Illustration Francesco Galle

Executive compensation

By Ken Hugessen

Think share units, not options

Aligning pay to performance in struggling mining and energy markets is hard, especially if executive pay packages are based on stock options. But there is another way

The last few years have brought many challenges for the mining and energy sectors in Canada. Continuing global uncertainty has slowed economic growth, and with it, demand for Canada's natural resources output. According to the Mining Association of Canada, the 2008 recession significantly reduced mineral demand and prices, and while both have bounced back since, concerns over U.S. and European debt and inflation in China have brought further market uncertainty. Beyond these macro environmental forces, the Canadian oilsands are also facing expansion challenges due to Alberta's constrained pipeline capacity and rising competition in the U.S. as new technologies emerge that allow for the exploitation of domestic reserves that were once unfeasible to develop.

These changes raise the question of how to assess the performance of these companies when the whole market is struggling, and specifically, how to measure and fairly reward management's contribution to company performance. Notwithstanding the current environment, the retention of executives remains a challenge, as does maintaining the motivation and focus essential to achieve the best possible results for the company.

These challenges are amplified for the many companies in the mining and energy sectors that have relied on stock options as the primary form of incentive compensation, and which are currently providing little if any payout. While it may be hard to argue with rewarding management for increasing stock prices, there is growing belief that options can overcompensate executives in a bull market, while under-compensating when the market's weak. As such, recent flat or declining share-price performance has hit option-dependent programs harder than other incentive programs, raising questions about the usefulness of options.

To reduce (but not eliminate) the impact of flat or declining markets on stock incentives, one strategy widely used by large issuers is to shift a portion of executives' options into some form of three-year restricted or performance share unit (RSU/PSU) program with either time-based vesting and/or with vesting tied to performance. While time-based RSUs are straightforward, they are often criticized for their lack of performance conditioning and because they maintain value in any scenario short of bankruptcy. As a result, more companies are moving towards PSU programs, or at least a mix of PSUs and RSUs.

After deciding to include PSUs in executives' long-term incentive compensation, the key decision is to choose an appropriate performance metric. While some companies will look at financial goals to determine PSU vesting, most use total shareholder return (TSR). TSR compares a company's total shareholder return to an index or peer group. Three years is the standard timeframe as this is the maximum tax deferral period permissible in Canada for cash-based plans. The resulting PSU award is dependent upon share-price performance relative to peer companies or a recognized index. And while for some companies a tailored peer group may be more suitable to benchmark against, measuring performance against an index can be simpler and easier to explain.

Mid-size and smaller issuers can easily adopt share-unit concepts already in place for large issuers and enjoy the benefits of less volatility yet still have performance-sensitive equity incentives that reward deserving executives in hard times.

Next, companies need to decide if they will assess performance by measuring the company's position among the performance hierarchy of the companies in the peer group or index, or within a range around the median TSR of the peer group/index. Finally, the company will need to decide on whether to use a single three-year performance measurement period, or to allocate some weighting to performance in each year within the three-year performance period. Assigning some weighting to each year's relative TSR performance will tend to reduce volatility of payouts.

RSU/PSU plans are already used by most large issuers, so mid-size and smaller issuers can easily adopt a similar approach and enjoy the same benefits of less volatility, while still providing performance-sensitive equity incentives. While stock options will no doubt remain an important and widely used form of compensation in the mining and energy sectors, industry cyclicality will make the payouts from these plans extremely volatile—a well-designed RSU/PSU plan can be an important complement to stock options, providing better retention and rewarding good performance relative to competitors, even in difficult times.

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