



**Pearl Meyer**

## PSU Design Alternatives

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# Overview

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- Premium Price Options
  
- “Tandem” or “Gap” Awards

# Premium-Priced Options

- ISS/GL prefer NEOs have the majority of LTI delivered in the form of “performance-based” equity
  - They do NOT consider standard “plain vanilla” options to be performance-based
- However, options granted with a premium exercise price may qualify as performance-based
  - Exercise price must be at least +10% higher than the stock price on the date of grant
  - The premium should be higher if the stock price is relatively low
    - E.g., a company whose stock price averaged \$25 last year, currently trading at \$10, would likely need an exercise price “substantially higher” than \$11 for ISS/GL to deem the options performance-based
- Note that adding price-triggered vesting will also result in “performance-based” classification by ISS/GL
  - Also, as illustrated on the next page, a price-vesting grant can often deliver more value to the participant than the premium price approach

	Advantages	Disadvantages
Premium strike price	<ul style="list-style-type: none"> <li>• Vesting certainty based on time</li> </ul>	<ul style="list-style-type: none"> <li>• Lower per unit value results in higher burn rate</li> <li>• <b>However, Black-Scholes valuation generally “undervalues” the price premium</b> (see example on following page)</li> </ul>
Share price vesting	<ul style="list-style-type: none"> <li>• <b>Once vested, participant gets full value of the award</b></li> </ul>	<ul style="list-style-type: none"> <li>• Price volatility could result in faster vesting than anticipated – undermining the retention value of the award</li> </ul>

# Comparison of Premium-Priced Options and Price-Vesting Options

- Assume the current stock price is \$30:
  - Fair market “plain vanilla” options would have a Black-Scholes\* value of approximately \$12.87
  - So, a \$100K target award would be 7,770 options
- If options were granted with a \$35 exercise price:
  - Assuming the same inputs, the B-S value would be \$11.41 per option, resulting in a grant of 8,764 options
    - Note that the \$5.00 price difference only decreases the Black-Scholes value of \$1.46
- If options were granted with a \$30 exercise price, but vesting tied to hitting a \$35 stock price
  - Again, assuming the same inputs, B-S value would be \$11.15 per option, resulting in a grant of 8,969 options
- Assume the stock price reaches \$50
  - The FMV vanilla option grant delivers a gain of \$155,400
  - The premium priced grant delivers \$131,460
  - The price vesting grant delivers \$179,380
- So, in this scenario, a price-vesting provision would be better than a premium-priced option
  - The Black-Scholes values are relatively similar, so there is no significant difference in share utilization
  - The participant receives significantly more value from the price-vesting alternative (i.e., there is incremental upside opportunity in return for the incremental risk)
  - NOTE: results are *highly variable* based on each company’s assumptions; this comparative analysis should be run as part of any grant consideration

\* *Black-Scholes assumptions:*

- *Option term 10 yrs*
- *Volatility 30%*
- *Risk-free rate 2%*
- *No dividends*



## Tandem or Gap plans

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- Many companies are reluctant to cancel or modify in-flight PSUs
  - Potential negative reaction from ISS/GL
  - Limited ability to meaningfully reset multi-year goals, given continued uncertainty and volatility
- However, in-flight cycles with pre-COVID goals may be viewed by participants as unrealistic/ unachievable
  - On the other hand, we've seen several examples of companies who have performed better than expected – with plans plan at or near target relative to original goals
- Two potential alternatives to amending in-flight grants:
  - A “tandem” plan – the original plan remains in place; a second award is layered with the original plan (may reflect different time frame and/or different metrics); participant receives “greater of” payment
  - A “gap” plan – the original plan remains in place; a second award is granted to provide additional “downside” protection. Opportunity under the second plan is capped to avoid double-counting



## Example Tandem Plan

- Original PSU granted with a three-year performance period 2020-2022
  - Target Award: \$100,000 (i.e., annualized value of \$33,333)
    - 50% revenue growth
    - 50% EBITDA growth
  
- Tandem PSU granted with two-year performance period 2021-2022
  - Target Award: \$66,667 (i.e., same annualized value of \$33,333)
    - 100% EBITDA margin
  - Rationale:
    - Target award recognizes shorter performance period
    - EBITDA margin metric responds to uncertainty in revenue growth goal-setting; rewards company for managing expenses to respond to whatever market conditions exist
  
- Tandem PSU provides for payout/forfeiture contingency:
  - Any award earned under the tandem grant is offset by the value of any award earned under the original PSU
    - By adding the contingency provision to the new grant, no modification is required for the original grant, so there is no “new measurement date”

# Example Gap Plan

- Original PSU granted with a 3-yr performance period 2020-2022
  - Target Award: \$100,000
    - 50% revenue growth
    - 50% EBITDA growth
  - Performance leverage sets threshold, target and maximum payouts

	Revenue	EBITDA	PSU Payout
Max	\$1.05B (+11.8% YOY)	\$240M (+29.6% YOY)	\$200,000
Target	\$1.00B (implied +6.5% YOY growth)	\$200M (implied +8.0% growth)	\$100,000
Threshold	\$0.95B (+1.2% YOY)	\$185M (equal to LY)	\$50,000

- Gap PSU provides additional downside protection/award opportunity, e.g.,
  - Incremental Gap Target: \$25,000
    - No payout below target
    - Max performance set equal to original threshold

	Revenue	EBITDA	Gap Payout
Max	\$0.95B (equal to original threshold)	\$185M	\$37,500
Threshold	\$0.75B (-20% YOY)	\$185M (equal to LY)	\$25,000



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