Targets in Tangles: LTIPs That Dangle

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Executive Summary

Traditional long-term executive incentive plans (LTIPs) often fall short in today's unpredictable business environment. They're based on fixed targets prone to overconfidence bias and erratic payouts, either vastly overpaying or underpaying in shifting business cycles. This can demotivate executives and misalign incentives. This paper presents a better, tested approach: the Indexed Long Term Incentive Plan. By benchmarking operating performance against industry peers and utilizing a percentile ranking, this model delivers predictable and performance-driven payouts, better supporting long-term value creation.

The Subject of This Study

This paper examines Trane Technologies' publicly disclosed financial data from 2015 through 2024. Trane Technologies (NYC:TT) is a global corporation focused on heating, ventilation, and air conditioning (HVAC) products and services for commercial and residential buildings as well as transportation. It operates through the Trane and Thermo King brands. In 2024, Trane Technologies reported revenues of about $19.8 billion. The company employs about 45,000 worldwide. The financial data for Trane Technologies and its peer group used in this analysis were sourced from S&P Capital IQ Pro. In the interest of full disclosure, the author is not affiliated with Trane Technologies in any way.

The LTIP Target Setting Challenge

Some U.S. companies have shifted to performance-based equity compensation – performance share units (PSUs) – replacing the once-ubiquitous stock option plan, perhaps due to their inherent payout volatility and the ensuing talent retention risk they pose.

PSUs have been a reality in Switzerland for a decade longer than in the United States because stock options never took root. That head start has led to a unique perspective, a chance to grapple with – and solve – the challenges of PSU-based LTIPs. This is particularly the case with overly ambitious target levels and oscillating payout results, paying below average – often nothing – and then paying the maximum in close sequence.

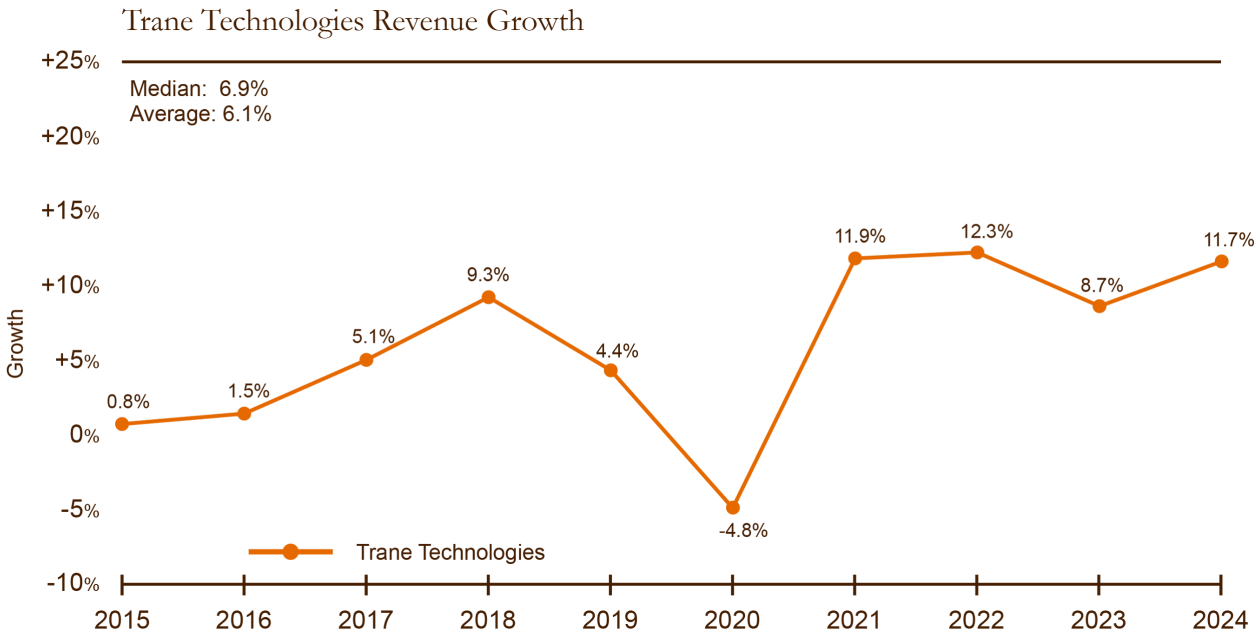
The most persistent challenge? Target-setting. It's the core of any effective PSU plan, but it's deceptively misleading.

This paper offers an examination into how to use indexing to measure operating performance in LTIPs to navigate an uncertain business world. The subject is Trane Technologies PLC, a global provider of climate-control products and services, and its performance in comparison to its industry peers.

Digging Deeper: Context is King

We start our illustration with a small yet impactful exercise. Ask yourself the following question: What's the right revenue growth target for Trane's LTIP? Look at the historical data, and you'll see the dilemma in Figure 1, which shows Trane's past revenue growth.

Figure 1: Trane Technologies' Revenue Performance

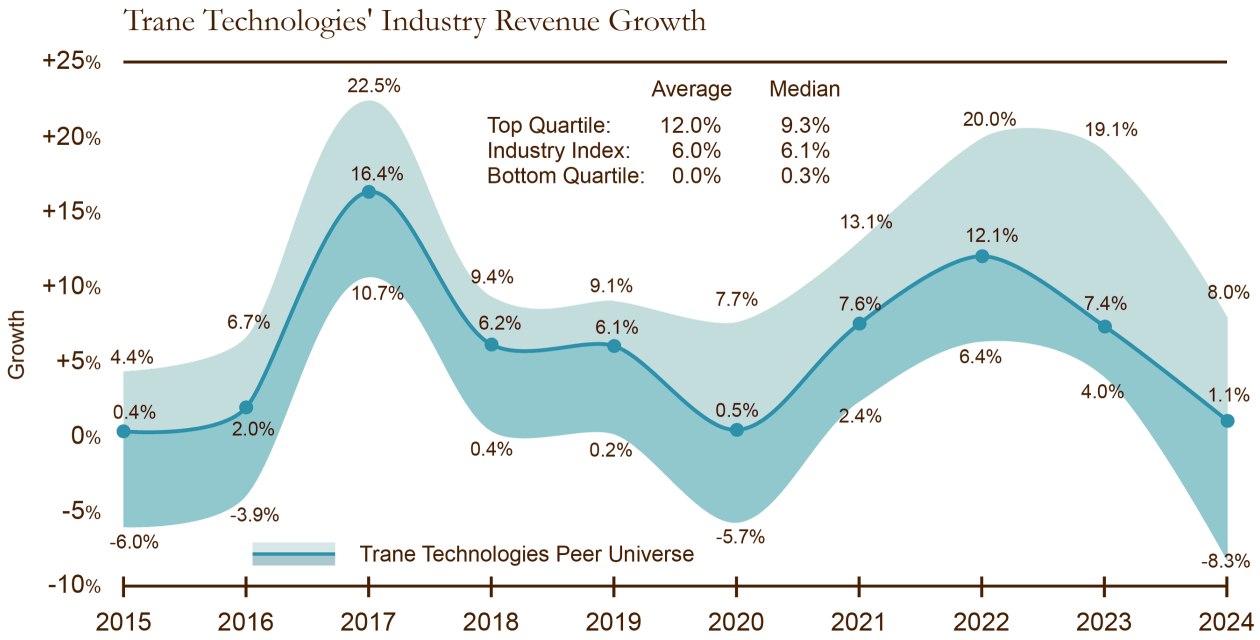


In the previous two years, the growth rate has ranged from 8.7% to 11.7%, whereas before the pandemic, it was near or below 9%. So, where do you set the revenue growth target for the three-year LTIP? Too high, and you risk demotivating your executives. Too low, and you're not driving the performance you need.

Now, take a moment to answer this crucial question. You've seen Trane's historical growth. Your mission is to set a meaningful annual growth target for its 2025-2027 long-term incentive plan. Seriously, jot it down. The more you engage, the more you'll glean from this process. Most boards responsible for LTIP target setting are not in as comfortable a position as you are. They might have only the past few years of data, while we give you 10 years of history.

To fully understand Trane's future growth potential, you want to look at the bigger picture – its industry. We give you this information as well. Take a look at Figure 2. It illustrates the industry's performance in which Trane operates. You see the Industry Index, which represents the median growth performance of Trane's peers. Notice the fluctuations – from a low of 0.4% in 2015 to a high of 16.4% in 2017, and an Industry Index average of 6.0%.

Figure 2 Trane Technologies' Peer Industry Revenue Performance



Armed with this broader industry perspective, let's revisit that target. Would you adjust it? Is it necessary to dial it up? Dial it down? Or should you stick with your gut feeling?

Again, write down your number for the Trane three-year LTIP revenue growth target because you will need it for the next step.

Too many boards overlook this crucial discussion when they define LTIP metrics.

The Ambition Factor: Are Your Targets Ambitious or Fair?

Now, let's examine the realism of your target. Table 1 outlines the percentile rankings for sales growth, showing Trane's isolated performance (first column) and the broader industry's performance (second column). The third and fourth columns refer to “The EBITDA Target Trap” example at the end of the article.

TABLE 1: Trane’s Performance vs. Industry Peers

	Sales Growth		Delta EBITDA	
History Percentiles	3Y CAGR Trane	3Y CAGR Industry	3Y Average Trane	3Y Average Industry
90th percentile	12.0%	16.9%	463	326
80th percentile	7.9%	11.3%	297	249
70th percentile	5.3%	8.4%	196	196
60th percentile	4.0%	6.4%	162	169
50th percentile	3.4%	4.8%	153	128
40th percentile	3.2%	3.4%	131	87

*Compounded annual growth rate

Examine your target in light of this data. Is it lingering around the median, the 50th percentile, or is it in the upper part of the numbers, even above the top quartile (75th percentile rank)? Be honest. It’s not always easy.

While setting ambitious targets makes perfect sense in a strategic plan, they backfire when linked to executive pay.

We have conducted this exercise numerous times and observed the same result in most situations. People, especially executives, are inherently ambitious. They don't aim for average; they strive for exceptional.

So, when I conduct this exercise in a controlled experiment with MBA classes, I consistently observe targets landing in the 60th to 80th percentile range. It’s a natural human inclination. Your own target probably falls within that range. This makes perfect sense. Targets should be ambitious, not average, right?

The problem is that any target above the average results in LTIP payout probabilities below the average.

While setting ambitious targets makes perfect sense in your strategic plan, even in your annual budget, it backfires when they’re linked to executive pay.

The Overconfidence Trap: When Ambition Backfires

We're wired for ambition. It's in our DNA. But here's the harsh reality: Ambition is great for strategic plans but can be disastrous for LTIPs. Setting targets that consistently outstrip industry benchmarks would mean systematically underpaying your talent. That erodes their motivation and puts them at risk of being poached by competitors.

Why does this happen? It's what behavioral economists call overconfidence bias. We overestimate our own abilities and our company's potential. It's a pervasive issue, and it's incredibly difficult to counteract.

But there is a way to reconcile ambition with reality. There is a way to counteract overconfidence bias and overly ambitious long-term targets – indexing operating performance. This combines company performance with industry performance.

Figure 3 shows how this combination looks for revenue growth, which is actually just a combination of the two charts you have already seen.

Figure 3: Operating Index Revenue Growth – Trane Technologies

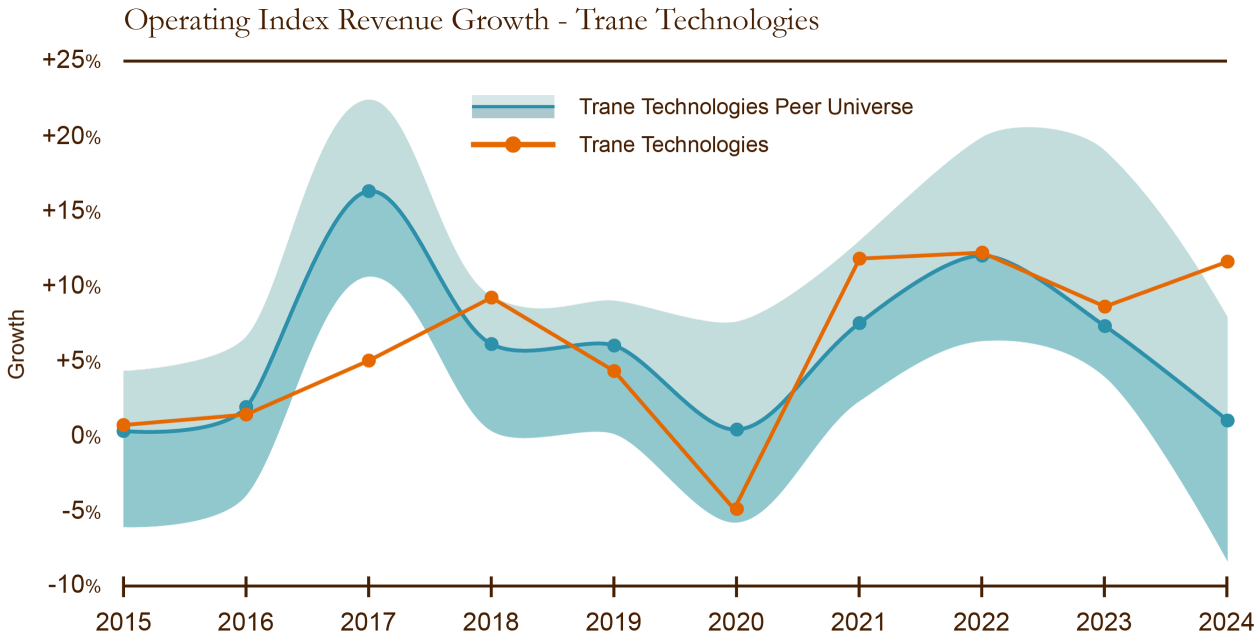


Figure 3 illustrates what we call the **Operating Index**. Imagine: your company's performance, the orange line, superimposed on the industry's landscape, the blue line and shaded areas. It’s a direct, intuitive comparison. And here’s the beauty of it: we can ditch arbitrary targets. One needn’t get bogged down in endless debates about specific numbers. The Index provides instant clarity.

With the Operating Index, we can see, at a glance, when the company is genuinely excelling and when it’s lagging behind, even without displaying the actual underlying numbers themselves, making it easy for non-financial executives.

Look at 2016. Sales growth increased that year, yet Trane’s orange line dips below the industry median. That's an underperformance. Conversely, 2023 shows an outperformance – despite lower sales growth than the previous year.

The beauty of the Operating Index is its versatility. It’s a universal language for performance, applicable to any metric you want to incorporate into your LTIP. Sales growth, earnings before interest, taxes, depreciation and amortization (EBITDA), earnings per share (EPS), and total shareholder return (TSR) – you name it.

The Operating Index: Ditching Targets, Caps and Floors While Embracing Resilience

This is not a constructed example. It’s a real company, Trane Technologies, and a real industry, its peers. Trane did have a lower growth in 2023 than in 2022, and yet, it did outperform the competition. A fixed target, no matter at what level, would have provided an unfair, lower payout than in the previous year. It would have led to a higher payout in 2022 when performance was actually worse than in 2023 when assessed relative to peers; in other words, the Operating Index is free of external effects that are outside of management control.

From 25 years of servicing clients with relative performance measurement, we know that most companies have such situations where they look bad in absolute numbers, but are actually good in relative numbers, and vice versa. The context, the industry index, reveals the true story.

This isn’t about raw numbers anymore; it's about context. It's about understanding how your company stacks up against its peers. And it's about creating LTIPs that are both motivating and fair, in any economic cycle.

And, there is more to it. While you may have set your target at the average (e.g., 6.0%), you are not yet done. For your LTIP, you also need to define a performance hurdle and a cap. Where would you set those limits?

We asked this question in about a dozen MBA classes and typically get floors at around 2% to 4% and caps at 8% to 12%. You are likely in this same space. If you are outside of it, it may be difficult to explain your position because some will say the hurdle is too low, and others will say the cap is unreachable.

Not reaching the hurdle is demotivating, while exceeding the cap motivates your people to postpone performance to the following year.

Used in LTIPs, there is a hidden problem with a floor at 3.0% and a cap at 10.0%. In three periods, your actual company performance would not have reached the hurdle and in another three periods, it would have exceeded the cap in the Trane Technologies example.

Both are undesirable in a compensation system. Not reaching the hurdle is demotivating, and exceeding the cap motivates your people to postpone performance to the following year.

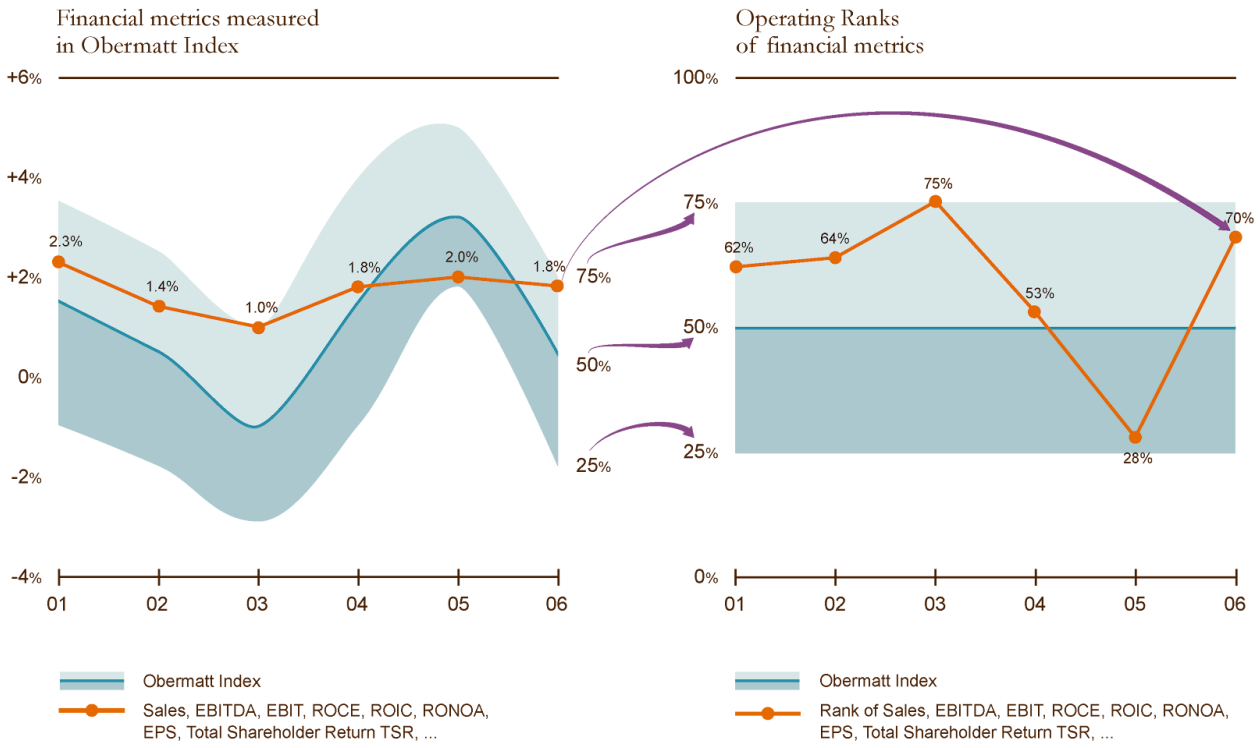
Yet in six out of 10 years, your LTIP would have had this problem. So, we found a second problem with fixed targets in LTIPs: LTIP caps and floors lead LTIPs to oscillate between paying nothing and paying the maximum. Your beneficiaries will not be satisfied that, on average, they may get their pay. They will complain that your LTIP design is unreliable.

Averaging annual performance over the years helps a little but indexing can solve it entirely because you can never be worse than the worst or better than the best. That makes your indexed LTIP payout resilient to any unexpected performance result.

Navigating Uncertainty: A New Approach to Long-Term Incentives in a Volatile World

However, the Operating Index itself doesn't tell you how much to pay. It provides the intuitive relative performance picture, but we must translate it into actual compensation outcomes. That's where the **Operating Rank** comes in.

Figure 4: Operating Ranks of Financial Metrics



Think of the Operating Rank as the bridge between performance and payout. Figure 4 illustrates this conversion in a way that resonates with managers. Look at year 2006 of the illustrative example. The Operating Index value of 1.8% translates into a 70th percentile rank in the Operating Rank. Similarly, a seemingly low 1.0% in 2003 actually becomes a 75th percentile rank.

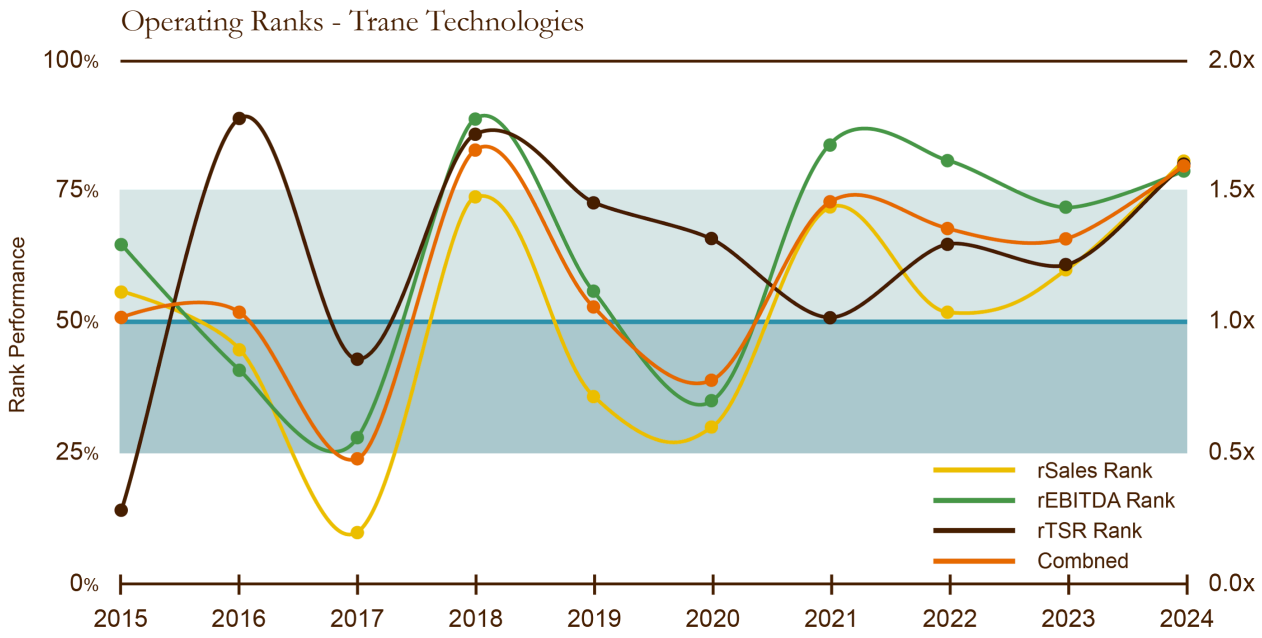
Why the apparent discrepancy? Because the Operating Rank is all about relative performance, while the Operating Index still uses absolute numbers. Executive performance is never about absolute numbers; it's about how you stack up against your peers. This is also how investors look at corporate performance.

That's the key to creating LTIPs that are fair and motivating. This percentile ranking system is a language that managers understand. It originates in sports, where it is prevalent, and provides a clear, intuitive way to see how performance translates into achievement and compensation. It's about moving beyond abstract metrics and creating a direct link between performance and reward.

Leveling the Playing Field: The Power of Combined Ranks

Here's where the Operating Rank shines. By converting all your performance metrics into percentile ranks, you've neutralized their inherent differences. You've taken metrics as diverse as revenue growth, EBITDA, EPS, and even TSR, and put them on a level playing field. This means you can combine all your metrics into a single, unified graph, such as Figure 5 – a clear, concise visual representation of overall performance, encompassing the key drivers of your business:

Figure 5: Operating Ranks – Trane Technologies



This Operating Rank for Trane Technologies brings together three of the most valuable LTIP metrics: sales growth, profit growth (in this case, EBITDA, but it could also be EPS or ROCE), and TSR.

There is more. See that orange line? That's the combined performance, the average of the three individual metrics. And here's where the power of a multi-metric LTIP approach becomes crystal clear. Look at the stability of that orange line. It's far less volatile than any of the individual metrics. It doesn't plummet like sales growth in 2017 or TSR in 2015. It doesn't spike as dramatically as TSR in 2016 or profits in 2018. It's a balanced, nuanced representation of the company's overall performance.

That balance is what we want in executive compensation. We don't want payouts swinging wildly between zero and the maximum payout due to fluctuations in a single metric. We want a system that rewards sustained, well-rounded performance. Indexing performance is the key to resilient LTIP payouts that work in any cycle, and keep managers motivated to beat the competition even in a recession when fixed targets become all but unreachable.

The LTIP Payout: Smoothing the Ride

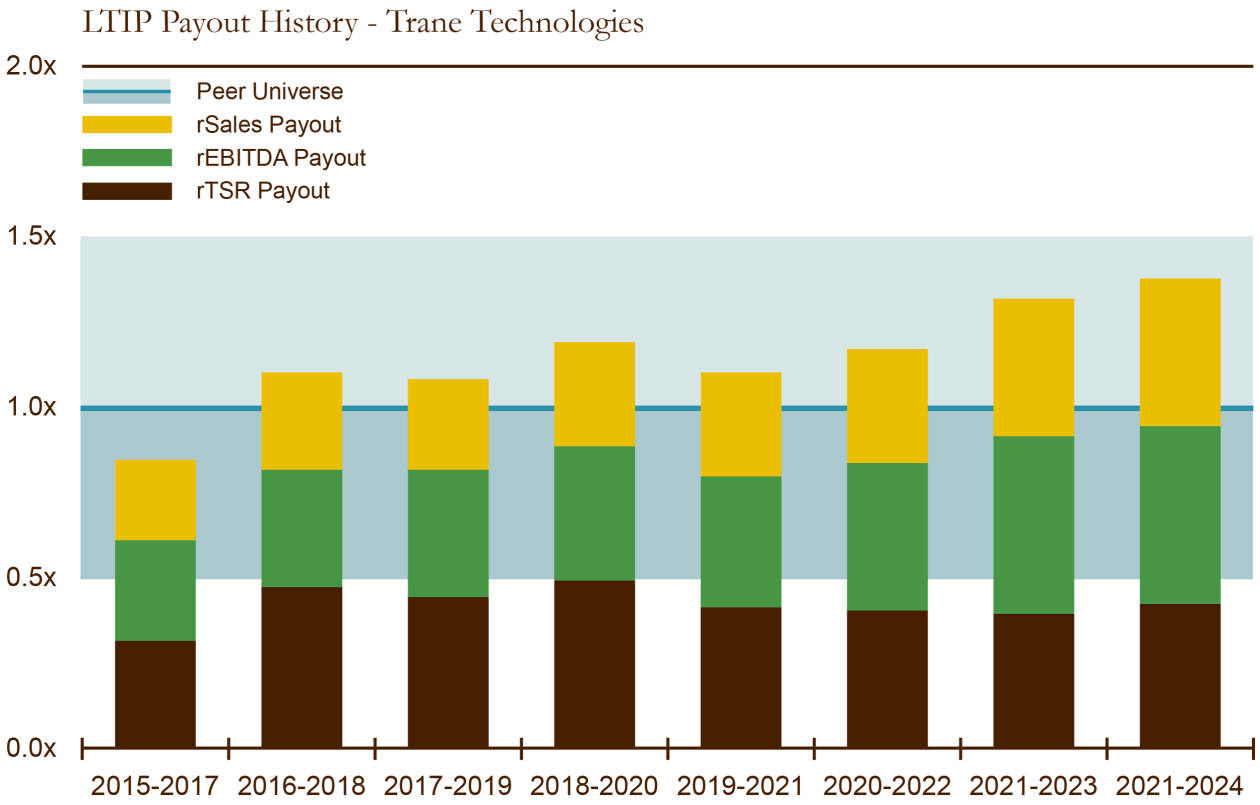
Now, let's take this a step further. In Figure 5’s Operating Rank illustration, the payout multiples for your LTIP are indicated by the right-hand vertical axis. A market median performance provides a market median payout: Median performance pays one times target pay, the pay level you have found to represent the market median level for your compensation plan beneficiary:

Median pay for median performance. The higher the pay, the higher the payout.

There is a natural cap of two times target pay at the 100th percentile rank (2.0x target pay). This means the worst in the peer group gets nothing (0.0x target pay), which is the bottom performance.

Let’s look first at what this LTIP would have paid to Trane Technologies' top management. Figure 6 on the next page transforms the annual Operating Rank view into a three-year LTIP payout simulation. The blue line, representing the median performance, delivers a payout of one times the grant value (1.0x). The maximum payout is twice the grant amount, while the minimum is zero.

Figure 6: LTIP Payout History – Trane Technologies



If Trane Technologies had used this approach, its LTIP payouts would have closely mirrored their actual performance trajectory: lower in the early years (2015-2017) and higher in recent years. The three colors represent the contributions from each performance metric, all based solely on publicly available data from Trane and its peers.

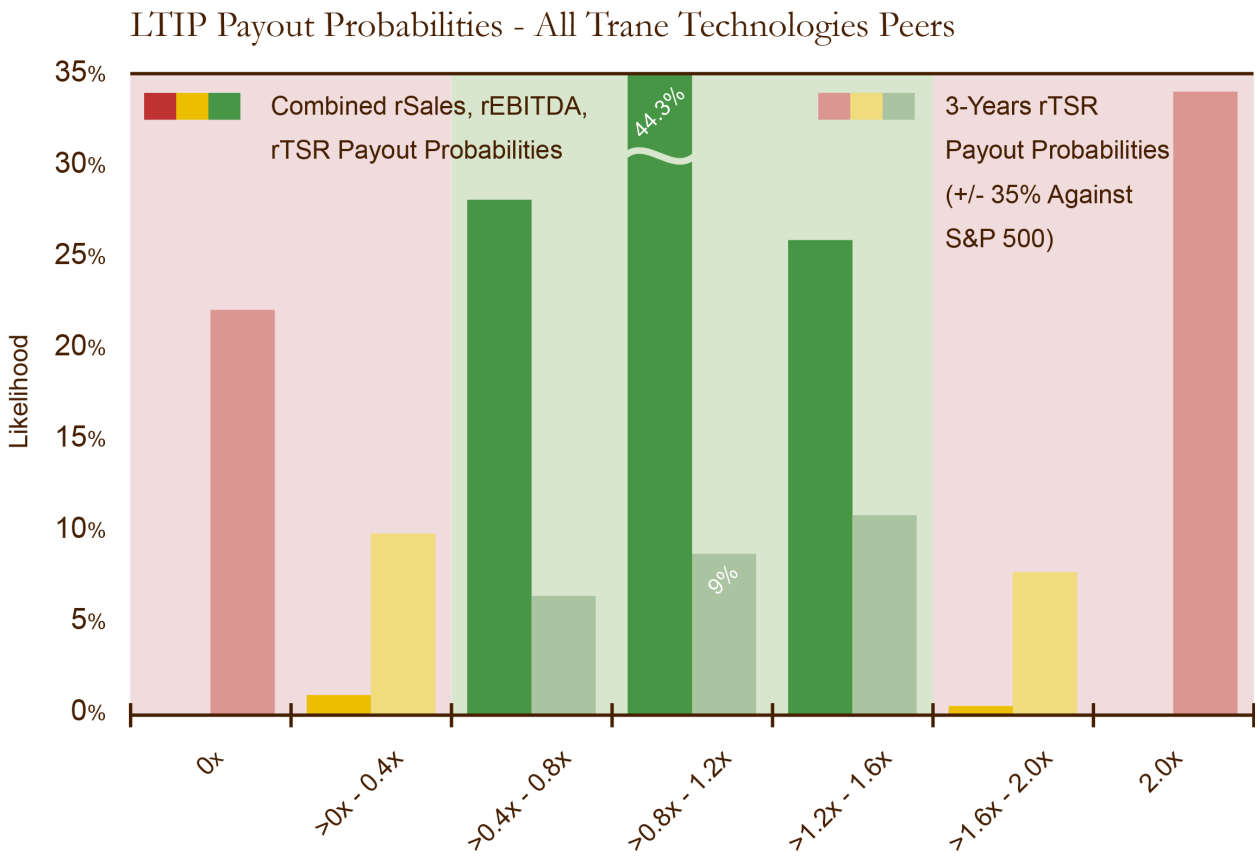
This is how we translate relative performance into tangible rewards. It's about creating an LTIP that incentivizes executives to deliver across all key metrics, driving sustainable, long-term value creation. This alignment between pay and performance is crucial for building trust and credibility in the compensation system.

Putting it to the Test: Quantifying the LTIP Risk

Let's quantify the key advantage of indexing LTIPs: resilience. We put it to the test. We apply the same LTIP methodology to Trane Technologies' peers, simulating payouts based on their actual historical performance data.

The "LTIP Payout Probabilities" charted in Figure 7 illustrates the risk profile of our indexed LTIP design for Trane Technologies, stress-tested against the performance of all its peers. This gives us a clear picture of the likelihood of various payout outcomes.

Figure 7: LTIP Payout Probabilities – Trane Technologies Peers



The results are compelling, as you can see in Figure 7, which shows the probabilities on the vertical axis for various payout ranges on the horizontal axis:

Notice the solid bars representing our indexed design. There's no bar for zero payout on the left. That's significant. Most payouts fall within a desirable range of 0.4x to 1.6x the grant amount. And the sweet spot? That's the middle bar, from 0.8x to 1.2x grant value, where the highest probability of vesting lies.

A whopping 44.3% of all indexed LTIPs in this industry would have vested within this desirable range using our indexed LTIP design, extending even above the chart ceiling.

Now, let's compare that to a typical relative TSR (rTSR) design, a common approach in the United States that we have simulated using the same peer set and plotted as shaded bars to the right of the solid bars in Figure 7. As companies typically do, we've used the S&P 500 as the benchmark, and we applied a vesting range of -35% to +35% relative to the index. If you significantly underperform the market (at -35%), you get nothing. You hit the maximum payout if you significantly outperform (at +35%).

But look at the payout probabilities for this popular rTSR design, the shaded bars. They're alarming. There is a 22% chance of zero payout and a 34% chance of maximum payout (shaded red bars). That means extreme outcomes – either alienating your executives or potentially upsetting shareholders – are the norm, occurring in 56% of cases. And the sweet spot? The probability of landing in that desirable 0.8x to 1.2x range is a meager 9%. Less than one-tenth!

This is the stark reality: Many current LTIP designs are volatile, unpredictable and often misaligned with the desired outcomes.

Remember, all this is based on actual data from the S&P.

The Payoff: Predictability, Performance and Peace of Mind

The presented analysis provides a validation of the indexed LTIP design. It demonstrates that this approach delivers payouts that are not only aligned with performance but also more predictable and less prone to extreme fluctuations. It's about creating an LTIP that rewards sustainable, long-term value creation, not just unwanted short-term spikes or dips in payouts. The indexed LTIP design offers a compelling alternative. It's about creating a compensation system that is:

- **Performance-driven.** Payouts are closely linked to relative performance, ensuring rewards are genuinely earned.
- **Predictable.** Payouts are less prone to extreme swings, providing greater certainty for executives and the company.
- **Balanced.** The design avoids overemphasizing any metric, promoting a holistic approach to value creation.

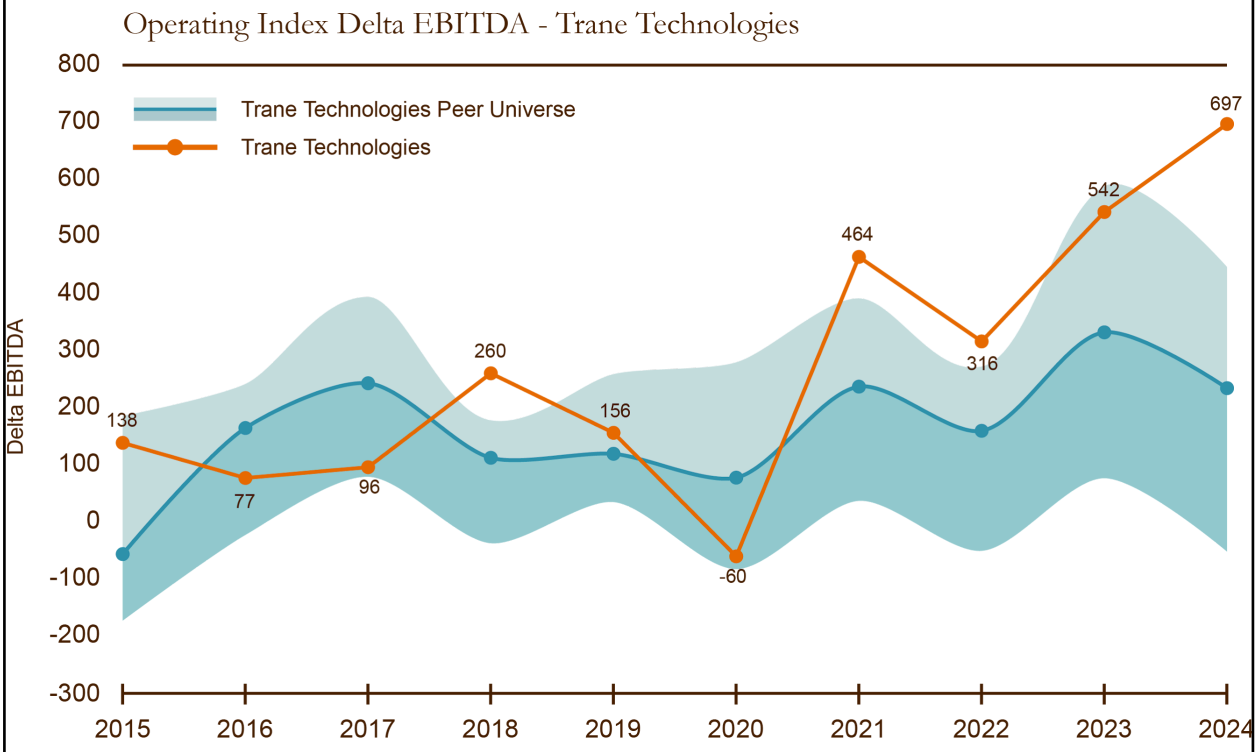
An indexed LTIP design is about moving beyond fixed-target-setting practices and embracing a more resilient, data-driven indexing aproach. It's about creating compensation systems that motivate executives to deliver sustainable, long-term value, in any market cycle. And, it's about building a stronger, more resilient connection between pay and performance, putting the entire team in one boat against the competition, not against each other.

The EBITDA Target Trap

Revenue growth is a critical metric, but it's not the whole story. To accurately gauge performance, we need to look at profitability. Let's shift our focus to the annual change in earnings before interest, taxes, depreciation, and amortization (EBITDA), the most relevant operating profit metric available. Now do the same target-setting exercise for annual EBITDA growth, using the company and industry information as we have for sales growth in the article above.

Just as we did with revenue, we need to consider both Trane's isolated performance and its performance relative to the industry. Figure 8 provides a comprehensive view:

Figure 8: Operating Index Delta EBITDA – Trane Technologies



Take a moment to digest the data. How does this information affect your perspective on target setting? Again, note your annual EBITDA growth target.

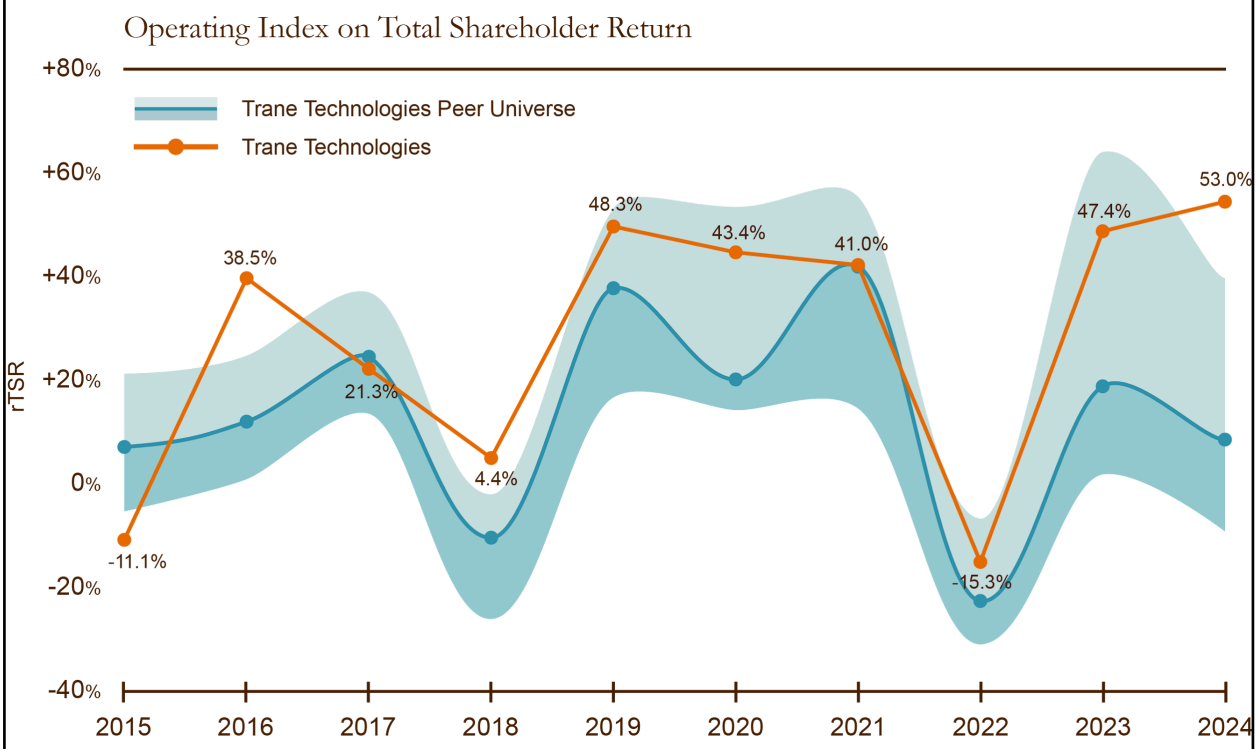
It's highly probable your LTIP target for EBITDA significantly outpaces the industry median of a $128 million annual increase (see Table 1 in the article).

And honestly, when you look at Trane's recent EBITDA leaps – $316 million to $697 million – that $128 million figure seems almost laughable.

Think about it: Would any board in their right mind sign off on an EBITDA improvement target of $128 million (industry median) to $153 million (company median), when they've recently seen $500+ million gains? Unlikely.

This isn't just a methodology for EBITDA. You can apply this procedure to such metrics as EBIT, earnings per share (EPS), return on capital employed (ROCE), and total shareholder return (TSR), as shown in Figure 9.

Figure 9: Operating Index for Total Shareholder Return



You don't need to benchmark to the S&P 500, a method that includes excessive risk, as is explained in the risk analysis section. The Operating Index cuts through the noise, providing a clear visual representation of performance relative to the market.

It moves beyond subjective targets and embraces objective, data-driven insights. It can create LTIPs that are aligned with performance, rather than being impeded by misaligned targets that can unfairly reward or punish executives.