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EXEQUITY

Independent Board and Management Advisors

Client Briefing

Benchmarking Pay for Performance

Pay for performance is a subject that often frustrates today's executives and compensation committees. We understand why. Common methods of assessing pay for performance such as those used by proxy advisory firms, institutional investors, The Conference Board, and some consultancies often result in unexpected "disconnects," potentially calling into question the compensation committee's decisions on pay.

The challenge for compensation committees in today's pay-for-performance environment is identifying a valid approach that effectively gauges the results of their decision making. Exequity's pay-for-performance assessment, ROX ("Return on Executives"), is the most effective and reliable method for assessing a company's pay-for-performance relationship because ROX incorporates the compensation committee's past pay decisions into the pay-for-performance equation. Measuring pay for performance with a long-term perspective on pay mitigates the skewing effects of a narrow 3-year (or other) measurement period. ROX invariably results in more accurate—and tightly aligned—reflections of the relationship between pay delivered and shareholder value created.

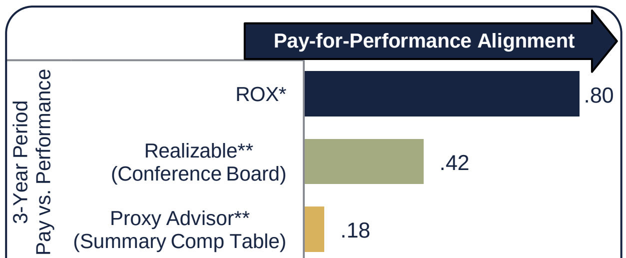
What Is ROX?

ROX is an analysis comparing returns to shareholders and to executives. What is the aggregate change in shareholder wealth in relation to the aggregate change in compensation value made available to executives? In other words, what is the return to shareholders in relation to their "investment" in executives? Was the board's decision making on behalf of shareholders effective?

ROX measures performance similarly to how investors realize returns on investments. While total shareholder return (TSR) has emerged as the primary metric for determining performance, TSR measured as a percent alone oftentimes inadequately portrays the magnitude of returns generated by executives on behalf of shareholders. The *dollar value* delivered to shareholders should also be considered because after all, just like executives, shareholders realize returns in *dollars*, not in percentages.

How to Test Pay-for-Performance Alignment?

To test ROX against other common methods of measuring pay for performance, we calculated how executive pay aligns with performance across S&P 500 companies. As illustrated in the graphic, ROX demonstrates a greater correlation between pay and performance than do the other models commonly employed.

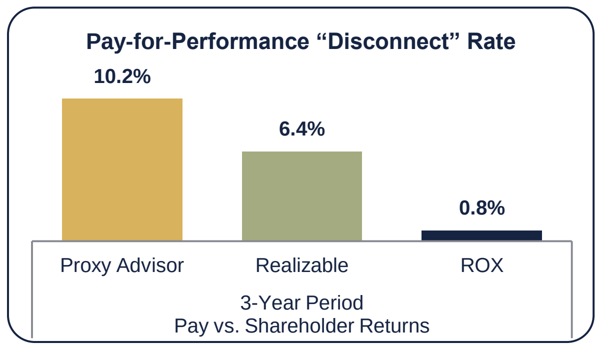


* Performance defined as 3-year change in market value plus dividends. Note that when performance is measured as 3-year TSR (percent), the correlation with ROX pay is 0.66, significantly better than Realizable or Proxy Advisor.
** Performance measurement is 3-year TSR (percent).

As many are all too well aware, proxy advisors such as ISS and Glass Lewis define pay using data disclosed in a company's SEC filings (i.e., Summary Compensation Table). These disclosures rely upon the *grant-date expense* for equity, typically the largest single component of executive pay, rather than a comprehensive view of true monetary value actually *earned* by an executive (i.e., pay realized and the change in potentially realizable value).

While improving upon the proxy advisor approach by revaluing equity awards, the "realizable" method (as defined by The Conference Board Working Group) nevertheless understates the correlation between pay and performance. Why? Realizable pay, like the models used by proxy advisors, is incomplete; it does not capture the totality of value earned as well as available to executives over and within the measurement period. The impact of decisions made by the compensation committee *prior to* the measurement period is ignored and realizable pay, by definition, resets each year to the most recent measurement period.

ROX improves upon the previously described methods by capturing the actual pay earned from all sources, including changes in equity value from grants made during the measurement period and *grants made prior to the start of the measurement period*. ROX tracks the results of decision making by compensation committees over a period of time that typically exceeds the arbitrary 3-year measurement period. The end result is that ROX measures *actual* pay, or the total value transferred from employer to employee.



The result of comparing actual pay (as defined by ROX) with company performance is fewer "disconnects" in pay-performance alignment. Often, a "disconnect" between pay and performance is defined as a "gap" between the percentile rank of pay relative to that of performance. For example, by ISS's standards, a 50 point percentile rank gap between relative pay and performance would trigger "High" concern, subjecting a company to additional scrutiny. Since the portrayal of the relationship between pay and performance using the proxy advisor method (i.e., Summary Compensation Table vs. TSR as a percent) is inherently flawed, there typically is a lot of "noise" in the results. Therefore, it is not surprising that the proxy advisor method results in a "disconnect" in 10% of instances. Proxy advisor methods, by design, result in a relatively high level of disconnects.[1] The ROX method demonstrates that there are far fewer pay-for-performance "disconnects" across S&P 500 companies than other methods might suggest.

Generally, compensation committees and executive teams tend to be confident that executive pay at their companies is tied strongly to company performance. ROX demonstrates that their collective intuitions are often far more accurate than the skewed pay-for-performance models employed by ISS and Glass Lewis. ROX also demonstrates that realizable pay, while well-intentioned, is incomplete.

The ability to clearly demonstrate the correlation between pay and performance is increasingly important in these days of activist shareholders. Compensation committees must therefore possess a robust and comprehensive analysis that reliably evaluates the relationship between pay and performance. ROX provides a powerful and reliable tool to illustrate the link between executive pay and performance.

[1] ISS has suggested that its Relative Degree of Alignment test "casts the widest net" to find pay-for-performance "disconnects" and, in fact, ISS has stated that for the Relative Degree of Alignment "High" concern level, it targets a "disconnect" rate of 10%. We find this high rate to be largely a result of flawed methods.

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