EXEQUITY

Independent Board and Management Advisors

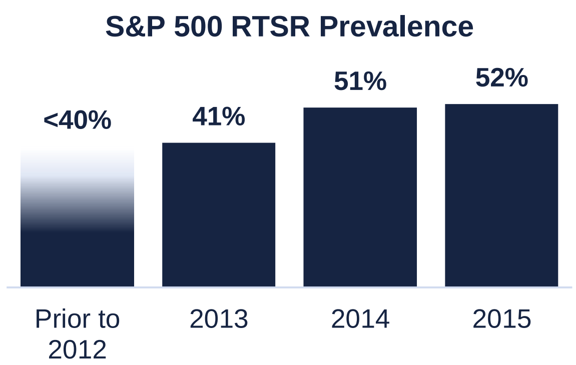
NASPP Chicago Chapter

Relative TSR Prevalence and Design of S&P 500 Companies

September 30, 2015

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
- Today, more than 50% of S&P 500 companies 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 2014 through February 2015
- 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 measure

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 52% from 51% in 2014
- Among Core companies, RTSR usage highest among Utilities (97%) and Energy (86%)
  - Within the Energy sector, RTSR is more prevalent among Oil & Gas companies (94%) than Energy Equipment (67%)
- Real Estate prevalence increased more year over year than any other sector (+12%)
- Most Non-Core sectors showed slight increases (~2%) in RTSR usage
- Retailers (subsets of consumer discretionary and consumer staples sectors) exhibit the lowest overall RTSR prevalence, under 25%

	GICS Sector (Selected GICS Subset)	2015 S&P 500	% Using RTSR 2015	% Using RTSR 2014
Core RTSR	Utilities	30	97%	97%
	Energy	43	86%	87%
	Energy Equipment & Services	*12*	*67%*	69%
	Oil, Gas & Consumable Fuels	*31*	*94%*	94%
	Real Estate	22	77%	65%
	Materials	29	59%	61%
	Core RTSR	***124***	***81%***	**79%**
Non-Core RTSR	Industrials	64	48%	44%
	Health Care	55	47%	44%
	Consumer Staples	40	45%	43%
	Food & Staples Retailing	*8*	*25%*	25%
	Consumer Staples (Ex. Retailing)	*32*	*50%*	47%
	Information Technology	64	41%	40%
	Financials (Ex. Real Estate)	63	37%	37%
	Consumer Discretionary	84	38%	37%
	Retailing	*31*	*19%*	16%
	Consumer Discretionary (Ex. Retail)	*53*	*49%*	49%
	Telecommunication Services[1]	6	83%	100%
	Non-Core RTSR	***376***	***43%***	**41%**
	S&P 500	**500**	**52%**	**51%**

[1] Included in Non-Core RTSR category due to small sample size. 5 companies in 2014.

- ***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
- 90% 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
- 37% of Non-Core RTSR companies benchmark against a multi-sector index
  - Of those, 90% use the S&P 500
  - 22% 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, 85% use the S&P 500

		RTSR Peer Group			
	GICS Sector (Selected GICS Subset)	**Broad-Based/ Multi-Sector Index**	**Single-Sector Index**	**Custom Comp. Peers**	**Custom Perf. Peers**
Core RTSR	Utilities	—	55%	14%	31%
	Energy	3%	11%	35%	51%
	Energy Equipment & Services	—	*38%*	*13%*	*50%*
	Oil, Gas & Consumable Fuels	*3%*	*3%*	*41%*	*52%*
	Real Estate	18%	71%	6%	6%
	Materials	35%	6%	29%	29%
	Core RTSR	***10%***	***33%***	***23%***	***34%***
Non-Core RTSR	Industrials	32%	19%	26%	23%
	Health Care	8%	35%	42%	15%
	Consumer Staples	44%	17%	17%	22%
	Food & Staples Retailing	*100%*	—	—	—
	Consumer Staples (Ex. Retailing)	*38%*	*19%*	*19%*	*25%*
	Information Technology	50%	27%	8%	15%
	Financials (Ex. Real Estate)	*17%*	*13%*	*30%*	*39%*
	Consumer Discretionary	59%	3%	16%	22%
	Retailing	*50%*	—	*17%*	*33%*
	Consumer Discretionary (Ex. Retail)	*62%*	*4%*	*15%*	*19%*
	Telecommunication Services[1]	60%	20%	—	20%
	Non-Core RTSR	***37%***	***19%***	***22%***	***22%***
	S&P 500	**26%**	**24%**	**23%**	**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
- Typical averaging period is 30 calendar or 20 trading days

	GICS Sector (Selected GICS Subset)	LTI Metric	LTI Modifier	Method	
				Rank	+/- Index Composite
Core RTSR	Utilities	97%	3%	100%	—
	Energy	97%	3%	97%	3%
	Energy Equipment & Services	*88%*	*13%*	*100%*	—
	Oil, Gas & Consumable Fuels	*100%*	—	*97%*	*3%*
	Real Estate	94%	6%	59%	41%
	Materials	94%	6%	94%	6%
	Core RTSR	***96%***	***4%***	***91%***	***9%***
Non-Core RTSR	Industrials	71%	29%	97%	3%
	Health Care	77%	23%	92%	8%
	Consumer Staples	72%	28%	100%	—
	Food & Staples Retailing	*50%*	*50%*	*100%*	—
	Consumer Staples (Ex. Retailing)	*75%*	*25%*	*100%*	—
	Information Technology	85%	15%	85%	15%
	Financials (Ex. Real Estate)	*83%*	*17%*	*87%*	*13%*
	Consumer Discretionary	59%	41%	97%	3%
	Retailing	*50%*	*50%*	*100%*	—
	Consumer Discretionary (Ex. Retail)	*62%*	*38%*	*96%*	*4%*
	Telecommunication Services[1]	60%	40%	100%	—
	Non-Core RTSR	***73%***	***27%***	***93%***	***7%***
	S&P 500	**82%**	**18%**	**92%**	**8%**

[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.	Thresh.	Max.	Thresh.	Max.
Core	100%	25%	90%	25%	90%	35%	200%	50%	200%
Non-Core	50%	25%	80%	25%	75%	37.5%	200%	50%	200%
S&P 500	100%	25%	80%	25%	75%	35%	200%	50%	200%

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			RTSR as Long-Term Incentive Modifier	Method					
			# Using RTSR	% Using RTSR	% Using	Median % of Performance Share Units	Mode % of Performance Share Units		Rank	+/- Index Composite	Broad-Based/ Multi-Sector Index	Single-Sector Index	Custom Comp. Peers	Custom Perf. Peers
Core RTSR	Utilities	30	29	97%	97%	65%	50%	3%	100%	—	—	55%	14%	31%
	Energy	43	37	86%	97%	100%	100%	3%	97%	3%	3%	11%	35%	51%
	Energy Equipment & Services	*12*	*8*	*67%*	*88%*	*50%*	*50%*	*13%*	*100%*	—	—	*38%*	*13%*	*50%*
	Oil, Gas & Consumable Fuels	*31*	*29*	*94%*	*100%*	*100%*	*100%*	—	*97%*	*3%*	*3%*	*3%*	*41%*	*52%*
	Real Estate	22	17	77%	94%	100%	100%	6%	59%	41%	18%	71%	6%	6%
	Materials	29	17	59%	94%	50$	50%	6%	94%	6%	35%	6%	29%	29%
	Core RTSR	***124***	***100***	***81%***	***96%***	***70%***	***100%***	***4%***	***91%***	***9%***	***10%***	***33%***	***23%***	***34%***
Non-Core RTSR	Industrials	64	31	48%	71%	50%	50%	29%	97%	3%	32%	19%	26%	23%
	Health Care	55	26	47%	77%	50%	50%	23%	92%	8%	8%	35%	42%	15%
	Consumer Staples	40	18	45%	72%	75%	100%	28%	100%	—	44%	17%	17%	22%
	Food & Staples Retailing	*8*	*2*	*25%*	*50%*	—	—	*50%*	*100%*	—	*100%*	—	—	—
	Consumer Staples (Ex. Retailing)	*32*	*16*	*50%*	*75%*	*50%*	*100%*	*25%*	*100%*	—	*38%*	*19%*	*19%*	*25%*
	Information Technology	64	26	41%	85%	67%	100%	15%	85%	15%	50%	27%	8%	15%
	Financials (Ex. Real Estate)	*63*	*23*	*37%*	*83%*	*50%*	*50%*	*17%*	*87%*	*13%*	*17%*	*13%*	*30%*	*39%*
	Consumer Discretionary	84	32	38%	59%	50%	100%	41%	97%	3%	59%	3%	16%	22%
	Retailing	*31*	*6*	*19%*	*50%*	—	—	*50%*	*100%*	—	*50%*	—	*17%*	*33%*
	Consumer Discretionary (Ex. Retail)	*53*	*26*	*49%*	*62%*	*50%*	*100%*	*38%*	*96%*	*4%*	*62%*	*4%*	*15%*	*19%*
	Telecommunication Services[1]	6	5	83%	60%	—	—	40%	100%	—	60%	20%	—	20%
	Non-Core RTSR	***376***	***161***	***43%***	***73%***	***50%***	***50%***	***27%***	***93%***	***7%***	***37%***	***19%***	***22%***	***22%***
	S&P 500	**500**	**261**	**52%**	**82%**	**50%**	**100%**	**18%**	**92%**	**8%**	**26%**	**24%**	**23%**	**27%**

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

Observations and Discussion

- Growth in prevalence of RTSR overall has flatlined in 2015
  - 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
- While RTSR may be possibly a "pure" metric from a pay-for-performance perspective, it is often viewed as a "lottery ticket" by participants

Observations and Discussion

- 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

Ben Burney, Senior Advisor, Exequity LLP

- 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 two 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.
- Ben received an M.B.A. from the Wisconsin School of Business at the University of Wisconsin-Madison. Formerly a freelance musician in New York, Ben received a Bachelor of Music degree from Oberlin College Conservatory.

Contact Information

- Office: (847) 996-3970
- Email: ben.burney@exqty.com