

AGENDA

‘Scramble Mode’ — Tool Aims to Ease Comp Rule Calculations

The Monte Carlo simulator will estimate the value of TSR-based performance awards

By Amanda Gerut | November 21, 2022

A compensation firm and a valuation consultant are teaming up to offer a new tool to help companies gauge the in-flight values of market-based performance awards. The two firms, Equilar and Equity Methods, hope the platform will help companies with calculations the SEC is requiring in its pay-versus-performance rule. The tool, a Monte Carlo valuation simulator, is expected to be available in mid-December.

Initially, Equilar and Equity Methods expect that companies will use the simulator to value performance awards with market conditions such as relative total shareholder return (TSR). Eventually however, some compensation committees will likely want to review the status of the pay-versus-performance (PvP) table on an ongoing basis, said Takis Makridis, president and CEO of equity valuation consulting firm Equity Methods. The simulator can provide ongoing information for boards that want to continually monitor the status of performance grants without the need to continually bring in a third-party firm to conduct extensive valuation calculations.

“It describes the ebb and flow in value of the in-flight awards, so boards can see how that value is evolving throughout the year,” said Makridis. He expects that some comp committees will proactively ask to see the table on a quarterly basis to see if the values are moving in the direction expected. “We want this to be a tool that is part of the heartbeat of keeping the committee apprised.”

Equity Methods prepares valuations for clients with comprehensive sensitivity analysis, including engagement with outside auditors. However, that approach would be “overkill for the sake of just doing rapid cuts at multiple junctions throughout the year” for boards that want to monitor awards, said Makridis. The partnership with Equilar will provide companies with values that wouldn’t be on par with those that would make the cut for SEC filing purposes, but will come “pretty close,” he said.

The SEC in August announced its finalized PvP disclosure rule, for which companies would need to include a new tabular disclosure, including a calculated figure termed “compensation actually paid” to the CEO, among other details. For fiscal-year companies, those disclosures will need to be included in 2023 proxy statements.

For certain awards such as stock options, companies can calculate the fair value of awards using the Black-Scholes formula, which has six inputs and is fairly straightforward. For compensation based on total shareholder return relative to, for example, an index or peer group, companies value grants using the more complicated Monte Carlo formula. Oftentimes, companies hire an outside valuation expert or tap the internal valuation teams at their compensation consulting firms. However, the timing of the rule — and the SEC’s timeline for compliance — has strained the capacity of such expertise.

Companies are seeking third-party expertise for the calculations for the two years prior to 2022, but calculations for this year are likely to be conducted in early 2023 to be entered into proxy drafts for the spring season. Accordingly, companies with TSR-based performance share plans are lining up valuation consultants so they can be in the queue to complete the calculations for their CAP disclosures and average CAP for named executive officers. At companies that have had CEO and NEO transitions, the calculations become more complex, sources said.

“The system is capacity constrained,” said one veteran consultant. “Nobody wants to say no, so it’s putting strain on the equity valuation community.”

In addition, in the first year of complying with the rule, companies have been modeling the table to see what it looks like and to show drafts to board members for review. William Main, director of sales and client services at Equilar, who is developing the simulator, said clients were “in scramble mode” trying to put together pro forma calculations in time for fourth-quarter comp committee meetings.

“What a lot of companies are doing is rushing to put something together ahead of Q4 meetings, and some want them even sooner than that,” he said. “For some of our clients, boards are requesting an early draft table as soon as this week or next week.”

The simulator will provide companies with figures that may not be the final disclosures in proxy statements filed with the SEC but will be serviceable enough to show directionality to the board, said Main.

He described the Monte Carlo modeler as part of a valuation dashboard that also contains the Black-Scholes formula and binomial options valuations. In addition, the platform will include correlation analysis of performance measures to absolute TSR, market cap-weighted TSR and pay and performance alignment.

In addition, Makridis noted that after working on about 200 valuation projects since the rule was first announced, the firm hasn't seen significant numbers of cases in which one's "jaw drops to the floor" showing serious distortions in the table. "We're guiding clients to think more in terms of program management and this theme of monitoring the relationships to understand why they move when they move."

"It's more of a motion picture and not a [static] picture because these numbers can and will move quarter after quarter," said Makridis. "Some companies will treat it less as just a photo today and more of something we need to live with and monitor."