



The New ROX Index

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Burning Platform

Is your company getting a bang out of its executive pay buck?

How do you know?

Is your executive team being rewarded extravagantly?

Is your executive team being rewarded fairly?

Is your executive team being rewarded poorly?

Prove it!



Agenda

1. What is ROX?
2. How do we perform a ROX analysis?
3. What can we learn from our ROX analysis?

Transformational way to think about:

- Appropriateness of executive pay packages
- Pay for performance assessment



Current Landscape

- Executive pay is complex
- Intense focus on alignment of executive pay with performance
 - ◆ Struggle to establish a clean way to evaluate that alignment
 - ◆ Confusion from multitude of ways in which executive pay is disclosed, measured, used, and critiqued
 - Compensation Committee
 - HR function
 - Finance/accounting function
 - Survey houses
 - SEC, investing public, & shareholders
 - IRS
 - Executives



Pay-for-Performance Conundrum

- When evaluating executive pay, most companies look at market data relative to a comparator group for key benchmark roles
- Traditional analysis includes competitive assessment of:
 - ◆ Actual base salaries
 - ◆ Target and/or actual annual bonuses earned
 - ◆ Long-term incentives granted during the year
- Traditional analysis focuses on comparison of *pay opportunities*
 - ◆ Does little to evaluate how *actual pay delivered* stacks up
- Difficult for Compensation Committees to evaluate whether pay opportunities translated into actual pay levels that correlated with performance

How does one gain better insight into whether an executive team is effectively shepherding a company toward enhanced shareholder value?



Overview of the New ROX Index

- Akin to evaluating effectiveness of operational leaders based on returns generated vs. investment in creating those returns
- **ROX = Return on Executives**
 - ◆ Actual value delivered and accruing to executives highlights the true value transfer from shareholders to executives
 - ◆ ROX expresses the amount of shareholder wealth created for each \$1 of executive pay delivered and accruing
 - ◆ $ROX = \text{Total Shareholder Return} \div \text{Executive Pay}$
 - $TSR = \text{increase in company's market cap} + \text{dividends paid}$
 - $EP = \text{salary} + \text{bonus earned} + \text{LTI earned during the period}$



Overview of the New ROX Index (cont'd)

- Long-term incentives earned during the period include:
 1. Actual value reaped from:
 - Gain on all stock options exercised during the period +
 - Value of all restricted stock vested during the period +
 - Value of all performance-based awards (stock or cash) vested/paid out during the period
 2. Appreciation (depreciation) on:
 - Spread value on all options held @ end of the period less spread value of all options held @ beginning of the period
 - Value of all RS held @ end of the period less value of all RS held @ beginning of the period



Example – Stock Options

- At FYE 2006, CEO held 500,000 options with spread value of \$10mm
- Stock price at FYE 2006: \$100
- During FY 2007, CEO:
 - ◆ Exercised 50,000 options with total spread value of \$3mm
 - ◆ Granted 25,000 options with strike price of \$110
- Stock price at FYE 2007: \$120
- At FYE 2007, CEO held 475,000 options with spread value of \$16.3mm
- Pay realized/realizable during FY 2007:

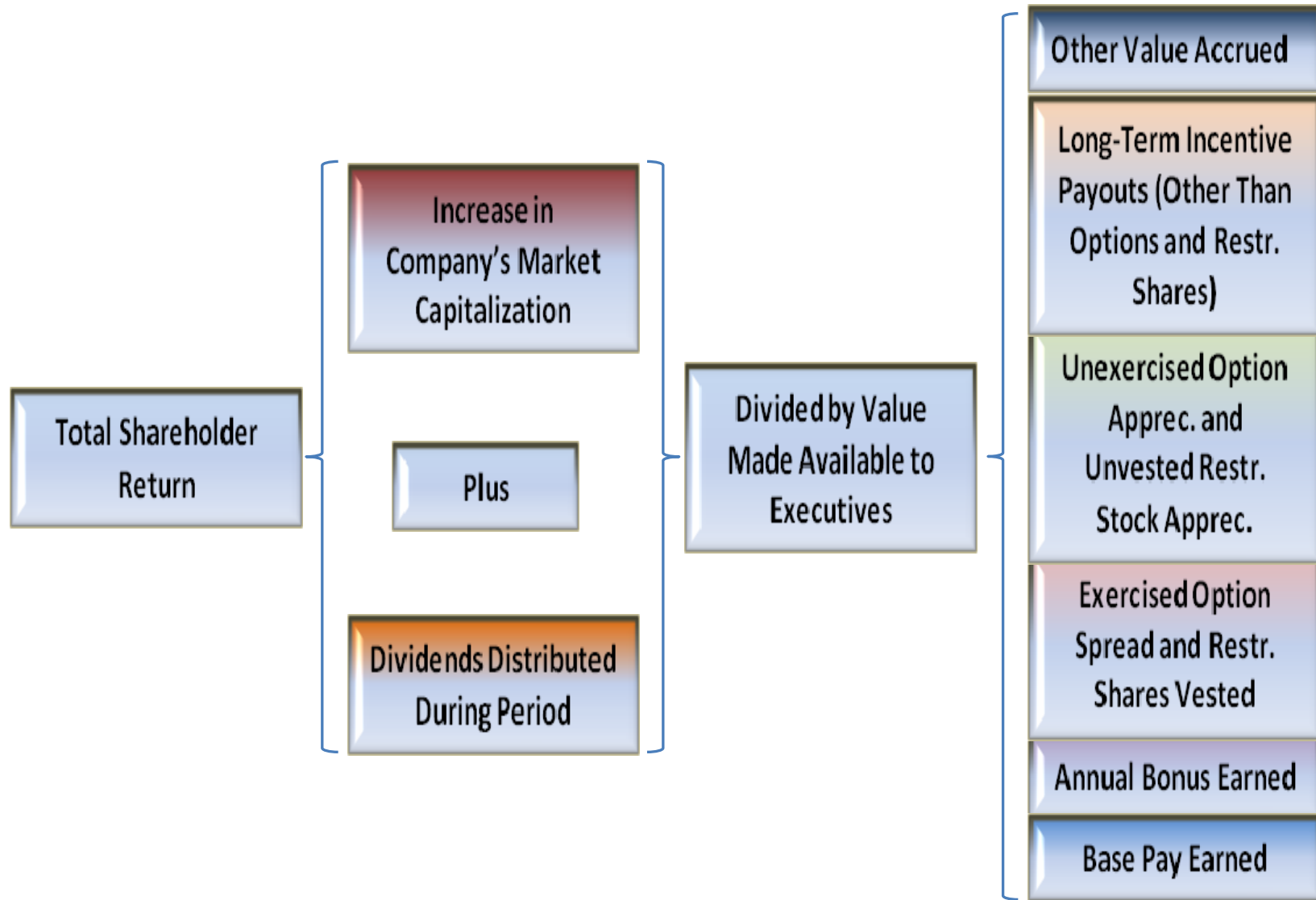
◆ Gain on options exercised during FY 2007	\$3,000,000
◆ Plus spread value at FYE 2007	\$16,300,000
◆ Less spread value at FYE 2006	– <u>\$10,000,000</u>
Total increase in realized/realizable option value	\$9,300,000
- In comparison, “pay opportunity” for 2007 grant – **\$917,000**
(25,000 options X \$110 x 1/3)



Comparison of Pay Opportunity vs. Realized/able Pay

	Pay Opportunity	Realized/able Pay
Base Salary	Actual earned	Actual earned
Annual Bonus	Target opportunity	Actual earned
Stock Options	Grant date fair value (typically using Black-Scholes)	Actual gain realized on exercise(s) + Increase/decrease in spread value
Restricted Stock	Grant date fair value	Actual value of shares that vested + Increase/decrease in value
Performance units/shares	Grant date fair value or target opportunity	Actual earned

Calculation of the New ROX Index



Purpose of the New ROX Index

- ROX Index – good starting point for analyzing whether executive pay correlates with company performance
 - ◆ No single “right” method for doing this analysis
 - ◆ Assumptions must be made – for example:
 - Time period
 - Treatment of unvested performance shares
- ROX Index provides directional guidance to:
 - ◆ Determine extent of historical correlation of pay and performance
 - ◆ Offer insight into whether the pay program has sufficient leverage
 - ◆ Highlight whether appropriate level of pay tied to stock performance



Who, What, Where, Why, When?

- How should performance be measured?
 - ◆ Evaluate performance based on Total Shareholder Return (TSR)
 - ◆ Critical measure of how well a company has performed for shareholders
 - ◆ Companies use various performance metrics in their compensation plans but believe those metrics ultimately drive long-term stock performance
 - ◆ As a result, TSR performance is generally an accurate and more meaningful measure of performance



Who, What, Where, Why, When?

- What period of time should be analyzed?
 - ◆ Since performance metric is TSR, historical performance should be measured over a sufficiently long period of time
 - ◆ To give more perspective, suggest looking at different periods:
 - Prior 3 fiscal years
 - Prior 5 fiscal years
 - Prior 10 fiscal years
 - Period of time since a transformational event, for example:
 - Big M&A transaction
 - New business strategy
 - New CEO



Who, What, Where, Why, When?

- Whose pay do we analyze?
 - ◆ Each of the top 5 executives individually
 - ◆ Top 5 executives in the aggregate – total top 5 spend
 - ◆ CEO only
 - Less comprehensive
 - But in most instances:
 - CEO pay serves as good barometer for total top 5 spend
 - CEO pay levels and structure typically cascade down to the next 4 highest paid
 - Thus, analyzing only CEO pay should provide good indication of what the results of a complete Top 5 study would generate



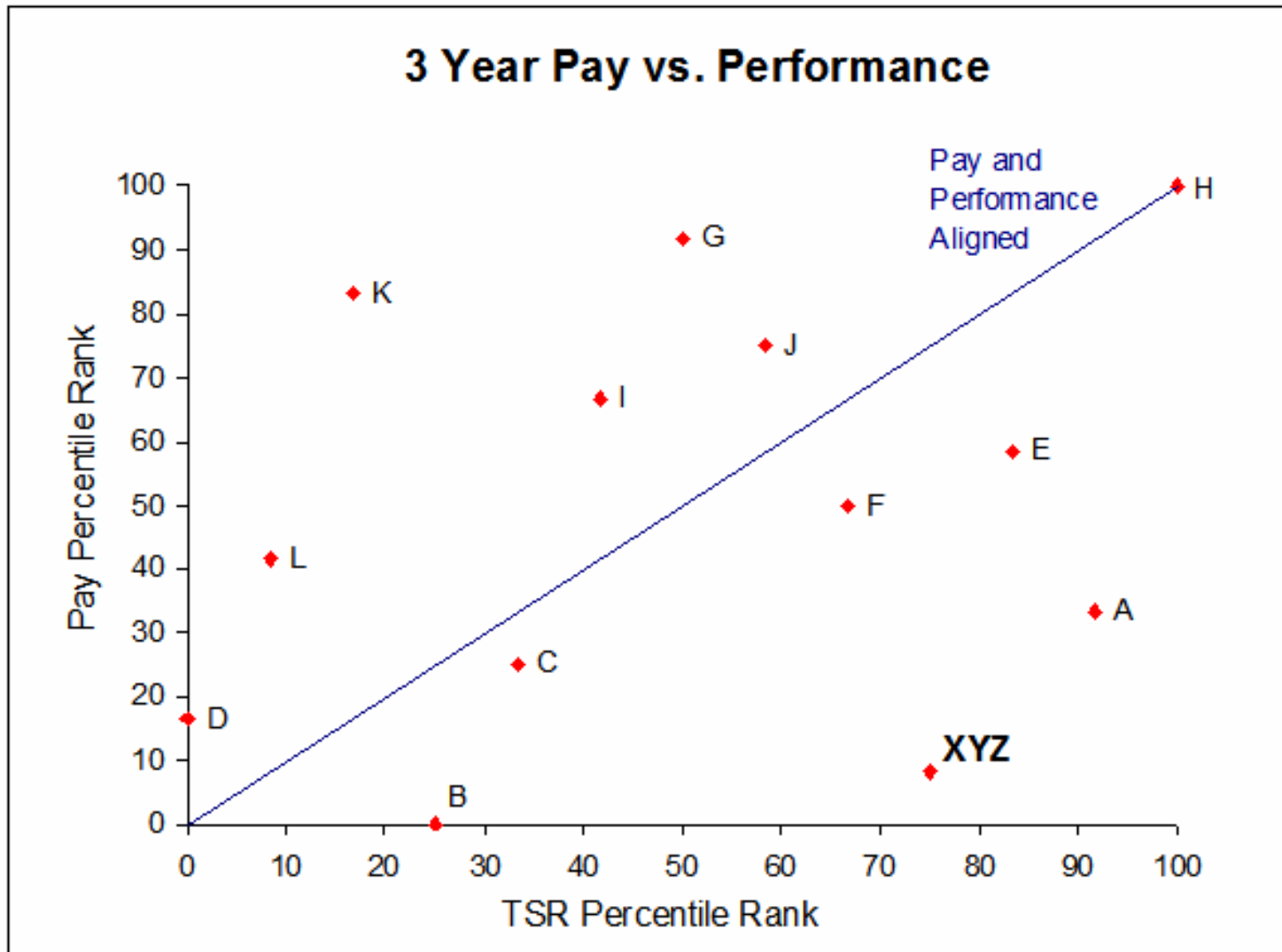
Who, What, Where, Why, When?

- How do we know if ROX results are good or bad?
 - ◆ Compare to peer group(s) used to benchmark executive pay
 - ◆ Compare to the company's historical ROX scores



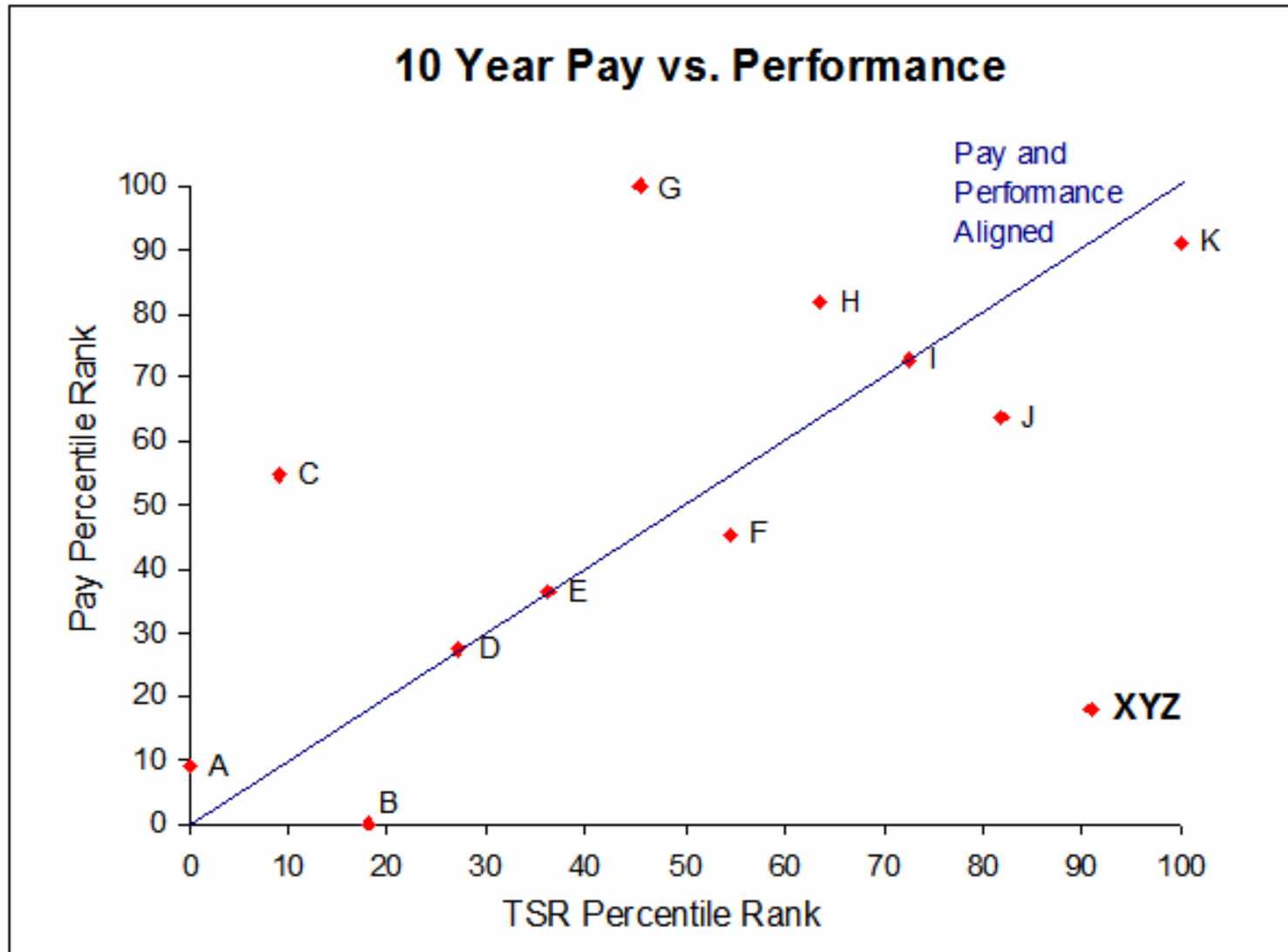
Who, What, Where, Why, When?

- How do the results look over 3 years?



Who, What, Where, Why, When?

- How do the results look over 10 years?



Do ROX Scores Vary by Company Size?

- ROX scores generally positively correlated with company size
- Executives of larger companies have greater leverage to preside over shareholder value creation
 - ◆ Such leverage is disproportionately larger than the value of the executive pay investment
 - ◆ Important to compare companies of similar size

Company Size	Highest CEO ROX Score	Median CEO ROX Score	Lowest CEO ROX Score
Large Cap	\$24,665	\$633	\$119
Mid Cap	\$2,586	\$73	\$13
Small Cap	\$659	\$66	\$17

- Similarly, exercise caution when comparing companies in different industries given unique market forces that can impact companies within a specific industry sector

Top 5 ROX

Median ROX Score:
\$299 of shareholder
value added for
each \$1 of pay
realized/able by
top 5

Or
Top 5 shared in
0.33% of
shareholder value
added

ROX Scores Top 20 S&P 500 Companies in 2006

Company	Total FY06 Comp From Summary Comp Table (\$mil)	Real FY06 Comp Cost to Shareholders (\$mil)	"Real" Minus "Accounting" Cost (\$mil)	One Year TSR (%)	Increase in Shareholder Value (\$bil)	ROX (\$mil)
Pfizer	36.540	28.029	(8.511)	15.30	25.839	\$922
Google	10.206	15.204	4.988	11.00	13.750	904
ExxonMobil	45.158	166.117	120.958	39.09	129.831	782
Verizon	57.869	48.851	(9.018)	33.95	29.777	610
Coca-Cola	63.697	48.383	(15.313)	23.08	21.845	451
IBM	48.781	56.763	7.982	19.74	24.839	438
GE	72.882	83.613	10.731	9.32	33.839	405
Citigroup	78.770	132.240	53.470	19.34	45.871	347
AT&T	122.937	155.540	32.612	52.47	49.883	321
Chevron	65.444	139.464	74.021	33.62	41.703	299
Bank of America	71.166	145.899	74.733	20.66	43.160	296
Johnson & Johnson	64.791	81.549	16.759	12.43	21.936	269
AIG	63.400	56.157	(7.242)	6.04	10.748	191
Altria	95.582	160.015	64.433	19.33	30.143	188
JPMorgan Chase	148.028	203.304	55.277	25.45	35.052	172
Wachovia	52.494	66.757	14.263	11.93	10.412	156
Wal-Mart	66.861	62.536	(4.325)	4.92	9.447	151
Wells Fargo	59.728	150.163	90.436	16.8	17.777	118
Conoco Phillips	69.650	264.341	194.691	26.44	24.397	92
Intel	34.406	(31.695)	(66.101)	-17.22	(24.916)	N/A
Average	66.419	101.662		19.18	29.767	374

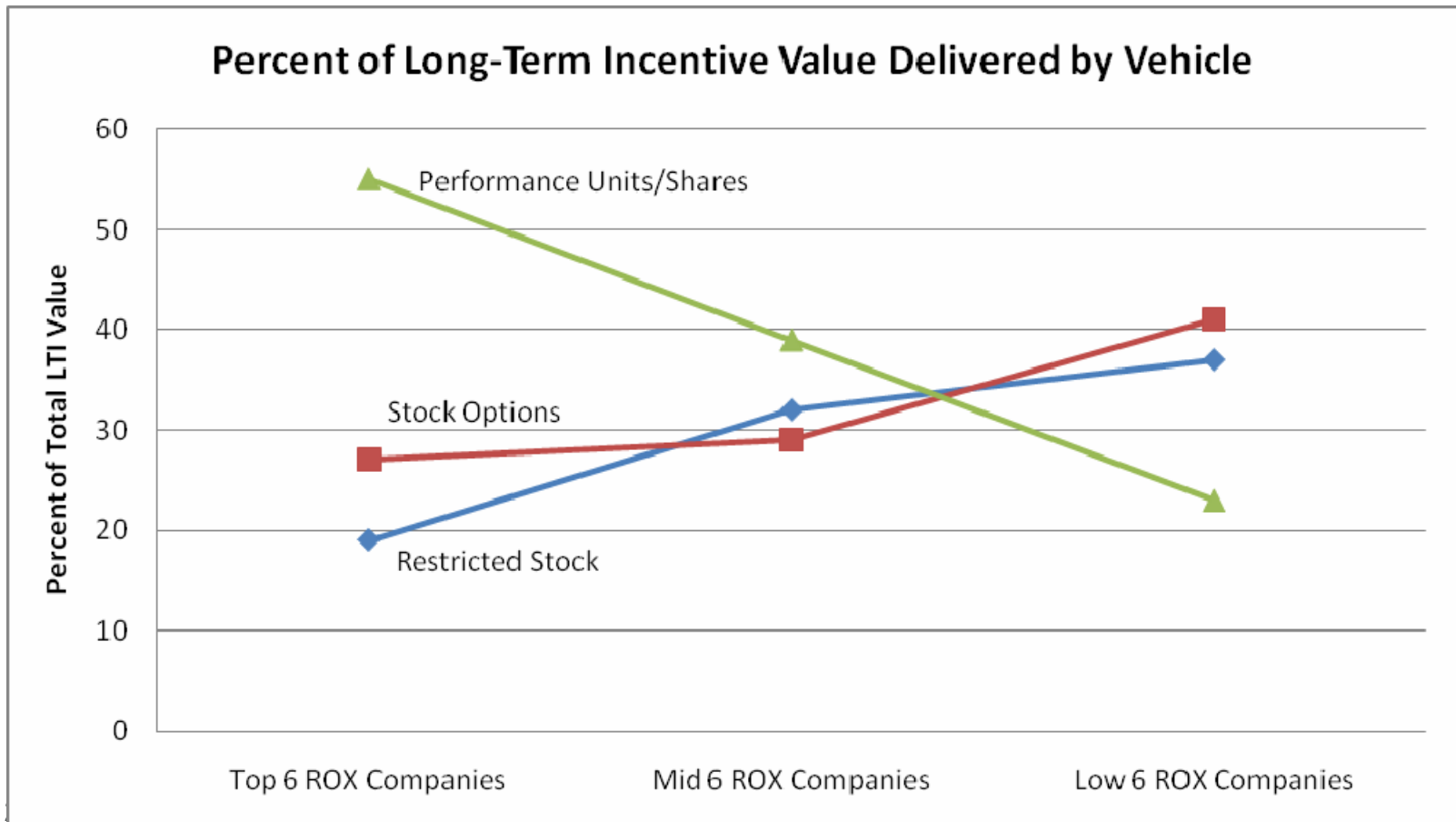
What are the ROX Scores of Highly Criticized CEO Pay Packages?

- Three companies that received heavy criticism in 2007 for their executive pay practices actually delivered some of the greatest returns on their executive pay spend
 - ◆ Pfizer – \$922 ↑ in shareholder value per \$1 of exec pay
 - ◆ ExxonMobil – \$782 ↑ in shareholder value per \$1 of exec pay
 - ◆ Verizon – \$610 ↑ in shareholder value per \$1 of exec pay
- Indicates that a narrow focus on pay volume alone can lead to questionable conclusions about the appropriateness of a company's executive pay program



Does ROX Provide Insight into Performance of Different LTI Vehicles?

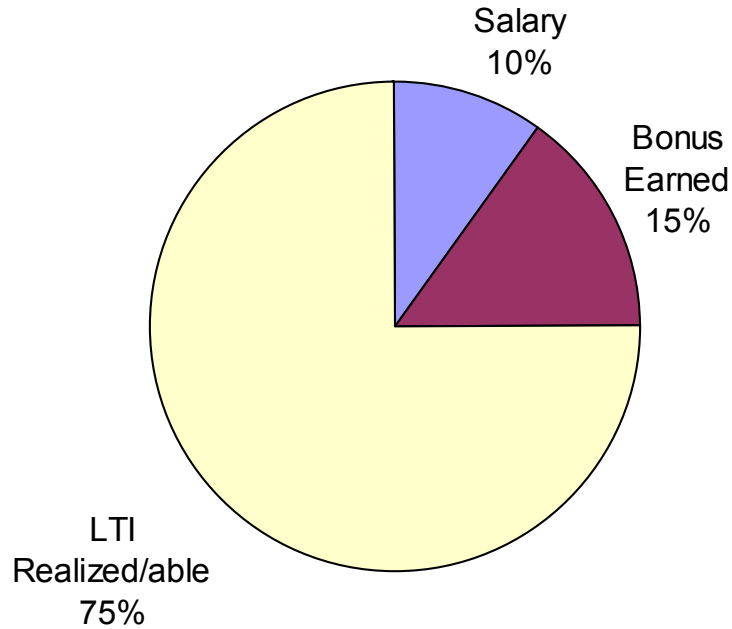
- Tested performance of LTI vehicles by plotting top 20 S&P companies' ROX scores against relative proportions of LTI value delivered
- Options appear inversely correlated with ROX performance
- Performance shares/units represent engine of incentive value delivery



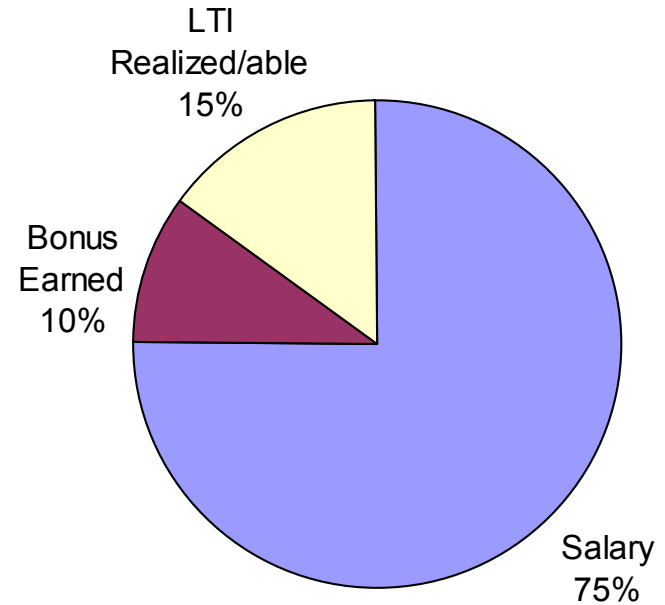
How Do ROX Scores Correlate with Pay Mix?

- Expectation

High Performance



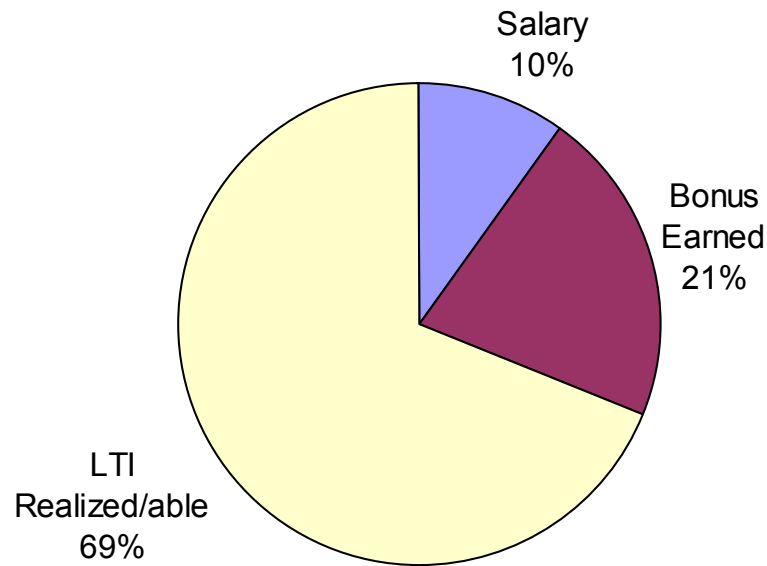
Low Performance



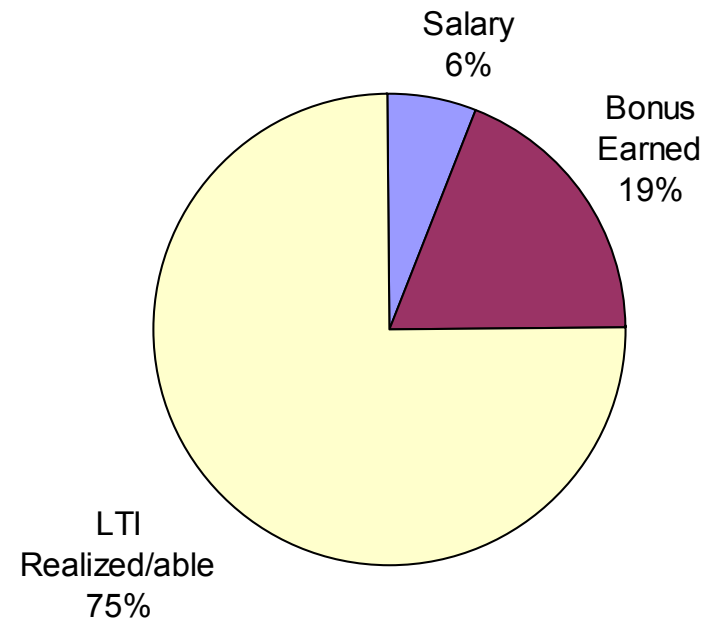
How Do ROX Scores Correlate with Pay Mix?

- Results of S&P 20 analysis

Top 6 ROX Companies



Low 6 ROX Companies



- Data set is limited but results are counterintuitive none the less



Should Director Pay be Tied to ROX?

- Operational leaders accountable for financial returns generated by assets under their control
- Should Boards be accountable for performance of corporate assets over which they have the most direct authority – CEO + team?
- Boards have direct influence over both major elements of ROX:
 - ◆ Maintenance of top team that drives company performance
 - ◆ Form & amount of pay delivered to that team
- Substantial outlay of executive compensation occurs when:
 - ◆ Existing executive fired
 - ◆ New executive hired from outside with lucrative sign-on package
- Should director pay be a function of cost efficiency of executive pay in relation to company stock performance, i.e., ROX?
 - ◆ Minimize turnover through effective leadership development & succession planning
 - ◆ Approve executive pay that best aligns with performance in a cost efficient way



Summary – The New ROX Index

New ROX Index provides:

- Useful tool to evaluate performance of top executive team in relation to total value made available to those executives
- Insight into cost efficiency of executive pay in the context of shareholder value gains
 - ◆ Relative to market
 - ◆ Relative to company history
- Pay for performance perspective when applied to companies criticized for sheer volume of executive pay
- Better understanding of ideal LTI pay mix by modeling potential ROX results associated with different LTI mixes and pay mixes
- Way to reward directors for efficient management of executive pay spend relative to shareholder returns



Conclusion

Is your company getting a bang out of its executive pay buck?

Know the answer!

Be able to prove it at the end of the day

+

Model it out at the beginning of the day so you get it right!

