Long-Term Incentives in the Age of Pay-for-Performance

Compensation Series

March 16, 2017
Meet The Presenters

**Steven L. Gerard (moderator)** served as the Chief Executive Officer of CBIZ, Inc., a provider of financial and employee business services, from October 2000 until March 2016. He continues to serve as the Chairman of the Board (since 2002). Prior management experience includes Chairman & CEO of Great Point Capital, Chairman & CEO of Triangle Wire & Cable, Inc. (and its successor Ocean View Capital), Citibank, N.A. and the American Stock Exchange. Mr. Gerard also serves as the compensation committee chair on the boards of Lennar Corporation and Las Vegas Sands. He also serves on the board of Joy Global, Inc.

**Matt Turner** is a managing director in Pearl Meyer’s Chicago office. He specializes in executive compensation strategy, incentive plan design, tailoring of performance measures, and the setting of shareholder-focused performance objectives. With 25 years of experience, Mr. Turner has worked with public and private companies in a range of industries. In addition to ongoing advisory services, he has also worked extensively with companies undergoing changes in ownership structure, business transformation, and other strategic events.

**Brett Herand** is a vice president in the Chicago office of Pearl Meyer. He works with boards and management on executive compensation issues related to performance measurement and value creation, incentive plan design, and technical advisory work with respect to tax, accounting, and SEC regulatory issues. Mr. Herand works with public and private companies across many industries and has been widely quoted in various publications.
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The replay and slides will be available early next week at www.NACDonline.org and www.pearlmeyer.com.
How did we get here?

• Pay-for-performance was a universal bromide in CD&As

• Early 2000s – Sarbanes-Oxley strengthened pay governance with majority independent director requirements and other indirect impact, including increased focus on executive pay

• 2010s – Dodd-Frank Act passed in response to financial markets crisis, say-on-pay requirement adopted in 2011. ISS and Glass Lewis evaluation of executive compensation programs include quantitative tests of pay-for-performance. SEC required disclosure of “pay-versus-performance” remains pending

• 2010s – Companies (and their consultants) begin to accommodate ISS/GL tests, as well as counter with alternative pay-for-performance tests, realized/realizable pay, and voluntary disclosure of supplemental information for say-on-pay consideration
Impact of pay-for-performance?

• Has incentive plan – LTI in particular – changed?  
  Yes

• Is **performance** improved?  
  No

• Is executive pay **better aligned** with performance?  
  Not clear

• How should directors think about LTI measures and goals to best align pay and performance?
How has LTI changed in the wake of pay-for-performance?

1. Increase in prevalence of TSR/rTSR as an LTI measure

2. Increase in performance-based LTI as a share of total LTI

3. Decrease in prevalence of stock option usage

4. More universal acceptance that LTI means multi-year measures and goals (not sequential single-year periods)

5. Consideration to non-financial performance dimensions (ESG, brand, customer, etc.)

6. LTI eligibility reduced in the wake of option expensing becoming mandatory; not many changes to eligibility since then
TSR is now the single most prevalent measure in public company LTI.

Prevalence of TSR as an Incentive Metric
S&P 500

% of Companies

Year

The LTI portfolio has been rebalanced toward performance-based LTI.

Evolution in LTI Mix
S&P 500 Subset

- **2011**:
  - Stock Options: 34%
  - Time-based Restricted Stock: 20%
  - Performance-based LTI: 46%

- **2013**:
  - Stock Options: 27%
  - Time-based Restricted Stock: 19%
  - Performance-based LTI: 54%

- **2015**:
  - Stock Options: 19%
  - Time-based Restricted Stock: 26%
  - Performance-based LTI: 54%
In 2015, Pearl Meyer partnered with Cornell to examine the use of total shareholder return (TSR) as a metric in long-term incentive (LTI) plans. Highlights of this study include:

**Performance**
- No evidence that the inclusion of TSR leads to increased firm performance. In fact, there is at least weak evidence that TSR is associated with lower shareholder returns and revenue performance.
- Consistent pattern of a negative relationship between the proportion of LTI focused on TSR and total revenue growth (with a one year lag)
- Slight positive relationship with ROE

**Prevalence**
- TSR presence in long-term incentives among S&P 500 companies has increased from 17% in 2004 to nearly 50% in 2013.
- All industry sectors have experienced significant growth in TSR presence in long-term incentives.

**Pay Mix**
- While more S&P 500 executives are subject to TSR today, the relative weight of TSR in the total long-term incentives has decreased over time.
- Larger and less profitable firms are most likely to add (or increase the weight of) TSR in long-term incentives.
Other trends in the use of TSR

• In combination with key financial measures

• As a *modifier* to financial performance results
  * +25% if rTSR is above the 75th %ile
  * -25% if rTSR is below the 25th %ile
  * No rTSR adjustment if between the 25th and 75th %iles

• With *limiters* to final award value
  * No more than a target number of shares may be earned if *absolute TSR* is not positive for the three-year period
  * Overall dollar-denominated award value limited to a multiple of target value (i.e., 350%)

• Targets above median performance; no payouts for below median performance
Are we seeing better alignment of pay and performance?

- For one client’s peer group for the three-year period ending 2011 to three-year period ending 2015, YES!

\[
R^2 = 6.6\% \\
2009-2011
\]

\[
R^2 = 38.1\% \\
2013-2015
\]
Are we seeing better alignment of pay and performance?

- For a different client’s peer group for the three-year period ending 2010 to three-year period ending 2015, NO CHANGE
Audience Poll

Which definition of “performance” do you believe is most appropriate for executive compensation purposes?

1. 100% Total Shareholder Return, relative to peers or broad market
2. 67% Total Shareholder Return, 33% key financial measures
3. 40% TSR, 40% key financial, 20% other
4. 25% TSR, 25% key financial, 50% other
Case example of pay-for-performance for a mutual insurance company

• Large, multi-line mutual insurance company

• “Shareholder value” is a more complex idea, since policy-owners (customers) are the claimants on the residual “equity” value of the company

• Pay-for-performance must take into account a more holistic definition of performance

• Performance framework reflects
  • Growth, profitability, and capital strength “above the line” and
  • Customer experience and strategic leadership “below the line”

<table>
<thead>
<tr>
<th></th>
<th>Percentile Rank against Peers</th>
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<tbody>
<tr>
<td>Combined Ratio 33%</td>
<td></td>
</tr>
<tr>
<td>Growth in NWP 33%</td>
<td></td>
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<tr>
<td>Risk-based Capital Ratio 33%</td>
<td></td>
</tr>
<tr>
<td>Customer satisfaction +/- 10%</td>
<td></td>
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<tr>
<td>Strategic leadership +/- 10%</td>
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</table>
Unfortunately, there are no silver bullets

- TSR does not drive performance

- Recent research (as yet unpublished) fails to show any particular financial performance measure is a driver of improved firm performance

- Same research also fails to show any link between the percentage of LTI delivered in performance-based vehicles and firm performance (i.e., the ISS criteria that seeks at least 50% of LTI in performance-based vehicles is irrelevant to firm performance)

- So, does anything matter?
Selecting the right metrics and designing effective incentives are key

- There are no incentive plan design or metric selection silver bullets. Business strategy and context, rather than market prevalence or fad, should drive metric selection. A company’s specific business and talent strategies, rather than median peer practices, should drive incentive plan design and pay mix.

- A well-designed and effective incentive compensation program is a critical element of improving firm performance. However, it must follow and flow from sound business and executive talent strategies.

Understand the Key Drivers of Business Success

Business Strategy

- Strategy and human capital objectives drive pay program design.

Leadership Strategy

- Review and Revise
  - Evaluate Compensation Decisions
  - Evolve Compensation Strategy

Review/Design Programs
- Compensation Philosophy & Strategy
- Compensation Program Design

Deliver
- Implementation
- Communication
- Financial Results

Understand the Context
Key elements to achieve pay-for-performance alignment and drive performance

Peer Group / Market
Define the relevant market for benchmarking pay levels
Consider the perspectives of external groups (i.e., ISS and GL)

Target Pay Positioning
The “starting line” for pay-for-performance

Pay Mix
Mix of base salary, annual cash incentive, and long-term incentives
Mix of cash versus equity

Plan Design
How performance is translated into award values
Leverage around target payout
Number of distinct measures

Perf. Linkage
The “centerpiece” financial measure(s)
Key operational and strategic measures

Goals / Perf. Range
What constitutes exceptional versus acceptable performance?
Threshold to superior/maximum range
What inputs drive the goals?
Incentive performance measures should reinforce business strategy execution.

Maximize shareholder value

Company-specific path to value creation taking into account:
- Market economics; competitive position
- Company strengths, weaknesses, opportunity, and risks

Specific/relevant financial measures, balancing growth and returns

Centerpiece Financial Measures

Driver Measures

Corporate Processes
Incentives, Planning, and Reporting
Resource Allocation

Operating Decisions

Operational measures tied to business strategy
Use the right measures in the right balance across the entire incentive framework

A properly balanced performance measurement framework will:

- Emphasize profitable growth/returns, consistent with strategy and market economics
- Include a mix of lead and lag measures to ensure appropriate line-of-sight
- Map measures to the right incentive plans based on timeframe and participant profile

<table>
<thead>
<tr>
<th>% of Target Total Pay</th>
<th>Individual “MBOs”</th>
<th>Top Line</th>
<th>Operating Income</th>
<th>Gross Margin</th>
<th>NI Margin</th>
<th>ROIC</th>
<th>Working Capital</th>
<th>Absolute Growth</th>
<th>Relative to Peers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Incentive Plan</td>
<td>35%</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
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<tr>
<td>Cash Long-Term Incentive Plan</td>
<td>15%</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
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<tr>
<td>Performance-Vested Restricted Stock</td>
<td>15%</td>
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<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Other</td>
<td>5%</td>
<td></td>
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<td>X</td>
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</table>
Tailor your performance measures to ensure economic relevance and fairness

<table>
<thead>
<tr>
<th>Potential Deviations from Standard Definitions</th>
<th>Some Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating income vs. all “earnings” (e.g., interest income, JV’s, discontinued ops)</td>
<td>Employee control and influence</td>
</tr>
<tr>
<td>Actual vs. standard tax rates (or pretax earnings)</td>
<td>Same as above; is management of a deferred tax asset part of operations?</td>
</tr>
<tr>
<td>Non-cash charges (depreciation, amortization, etc.)</td>
<td>Unusual period of growth; management inherited goodwill; distortions to investment decisions</td>
</tr>
<tr>
<td>Effects of exchange rates</td>
<td>Employee control and influence; financial vs. operational hedging; distortions to investment decisions</td>
</tr>
<tr>
<td>Inventory valuation</td>
<td>Differences from peers for relative performance comparisons; large swings in actual value of inventory</td>
</tr>
<tr>
<td>Adjustment of balance sheet values (marking to market; recognizing non-GAAP assets; goodwill/R&amp;D impact)</td>
<td>Distorting investment decisions; protecting brand value; accountability for profit and returns</td>
</tr>
<tr>
<td>Capitalizing R&amp;D or marketing expenses</td>
<td>Encouraging investment without undue impact on short-term financial metrics</td>
</tr>
<tr>
<td>Suspending the impact of acquisitions for a period of time</td>
<td>Acquisition strategy with multi-year integration</td>
</tr>
</tbody>
</table>
Case example – industrial company

- **Strategy/market economics**
  - Establish/maintain operational excellence leading to competitive advantage in the collection, recycling, and processing of scrap metal; ancillary businesses
  - Margins and stock price highly sensitive to global scrap metal prices
  - Smaller player in the market
  - Maybe one or two publicly traded peers

- **Value driver analysis difficult; few acceptable public peers; conclusions from the traditional metals industry analysis have limited usage**

- **Mapping of firm’s value chain proves useful**
  - Identify key levers of value creation
  - Understand where exogenous factors may drive volatile results
  - *Some measures that are important for decision-making, but less useful for incentive design*

- **Incentive and performance framework sends the right signals to management**
  - AIP → EPS (50%), Strategy (20%), Cost savings (10%), Inventory (10%), Safety (10%)
  - LTIP → Restricted stock (33%) Performance shares: rTSR (33%), CFROI (33%)
Set performance goals that are reasonable and relevant

In general, a good rule of thumb is that over a 10-year period:

Industries and specific peer groups may differ

Certainly, a superior management team may achieve high performance levels more often, but…

- Does the company’s long-term stock price performance support such a belief?
- Are you confident the measures of performance used really directly relate to shareholder value creation?
- Is the current management team driving the performance results or exploiting the cumulative effect of effective strategy decisions and implemented by prior management teams?
The goal-setting process requires early and frequent compensation committee involvement

<table>
<thead>
<tr>
<th>Traditional Approach</th>
<th>Today’s Required Approach</th>
</tr>
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<tbody>
<tr>
<td>• Budget-driven</td>
<td>• Multiple performance perspectives</td>
</tr>
<tr>
<td>• Target-focused</td>
<td>• Multiple pay/performance scenarios considered</td>
</tr>
<tr>
<td>• Compensation committee involved at the</td>
<td>• Consideration of HR matters</td>
</tr>
<tr>
<td>end of the process</td>
<td>• Early, active involvement of the compensation committee</td>
</tr>
</tbody>
</table>
Goal-setting should incorporate multiple perspectives to better ground goals in reality.

**Historical Perspectives**
- Historical Company and/or Industry Avg.
- Margins Relative to Comparables
- Bottom-up Budget

**Forward-Looking Perspectives**
- Cost of Capital
- Shareholder Expectations
- Multiple Performance Scenarios
- Analyst Estimates

**Company Earnings Goals**
Different perspectives provide different answers

- **Bottom-up budget**
  - $1.73
  - $1.97

- **Sell-side analyst**
  - $1.85
  - $2.08

- **Shareholder expectations**
  - $1.93
  - $2.20

- **Cost of capital**
  - $1.99
  - $2.16

- **Peer companies: Forward**
  - $1.68
  - $1.99

- **Peer companies: Historical**
  - $1.80
  - $2.02

- **Historical**
  - 201X 201X 201X
  - $1.60 $1.69 $2.13

- **Shareholder expectations**
  - 201X
  - $1.80

- **Sell-side analyst**
  - 201X
  - $1.99

- **Bottom-up budget**
  - 201X
  - $1.73

- **Cost of capital**
  - 201X
  - $1.99

- **Peer companies: Historical**
  - 201X
  - $1.80

- **Historical**
  - 201X
  - $1.80

- **Sell-side analyst**
  - 201X
  - $1.99

- **Bottom-up budget**
  - 201X
  - $1.73
Inventory potential impact of events on performance. Set goals accordingly

Event Impact on EPS Performance

<table>
<thead>
<tr>
<th>Event</th>
<th>Impact on EPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>DE1: Loss of key customer accounts</td>
<td>-$0.30</td>
</tr>
<tr>
<td>DE2: Consumer spending slowdown</td>
<td>-$0.21</td>
</tr>
<tr>
<td>DE3: Delayed new product launch</td>
<td>-$0.09</td>
</tr>
<tr>
<td>DS1: DE1 + DE2 + DE3</td>
<td>-$0.05</td>
</tr>
<tr>
<td>Target</td>
<td>$2.00</td>
</tr>
<tr>
<td>UE1: Impact of new account pursuit</td>
<td>$0.08</td>
</tr>
<tr>
<td>UE2: Favorable legislation</td>
<td>$0.16</td>
</tr>
<tr>
<td>UE3: Price-taking</td>
<td>$0.25</td>
</tr>
<tr>
<td>US1: UE1 + UE2</td>
<td>$0.28</td>
</tr>
<tr>
<td>US2: UE1 + UE2 + UE3</td>
<td>$0.40</td>
</tr>
</tbody>
</table>

DE1: Loss of key customer accounts
DE2: Consumer spending slowdown
DE3: Delayed new product launch
DS1: DE1 + DE2 + DE3
UE1: Impact of new account pursuit
UE2: Favorable legislation
UE3: Price-taking
US1: UE1 + UE2
US2: UE1 + UE2 + UE3
Avoid five goal-setting pitfalls

1. Relying principally on the company budget process (or any single perspective)

2. Presuming that financial performance relative to peers is as relevant as (or more relevant than) stock price performance relative to peers

3. Fixating on year-over-year performance, or continuous improvement

4. Not doing a sanity check by modeling the potential outcomes

5. Becoming too anchored to past results or circumstances
Build a performance culture through effective communications

Requires involvement at the most senior levels of management:
- C-suite
- Business leaders

Involves socialization with and input by essential stakeholders:
- Internal and external counsel
- Investor relations
- Corporate communicators
- The board

Poses significant risks if not managed carefully:
- Employee disengagement
- Plan misinterpretation
- “Insider information”

Aids in individual performance discussions:
- Clearer and documented performance feedback

Planning for communication must be part of incentive plan design strategy and implementation—not an afterthought.
Questions?
Join NACD and Pearl Meyer for our next program:

The Role of Incentives in Creating an Innovation-Centric Culture

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2:00 – 3:00 p.m. EDT
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Thank You