GRG Remuneration Insight 79

Retesting Long Term Incentives

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Introduction

Retesting of long term incentives (LTI), where executives are given more than one opportunity to meet LTI vesting conditions by changing the measurement period, has not been well regarded by external stakeholders for some time. However, with stakeholder groups calling for LTI measurement periods to be extended beyond three years, an unexpected compromise has emerged, and it involves retesting.

Retesting's Chequered History

The retesting of LTI developed a bad reputation when it started to be used in ways that clearly advantaged management, and undermined the efficacy of LTI as a motivator and alignment tool. For example there were cases where the retesting of total shareholder return (TSR) vesting conditions would move both the start and end dates by say 12 months, so that if no LTI vested due to poor performance in one measurement period, the whole measurement period could be shifted to one that would trigger vesting. This also resulted in cases of two grants of LTI vesting in relation to the same performance or measurement period, often referred to as double dipping.

In some retesting arrangements, retesting could occur even if vesting occurred at the earlier test, and provided opportunity for additional vesting of LTI, without the downside of clawing back vested LTI if the outcome was worse than at the previous test.

These cases led to criticism of retesting as only benefiting management by providing an opportunity for two bites of the cherry. In some cases there were so many opportunities to retest that it was unlikely that some vesting would not occur.

Clearly such arrangements did not align with the principles of good governance, or even of ensuring that LTI was at-risk and providing an appropriate motivator for management to focus on long-term value creation.

Retesting Set to Rights

GRG takes the view that when retesting is applied appropriately to performance rights, it can produce improved governance and stakeholder alignment outcomes at the same time as ensuring more appropriate reward outcomes under the LTI plan. This is particularly the case for market-based vesting conditions, which tend to be subject to a number of factors that are external to the Company and which often produce anomalies in share prices at specific points in time. This in turn can produce anomalies in TSR calculations etc. Retesting could also apply to non-market vesting conditions if they may be subject to timing based volatility.

The features of a retest that GRG would generally consider to be appropriate are:

- There is only one retest opportunity,

- The retest may only apply if no vesting occurs at the initial test (therefore no "two bites at the cherry"),
- The start of the measurement period should not change for any reason,
- The retest should occur 12 months after the end of the original measurement period,
- The application of the retest extends the measurement period from (typically) three years, to (typically) four years, which creates the outcome often sought by external stakeholder groups (a four year performance assessment and measurement period which will not be the same as any other LTI measurement period – no double dipping),
- The vesting scale or hurdle is pro-rata increased in difficulty to account for the additional time made available (the cherry in effect becomes harder to reach, but is not taken off the table),
    - It is important that the additional time and retest does not and is not seen as making the vesting easier in any way, or increasing the probability of vesting in normal circumstances, it should be intended to address anomalies,
- The details and implications of the retesting approach, such as those outlined above, should be included in public explanations of the operation of the LTI plan (such as the Remuneration Report).

Such an approach supports good remuneration governance because;

- executives are not disadvantaged by timing issues in the calculation of the relevant performance measure,
- executives are less incentivised to game the system due to timing of particular events or decisions that need to be addressed,
- executives are incentivised to perform even when it is clear that objectives will not be met at the end of a particular measurement period, and
- it improves alignment between the interests of shareholders (assuming they are linked to the LTI metric) and those of management in ensuring recovery of performance in relation to the metric and seeking performance that is sufficiently outstanding to compensate for the low performance as assessed at the end of the original measurement period.

Addressing the Concerns of External Stakeholder Groups

Whilst the ASX Corporate Governance Council's current Principles and Recommendations do not address retesting specifically, the principles espoused therein that relate to LTI make it clear that risk taking behaviour, fairness, alignment and issues of "short-termism" should be considerations in assessing LTI design. GRG suggests that the application of retesting in the manner described above is an appropriate contributor to addressing these considerations.

However, due to the dubious history of retesting a number of third-party governance observers, such as the ASA and proxy advisors, have taken a default position that retesting is to be discouraged in recent years. Based on GRG's conversations with the leading proxy advisors in 2015, this view may be shifting, but only where assurances can be given that the poor practices of the past will not be repeated.

Therefore, a key aspect of applying retesting will be the clear articulation of when and how retesting is intended to apply, and that the concerns with retesting have been considered and addressed.

It is important that when retesting applies, vesting scales are expressed in such a way that it is clear how the scale or hurdles would adjust in response to an extension of the measurement period.

The aspects of retesting that will tend to result in criticism from external stakeholders, summarised from a review of the current guidelines of various proxy advisors and the ASA include:

- when retesting applies for a period of more than one year following the initial test,
- when retesting results in more than five grants of LTI being in play at any one time,
- when retesting does not pro-rata increase the difficulty of hurdles but only provides additional time to meet the original hurdles,
- when retesting changes the start of the measurement period instead of extending the length of the measurement period applied to the original start date,
- when executives may be seen to get two bites of the cherry, and
- when executives may be seen to double dip for rewards linked to a single performance assessment.

GRG proposes that the retesting approach suggested in this article would not be subject to any of the above criticisms. Based on the experiences of our clients who have adopted such approaches, negative votes related to this structure have not been observed.

Examples and Illustration

The following is an example of a vesting scale that is commonly used and which cannot be scaled to account for additional time added to a measurement period, related to a retest:

Performance Level	EPS Growth	% of Stretch Vesting
Below Threshold	<9%	0%
Threshold	=9%	25%
Between Threshold and Target	>9% & < 12%	Pro-rata
Target	12%	50%
Between Target and Stretch	>12% & <18%	Pro-rata
Stretch	≥18%	100%

Because the scale is not expressed on an annualised basis, it cannot be pro-rata adjusted, and therefore applying retests to this scale would potentially decrease the difficulty. It would not be appropriate to apply a retest to this type of scale.

The following vesting scales are examples of conditions that would be conducive to pro-rata adjustment in the case of a retest, such that the difficulty scales with the measurement period (note that CAGR = compound annual growth rate):

External Metric - TSR Based Example

Performance Level	Indexed TSR of the Company	% of Stretch Vesting
Below Threshold	<TSR of the Index	0%
Threshold	=Index TSR	25%
Between Threshold and Target	>TSR of the Index, < Index TSR + 3% CAGR	Pro-rata
Target	Index TSR + 3% CAGR	50%
Between Target and Stretch	>Index TSR + 3% CAGR, < Index TSR + 6% CAGR	Pro-rata
Stretch	≥Index TSR + 6% CAGR	100%

Internal Metric - Financial Based Example

Performance Level	EPS of the Company (Start vs End of Period)	% of Stretch Vesting
Below Threshold	<3% CAGR	0%
Threshold	=3% CAGR	25%
Between Threshold and Target	>3% CAGR & <6% CAGR	Pro-rata
Target	6% CAGR	50%
Between Target and Stretch	>6% CAGR & < 9% CAGR	Pro-rata
Stretch	≥ 9% CAGR	100%

Both of these metrics are expressed on a time-independent basis and can apply to a multi-year measurement period of any length, without compromising the calibration of the scale or undermining the difficulty of achievement.

The following is an illustration of a typical performance rights LTI scheme with retesting, assuming grants began in 2010, and that 1 year retesting applied to every grant and that no vesting occurred at any first test of any grant (the worst case scenario, which would be highly unlikely in normal circumstances):

2010	2011	2012	2013	2014	2015	2016	2017	2018	2016 "Grants In Play" Count
Grant 1 Measurement Period			G1 Retest						
	Grant 2 Measurement Period			G2 Retest					
		Grant 3 Measurement Period			G3 Retest				
			Grant 4 Measurement Period			G4 Retest			1 Grant in Play
				Grant 5 Measurement Period					2 Grants in Play
					Grant 6 Measurement Period				3 Grants in Play
						Grant 7 Measurement Period			**4 Grants in Play MAX**

The diagram shows that, at worst, the measurement period of the LTI effectively becomes 4 years, and the outcomes are no different than those that would apply if the standard measurement period was 4 years. No more than 4 grants can be "in play" at any given time.

Conclusion

By giving appropriate consideration to retesting and adjusting plan rules and or offers where necessary to apply the type of approach outlined in this article, GRG would expect that most stakeholders would recognise the improved fairness, alignment, and motivational outcomes made possible by retesting. If clearly explained, significant opposition from the major external stakeholder representatives including the ASA and proxy advisors should not be expected. On the contrary, it would appear to GRG that it would make sense for them to support such practices in the future for the reasons outlined herein. Readers should feel free to make use of this article in discussions on the matter. Please contact us for further information on retesting and how your LTI plan might be adjusted to produce a better optimised framework.