FINANCIAL POST

Tesla electrifies the paycheque

With the release of Elon Musk's Tesla pay package last month, gasps were heard in boardrooms across Canada. Thousands of companies will be holding their annual advisory vote on compensation - otherwise known as say-on-pay - and Musk's pay package changes everything. Many directors are deliberating how to remunerate their top talent while meeting the changing expectations of shareholders.

The present value of Musk's 10-year stock-option grant, vesting in 12 tranches based on aspirational performance metrics, totals a whopping US$2.6 billion, with the future value that could be realized reaching US$55.8 billion. Unlike the non-binding say-on-pay vote in Canada, Tesla shareholders will have the power to bless or deny the pay package, a privilege they did not have when the last one was approved in 2012.

Beyond the dollar amount there are a few unique features that boards should note. First, it demonstrates the pay-for-performance doctrine in the purest way with an "all-or-nothing" design. The vesting conditions of each tranche are comprised of one market-capitalization milestone (at the increment of US$50 billion up to US$650 billion after first reaching US$100 billion from the current US$55 billion) and one operating milestone (out of eight topline milestones and eight bottom-line milestones: revenue from US$20 billion to US$175 billion; adjusted EBITDA from US$1.5 billion to US$14 billion).

Second, it is a long-term package that lasts 10 years but has no quarterly or annual targets. The milestone can be reached at any time within the 10 years. Multiple tranches can vest at once. In a world where short-termism has gained popularity, this feature really stands out.

Third, forget about total shareholder return and real profitability. Growing market capitalization and topline revenue are most important here.

The bottom-line measure, adjusted EBITDA, will exclude the expense of stockbased compensation, such as this pay package.

Plus, Tesla could meet all the eight top-line milestones and only four of the eight bottom-line milestones.

For a company like Tesla, if it can grow the number of shares without a stock-price decrease or raise money without making money, Musk will still be able to hit all the milestones. Shareholder return or real profitability could be further down the horizon. But who will complain with such magnificent growth? Fourth, there is no benchmarking. Looking at what your peers are doing has been popular in recent years in particular because of the growing amount of disclosure on executive compensation. Positioning executive pay at the peer median has also become acceptable.

However, cherry-picking peers and inflating benchmark pay have resulted in increasing critiques over the benchmarking approach.

With no peers for Tesla to look to, this new package is not much different from the one Musk was given in 2012, except that the then-present value of the 2012 package was only US$78 million, a rounding error of this new package.

So could an approach like this work at other companies? Keep in mind the package is all Musk will get. No base salary, no annual bonus, no pension, and no perks, but Musk is already a multibillionaire and does not need these extras. Lower-ranked executives at Tesla have more conventional packages. So, the question for boards is whether their CEO should be incentivized differently if he or she is a visionary founder or if retaining the CEO is a, if not the, most critical component of driving long-term value.

Boards also need to ask if they could sell a package with similar features to their shareholders. Tesla engaged with 15 of its largest institutional shareholders over six months while designing this package. Proxy advisers such as Institutional Shareholder Services and Glass Lewis are likely to support the package even though it runs afoul of their quantitative assessment, which is not designed to assess a plan this unusual.

Tesla did take note of concerns raised previously and included a clawback, fiveyear post-exercise holding period - all will be liked by proxy advisers.

With Tesla shareholders likely to endorse the package, the lesson for directors should not be taken from the headline number but a close calibration between pay and performance that says to shareholders, "we're with you."

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