Realizable Pay 101: What you really need to know

More and more institutional investors are using realizable pay as a way to gauge a company’s pay-for-performance commitment. But compensation consultants (and companies, too, to a lesser degree) have been touting forms of realizable pay since at least 2005. Why are investors only now starting to pay close attention to realizable pay?

The answer is in the changing structure of pay. 2012 marked a seminal year in executive compensation: the first year where the majority of CEO grant-date pay was performance based. Granted pay and target pay, two bellwether compensation measures, are still important – but they don’t help investors understand the impact of a performance-oriented compensation package. Compensation consultants and companies are usually driven to demonstrate a tight linkage between a company’s performance (usually measured with Total Shareholder Return) and an executive’s compensation. Realizable pay is the compensation measure that neatly fills that need.

But, as one of our clients put it, we’re still in the “wild west” days of realizable pay; there’s no standard definition for how to calculate it, there’s no standard presentation format, and it’s unclear how institutional investors will use the information when they make portfolio allocation decisions and proxy voting decisions.

Companies need to know a little about realizable pay before they work with their compensation committees and compensation consultants to decide how they should use realizable pay in their CD&A. Here are a few of the “101” level questions you should know the answers to when you talk about realizable pay:

**What is realizable pay, and how is it different than more traditional compensation measures?**

Realizable pay is a compensation measure that focuses on a different part of the “compensation lifecycle” than traditional measures. Most conventional executive pay metrics focus on the ends of the compensation lifecycle – when the pay is granted, and when it is ultimately realized by the executive. But realizable pay focuses on the middle of the compensation lifecycle – after it has been granted, but before performance-based or time-based awards have all been ultimately realized.
Note, there’s an important distinction between realizable and realized. Realized only includes compensation that the executive has completely harvested the value from – exercised options or sold their earned performance shares, for instance. And in many cases, realized pay includes any compensation realized during the period – including the exercise of equity options that may have been granted ten years ago.

Realizable, on the other hand, is a more hypothetical metric – it’s the value of compensation over a measured period, given the performance of the company and the associated awards of performance-based awards and appreciation or depreciation of other equity and equity-like awards. Realizable pay could be higher or lower than granted pay, depending on a company’s performance and how performance targets were set.

**What are some of the controversies around calculating Realizable Pay?**

Realizable Pay can be calculated in a number of ways – and the method you choose to calculate realizable pay can have a dramatic impact on the realizable pay number you end up with. Two of the most contentious assumptions revolve around how to value options, and when to “lock in” the value of time-based and performance-based awards.

For options, the two most frequently used methods are including only the intrinsic value of an option (the exercise price less the closing price at the end of the realizable pay measurement period), and using a more comprehensive valuation technique such as a Black-Scholes model.

The intrinsic value model is helpful to companies that are trying to minimize the reported value of realizable pay; in some cases, where there are large equity grants that are marginally out of the money and have long durations to expiration, intrinsic value can vastly understate the value of an executive’s equity awards. They’re valued at zero!
On the other hand, a Black-Scholes model is much more comprehensive, and in most cases, comes much closer to the true value of an option award. However, for most executives, it systematically (though usually mildly) overstates the value of the awards due to holding period restrictions, exercise blackouts, and other issues. And, of course, it has the impact of making realizable pay look larger in the eyes of investors.

The other major contention is around when performance and time-based awards have their value “locked in” to the realizable pay calculation. Some believe that once an award is earned, it should be locked in – whether or not the award has vested. Others believe that awards should be “locked in” when they vest – regardless of holding restrictions or blackouts around exercising. Finally, some believe that awards should all be valued at the end of the realizable pay measurement period; this provides the cleanest “apples to apples” comparison among companies.

Depending on what assumptions you make, you might end up with dramatically different values that you disclose to your investors. Here’s an example of an S&P 500 company that highlights the range of values available depending on the calculation technique:

**Impact of using different Realizable Pay calculation methods**
3-Year CEO Realizable Pay for Sample S&P 500 Company

![Bar chart showing different calculation methods for realizable pay]
How should I think about disclosing realizable pay?

Disclosing your realizable pay can be a big decision – but in most cases, presents a great opportunity to demonstrate your compensation program’s commitment to pay-for-performance. But there’s no “one way” to disclose it; we’ve seen companies gravitating towards one of three ways to disclose based on their performance track record. The following table highlights the most common objectives and features that we see companies using to disclose realizable pay.

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<th>Good Pay for Performance alignment – Positive Company Performance</th>
<th>Commonly Cited Disclosure Objectives</th>
<th>Typical disclosure features</th>
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<tbody>
<tr>
<td>• Ensure good justification case is made for above-median executive compensation</td>
<td>Disclose Realizable Pay via a peer-based comparison</td>
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<tr>
<th>Good Pay for Performance alignment – Moderate Company Performance</th>
<th>• Communicate tight pay-for-performance linkage</th>
<th>Disclose Realizable Pay via a time series of Realizable Pay and company performance</th>
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<td>• Track varying realizable pay levels based on individual company performance</td>
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<tr>
<th>Good Pay for Performance alignment – Poor Company Performance</th>
<th>• Highlight high degree of granted pay that is no longer realizable</th>
<th>Disclose Realizable Pay by displaying percentage of Granted Pay that is no longer realizable</th>
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| Poor Pay for Performance alignment | Companies with poor pay-for-performance alignment typically do not disclose realizable pay. In some cases, the conspicuous absence of a realizable pay disclosure can be a concern. | |

How can ISS Corporate Services help?

ISS Corporate Services is serving its ExecComp Suite and ExecComp Analytics clients by helping them:

- Understand how to use realizable pay effectively to highlight a company’s pay-for-performance commitment
- Calculate realizable pay using a variety of calculation methods, including the ISS defined calculation method
- Select the presentation style that companies can get the most mileage out of with their institutional investors and advisors
- Anticipate questions and issues that institutional investors may have with their realizable pay when compared to granted pay
- Identify potential adjustments to their executive pay program to reinforce its pay-for-performance commitment