THOUGHT LEADERSHIP FROM FW COOK

STRETCHING FOR THE STARS

An aspirational compensation program just may give your executive team the incentive to go above and beyond—but at what cost? Here's a look at pros, cons and best practices.

GENERALLY, COMPENSATION programs are carefully designed to reward executives when companies outperform their peers on metrics deemed to best align with strategic goals. But what about when a board wants its executive team to do more than outpace competitors—wants, in fact, for them to shoot for the moon? It stands to reason that a stratospheric target should warrant something more than the standard mix of salary plus annual and long-term incentive pay, but what?

Elon Musk's name is synonymous with stratospheric targets, so it's perhaps fitting that his compensation plan at Tesla is among the best-known models of aspirational pay, or tying a large payout to the achievement of stretch goals. Announced in 2018, the 10-year plan called for Musk to receive nothing at all unless Tesla's value jumped from its $60 billion at the plan's inception to $100 billion. However, hitting that target along with certain financial goals would only trigger the first of 12 equity tranches of 1.68 million stock options, with each $50 billion in market cap growth thereafter and a financial goal, earning an additional tranche.

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>
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Musk's comp plan made headlines and is also credited with an uptick in incentive pay programs that seek to incent skyrocketing performance by dangling astronomical payouts in front of executives. While still unusual, such plans are becoming more common, particularly in high-growth industries and the tech sector, where both fierce competition for talent and the desire to motivate potentially game-changing strategic actions may be fueling the increase, points out Michael Chavira, a managing director at FW Cook. These plans are sometimes used in situations where the CEO is a founder with an already-meaningful ownership stake (like Musk) or where executives have been rewarded well for strong performance to date and such a plan incents them to achieve the next stage of company growth, he adds.

"Most companies stick with a traditional incentive program tied to their strategy, but some choose to layer on top a 'home run' plan that pays out extra if the company reaches stretch goals, often tied to stock price," he explains, noting that the performance-based nature of the awards tends to mitigate shareholder pushback. "The rationale is that they only pay out if you hit an aspirational level, and if you get to that level, shareholders should be pleased."

DESIGNED TO INSPIRE

By definition, aspirational plans are tied to significant performance milestones. However, design features vary. Basic 'home run' plans simply tie equity awards to stock price hurdles, essentially relying on the metrics of

Elon Musk's Tesla Pay Tranches

Tranches Earned	Est. CEO Value Realized ($B)	Est. Shareholder Value Realized ($B)	% of Value Realized by CEO	% of Value Realized by Shareholders
0 Tranches	$0.0	<$41	0.0%	100.0%
2 Tranches	$1.4	$91	1.6%	98.4%
4 Tranches	$6.3	$191	3.3%	96.7%
8 Tranches	$25.3	$391	6.5%	93.5%
12 Tranches	$55.8	$591	9.4%	90.6%

the underlying compensation program to also incent operational and financial performance. More complex arrangements call for hitting additional financial metrics. "There may also be a comparison to a broader index, where you need to exceed the performance of that index to get a full payout," explains Chavira. "That way, the company isn't paying out the maximum if the higher price performance is related to a broader stock market increase."

Still, other plans link payouts to financial goalposts, such as revenue or profitability hurdles. In addition to raising Tesla's market cap, for example, Musk needed to hit revenue or EBITDA targets to earn his options.

Ideally, in addition to rewarding exceptional performance and potentially motivating transformational strategic actions, an aspirational pay program should incorporate risk-mitigation features. "Stock price hurdles are generally measured over a 30-day, 60-day or longer period to ensure that performance is sustained," explains Stephan Bosshard, a principal at FW Cook. "At Tesla, market cap hurdles must be achieved based on both 6-month and 30-day trailing average."

Given the potential for large payouts, retention is also an important consideration when designing aspirational pay programs, adds Chavira. "It is important that longer vesting be associated with the awards so that executives cannot take the money and run. It also ensures that decision-making is in the best interest of the shareholders and the long-term success of the company. It is an easier sell to shareholders if the program balances performance and retention."

Stock holding requirements after vesting further align executives with the long-term interests of the company. For example, Tesla's plan calls for a five-year, post-exercise holding period designed to mitigate extreme risk-taking and to ensure shareholder alignment.

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POTENTIAL PITFALLS

In designing aspirational compensation plans, companies are also mindful of how such equity grants will be valued for disclosure purposes. "Many of these plans are designed to have a grant date fair value in the proxy summary compensation table that is much lower than the potential payouts," explains Chavira.

At Tesla, for example, Musk earned the maximum payout of $55.8 billion when the company's market cap hit $650 billion (now that the market cap is hovering at $900 billion, his ultimate realized value is actually higher). Yet, the disclosed grant value in the proxy was just $2.6 billion based on the award's grant date accounting value. Using options over full-value shares, setting aspirational performance targets and adding the five-year holding period all contributed to reducing the valuation.

Boards should also be aware that how grants are treated from an accounting perspective will vary depending on the metrics being used and other plan features, such as holding periods. "When you design the plan based on financial performance and don't hit your goals, you can reverse the expense," notes Bosshard. "But if you use market conditions like stock price, the expense is fixed on the grant date and cannot be reversed."

It is also important to consider what will happen in the program's aftermath. Will it be viewed as setting a precedent that executives will expect to continue going forward? Will morale or retention be negatively impacted if the target isn't hit? "You do need to be careful, because once you do one, you may be setting an expectation for the next one—and reaching and sustaining this kind of aspirational performance is difficult," cautions Chavira.

As with any atypical compensation feature, companies that adopt aspirational plans also risk attracting scrutiny. However, because most aspirational awards are tied to significant share price performance, shareholder pushback tends to be minimal. Companies concerned about shareholder ire can also consider Tesla's tactic of having shareholders vote on the program. "Tesla asked shareholders to approve the structure," says Chavira, who notes that unlike Say on Pay votes, the results of a shareholder vote on an aspirational program are binding. "Whenever you feel you're pushing the limits on compensation, you always have the option of putting it to a shareholder vote."

Michael Chavira, managing director at FW Cook, has over 20 years of experience designing total compensation strategies, including short- and long-term incentives.

Stephan Bosshard, principal at FW Cook, has over 15 years of experience providing consulting services in various compensation matters, including incentive design and executive and director compensation benchmarking.