Chemical Industry Long-term Incentives: Relative TSR Remains in the Driver's Seat

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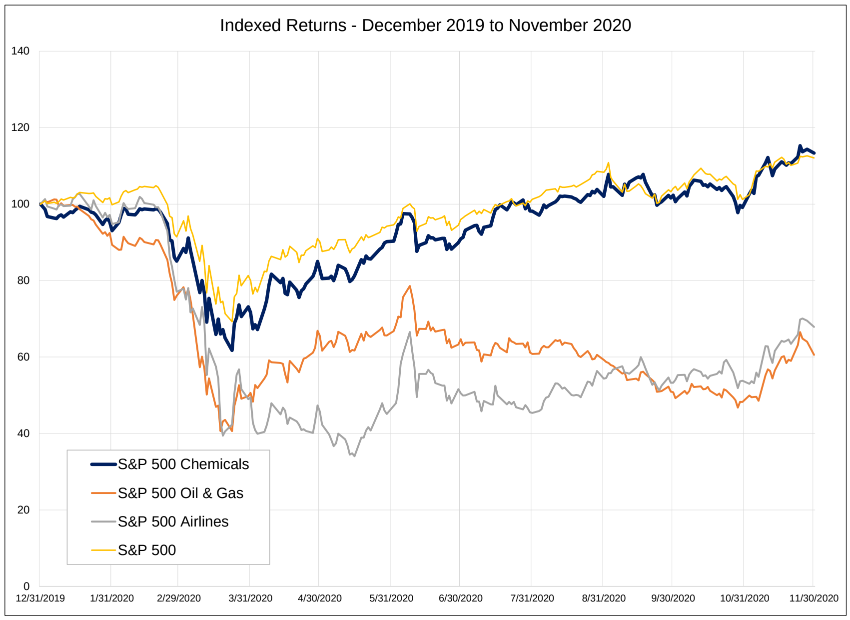
In July we observed that the chemical industry seemed to be weathering the COVID-19 storm better than some industries within the S&P 500. While more challenged industries like airlines and oil and gas took widespread actions to cut compensation and capital expenditures, only a handful of large chemical companies had announced any such actions. In fact, as shown in the chart, through the end of November, the chemical industry as a whole has made up for early stock price declines and is tracking closely with the S&P 500.



Of course, this index result does not necessarily mean everything is going well or has returned to pre-COVID levels – for example, revenues and earnings are down across the industry. In addition, the term "Chemical Industry" refers to a broad group of companies that fall into a variety of categories. Perhaps most importantly for compensation planning purposes, uncertainty still reigns supreme. Depending upon product mix and geographic footprint, there are still legitimate concerns regarding global economic conditions, long-term demand cycles, environmental issues, supply chain disruptions, and workforce productivity. Despite promising news on vaccines, we are seeing a second wave of COVID-19 infections spurring new restrictions in the United States and in other parts of the world. A new presidential administration may also bring changes in tax and regulatory regimes – the likelihood of this will become clearer after the Senate runoff elections in Georgia. In this environment, companies continue to discuss and reconsider their compensation plans, with the possibility of design changes for 2021 to deal with the current situation.

In the face of this uncertainty, most compensation committees initially turned their focus to administration of the annual incentive plan: how to approach decision making with regard to 2020 payouts. With year-end fast approaching and year-end stock prices slightly less difficult to predict, companies are also thinking about the impact of COVID-19 on long-term incentive compensation:

- Whether and how to address "in-flight" long-term performance plans
- What design changes, if any, should be considered for 2021 awards

What to Expect for In-Flight LTI Awards

Compensation Committees are typically much more reluctant to adjust metrics or outcomes for long-term incentive plans than they are for annual incentive plans. We expect that reluctance to hold sway again for 2020, with fewer adjustments to in-flight LTI as compared to in-flight STI plans. As a result, the list of *things we don't expect to see* (except in extreme situations) is longer than the list of actions we think committees may take:

What We Don't Expect for in-flight Performance Plans	What We Do Expect for in-flight Performance Plans
☒ Repricing or exchanging of options ☒ Explicit replacement of lost equity value, especially for time-based shares ☒ Adjustment to relative performance measures (e.g., relative TSR) ☒ Widespread use of discretion to move payouts above target	☑ Committees to thoughtfully consider action for plans / payouts with absolute financial performance metrics ☑ Committees to wait until the end of the applicable performance period to consider any action

Across the chemical industry, relative TSR remains by far the most common long-term performance metric, used by between 60% and 70% of large U.S. chemical companies. However, a significant number use absolute financial performance metrics like return on capital or EPS in place of or in combination with relative TSR. Any decision on adjusting outstanding awards should incorporate a variety of considerations, including:

- How profound is the impact of COVID-19? Is the impact material enough to merit consideration, or should plans be allowed to play out? A consistent approach over time should, in most cases, mean that payouts average somewhere around target – adjustments within individual performance periods can throw off this balance.
- If all plans are completely "out of the money," does the Board have retention concerns, with the possibility of employees, especially staff roles, leaving for other sectors with outlooks that are more favorable?
- How easily can the COVID-19 impact be isolated? Some companies may simply choose to truncate their 3-year performance period through the end of March and prorate payouts accordingly – we have seen this approach used with a few early filers.
- How much sacrifice has there been elsewhere in the compensation program (e.g., salary reductions and reduced or eliminated 2020 bonus)? More sacrifice elsewhere may mean the committee is more open to considering adjustments or providing other rewards.
- What is the nature and depth of the impact on shareholders and other stakeholders?
- Were employees laid off or furloughed? Were there widespread pay reductions?
- What are the accounting and disclosure implications of any potential actions? Will the company need to engage in shareholder outreach to reinforce its story?

What to Expect in Performance-based LTI for 2021

Heading into 2021, we expect to see significant variability in how companies calibrate their long-term incentive values relative to 2019 and early 2020. Companies whose stock price has recovered, but for whom performance awards with absolute financial metrics have been negatively impacted by the pandemic, may consider enhanced 2021 grant values as a way to boost retention and reset the incentive bar to keep employees "in the game" without making potentially unpopular and technically complex adjustments to outstanding awards. Meanwhile, some companies may face share constraints that limit their alternatives, or may determine that awarding the same or similar value or number of shares is the more appropriate approach given the circumstances.

Based upon our own internal client surveys and experience thus far, we also expect to see:

- **Increased weight on time-vested restricted stock (RS) / restricted stock units (RSUs)…within reason.** RS / RSUs can help boost retention and progress toward meaningful share ownership – and in an uncertain environment, it can become much more attractive to employees than the potential upside of a performance-based award. For companies where restricted stock currently makes up less than 50% of LTI value, or where LTI grant values are falling year-over-year, it may be easier to make a compelling case this change externally. However, companies should expect pushback if time-based restricted stock (for the CEO in particular) starts to make up more than 50% of total LTI value, or if the added RS / RSU portion is part of a meaningful increase in total CEO pay year-over-year. ISS has already indicated in their recent FAQs that they will view weightings of > 50% on RS / RSUs unfavorably, and they instead favor use of other approaches to managing uncertainty with goal-setting, such as shifting to TSR (see next point).
- **Temporary pause in the trend toward more absolute financial metrics in LTI plans.** Reliance on TSR as a driver of long-term incentive plans has been under fire over recent years (prior to COVID-19), from investors and from award recipients. Many investors prefer to see greater use of financial and operational metrics that support sustainability, align with the purpose and strategy of the organization, and measure what management is doing to drive results. However, despite increasing criticism of its shortfalls, relative TSR is popular because it communicates clearly to shareholders the importance of direct alignment, and it **eases the process of multi-year goal setting**. Given all the uncertainty faced by chemical companies entering 2021, we expect these advantages to drive a temporary increase in prevalence of TSR as a performance metric.
- **Possibility of shortened performance periods**. Another potential lever available to companies trying to tune their plans to react to uncertainty is to shorten the period over which performance is measured. Shorter performance periods can reduce the pressure to develop appropriately challenging but achievable multi-year measures. Shorter performance periods can also help focus employees on the critical financial and operational milestones that must be achieved in the near-term to help weather the storm, while multi-year vesting stays in place to preserve the long-term nature of the plan and promote retention. However, companies who are shortening their performance periods should prepare for external pushback, particularly from advisory firms who may no longer consider such awards truly "long-term." The shortened performance period concept commonly takes one of two forms (1) a 1-year or 2-year performance period followed by a time-based vesting to arrive at an overall 3-year timeframe or (2) setting of 3 individual 1-year goals, with an overall vesting requirement of 3 years.

Despite challenges, most chemical industry companies appear to be heading into 2021 reasonably well positioned, with recovering stock prices and a correspondingly wider array of viable compensation alternatives than are available to companies in more challenged industry sectors. There are also optimistic reports about a "light at the end of the tunnel" for COVID due to significant progress on the development and initial distribution of a vaccine. That said, with a recent second wave of infections and all-time highs for hospitalizations and fatalities, a high degree of uncertainty remains. For successful long-term incentive compensation design in 2021, flexibility and a willingness to adapt will be critical, as will the ability to balance both internal and external considerations. Of course, the Chemical Industry is accustomed to volatility and managing through uncertainty – in this sense, 2021 may not be much different from any other year in executive compensation for the chemical industry.