay opportunities and, more specifically, that equity award dollar values should not be kept whole during periods of sharp stock price decline. At this stage, we do not expect ISS to provide a broad "free pass" in light of COVID-19.
Possible Windfalls	While the primary focus today may naturally rest on competitive pay levels and motivation, the chance of windfall outcomes from new awards should be modeled to understand possible results under varying share price recovery and performance scenarios.
Judgment Issues	
Competitive Compensation	Employee perceptions and expectations for "competitive compensation" based on last year's awards must be balanced with the expectation that 2020 market compensation levels, particularly equity incentives, could decline measurably. As a result, historical market data may overstate the current competitive market.
Reduced "Holding Power"	The value of outstanding unvested awards has plunged at most companies due to lower stock prices and uncertainty that historical performance conditions can be achieved — this issue is further exacerbated for companies with an abundance of deeply under-water stock options.
"Retention" As A Rationale	While "retention" is often used as one rationale for equity awards, particularly for senior executives, proxy voting advisors and shareholders may criticize using this rationale as justification for shifting award mixes away from performance-based grants (i.e., stock options/performance shares) toward time-based restricted stock.

Alternative Approaches for Calibrating Equity Awards in the COVID-19 Environment

When equity markets collapsed in the 2008-2009 financial crisis, the vast majority of companies responded by altering their equity award calibration methodology. While some companies took more dramatic actions than others, individual circumstances dictated where each company fell along the continuum. Many of the same approaches are still valid, and we expect companies to tailor their responses to meet their individualized needs.

Below, we highlight many possible award calibration approaches for companies to consider in setting near-term equity grants. While these strategies can be used in isolation, our experience suggests that reviewing a range of perspectives helps to ensure desired outcomes are balanced and fully vetted. Alternative approaches include:

Alternative Approach	Description / Considerations
No Change	Make no change to the historical process of determining award sizes: a. Most appropriate for companies experiencing only a modest decline in share prices or those that have historically issued grants on a "fixed share" basis, where the number of shares is generally held constant from one year to the next regardless of the share price at the time of grant. b. Companies experiencing a significant drop in share price must consider the implications of increased share use, decreased share reserve life, adverse shareholder and proxy advisor reactions, and the possibility and implications of windfall outcomes for executives.
Adjust the Calibration Share Price	Use a share price other than the current price on the date of grant to calibrate the number of shares to grant: a. Typically determined based on an average share price over the 30, 60, or 90 trading days prior or some other time period that captures the current COVID-19 environment. b. Alternatively, companies that recently granted annual awards (e.g., in February or March) may choose to retain the calibration price from those recent awards in calibrating any new near-term grants (e.g., for off-cycle or non-employee director awards made between April and June).
Reduce Targeted Award Value	Reduce the targeted award value and calibrate awards using the current or adjusted price: a. Recognizes that currently available market data is generally based on 2018/2019 information (near-peak stock market prices and record low unemployment) and may overstate expected 2020 market practices for equity award values. b. Ultimately a way to manage share use that must be balanced with the resulting burn rate.
Target a Maximum Burn Rate/Share Use	Establish a maximum annual equity budget in terms of shares and then allocate the share pool based on relative priorities: a. Maximum burn rate can be set in historical reference to company, industry/peer, and/or ISS standards. b. Maximum burn rate often also considers the desired life of the remaining share pool.
Award the Same Number of Shares vs. Prior Year	Grant approximately the same number of shares to each participant as was granted in the prior year: a. Reflects the standard annual approach for some companies/industries (i.e., a fixed share approach). b. Likely to result in significantly lower compensation value for 2020 that is approximately equal to the company's year-over-year share price decline.

Alternative Approach	Description / Considerations
Shift Equity Mix	Shift equity award mix away from stock options and deliver a greater portion of total award in "full-value" vehicles (i.e., time-based restricted stock and/or performance shares): a. Conserves shares relative to stock options. b. Heavier performance share use conserves shares but must be balanced with increased pressure on goal-setting during an uncertain time. c. Full-value shares, particularly time-based restricted stock/units, can provide more certainty to recipients.
Utilize Cash-Based Awards	Deliver a portion of long-term incentive value to some or all participants using cash-based awards: a. Can be structured to mimic the economics of equity-based awards without using shares. b. Conserves share pool and limits burn rate but uses cash in an environment where many companies will be strapped for cash; this is also likely to result in variable accounting liability.
Limit/Target Participation	Flex equity award sizes/values/vehicles based on employee role criticality and other factors to minimize the impact on key talent, essentially maintaining consistency for roles most critical to the organization's success.

Conclusions

As is becoming abundantly clear, COVID-19 will have far-reaching effects with company-specific and broader implications that have yet to be understood. In approaching the near-term issue of calibrating equity awards, history, logic, and good governance suggest that revised approaches ultimately are likely to result in lower equity award values for many award recipients in 2020 and perhaps into 2021.

While each company will choose a specific approach that best fits its needs, all will benefit from a thoughtful, balanced, and conservative approach to equity award calibration that responds to the current environment and can be rationally communicated both internally to employees and externally to other stakeholders.

Stay tuned for a more detailed discussion of this topic and the alternatives noted above. We will also continue to monitor company disclosures and will provide our observations in the next Viewpoint update on this topic. We will also share weekly updates on our website: paygovernance.com.

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