Executive Compensation: The Good, the Bad and the Ugly

Summary

The US E&P sector has rebounded strongly from its 2020 lows, driven by the move of WTI prices above $70/bbl and the promise of a new business model. However, the combination of higher commodity prices and a rising rig count has sparked a debate over whether the vows of capital discipline taken by CEOs at the depths of the crisis will hold. Are we truly charting a new course forward for the sector, or will this be a repeat of the 2016-2018 cycle when misplaced growth ambitions drove a collapse in valuation multiples? From our perspective, the fate of the industry hinges on whether Boards can successfully align executive compensation with the new E&P business model. As Charlie Munger once said, "show me the incentive and I'll show you the outcome." With that directive in mind, we thought it made sense to review company 2021 proxy statements and assess the degree to which Boards have addressed the deficiencies we highlighted in our original white paper on governance, "Bringing Alignment and Accountability to the E&P Sector."

Our conclusion is that the progress over the past year has been too incremental relative to the scale of shareholder value destruction over the past decade. While we are encouraged by the significant shift away from production metrics within short-term incentives, the evolution of long-term incentives has been far more measured. The percentage of time-based compensation remains too high, while the performance-based component is still largely tied to relative total shareholder return (TSR) within a narrow peer group. Furthermore, the pandemic once again exposed the unwillingness of Boards to hold management teams accountable, even after a protracted period of shareholder value destruction. As we highlight in the paper, total CEO compensation in 2020 was only 1% lower than 2018 despite a 60% decline in share prices over the same period. If we truly want to end the pro-cyclical behavior that has historically plagued the industry, commodity prices can no longer serve as both a tailwind and scapegoat for rewarding executives.

The goal of this paper is to help ensure that that the progress made over the past year is viewed as a starting point for further engagement between investors and Boards. Investors should applaud those who are willing to make more meaningful changes to their compensation plans and hold the laggards accountable. Higher commodity prices may temporarily alleviate some of the investor pressure on reforming governance, but it is important to remember that this is a highly cyclical industry destined to repeat the mistakes of the past if the underlying issues around alignment and accountability are not properly addressed.

A Failed Business Model

Over the past decade the E&P industry prioritized growth over returns. It continued to reinvest at excessively high rates despite the inability to cover its cost of capital. In theory, companies were attempting to maximize Net Asset Value, but the strategy failed to account for the underlying cyclicality of commodity prices or the continued deferral of free cash flow in an environment where investors are increasingly concerned about the transition away from fossil fuels. Even as investors abandoned the sector and valuation multiples collapsed, the industry remained committed to a failed business model. Why did the value destructive behavior persist for so long? Why did it take a global pandemic and negative oil prices to finally see a commitment to a new model? From our perspective, the answer lies in the misalignment of incentives. We previously identified three key deficiencies in the governance of public E&P companies:

1. **Asymmetry Between Success and Failure**
   A lack of downside risk to job security or compensation results in a pro-cyclical bias and excessive risk-taking. The industry has not only found a way to get paid for the beta in a rising commodity price environment, but it is also able to use it as an excuse when prices fall. That asymmetry materializes in consistent payouts over 100% of target bonuses, large cash payouts into bankruptcy, low dismissal rates for CEOs and discretionary adjustments to compensation plans when the macro environment deteriorates. We have called for greater accountability at the Board level, so executives operate with a clear sense of downside risk. Given that 2020 might have been the ultimate downside scenario it provides a real-time look at how willing Boards were to hold management teams accountable.

2. **Low Insider Ownership**
   Low levels of insider ownership result in an agency problem between shareholders and management. Given the separation of ownership and control, compensation plans must motivate managers to internalize the wealth effects of their decisions. Kimmeridge believes that long-term incentives at the CEO level should be 100% performance-based, while change of control payouts should be restructured to promote alignment with shareholders.

3. **Reliance on Relative TSR with a Narrow Peer Group**
   Investors often criticize the herd mentality within the E&P industry. We attribute it to the disproportionate reliance on relative TSR where most executives can receive 100% of their target long-term incentives for median performance. Executives continually evolve their strategy to ensure they look similar enough to peers and chase what is currently rewarded by the market. This is often at the expense of pursuing a strategy that would be in the best interest of their long-term shareholders. That is why investors are paranoid about what will happen if the market begins to reward production growth again. We have advocated for incorporating financial metrics such as cumulative free cash flow and return-based metrics within long-term incentives. Incentives should be tied to successful execution of the corporate strategy, rather than simply the outcome of relative share price performance. Additionally, when relative TSR is utilized, companies should broaden out the peer group so that it is representative of the opportunity set across the sector using indices. Finally, we have advocated for a matrix approach to the intersection of relative and absolute performance so that the penalty for negative returns goes beyond capping payouts at 100% of target.

To address these three deficiencies and promote greater alignment and accountability, Kimmeridge proposed the following principles for reforming executive compensation:

1. Eliminate growth metrics and discretion from short-term incentives
2. 100% performance-based long-term incentives that are only settled in shares
3. Deemphasize relative TSR for absolute TSR and long-term financial metrics

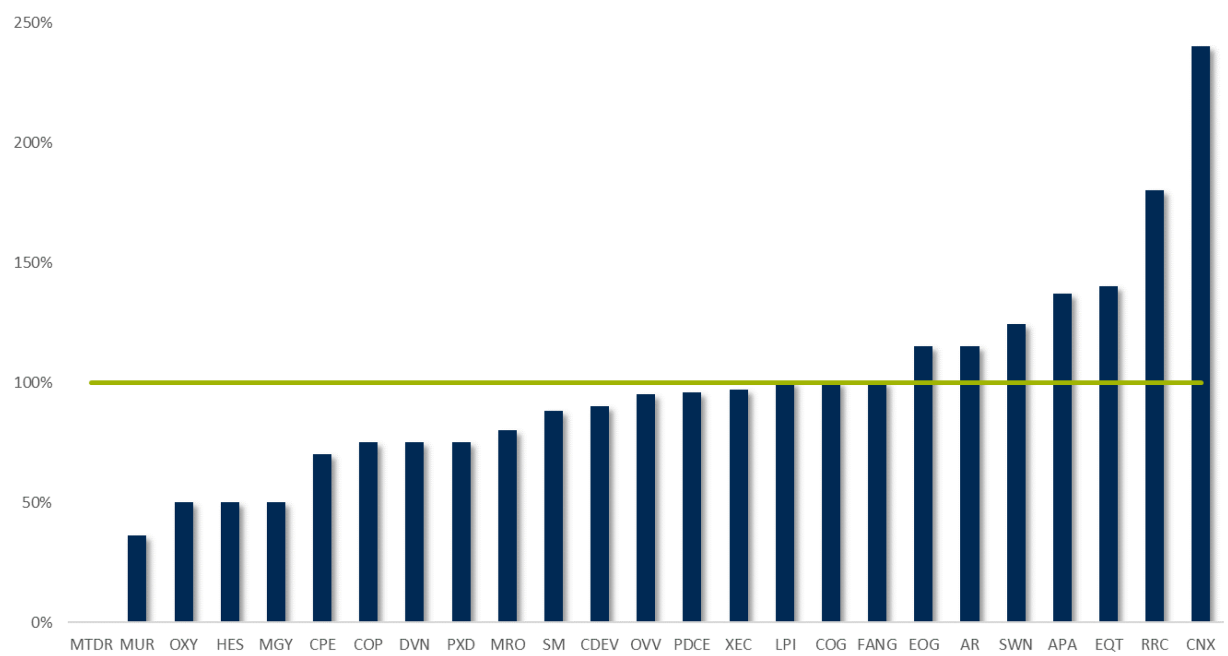
4. Increase change of control payouts with improved shareholder alignment

What follows is our assessment of Boards' willingness to hold management teams accountable in 2020 and embrace these principles in establishing their 2021 compensation plans. For this analysis we reviewed the disclosures in the Proxy Statements for 27 public US E&P companies ("US E&P Companies") and highlight examples of companies which we believe made industry-leading progress within their compensation plans.

Accountability

2020 was the ultimate test in Board accountability. The exceptional volatility in both commodity and share prices forced Boards to react real-time. It became clear which Boards were willing to hold management teams accountable and which were focused on ensuring their executives were still rewarded as their share prices collapsed. Maybe it was the severity of the crisis or the heightened scrutiny on the issue, but we did finally see most annual bonuses paid below target in 2020.

Figure 1: Short-Term Incentive Payout as a Percentage of Target (2020)

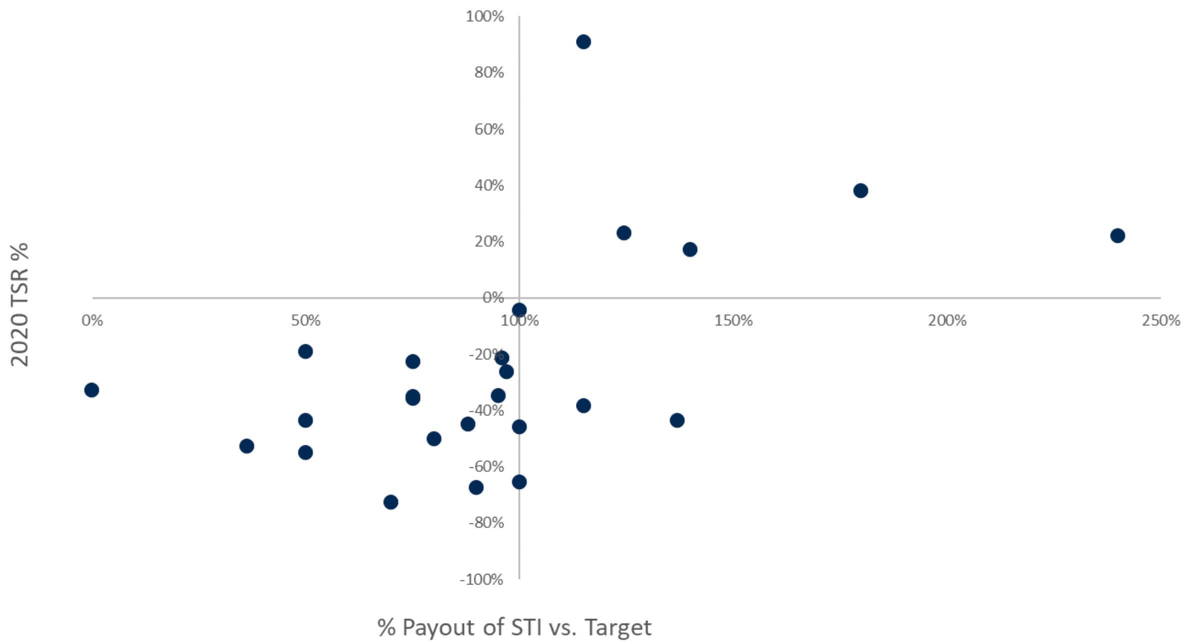


Source: Proxy Statements[1]

However the median payout of 95% still seems unjustifiably high for what transpired last year when the median share price return was -36%. And there was significant clustering around a 90% payout of target for stocks that were down between 20-67%:

[1] Short-Term Incentive (STI) payout relative to 100% target for 25 of the 27 US E&P Companies. Excludes OAS and WLL, which declared bankruptcy in 2020.

Figure 2: Short-Term Incentive Payout Relative to TSR (2020)



Source: Proxy Statements and Bloomberg[2]

Overall, we saw a median decline in total CEO compensation of 14% compared to 2019, but that still only represents a 1% decline from 2018 levels. During that three-year period, those same companies had a TSR of -60%.[3]

And while the bonus payouts in 2020 may seem less egregious now given the recovery in share prices since last November, it is important to note that Boards actively changed compensation plans at the depths of the crisis once it became clear that companies would miss their operational and financial targets. Some Boards instituted a corresponding cap on the payout of adjusted metrics, while some allowed their executives to enjoy elevated payouts even after moving the goal post. Here are examples of the different approaches that Boards took:

- Matador: Zero cash bonuses to any named executives in 2020; total CEO pay -79%
- Murphy: No changes to STI metrics and only paid out 36% of target bonus
- Devon: Updated goals in March 2020 but negative discretion reduced payout from 153% to 75%
- Hess: Adjusted STI targets and weightings in June 2020 but capped payout at 50% of target
- Pioneer: Adjusted STI goals but reduced maximum score by 50%; payout was 75% of target
- Apache: Introduced new STI metrics for 2H2020 with no cap and paid out 137% of target

[2] Short-Term Incentive ("STI") payout relative to 100% target for 25 of the 27 US E&P Companies. Excludes OAS and WLL, which declared bankruptcy in 2020.

[3] Median change in compensation calculated for 19 of the 27 US E&P Companies which maintained the same CEO from 2018-2020. Cumulative three-year TSR calculated on Bloomberg from 1/1/18 to 12/31/20.

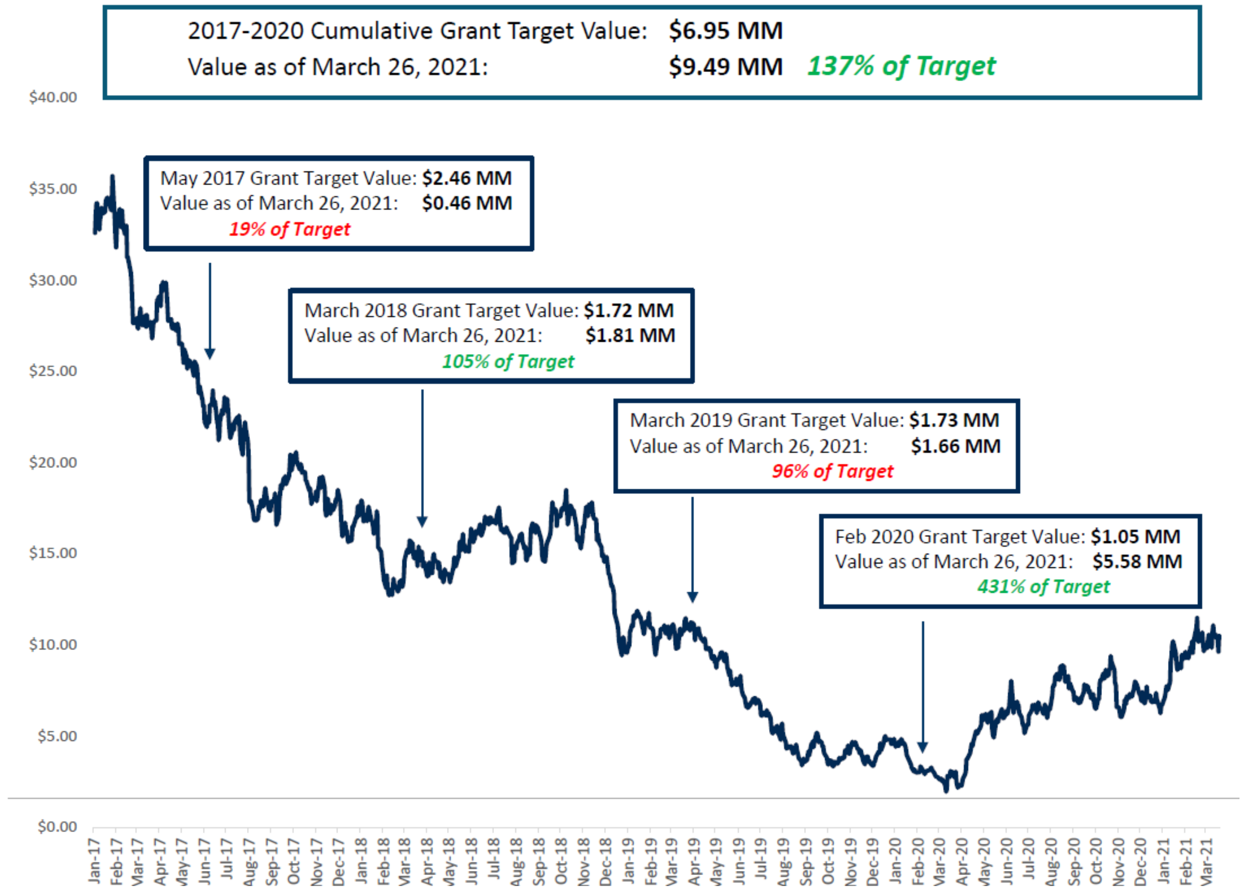
- Callon: Introduced a new incentive program in September 2020 that would allow executives to receive quarterly cash awards from a pool equal to 2.5% of free cash flow for six quarters through 2021 up to $6M

While some may be sympathetic to the argument that executives could no longer deliver on their original targets as the pricing environment deteriorated, we have yet to witness the reciprocal. When oil prices rise more than expected and targets are easier to achieve, Boards never seem to raise the bar to mitigate the payout. This is the asymmetry we have consistently highlighted as the underlying flaw in compensation for the industry.

The crisis also exposed the fallacy that Boards foster alignment between shareholders and executives through long-term, stock-based incentives. Any criticism of executive compensation plans often engenders a response around the need to look at realized compensation versus grant date value. The argument is that even if a CEO is paid 100% of the grant value for their long-term incentives (LTI), the realized value goes up and down with the share price. The issue, however, is that as the stock falls the CEO generally receives a greater number of shares each year. The CEO effectively dollar cost averages without having to risk any of their own capital. We would highlight Range Resources as an example of how executives can benefit from the underlying volatility in their share price, irrespective of the longer-term performance trend. While this is a wide-spread issue across the sector, the share prices of natural gas-focused companies like Range recovered earlier than the oilier E&Ps, making the appreciation in value of the 2020 LTI grants evident in the 2021 proxy filing.

At the time of proxy filing in March 2021, Range's share price had declined by 68% from the start of 2017 and materially underperformed the S&P E&P index (XOP), which had fallen by 50%. However, as disclosed in their proxy filing, the value of the CEO's TSR Performance Share Units (PSUs) from those four years were tracking at 137% of target. This is largely the result of the CEO being awarded his performance shares at $3/share in February 2020, where the expected value had increased by over 400% as of March 2021. Additionally, Range benefited from a self-selected peer group in which one-quarter of the 2020 companies declared bankruptcy and the only penalty for negative TSR over the years was a cap of 100% of target.

Figure 3: Range Resources TSR PSU Grant Date Target vs. Value as of March 26, 2021



Source: Range Resources Proxy Statement and Bloomberg[4]

To their credit, some Boards did identify the potential dilution associated with awarding stock-based compensation during an extreme dislocation in the market and adjusted the cost basis to mitigate the impact.

- Matador: LTI share awards based on $12.50/share vs. the actual $2.41 share price on grant date
- Antero: Deferred grant date from April to July to account for low share price.
- SM Energy: Deferred grant date from July to December to account for low share price.
- EOG: Granted same number of shares as 2019, resulting in a ~50% reduction in grant value.

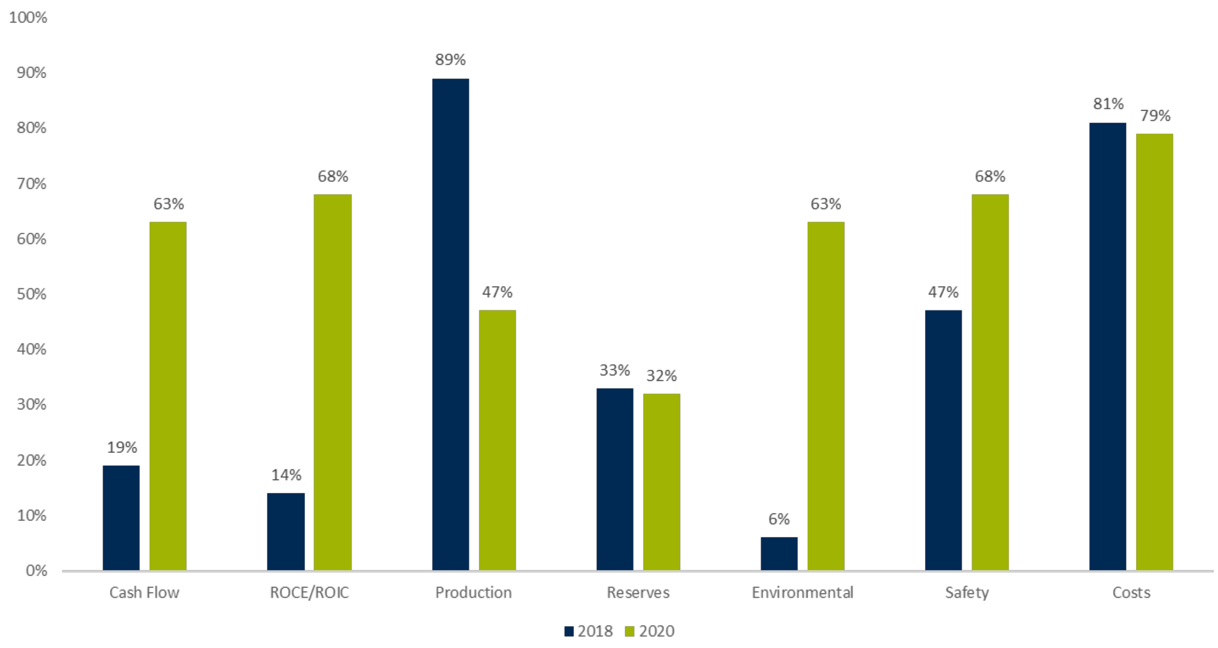
It will be quite telling which companies choose to continue their selective disclosure of expected realized compensation, which was clearly an attempt to divert investor attention away from the SEC standardized disclosure of grant date target value. While they were eager to advertise the lower potential payouts as share prices fell, they may be less willing to disclose the lucrative payouts associated with the 2020 awards.

[4] Chart prepared by Kimmeridge using grant date target value and expected value as of 3/26/21 for 2017-2020 PSU awards as disclosed in Range's 2021 proxy statement. Final realized value could prove to be meaningfully different based on absolute and relative TSR.

Principle #1: Eliminate Growth Metrics and Board Discretion

Investor criticism around metrics related to volume growth and the degree of discretion in annual bonuses appears to be resonating. A recent study by compensation consultant Meridian noted that in 2018 production was the single most common metric for public E&P companies, with a weighting of 25% of annual incentive targets. In 2021, less than half of the companies still had production as a performance metric and the weighting has shrunk to 11%. Importantly, we have seen the prevalence of return-based metrics, which we highlighted in our original paper as having the highest historical correlation to TSR, rise from 14% to 68%. Meridian also found that annual incentive plans are increasingly quantitative, with the percentage allocated to qualitative or discretionary factors having decreased from 27% to 18%.[5]

Figure 4: E&P Annual Incentive Metric Prevalence



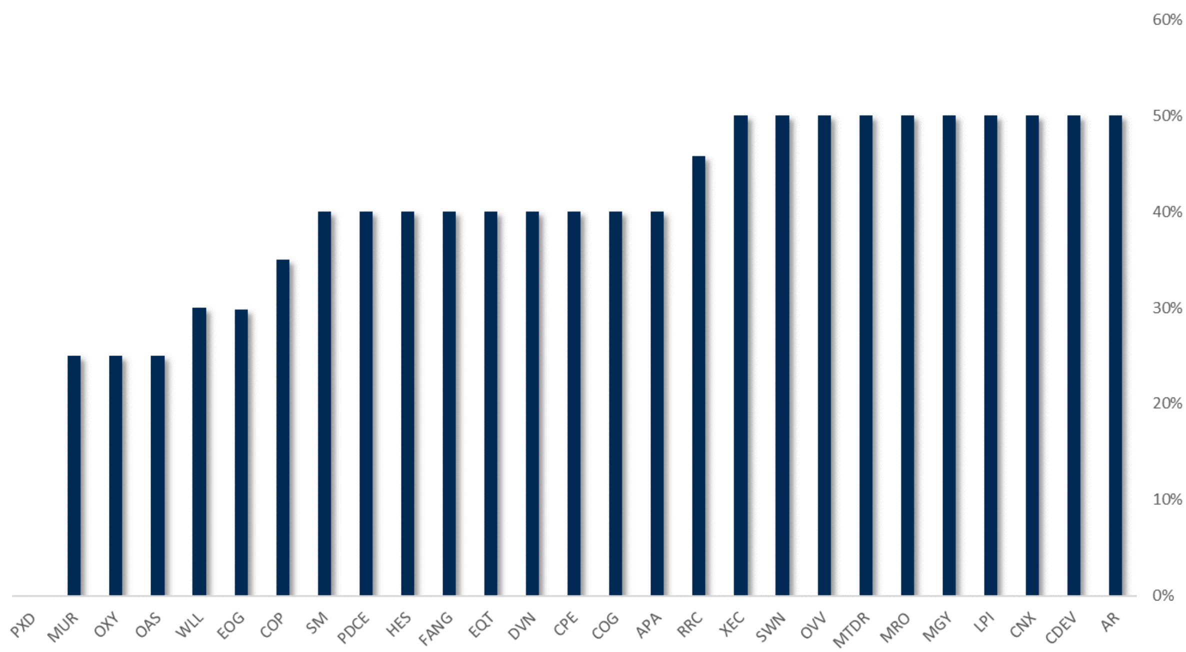
Source: Meridian

Principle #2: Performance-Based Incentives Settled in Shares

Time-based stock acquired at zero cost, without a performance threshold, is simply a payoff for continued employment. While it may be necessary to retain certain employees, we believe long-term incentives for the CEO should be 100% performance-based. If a CEO wants to depart for greater time-based compensation, they are the not the right person to lead the company. We have seen some incremental progress on this front, but the average long-term incentive structure for CEOs is still 40% time-based.

[5] Meridian Energy Insights Post #69 - E&P Short-Term Incentive Design Reflects Changing Priorities

Figure 5: Time-Based Percentage of Long-Term CEO Incentives



Source: Proxy Statements

We would highlight notable improvement from previous outliers like Centennial (CDEV), which moved from 33% to 50% performance-based, as well as the companies that raised the bar after emerging from bankruptcy, with Oasis (OAS) and Whiting (WLL) moving to 75% and 70% performance-based, respectively. The clear leader on this front has been Pioneer (PXD), which has structured CEO long-term compensation to be 100% performance-based. We hope to see the rest of the industry follow Pioneer's lead and abandon time-based stock awards for CEOs.

Principal #3: Deemphasize Relative TSR for Absolute TSR and Long-Term Financial Metrics

This is the area where we have seen some improvement, with more companies incorporating absolute performance payouts, adding broader indices as a measure of relative performance and including financial metrics within their long-term incentive plans. One concern we have is that indices are being adopted as if they were just another peer on a long list of companies used to measure relative performance, which obviously dilutes the relevance of using a comprehensive index. We believe indices should replace the self-selected peer group all together, like we saw with Oasis and Laredo. Another concern is that most Boards are still willing to pay 100% of target for median relative performance with negative absolute returns. Shareholders should demand that the bar is raised for what is meant to be performance-based compensation. We believe the below elements within company plans are helping redefine long-term performance incentives.

TSR Calculation in LTI

- Oasis: 50% absolute TSR and 25% relative TSR (half measured against Russell 2000 index)
- Laredo: 25% absolute TSR and 25% relative TSR using E&P stocks in the Russell 2000 index

- Cimarex: 50% reduction to payout for negative absolute TSR
- PDC Energy: Modifier of 50-150% vs. target for <0% to 15%+ absolute TSR
- EQT: Adopted performance matrix for the intersection of ATSR and RTSR

Financial Metrics in LTI

- Marathon: Introduced a free cash flow PSU metric (two-year cumulative free cash flow)
- Ovintiv: Added ROIC to financial metrics, which comprise 50% of the PSU calculation
- Callon: 100% of PSU awards tied to free cash flow and ROCE performance

Principle #4: Restructure Change of Control Payments

This is the area where we have seen the least amount of progress. Many Boards are reluctant to force CEOs to take restricted stock in a combined company, even if it results in a higher payout. Once again, we saw a post-bankruptcy Board take a leadership position after Whiting disclosed that in the event of a change of control, a portion of the CEO's severance will be in stock with a mandatory holding period:

> "Unlike all or substantially all of our peers, in the event of a change in control, one-third of our CEO's severance is payable in stock with a mandatory holding period, thereby linking our CEO's severance pay to a change in control transaction that is ultimately accretive to our stockholders."
>
> \- Whiting 2021 Proxy

As the trend in industry consolidation intensifies and zero premium mergers become more prevalent, it is critical that Boards ensure there is alignment between management and shareholders. If a CEO is not willing to take equity in the deal, why should investors?

Investor frustration on this issue reached a fever pitch with the proposed merger between Cimarex and Cabot in May 2021. Both CEOs were entitled to a change of control payment despite the expectation that both will remain employed through the combination. What investors found particularly offensive was that the Cabot Board approved amendments to the change of control agreements on the eve of announcing the transaction. They amended the definition of a business consolidation to include an event where Cabot is the company issuing stock or making the acquisition. Ironically, Cabot had historically highlighted the "double-trigger" within their change of control agreements as being aligned with shareholder interests. The double-trigger implies that there is only a payment when the company is acquired and the executive is terminated. Apparently, they now believe these payments should be triggered even when Cabot is the surviving entity, as is the case with this merger. Unfortunately, actions like this only reinforce the perception that Boards have more allegiance to the management teams than the shareholders they represent. It is worth noting that the CEO of Cimarex voluntarily deferred the vesting of shares he was entitled to through the "single-trigger" provision in his change of control agreement. While commendable, investors would prefer to see Boards structure these agreements with greater shareholder alignment ahead of any transaction.

Conclusion

We are encouraged by some of the progress we have witnessed in evolving executive compensation, but much more needs to be done. The E&P business model is evolving at a rapid pace and incentives need to follow suit. We recognize that there is not a one-size-fits-all approach to designing executive compensation programs and our intention is not to be prescriptive at the individual company level. However, we maintain that there are basic principles that could help foster greater alignment and accountability. A consistent theme over the past year has been the outsized progress within post-bankruptcy companies, which highlights the benefit of starting with a clean sheet of paper. We recognize the challenges of inertia at public companies and recommend that all companies go through the exercise of starting with a tabula rasa, rather than trying to tinker with existing plans. As the sector continues to struggle with reestablishing investor credibility, we believe overhauling executive compensation plans is the key to accelerating a change of perception.

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