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# 2016 EXECUTIVE COMPENSATION REPORT: HOMEBUILDERS ANNUAL AND LONG-TERM INCENTIVE PRACTICES

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ANNUAL AND LONG-TERM INCENTIVE PRACTICES FOR  
EXECUTIVES AT THE TOP 20 HOMEBUILDERS

CRITICAL THINKING  
AT THE CRITICAL TIME™

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## Methodology

The FTI Consulting, Inc. Homebuilders Annual and Long-Term Incentive report provides an overview of annual incentive plan (“AIP”) and long-term incentive (“LTI”) compensation practices at the largest 20 public homebuilders. Any reference in this report to “homebuilder(s)” only denotes the top 20 homebuilders included in the study.

The following information is based on our extensive review and analysis of compensation-related disclosure obtained through public documents filed with the Securities and Exchange Commission. FTI Consulting has specifically analyzed long-term incentive information disclosed within the most recently filed proxy statements. Our goal is to provide the most timely and accurate information available for a more in-depth understanding of the LTI vehicles used in the homebuilding industry.

The top 20 public homebuilders were determined based on year-end 2015 enterprise values. Enterprise value includes the value of common shares plus debt and the book value of any preferred shares less cash.

## Executive Summary and Key Findings

The FTI Consulting, Inc. Homebuilders Annual and Long-Term Incentive report presents a summary of the practices and trends of AIP and LTI plans at the top 20 homebuilders to provide an overview of incentive design trends as investors and proxy advisory groups continue to scrutinize pay-for-performance structures. Key findings from our study include:

### Annual Incentive Plans

- Most annual incentive plans use two performance metrics.
- Pre-tax income is the most prevalent AIP performance measure and is used by 70% of homebuilders.
- AIP performance is typically measured on an absolute basis.

### Long-Term Incentive Plans

- All 20 homebuilders included in the study grant long-term incentives to their NEOs.
- Homebuilders generally implement a balanced LTI program with the majority of companies utilizing a combination of two or more equity compensation vehicles.
- Performance shares are the most commonly utilized equity vehicle with 75% of homebuilders granting such awards for 2015 performance.
- A significant number of homebuilders utilized time-vested shares, with 65% granting such awards.
- Time-based vesting periods are generally three years for time-vested shares, while stock options/SARs generally use a period of 4 or more years.
- Three years is by far the most prevalent performance period in the homebuilding industry and generally represents a cumulative (or aggregate) three-year period.
- Total shareholder return (TSR) is the most prevalent performance measure and is utilized for 80% of performance shares.
- A select homebuilder peer group or the executive compensation peer group is the most prevalent relative performance measure for performance shares.

## Annual Incentive Plan Design Features

All of the Top 20 Homebuilders included in the study utilized an annual incentive plan in 2015 to reward and motivate their executives. The following section highlights the key design feature of these plans.

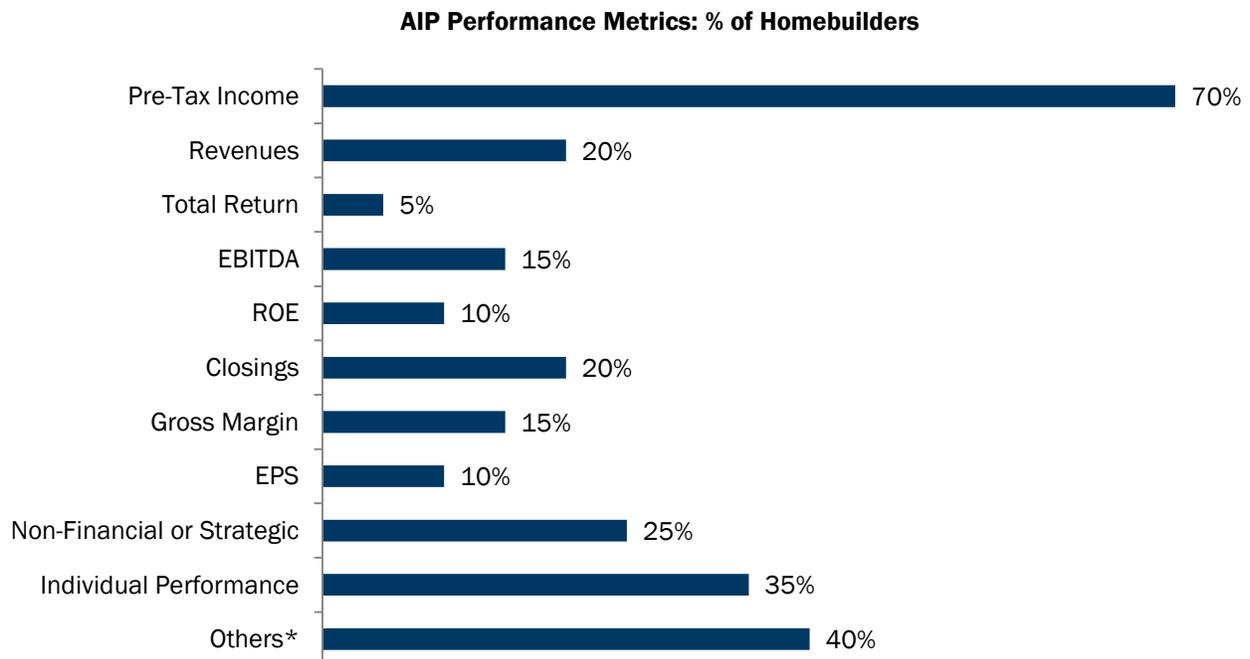
### Number of AIP Performance Metrics

Most homebuilders use multiple metrics to measure performance, with 80% using 2 or more metrics. The most common approach is to use 2 metrics.

Number of Metrics	1	2	3	4	5+
% of Homebuilders	20%	45%	5%	15%	15%

### Types of Performance Metrics

Pre-tax income is by far the most common AIP performance metric with 14 companies (70%) using this measure in their 2015 AIP. Revenues, home closings, gross margin and EBITDA were also frequently utilized. Additionally, 35% of homebuilders used individual performance as a factor in setting cash bonus payouts. A detailed breakdown is shown in the chart below.

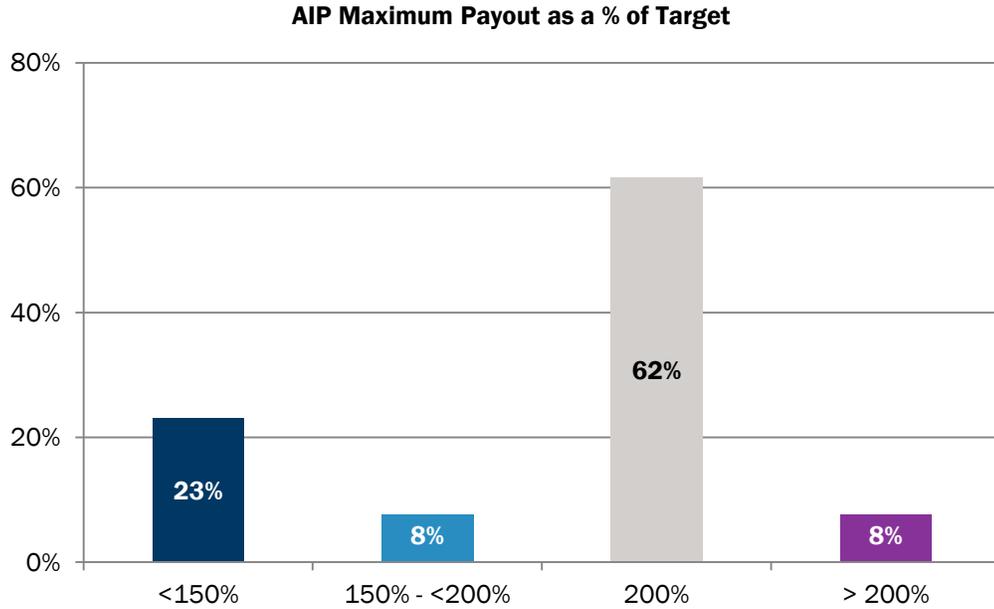


\*Others include: Inventory Turnover, SG&A/Gross Margin, Return on Inventory, Net Operating Cash, etc.

## Payout Leverage

The majority of the top 20 homebuilders (75%) have clearly stated AIP opportunities. The median target bonus for CEOs was 150% of base salary. Among those with stated percentages, the vast majority (62%) set the maximum payout percentage at 200% of the target payout.

A detailed breakdown is shown in the graph below.



## Long-Term Incentive Vehicles and Utilization

### Description of Long-Term Incentive Vehicles

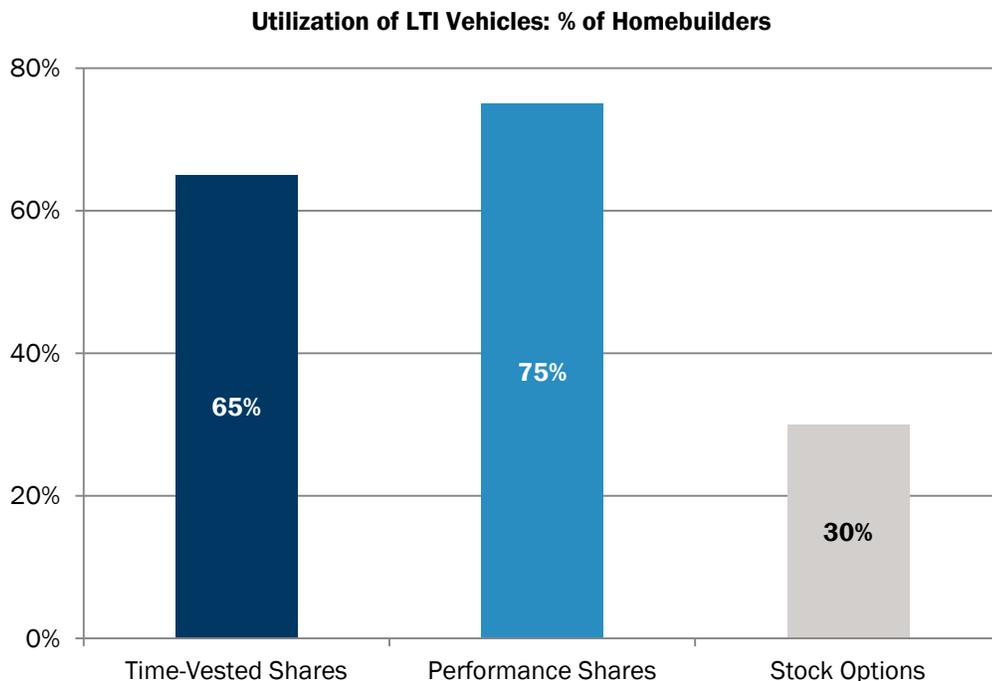
**Stock Options/Stock Appreciation Rights (“SARs”):** Represents the right to purchase shares of company stock at a specified price (generally the stock price on the date of grant) over a specific period of time (Stock Options) or the right to receive the increase in stock price between the grant date and exercise date (SARs). Dividends or dividend equivalents are generally **not** granted in conjunction with stock options/SARs.

**Time-Vested Shares:** Grant of an actual share of stock or “unit” that is subject to restrictions and risk of forfeiture until vested over a specified period of time. Time-vested restricted shares are generally entitled to receive dividends or dividend equivalents during the vesting period.

**Performance Shares:** Represents shares or units of stock that may be earned based on the achievement of specified performance hurdles over a pre-determined time period (performance period or measurement period). Any shares that are not earned are forfeited by the recipient. Performance shares are generally **not** entitled to receive dividend or dividend equivalents during the performance period.

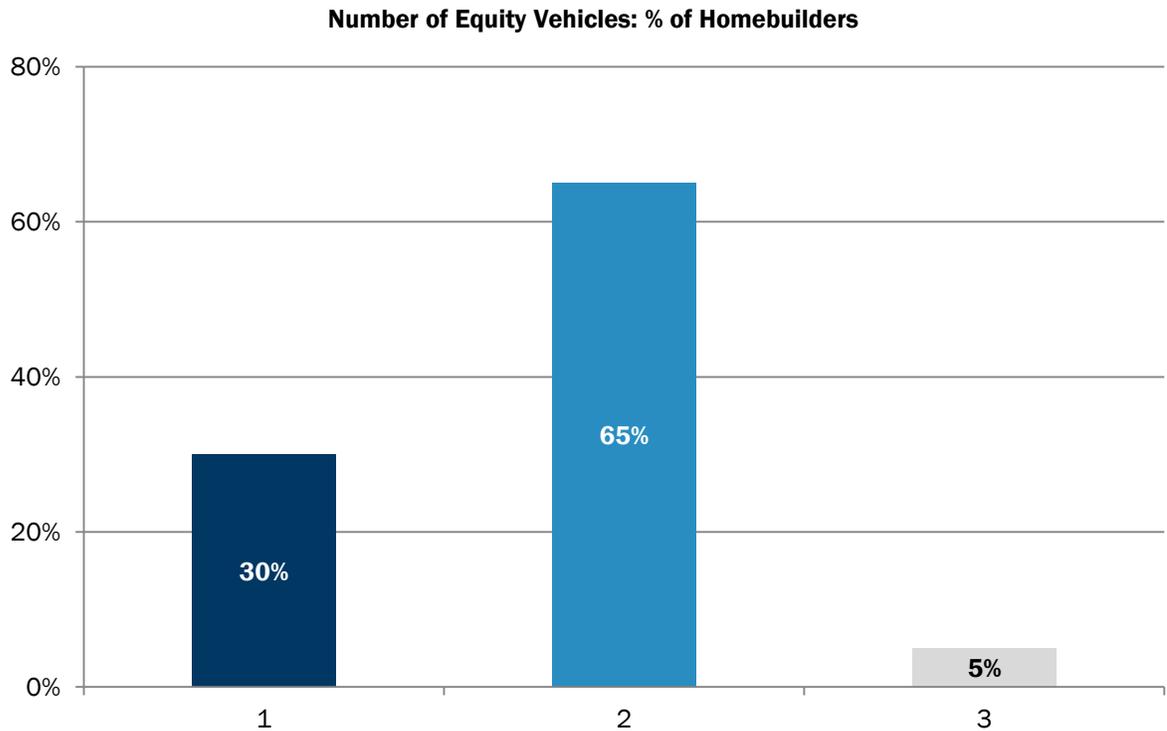
### Utilization by Long-Term Incentive Vehicle

Performance shares are the most predominant LTI vehicle in the homebuilding industry and represent a focus on pay-for-performance. Additionally, the utilization of a performance-based equity element is preferred by investors and proxy advisory groups. Time-vested shares are also popular as they provide shoulder-to-shoulder alignment between management and shareholders, as management is then subject to the same fluctuations in the company’s stock. Stock options remain a minority with a utilization rate of only 30%.



## Number of Long-Term Incentive Vehicles Granted

The majority (65%) of homebuilders employ a balanced LTI approach that includes two equity vehicles in their LTI program, with a sizeable minority (30%) electing to use only one incentive vehicle. Only one of the top 20 homebuilders (Taylor Morrison Home Corporation) chooses to utilize all three incentive vehicles.



## Time-Vested Long-Term Incentives

### Vesting Period

Three years is the most common vesting period for time-based shares in the homebuilding industry at 77%, while stock options/SARs have a noticeably longer vesting time with 60% at four years and the rest at five years or more. The detailed breakdown is shown in the chart below.

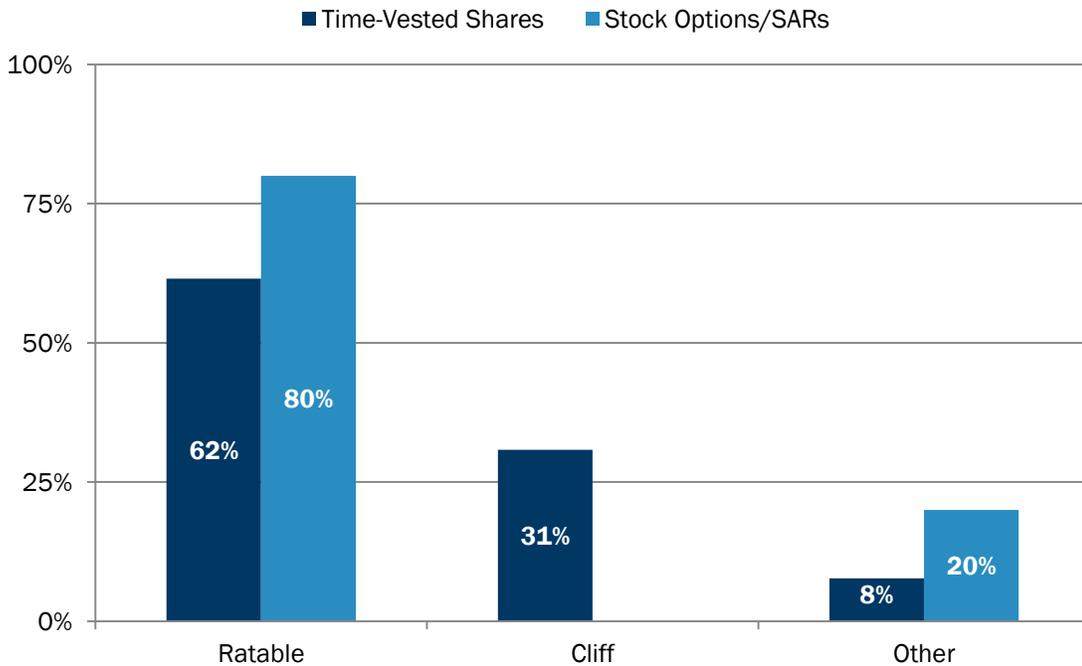
Vehicle Type	1 Year or Less	3 Years	4 Years	5 Years or More
Time-Vested Shares	8%	77%	15%	0%
Stock Options/SARs	0%	0%	60%	40%

## Vesting Type

Time-vested shares and stock options/SARS generally vest using one of the following schedules:

- **Ratable:** Vest in equal tranches over a set number of years;
- **Cliff:** All shares or units vest 100% at the end of the vesting period; or
- **Other:** Shares or units may vest using an uneven vesting schedule (i.e., 25% in year 1, 25% in year 2 and 50% in year 3).

Ratable vesting schedules are the most predominant in the homebuilding industry. A detailed breakdown of the percent of homebuilders using each LTI vehicle is shown in the graph below.



## Performance Shares

### Performance Period

Three years is the most common performance (or measurement) period in the homebuilding industry.

Performance Period	1 Year or Less	2 Years	3 Years	4 Years or More
% of Homebuilders	7%	7%	67%	13%

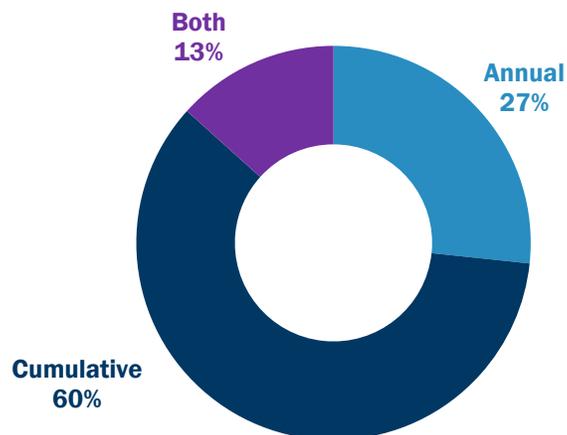
## Vesting Tail Following the Performance Period

The vast majority of homebuilders granting performance shares do not utilize a vesting tail (or additional time-based vesting requirement) after the performance period.

Vesting Tail (Years)	None	1 Year	2 Years	3 Years or More
% of Homebuilders	93%	0%	7%	0%

## Annual and Cumulative Performance Periods

The vast majority of homebuilders (73%) applied a cumulative performance period to some extent in 2015, with 13% combining the annual and cumulative evaluation methods (i.e., cumulative performance period for certain metrics, annual performance period for others). This is likely the result of the increasing influence of proxy advisory firms that have a stated preference for longer performance periods.



## Performance Measures

### Types of Performance Measures

Total Shareholder Return (TSR) is the predominant performance measure as a result of the following:

- Provides for fixed equity accounting under ASC 718 and generally results in an accounting discount.
- Directly links management compensation with shareholder's interest.
- Is more easily explained and justified to investors and proxy advisory firms.

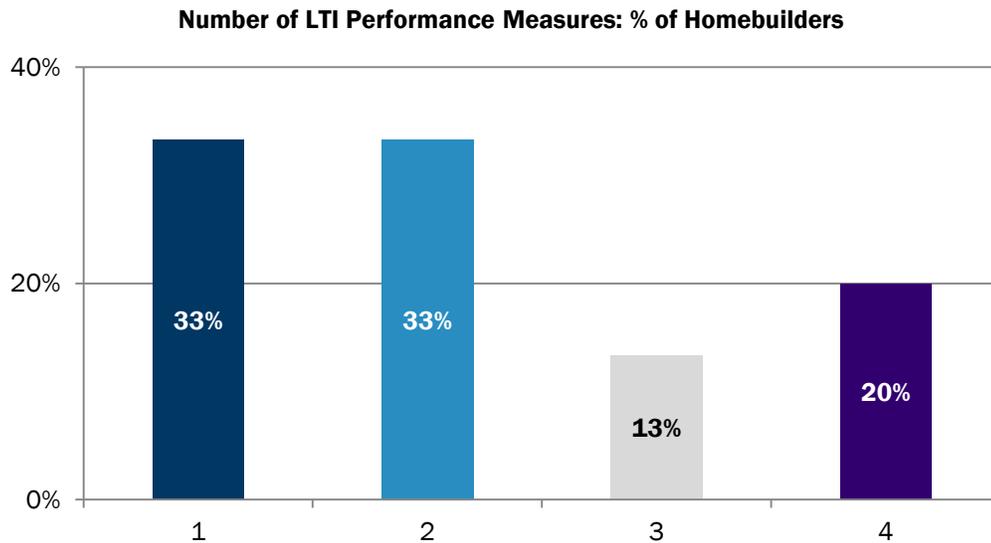
A detailed breakdown of performance measures utilized is as follows:

Performance Measure	Performance Shares*
TSR (Total Shareholder Return)	80%
Profit (Pre-tax Income, EPS, etc.)	47%
Capital Efficiency (Return on Assets/Equity/Invested Capital)	40%
Revenue	27%
Leverage	13%
Other	13%

\*Some plans include more than one performance measure.

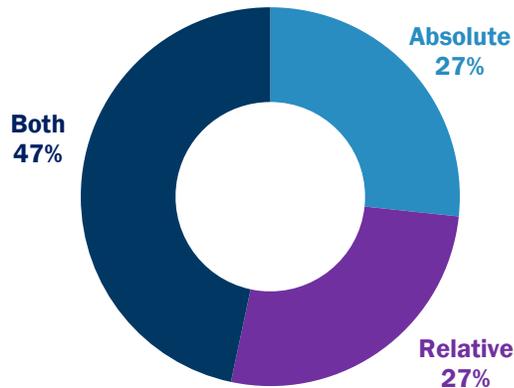
## Number of LTI Performance Measures

The homebuilding industry generally uses only one or two measures to determine if performance shares have been earned.



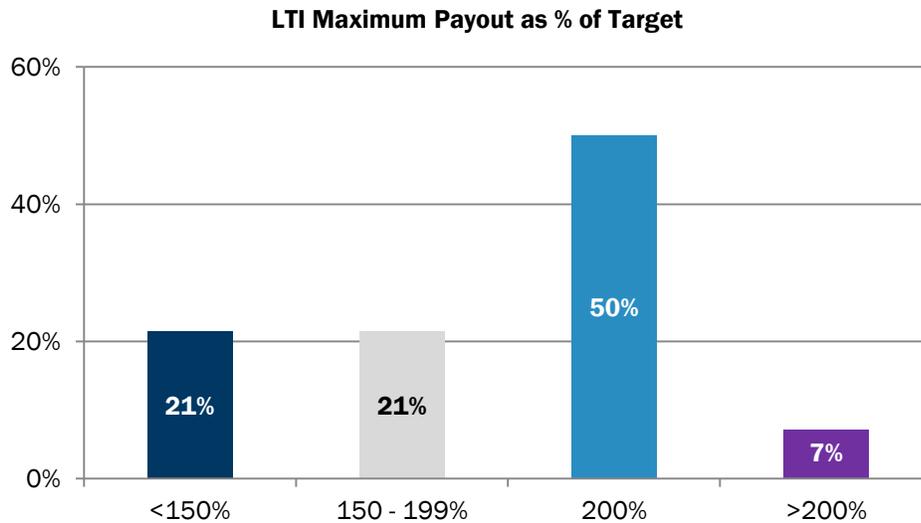
## Absolute or Relative Performance Hurdles

Performance measures may be based on an absolute hurdle, relative hurdle or a combination of both. Over the past several years, homebuilders have increased the utilization of relative performance measures with over 73% of both performance shares incorporating a relative measure. A detailed breakdown of the percent of homebuilders using absolute or relative performance hurdles is shown in the graph below.



## Performance Share Payout Leverage

The majority of homebuilders award between 0% and 50% of target performance shares (normalized to 100%) at the threshold level. Maximum awards are primarily paid out at 200% of target as seen below. 100% of the homebuilders that award performance shares have such shares interpolated on a linear basis for in between performance.



## Relative Performance Benchmarks

Over 73% of homebuilders use performance shares that are earned based upon the achievement of pre-determined relative benchmarks as follows:

- Most homebuilders utilize either the executive compensation peer group or a select group of homebuilders.
- One homebuilder uses the S&P 500 Index.

A detailed breakdown is shown in the chart below:

Relative Benchmarks	% of Homebuilders
Executive Compensation Peer Group	55%
Homebuilders Peer Group	55%
S&P 500 Index	9%

\*Some plans include more than one metric

## Post Vesting Holding Periods

Over the past couple of years, there has been a marked increase in the number of companies (including REITs) that are incorporating mandatory holding periods (or no-sell provisions) in their equity-based compensation program (generally for an additional 1 to 3 years). Though only 5% of the top 20 public homebuilders currently utilize post vesting holding period restrictions, the increasing use of such restrictions has become a general trend for the following reasons:

1. Proxy advisory firms (such as ISS) have clearly illustrated that the mandatory holding periods are a form of good compensation governance
2. Provides a mechanism for the recoupment of incentive-based compensation if a clawback policy ever needed to be enforced
3. Such provisions often result in a 5% to 20% accounting discount under ASC 718 (one of the biggest benefits). This discount results in a reduction in stock-based compensation expense for the financial statements and also reduces the compensation value that will be disclosed in the Summary Compensation Table and Grants of Plan-Based Awards Table in the annual proxy statement.

Generally, such provisions only apply to restricted shares or performance shares granted to executive officers and in many cases are limited to only the CEO. One of the factors often overlooked in adopting post vesting holding periods is the tax considerations. Restricted shares are taxed upon vesting (notwithstanding if an 83(b) election was made), while restricted stock units are subject to income tax when the award is distributed (although FICA/FUTA taxes are still due upon vesting). Thus, it is often appropriate to permit individuals to sell stock to cover taxes and only subject the post-tax shares to the no-sell period.

## List of Top 20 Homebuilders

- AV Homes, Inc.
- Beazer Homes USA, Inc.
- Cal Atlantic Group, Inc.
- Century Communities, Inc.
- D.R. Horton, Inc.
- Hovnanian Enterprises, Inc.
- KB Home
- Lennar Corporation
- LGI Homes, Inc.
- M.D.C Holdings
- M/I Homes, Inc.
- Meritage Homes Corporation
- NVR, Inc.
- PulteGroup, Inc.
- Taylor Morrison Home Corporation
- The New Home Company Inc.
- Toll Brothers, Inc.
- TRI Pointe Group, Inc.
- WCI Communities, Inc.
- William Lyon Homes

## About FTI Consulting Executive Compensation and Corporate Governance Solutions

FTI Executive Compensation and Corporate Governance Solutions provides objective and strong advice to design and implement a comprehensive executive compensation program that attracts and retains top talent that effectively rewards and motivates management and employees for the right kind of performance while closely aligning the interests of employees with those of the company’s shareholders and investors. Our dedicated team has practical hands-on experience partnering with Compensation Committees and management teams to design custom-tailored compensation programs around the key drivers and unique dynamics of each client. We have served as the compensation consultants and corporate governance advisors to over 100 public and private companies on a range of compensation and corporate governance related matters, including:

Executive Compensation and Corporate Governance Solutions	
Compensation Plan Design and Implementation Services	Corporate Governance Services
<ul style="list-style-type: none"> <li>▪ Annual compensation program and peer group review</li> <li>▪ Annual bonus program design</li> <li>▪ Long-term compensation program design</li> <li>▪ Employment Agreement review and analyses</li> <li>▪ Proxy drafting and shareholder outreach support</li> <li>▪ Equity incentive plan review and upsizing</li> <li>▪ Compensation tax and accounting consulting services</li> </ul>	<ul style="list-style-type: none"> <li>▪ Corporate governance policy review</li> <li>▪ Compensation-related risk assessments</li> <li>▪ Board and executive performance evaluations</li> <li>▪ Succession planning guidance</li> </ul>

The views expressed herein are those of the authors and are not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, affiliates or other professionals.



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### About FTI Consulting

FTI Consulting, Inc. is a global business advisory firm dedicated to helping organizations protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment. FTI Consulting professionals, who are located in all major business centers throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges in areas such as investigations, litigation, mergers and acquisitions, regulatory issues, reputation management and restructuring. More information can be found at [www.fticonsulting.com](http://www.fticonsulting.com).