C-SUITE

Issue 19, Winter 2016

2016 Outlook

Companies step up outreach to improve shareholder engagement

Hot button issues for 2016

Choosing metrics for judging incentive plans

Spotlight on director pay

Transform your board into a competitive weapon

Interviews with The Santa Fe Group, Glass Lewis and PwC U.S.

EQUILAR

Compensation As a Catalyst

Why TSR is not the “magic metric” for incentive plans

Q&A with David Swinford

PEARL MEYER

Total Shareholder Return (TSR) is a popular metric companies use to benchmark and reward executive compensation—in fact, nearly 50% of all companies pay their top employees at least partially based on this measurement. However, research shows that TSR may not be the most accurate portrayal of improved company performance in the short term. *C-Suite* spoke with David Swinford, President and CEO of compensation consultant Pearl Meyer, to discuss the ramifications of using TSR as a cornerstone of incentive programs, and why other metrics may work better to depict a more direct line to company performance in the short term.

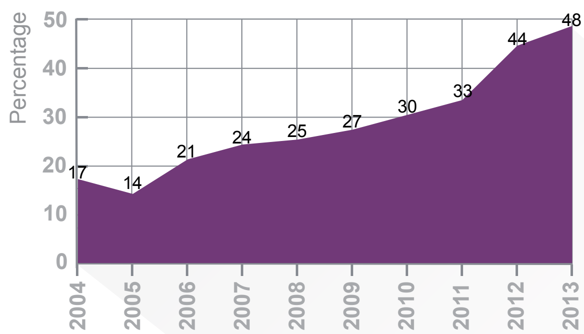
Pearl Meyer

David Swinford is President and CEO of compensation consulting firm Pearl Meyer. He can be reached at david.swinford@pearlmeyer.com.

What do boards need to do first when they begin thinking about compensation as a tool for creating value?

David Swinford: It's important to set aside the notions that compensation is primarily about compliance or controlling costs. Economies, companies and markets all evolve, and we must as well. Compensation is fundamentally linked to building a strong pipeline of leadership talent for the long run and to communicating the organization's priorities, both strategic and tactical. It is a tool that can drive change and reinforce the behaviors that lead to the achievement of planned goals. Those that do this effectively are able to accomplish more than just planning for change. They operate according to a healthy balance of short- and long-term business objectives, and it allows them to achieve a point of differentiation in how they execute strategy.

Figure 1
Percent of Companies Using TSR as an Incentive Metric



How can boards begin to align pay and business strategies?

Swinford: First, move away from the idea that conforming to the norm, or matching best practices, is a healthy approach. You want to incorporate market intelligence and data, but let it inform, not dictate, your compensation program. This is especially important when new regulations introduce complexity.

As the companies we work with begin this journey, we suggest maintaining a sharp focus on what's best for the organization and adopting a long-term mindset. Where you can truly achieve success is by identifying the unique compensation approach that drives value for your company.

So how do you measure value creation?

Swinford: This is a great question. Over the long-term—meaning in the neighborhood of ten years or so—total shareholder return or "TSR" is a very good indicator of value creation, and it aligns corporate results with shareholder gains. However, when we start to talk about TSR, things become confused very quickly. That's because there are some very important distinctions between using TSR as a true long-term indicator of having built value—where we believe it does work and work well—and using TSR to try and measure value creation over a relatively short time period. Even three or five years, which are often thought to be long term, are not long enough for the TSR measure by itself to tell you whether or not you've been successful. The other place where TSR can pose a real problem is when it is used as an incentive measure, instead of as a long-term alignment measure.

Roughly half of public compensation committees have adopted TSR as a cornerstone of their incentive programs. How do you suggest managing this, now that your firm has begun to suggest this is not the right or "magic" metric?

> "TSR is a great alignment tool and an excellent way to measure long-term value, but as an incentive, it cannot drive a management team to perform the steps that need to be executed to achieve that long-term value creation."

Swinford: Our research with Cornell University uncovered some interesting findings—chiefly, that there is no evidence use of TSR as an incentive metric improves company performance. That's an incredible discovery! We had suspicions that this might be the case, but the empirical research of data from S&P 500 companies over a 10-year span is definitive and it represents a sea change in how boards should think about the use of TSR.

In very simple terms, companies should not think about TSR in relation to incentivizing management teams. Instead, compensation committees should understand their company's business objectives and their long-term value creation strategy and then design the incentive component of the compensation program to reflect achievement of milestones toward those goals.

> "There are some very important distinctions between using TSR as a true long-term indicator of having built value and using TSR to try and measure value creation over a relatively short time period."

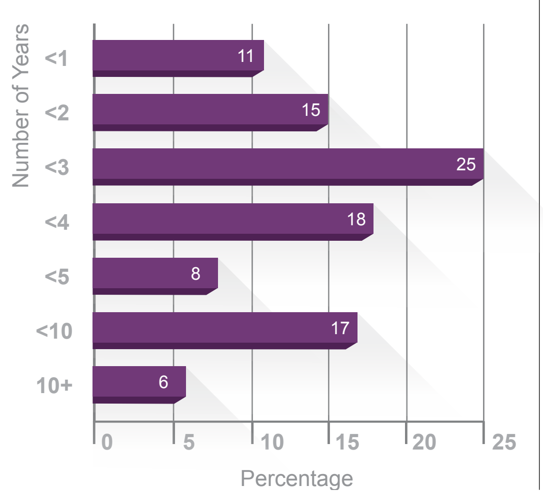
With that being the case, why do you think so many companies are using TSR as an incentive measure?

Swinford: Some of the additional findings of our research touch on this question. We found that larger, less profitable firms are more likely to rely on TSR as an incentive measure. Also, while it is becoming more prevalent in long-term incentive plans—jumping from 17% in 2004 to 48% in 2013—those who are more recently incorporating TSR are not putting as much weight on it.

We think that's likely because they are doing it as a way to bow to external pressure, but they recognize that as an incentive measure, it simply doesn't work and therefore don't want to put the entire plan on the line.

Among the proponents of TSR, there seems to be a broad assertion that somehow using TSR as an incentive can level the playing field among peers and help smooth out market movements and industry cycles. Those are reasonable goals, but not realistic in this context and not how TSR actually works. It is a great alignment tool and an excellent way to measure long-term value, but as an incentive, it cannot drive a management team to perform the steps that need to be executed to achieve that long-term value creation.

Figure 2
Length of Time Using TSR
as an Incentive Metric



If TSR is not the best incentive metric, what works better?

Swinford: I'm glad you asked! As we said, the research shows that TSR is not a magic metric and unfortunately, there is no single alternative measurement that will fill the gap. It really comes down to the individual value drivers for a company. That means taking a look at your company-specific path to value creation, incorporating your business and financial strategies, along with considerations for your industry, your competitive position, the general market economics, etc.

For example, does a consistent increase in market share over a set time period signal success or is a competitive roadmap of new products more critical in your industry? Maybe it's geographic expansion that drives the business. Each of these will have very different performance metrics, both short- and long-term.

Going further, you may also include financial measures that indicate a healthy balance between growth and returns or operational measures that directly tie to your business strategy. The key is that this matrix is going to be unique for each firm and if you analyze your value drivers and design the compensation plans accordingly, you've taken a huge step toward helping achieve strategy execution. In many cases, you've just set your firm above the competition in terms of laying a foundation for success, and that's a competitive advantage you don't want to leave on the table. CS