Performance Metrics and Their Link to Value

Prepared by Farient Advisors LLC

Summary Report

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Performance Metrics and Their Link to Value

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Farient Advisors

Farient Advisors LLC (www.Farient.com) is an independent executive compensation and performance consultancy which helps clients make performance enhancing and defensible executive compensation decisions that are in the best interests of their shareholders. Farient provides a comprehensive array of executive compensation and performance advisory services, including compensation strategy and planning, program design, decision support, process support, and other services including board of director compensation, technical reviews, investor communications, and assistance in transactional situations. In addition, based on its extensive data base covering the Russell 3000, Farient offers a proprietary performance and pay Alignment Model to help assess, improve, and convey pay and performance alignment. Farient Advisors was founded in 2007 and has offices in Los Angeles and New York. Farient also is affiliated with Kepler Associates, a London-based firm.

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Background on Data Provider

Data for this research report is provided by **Incentive Lab**, a financial data and science firm that focuses on providing clients with superior data and essential insight into their executive compensation practices. Incentive Lab's proprietary compensation data and their team of world-class academicians and analysts deliver unparalleled depth and insight into executive compensation.

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Executive Summary

One clear outcome from Say on Pay voting on executive compensation has been a focus on pay for performance. To determine how well executives are aligned to the long-term performance of their companies, investors are evaluating to what extent executive compensation, particularly for the CEO, is linked to company performance, as opposed to being based on the passage of time – what is sometimes referred to as "pay for pulse."

As the prevalence of performance-based compensation rises, it is incumbent upon boards to become increasingly discerning about how that performance is being measured. The performance metrics selected, as determined by the company and its board of directors, are deemed to be the best measures of corporate success. Investors and other interested stakeholders wish to validate that these metrics are in fact linked to Total Shareholder Return, or TSR.

Shareholders are increasingly augmenting the discussion on *how much* compensation is performance-based with *how* that performance is being *measured*. They want to understand what metrics are used in performance-based long-term incentive (LTI) plans, why those measures were chosen, and how performance against those measures impacts shareholder value.

This groundbreaking research covers 1,800 companies, all 24 GICS Industry Groups, and fourteen years of data (from 1998-2011). It identifies the primary metrics used in executive compensation plans, overall and by industry, company size, and valuation premiums, and then tests these metrics to determine whether the metrics being used have the highest impact on TSR results. It provides the most definitive answer to date on a critical question: "Are companies choosing their long-term incentive (LTI) metrics wisely for the most sustainable benefit to shareholders?"

Key Findings and Conclusions

- Executive compensation design has moved towards long-term incentive (LTI) components in an attempt to align management interests with those of long-term shareholders; further, 70% of companies are now offering performance-based equity, up from 20% ten years ago
- Among companies using performance-based LTIs, most (53%) use a mix of TSR and financial measures in their equity LTI plans; others (28%) use financial measures only; and a smaller minority (15%) use TSR only. This use rate puts a premium on getting the financial measures right
- In aggregate, performance metrics are generally well-aligned with shareholder value. Earnings Growth, followed by Returns and Revenue Growth, has the greatest impact on TSR. In general, this matches the use patterns for financial metrics in LTIs: Earnings Growth is the most popular financial measure, followed by Returns and Revenue Growth. TSR (usually measured on a relative basis) is used as a direct measure of shareholder value in over 40% of companies with performance-based LTIs
- Many industries have a number of metrics to choose from. Half of the 24 Industry Groups have at least three metric categories with strong correlations
- However, the optimal use of measures differs considerably by industry. Industry Group, in general, as an indicator of business model, has the strongest influence on performance metrics used, with size and valuation premiums having little impact on metric selection

- The good news is that half of the 24 Industry Groups use metrics that most highly correlate to value, and also use TSR as a direct measure of shareholder value
- The bad news is that the other half of Industry Groups could use some improvement. The companies in these industries either are not using the metrics that are most strongly correlated to value or, when the overall correlations of financial metrics to shareholder value are poor, they are not sufficiently using TSR as a direct measure of shareholder performance

As indicated in the table below, some industries demonstrate a clear alignment between the metrics most frequently used in LTI equity plans and shareholder value. Half of the 24 Industry Groups show solid to strong alignment in that the metrics used most often also are those that best correlate to value. The other half could benefit from some improvement. It is important to note that these statements do not apply to individual companies. Rather, they point more generally to those industries in which improvement opportunities might exist. Industries are listed in order of GICS code.

Strength of Alignment - Performance Metrics vs. TSR		
Good (12)	**Moderate (8)**	**Weak (4)**
Energy	Transportation	Telecommunications
Materials	Consumer Services	Food & Staples Retailing
Capital Goods	Media	Pharma, Biotech & Life Sciences
Commercial & Prof Svcs	Household & Personal Products	Semiconductors
Automobiles & Components	Banks	
Consumer Durables & Apparel	Insurance	
Retailing	Real Estate	
Food, Beverage & Tobacco	Software & Services	
Health Care Equipment		
Diversified Financials		
Technology Hardware & Equip		
Utilities		

Which Metrics Correlate Best to TSR?

The table below builds on the table from the previous page to show which metrics have the best correlation to TSR for each industry group. Overall, Earnings Growth measures have had the strongest correlation to value (TSR). Earnings Growth was ranked #1 in 17 of the 24 industry groups (with one tie).

Metrics Best Correlated to TSR by Industry

		Which Metrics Correlate Best to TSR?				
Industry Sector	**Industry Group**	**Earnings Growth**	**Revenue Growth**	**Returns**	**Cash Flow (CapEx)**	**Earnings Margins**
Single-Group Sectors	Energy	2		**1**		
	Materials	**1**	2			
	Telecommunication Services				2	**1**
	Utilities	**1**		2		
Industrials	Capital Goods	**1**	2			
	Commercial & Professional Services	**1**	2			
	Transportation	2		**1**		
Consumer Discretionary	Automobiles and Components	**1**		2		
	Consumer Durables and Apparel	**1**	2			
	Consumer Services	**1**	2			
	Media	**1**			2	
	Retailing	**1**	2			
Consumer Staples	Food & Staples Retailing	**1**			2	
	Food, Beverage & Tobacco	**1**	2			
	Household & Personal Products			2	**1**	
Health Care	Health Care Equipment & Services	**1**	2			
	Pharma, Biotech & Life Sciences	**1**	2			
Financials	Banks	**1**				
	Diversified Financials	**1**				2
	Insurance	2		**1**		
	Real Estate	**1**			**1**	
Information Technology	Software & Services		**1**			**1**
	Technology Hardware & Equipment	**1**	2		2	
	Semiconductors			2	**1**	

(green)	*Metrics used generally match metrics correlated with value (TSR)*
(yellow)	*Improvement opportunities exist*
(red)	*Significant divergence between metrics used and those correlated to value*
1 or 2	*Metric types most highly correlated to TSR - Best and second best correlation*

To determine which industries had good, moderate or weak alignment, we compared metrics used most frequently against the metrics with the best correlation to TSR. Divergence between usage and correlation led to an assessment of where opportunities for improvement exist.

What Are the Greatest Areas of Improvement for Each Industry?

While some improvements already may have been made given the time horizon of this analysis (i.e., covering the years 1998-2011), patterns in the data suggest that opportunities for improvement still exist. These improvements vary by industry, as shown in the table that follows. They include:

- Greater need to use TSR directly when correlations to value are poor
- Need to balance growth with a greater use of efficiency measures, like Returns and/or Margins
- Greater need to take capital investments into account, not just the earnings from those investments
- Recognition that Revenue Growth can be a close second in correlation to value compared to Earnings Growth, offering the opportunity to supplement Earnings with Revenue Growth if indicated by the company's strategy and growth opportunities in its industry

Improvement Opportunities in the Use of Metrics by Industry

		To Improve Alignment, Increase Focus On:					
Industry Sector	**Industry Group**	**TSR (direct)**	**Earnings Growth**	**Revenue Growth**	**Returns**	**Cash Flow (CapEx)**	**Earnings Margins**
Single-Group Sectors	Energy						
	Materials						
	Telecommunication Services	✓				✓	✓
	Utilities						
Industrials	Capital Goods			✓			
	Commercial & Professional Services						
	Transportation				✓		
Consumer Discretionary	Automobiles and Components			✓			
	Consumer Durables and Apparel						✓
	Consumer Services	✓		✓			
	Media	✓					
	Retailing			✓			
Consumer Staples	Food & Staples Retailing	✓				✓	
	Food, Beverage & Tobacco			✓			
	Household & Personal Products				✓	✓	
Health Care	Health Care Equipment & Services	✓					
	Pharma, Biotech & Life Sciences	✓					
Financials	Banks	✓					
	Diversified Financials						
	Insurance	✓					
	Real Estate		✓				
Information Technology	Software & Services	✓					✓
	Technology Hardware & Equipment					✓	
	Semiconductors	✓			✓	✓	

Metrics used generally match metrics correlated with value (TSR)
Improvement opportunities exist
Significant divergence between metrics used and those correlated to value

Recommended Actions

We predict that metrics will become increasingly important and visible as investors and executives try to better align executive incentives with shareholder interests. This analysis suggests some key steps that investors and companies should take in order to improve that alignment. These include:

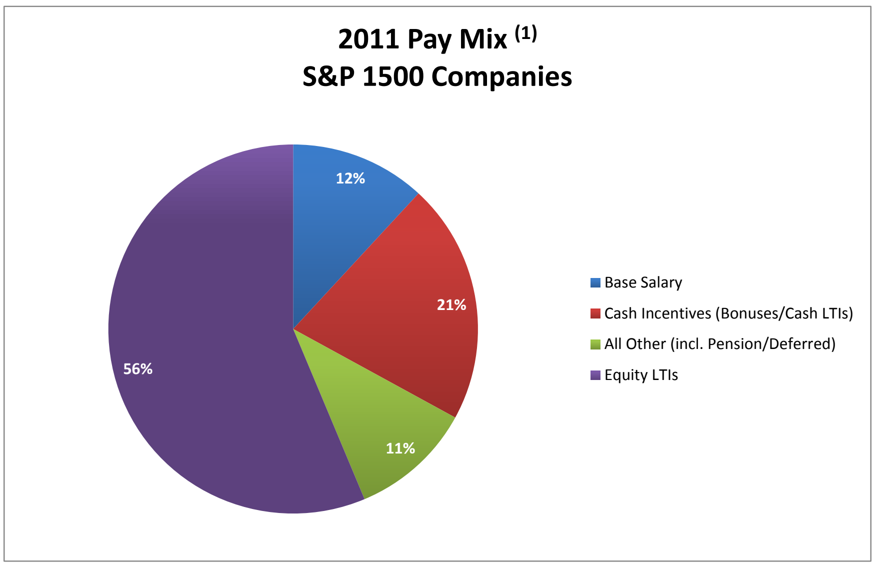
- Companies should undertake their own analysis to determine which measures of performance have the most influence on their shareholder value. In this regard, various measurement definitions (e.g., how depreciation, capital expenditures, asset definitions, and other items are treated) could make a significant difference to shareholder value and should be given careful consideration
- Companies should try to find two or three key metrics that appropriately balance growth and returns and demonstrate a proven link to value. However, if overall correlations to value are poor, or only one financial metric correlates to value, then companies should choose a single financial metric, non-financial metrics, and/or TSR, and should support this choice with a strong rationale
- Investors are likely to increase engagement activities around executive compensation in general, and specifically on performance metrics. In communicating with investors, companies should present (and investors should expect) compelling evidence as to how various measures of performance will lead to enhanced shareholder value

* * * * *

We hope that this analysis is illuminating for investors and companies alike, and that it contributes to the quality of the dialog around how incentive programs, and the metrics that drive them, can enhance shareholder value and support the alignment between pay and performance.

Report Overview

Performance is viewed by most investors as encompassing results over the long term, defined as three years or more. Executive compensation design has moved towards long-term incentives (LTIs) in an attempt to align management interests with those of long-term shareholders. According to research conducted by Farient Advisors, equity LTIs (stock options, restricted stock (or units), and performance shares (or units)) now comprise over half of total compensation for CEOs in the S&P 1500, as shown in the graph below.



(1) Based on Summary Compensation Table data

The prevalence of performance-based equity (i.e., equity that vests based on performance vs. time) has shifted dramatically over the past decade, with approximately 70% of companies offering performance-based equity today, up from 20% ten years ago. As the prevalence of performance-based compensation rises, it is incumbent upon boards to become increasingly discerning about how that performance is being measured. The performance metrics selected, as determined by the company and its board of directors, are deemed to be the best measures of corporate success. Investors and other interested stakeholders wish to validate that these metrics are in fact linked to Total Shareholder Return (TSR), defined as stock price appreciation plus dividends, as if those dividends had been reinvested in the company's stock.

To conduct this research, we identified the primary metrics being used in executive compensation plans, overall and by industry, company size, and valuation premiums. We then tested the extent to which those metrics correspond to TSR to help answer the question, "Are companies choosing the right performance metrics?"

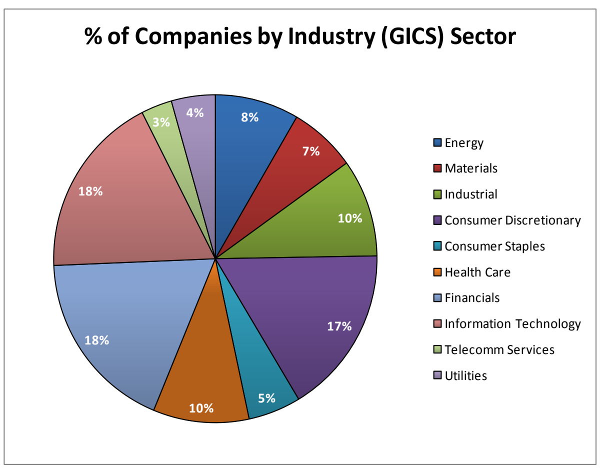
Profile of Data and Research Universe

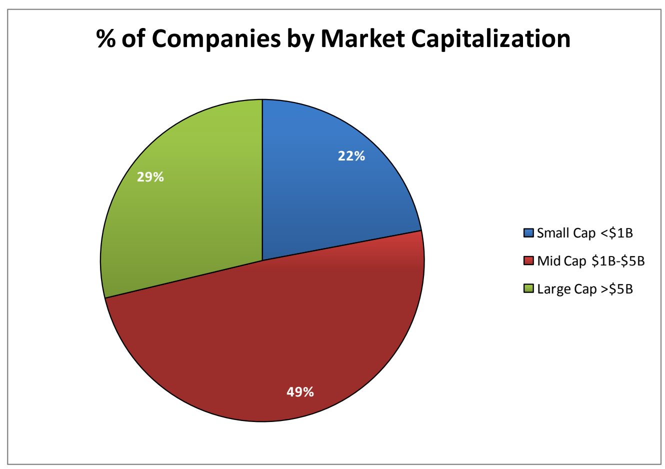
The database used for this research was largely provided by Incentive Lab, which collects and analyzes data on performance metrics. Data from 1998-2011 were used in the research, capturing the top 750 companies in market capitalization for each year covered, for what comprised a database of over 1,800 companies.

Data on performance metrics were supplemented by additional data provided by Farient Advisors on executive pay trends. Farient conducted an in-depth analysis based on its experience analyzing and developing pay programs and performance measurement systems that link to shareholder value.

In conducting this research, Farient analyzed companies by Industry (as indicated by their 2- and 4-digit Global Industrial Classification Standard Codes (GICS)), size (as indicated by market capitalization), and valuation premiums (i.e., the premium of the market value over the book value of the company). This research is intended to identify patterns, trends, and data relationships across the broad categories, but not to draw conclusions about specific companies. All data collected pertain to that for the Named Executive Officers, as disclosed in company proxy reports to shareholders.

As indicated in the charts below, the companies in the performance measurement data set span all industries, as well as a wide range of sizes (based on market capitalization) and valuation premiums (based on market-to-book ratio). The valuation premiums split companies evenly into three equal groups – Growth (i.e., those with valuation premiums of 2.7 or higher), Value (i.e., those with valuation premiums of 1.5 or lower) and Neither (i.e., those with valuation premiums higher than 1.5 but lower than 2.7).





Organization of Research Results

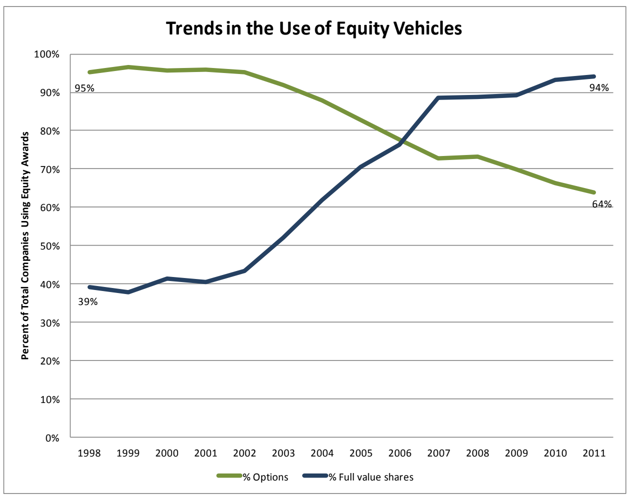
We have organized our findings broadly into five chapters: (1) trends in equity compensation; (2) trends in the use of various performance metrics; (3) trends in relative vs. absolute benchmarks; (4) metrics most correlated with TSR; and (5) the extent to which companies are using metrics most correlated with TSR.

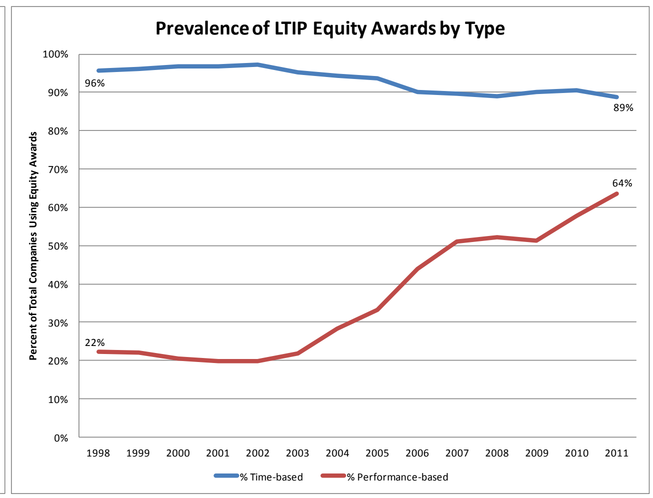
This research report provides a deep review of trends in pay practices over the 1998-2011 periods, followed by an extensive analysis of the correlation between performance metrics and shareholder value – are the right metrics being chosen? The contents of the chapters, as well as a selection of some of the high level results, are included in the following outline.

Chapter I: Trends in Equity Compensation

Specifically, the **Trends in Equity Compensation** chapter is arranged as follows:

- Equity award types – trends in the use of stock options compared to "full-value" shares, which are defined to include both restricted shares or units (time-based) and performance-based shares or units, and current use by industry, size, and valuation premiums. The chart on the left, below, shows the trend over the 1998-2011 time period, when full-value shares overtook options as the primary LTI equity vehicle
- Performance-based Equity – trends in use of performance-based (vs. time-based) equity and current use by industry, size, and valuation premium. The chart on the right, below,
- Pay Mix – current use of different pay components (e.g., salary, cash incentives and LTIP awards) by industry





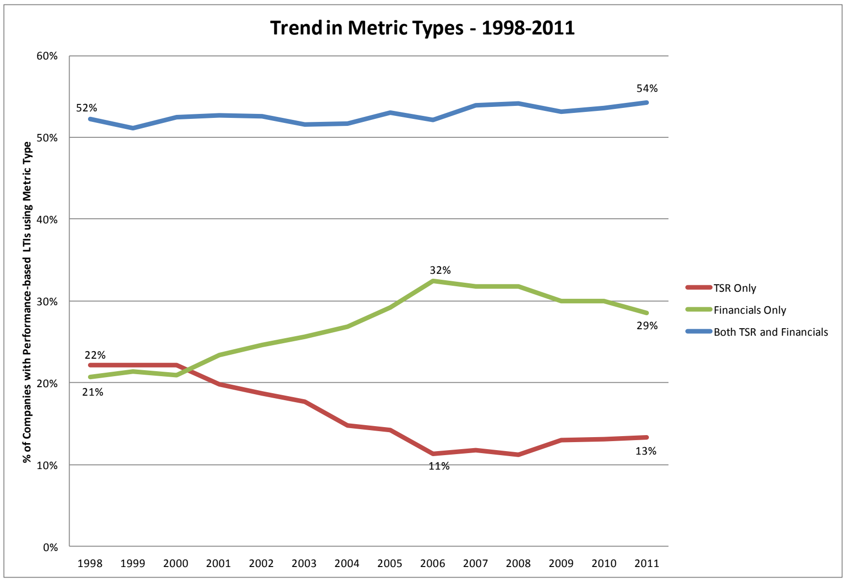
Chapter II: Trends in Performance Metrics

To analyze trends in performance metrics, we grouped specific metrics into the broader categories, shown below, to simplify our discussion and presentation of metrics, where appropriate. These broader categories, or Metric Types, will be used to summarize results throughout this report.

Specifically, the **Trends in Performance Metrics** chapter is arranged as follows:

- Performance Metrics – trends in the use of various metrics
- Specific Financial Performance Metrics – trends in the use of specific financial metrics
- Performance Metrics by industry, size, and valuation premiums – current use of various metrics by industry, size, and valuation premiums

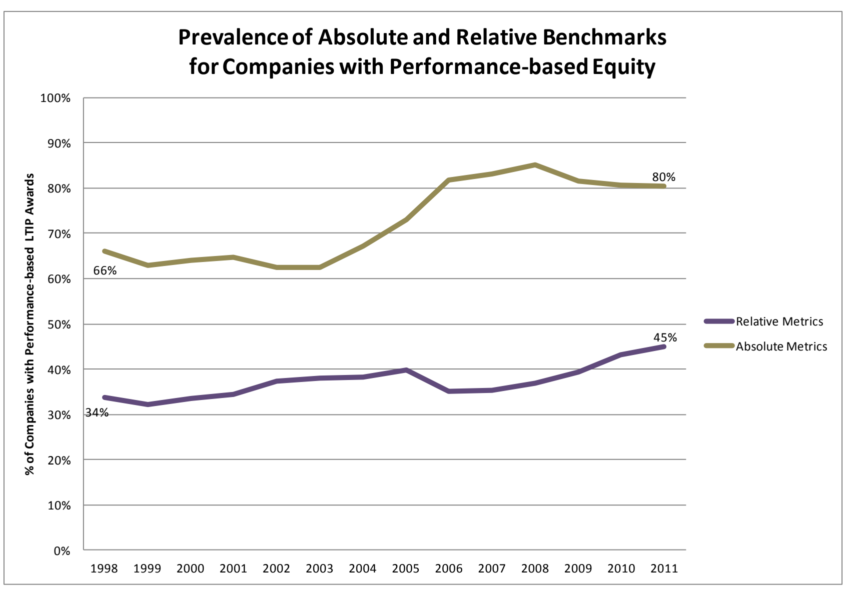
The chart below shows the overall trend in recent years has been a declining use of "financial" metrics (e.g., earnings, returns) and an increase in the use of TSR.



Chapter III: Trends in Relative vs. Absolute Benchmarks

Specifically, the **Trends in Relative vs. Absolute Benchmarks** chapter is arranged as follows:

- Absolute and Relative Performance Benchmarks – trends in use of absolute vs. relative benchmarks for determining the number of performance shares earned
- Comparisons Used for Relative Benchmarks– trends in the type of benchmark used (peer group vs. index (or companies in the index))
- Relative Performance-based Equity Awards – current use of relative benchmarks by industry, size, and valuation premiums



Chapter IV: Metrics Most Correlated with TSR

To determine **which metrics are most correlated with TSR**, we analyzed the correlations between financial measures of performance and TSR over 3- and 5-year rolling periods, using the 1998 to 2011 data set. To conduct the correlation analysis, we tested over 20 specific financial measures. We also tested static as well as dynamic growth measures. For example, we tested both earnings as a percent of sales (a static measure) as well as earnings growth (a dynamic measure).

This chapter explores the correlation results, i.e., which measures of performance correlate most closely with TSR by the 24 GICS Industry Groups.

Chapter V: The Extent to Which Companies Are Using Metrics That Best Correlate with TSR

To determine **the extent to which companies are using metrics that most closely correlate to TSR**, we compared the list of most frequently used performance metrics to the list of metrics that most closely correlate to TSR by Industry Group.

In this final chapter, we show which industries generally are using and which are not using those measures that most closely relate to shareholder value. In addition, we share our observations on areas for improvement by Industry Group.

Key Takeaways

In our closing remarks, we discuss the key takeaways from our analysis for investors as well as issuers.

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