UK EXECUTIVE COMPENSATION SERVICES

2023 BONUS AND LTIP TARGET SETTING TOOLKIT

February 2023

ALVAREZ & MARSAL

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Introduction

Setting performance targets, for both short and long-term incentives, is one of the key activities in the remuneration committee's annual cycle. It has always been a difficult task to fairly balance the interests of all stakeholders, ensuring the targets are sufficiently stretching to satisfy shareholder expectations, but at the same time being considered fair and achievable by management. It has become even more challenging during the current period of prolonged uncertainty.

Effective target setting starts with process. In particular, ensuring that the company's expected performance, as it is captured in the annual budget or the long-term business plan, is scrutinised and agreed by the board before being used as the basis for incentive target-setting by the remuneration committee. Then, ensuring that relevant data and reference points are provided to the remuneration committee to support their judgment in calibrating the target ranges.

As with any decision for a remuneration committee, it is important that the targets are set in the context of the specific circumstances and needs of the business, rather than by simply following market norms. At the same time, it is only natural for remuneration committees to ask "how does this compare to what others do?", and therefore providing relevant market reference points can help the committee in making an informed judgment when target setting.

The purpose of this 'toolkit' is to support remuneration committees and reward teams in this task by providing a range of market reference points on performance targets for profit metrics within both the annual bonus and long-term incentive of companies in the FTSE 100, FTSE 250, and FTSE Small Cap. We focus on profit as the most commonly used metric, often with the largest weighting, in these incentive plans.

Data is sourced from our A&M incentive targets database which is based on the latest available public disclosure as at January 2023.

Should you wish to discuss any aspect of the data shown, its implications for your business, or to request more specific data cuts or analysis, please reach out to your A&M contact.

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Overview of a Good Target-Setting Process

Effective target setting starts with process. While this report is focused on targets for financial metrics, the principles below are relevant for ***any*** type of performance measure used in incentives, both short and long-term

Board

The forum to **discuss, scrutinise, challenge, and agree the plan** for company performance.

This might include:

- **Non-executive scrutiny:** – What can the business reasonably be expected to deliver?
- **Sensitivity/scenario analysis** – what are the upside/downside opportunities & risks?
- **Relativity to market expectations** – how will we guide the market, how do plans compare to current and expected analyst consensus, what is the external messaging?

Agreed Budget / Plan

As an output from the board, the agreed business plan can then be used as an input into RemCo decision making on incentive targets.

Ideally, there should be a shared understanding of:

- The achievability of the plan; and
- The upside / downside risks

RemCo

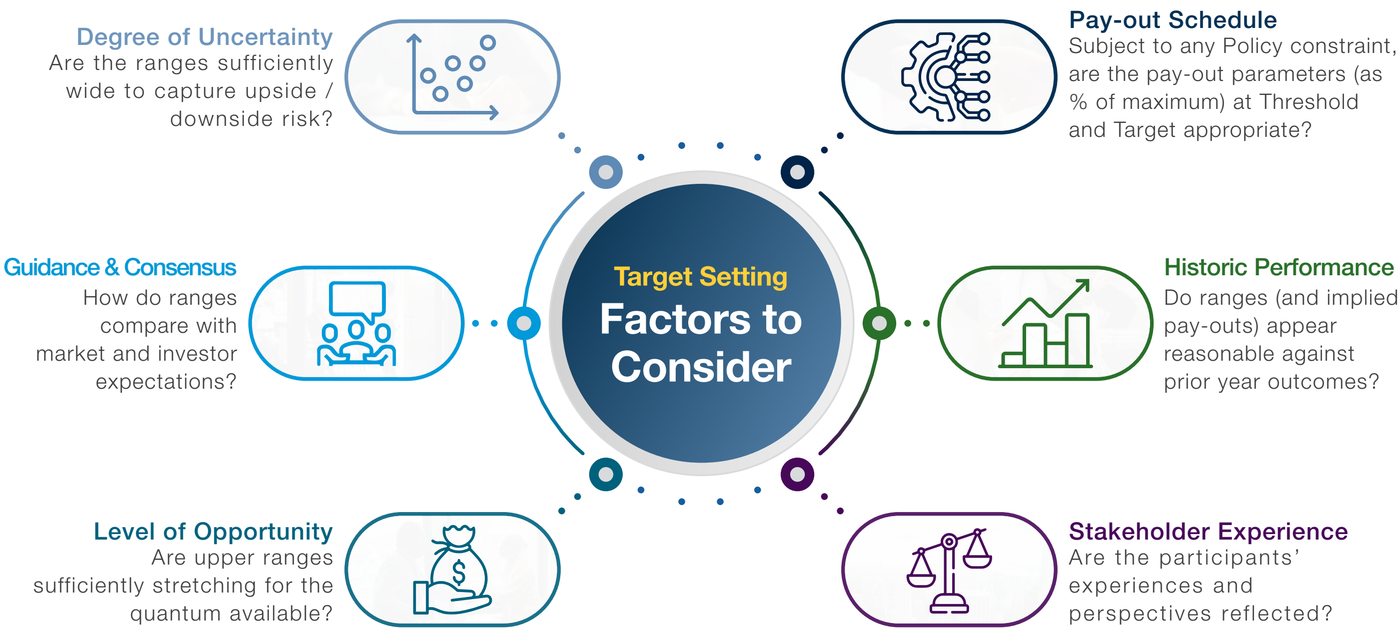
The forum to **calibrate the incentive targets using the agreed plan as a reference point.** It is not good practice to re-open the board's discussion on the plan itself.

Good process can include:

- Effective committee papers with relevant data and reference points readily available, and with clear references to the related board papers and decisions
- Ensuring due consideration of the targets each year, rather than a simple 'rollover' from prior years
- 'Two bites at the cherry' – an initial meeting to provide input on draft targets, with a second meeting for final approval
- Considering relativity of targets to guidance and market expectations

Calibrating Incentive Targets: Making an Informed Judgement

In the context of the board's plan, the remuneration committee must then calibrate the performance target ranges. There is unlikely to be a 'formulaic' answer to this exercise and therefore judgement is required. In making an informed judgement on the calibration of performance ranges, a variety of factors and reference points may be relevant.



While not providing 'the answer', market data can offer useful supporting reference points when considering some of these issues (with data potentially provided for the whole market, a specific industry, and/or a bespoke peer group).

This 'toolkit' therefore provides data on the following aspects of market practice for bonus and LTIP target calibration:

- **Structure of pay-out / vesting schedule –** how many points in the schedule? What level of pay-out at each point?
- **'Shape' of performance ranges –** how 'symmetrical' are typical bonus ranges around the Target point?
- **Implied profit growth in target ranges –** what level of growth is required for Threshold, Target and Maximum pay-out?
- **Historic levels of pay-out / vesting in the market –** what can be expected to pay out, on average over time, in the market?

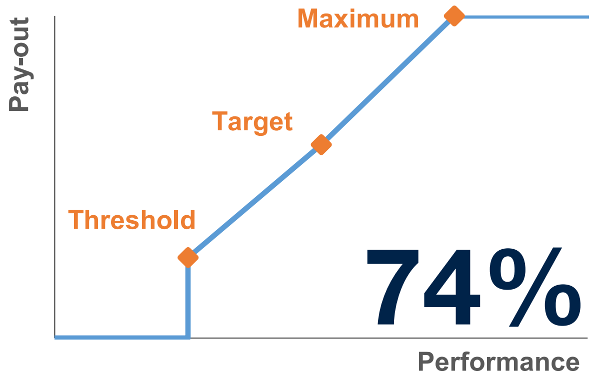
Market data – Key Findings

Annual Bonus	LTIP
Most companies use a three-point schedule with Threshold, Target, and Maximum points. The level of pay-out for Threshold performance is normally either 0% or 25% (of maximum). The level of pay-out for Target is almost always 50% of maximum.	Most companies use a two-point schedule with Threshold and Maximum points The level of pay-out for Threshold performance is very often 25% of maximum
There is a wide variety of practice in terms of the 'width' of profit ranges around Target. Ranges are generally narrower in the larger companies (e.g. in the FTSE 100 it is common for ranges to be narrower than +/-10%, but ranges in excess of +/-10% are more common in the FTSE 250 and Small Cap)	Over 10% of companies disclosed targets via regulatory news statements, or on the website, rather than in the DRR.
Ranges are often 'symmetrical' around Target, but in around half the market asymmetrical ranges are used, skewed either to the upside or the downside around Target. Ranges for Revenue are typically narrower than for Profit, and ranges for Cash Flow are typically wider.	There is a range of practice in terms of calibration of earnings per share ("EPS") targets. In the FTSE 100, most companies continue to disclose ranges as percentage growth targets. In smaller companies, it is more common to calibrate EPS targets as absolute amounts, sometimes on a cumulative basis over the performance period.
There is a wide range of practice on the level of implied profit growth in target ranges. However, greater levels of growth are typically required in smaller companies. In this sample, the median growth rate for Target pay-out in the FTSE Small Cap is c.20%, falling to c.11% in the FTSE 250 and c.6% in the FTSE 100.	The median level of growth required for Threshold and Maximum vesting (i.e. c.5% and c.12%) is broadly the same across all three market segments. However, there is a wider range of expected performance in the FTSE 250 and Small Cap compared to the FTSE 100, with around a quarter of both groups requiring growth in excess of 20% per annum for maximum vesting.
Over the past four years, and looking at the market as a whole, around one in five bonus outcomes are at (or close to) maximum and one in five are zero. Most outcomes are at or above Target, with a median pay-out of 60%.	For the LTIP, there is a wider distribution of outcome, with a lower expected outcome on average, than for the annual bonus. Around one in five receive maximum vesting, with one in three lapsing in full. The median outcome is 45% of maximum.

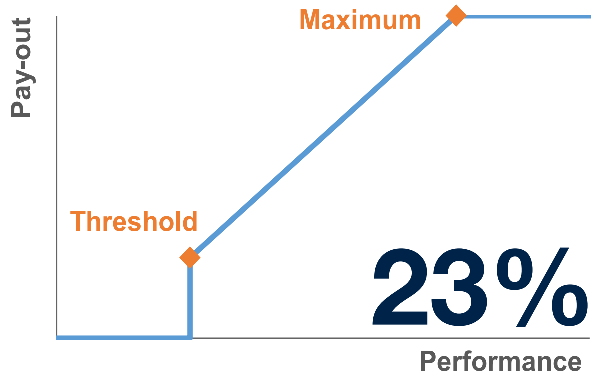
Annual Bonus: Pay-out Structure

Most companies disclose the operation of a three-point schedule, with pay-outs for "Threshold", "Target" and "Maximum" (although sometimes labelled differently), and with typically a straight-line payout between those points. Around a quarter of the market disclose a two-point schedule, using only Threshold and Maximum points. The use of a pay-out schedule with four or more points remains relatively unusual.[1]

Three-point bonus schedule



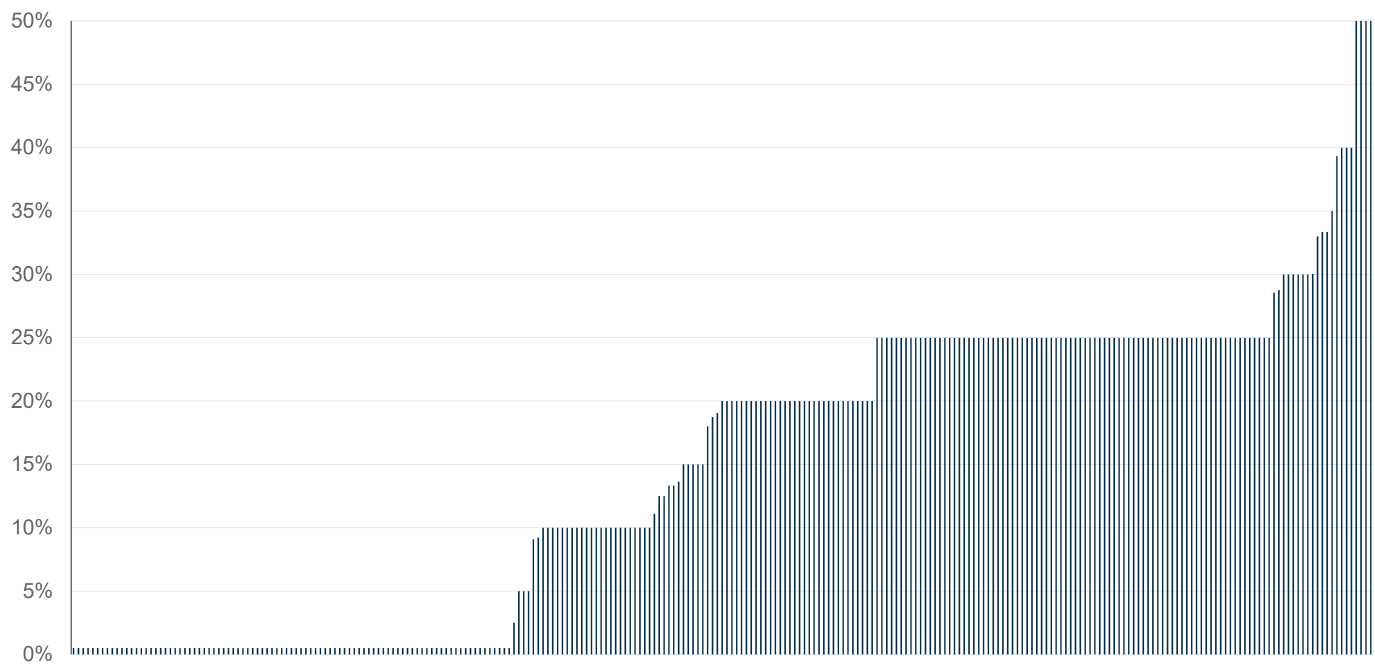
Two-point bonus schedule



There is a range of practice for the level of pay-out for delivering Threshold performance, as shown in the chart below (with each bar representing one company across the full market.) The median is 20 percent of maximum, but around two thirds of the market use either 0 percent or 25 percent.

For hitting Target, the vast majority of companies pay out 50 percent of the maximum, in line with shareholder guidance, although a handful of companies have retained a higher level of pay-out.

Pay-out (% of Maximum) for achieving Threshold performance



Annual Bonus: Width of Profit Target Ranges

For companies with a three-point schedule, the Threshold and Maximum points will be calibrated as a range around Target (which will often, but not always, be aligned to the board's annual budget.)

The charts illustrate market practice for the range of Threshold and Maximum around the Target point, with each bar representing one company. For example, if a bar shows a +10 percent above the axis and a -10 percent below the axis, then the Maximum is 10 percent above Target, and the Threshold is 10 percent below Target.

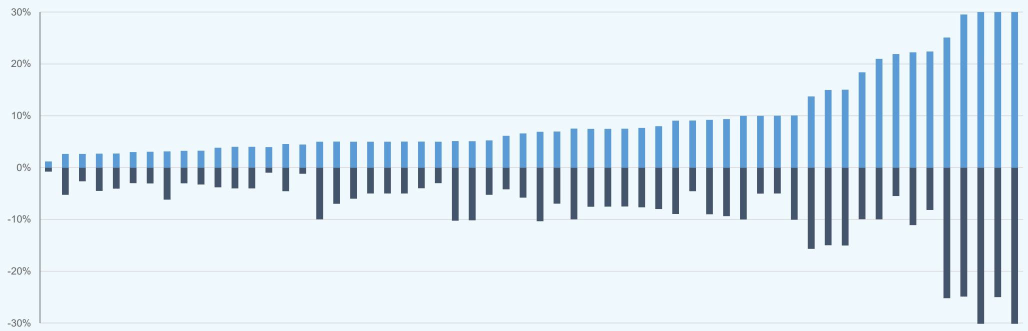
As would be expected, there is a wide range of practice, reflecting different levels of uncertainty and volatility in different businesses and sectors.

It can be seen that ranges around Target are generally narrower in the larger companies. For example, in the FTSE 100 it is common for ranges to be narrower than +/-10 percent, but ranges in excess of +/-10 percent are more common in the FTSE 250 and Small Cap.

FTSE 100

Median: c.7%

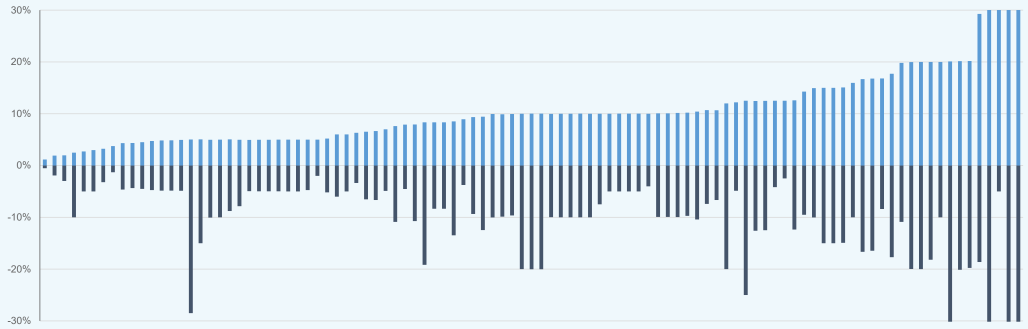
Quartile range: c.4-10%



FTSE 250

Median: c.10%

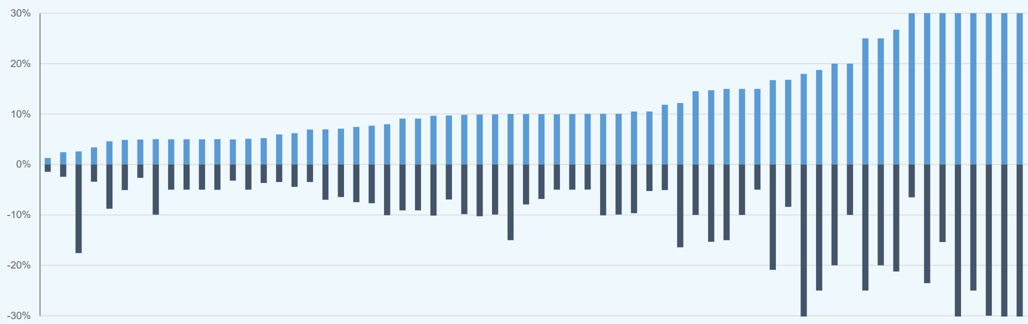
Quartile range: c.5-13%



FTSE Small Cap

Median: c.10%

Quartile range: c.6-16%



Annual Bonus: 'Symmetry' around Target in Profit Ranges

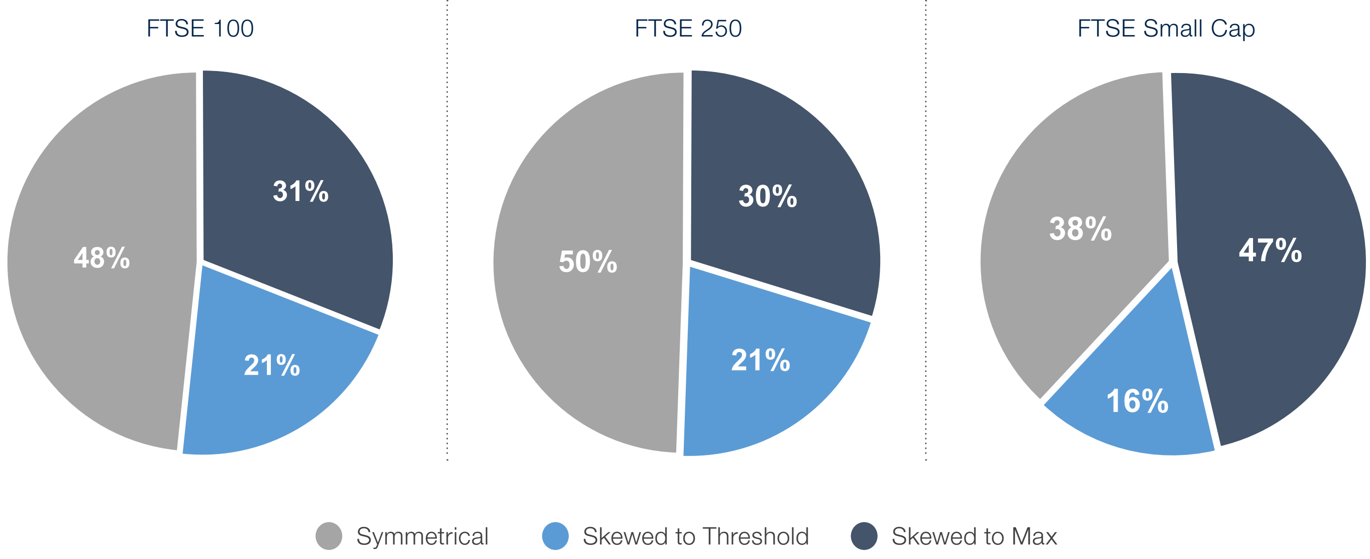
As can be seen in the previous charts, companies take different approaches to how 'symmetrical' the range is around the Target point, with three alternatives possible:

The rationale for these different designs may depend on a range of factors in any given year. For example, the perceived level of stretch in the Target level (which often, but not always, will be directly linked to the budget itself), as well as the extent of upside and downside risk to expected performance.

As the charts below show, although a simple symmetrical range is generally most common, around half the market employ a 'skewed' approach, most typically with the targets skewed towards the maximum end of the range (particularly in the FTSE Small Cap).

With skewed ranges, it is relatively common for the skew to appear to be based on some 'rule of thumb' in the calibration (for example, where the skew to the upside will be exactly double (or half) the downside value).

Proportion Adopting Symmetrical vs. Skewed

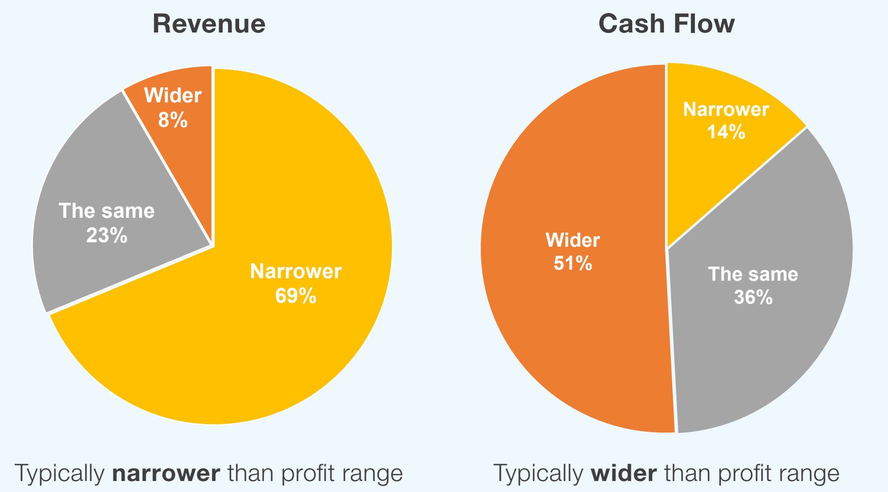


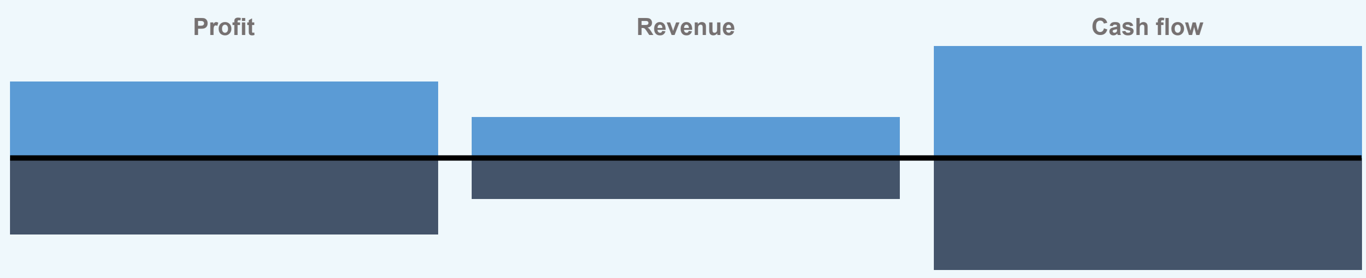
Annual Bonus: Relativity to Other Metrics (Revenue and Cash Flow)

Revenue and Cash Flow are the two most commonly used financial performance measures alongside profit in annual bonus plans. Using the market data, one can also make observations around the typical relativity, in comparison to the profit range in the same company, of the width of target ranges for these two measures.

The analysis shows that the target ranges for Revenue are typically narrower than those for profit in the same company, likely reflecting the lower expected volatility in that top-line metric. For Cash Flow, the range is often wider (or the same) than for profit, and rarely narrower.

Width of the bonus target range ***relative to the profit range*** in the same company.





Illustrative example of relativity of different ranges around Target

While deviating from the market norms may make sense depending on the particular circumstances of the business for each metric, the differences in practice show the importance of taking a thoughtful approach to how target ranges are calibrated for each specific measure.

Annual Bonus: Implied Level of Growth in Profit Ranges

Most annual bonus profit targets are disclosed as monetary values, but they can be converted into an implied growth rate from the prior year actual. These growth rates are shown on the charts, with each bar again representing the target range (from Threshold to Maximum) for one company. The caveats to this data should be noted. These growth rates are shown on the charts, with each bar again representing the target range (from Threshold to Maximum) for one company. The caveats to this data should be noted.[2]

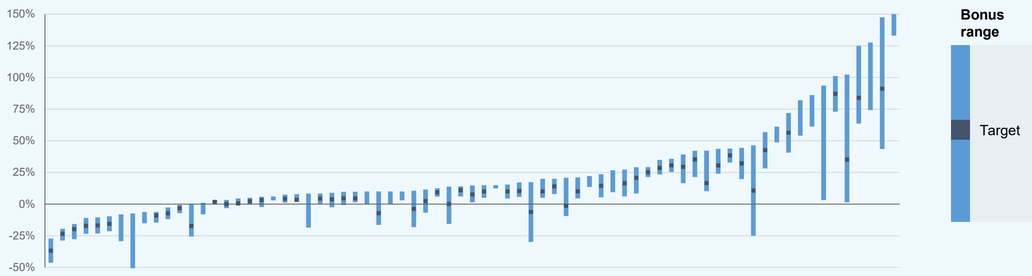
There is a wide range of implied growth levels in the market data, which is to be expected given different sectoral exposures to growth and/or company specific factors for any given year. However, it can be seen that greater levels of growth are required in smaller companies. For example, in this data set, the median growth rate for Target pay-out in the FTSE Small Cap is c.20 percent, falling to c.11 percent in the FTSE 250 and c.6 percent in the FTSE 100.

Many companies will often consider positioning the Threshold above the prior year actual (i.e. to ensure some year-on-year growth is delivered before bonus starts to accrue.) However, the data shows, at least for this year, a sizeable portion of the market setting Threshold (and in some cases even Target and Max) below the prior year actual.

FTSE 100

Implied growth (median):

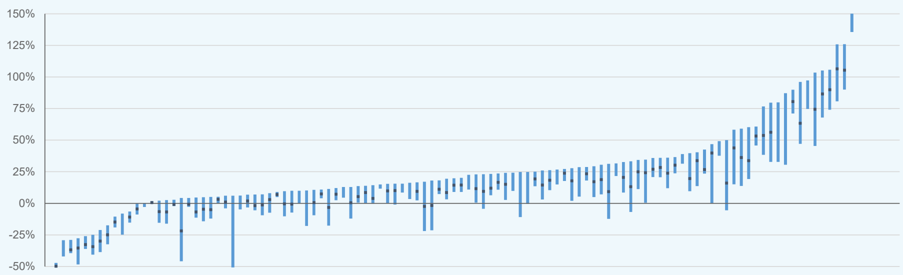
- Maximum: 15%
- Target: 6%
- Threshold: 2%



FTSE 250

Implied growth (median):

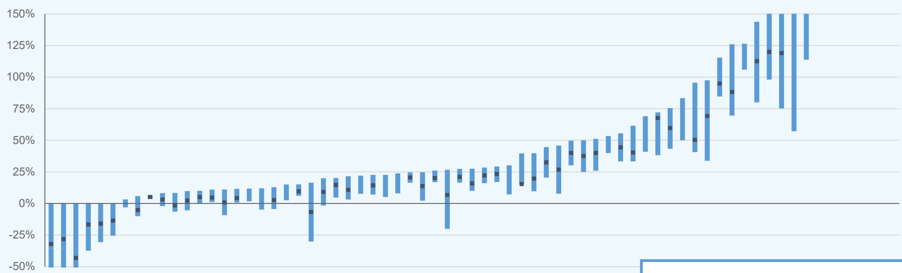
- Maximum: 23%
- Target: 11%
- Threshold: 3%



FTSE Small Cap

Implied growth (median):

- Maximum: 27%
- Target: 20%
- Threshold: 10%



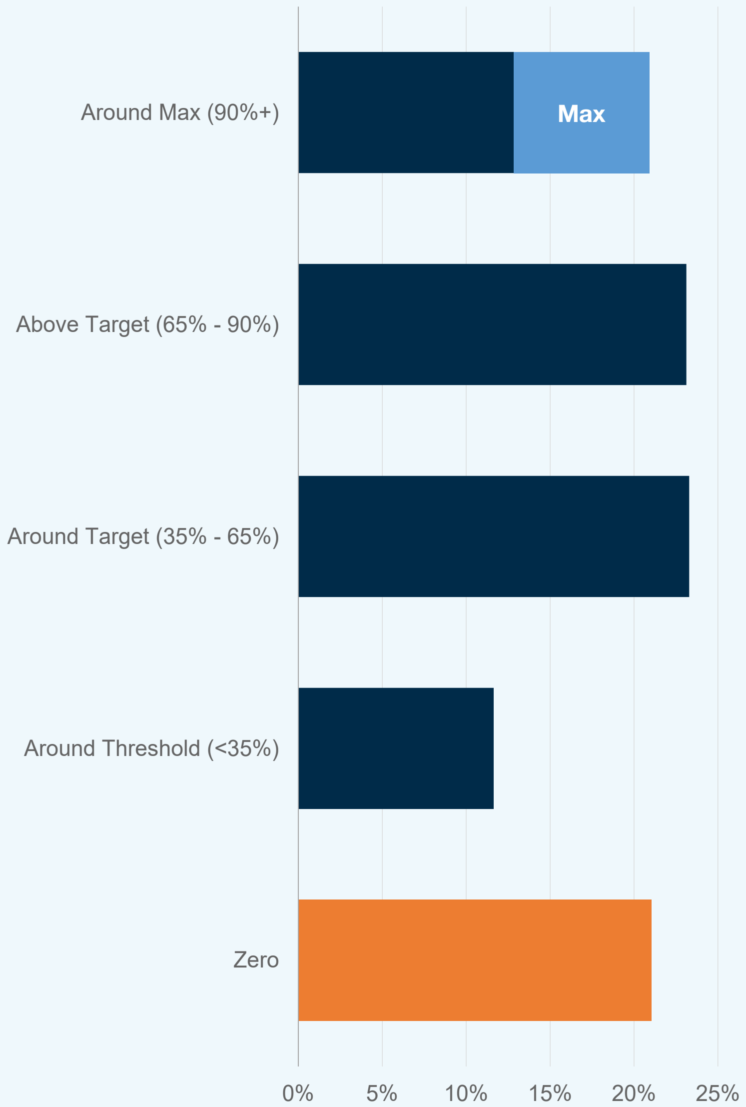
Some companies with very high implied growth rates cannot be displayed on the charts given the scale of the y-axis

Annual Bonus: Typical Levels of Pay-out in the Market

The chart below shows market data on the level of annual bonus pay-out for the CEO over the last four AGM seasons, in aggregate and across the FTSE 100, 250 and Small Cap combined.

While there is some variation in outcome over this period depending on the year, as well as the sector and segment of the market, this data provides a further reference point for remuneration committees when calibrating bonus target ranges, by indicating what might be broadly expected, on average and over time, to pay out.

Distribution of bonus pay-out outcomes



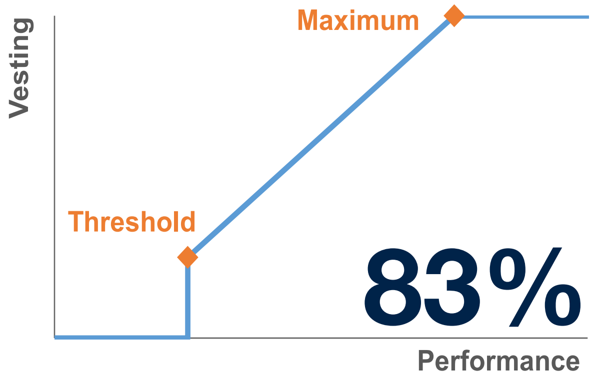
This data shows that over this four-year period:

- Around one in five received a pay-out around Maximum (above 90%), although only 8% received the full pay-out. Receiving a maximum bonus is therefore relatively unusual.
- Roughly one quarter of outcomes were in a range which might be classified as “Above Target” (i.e. in the range 65% to 90% of max) and a further quarter received outcomes at or around the typical Target level of 50%. The median and average level of pay-out over this period were 60% and 53% of maximum, respectively.
- Around one in five resulted in a zero pay-out, although this tended to be more prevalent in FTSE Small Cap companies.

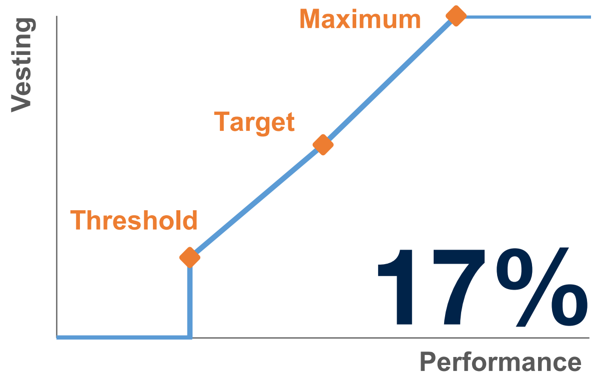
LTIP: Vesting Schedule and Disclosure

In contrast to the annual bonus, for Long Term Incentive Plan ("LTIP") awards most companies operate a two-point vesting schedule, with defined parameters for "Threshold" and "Maximum", and a straight-line vest between points. A minority of companies operate a schedule with one (or more) additional points, often including a "Target".

Two-point LTIP schedule



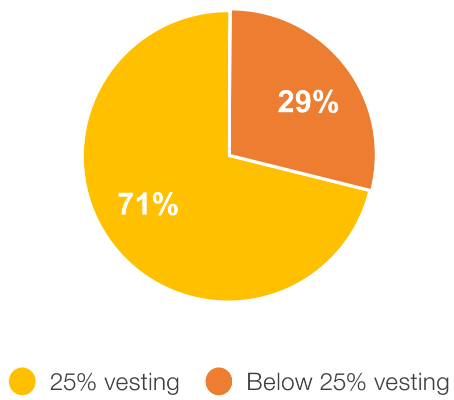
Three (or more) point LTIP schedule



For meeting "Threshold" performance, it is very common for 25 percent of the maximum award to vest, with nearly three quarters of the market adopting that approach. Some companies use a lower amount (often 15 percent or 20 percent) but, unlike the annual bonus, a vesting of 0 percent of the maximum is unusual.

It is best practice, and well-established market practice, for LTIP targets to be disclosed prospectively in the DRR. In our sample, a relatively large minority of companies did not include LTIP targets in the DRR and instead disclosed in a Regulatory News Services (RNS) announcement (or via the website) at the time of grant. It remains to be seen whether this is an emerging trend or the result of higher than normal levels of uncertainty when these particular awards were granted.

Proportion of market with 25% vesting at Threshold



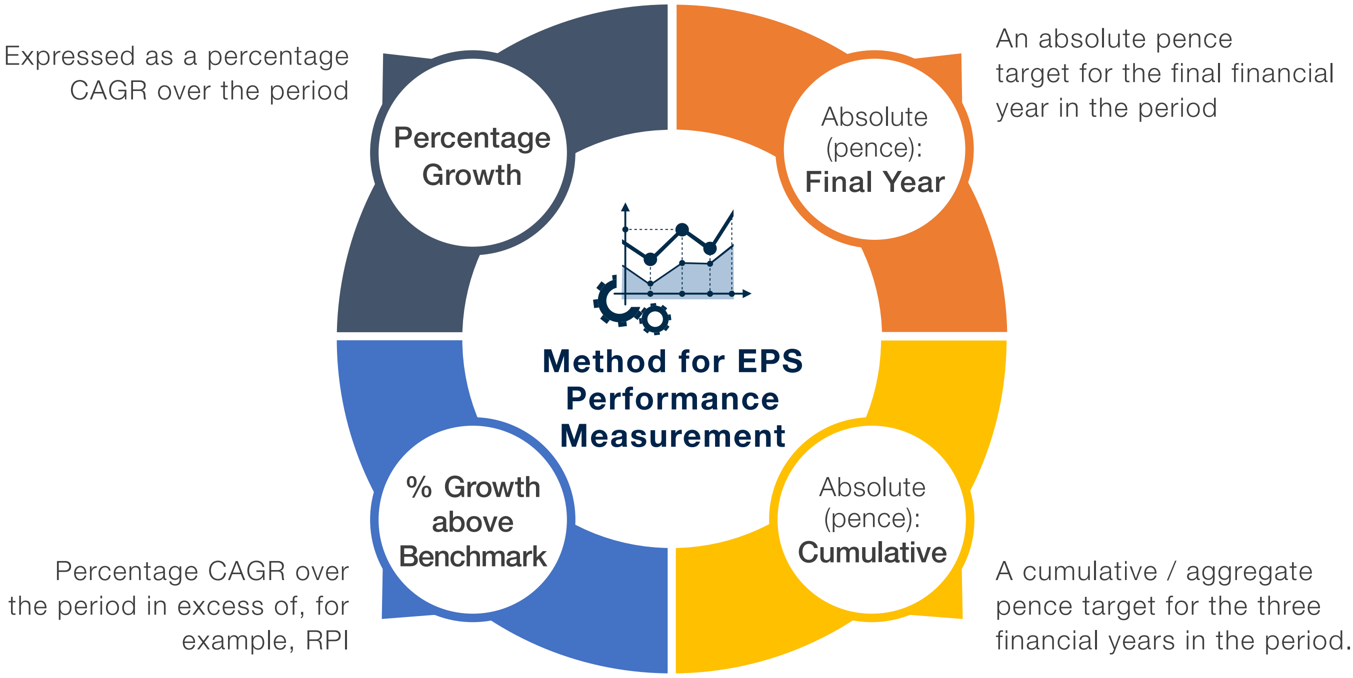
Proportion of market disclosing via RNS

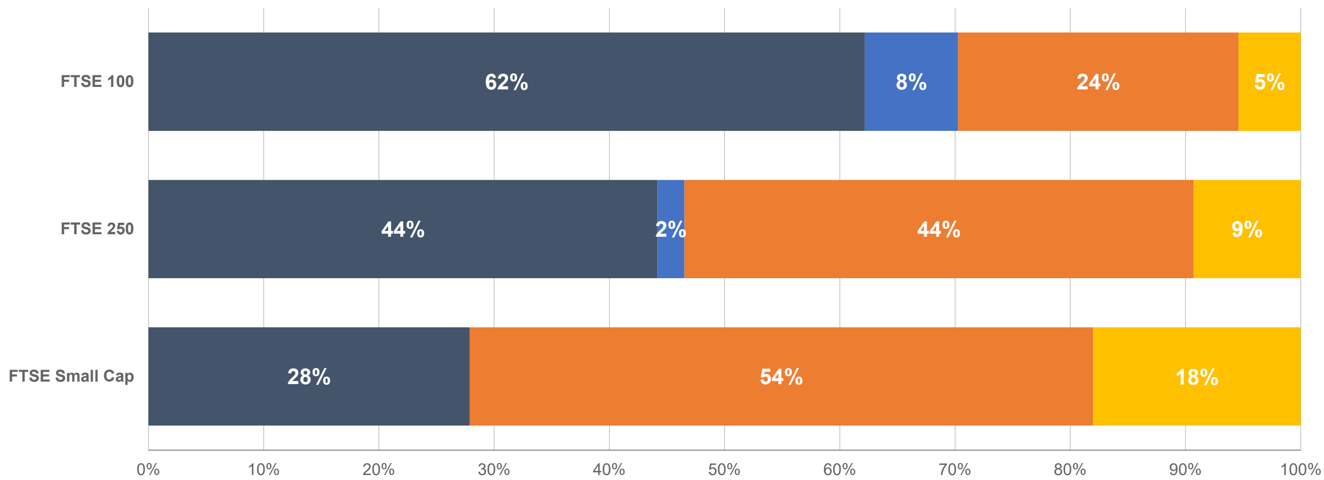
>10%

(Higher in the FTSE 250 and
Small Cap than in the FTSE 100)

LTIP: Basis for Measuring EPS Performance

For profit targets in the LTIP, almost 95 percent of companies use earnings per share (EPS) as the profit metric. There are different approaches for calibrating and disclosing the targets, with very mixed market practice, as shown.





It can be observed that:

- The previously ‘conventional’ approach of disclosing targets as a percentage growth rate remains the most common approach in the FTSE 100, but is now a minority practice in the FTSE 250 and Small Cap.
- In the FTSE 250 and Small Cap, it is more common for targets to be expressed on an absolute (pence) basis, and relatively common for this to be assessed on a ‘cumulative’ basis over the performance period.
- Measuring growth relative to a benchmark (such as RPI) is now very unusual, particularly in smaller companies.

LTIP: Profit Target Ranges

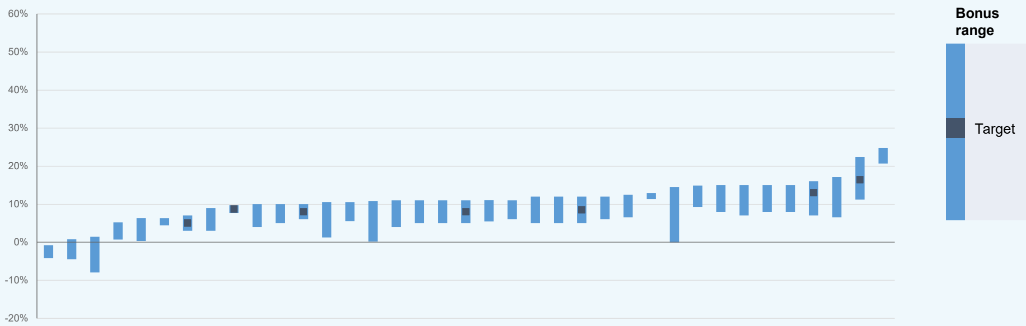
The charts show the range of market practice for profit target ranges in LTIP awards, with each bar again representing the target range (from Threshold to Maximum) for one company. The assumptions and caveats to this data should be noted.[3]

There is a wide range of targeted growth levels in the market data, which is to be expected given different sectoral exposures to growth and/or company specific factors for any given year.

The median level of growth required for Threshold and Maximum vesting (i.e. c.5 percent and c.12 percent) is broadly the same across all three market segments. However, there is a wider range of expected performance in the FTSE 250 and Small Cap compared to the FTSE 100, with around a quarter of both groups requiring growth in excess of 20 percent per annum for maximum vesting.

FTSE 100

	LQ	Median	UQ
Maximum	10%	11%	14%
Threshold	3%	5%	7%

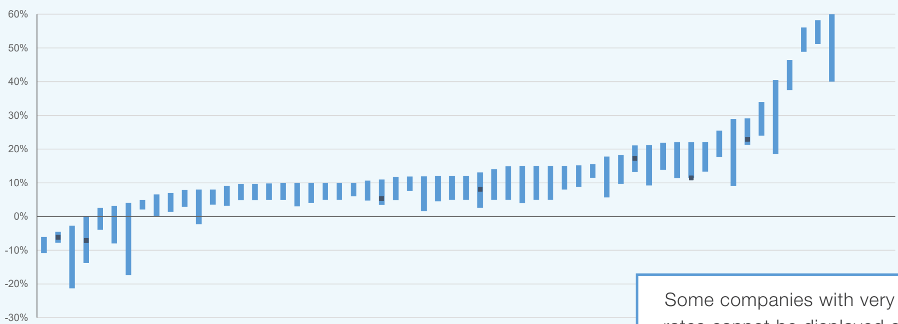


FTSE 250

	LQ	Median	UQ
Maximum	8%	12%	17%
Threshold	3%	5%	8%

FTSE Small Cap

	LQ	Median	UQ
Maximum	10%	12%	22%
Threshold	3%	5%	11%



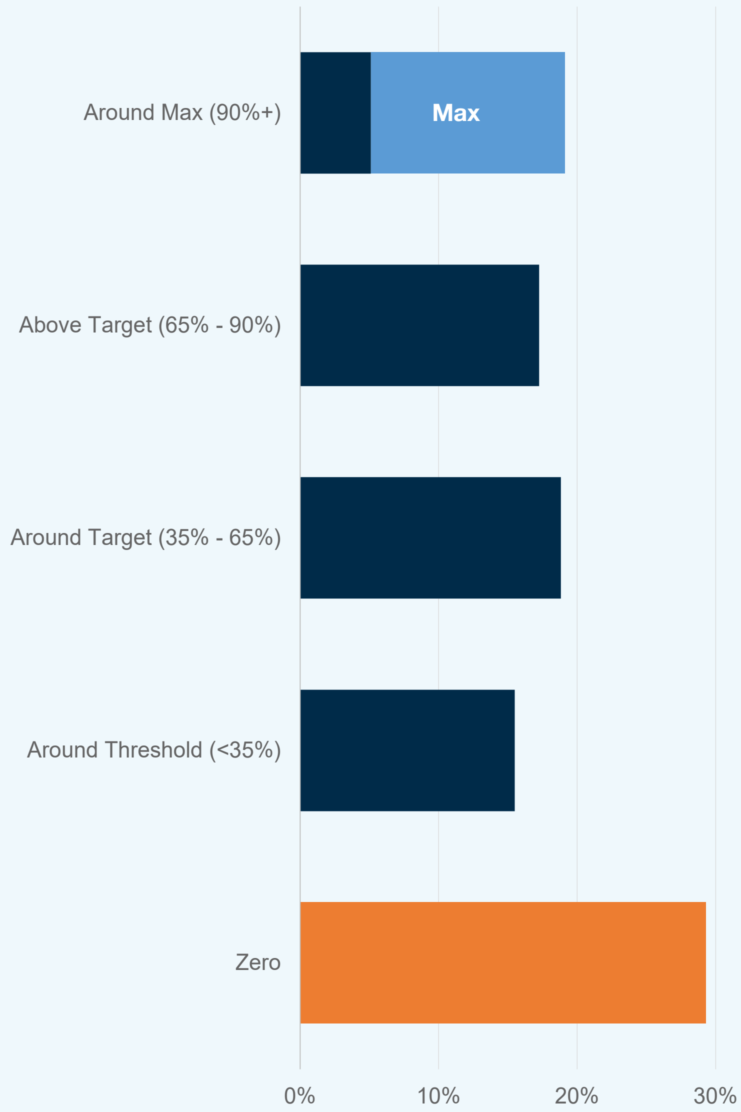
Some companies with very high growth rates cannot be displayed on the charts given the scale of the y-axis

LTIP: Typical Levels of Pay-Out in the Market

The chart below shows market data on the level of LTIP vesting for the CEO over the last four AGM seasons, in aggregate and across the FTSE 100, 250 and Small Cap combined.

While there is some variation in vesting outcome over this period depending on the year, as well as the sector and segment of the market, the data provides a further reference point for remuneration committees when calibrating LTIP ranges, by indicating what might be broadly expected, on average and over time, to vest.

Distribution of LTIP vesting outcomes



This data shows that over this four-year period:

- Around one in five received vesting above 90%, with 14% seeing maximum vesting.
- There is a wider distribution of vesting outcome, with lower expected outcomes on average, than for the annual bonus.
- Around one in three awards in this period lapsed in full.
- The median and average outcome was 45% of maximum.

End Notes

The report includes companies in the FTSE 100, FTSE 250 and FTSE Small Cap indices (as at November 2022) with year-ends from October 2021 to September 2022, and using the most recently disclosed data as at January 2023.

1. The number of points in a bonus or LTIP schedule is based on the public disclosure. It is possible that some companies disclosing the use of a two-point schedule (Threshold and Maximum) may, in practice, be operating a schedule with three or more points but which has simply not been disclosed.

2. Calculating an implied growth rate requires comparing the disclosed bonus targets with the disclosed prior year actual for the same performance measure. However, it should be noted that these figures are often not directly comparable for a range of reasons (such as currency or price adjustments, M&A, specific adjustments for bonus plan purposes, etc.). Every care has been taken to ensure the numbers used are as comparable as reasonably possible, and where they are considered to be insufficiently reliable have been excluded.

3. The most recently disclosed LTIP targets are shown, which will typically use the prospective disclosure for the forthcoming LTIP award. Where this is not disclosed, target data for the award made in the year is used. All profit targets are included. Where targets are disclosed as absolute (pence) values, an implied growth rate is calculated using a 'base year' and, as per note 2 above, it should be noted that these figures may not be directly comparable for a range of reasons. Every care has been taken to ensure the numbers used are as comparable as reasonably possible, and where they are considered to be insufficiently reliable have been excluded. Where targets are disclosed as a cumulative pence value, the implied growth rate represents the constant rate of growth from the base year which would equate to the cumulative targets over the period. Where EPS targets are set in excess of a benchmark (e.g. inflation or market growth metric), for the purposes of this data they have been converted to absolute growth using a simplified assumption of 3 percent per annum.

ABOUT ALVAREZ & MARSAL

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