# NASPP Chicago Chapter

## 2016 Trends in Relative TSR

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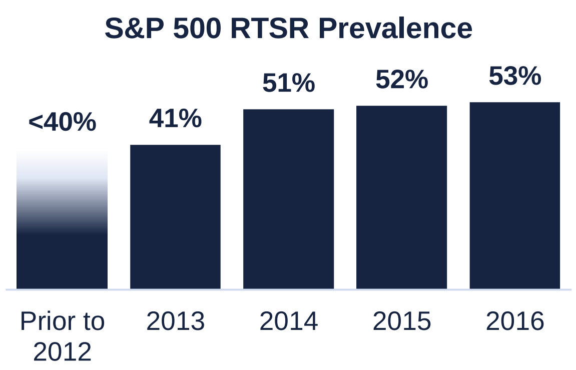
EXEQUITY

Independent Board and
Management Advisors

# About This Material

- Over the past several years, relative total shareholder return (RTSR) has become the single most discussed and utilized long-term incentive performance metric
- Historically, RTSR plans were found primarily within Energy and Utilities companies
- More than 50% of S&P 500 companies continue to use RTSR as a performance metric in long-term incentive plans
- Exequity’s study of RTSR prevalence and design elements reflects S&P 500 companies with years ending March 2015 through February 2016
- We collected data on the following elements of RTSR plans:
  - Peer group—index vs. peer group
  - Measurement method—relative ranking
  - Usage—metric vs. modifier
  - Design elements—pay/performance leverage, averaging period
- This material discusses our findings and discernible differences in RTSR prevalence and design between the traditional users and companies in industries more recently adopting this measure



# About RTSR

- TSR defined as change in share price plus reinvested dividends
- Traditionally, and to this day, RTSR is highly prevalent among Energy and Utilities companies
  - These companies' stock prices tend to be closely correlated, so it follows that TSR differences can more confidently be attributed to the success of management's stewardship
  - Energy and Utilities companies tend to experience similar headwinds and tailwinds
- The rise of RTSR as the dominant performance metric has many roots from the increasing influence of proxy advisors such as ISS to Say-on-Pay
  - The SEC's pay-for-performance rules may further encourage companies to consider RTSR
- Companies seeking (or feeling pressure from shareholders/ISS) to deliver a greater share of equity with performance conditions but finding it challenging to set reasonable goals may turn to RTSR for several reasons:
  - "Checks the box" for ISS
  - Perceived as shareholder-friendly—alignment with shareholder experience
  - Objective
  - Requires no goal setting
  - Most prevalent long-term incentive metric

# RTSR Program Design—General Market

## Relative Ranking

- Relative ranking is the most common RTSR program design
- The sponsor company's TSR is measured relative to a peer group of companies
- Relative performance is determined based on the sponsor's rank within the selected peer group
  - Rank is typically determined on a percentage rank basis, e.g., Microsoft Excel PERCENTRANK function
    - Alternative percentage rank calculations exist
  - Numerical rank is also used by some companies
- Relative ranking method commonly used when RTSR is a long-term incentive metric or when employed as a modifier, e.g., modifies payout under other performance measures

## TSR Variance from Index Composite

- RTSR performance based on its proximity to a specified index
  - The spread between a company's TSR and the index composite defines relative performance
- A related method measures a company's TSR based on proximity to the peer group median

**Long-Term Incentive Metric**
**Relative Ranking TSR Pay/Performance Structure**

| | Performance Percentile | Payout as a % of Target |
|---|---|---|
| Below Threshold | <25% | 0% |
| Threshold | 25% | 50% |
| Target | 50% | 100% |
| Above Target | 75% | 150% |
| Maximum | 90% | 200% |

**RTSR Modifier**
**Relative Ranking Pay/Performance Structure**

| | Performance Percentile | Modifier % |
|---|---|---|
| Threshold | <25% | -25% |
| Target | 50% | 0% |
| Maximum | >75% | +25% |

**TSR Variance from Index Pay/Performance Structure**

| | Variance from Index | Payout as a % of Target |
|---|---|---|
| Below Threshold | <0% | 0% |
| Threshold | 0% | 25% |
| Target | +10% | 100% |
| Maximum | +20% | 150% |

*For demonstrative purposes*

# S&P 500 Prevalence

- Overall, prevalence across the S&P 500 is up slightly year over year to 53% from 52% in 2015
- Among Core companies, RTSR usage highest among Utilities (97%) and Energy (85%)
  - Within the Energy sector, RTSR is more prevalent among Oil & Gas companies (93%) than Energy Equipment (60%)
- Materials prevalence increased more year over year than any other sector (+8%)
- Information Technology prevalence increased 7% year over year
- Retailers (subsets of consumer discretionary and consumer staples sectors) exhibit the lowest overall RTSR prevalence, under 30%

| | GICS Sector (Selected GICS Subset) | S&P 500 | % Using RTSR | |
|---|---|---|---|---|
| | | | 2016 | 2015 |
| Core RTSR | Utilities | 29 | 97% | 97% |
| | Energy | 40 | 85% | 86% |
| | *Energy Equipment & Services* | 10 | 60% | *67%* |
| | *Oil, Gas & Consumable Fuels* | 30 | 93% | *94%* |
| | Real Estate | 27 | 78% | 77% |
| | Materials | 27 | 67% | 59% |
| | ***Core RTSR*** | **123** | **82%** | ***81%*** |
| Non-Core RTSR | Health Care | 56 | 48% | 47% |
| | Information Technology | 67 | 48% | 41% |
| | Industrials | 65 | 43% | 48% |
| | Consumer Staples | 38 | 47% | 45% |
| | *Food & Staples Retailing* | 7 | 29% | *25%* |
| | *Consumer Staples (Excluding Retailing)* | 31 | 52% | *50%* |
| | Consumer Discretionary | 83 | 42% | 38% |
| | *Retailing* | 31 | 23% | *19%* |
| | *Consumer Discretionary (Excluding Retail)* | 52 | 54% | *49%* |
| | Financials (Excluding Real Estate) | 63 | 35% | *37%* |
| | Telecommunication Services[1] | 5 | 80% | 83% |
| | ***Non-Core RTSR*** | **166** | **44%** | ***43%*** |
| | **S&P 500** | **500** | **53%** | **52%** |

[1] Included in Non-Core RTSR category due to small sample size.

- ***Core RTSR:*** *Companies in the following GICS classifications: Energy, Materials, Real Estate, Utilities*
  - *Share prices of Core RTSR companies are significantly affected by exogenous factors outside of management's control, such as commodities prices and interest rates—**RTSR usage higher***
- ***Non-Core RTSR:*** *Companies in remaining GICS classifications*
  - *Share prices of these companies are impacted by more varied forces—**RTSR usage lower***

# RTSR Peer Group

- Overall, peer group usage is roughly evenly divided between broad indices, single-sector indices, custom compensation peers, and custom performance peers
- 88% of Core RTSR companies benchmark against focused peer groups (i.e., single-sector or custom peer groups)
  - Energy and Utilities rarely use a multi-sector index
- 38% of Non-Core RTSR companies benchmark against a multi-sector index
  - Of those, 83% use the S&P 500
  - 25% of all S&P 500 companies benchmark against the S&P 500
- Consumer Staples, Consumer Discretionary, and Information Technology companies are significantly more likely to use a multi-sector index
  - Of these, 88% use the S&P 500

| | GICS Sector (Selected GICS Subset) | RTSR Peer Group | | | |
|---|---|---|---|---|---|
| | | **Broad-Based/ Multi-Sector Index** | **Single-Sector Index** | **Custom Comp. Peers** | **Custom Perf. Peers** |
| Core RTSR | Utilities | — | 50% | 18% | 32% |
| | Energy | 3% | 15% | 26% | 56% |
| | *Energy Equipment & Services* | *—* | *67%* | *—* | *33%* |
| | *Oil, Gas & Consumable Fuels* | *4%* | *4%* | *32%* | *61%* |
| | Real Estate | 19% | 76% | — | 5% |
| | Materials | 39% | 6% | 28% | 28% |
| | ***Core RTSR*** | ***12%*** | ***36%*** | ***19%*** | ***34%*** |
| Non-Core RTSR | Health Care | 15% | 33% | 37% | 15% |
| | Information Technology | 47% | 28% | 13% | 13% |
| | Industrials | 39% | 18% | 18% | 25% |
| | Consumer Staples | 39% | 11% | 28% | 22% |
| | *Food & Staples Retailing* | *100%* | *—* | *—* | *—* |
| | *Consumer Staples (Excluding Retailing)* | *31%* | *13%* | *31%* | *25%* |
| | Consumer Discretionary | 57% | 3% | 14% | 26% |
| | *Retailing* | *57%* | *—* | *14%* | *29%* |
| | *Consumer Discretionary (Excluding Retail)* | *57%* | *4%* | *14%* | *25%* |
| | Financials (Excluding Real Estate) | 23% | 9% | 27% | 41% |
| | Telecommunication Services[1] | 25% | 25% | — | 50% |
| | ***Non-Core RTSR*** | ***38%*** | ***17%*** | ***21%*** | ***23%*** |
| | **S&P 500** | **28%** | **24%** | **20%** | **27%** |

[1] Included in Non-Core RTSR category due to small sample size.

***Note:*** *6.5% of S&P 500 companies benchmark to more than one peer group. The data above reflects the primary RTSR peer group. The S&P 500 is the most prevalent secondary RTSR peer group.*

# RTSR Plan Design

- RTSR as a discrete metric is the most common approach used by companies incorporating RTSR into long-term incentive plans
- RTSR modifiers are becoming increasingly common
  - Benefits of shareholder alignment
  - Reduces RTSR exposure
- Metric approach most prevalent among Core companies (>95%); modifier more prevalent among Non-Core (>25%)
- Relative rank method is significantly more common than +/- index composite approach—REITs excepted
- Among Core companies, RTSR commonly comprises 100% of performance-based long-term incentives; among Non-Core, 50%
- Pay/performance leverage is similar between Core and Non-Core companies

| | GICS Sector (Selected GICS Subset) | LTI Metric | LTI Modifier | Method: Rank | Method: +/- Index Composite |
|---|---|---|---|---|---|
| Core RTSR | Utilities | 93% | 7% | 100% | — |
| | Energy | 97% | 3% | 97% | 3% |
| | *Energy Equipment & Services* | *83%* | *17%* | *100%* | — |
| | *Oil, Gas & Consumable Fuels* | *100%* | — | *96%* | *4%* |
| | Real Estate | 100% | 5% | 67% | 38% |
| | Materials | 89% | 11% | 94% | 6% |
| | ***Core RTSR*** | ***95%*** | ***6%*** | ***91%*** | ***10%*** |
| Non-Core RTSR | Health Care | 78% | 22% | 85% | 15% |
| | Information Technology | 75% | 25% | 78% | 22% |
| | Industrials | 79% | 21% | 96% | 4% |
| | Consumer Staples | 61% | 39% | 100% | — |
| | *Food & Staples Retailing* | *50%* | *50%* | *100%* | — |
| | *Consumer Staples (Ex. Retailing)* | *63%* | *38%* | *100%* | — |
| | Consumer Discretionary | 60% | 40% | 91% | 9% |
| | *Retailing* | *43%* | *57%* | *86%* | *14%* |
| | *Consumer Discretionary (Ex. Retail)* | *64%* | *36%* | *93%* | *7%* |
| | Financials (Ex. Real Estate) | 82% | 18% | 77% | 23% |
| | Telecommunication Services[1] | 75% | 25% | 100% | — |
| | ***Non-Core RTSR*** | ***72%*** | ***28%*** | ***88%*** | ***12%*** |
| | **S&P 500** | **81%** | **19%** | **89%** | **11%** |

[1] Included in Non-Core RTSR category due to small sample size.

| | Mode % of PSUs | Performance Median Thresh. | Performance Median Max. | Performance Mode Thresh. | Performance Mode Max.[1] | Payout Median Thresh. | Payout Median Max. | Payout Mode Thresh. | Payout Mode Max. |
|---|---|---|---|---|---|---|---|---|---|
| **Core** | 100% | 25% | 87.5% | 25% | 75% | 37.5% | 200% | 50% | 200% |
| **Non-Core** | 50% | 25% | 80% | 25% | 75% | 50% | 200% | 50% | 200% |
| **S&P 500** | 50% | 25% | 80% | 25% | 75% | 50% | 200% | 50% | 200% |

[1] Among core companies, prevalence of 75$^{th}$ and 90$^{th}$ percentiles is nearly evenly split: 29% use the 75$^{th}$ and 28% use the 90$^{th}$. Among Non-Core companies, 66% use the 75$^{th}$ percentile and 26% use the 90$^{th}$ percentile.

***Note:*** *When RTSR is used as a modifier, the most common performance hurdles are 25$^{th}$ and 75$^{th}$ percentiles (threshold and maximum, respectively), and the median/mode percentage modifier is +/- 25%.*

# Other Design Elements

**Stock Price Averaging**

- To smooth out share price volatility at the beginnings and ends of performance periods, some companies measure TSR using an average stock price
- Stock price averaging periods range from 5-trading to 90-calendar days (e.g., 4th quarter average)
- 60% of companies use 1–4 weeks (usually 20-trading or 30-calendar days), 20% use a period of 6–10 weeks, and 20% use a 90-calendar day period (not all companies disclose averaging periods)
- Averaging periods are perceived as shareholder neutral
- While on average, differences are minimal, calculated TSR and RTSR percent ranks increasingly deviate from the shareholder experience as averaging periods are extended

| | Change in Absolute TSR vs. Period-End Price | | | Change in RTSR Percentile Rank vs. Period-End Price | | |
|---|---|---|---|---|---|---|
| | 30-Day | 60-Day | 90-Day | 30-Day | 60-Day | 90-Day |
| Average[1] | 1% | 0% | -1% | 3% | 6% | 9% |
| Max[2] | 52% | 109% | 153% | 12% | 23% | 62% |
| Min[2] | -72% | -130% | -205% | -44% | -76% | -81% |
| Standard Deviation | 10% | 18% | 29% | 4% | 8% | 12% |

[1] Average change in RTSR percentile rank is based on the absolute value of change in percentile rank.

[2] Excludes outliers in the lowest and highest 1% due to periodic extreme share price swings (e.g., Netflix).

# Other Design Elements

**Negative TSR Cap**

- Some companies impose a “cap” on RTSR payouts when absolute TSR is negative
  - Considered a “shareholder friendly” design element
- Currently, less than 20% of companies disclose an absolute TSR cap, but prevalence is increasing

**Above-Median Target Performance Percentile**

- Recently, proxy advisors have begun subjecting RTSR plans to an increased level of scrutiny, occasionally criticizing companies for prescribing a target-level payout at median performance
- Despite criticism from ISS and others, more than 90% of S&P 500 companies target the peer group median

# Detailed Results

| | GICS Sector (Selected GICS Subset) | S&P 500 | Companies Using RTSR in Long-Term Incentive Plans: # Using RTSR | % Using RTSR | RTSR as Long-Term Incentive Metric: % Using | Median % of Performance Share Units | Mode % of Performance Share Units | RTSR as Long-Term Incentive Modifier | Method: Rank | +/- Index Composite | RTSR Peer Group: Broad-Based/ Multi-Sector Index | Single-Sector Index | Custom Comp. Peers | Custom Perf. Peers |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Core RTSR | Utilities | 29 | 28 | 97% | 93% | 50% | 50% | 7% | 100% | — | — | 50% | 18% | 32% |
| | Energy | 40 | 34 | 85% | 97% | 100% | 100% | 3% | 97% | 3% | 3% | 15% | 26% | 56% |
| | *Energy Equipment & Services* | *10* | *6* | *60%* | *83%* | *50%* | *50%* | *17%* | *100%* | — | — | *67%* | — | *33%* |
| | *Oil, Gas & Consumable Fuels* | *30* | *28* | *93%* | *100%* | *100%* | *100%* | — | *96%* | *4%* | *4%* | *4%* | *32%* | *61%* |
| | Real Estate | 27 | 21 | 78% | 100% | 90% | 100% | 5% | 67% | 38% | 19% | 76% | — | 5% |
| | Materials | 27 | 18 | 67% | 89% | 50% | 50% | 11% | 94% | 6% | 39% | 6% | 28% | 28% |
| | ***Core RTSR*** | ***123*** | ***101*** | ***82%*** | ***95%*** | ***66%*** | ***100%*** | ***6%*** | ***91%*** | ***10%*** | ***12%*** | ***36%*** | ***19%*** | ***34%*** |
| Non-Core RTSR | Health Care | 56 | 27 | 48% | 78% | 50% | 50% | 22% | 85% | 15% | 15% | 33% | 37% | 15% |
| | Information Technology | 67 | 32 | 48% | 75% | 50% | 100% | 25% | 78% | 22% | 47% | 28% | 13% | 13% |
| | Industrials | 65 | 28 | 43% | 79% | 50% | 50% | 21% | 96% | 4% | 39% | 18% | 18% | 25% |
| | Consumer Staples | 38 | 18 | 47% | 61% | 50% | 100% | 39% | 100% | — | 39% | 11% | 28% | 22% |
| | *Food & Staples Retailing* | *7* | *2* | *29%* | *50%* | — | — | *50%* | *100%* | — | *100%* | — | — | — |
| | *Consumer Staples (Excluding Retailing)* | *31* | *16* | *52%* | *63%* | *50%* | *50%* | *38%* | *100%* | — | *31%* | *13%* | *31%* | *25%* |
| | Consumer Discretionary | 83 | 35 | 42% | 60% | 50% | 100% | 40% | 91% | 9% | 57% | 3% | 14% | 26% |
| | *Retailing* | *31* | *7* | *23%* | *43%* | — | — | *57%* | *86%* | *14%* | *57%* | — | *14%* | *29%* |
| | *Consumer Discretionary (Excluding Retail)* | *52* | *28* | *54%* | *64%* | *50%* | *50%* | *36%* | *93%* | *7%* | *57%* | *4%* | *14%* | *25%* |
| | Financials (Excluding Real Estate) | 63 | 22 | 35% | 82% | 50% | 50% | 18% | 77% | 23% | 23% | 9% | 27% | 41% |
| | Telecommunication Services[1] | 5 | 4 | 80% | 75% | — | — | 25% | 100% | — | 25% | 25% | — | 50% |
| | ***Non-Core RTSR*** | ***377*** | ***166*** | ***44%*** | ***72%*** | ***50%*** | ***50%*** | ***28%*** | ***88%*** | ***12%*** | ***38%*** | ***17%*** | ***21%*** | ***23%*** |
| | **S&P 500** | **500** | **267** | **53%** | **81%** | **50%** | **50%** | **19%** | **89%** | **11%** | **28%** | **24%** | **20%** | **27%** |

[1] Included in Non-Core RTSR category due to small sample size.

# Observations and Discussion

- Growth in prevalence of RTSR overall is slow—1% growth in 2015 and 2016
  - Peak RTSR?
  - Recent increase in prevalence partially attributable to modifier approach
  - Difficult to move away from RTSR, especially if goal setting is challenging
- The rise of RTSR as the dominant performance metric has many roots from the increasing influence of proxy advisors such as ISS to Say-on-Pay
  - The SEC's pay-for-performance rules may further encourage companies to consider RTSR
  - SEC's rules place great emphasis on relative performance versus peer index
  - We doubt a significant number companies will redefine their existing RTSR performance goals to align with the SEC's relative performance analysis, but peer groups may align
    - Focus remains on relative performance versus "peers"
- Companies more recently employing RTSR did not follow the lead of Energy and Utilities companies with regard to peer group selection—arguably the single most important consideration for companies employing RTSR
  - Non-Core companies commonly rely on relative performance versus the S&P 500
    - Is relative performance versus the S&P 500 or other multi-sector index meaningful?
    - Many companies have determined that a broad index is inappropriate, possibly due to low correlations between their stocks and stocks in other industries

# Observations and Discussion

- Companies seeking (or feeling pressure from shareholders/ISS) to deliver a greater share of equity with performance conditions but finding it challenging to set reasonable goals may turn to RTSR for several reasons:
  - "Checks the box" for ISS
  - Perceived as shareholder-friendly—alignment with shareholder experience
  - Objective and requires no goal setting
  - Most prevalent long-term incentive metric
- Companies considering RTSR should beware its faults, among them:
  - Does not provide strategic direction, i.e., does little to motivate executive behaviors
  - Accounting cost is fixed, i.e., not reversible if performance falls short of threshold
  - Relative performance can vary significantly month to month, quarter to quarter
  - May be difficult to identify an appropriate comparator group
- Misperceptions remain with regard to how companies use RTSR
  - ISS recently suggested that use of performance peer groups was "more trouble with investors than it's worth to executives" and "the overwhelming majority of companies use the same peer group for pay benchmarking and performance comparisons" (ISS *ExecComp Insights 5/2016)*
- Only 20% use compensation peer groups for benchmarking relative performance in incentive plans which is down from 23% in 2015
  - Interestingly, ISS makes no mention of companies using the S&P 500 index constituents
- We suspect most institutional investors (ISS's clients) understand that in many cases differences exist between talent and capital competitors

# Observations and Discussion

- While RTSR may be possibly a “pure” metric from a pay-for-performance perspective, it is often viewed as a “lottery ticket” by participants
- One possible source of lottery ticket notion may lie in peer group selection
  - Common approaches to peer selection involve:
    - GICS classifications
    - Competitors for capital
    - Prevalence statistics
    - Sometimes the S&P 500 is chosen simply due to too few immediate competitors
- Primary goal of RTSR is pay-for-performance
  - Market cycles have a significant impact on relative performance—peer group is critical
  - The “lottery ticket” nature of some RTSR programs is the antithesis of pay for performance
    - Relative performance could be significantly influenced by a company’s risk/reward profile relative to the market cycle
    - Riskier assets outperform in bull markets, less risky assets outperform in bear markets
  - If performance outcomes are significantly influenced (or even predetermined) by market cycles, then participants are right to be suspect of RTSR plans
- Rigorous market analysis highly recommended before determining appropriateness of RTSR as a performance metric—analysis should also assist with peer group determination
  - Market Analytics is Exequity’s solution

# Ben Burney

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- Ben is a senior advisor with Exequity in Libertyville, Illinois. Ben's consulting activities involve all facets of executive and director compensation including peer group design, executive compensation benchmarking, incentive design, outside director compensation, and defining the pay-for-performance relationship. Ben's clients include companies ranging from multinationals to privately held companies and non-profits in a variety of industries including hospitality, real estate, insurance, commodities and chemicals, and manufacturing, among others.
- An expert in statistical analysis, Ben leads Exequity's advanced analytics and research capabilities. Ben's research into relative performance outcomes led to the development of Market Analytics, a proprietary analysis Exequity's clients use to assess and develop peer groups.
- Ben co-authored the chapter on long-term incentives for the 6th edition of *The Compensation Handbook*, published in May 2015, and authored several Client Briefings for Exequity (Benchmarking Pay-for-Performance and Relative TSR Prevalence and Design of S&P 500 Companies).
- Prior to joining Exequity, Ben was an executive compensation consultant at Hewitt Associates. Ben has four years of experience in financial services, working at a private equity firm and in executive search, specializing in recruiting investment bankers and private equity professionals.
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