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The Real Value Drivers: Linking Incentives to Shareholders

Q&A with the Panelists

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Agenda

- Check-the-box incentive plans have become all too common in an era of compliance-driven compensation design.
- Today's session will focus on:
  - How boards and management teams can drive competitive advantage by selecting performance metrics and setting goals that link with the value proposition for shareholders (growth stock, value stock, high yield).
  - Ways to align incentives with each company's unique business strategy, including dimensions of business success beyond financial metrics.
  - Exploring connections between incentive design and culture, leadership development, diversity and innovation.
  - How incentive design can be used to clarify the pay-for-performance message for investors, advisory firms and participants.

Selecting the *right* metrics

- Analyst reports, company investor day presentations and company strategic plans should be the starting point for identifying performance metrics and value drivers.
- Knowledge of peer group practice provides context, but “copycat” incentive plans dull the message.
- Think like a majority shareholder – that’s what an activist will do.

Is R-TSR right for you?

- Investors and proxy advisory firms have their own performance models, but they do not expect companies to use exactly those metrics in their incentive plans.
- R-TSR has become the majority practice "shareholder alignment metric" for long-term incentives.
- However, research shows little correlation between use of R-TSR metrics and performance, and executives often view R-TSR awards as a "lottery ticket."
- Still, R-TSR metrics act as an insurance policy to protect against outsized payouts when relative stock performance is poor.

What about other non-financial metrics?

- Non-financial metrics are gaining interest from companies and investors. For example, goals aligned with:
  - Environmental issues – carbon footprint, greenhouse gas, etc.
  - Diversity – employee population and/or suppliers
  - Innovation – speed to market, mix of new products/services
  - Leadership development and succession readiness
  - Customer satisfaction – net promoter scores
- Non-financial goals should still be SMART: Specific, Measurable, Attainable, Relevant and Time-bound.
- On the horizon – one shareholder proposal requested a report on the feasibility of integrating cyber security and data privacy metrics into the incentive plans.

Market Practices: Top 200 Companies

Most prevalent Annual Incentive performance measures:

- Other non-financial goals (52%)
  - e.g., customer satisfaction, safety, etc.
- Revenues (49%)
- EPS (38%)
- Operating income/margin (35%)
- Cash flow (29%)

Most prevalent Long-Term Incentive performance measures:

- Relative TSR (50%)
- EPS (32%)
- Return on capital/return on invested capital (29%)
- Revenues (15%)
- Cash flow (14%)

When to change metrics

- Changes in business strategy or in annual business priorities are indicators that incentive metrics should be revisited.
- Restructuring to improve new product speed-to-market or to become more customer-centric, creates misalignment if incentives reward the same year-over-year EPS growth metric.
- Unusual payout patterns, e.g., consecutive years of max or zero payouts, are also a sign that performance metrics need to be revisited.

Sending the *right* message

- Performance metrics and goals are sending a message to shareholders, employees, proxy advisory firms and others.
- To test whether it is the right message, consider:
  - Where are targets set in relation to earnings guidance?
  - Are incentives aligned with the strategy and metrics that are the focus of investor presentations?
  - Are non-financial metrics aligned with the company's culture and values?
  - Could a potential new hire understand what distinguishes your company from others by reviewing your incentive plan design?

Summary

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- When selecting the *right* metrics, look to the business strategy
- R-TSR provides shareholder alignment, in moderation
- Other non-financial metrics only work if they are relevant and measurable
- Most prevalent metrics: adjusted EPS and R-TSR are outcome-oriented
- It’s time to change metrics when the business changes
- Sending the *right* message means clarity and consistency with other messaging

Q&A Session

Speaker Bios

Speakers

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Yvonne Chen is Managing Director in the New York office of Pearl Meyer. She joined the firm in 1998. With more than 25 years of business experience, Ms. Chen consults with companies, subsidiaries and joint ventures in the development of compensation objectives, value-based pay and performance alignment, incentive plan design and compensation-related governance matters. Ms. Chen has expertise in executive and director compensation matters and regularly consults with compensation committees of large, publicly-traded companies, as well as a range of mid-sized to smaller companies and privately-held clients in the telecommunications, manufacturing, healthcare, hospitality, real estate/REIT and utility sectors.

A graduate of the Massachusetts Institute of Technology, Ms. Chen holds an M.B.A. from the University Of Chicago Graduate School Of Business. Ms. Chen previously was a Principal in the executive compensation practice group at William M. Mercer, Incorporated and held positions at SCA Consulting, KeySpan Corporation and Aetna Life & Casualty Corporation.

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Bob McCormick joined CamberView as a Partner in 2017. Prior to joining CamberView, Mr. McCormick served as Chief Policy Officer of Glass Lewis where, for over a decade, he oversaw the analysis, voting recommendations and report writing on management and shareholder proposals for over 20,000 public company shareholder meetings in more than 100 countries. Previously, Bob McCormick was the Director of Investment Proxy Research at Fidelity Management & Research Co., which he joined in 1997. At Fidelity, he managed the proxy voting of more than 700 retail and mutual fund accounts, holding 4,000 domestic and international securities worth in excess of $1 trillion. Prior to joining Fidelity, McCormick was a staff attorney at Keenan, Powers & Andrews and Prudential Securities Incorporated, both in New York City.

Bob McCormick is an attorney who earned his law degree from Quinnipiac University School of Law after graduating with honors from Providence College. He serves on the board of the Northern California Chapter of NACD and on the advisory board of the University of Delaware's Weinberg Center on Corporate Governance.

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Linda A. Mills is former corporate vice president of operations for Northrop Grumman, a leading global security provider of advanced solutions for defense, intelligence, civil agency and commercial customers. At Northrop Grumman, Ms. Mills was responsible for driving effective operations to enable top performance, innovation and affordability. She was directly responsible for corporate programs, quality, technology and engineering and the associated corporate councils.

Ms. Mills was named one of the 50 Most Powerful Women in Business by Fortune magazine and received the Federal 100 Award from Federal Computer Week, recognizing government and industry leaders who have played pivotal roles in the federal government IT community. Ms. Mills serves on the board of the Smithsonian National Air and Space Museum and the board of visitors for the University of Illinois College of Engineering. In addition to Navient, Ms. Mills also serves on the board of directors of American International Group, Inc. (AIG).