EQUITY COMPENSATION CHALLENGES AND SOLUTIONS IN THE FACE OF MARKET UNCERTAINTY

April 22, 2020

CERTAINTY | INGENUITY | ADVANTAGE

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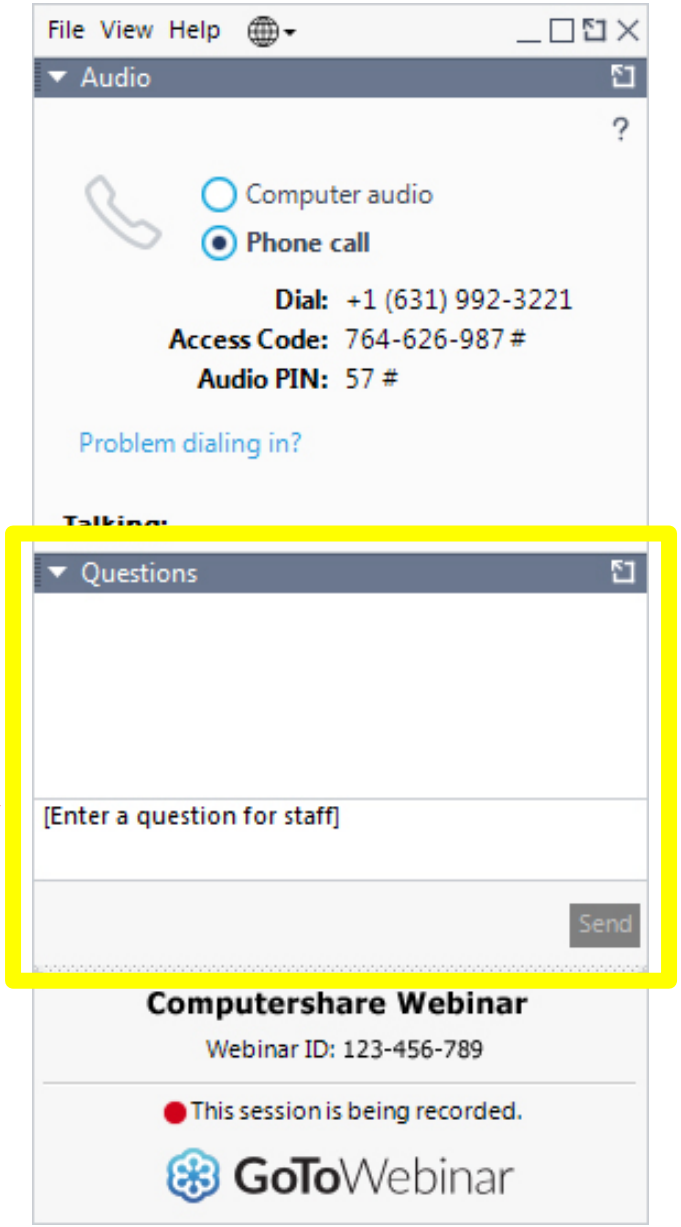

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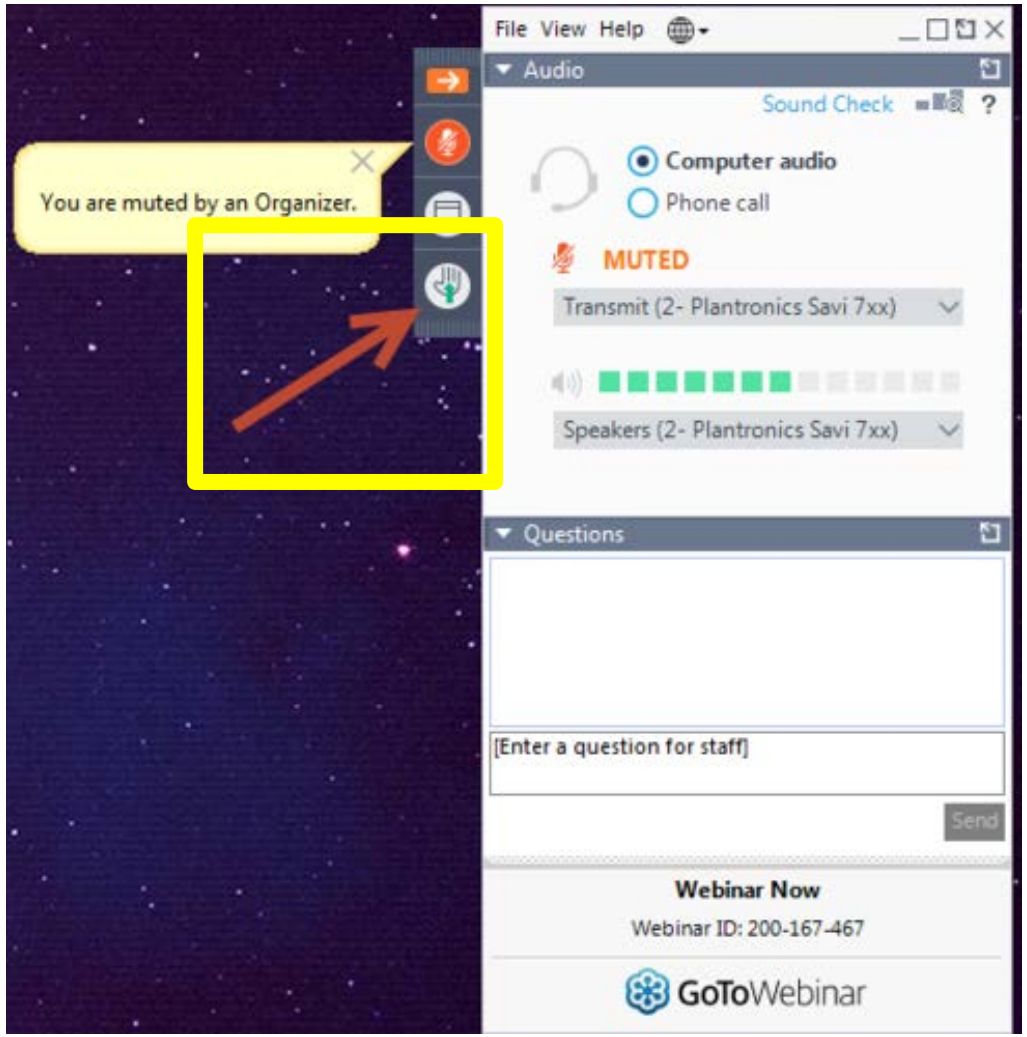

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Introductions

Jon Burg, Partner and Practice Leader, Infinite Equity

Jay Foley, Managing Director, Employee Share Plans, Computershare

Liz Stoudt, Partner, Infinite Equity

Andrew Schwartz, Vice President, Executive Services, Computershare

Sean Davis, Senior Solutions Specialist, Plan Managers, Computershare

Robyn Shutak, Equity Advisory Services Practice Leader, Computershare

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Equity Compensation Challenges and Solutions in the Face of Market Uncertainty

Jon Burg, Infinite Equity
Liz Stoudt, Infinite Equity

April 22, 2020

Sean Davis, Computershare NA
Jay Foley, Computershare EMEA
Andrew Schwartz, Computershare NA
Robyn Shutak, Computershare NA

INFINITE EQUITY

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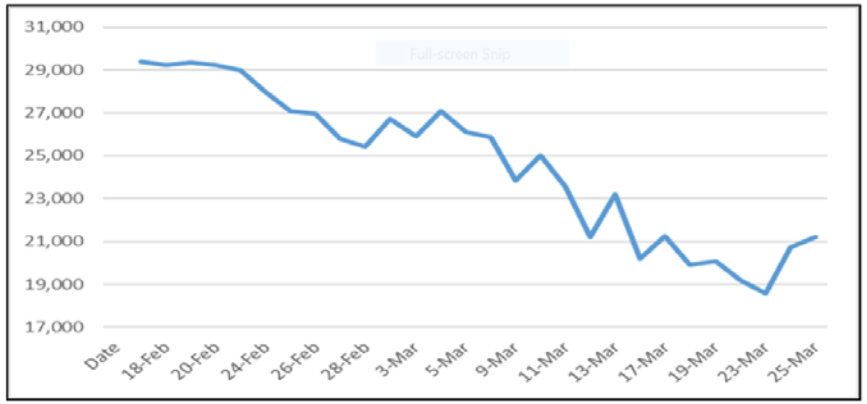
Present and Future State of Business

In General

- Covid-19 massive impact to global economy
- Economic situation remains highly fluid
- New ways of working, e.g., virtual shareholder meetings, work from home arrangements
- Wealth depletion

Figure 1. Dow Jones Industrial Average

February 14, 2020 to March 25, 2020



Source: Financial Times.

Compensation Programs

- New business challenges that were largely unexpected weeks ago impacting plan operations, design, etc., e.g., performance goal setting impacts, depletion in award values, furloughs/LOA's
  - Emerging actions/responses
  - How do we address these challenges/balance effective incentives with sensitivity to investor, public and political perception
  - No one size fits all
    - Was 2008 Financial Crisis a dry-run for current pandemic?

Equity Compensation and Market Uncertainty

Despite the current market environment, equity compensation **aligns with strategy and success**

Management

- **Attract, retain, and motivate** employees
- Focus employees on **key company objectives**
- **Drive shareholder value** with effective equity compensation programs

Employee

- **Broad ownership** allows employees to participate in the growth of the company
- Ownership **motivates and rewards** key employees
- Employees with ownership are more **satisfied and engaged** with their company

Shareholder

- Employee ownership will **align** employee motivation and performance with shareholders
- Balance broad ownership with **dilution**
- Compensation delivered **highly correlated** with shareholder returns

Equity Compensation Design and Market Uncertainty

Certain forms of equity perform better in maintaining value in a down market or contain characteristics that allow for better responsiveness

Stable Value	Unstable Value	Responsive
• Restricted Stock Units • ESPP & Matching Schemes	• Stock Options • Performance Share Plans with Absolute Measures	• Performance Share Plans with Relative Measures • Indexed Vehicles

Overview of Client Actions Globally – March to April 2020

COMMUNICATIONS

Initiating a stock purchase plan communications campaign targeted at program features, e.g., contribution adjustments, withdrawal procedures; tax implications

SCHEDULING

Annual grant delayed to summer; delayed launch of new enrolment period for SIP, GESPP and SAYE

INCENTIVES

Offering matching shares without participant contributions; establishing Employee Benefit Plans to minimize share acquisition costs; cash bonus to supermarket workers; hospitality co. suspending company match under share plan

STAFFING

Skeleton crew handling benefits program due to furloughs (retail client)

CORPORATE ACTIONS

Initiating a reverse stock split to minimize the number of shares in the market and boost stock price

Short to Long-term Considerations
Equity Compensation During Downturns

- Immediate
- Immediate to Mid-term
- Long-term

Immediate Considerations: Communications

Communications

Outstanding Equity Awards may provide reduced retention value and may result in disgruntled employees.

Challenges

- Employee **engagement is down** and **morale is low**.
- Pre-pandemic full-value award grants have **materially diminished in value** and stock option grants are now **underwater**.
- No **budget** to spend on a new program.
- Employees **not in the workplace**.

Solutions

- **Feature the benefits of your stock purchase plan.** These programs have a direct impact on employee productivity and talent retention.
- Leave your programs alone for now—**change-up your messaging**. Review range of communications channels.
- Consider a targeted communications campaign highlighting why your stock purchase plan is a great tool to **insulate employees from macroeconomic disruptions**.

It's times like these where companies fully begin to understand the real value that an stock purchase plan can have for productivity and talent retention.

Communications

Plan participation and leaves/furloughs

Impact to participant contributions

Employees still receiving pay through payroll **versus** employees on unpaid leave

Step 1	Step 2	Step 3

• Understand the detail of the arrangements you are considering in each country, e.g., UK COVID-19 Job Retention Scheme versus US rules	• Review compensation arrangements, i.e., your plan rules, LOA policy, participant documentation	• Identify employees affected
		  • What is start date of leave?
		  • Does employee have right to re-employment

Communications

US participant taxation:

Sales of ESPP Shares	Incentive Stock Options (Cash Exercises)
Disqualifying dispositions: Income = ALWAYS discount on purchase date	Spread at exercise added to AMT income in calendar year of exercise
Qualifying dispositions: Income = Discount on grant date price (beginning offering price) • If sale price < discounted price at grant date, no ordinary income	If underlying stock sold before end of year, avoid AMT income
IRS Limit on Net Capital Losses: $3K PY • Look to offset with stock with gains • Loss carried forward for life	If sale price < exercise price, no ordinary income
	Look out for Wash Sales • Sell stock at loss • Purchases of same stock 30 days before or after sale • All or part of loss disallowed • Dividend reinvestment and automatic purchases, 401(k) company stock purchases

Implications should be communicated to participants.

Immediate to Mid-term Considerations: Canada - Plan Design Considerations

Canadian Employee Benefit Plan Trust

An Employee Benefit Plan Trust facilitates the purchase and holding (until vesting of RSUs/PSUs) of shares at the current share price, thus crystalizing the cost of the shares at the current share price

Scenario

- A Canadian company/subsidiary grants various awards, including RSUs and PSUs to its employees
- Awards settle in 3 years with shares acquired on the market at vesting
- Company's share price has decreased significantly and suddenly but is expected to increase again over time
- Company is looking for ways to potentially minimize future share acquisition costs related to settling these awards

Considerations

- Company must have sufficient funds on hand which it can afford to utilize
- Does not guarantee cost savings to company, as share price at vesting may be lower than it is at purchase
- Detailed rules as to when plan sponsor can expense employer contributions for purposes of income tax; however, in general, plan sponsor can expense employer contributions only when shares are distributed from the trust and at their original cost

Administration

- Forfeitures: Can purchase enough shares to bring trust to a certain coverage percentage (100% or less)
- Dividends not paid out of trust in same year as received
  - Can have dividends distributed from trust back to plan sponsor (client) as income, where such funds are retained or contributed back to trust as an employer contribution
  - Trustee can hold shares as registered shareholder with dividend waiver in place (where awards don't attract dividend

Award Sizing and Dilution

Award Sizing and Dilution

There are generally two approaches for award sizing in **omnibus plans**:

Approach	Down Market Challenges	Solutions
1. Value-Based	• Grant a lot more shares than expected resulting in an increased burn rate • May need to request additional shares sooner	• Best practice: Use averaging periods vs. spot price to smooth volatility • Reduce or defer grants until market stabilizes • Separate annual grant into multiple grants throughout year for dollar cost averaging
2. Fixed Shares	• Award recipients may receive significantly less value than intended	• Defer grants until market stabilizes • Separate annual grant into multiple grants throughout year for dollar cost averaging

It is critical to monitor the situation:

- **Consider actual vs. expected for shares granted**, and what historical grants among respective job levels had been
- **Evaluate "retention value"** to identify key employees at higher risk
- **Burn rate modeling** under various stock price scenarios

Award Sizing and Dilution

Employee Stock Purchase Plans ("ESPPs") may face additional challenges with a declining stock price

Challenges

- More employee contributions will be impacted by the **$25K limit**
- **No share limit:** More shares are purchase than expected resulting in increased share usage
- **Share limit:** Share limit may be hit, leading to refunds and unhappy or confused participants

Solutions

- Consider implementing **per purchase share limits** if they are not already in place
- **Forecast anticipated share usage**
- **Employee communication** is essential so the benefit is still valued and declining stock price implications are clearly understood

It is critical to confirm plan provisions so the impact of low stock prices can be planned for and effectively communicated to participants

Modifications

To Modify or Not to Modify?

Companies face numerous considerations before undertaking a modification:

Challenges

- **Accelerations** for layoffs
- **Stock options** deeply underwater for sustained periods
- **Performance or market goals** are completely unattainable in an uncertain market
- **Award sizing** methodology resulted in lower value being granted for RSUs

Solutions

- **Do nothing** – there are too many uncertainties in the market to act now and even in the future the optics and governance implications are too negative
- **Use discretion** where available
- **Modify awards**
- **Grant new awards**

"A change in the terms or conditions of a share-based payment award." *(ASC 718-10-20)*

Modifications in a Down Market

In addition to acceleration of unvested stock options or RSUs for terminating employees, the following modifications to outstanding awards may be contemplated:

	Absolute Performance Metrics	Stock Options
1. Extend time horizon	Extend time period to meet goal (including market conditions such as stock price hurdles or internal financial metrics)	Extend post-termination exercise window
2. Replace award	Replace with time-based or relative metrics	Underwater exchange or repricing
3. Adjust targets	Re-align goals with reasonable business expectations	Underwater exchange or repricing
4. Do nothing	Defer decision-making until the situation stabilizes	

Governance and accounting implications should be considered in any decision

Long-term Considerations: Plan Design Considerations

Plan Design Considerations
Full Value Awards

Vehicle	Characteristics	Challenges	Solutions
RSU	• Stable vehicle that delivers value in all markets	• Weakest link between performance and value • May not deliver high enough value in down markets	• Longer vesting schedules • Post-vest hold period
PSU – Absolute	• Easy for participant to understand • Ties value delivered to performance	• Hard to set long-term goals that are rigorous but realistic • Changing markets can make goals unattainable or too easy	• Define performance goal for each year only at beginning of year (not at grant) • Growth metric with “banking” at interim years • Tie current year goal to prior year actual performance as a growth metric
PSU – Relative	• Eliminates need to set long-term absolute goals • Ties value delivered to performance	• Need to identify appropriate peer group • Likely must use consistently disclosed metrics (e.g., GAAP without adjustment)	• Mix relative metrics with absolute metrics or time-based RSUs • Relative TSR (market condition) can be a modifier to performance condition awards

Plan Design Considerations – Goal Setting

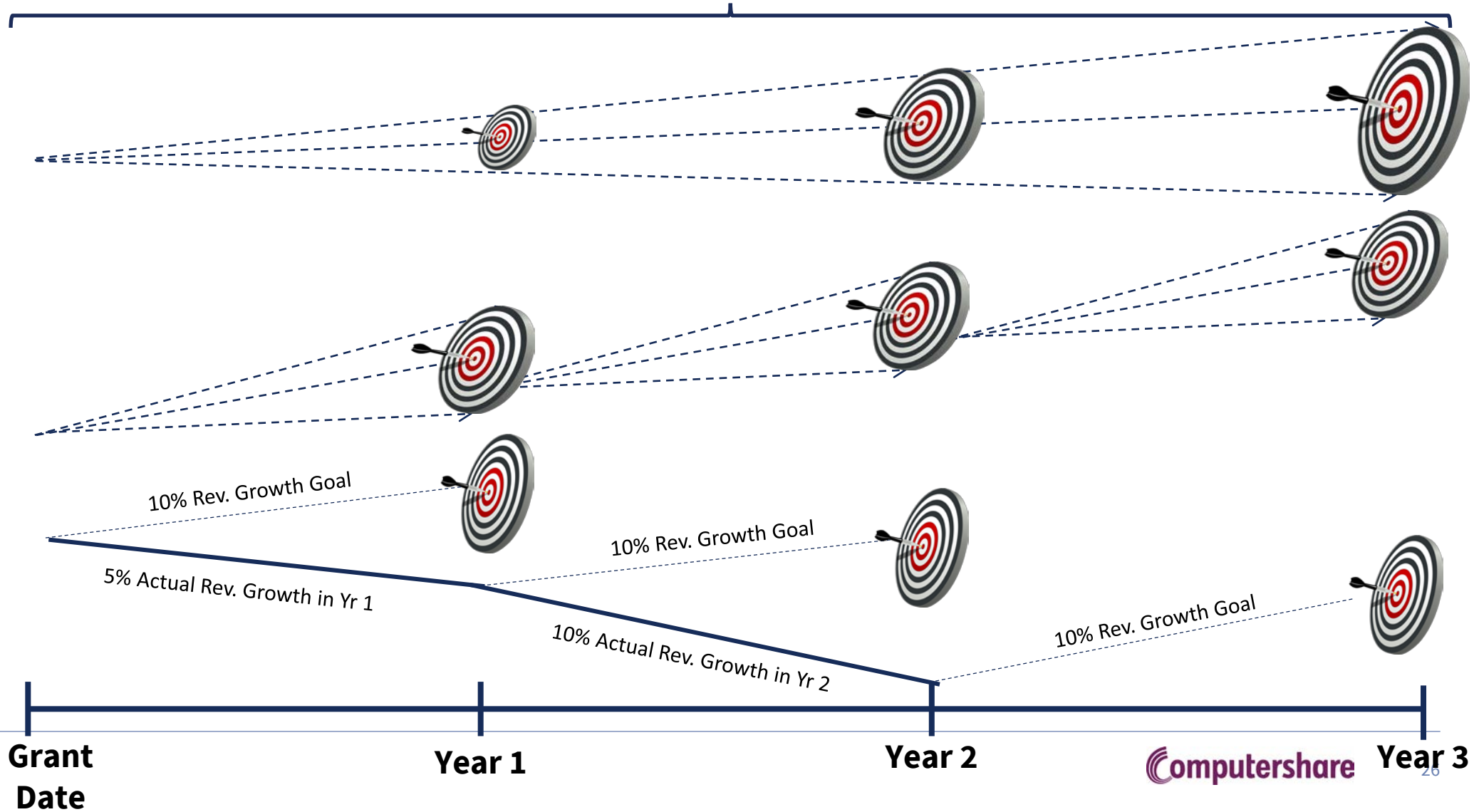
Approach

Performance Measurement

Compound Annual Growth Rates

Multi-Tranche Measured Annually

Compound Annual Growth Rates with Adjustments



Plan Design Considerations
Employee Stock Purchase Plans

Employee stock purchase plans (ESPPs) are stable equity tools that deliver value in all markets

- Typically offered at a discount (sometimes substantial) to a broad-based pool of employees, making it both a compensation and an ownership tool
- Purchased shares provide same rights as other stockholders (dividends, voting, etc.)

It is critical to identify the purpose of plan (who do you want to incentivize?)

Challenges	Solutions
• Stringent regulations exist on the benefits offered, length of offering period, eligibility requirements, and many other facets of qualified plans.	• A nonqualified plan can offer a range of design features for companies in different financial situations, usually requires less money to create and may be structured in many ways as they don't come with compliance limitations.
• Tax treatment may be beneficial for employees but is much more complex; tax deduction for company only occurs upon disqualifying disposition	• Tax treatment is less beneficial but simpler and is uniform globally (taxed at purchase); tax deduction for company on benefits provided is a significant benefit
• Plan inherently favor employees with higher incomes given their ability to contribute and that all employees must have equal rights and privileges	• Benefits may be tiered at different contribution levels and can be more favorable to employees contributing at lower levels (e.g., highest match available at lowest contribution tier)

Plan Design Considerations
Employee Stock Purchase Plans

Companies can consider the flexibility of nonqualified ESPPs in light of COVID-19 and the impact on essential workers.

Companies with strong revenue and cash flow and increases in staff

- Examples: big box stores, grocers, food supply chain, consumer staples
- Offer significant matching programs
- Offer a stipend (i.e., $20 per month), potentially only to hourly workers, certain pay grades, or employees with salary below a certain level
- Frequent purchases (i.e., monthly)
- Cashless participation to support employees with little to no disposable income
- Strategy: Immediate as employee engagement and retention are crucial during the pandemic with workers risking their health as they keep working

Companies with revenue declines, closed operations, layoffs, and/or furloughs

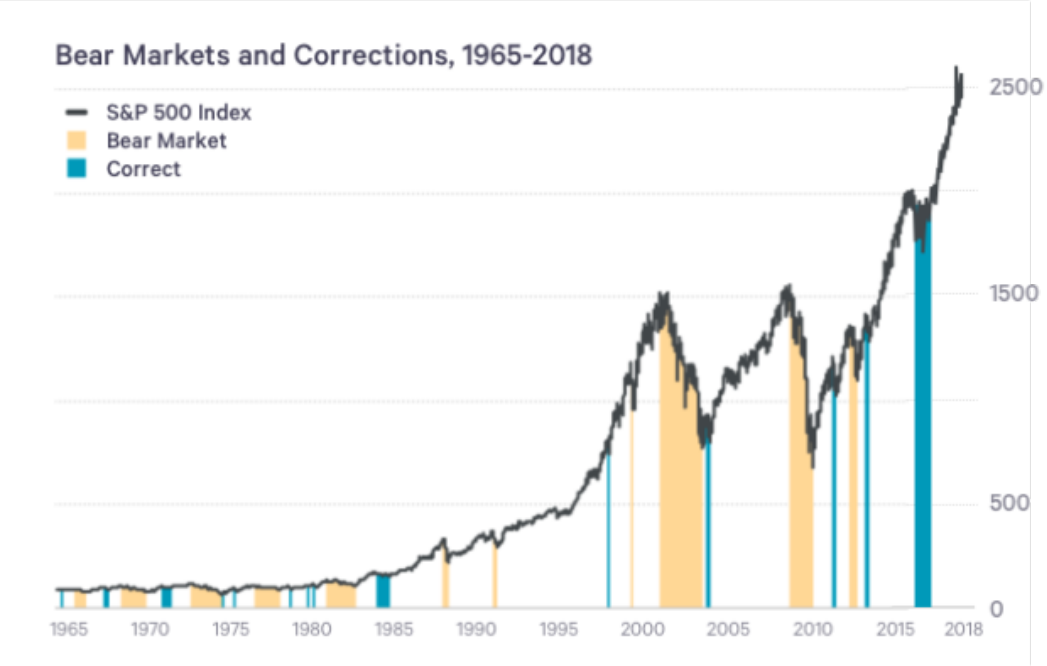
- Examples: restaurants, non-essential retail stores, airlines, oil and gas
- Offer a modest matching program; companies with strong dividends (like oil companies) can promote benefit of a smaller match plus value of dividend
- One-time stipend to kick-start program to encourage participation for previously furloughed or laid off employees without an ongoing company cash outlay
- Frequent purchases (i.e., monthly)
- Cashless participation to support employees with little to no disposable income
- Strategy: Mid-term as stores begin to re-open, revenue gradually increases, and company needs to both retain and attract workers; cannot assume furloughed employees will automatically come back as numerous companies begin to hire

Plan Design Considerations
Stock Options

Stock options are highly leveraged awards that deliver great value for stock price growth

- Long lived equity instruments (typically 7 to 10 years)
- Recovery periods from Bear Market / Correction since 1960s
  - ~1 year peak to trough
  - ~2 years trough to recovery

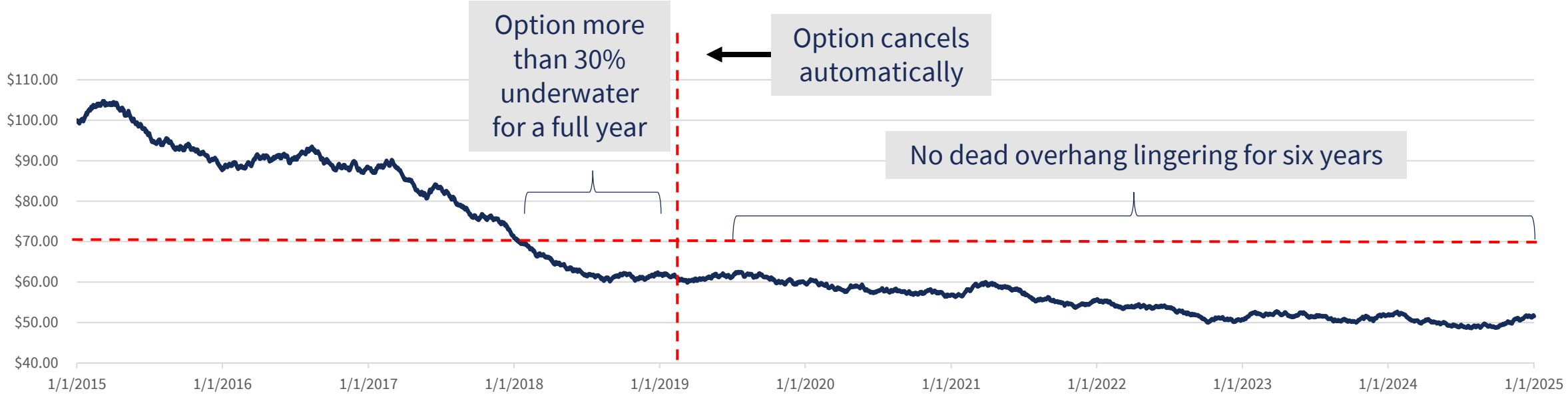
It is critical to educate participants about how stock options gain value



Challenges	Solutions
• No value in down market • Underwater options can create dead overhang and demotivate employees	1. Tie strike price to index return 2. Auto-cancel of underwater options 3. Value cap to limit windfall payout and lower fair value

Stock Option Considerations
Auto-Cancel Feature

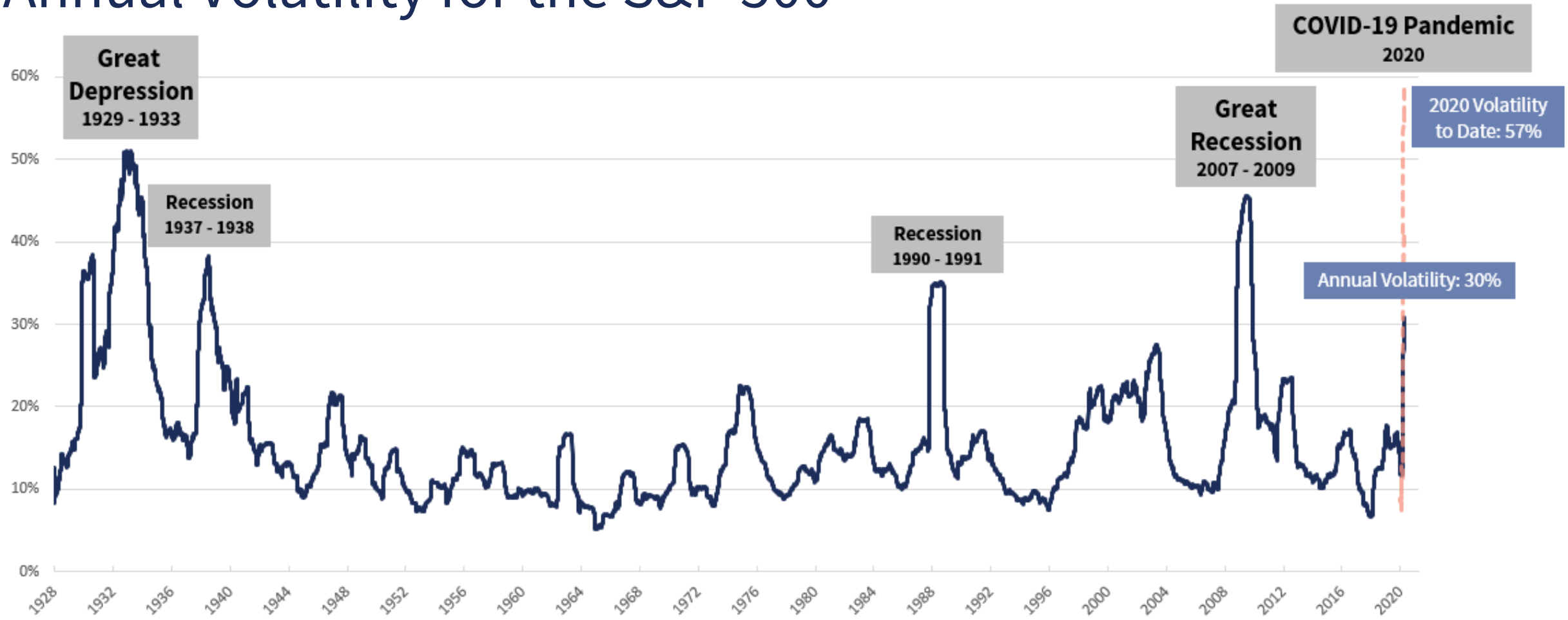
- Regular stock options that cancel if the stock price declines certain % for set amount of time
- Cancelled shares return to the pool
- No consideration given to the individual holding the options
  - Do not grant replacement awards



Dealing with Market Volatility

Market Volatility

Annual Volatility for the S&P 500



There is correlation between periods of high volatility and recession

Company Volatility Approaches

Volatility Considerations	Challenges	Solutions
Historical Volatility	• Unprecedented market volatility resulting in extremely high historical volatility • Most companies rely exclusively or in part on historical volatility for valuing options and market-based awards • Auditors will scrutinize any method that excludes or minimizes certain periods of time	• Longer look-backs more stable over time and may better represent future expected volatility • Likely unable to exclude spring of 2020 from calculations, but may be able to place less weight on an extremely volatile period of time due to general market decline because of the possibility of mean reversion
Implied Volatility	• Implied volatility always subject to volatility given short-term nature, but this is exacerbated in an uncertain market • Common approach is 50%/50% weighting on historical and implied volatility	• Consider placing a smaller weight (max 25%) on implied volatility
Volatility after an Acquisition or Restructuring	• Recession may make some companies targets for takeovers • Some companies will see massive layoffs and/or restructurings • Historical volatility may not be representative of expected future volatility	• Consider whether any reliance could be placed on company's historical volatility • Consider historical volatilities of peer companies for a transitional period until there's sufficient volatility

Approaches to Mitigate Impact of Higher Volatility

Design Consideration	Description
Negative TSR Cap	• Typically caps payout at target when TSR is negative • Aligns with shareholders by capping payout when returns are negative
Dollar Value Payout Cap	• Overall payout is capped at multiplier of grant price, frequently 4x – 6x • Value caps can reduce the accounting fair value without impacting perceived value, particularly for high volatility companies
Mandatory Holding Periods after Vesting	• A mandatory holding period aligns with longer-term shareholder growth • Opportunity for illiquidity discount if holding period is specific to the security