Pay Governance®
Advisory Services to Compensation Committees

OPINION
Viewpoint on Executive Compensation

Smoothing Equity Awards Delivery in Volatile Times – Do Semi-Annual or Quarterly Grants Make Sense for Your Company?

– AUBREY BOUT, JASON AUWARTER AND BLAINE MARTIN

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

The COVID-19 pandemic and accompanying economic disruptions have created significant operational and financial challenges for most companies. In addition to these challenges, companies have been impacted by record levels of share price volatility. For companies that are preparing to grant annual equity awards in the second quarter of 2020 or later in the year, the timing of these equity grants presents a unique challenge: if companies calibrate equity awards based on significantly lower stock prices, share plan usage and dilution will increase, potentially resulting in negative investor reactions; conversely, calibrating equity awards based on a higher-than-current price could potentially be detrimental to employee morale. Therefore, in some cases, companies may benefit from the use of smaller, more frequent grants (e.g., semi-annually or quarterly) to potentially mitigate these issues. Since most calendar year companies already made their equity grants in Q1 2020, semi-annual or quarterly grants would not be applicable unless high share price volatility persists into next year.

The Impact of Long-Term Incentive Grant Timing

The use of annual equity grant cycles is large majority market practice among public companies. However, while less common, Pay Governance observes that some companies have historically used semi-annual or quarterly grants. The use of multiple equity awards in a given year is more common for companies that either deliver a large proportion of long-term incentives through stock options and/or which regularly experience significant price volatility. Further, this approach has also been used by some companies in turnaround situations or in periods following IPO/spinoffs.

While companies in volatile industries such as technology and biotech have found it appropriate to grant equity on a semi-annual or quarterly basis, given the uncertainty of COVID-19 and how long it will persist, companies in other “disrupted” and highly volatile sectors (retail, hospitality, airline, financials, energy/ oil & gas, and equity REITs) may want to explore this “spread out” approach to granting stock.

The example below illustrates how moving to semi-annual/quarterly equity granting can create significant variation in both long-term realizable equity value for

PARTNERS

Aubrey Bout
John R. Ellerman
John D. England
R. David Fitt
Patrick Haggerty
Jeffrey W. Joyce
Ira T. Kay
Donald S. Kokoskie
Brian Lane
Joe Mallin
Jack Marsteller
Richard Meischeid
Sandra Pace
Steve Pakela
Jaime Pludo
Matt Quarles
Lane T. Ringlee
Brian Scheiring
John R. Sinkular
Christine O. Skizas
Bentham W. Stradley
Jon Weinstein

participants and share usage depending on share price movement. For these reasons, some companies should consider this approach as a long-term smoothing mechanism rather than a one-off tactic that would create short-term “winners” or “losers” depending on share price movement during the year.

Stock Price Movement Q2 to Q4	Factor	Full Q2 Grant	Semi-Annual Grant (Q2 + Q4)	% Change for Semi-Annual Approach	Observations
Stock Price Up 30% in Q4 (from $100 in Q2 to $130 in Q4)	Grant Value	$100,000	$100,000	0%	Same grant value
	Total Share Usage	**3,250**	**2,875**	**-12%**	**Conserves share pool**
	Realizable Value at $140	**$155,000**	**$102,480**	**-34%**	**Significantly reduces realizable value**
Stock Price Down 30% in Q4 (from $100 in Q2 to $70 in Q4)	Grant Value	$100,000	$100,000	0%	Same grant value
	Total Share Usage	**3,250**	**3,947**	**21%**	**Reduces life of share pool**
	Realizable Value at $140	**$155,000**	**$252,570**	**63%**	**Significantly increases realizable value**

Assumptions:
1) $100,000 grant value.
2) 75% stock option / 25% RSU LTI mix.
3) Stock options calibrated using constant 25% Black-Scholes ratio.

Considerations for Semi-Annual/Quarterly Equity Grants

Companies considering if and how to implement semi-annual/quarterly equity grants should weigh the pros and cons for shareholders and employees, although the specific implications of a more frequent grant approach may vary depending on actual share price movement throughout the year. As a result, use of a semi-annual/quarterly grant strategy is a decision that should be set for several years, and communication to employees/participants is critically important at roll-out. Below we discuss the potential impact to participants, the company, and shareholders:

- **May improve employee morale and retention**. This approach may reduce the risk of an entire stock option or share grant at a high share price going quickly “underwater” or declining in value. Employing semi-annual or quarterly equity grants is somewhat akin to a dollar cost averaging investment strategy, where investments are made regularly over time rather than annually.
- **May allow for more consistent equity plan share use**. Short-term declines in share prices can mean that dollar-denominated equity grant values deliver significantly larger numbers of shares or stock options, potentially stressing equity plan share pool budgets or even plan limits. By spreading the grant dates throughout the year (semi-annually/quarterly), equity grant calibration prices are more likely to reflect the annual share price average for the full year. For some smaller companies that use fixed share guidelines (versus dollar-value guidelines), the number of shares would be “locked-in” for the year, so burn rate and dilution would be effectively predicted and managed.
- **May improve external optics**. In cases of equity grants following significant share price declines, shareholders and other constituents may perceive future realizable pay as a “windfall” if there is a quick recovery in the company’s stock price. Semi-annual/quarterly equity grants at times of low share prices (i.e., not granting the full annual award at the multi-year stock price low) are a shareholder-friendly approach that mitigates this effect. Further, critiques of executive compensation that have incorrectly

assumed that management tries to "time the market" to get favorable grants (more shares) would be further debunked by a semi-annual/quarterly grant approach.

While these benefits may be desirable for some companies, there are other considerations that may make semi-annual/quarterly grants less feasible in other cases, including:

- **May be too late for FY 2020.** For many companies that have already granted their full annual LTI awards for the current fiscal year, making a new award later in the same year following a large decrease in price would likely be viewed unfavorably by shareholders and proxy advisors. Grant schedules could be changed for 2021, but this may not be necessary if stock price volatility normalizes through the end of 2020. Companies that are concerned about employee motivation and retention could pull forward a portion of the annual Q1 2021 grant and make a semi-annual grant in Q3 2020, with semi-annual grants continuing into the future.
- **May present goal-setting challenges when using three-year performance plans.** For many companies using a traditional performance plan, additional grants may suggest the need to set new goals every six months in the case of semi-annual grants. Executives may also lose line-of-sight to their awards since they would have to track additional performance cycles over multiple performance periods (e.g., in the third year, there would be six total outstanding performance cycles in play).
- **Would necessitate additional administration and communication.** For companies with extensive long-term incentive plan participation, the additional time required to grant and track multiple awards may not be desirable. Further, companies would need to enhance plan communications to assist grantees in understanding progress versus goals and vesting schedules.
- **Could disappoint employees used to receiving all equity grants at the beginning of the year.** It is possible that some employees and executives might not look favorably on a "delay" in receiving their full equity grant. Strong communications and company-published FAQs are key to explaining the benefits of semi-annual or quarterly grants. Advanced notice and thoughtful communications would be helpful in gaining the trust of employees in these uncertain times.
- **Would be inconsistent with market practice.** The vast majority of companies make annual equity awards. Some companies and boards may not be comfortable breaking with typical market practice.

Guidelines for Granting Semi-Annual/Quarterly Equity Grants

The suggested guidelines below reflect guardrails for considering semi-annual or quarterly equity grants based on our consulting experience with companies that have considered or implemented this approach.

1) **Best suited to address broad, company-wide retention issues.** Changing the design of the plan to allow for multiple annual grants improves company-wide retention concerns and aggregate share use. However, other approaches may be more appropriate when concerns are limited to a subset of the plan participants (e.g., targeted retention bonuses for select employees critical to company success, shifting the LTI mix to more RSUs for broad-based employees to conserve shares, etc.)

2) **In our experience, semi-annual awards provide balance between smoothing volatility and additional administration.** Companies making multiple annual equity grants have typically chosen semi-annual, quarterly, or monthly awards; semi-annual is most common. We prefer the semi-annual approach to provide the benefit of grant price smoothing while limiting the additional administrative burden of calibrating and documenting grants more than twice in a year. The frequency of grants should be customized to each company's situation and administrative capabilities.
3) **Semi-annual/quarterly grants work best for time-vested awards.** Most companies granting semi-annual equity awards provide equity entirely or mostly as stock options, reflecting the value of smoothing the exercise strike price throughout the year for companies with volatile stock prices.
4) **Semi-annual/quarterly grants are likely NOT appropriate for performance-based awards.** We do not generally recommend that companies make multiple performance share grants (PSUs) on a semi-annual/quarterly basis. In addition to the complexity of following multiple performance periods for each year, investors and proxy advisors may view multiple PSU grants in a year with different goals as providing an opportunity to "retest" performance hurdles. For companies making both performance (PSU) and time-vested grants (stock options and/or RSUs), consider continuing to make PSU grants on the same once-annual grant date but making stock option/RSU grants semi-annually. Another approach we have observed is to continue to grant PSUs in Q1 or Q2 and move stock option/RSU grants to Q3 or Q4, thereby smoothing vesting events over time.
5) **Semi-annual/quarterly granting should not be a short-term practice.** While companies often implement this approach to address short-term share price volatility, most companies should maintain the approach for multiple years after volatility normalizes. In some cases, semi-annual/quarterly grants are an ongoing, long-term grant approach that is maintained after normalization, often because the company and employees value the smoothing of grant prices and more frequent grants.
6) **Communication is key, and decisions should be targeted to be value-neutral.** Any decision to implement semi-annual/quarterly granting should be carefully communicated to plan participants so as not to be interpreted as a "takeaway" and not perceived by shareholders and proxy advisors as "springloading" (i.e., intentionally timing option grants at a low price). For these reasons, semi-annual/quarterly grants should be communicated as a permanent or semi-permanent (several years) approach that will minimize the impact of a single day's share price on realizable value in any given year.
7) **Align timing of grants for all LTI participants.** When companies move to a semi-annual/quarterly equity grant approach, the approach is typically applied to all equity plan participants, including both executives and broad-based employees receiving equity grants. Using the same approach for all participants reduces the risk of employees perceiving the approach as an austerity measure or a mechanism to provide some employee groups with special treatment during a period of uncertainty.
8) **Consider disclosure implications and rationale.** If a company shifts named executive officer equity awards to a semi-annual/quarterly grants, this change and an accompanying rationale will need to be disclosed in the annual proxy statement. This rationale should include the benefits for both the company/shareholders and employees, including smoothing annual share usage, managing employee perception of equity award value, etc. We are not aware of any proxy advisor policies specific to semi-annual/quarterly grants and we have not observed any critical comments from proxy advisors on the approach of making more frequent equity grants.

Conclusion

As companies consider their equity strategies in periods of uncertainty and increased share price volatility, semi-annual/quarterly equity grants are one tool among a range of options to mitigate the impact of abnormally high share price volatility. The use of semi-annual/quarterly equity grants is best applied to time-vested equity, particularly stock options. The recent shift towards delivering more equity to executives as PSUs means that this grant strategy may be less impactful or desirable than it was in past periods of volatile share prices when the use of time-based equity was more prevalent. However, for a specific group of companies with high share price volatility and that grant significant portions of equity through stock options and/or restricted shares/RSUs, this approach may improve employee perception of equity grants and normalize share pool usage over time.

****

General questions about this Viewpoint can be directed to Aubrey Bout at aubrey.bout@paygovernance.com, Jason Auwarter at jason.auwarter@paygovernance.com or Blaine Martin at blaine.martin@paygovernance.com.

Pay Governance will return to these and other potential executive compensation strategies in subsequent Viewpoints, blog posts, and other communications. We will provide weekly updates on our website: paygovernance.com.