

The art of vesting curve calibration: Interplay of aspiration and riskiness

The design and management of long-term incentive programs ("LTIP") for both top executives and employees is becoming increasingly challenging not least due to numerous technical aspects such as definition of performance measures, vesting curve patterns, maximum vesting levels, etc.¹

¹ See also "[Three key questions to structure an LTIP discussion](#)".

This paper focuses on calibration questions of vesting curves regarding target level and riskiness. In our long-lasting industry experience, we have observed how even well-designed compensation schemes will at times fail, and then mainly because they are either too sensitive or not sensitive enough to market developments and performance fluctuations.

The key lies in identifying an appropriate aspiration level for target performance as well as adequate performance sensitivity of payouts realizable from such plans.

Considerations for targets and aspirations

When determining the target performance level companies commonly rely on one or more of the following reference points:



The mid- to longer-term strategic planning of management typically involves ambitious forecasts of business performance, qualifying it as a potential source of demanding performance targets for LTIPs. Yet linking the achievement of management planning to the realization of expected or above expected vesting requires the Board of Directors to quantitatively assess the inherent ambition level of management's planning. Specific questions include evaluating whether linking "at target" LTIP outcomes to the accomplishment of the strategic plan seems adequate considering that LTIPs form a part of employees' competitive pay packages in the majority of listed companies in Switzerland.



Equity analysts' estimates could be seen as more objective external assessments of expected company performance. However, this approach calls for sufficient coverage (with similar level of content) and availability of estimates prior to the LTIP grant on a regular (annual) basis. Further aspect to bear in mind is a

potential "instability" of the equity analysts estimates over the LTIP's performance period as they are continuously updated to reflect latest available information.

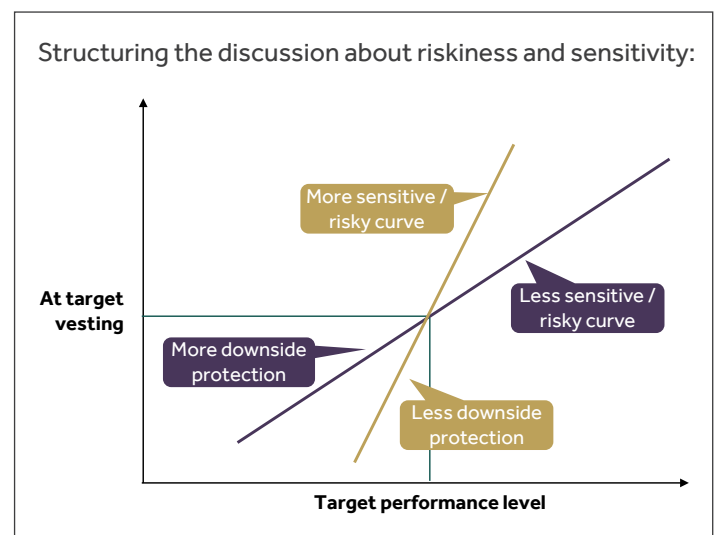


As an alternative, appropriate objectivity and, hence, positive perception from both plan participants and investors could also be achieved by linking expected vesting under the LTIP to the (operational) performance level associated with investor return expectations on the market value of a company. This is done by multifactor valuation models and statistical analysis, the outcomes of which are further benchmarked against historical company performance and/or peer performance. Management strategic planning and analysts' estimates do not have an impact on this methodology yet serve as a reference point in the decision-making process.

Considerations for riskiness and sensitivity

Once consensus about the target performance level is reached within the Board of Directors, the focus can shift to the sensitivity of the LTIP vesting to performance changes below and above target performance level.

In our experience, long-run robust compensation systems are characterized by symmetric curves where significant declines or improvements in performance lead to proportionate payout decreases or increases (see illustrative graph below).



The following two basic alternatives can help deciding on the inherent risk of the curve:



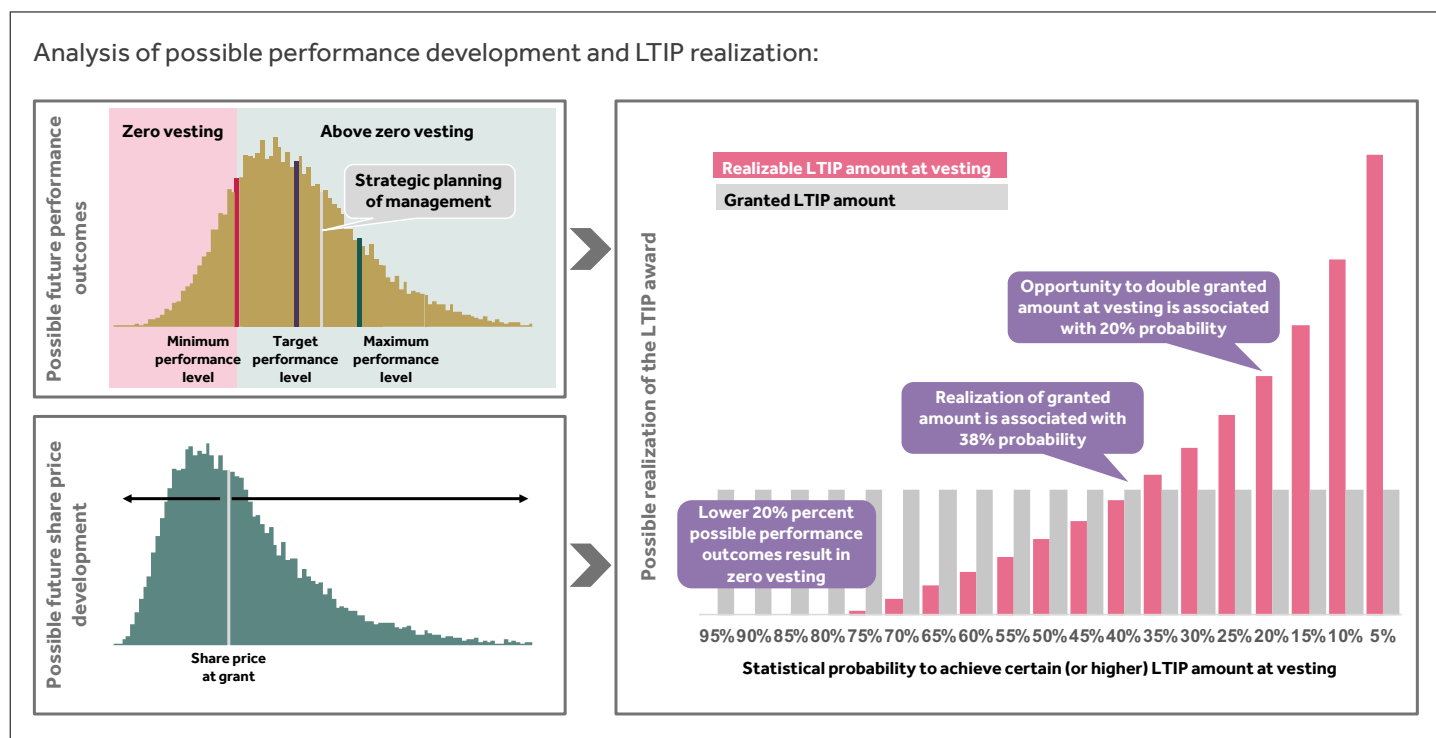
"Probability considerations" suggest that the riskiness of the vesting curve should be set in a way that above zero vesting is achievable with a certain statistical probability (commonly 70% to 80% for LTIPs considered part of competitive pay packages).



"Investor return considerations" suggest that the sensitivity of performance achievements and reward outcomes should be set in a way that vesting is only enabled once positive investor return is achieved over the LTIP performance period.

Independent of the opted approach, integrating different views and perspectives when quantifying a vesting curve for a performance-based LTIP can reinforce the Board of Director's confidence in the overall quality and robustness of the suggested financial targets and, thus, the overall LTIP viability.

Modelling possible vesting scenarios and simulating future LTIP outcomes provides further insights into how LTIPs "behave" in general and/or in particular situations and considerably supports the decision-making process on Board of Directors level (see illustrative graphs below).



Finally, the disclosure of the target setting process in compensation reports eases the communication and may positively impact shareholders' assessment of the opted approaches by creating comprehension and acceptance. In this regard, it is also essential

to illustrate the implications and interlikages of the opted approaches with the company's overall pay strategy².

² For further insights regarding communication, see also also "[Lessons Learned aus Say-on-Pay 2020 – 7 Leitsätze zur Vergütungskommunikation](#)".

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