Relative Total Shareholder Return Compensation

Trends, Challenges, and Valuation Considerations

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Executive Summary

Relative total shareholder return (TSR) has become a central metric in long-term incentive plans, particularly for aligning executive compensation with shareholder outcomes. As companies navigate market volatility and evolving governance standards, a clear understanding of relative TSR-based awards is essential for effective plan design and regulatory compliance.

Definition and Mechanics

Relative TSR compensation typically involves performance-based equity awards—such as performance stock units (PSUs) or restricted stock units (RSUs)—that vest or pay out based on a company's TSR performance relative to a defined peer group or market index over a specified period, commonly three years. TSR reflects stock price appreciation plus reinvested dividends, offering a comprehensive measure of shareholder value creation.

Unlike absolute TSR, which evaluates a company's standalone performance, relative TSR benchmarks performance against peers. This structure is intended to reward outperformance regardless of broader market conditions. For example, executives may earn 150-200% of the target award for top-quartile performance, while below-median results may result in no payout. Under ASC 718, these awards are classified as market-condition grants, requiring fair value measurement at the grant date without subsequent adjustment for performance outcomes. Common design features include interpolation between performance thresholds, discrete payout levels, and caps for negative absolute TSR. As we have previously **discussed**, new proxy disclosure rules implemented in 2022 brought greater attention to these types of plans and awards.

Adoption Trends

Relative TSR has seen widespread adoption among U.S. public companies. In 2024, **over 70% of S&P 500** companies granted PSUs tied to relative TSR, a significant increase from prior decades. Some companies also use hybrid models that combine TSR with financial metrics such as earnings per share (EPS) or return on invested capital (ROIC). Adoption rates among smaller companies remain lower (40–50%), often due to challenges in peer group selection and valuation.

For a summary of the changes and SEC commentary following the first year of pay versus performance on relative TSR plans, **see our prior article on the topic.**

Implementation Challenges

Despite its advantages, relative TSR presents several design and operational challenges:

- **Peer Group Selection:** Identifying appropriate comparable companies is complex and subject to scrutiny. Differences in industry, size, or business model can distort outcomes. Peer group changes due to mergers, acquisitions, or delistings require ongoing updates.
- **Market Sensitivity:** TSR can be affected by external factors beyond management's control. High relative rankings may occur despite negative absolute returns, raising concerns about fairness.
- **Negative TSR Caps:** Without caps, awards may vest at high levels even when shareholders experience losses. Many plans now include caps (e.g., limiting payouts to 100% if TSR is negative).
- **Accounting and Disclosure:** ASC 718 prescribes grant-date fair value recognition, which typically requires the use of Monte Carlo simulation. Disclosure complexity and potential SEC scrutiny may add to the administrative burden.
- **Proxy and Shareholder Oversight:** Poorly designed plans may face negative say-on-pay votes. Proxy advisors penalize plans with low rigor or excessive payouts, prompting companies to enhance design robustness.

Valuation Considerations

Valuing relative TSR awards typically involves Monte Carlo simulation, which models thousands of potential stock price paths for the company and its peers. This method incorporates volatility, correlation, and dividend assumptions to estimate fair value at grant.

Key steps include:

1. **Input Collection:** Gather historical stock returns, risk-free rates, and peer correlations.
2. **Simulation:** Project stock paths using stochastic models such as geometric Brownian motion.
3. **Payout Calculation:** Determine TSR rankings for each path and apply the plan's payout scale.
4. **Fair Value Estimation:** Calculate the average discounted payout across simulations to determine fair value.
5. **Tests of Reasonableness:** Sensitivity analyses are often used to assess the impact of changes in key assumptions.

U.S. GAAP (ASC 718) requires Monte Carlo simulation for awards with market conditions, especially when payout structures are non-linear or include caps. Monte Carlo simulation requires technical expertise to implement, and inaccurate inputs or flawed modeling can lead to distorted compensation expense and misleading proxy disclosures.

Implications and Key Takeaways

Relative TSR remains a widely adopted mechanism for aligning executive pay with shareholder outcomes. Its effectiveness depends on thoughtful plan design, including:

- Selecting relevant and stable peer groups
- Incorporating safeguards such as caps on negative TSR
- Applying robust valuation methodologies

As market conditions evolve, companies should regularly review and adjust their compensation frameworks to maintain alignment with governance expectations and shareholder interests.

How Mercer Capital Can Support

Mercer Capital provides specialized valuation services for equity-based compensation, including relative TSR awards under ASC 718. Our team offers independent fair value assessments, Monte Carlo simulations, and strategic guidance on plan design and peer benchmarking. Contact Mercer Capital to learn how we can support your financial reporting and executive compensation strategies.

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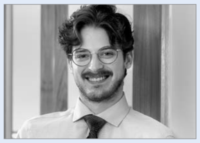

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