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Technology Industry 2025 Market Trends – Relative TSR Metric Design

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For the next installment of our technology industry research, Compensation Advisory Partners (CAP) reviewed long-term incentive relative total shareholder return ("rTSR") metric design practices across 52 companies in the Technology industry as well as general industry (the Nasdaq 100 index for purposes of this research). The technology companies are split into three groups by revenue size: $500 million to $2 billion ("Small"), $2 billion to $5 billion ("Medium"), and over $5 billion ("Large").

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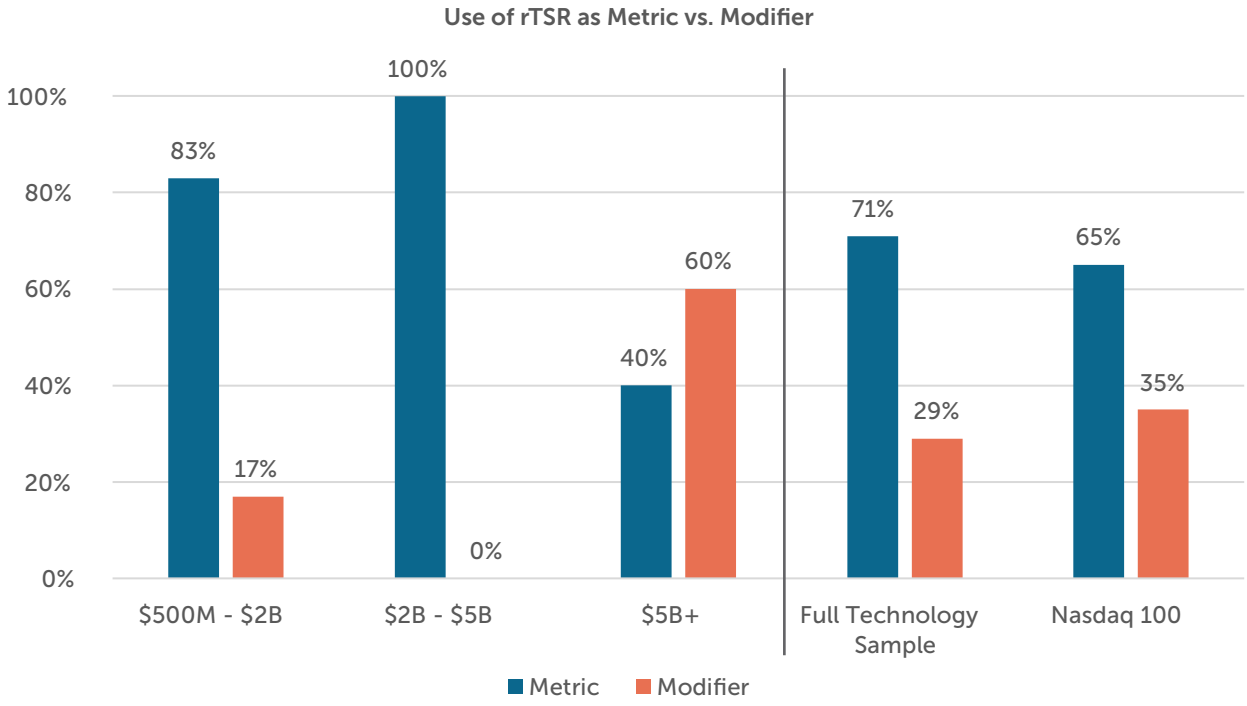
This report reviews key design practices and considerations of using relative TSR in long-term incentive plans. Relative TSR is a widely used metric in long-term incentive plans as it aligns executives to the shareholder experience and avoids the challenges of setting internal performance targets. In our review, we found that 46% of the technology companies use rTSR while 52% in the broader sample of Nasdaq 100 companies use the metric in their long-term incentive plan. CAP's design considerations are intended to inform of best practices in technology companies around use of rTSR in long-term incentive programs.

Design Consideration: rTSR as Metric or Modifier

Twenty-four of the 52 technology companies in our study use rTSR in their long-term incentive plans (i.e. 46%). Of those, 17 companies (71%) use it as a weighted performance metric, and 7 companies (29%) use it as a payout modifier. Larger companies overall are more likely to use rTSR as a modifier, while medium and smaller companies in the technology sample more commonly use rTSR as a weighted metric.



Companies most often balance the use of rTSR with other financial metrics, depending on company strategy and long-term priorities. Pairing rTSR with financial metrics can mitigate the impact of volatile markets, provide more balance and reward executives for meeting operational goals. When rTSR is used in the performance plan as a weighted metric along with other metrics, the average weighting is 50% of the award. A quarter of the technology companies using rTSR as a weighted metric use it as the sole metric in the performance plan. Using rTSR as a weighted metric creates greater alignment between executive pay and shareholder outcomes.

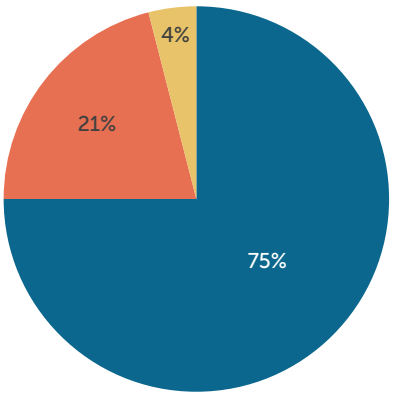
Award modifiers (versus weighted measures) can add complexity yet are effective at promoting alignment between executives and shareholders while still prioritizing operational performance as the rTSR impact is smaller. A criticism of rTSR is that it is an outcome measure, versus one that drives performance, but market and operational performance may not always be aligned so using it as a modifier can help provide balance. At median of both the technology company sample and Nasdaq 100 companies, the modifier can adjust payouts by ±25%.

Design Consideration: TSR Comparator Groups

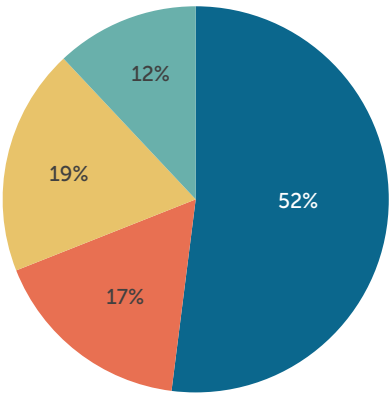
The choice of a comparator group sets the context for how rTSR performance will be evaluated. There are four typical options as discussed below.

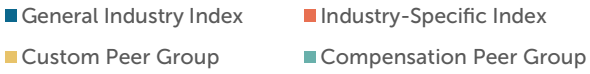
Comparator Group	Pros	Cons
General Industry Index (e.g. Nasdaq 100, S&P 500, Russell 3000, etc.)	• Includes companies outside the industry, which can smooth payouts • Reflects broadest group of companies competing for investor dollars • Broader reference point results in a large sample size which minimizes impact of M&A on comparator companies	• Includes companies outside the industry, which can lead to payout outcomes misaligned with operational/industry performance • Smaller companies may not be a constituent of a broad market index yet
Industry Specific Index (e.g. S&P 500 IT Sector, Nasdaq Internet, etc.)	• Includes companies within the industry that are in similar operational environments and subject to similar industry factors / influences	• Outcomes can be misaligned with broader market performance (e.g., if industry is underperforming other industries but leading industry, can result in max payout)
Custom Performance Peer Group	• Can include companies that experience similar headwinds/ tailwinds and that are the most direct business competitors • Can be selective in determining comparator group	• Can be criticized that peers are hand selected or "cherry picked" to result in best results • May need to reevaluate with each grant depending on M&A activity • Can sometimes result in a small comparator group where small changes in performance can result in large differences in payout
Compensation Benchmarking Peer Group	• Easy to understand for participants • Credible list of companies that management and committee have already agreed upon	• Benchmarking peer group may be broader and include companies that are competitors for talent but not business • Any changes to benchmarking peer group will need to be evaluated in light of impact to rTSR-based awards

Technology Cos. - TSR Comparator Groups



Nasdaq 100 Cos. - TSR Comparator Groups





Among the 24 technology companies using rTSR, 75% use a general industry index, 21% use a technology-specific index, and 4% use a custom performance peer group. Common indices used in the technology sample include the Russell 3000, S&P 500, Nasdaq Composite and Nasdaq 100. In comparison, of the 52 companies in the Nasdaq 100 using rTSR in their long-term performance plans, 52% use a general index, 17% use an industry index, 19% use a custom performance peer group, and 12% use their compensation benchmarking peer group. More technology companies may use a general industry index given that: (1) industry indices may include companies that are largely different (i.e., hardware versus software), and (2) for smaller companies, there may be limited choices of industry indices that are reflective of similar stage companies.

Regardless of the comparator group selected, the comparators/constituents are locked at the start of the performance period. As a result, an approach should be determined in advance to address companies that are acquired, go bankrupt, or are otherwise unable to be included for the full performance period. These provisions should be defined up front in the award agreement to avoid any uncertainty.

Design Consideration: Performance Goals and Payout Scales

Another key design feature includes performance goals and corresponding payout leverage. Among technology companies using rTSR, at median, the payout scale ranges from 50% of target at threshold to 200% of target at maximum, with target performance goals most commonly set at median performance (50th percentile) relative to comparator companies. About a third of the technology companies using rTSR target above-median performance for a target payout, which is a fairly progressive design feature. Proxy advisory firms have criticized median performance that results in a target (or, 100%) payout, despite this being most common practice in both our technology sample and the broader market. Many companies remain comfortable with this approach given that there are items outside of an executive's control impacting stock price and returns.

Performance Goals	Most Common Threshold Payout Goals (%)	
	Technology Cos.	Nasdaq 100
>30th %ile	7%	7%
30th %ile	13%	4%
25th %ile	80%	82%
<25th %ile	0%	7%

Performance Goals	Most Common Target Payout Goals (%)	
	Technology Cos.	Nasdaq 100
60th %ile	13%	7%
55th %ile	27%	31%
50th %ile	60%	62%

Performance Goals	Most Common Maximum Payout Goals (%)	
	Technology Cos.	Nasdaq 100
100th %ile	7%	11%
90th %ile	27%	18%
85th %ile	20%	7%
80th %ile	13%	14%
75th %ile	33%	50%

The structure at technology companies is generally aligned with the broader market. The Nasdaq 100, at median, sets payout curve ranges from 30% of target at threshold to 200% at maximum, with similar prevalence of target goals set at and above median performance.

Most companies set goals that target a relative percentile positioning within the comparator group. A less common approach (2 of the 24 technology companies) is to compare company returns to total index returns. This approach can lead to unexpected outcomes given that most indices are weighted by market capitalization and index performance can be driven by a select group of companies. It can also be difficult to determine the number of percentage points of outperformance (or underperformance) that results in maximum (or threshold) payout.

Performance goal ranges are generally consistent across small, medium, and large revenue groups, though larger companies more commonly set target performance goals above the 50th percentile. It is common for maximum performance goals to be set above the 75th percentile in the technology industry. In the technology sample, 67% of companies set maximum performance goals above the 75th percentile, and 33% set max goals at the 75th percentile, compared to 50% of Nasdaq 100 companies that set maximum performance goals above

the 75th percentile and 50% that that set max goals at the 75th percentile. Threshold performance is typically set at the 25th percentile.

All 24 technology companies measure rTSR performance over at least three years, with 75% using a three-year cumulative period. Many companies, mix and match the length of the performance period used for rTSR and accompanying financial performance metrics, and often use a shorter performance period (i.e., less than three years) for financial measures. Of the 18 technology companies pairing rTSR with financial metrics, 28% measure financial performance over the same three-year period; 44% of companies use three one-year periods. The remaining 28% use a one-year period in conjunction with a three-year rTSR performance period.

The use of mixed performance periods reflects the challenging nature of financial goal setting in a high-growth and/or volatile macroeconomic environment. While relative performance measures like rTSR should account for external risk factors affecting the industry or broader market, long-term absolute financial results can be impacted by factors not predicted at the time of goal-setting which are beyond executives' control.

Additional Considerations

TSR Calculation Methodology

When setting performance goals, it is important to clearly define the methodology for calculating TSR. It has become exceedingly common to use an average stock price for both the beginning and end of the performance period versus using spot prices. The most common averaging period among technology companies in the sample is 30 trading days (preceding the beginning and end dates of the performance period). Average prices can reduce irregular outcomes caused by stock price volatility on one specific date for both the company and the comparator companies.

When implementing or making changes to rTSR in the plan, historical back testing can also be helpful. This can help with selection of comparator companies as well as determining the appropriate trailing period for calculating TSR. It is important to ensure that outcomes are varied over time and that design features are not always advantageous (or disadvantageous) based on program choices.

Accounting Treatment and Number of Shares Granted

Given the accounting rules for market-based performance awards, grant date fair values for awards with an rTSR component may not align with intended target value. Market-based awards require a Monte Carlo valuation to determine fair value so the reported value of rTSR awards in the Summary Compensation Table and Grants of Plan Based Awards Table will be different (oftentimes higher) than a time-based award or performance-based award without market conditions. This can have communication implications when reported values of equity awards are misaligned from the intended target value. This happens when the spot price (or trailing average trading price) is used to determine the number of shares at grant.

When companies determine the number of shares using the Monte Carlo valuation, executives may view this as punitive since they typically receive less shares than if a spot price (or average price) is used. Monte Carlo valuations often result in a premium price compared to the spot price on date of grant. Using the Monte Carlo Value to determine the number of shares is generally less common, particularly if there are financial metrics included in the long-term incentive plan.

Award Caps

An additional feature included in performance plans using rTSR, is an award cap. Award caps are used to prevent above-target payouts if absolute TSR is negative, (e.g., payout is capped at 100% if absolute stock price decreases during the period). This prevents outsized payouts when shareholders are experiencing negative returns, even if the company overall is performing better than the comparator group. For companies using rTSR, 38% of the technology sample and 50% of the Nasdaq 100 companies cap payouts at target for absolute stock price decline. This feature is viewed as a good governance practice and is well received by shareholders and proxy advisory firms.

Conclusion

Relative TSR is generally considered to be a clear and easy to understand metric in long-term incentive plans. It is a simple way to provide balance and include both relative and absolute performance considerations. While often used at larger established companies, our study shows that technology companies, even with a smaller market cap, use rTSR given the challenges of setting long-term financial performance goals. Used effectively, relative TSR can enhance program design, particularly when balanced with other performance metrics and/or long-term incentive vehicles.