

# Are Executive Incentive Plan Payouts for AIP and PSUs Aligned with Shareholder Returns?



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## Introduction

There is a widespread belief among shareholders, executives, board members, media, and academics that incentive plan metrics, goals, and the resulting performance and payouts, should be closely aligned with a company’s total shareholder return (TSR) over time. This alignment reinforces that companies are focusing on performance measures that correlate with shareholder value creation and setting sufficiently challenging goals so that if achieved, demand for the stock will go up, and if not achieved, demand for the stock will go down. Based on the high levels of majority shareholder support for Say on Pay (SOP) over the years, including 99% of companies receiving majority support in 2024, it would appear companies are meeting shareholders’ expectations.

Recent research reports conducted by one of the proxy advisory firms, however, suggest that both annual and long-term incentive plan goals may not be sufficiently rigorous, as most large companies have paid above-target incentives in each of the last 5 to 6 years. Pay Governance delved deeper into this phenomenon by examining if above target incentive payouts were aligned with returns to shareholders and how often individual companies exceeded target over the last 5 to 6 years. Our research indicates that over the last 6 years, S&P 500 companies\* that had above-median annual incentive plan (AIP) and performance share unit (PSU) payouts also had higher TSR compared to companies that had below-median AIP and PSU payouts. Our analysis includes comparisons on both an industry sector and total sample size basis, with comparable results.

We also found that only a small percentage (3%) of companies persistently paid incentives significantly above target over the 5-to-6 year measurement periods.

	% of Companies That Persistently Paid Incentive At/Above Target		
	AIP Paid Between 100%-200% of Target	AIP Paid Between 125%-200% of Target	AIP Paid Between 150%-200% of Target
Paid AIP each of the last 6 years	20%	7%	3%
Paid AIP each of the last 5 years	29%	14%	3%

\* We excluded companies in the Energy, Utilities, and Real Estate industries due to regulatory differences as well as unique compensation practices and incentive metrics that do not align with other industries.



# Our Research Demonstrates Consistent Alignment of Incentive Payouts and TSR Over Time

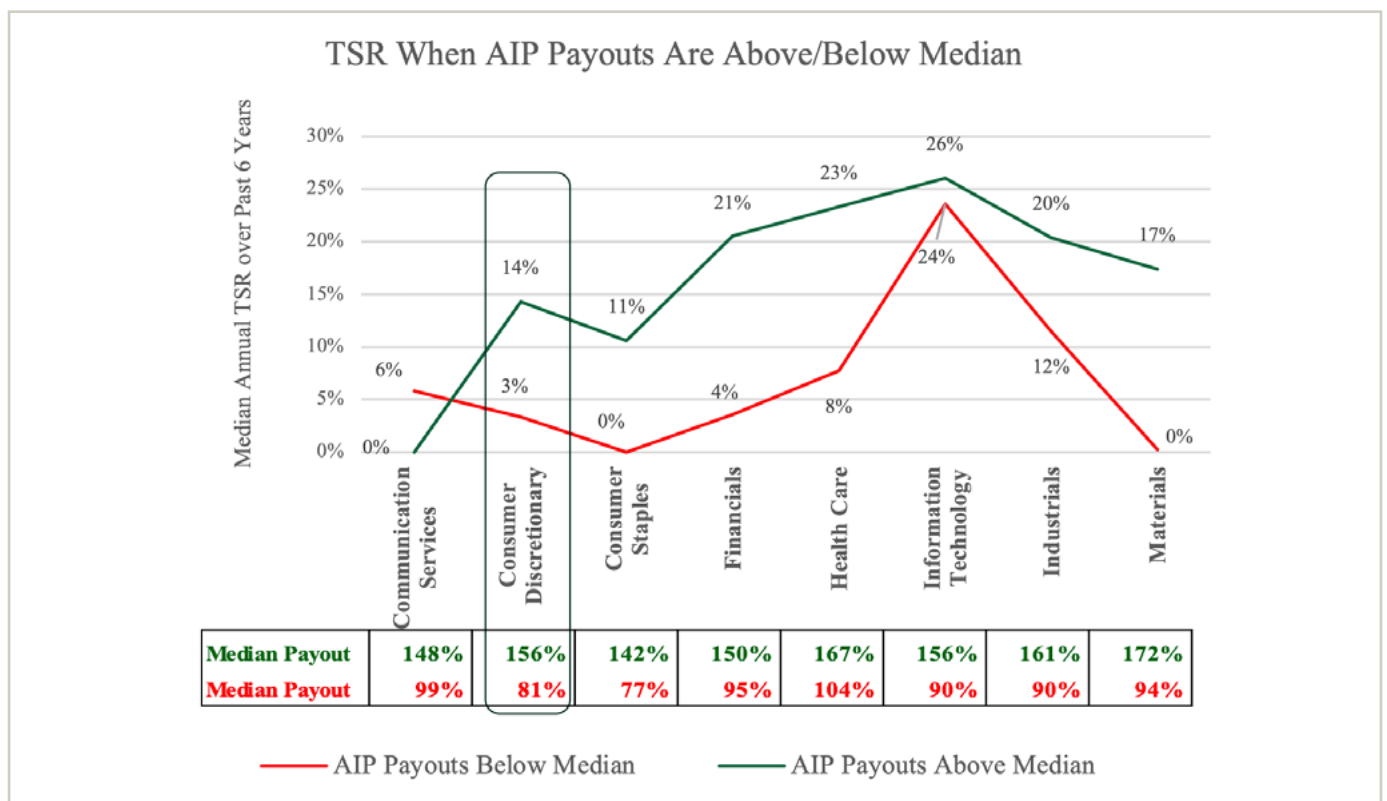
## AIP Alignment

Most AIPs are based on financial and non-financial measures that focus on the achievement of short-term results that position companies for long-term success. As a result, attaining these annual incentive measures may not have an immediate impact on stock price or TSR, but over time there should be a relationship of annual incentive payouts to shareholder returns.

Our AIP analysis is based on 6 years of data from 315 S&P 500 companies, totaling approximately 1,900 datapoints to assess shareholder alignment of AIP payouts and TSR both on an industry and total sample size basis. A summary of our key findings includes:

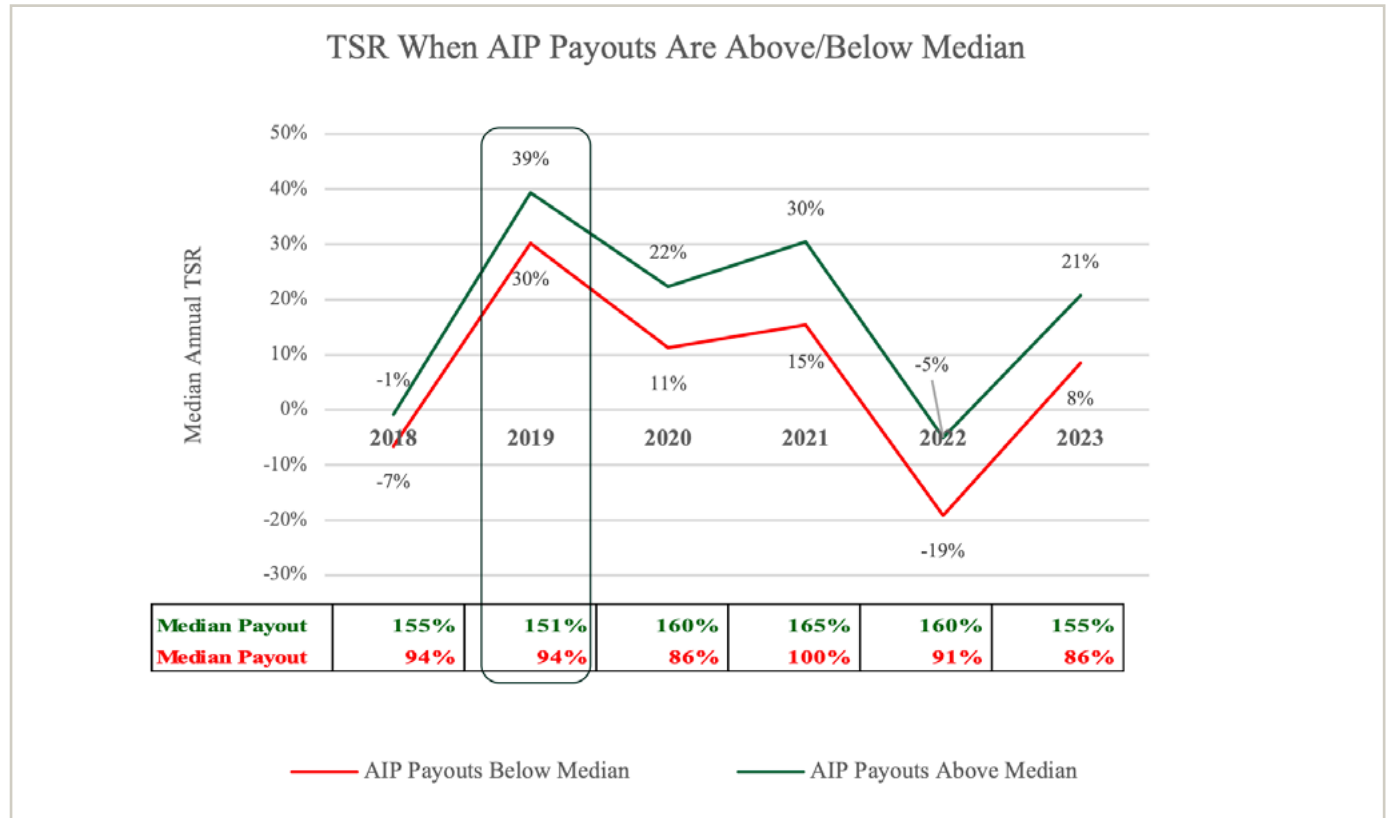
1. **AIP Industry Analysis:** As detailed in Chart 1, in every industry except communication services, companies with above-median AIP payouts have higher TSR compared to companies with below-median AIP payouts. For example, in the consumer discretionary industry, for the group of companies that had above-median AIP payouts (median payout = 156% of target) during the past 6 years, median TSR was +14%, while for the group of companies with below-median AIP payouts (median payout = 81% of target), median TSR was +3%

Chart 1: AIP Industry Analysis



AIP “All Industry” Analysis by Year: As detailed in Chart 2 which includes all industries, over the past 6 years, companies with above-median AIP payouts have higher TSR compared to companies with below-median AIP payouts. For example, in 2019, for the group of companies with above-median AIP payouts (median payout = 151% of target), median TSR was +39% while for the group of companies with below-median AIP payouts (median payout = 94% of target), median TSR was +30%.

Chart 2: AIP “All Industry” Analysis by Year



Alignment of annual TSR and AIP payouts is not perfect for year-over-year comparisons due to macroeconomic factors. For example, in 2022, when the economy had recession concerns, overall TSR was negative, but AIP payouts were only modestly different from prior years because internal operating goals were likely lower but still achieved. Each company sets their guidance and goals based on expectations of strong tailwinds or headwinds and other strategic factors typically during the first quarter of the fiscal year, which can result in above-target AIP payouts even when fiscal year-end TSR is below prior year.

## Long-Term Incentive Plan / PSU Alignment

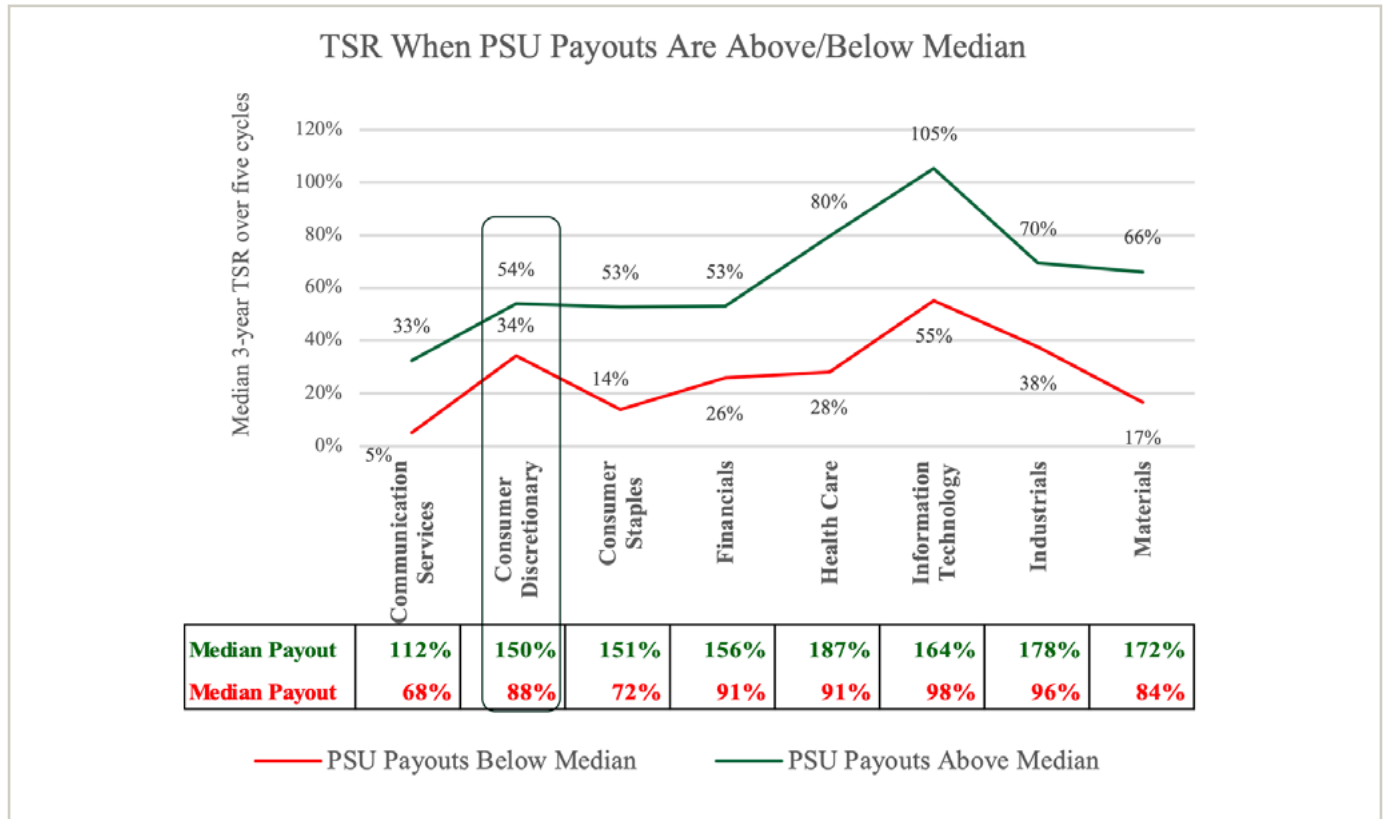
Most performance-based long-term incentive plans are linked to the achievement of multi-year financial measures that are intended to align with shareholder outcomes. As a result, shareholders are likely to closely scrutinize long-term incentive plan payouts that do not align with shareholder returns. Indeed, one of the major proxy advisory firms has begun to take a closer look at the design and performance measures of these plans if they determine there is a pay for performance disconnect.

Our PSU analysis is based on the five completed PSU cycles (in the case of 3-year performance cycles: 2017-2019, 2018-2020, 2019-2021, 2020-2022, and 2021-2023) for 290 S&P 500 companies, totaling 1,450 datapoints to evaluate shareholder alignment of PSU payouts and TSR. A summary of our key findings includes:



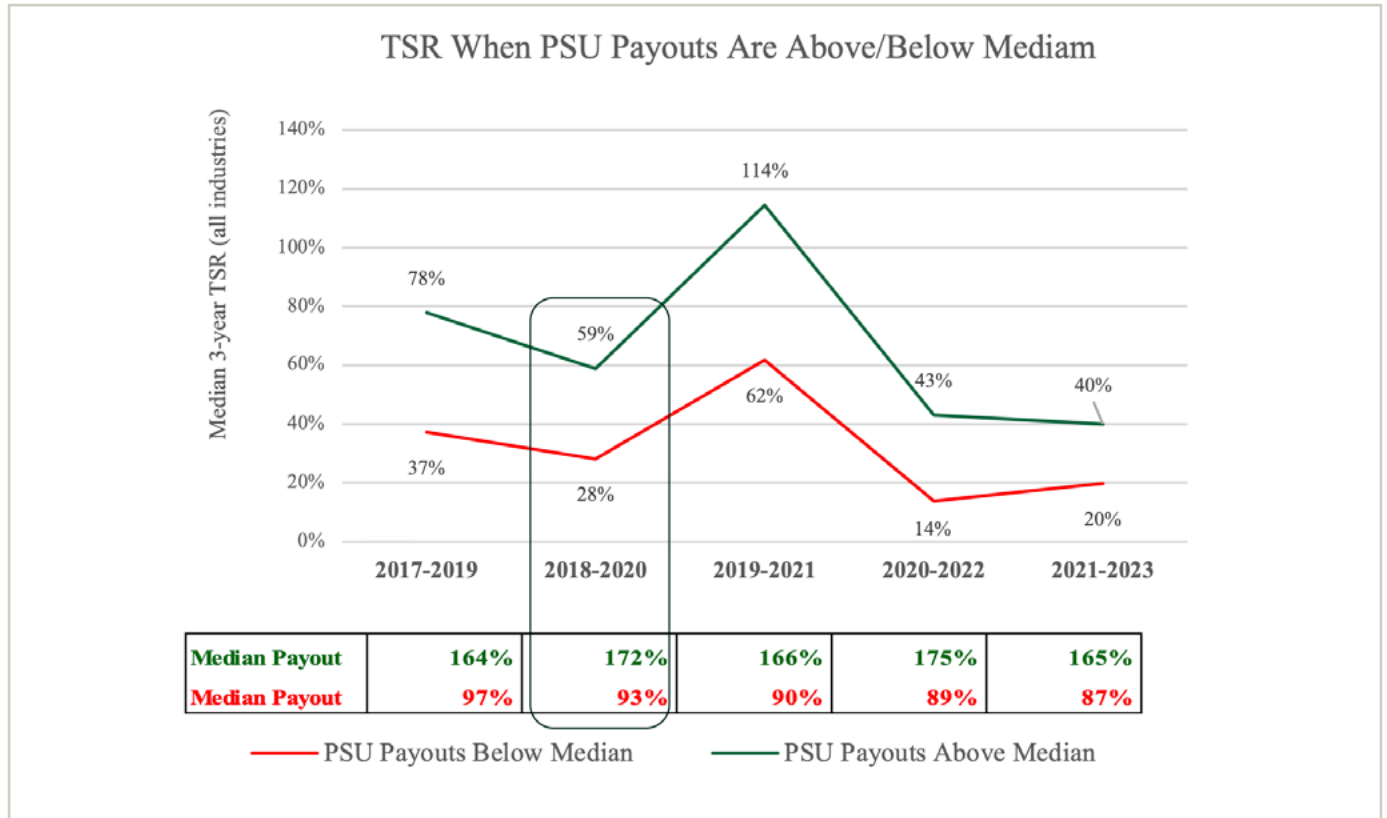
1. PSU Industry Analysis: As detailed in Chart 3, all industry segments show that companies with above-median PSU payouts have higher TSR compared to companies with below-median PSU payouts. For example, in the consumer discretionary industry, for the group of companies with above-median PSU payouts (median payout = 150% of target) during the past five cycles, median TSR was +54 while for the group of companies with below-median PSU payouts (median payout = 88% of target), median TSR was +34%.

Chart 3: PSU Industry Analysis



2. PSU "All Industry" Analysis by Cycle: As detailed in Chart 4, over the past five cycles for all industries, the group of companies with above-median PSU payouts have higher TSR compared to the group of companies with below-median PSU payouts. Among the group of companies with below-median PSU payouts, their average PSU payout over the past five cycles is below 100% of target for all cycles. For example, in the 2018-2020 cycle, for the group of companies with above-median PSU payouts (median payout = 172% of target), median 3-year cumulative TSR was +59% while for the group of companies with below-median PSU payouts (median payout = 93% of target), median 3-year cumulative TSR was +28%.

Chart 4: PSU “All Industry” Analysis by Cycle



Are there other factors that confirm the alignment of AIP/PSU payouts and TSR results?

Yes, three additional factors affirm this alignment:

1. Companies with positive TSR are more likely to pay AIP and PSUs above target.
  - In the five PSU cycles reviewed, 67% of payouts were at/above target and in 91% of these cases, the companies had positive TSR while only 9% had negative TSR. This indicates that misalignment or shareholder-unfriendly outcomes are not prevalent.
  - Across all six AIP cycles reviewed, 69% of payouts were at/above target, which is similar to the results reported in the proxy advisory study. Of these companies, 72% had positive TSR while 28% had negative TSR. It is our experience that AIP payouts are generally less correlated to TSR compared to PSUs, as the AIP measures are often designed to promote future success.
  - Combining both AIP and PSU incentive plans represents 3,200 data pairs. Based on the combined dataset, 67% of payouts were at/above target. Of the companies with at/above target payouts, 80% had positive TSR while 20% of those companies had negative TSR. In our view, this demonstrates a robust alignment of incentive payouts with shareholder outcomes among the 290 companies included in the test companies over the past 6 years.
  
2. The role of providing guidance to investors.
  - Generally, exceeding annual guidance positively impacts stock prices unless subsequent guidance disappoints.
  - If a company consistently beats guidance, resulting in above-target payouts perceived as being too easy to achieve, the market may eventually respond negatively.



3. Separately, Pay Governance conducted research<sup>1</sup> on the alignment of CEO pay with TSR based on the Pay Versus Performance rules mandated by Dodd Frank. Our analysis found a strong correlation of Compensation Actually Paid (CAP), with TSR over 2020-2023.

## Conclusions and Implications for Individual Companies

Contrary to the concern and criticism that AIP and PSU performance measures may not be sufficiently rigorous and the resulting incentive payouts may be too high, our study shows that such payouts are aligned with shareholder outcomes. This may partially explain why shareholders have consistently and strongly supported Say on Pay for the last several years. We recommend that companies continue to set appropriate and rigorous performance targets when issuing investor guidance and setting incentive plan goals. This disciplined process observed by many companies increases the likelihood that payouts are aligned with operating performance, shareholder experience, and yield motivation and retention value.

Typical analytical tools used by Pay Governance and many companies for selecting appropriate performance measures and testing goal rigor include:

1. Ensure that incentive metrics are correlated with TSR.
2. Compare the goals before final approval with a multidimensional assessment of internal and external expectations of the company's performance including, for example, analysts' expectations for company and peers, history of goals, and other relevant factors.
3. Assess historical alignment of incentive payouts and TSR.
4. Utilize realizable pay and CAP to assess the payouts for a multi-year period and alignment with TSR to evaluate if changes are required to improve alignment.

## Appendix

Table 1: AIP Industry Analysis		When AIP Payout is <b>Below</b> Median		When AIP Payout is <b>Above</b> Median	
Industry	Count	Median Annual TSR over Six AIP Cycles	Median AIP Payout over Six Cycles	Median Annual TSR over Six AIP Cycles	Median AIP Payout over Six Cycles
Communication Services	13	6%	99%	0%	148%
Consumer Discretionary	41	3%	81%	14%	156%
Consumer Staples	29	0%	77%	11%	142%
Financials	41	4%	95%	21%	150%
Health Care	58	8%	104%	23%	167%
Information Technology	52	24%	90%	26%	156%
Industrials	55	12%	90%	20%	161%
Materials	26	0%	94%	17%	172%

Table 2: AIP “All Industry” Analysis by Year		When AIP Payout is <b>Below</b> Median		When AIP Payout is <b>Above</b> Median	
Year	Count	Median Annual TSR	Median AIP Payout	Median Annual TSR	Median AIP Payout
2018	315	-7%	94%	-1%	155%
2019	315	30%	94%	39%	151%
2020	315	11%	86%	22%	160%
2021	315	15%	100%	30%	165%
2022	315	-19%	91%	-5%	160%
2023	315	8%	86%	21%	155%

Table 3: PSU Industry Analysis		When PSU Payout is <b>Below</b> Median		When PSU Payout is <b>Above</b> Median	
Industry	Count	Median 3-Year TSR over Five PSU Cycles	Median PSU Payout over Five Cycles	Median 3-Year TSR over Five PSU Cycles	Median PSU Payout over Five Cycles
Communication Services	11	5%	68%	33%	112%
Consumer Discretionary	33	34%	88%	54%	150%
Consumer Staples	28	14%	72%	53%	151%
Financials	40	26%	91%	53%	156%
Health Care	54	28%	91%	80%	187%
Information Technology	48	55%	98%	105%	164%
Industrials	52	38%	96%	70%	178%
Materials	26	17%	84%	66%	172%

Table 4: PSU “All Industry” Analysis by Cycle		When PSU Payout is <b>Below</b> Median		When PSU Payout is <b>Above</b> Median	
PSU Cycle	Count	Median 3-Year TSR	Median PSU Payout	Median 3-Year TSR	Median PSU Payout
2017-2019	292	37%	97%	78%	164%
2018-2020	292	28%	93%	59%	172%
2019-2021	292	62%	90%	114%	166%
2020-2022	292	14%	89%	43%	175%
2021-2023	292	20%	87%	40%	165%

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1. Ed Sim, Ira Kay, and Mike Kesner. Does Compensation Actually Paid Align with Total Shareholder Return? Harvard Law School Forum on Corporate Governance. August 8, 2024. <https://corpgov.law.harvard.edu/2024/08/08/does-compensation-actually-paid-align-with-total-shareholder-return/>