

— Equity-based incentives: the largest, most misunderstood component of executive compensation

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LANE CAPUTO
COMPENSATION



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INTRODUCTION

Equity-based incentives are the largest component of executive pay. They are also among the most poorly understood elements of executive compensation, which often results in a general misperception that many executives enjoy unwarranted or unfair levels of compensation. This is especially true when economic times are difficult, when shareholders and employees alike are suffering financial setbacks, and a story circulates about a corporate executive who “took home” a seemingly disproportionate compensation package.

It’s a popular story, one that is guaranteed to spark strong emotions, but it is also a story that is supported by **required** valuation models that were never designed to value employee equity incentives. These models, mandated by accounting standards (*IFRS 2 Share-based Payment*) for accounting purposes, but also widely used by companies to disclose the ‘fair value’ of equity incentives granted to executives, can create significant disparities between the value that publicly-traded companies disclose with regard to their executives’ compensation and the value that executives actually realize from these incentives.

This report explains—for the benefit of the public, business press, large shareholders, and their proxy advisors—how long-term, equity-based incentives (stock options, Restricted Share Units [RSUs], Performance Share Units [PSUs], Deferred Share Units [DSUs]) are currently valued, why and how a different viewpoint can be used to more accurately capture and communicate their value, and, ultimately, whether this value is aligned with shareholder value creation.

UNDERSTANDING GRANT DATE FAIR VALUE

Publicly-traded companies must expense the **grant date fair value** (GDFV) of equity incentives awarded to all employees in their financial statements. These companies must also disclose a GDFV for equity incentives awarded to their Named Executive Officers (the CEO, CFO, and next three highest-paid corporate officers) in the annual Management Information Circular (proxy). The most commonly used GDFV methodologies *estimate* what an equity incentive is worth today, even though whatever “value” is ultimately realized won’t be received until some point (typically, 3-5 years) in the future.

Under the terms of most equity incentive awards, executives aren’t able to exercise these incentives or realize value for several years from the year of award. Even when executives are permitted to exercise, they are frequently prohibited from trading by regulatory or company-imposed blackouts, and there is often pressure from shareholders and boards of directors to delay value realization as long as possible.

The valuation model most popularly used for stock options, the Black-Scholes-Merton model, calculates the theoretical value of an employee stock option at the time of award, even though the value ultimately realized, if any, will be many years into the future. The model was not, however, developed for the purpose of valuing employee stock options and other equity incentives (a term that encompasses any long-term incentive vehicle that derives its value from the price of the company’s equity). It and other similar models for valuing share-based payments (lattice, Monte Carlo) are inherently flawed - especially in cyclical commodity industries such as the resource extraction sectors - in that the share price at the time of award is a significant determinant of the value of the equity incentive. Near the top of a cycle (high commodity prices and share prices), models ascribe relatively high fair value to equity incentives, while at the bottom of a cycle (low commodity prices and share prices), models ascribe low fair value - in practice, the reverse is true for award recipients. In the energy or mining sectors, for example, equity incentives granted at the peak of the commodity cycle (2011/12 for mining; 2013/14 for energy) were some of the highest values reported over our study period, but the value of RSUs and PSUs ultimately realized was materially less and most stock options awarded during these years expired totally worthless.

However, the business press, the public, large shareholders, and their proxy advisors use the GDFV generated by such models—data that bears no resemblance to the value that will actually be realized from these incentives—when determining how to vote for management compensation proposals, such as Say on Pay resolutions, etc. In essence, stakeholders are making important decisions and impressions based on flawed data, and even though many of these stakeholders intuitively know this to be true, there is no agreed-upon alternative for more accurately reporting the true value of these incentives and their alignment (or otherwise) with shareholder value. The Canadian Securities Administrators (CSA) *Form 51-102F6 – Statement of Executive Compensation* requires issuers to disclose the fair value of equity incentives on their grant date for each of the most recent three years. These values are disclosed in the Summary Compensation Table (SCT) - the tabular disclosure of all compensation elements that most stakeholders reference - without any allowance for tracking the *actual* value of these incentives in the SCT for comparison.

TESTING THE MODELS

During our work with clients, we have learned not to place too much confidence in the reliability of valuation models. However, over the past several years, as scrutiny of executive pay has intensified and these values now figure prominently in the analyses performed by proxy advisors, institutional investors, and regulators, we wanted to take a deeper dive into how closely the valuations track reality.

A 2021 Lane Caputo study tested the validity of valuation models and the corresponding compensation values disclosed by public issuers by tracking the actual value received from these incentives over time, versus the GDFV disclosed in the year of award.

We tracked three groups of companies over several years: constituents of the S&P/TSX Global Gold, the S&P/TSX Capped Energy, and the S&P/TSX 60 indices. We compared the reported long-term incentive value for Named Executive Officers reported in each year against three different scenarios:

1. Value disclosed each year in the SCT, versus the value actually realized by CEOs in that year.
2. Value disclosed each year in the SCT, versus the maximum possible value realizable.
3. Value disclosed each year in the SCT, versus the actual value received by CEOs over the 3-5 year term of these same awards.

For each of the exhibits below, the dark blue bars show the aggregate reported value of equity incentives for all of the CEOs in each index, for each year of the study - these reported values are consistent throughout all three scenarios. The gold bars represent the value of the scenarios listed above, for each year of the study, versus their reported value. The aggregate share price performance of the index is overlaid to illustrate the effect of the share price on both reported and realized value.

SCENARIO ONE

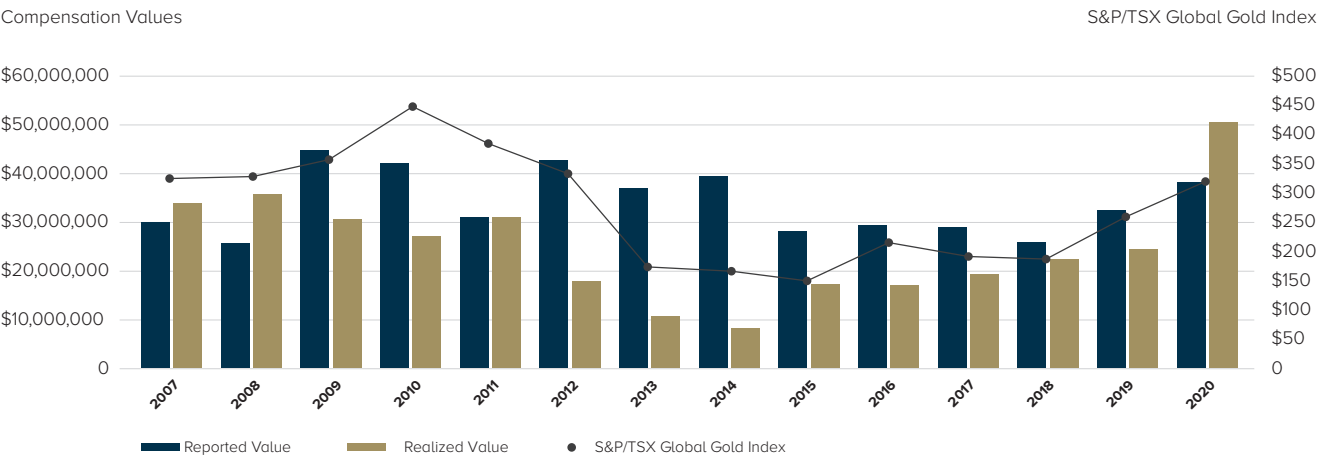
Value disclosed at the beginning of each year, versus the value actually realized in that year.

(Note: This is the value realized in the year from previously-awarded incentives, since no incentives awarded in the current year would yet have vested).

This analysis compares the actual “take-home” equity pay for the year against the *reported* compensation in that same year; the reported value is often quoted by the media as “take-home pay.” We ran this analysis to counter the popular story that runs something like this: “Jane Smith took home \$8 million in 2020, even though she presided over a decline in shareholder value of 20%.”

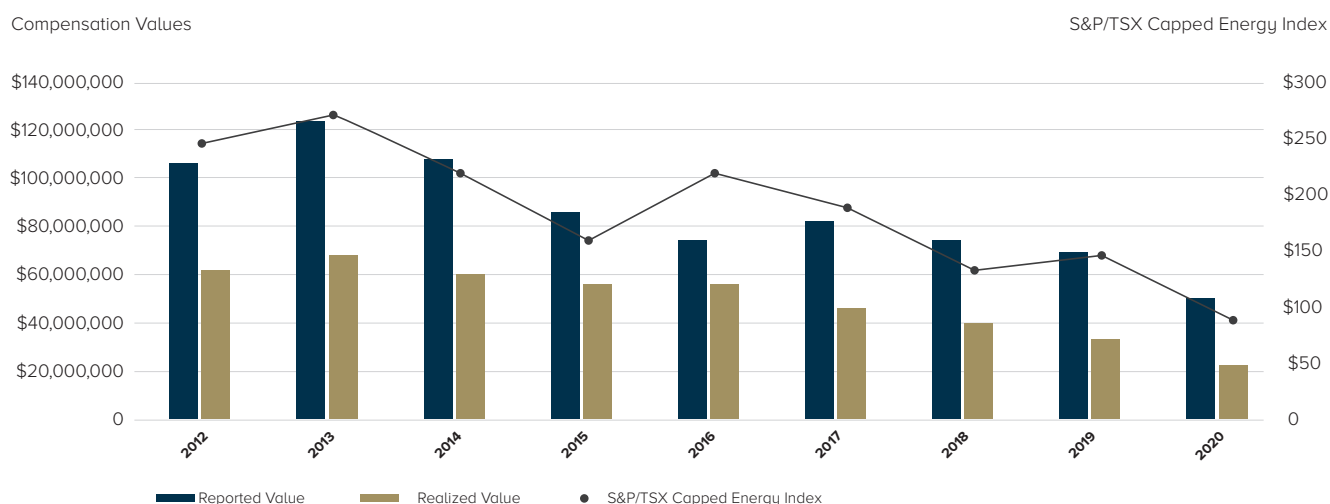
Result: In almost every year of the study, the actual value Jane Smith and all CEOs collectively received from equity incentives was materially lower than reported value (averaging only 73%, 58%, and 80% of reported value over the entire study period, respectively, in the Global Gold, Capped Energy, and TSX 60 indices).

Grant Date Fair Value vs. Realized Value (same year) CEOs of the Global Gold Index



Grant Date Fair Value vs. Realized Value (same year)

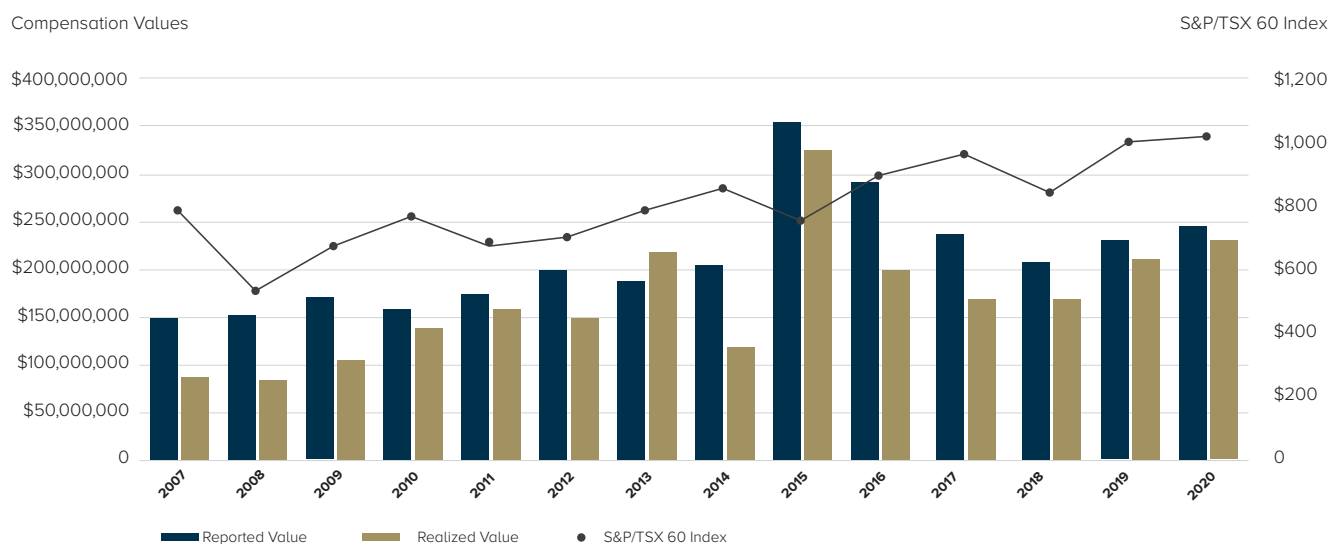
CEOs of the Capped Energy Index



Note: Analysis of the S&P/TSX Capped Energy Index excludes the income trust era, and hence comprises only nine years of history.

Grant Date Fair Value vs. Realized Value (same year)

CEOs of the TSX 60 Index



SCENARIO TWO

Value reported in each year, versus the maximum possible value from that same award.

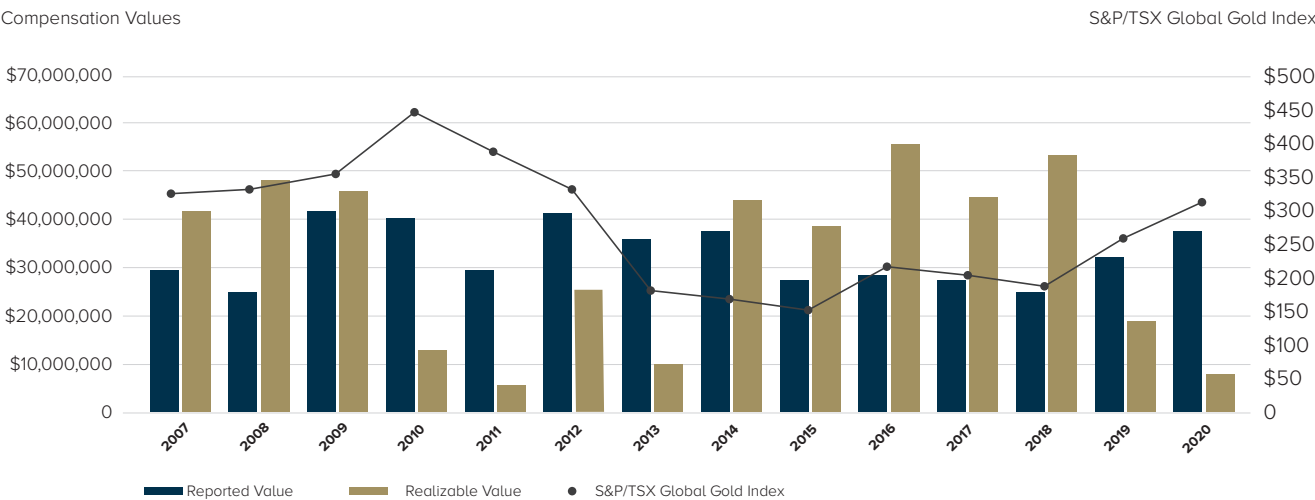
This scenario tests the predictive value of the model - what if Jane Smith had exercised at the highest possible price during the life of the incentive and if she had no restrictions on exercising (such as insider trading concerns, blackout policies, shareholder pressure not to trade, etc.)?

Result: For several years of each study period, Jane Smith and all CEOs collectively could never have realized the reported value of the awards - even under absolutely perfect circumstances. On average, over the study period, CEOs of the Global Gold, Capped Energy, and TSX 60 indices could have only realized 98%, 65%, and 117% of reported value, respectively.

Note that, while the study period averages for the Global Gold and TSX 60 indices appear quite close to the GDFV, when viewed on a year by year basis, the fair value generally wildly over-shoots, or undervalues the actual value realizable. Additionally, this scenario assumes zero trading restrictions (other than vesting) and 100% perfection in market-timing the redemption of equity incentives at peak share prices over the term- a completely impossible scenario developed to test whether the achievement of fair value was possible over the long-term given no restrictions.

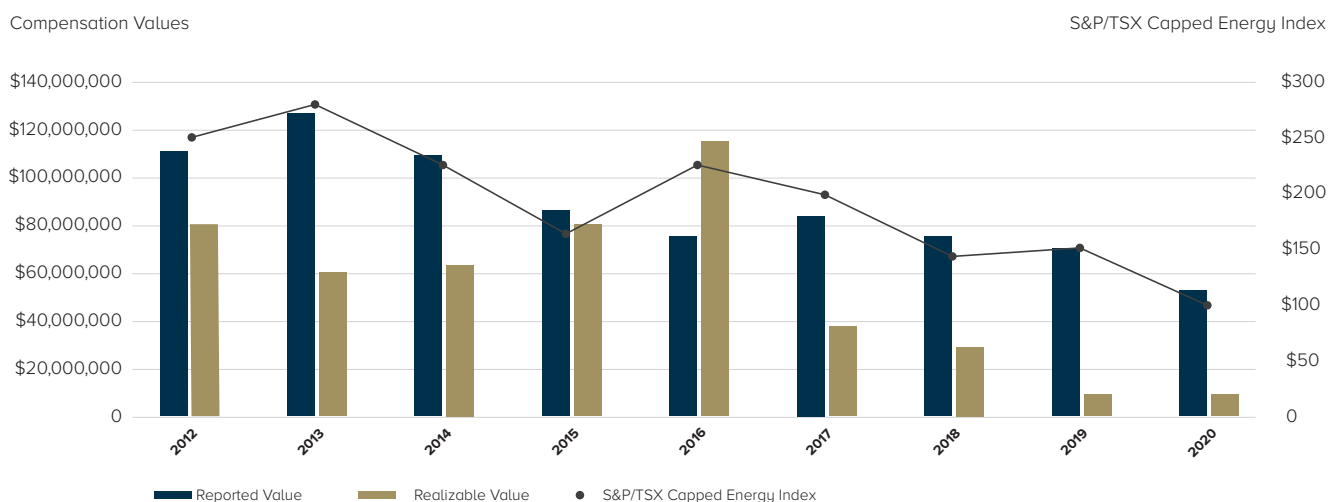
Grant Date Fair Value vs. Maximum Realizable Value

CEOs of the Global Gold Index



Grant Date Fair Value vs. Maximum Realizable Value

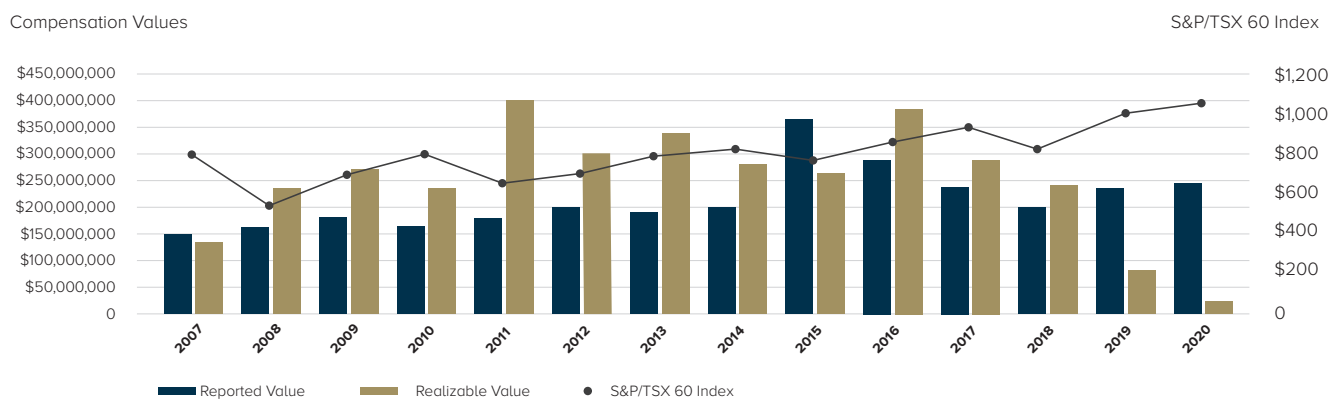
CEOs of the Capped Energy Index



Note: Analysis of the S&P/TSX Capped Energy Index excludes the income trust era, and hence comprises only nine years of history.

Grant Date Fair Value vs. Maximum Realizable Value

CEOs of the TSX 60Index



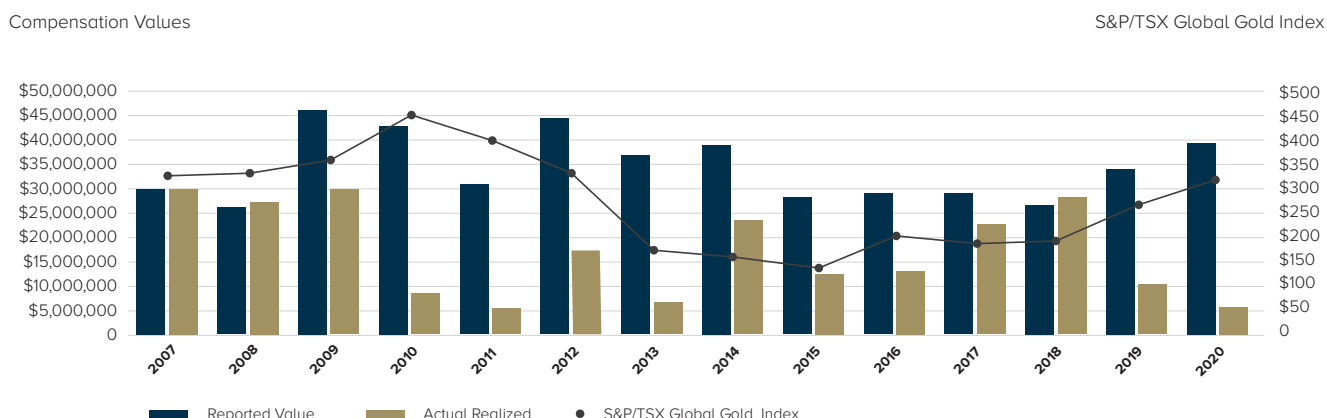
SCENARIO THREE

What really happened - actual value received by executives 3-5 years from the date of award, versus the value reported.

Result: When we tracked the vesting end exercise of each individual stock option, RSU and PSU during the study period, we found that the value **actually received** by all CEOs on average was 49%, 47%, and 67% of the “value awarded” ⁽¹⁾ for the Global Gold, Capped Energy, and TSX 60 indices, respectively. ⁽²⁾⁽³⁾ Despite the *theoretical* possibility that near-GDFV pay could be achieved, on average, over longer time periods, the reality is that executives actually “take home” much less than what is reported in the SCT.

Grant Date Fair Value vs. Actual Realized Value

CEOs of the Global Gold Index



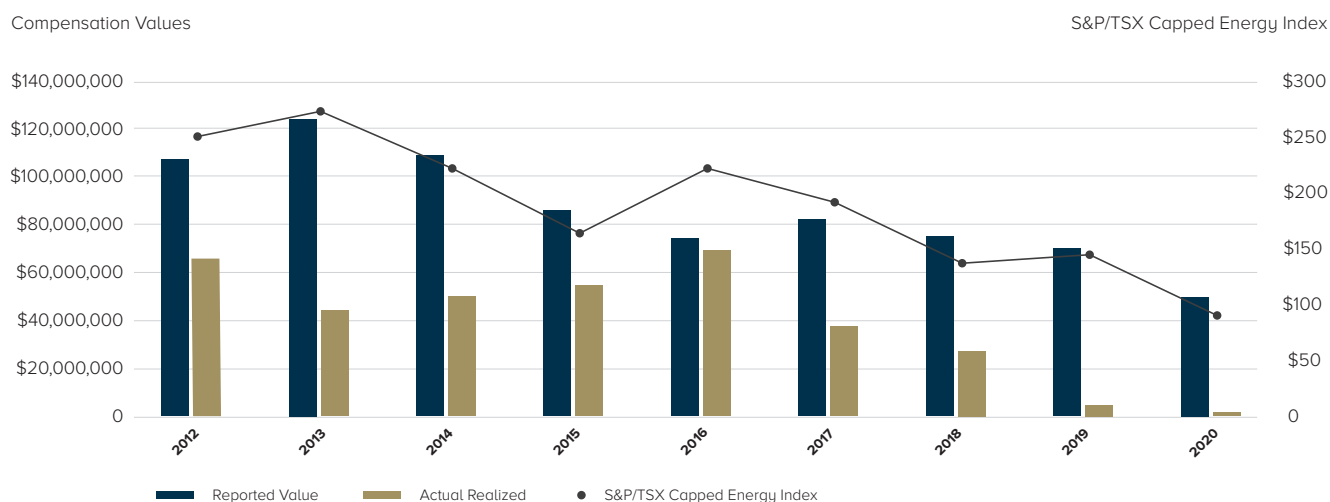
¹ Actual vesting dates, numbers of incentives vesting, performance multipliers, and share prices at time of vesting/exercise/redemption were tracked via the System for Electronic Disclosure by Insiders (SEDI), Management Information Circulars, and company financial statements. Where performance multipliers were undisclosed or unable to be calculated, we assumed a performance multiplier of 1.0.

² Executives fully realize these incentives after 3-5 years (generally, within 3 years). Value still to be realized in the final 1-2 years of our study period will reduce our study findings somewhat versus actual.

³ In our 2018 study using 10 years of history (6 years for the Capped Energy Index), we found that the value actually received from equity incentives was only 34%, 38%, and 73% of the value reported for the Global Gold, Capped Energy, and TSX 60 indices, respectively.

Grant Date Fair Value vs. Actual Realized Value

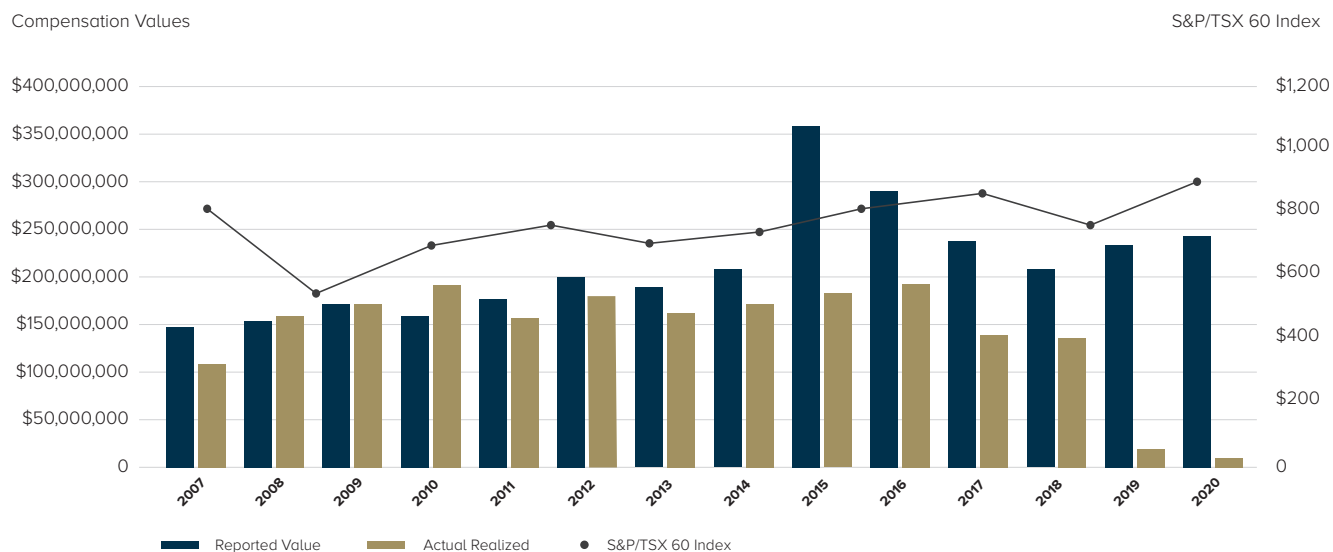
CEOs of the Capped Energy Index



Note: Analysis of the S&P/TSX Capped Energy Index excludes the income trust era, and hence comprises only nine years of history.

Grant Date Fair Value vs. Actual Realized Value

CEOs of the TSX 60 Index



KEY TAKEAWAYS

While the results of our study have shown that the GDFV reported by public issuers has dramatically overestimated the value actually received over the past decade, expectations for a robust commodity market over the medium-term may result in these same valuation methodologies soon dramatically undershooting realizable value as share prices escalate in response to rising commodity prices. Undershoot or over-value, valuation methodologies are poor predictors of the value that recipients will eventually realize from equity incentives. At the same time, stakeholders - including the public, the business press, and large shareholders and their proxy advisors - rely on these values to make decisions that can have very real impacts to a company and its pay programs.

There are a number of strategies that can be undertaken to better communicate the differences between required fair value disclosure versus the actual experience of a company and its employees that will, in turn, facilitate a more accurate understanding by stakeholders of the very real differences between these two ends of the spectrum. This responsibility will lie primarily with the reporting companies as, aside from the required disclosure format, companies are afforded a great deal of flexibility in adding supplemental information to the required reporting format (including the calculation of GDFV itself, from a compensation disclosure perspective).

The first strategy is for companies to **emphasize realizable/realized pay** in proxy disclosure and shareholder communications. Companies should highlight the fact that the reported GDFV does not in fact equal actual realized value and make maximum use of charts, tables, and other supplementary information to illustrate the greater alignment of executive equity incentives with shareholder experience, as opposed to relying solely on the mandatory disclosure format. Supplementary disclosure need not be limited to the three-year lookback required under the disclosure guidelines - we are, after all, talking about *long-term incentives*. Companies should demonstrate to stakeholders how actual realized compensation values have fluctuated in alignment with shareholder value over a longer period of time.

Companies should also consider **different approaches to determining the number, or value, of annual equity-based incentive awards**. Doggedly following a model with very little predictive value to determine the size of “target value” awards to executives and to communicate this value externally to other stakeholders is clearly insufficient in isolation. In cyclical commodity sectors, companies should consider applying upper and lower ‘collars’ to the model inputs (share price volatility, trailing average share prices, etc.) to mitigate the tendency of valuation methodologies to overshoot or undervalue the value of equity incentives at the extreme ends of the commodity cycles.

Lastly, companies should **look to their own history on realized versus reported value**. Compensation disclosure regulations require that a company use and disclose a valuation methodology for equity incentives. The fair value reported in the Summary Compensation Table can deviate from the fair value expensed for these instruments in the financial statements, but the deviation must be quantified and explained. If a company has 10 years of history proving that only 50% of the value expensed in its income statements has ever been realized by recipients, that may be a very good reason to differentiate these values.

Implementing, tracking, and updating the action items above will be time consuming and require additional rigor on the part of both companies and their stakeholders, but a more meaningful discussion about the largest component of executive compensation will be worth the effort. With public issuers making the effort to more clearly articulate actual realized value and corresponding alignment with shareholders, the onus will pass to the various stakeholders to digest and understand this information and not revert only to the SCT as the main source of decision-making, or opinion-forming, information.



ABOUT **LANE CAPUTO**

Lane Caputo Compensation Inc. is an independent executive compensation advisory firm specializing in guiding boards and leadership teams in linking their organization's performance - from strategy to execution - to executive compensation programs.

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