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How Long-Term Performance Plan Metrics Are Evolving in the Technology Sector

The elimination of 162(m) in the new tax law could help usher in a new era of LTI plan metrics where there is more focus on industry and company dynamics than proxy advisors' standards.

The elimination of 162(m) in the Tax Cuts and Jobs Act of 2017 provides an opening for a new era in long-term incentive (LTI) metrics. Previously, companies could deduct performance-based compensation to their named executive offices if it met the requirements of 162(m). But with the performance-based exemption eliminated thanks to the tax bill, companies can consider a wider range of performance metrics and practices— including operating metrics that might be better suited to motivating their executives.

Under 162(m), boards couldn't use positive discretion (only negative discretion) to change the goalposts in the performance plan without violating the tax rules of what is eligible for performance-based pay. Therefore, relative total shareholder return (TSR) became a "safe" metric. For example, if the economy took a turn for the worse and executives didn't meet absolute financial targets, companies only needed to outperform their peers instead of past performance. Companies can now more liberally apply discretion to performance targets— although we caution businesses to do so responsibly as they still must answer to their shareholders. As such, boards and executives may want to reconsider the types of metrics they include in their performance-based equity plans. And while we don't see relative TSR going away, it's increasingly being used as a modifier to other operational metrics. As a modifier, relative TSR is used as a secondary metric to limit or augment payouts based on the financial returns of the organization compared to its peers.

We also see the tax bill encouraging technology companies to use longer performance periods. Most investors and proxy advisory firms like to see three-year terms for long-term incentive plans. However, innovation-based organizations often operate with limited vision into the future. They must deal with operating conditions that may only extend as far out as 18 months to two years. With the ability to exercise discretion, companies might feel more comfortable establishing three-year performance periods, which are preferred by most institutional investors and proxy advisory firms.

And if executive compensation practitioners and boards of directors needed another reason to rethink their performance metrics, they can find one in the proxy advisory firm landscape. Starting with the 2018 proxy season, Institutional Shareholder Services (ISS) began formally evaluating three-year performance on various financial metrics, in addition to relative TSR. These additional metrics include return on invested capital (ROIC), return on assets (ROA), return on equity (ROE), EBITDA growth and cash flow growth. This gives public companies a bit more freedom to adopt metrics in addition to TSR. By the same token, it could also mean that the additional

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metrics ISS is using to assess performance could be adopted on a widespread basis and box companies into these metrics.

Within the technology sector, there are certain market dynamics unique to each industry. It's important for professionals involved in the design of long-term incentives to keep these nuances in mind as they think about designing plans that reflect the characteristics of their business and broader industry.

The following examples highlight the unique characteristics of certain technology industries that companies within these industries could incorporate more in their future performance plan metrics:

- **E-Commerce Companies:** Internet-related businesses have historically focused on top-line growth as the primary measure of success, but since growth can be rapid and unpredictable, we recommend e-commerce firms consider using measures like revenue, operating income and EBITDA. This focuses executives' attention on key goals and reduces the importance of precise goal-setting that is typically required for bottom line or return metrics. Smaller e-commerce companies might want to focus on volume-based metrics (e.g., number of customers or transactions), revenue growth and market share as these will be key measures of success for firms not yet reporting a profit.

- **Software companies:** This high-growth, high-profit industry should focus on metrics that are balanced across various operating and financial measurements. Indeed, our research finds software companies are moving toward a combination of market and operating metrics— from 28% that reported using both in 2015 to 33% in 2016 (based on 2016 and 2017 proxy statements). The most common operating metrics include revenue growth followed by operating income and earnings per share, according to the 2017 Radford Performance-Based Equity Report for Software Companies.

- **Semiconductor companies:** The semiconductor industry is unique in that it is inherently more cyclical because the business is more directly related to consumer spending. As such, we find there are two common approaches companies take to designing incentive plans. The first is designing performance plans with aggressive metrics that pay out big when business is booming, while the alternative approach is more conservative, developing consistent payouts at, or slightly below, target most years. When deciding which approach is best for your organization, we recommend semiconductor companies think about what approach aligns best with their compensation philosophy, culture and what their employees value.

Next Steps

We encourage companies to be thoughtful in choosing the metrics that make the most sense for their organization and industry. The elimination of 162(m) should make organizations feel less restricted to using metrics that conform to the standards set by proxy advisory firms. However, it's important to keep in mind that if you decide to make changes to the design of your performance-based equity, you need to clearly and persuasively communicate the intent behind those changes in the proxy statement as well as consider additional shareholder outreach ahead of the proxy season.

If you have any questions about long-term incentive design and want to speak with a member of our compensation consulting group, please write to consulting@radford.com.

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