Pearl Meyer

CLIENT ALERT

ISS Announces Pay-For-Performance Methodology Updates for 2017

Six New Financial Metrics to Supplement Total Shareholder Return

ISS has announced significant changes to the methodology underlying its pay-for-performance (PFP) model after considering feedback on its 2017 Policy Survey from institutional investors and companies.

By way of background, ISS' PFP test is a two-step process. ISS' quantitative PFP test is the initial screen for its say-on-pay voting recommendation. Once the quantitative test is complete, ISS then conducts a qualitative assessment to determine a final vote recommendation. Approximately one-half of the companies that fail the quantitative test ultimately receive an ISS "For" recommendation on the say-on-pay vote.

For many years, ISS measured the quantitative alignment between pay and performance strictly relative to one performance measure—total shareholder return (TSR). However, in recent years using TSR as the single measure has been challenged for its questionable ties to longer term success of a company.

In reaction to ISS' 2017 Policy Survey, both investors and companies were highly supportive of using metrics beyond TSR for PFP evaluations. Metrics of preference included the following:

Metrics Preferred	Investors	Non-Investors
Revenue (such as total or growth)	18%	24%
Earnings (such as EPS/EBITDA)	26%	38%
Return (such as ROA/ROE)	35%	18%
Return on Investment (such as ROIC)	47%	23%
Cash Flow (such as OCF/FFO)	25%	20%
Economic Profit	22%	9%
Other	16%	10%

In response, ISS will now supplement TSR with the following financial performance measures for purposes of assessing alignment with executive compensation:

- Return on equity;
- Return on assets;
- Return on invested capital;
- Revenue growth;
- Earnings before interest, taxes, depreciation, and amortization; and
- Cash flow (from operations) growth.

While ISS did not provide specific methodology for application of these measures, it indicates the following:

- **Financial performance measures will be standardized in a table.** ISS' proxy research reports have referenced financial performance data for many years for analyst reference but such measures have never been presented in any specific format. Research reports published on or after February 1, 2017 will now contain a standardized comparison of a company's CEO pay and financial performance ranking (based on the six factors above), relative to its ISS-defined peer group. The metrics and weightings will be based on the company's four-digit GICS industry group, and are based on extensive back-testing over multiple years. The financial performance and pay ranking information will be displayed for all companies in a standardized table.

- **New financial measures will only be used in qualitative evaluation for the 2017 proxy season, but may be part of the quantitative PFP test in subsequent years.** This new assessment will not be a component of ISS's quantitative PFP screening for 2017, and the calculation and scoring of the three existing tests in the quantitative screening—Relative Degree of Alignment, Multiple of Median, and Absolute Pay-TSR Alignment—are not impacted by this change. However, ISS may use the relative financial performance information in its qualitative assessment of a company's PFP alignment in the 2017 proxy season. It is unclear how it will be weighted or factored into the analysis for the 2018 proxy season and whether or not these measures will be part of the quantitative analysis going forward.

- **Projections for relative financial performance will be available by mid-December.** Online projections of the relative financial performance evaluation will be available to certain subscribers of ISS.

> ***Pearl Meyer Observation:*** Focus on new financial measures in the Compensation Discussion & Analysis (CD&A) is now critical, particularly if the forecasted PFP quantitative screen indicates concern. While in the past many companies have included a discussion of such strategic measures in addition to TSR, the stakes for demonstrating alignment with these measures are higher this year. This is true regardless of ISS policy, as the 2017 Survey Policy indicated that institutional investors will have a renewed and focused interest on these metrics.

- **Companies should check their peer group between November 28 and December 9, 2016.** Because ISS must construct its peer groups before most companies' 2017 proxy filings are available, companies subject to ISS' quantitative PFP screens that will hold shareholder meetings between Feb. 1, 2017 and Sept. 15, 2017 may submit the peer groups used in setting compensation for the most recently completed fiscal year prior to their upcoming shareholder meeting. (For companies with calendar fiscal years, this means the 2016 peer group, not the 2017 peer group.) Most companies have a login to check this group but we can assist with this process if one has not been obtained. During this window, companies may also provide ISS with any corrections or feedback on the peer group.

Aside from these additional measures, another important change has been made to the quantitative PFP test for this year. Currently, there are three parts of the PFP test:

- **Relative Degree of Alignment (RDA):** This relative measure compares the percentile ranks of a company's CEO pay and TSR performance, relative to an industry and size-derived comparison group, annualized for the prior three fiscal year periods. Specifically, CEO pay is averaged for the three-year period; annualized TSR is the geometric mean of the three fiscal year TSRs in the period.

- **Multiple of Median (MOM):** This relative measure expresses the prior year's CEO pay as a multiple of the median pay of its comparison group for the same period.

- **Absolute Pay-TSR Alignment:** This measure compares the trends of the CEO's annual pay and the value of an investment in the company over the prior five-year period.

Up to now, most companies have been eligible to receive a score on the RDA test after one full fiscal year of trading as a public company. However, ISS has indicated that the focus of the test should be long-term alignment of a company's CEO pay and TSR performance relative to its ISS peer group. Accordingly, effective for shareholder meetings on or after Feb. 1, 2017, ISS will require two full years of trading data and two years of CEO pay data before applying the RDA test as part of its quantitative screening. Similarly, the six new relative financial performance measures will only apply to companies with at least two full years of trading data and financial results as a public company.

> ***Pearl Meyer Observation:*** For companies with fewer than two years of public data, increased focus will now be placed on the MOM and Absolute Pay-TSR Alignment tests.

What Should Companies Be Doing Now?

Unfortunately, once again companies will be forced to play Monday morning quarterback as ISS has released important changes almost a year after compensation planning for the relevant period took place. The good news is that the new measures will likely impact only companies at risk of failing the current quantitative screen, at least for this year, as consideration of the financial measures will be limited to the qualitative screen.

Nonetheless, we recommend all companies take immediate action to:

- Pull data on the six new measures (which can be sourced from S&P Compustat).
- Assess which measures are applicable to the company's industry (ISS may be forthcoming with weightings later this month).
- Consider drafting disclosure designed to address:
  - Whether the measures were factored into any of the compensation plans;
  - How they impacted compensation results; and
  - Why certain measures are or are not important to long-term company strategy.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.

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