EXEQUITY

Independent Board and Management Advisors

NASPP Chicago Chapter

2017 Trends in Relative TSR

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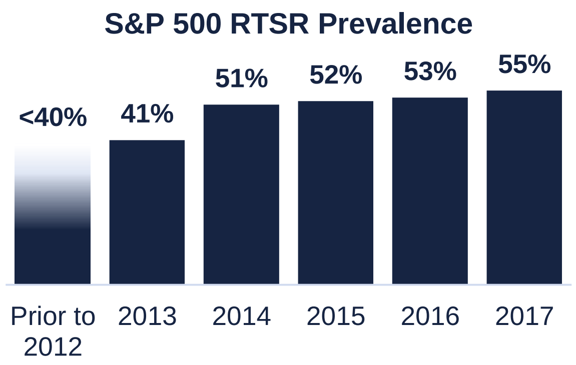
About This Material

- 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
  - Continues to inch upward in prevalence
- Exequity's study of RTSR prevalence and design elements reflects S&P 500 companies with years ending March 2016 through February 2017
- 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—88% use a rank method
  - Of those, 84% use percentage rank basis, e.g., Microsoft Excel PERCENTRANK function
  - 16% use numerical rank
- 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 or Peer Median

- RTSR performance is based on its proximity to a specified barometer of performance; two primary methods:
  - +/- Index: The spread between a company's TSR and the index composite defines relative performance
  - +/- Peer Median: The spread between a company's TSR and the median of a specified peer group

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 55% from 53% in 2016
- Among Core companies, RTSR usage is highest among Utilities (93%) and Real Estate (90%)
- Within the Energy sector, RTSR is more prevalent among Oil & Gas companies (93%) than Energy Equipment (57%)
- Prevalence among Real Estate and Materials companies increased significantly, +12% and 11%, respectively
- Retailers (subsets of consumer discretionary and consumer staples sectors) exhibit the lowest overall RTSR prevalence, under 30%
  - Prevalence also dropped slightly for 2017

	GICS Sector (Selected GICS Subset)	S&P 500	% Using RTSR	
			2017	2016
Core RTSR	Utilities	26	93%	97%
	Energy	31	86%	85%
	Energy Equipment & Services	*4*	*57%*	*60%*
	Oil, Gas & Consumable Fuels	*27*	*93%*	*93%*
	Real Estate	26	90%	78%
	Materials	19	76%	67%
	Core RTSR	**102**	**86%**	**82%**
Non-Core RTSR	Health Care	33	55%	48%
	Information Technology	34	52%	48%
	Industrials	34	49%	43%
	Consumer Staples	15	41%	47%
	Food & Staples Retailing	*2*	*29%*	*29%*
	Consumer Staples (Excluding Retailing)	*13*	*43%*	*52%*
	Consumer Discretionary	32	39%	42%
	Retailing	*7*	*21%*	*23%*
	Consumer Discretionary (Excluding Retail)	*25*	*51%*	*54%*
	Financials (Excluding Real Estate)	20	32%	35%
	Telecommunication Services[1]	4	80%	80%
	Non-Core RTSR	**172**	**45%**	**44%**
	S&P 500	**274**	**55%**	**53%**

[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
- Core RTSR companies tend to benchmark against focused peer groups (i.e., single-sector or custom peer groups)
  - Materials companies are the exception
- 36% of Non-Core RTSR companies benchmark against a multi-sector index
- 23% 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

	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	—	42%	19%	38%
	Energy	—	13%	29%	58%
	Energy Equipment & Services	—	*75%*	—	*25%*
	Oil, Gas & Consumable Fuels	—	*4%*	*33%*	*63%*
	Real Estate	4%	85%	8%	4%
	Materials	37%	5%	26%	32%
	Core RTSR	**8%**	**37%**	**21%**	**34%**
Non-Core RTSR	Health Care	18%	45%	24%	9%
	Information Technology	56%	24%	9%	12%
	Industrials	32%	15%	18%	32%
	Consumer Staples	33%	13%	27%	27%
	Food & Staples Retailing	*100%*	—	—	—
	Consumer Staples (Excluding Retailing)	*23%*	*15%*	*31%*	*31%*
	Consumer Discretionary	53%	6%	16%	25%
	Retailing	*57%*	—	*14%*	*29%*
	Consumer Discretionary (Excluding Retail)	*52%*	*8%*	*16%*	*24%*
	Financials (Excluding Real Estate)	15%	15%	25%	45%
	Telecommunication Services[1]	25%	25%	25%	25%
	Non-Core RTSR	**36%**	**21%**	**19%**	**23%**
	S&P 500	**26%**	**27%**	**19%**	**27%**

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

Note: *Approximately 4% 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	+/- Index Composite
Core RTSR	Utilities	96%	4%	96%	4%
	Energy	97%	3%	97%	3%
	Energy Equipment & Services	*75%*	*25%*	*100%*	—
	Oil, Gas & Consumable Fuels	*100%*	—	*96%*	*4%*
	Real Estate	100%	0%	54%	50%
	Materials	89%	11%	95%	5%
	Core RTSR	**96%**	**5%**	**85%**	**16%**
Non-Core RTSR	Health Care	76%	24%	82%	18%
	Information Technology	82%	18%	76%	24%
	Industrials	74%	26%	97%	3%
	Consumer Staples	73%	27%	100%	—
	Food & Staples Retailing	*50%*	*50%*	*100%*	—
	Consumer Staples (Ex. Retailing)	*77%*	*23%*	*100%*	—
	Consumer Discretionary	63%	38%	94%	6%
	Retailing	*43%*	*57%*	*86%*	*14%*
	Consumer Discretionary (Ex. Retail)	*68%*	*32%*	*96%*	*4%*
	Financials (Ex. Real Estate)	75%	25%	90%	10%
	Telecommunication Services[1]	50%	50%	100%	—
	Non-Core RTSR	**73%**	**27%**	**89%**	**11%**
	S&P 500	**82%**	**19%**	**88%**	**13%**

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

	Mode % of PSUs	Performance				Payout			
		Median		Mode		Median		Mode	
		Thresh.	Max.	Thresh.	Max.[1]	Thresh.	Max.	Thresh.	Max.
Core	100%	25%	85%	25%	75%	38.75%	200%	50%	200%
Non-Core	50%	25%	77.5%	25%	75%	50%	200%	50%	200%
S&P 500	50%	25%	80%	25%	75%	40%	200%	50%	200%

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

Note: *When RTSR is used as a modifier, the most common performance hurdles are 25th and 75th percentiles (threshold and maximum, respectively), and the median/mode percentage modifier is +/- 25%. Data displayed in the above table excludes performance ranges for companies using RTSR as a modifier.*

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
- 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 (averaging period disclosures vary)
- 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

Negative TSR Cap

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

Above-Median Target Performance Percentile

- Proxy advisors have been 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, 92% of S&P 500 companies target the peer group median
- Among the remaining 8%, 52% target the 60th percentile and 35% the 55th percentile

Observations and Discussion

- 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
- 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
- Growth in prevalence of RTSR overall is slow, but steady—2% growth in 2017, 1% in 2015, 2016
  - Difficult to move away from RTSR, especially if goal setting is challenging
  - Prevalence among consumer companies dropped slightly in 2017
- *When will we reach peak RTSR?*

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 classification screens, subjective assessments of capital competitors; if no obvious peers, default seems to be the S&P 500
- Exequity recommends a rigorous market analysis before determining appropriateness of RTSR as a performance metric—analysis should also assist with peer group determination
  - A viable and reasonable peer group is the most critical factor when determining whether or how to incorporate RTSR into a performance plan
  - Peer group viability may be determined by measuring similarities in market characteristics (correlation, volatility) between the sponsor and each peer company
    - A company’s outperformance of a peer group of highly correlated stocks suggests management’s stewardship resulted in superior TSR
    - However, relative performance could be significantly influenced by a company’s risk/reward profile relative to the market cycle
    - Risk/reward axiom: low-risk assets would be expected to outperform in bear markets and underperform in bull markets and vice versa for high-risk assets
- Improper peer group selection may result in “stacking the deck” such that a company may be expected to outperform or underperform depending on market conditions (bull/bear market) and/or generate results that are not meaningful due to poor correlations

Observations and Discussion

- Core company peer group observations:
  - Energy: Typically use custom compensation or performance peer groups
  - Utilities: Typically use a single-sector index or custom performance peer group
  - Real Estate: Typically a single-sector index
  - Materials: Mix of broad sector index or custom peer groups (custom or performance)[1]
- Non-Core company peer group observations:
  - Health Care: Typically use a single-sector index
  - Information Technology: Typically a broad index
  - Industrials: Mixed between broad index and custom performance peer group
  - Consumer: Mixed among all categories, but preference overall for broad index
  - Financials: Typically a custom performance peer group
- Non-Core companies commonly rely on relative performance versus the S&P 500 while most Core companies (except Materials) have determined that a broad index is inappropriate
- Key questions in light of peer group usage trends:
  - *Is relative performance versus the S&P 500 meaningful? Versus a custom peer group?*
  - *Is RTSR a reliable gauge of shareholder value creation?*
- Exequity's Market Analytics is our solution to determining reasonability/reliability of using RTSR

[1] The inherent dissimilarities among Materials companies is likely why no S&P 500 Materials company benchmarks to the S&P 500 Materials Index companies. One company benchmarks to the S&P 1500 Chemicals Index.

Observations and Discussion

- Analyses conducted by Exequity using Market Analytics demonstrate the historical users of RTSR (Energy and Utilities, but also REITs) tend to exhibit very similar market characteristics while most Non-Core companies tend not to share such similarities
  - As a result, many Non-Core companies (and also some Materials companies) have a greater difficulty picking relevant, closely correlated peers (i.e., reasonable and reliable)
- This phenomenon is likely at the root of why Non-Core companies use RTSR differently than Core companies—and evidenced by the three trends:
  - Non-Core companies are less likely to use RTSR
  - When they do, they are more likely to incorporate RTSR in such a way as to mute its impact on total compensation (RTSR modifier or lower weighting)
  - They are more likely to use a broad peer group such as the S&P 500
    - S&P 500 usage is often rationalized by statements describing performance against a broad range of pre-determined capital competitors of which the sponsor is a member
- On average, any S&P 500 company demonstrates low comparability to the remaining index constituents—based on Market Analytics results
- In this light, the S&P 500 may be as defensible as any peer set from an external optics perspective, but among the least defensible in terms of performance comparability
  - Such use of RTSR may actually run counter to the pay-for-performance philosophy virtually all companies espouse
  - The “lottery ticket” nature of some RTSR programs is the antithesis of “pay for performance”

Detailed Results

	GICS Sector (Selected GICS Subset)	S&P 500	Companies Using RTSR in Long-Term Incentive Plans								RTSR Peer Group			
					RTSR as Long-Term Incentive Metric				Method					
			# Using RTSR	% Using RTSR	% Using	Median % of Performance Share Units	Mode % of Performance Share Units	RTSR as Long-Term Incentive Modifier	Rank	+/- Index Composite	Broad-Based/ Multi-Sector Index	Single-Sector Index	Custom Comp. Peers	Custom Perf. Peers
Core RTSR	Utilities	28	26	93%	96%	50%	50%	4%	96%	4%	—	42%	19%	38%
	Energy	36	31	86%	97%	100%	100%	3%	97%	3%	—	13%	29%	58%
	Energy Equipment & Services	*7*	*4*	*57%*	*75%*	—	—	*25%*	*100%*	—	—	*75%*	—	*25%*
	Oil, Gas & Consumable Fuels	*29*	*27*	*93%*	*100%*	*100%*	*100%*	—	*96%*	*4%*	—	*4%*	*33%*	*63%*
	Real Estate	29	26	90%	100%	73%	100%	0%	54%	50%	4%	85%	8%	4%
	Materials	25	19	76%	89%	50%	100%	11%	95%	5%	37%	5%	26%	32%
	Core RTSR	**118**	**102**	**86%**	**96%**	**65%**	**100%**	**5%**	**85%**	**16%**	**8%**	**37%**	**21%**	**34%**
Non-Core RTSR	Health Care	60	33	55%	76%	50%	50%	24%	82%	18%	18%	45%	24%	9%
	Information Technology	66	34	52%	82%	50%	50%	18%	76%	24%	56%	24%	9%	12%
	Industrials	69	34	49%	74%	50%	50%	26%	97%	3%	32%	15%	18%	32%
	Consumer Staples	37	15	41%	73%	59%	100%	27%	100%	—	33%	13%	27%	27%
	Food & Staples Retailing	*7*	*2*	*29%*	*50%*	—	—	*50%*	*100%*	—	*100%*	—	—	—
	Consumer Staples (Excluding Retailing)	*30*	*13*	*43%*	*77%*	*50%*	*50%*	*23%*	*100%*	—	*23%*	*15%*	*31%*	*31%*
	Consumer Discretionary	82	32	39%	63%	50%	50%	38%	94%	6%	53%	6%	16%	25%
	Retailing	*33*	*7*	*21%*	*43%*	—	—	*57%*	*86%*	*14%*	*57%*	—	*14%*	*29%*
	Consumer Discretionary (Excluding Retail)	*49*	*25*	*51%*	*68%*	*50%*	*50%*	*32%*	*96%*	*4%*	*52%*	*8%*	*16%*	*24%*
	Financials	63	20	32%	75%	50%	50%	25%	90%	10%	15%	15%	25%	45%
	Telecommunication Services[1]	5	4	80%	50%	—	—	50%	100%	—	25%	25%	25%	25%
	Non-Core RTSR	**382**	**172**	**45%**	**73%**	**50%**	**50%**	**27%**	**89%**	**11%**	**36%**	**21%**	**19%**	**23%**
	S&P 500	**500**	**274**	**55%**	**82%**	**50%**	**50%**	**19%**	**88%**	**13%**	**26%**	**27%**	**19%**	**27%**

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

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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, insurance, commodities, 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 covering pay-for-performance and relative TSR prevalence and design. Ben's research into relative TSR usage was recently featured in *Agenda*, a *Financial Times* publication.
- 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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