Client Briefing

Relative TSR Prevalence and Design of S&P 500 Companies

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Independent Board and Management Advisors

Over the last several years as compensation committees and executives strive to align pay with shareholder returns, they have increasingly turned to market-based performance measures such as relative total shareholder return[1] (RTSR). Traditionally, RTSR was used primarily by Energy and Utilities companies, largely because these companies' stock prices tend to be closely correlated, so TSR differences can more confidently be attributed to the success of management's stewardship. Today, however, more than 50% of S&P 500 companies use RTSR in their long-term incentive plans.

With RTSR prevalence at such a high level, we analyzed the key design elements in an effort to discern *how* RTSR is being implemented across these companies and whether the new entrants to the RTSR fold designed their plans similarly to the traditional Energy or Utilities companies.

Summary of Findings

More than 50% of S&P 500 companies now use RTSR as a metric or modifier in long-term incentive awards. RTSR as a discrete metric is the most prevalent method, used by 82% of companies, while 18% utilize RTSR as a modifier. Among companies employing RTSR as either a metric or modifier, approximately one-half measure RTSR against a custom group of companies, and of those companies, 46% against the same peer group used for benchmarking compensation levels and 54% against a custom performance peer group. The remaining half measure RTSR against a pre-defined set of peers determined by a third party (e.g., a stock index such as the S&P 500), and of those companies, 52% of companies use a multi-sector index (e.g., the S&P 500) and 48% a single-sector index (e.g., S&P 500 Utilities or FTSE NAREIT Index). The single most utilized index is the S&P 500, used by 22% of all companies using RTSR.

Overall, 50% of performance awards are measured based on RTSR. Threshold performance is commonly the peer group 25th percentile and maximum is commonly the 75th or 90th percentile. Payouts for achieving threshold performance tend to range between 25% and 50% of target, maximum between 150% and 200%.

The remainder of this Client Briefing describes in greater detail our findings and discernible differences in RTSR prevalence and design between the traditional users of RTSR and companies in industries more recently adopting this measure.

[1] Total shareholder return is defined as the change in a company's stock price plus reinvested dividends.

Prevalence

Energy and Utilities companies continue to be the primary users of RTSR across the S&P 500, with almost 90% of Energy and nearly all Utilities companies using RTSR. Of the remaining industries with 20 or more companies in the S&P 500, Materials and Real Estate companies are the only others with 60% or higher RTSR prevalence. Within each of these high-prevalence sectors, companies tend to face similar commodity price pressures or economic similarities, potentially rendering RTSR a more reliable method for identifying financial and operational outperformance via market performance. (We refer to Energy, Materials, Real Estate, and Utilities companies collectively as the Core group of RTSR users, while the remaining companies we refer to as Non-Core.)

We note that Non-Core RTSR companies generally have lesser (or more diversified) commodity pricing (or other) pressures and tend to use RTSR with roughly one-half the frequency of Core companies. Prevalence among other Non-Core companies is generally within the 40% to 50% range. We would posit that Non-Core companies experience a more diverse array of stock price pressures than do Core companies by virtue of various factors applying as independent variables, from raw materials and transportation costs to consumer preferences.[2] It appears to us that industry-specific forces are driving the ways in which RTSR is used in pay programs.

The table below reflects the prevalence of RTSR programs within selected industries:

	GICS Sector	S&P 500	# Using RTSR	% Using RTSR
Core RTSR	Utilities	30	29	97%
	Energy	43	37	86%
	Real Estate	22	17	77%
	Materials	29	17	59%
	Core RTSR	**124**	**100**	**81%**
Non-Core RTSR	Industrials	64	31	48%
	Health Care	55	26	47%
	Consumer Staples	40	18	45%
	Information Technology	64	26	41%
	Consumer Discretionary	84	32	38%
	Financials (Excluding Real Estate)	63	23	37%
	Telecommunication Services	6	5	83%
	Non-Core RTSR	**376**	**161**	**43%**
	S&P 500	**500**	**261**	**52%**

Note: *Prevalence data for 2015 collected from proxies filed for S&P 500 companies with fiscal years ending March 2014 through February 2015.*

[2] For example, the share price of a health care equipment company reliant upon a certain precious metal (presumably provided by a Materials company) may exhibit sensitivities to the price swings of this commodity, but this will be one of many factors impacting this hypothetical health care company's share price. The precious metal company's share price will show much greater—and direct—sensitivity to the same price swings.

Overall, prevalence for 2015 is consistent with 2014 but higher than in 2013:

	2015 % Using RTSR	2014 % Using RTSR	2013 % Using RTSR
Core RTSR	81%	79%	70%
Non-Core RTSR	43%	41%	32%
S&P 500	52%	51%	41%

Note: *2015 reflects prevalence for companies with fiscal years ending March 2014 to February 2015; 2014, March 2013 to February 2014; and 2013, March 2012 to February 2013.*

Metric Versus Modifier

Companies typically employ RTSR in one of two ways: as a discrete metric within a performance plan or as a modifier to a financial metric. Used as a discrete metric, RTSR is assigned a weighting within the performance share plan, e.g., a company using RTSR as a discrete metric may weight it 50% and return on capital 50%. As a modifier, RTSR generally adjusts performance plan payouts, which typically measure a non-market metric (e.g., return on capital). In most cases, RTSR modifiers provide for upward or downward adjustment to plan payouts (e.g., a modifier of +/- 25%), though companies may also utilize downward-only or upward-only modifiers.

A majority of S&P 500 companies use RTSR as a discrete metric within their performance plans. The most prevalent weighting given to RTSR under performance share plans is 100%, but at the median, RTSR weighting is 50%. Core companies use RTSR as the sole performance metric more frequently than Non-Core companies. Core companies also use RTSR as a discrete metric in their performance plans more frequently than Non-Core companies.

Recently, more companies adding RTSR to their performance plans have done so by using the modifier approach, which accounts for much of the increase in overall RTSR prevalence from 2013 (roughly 40% in 2013 to 50% in 2014).

The table below identifies the ways in which RTSR is used within selected industries:

			RTSR as Long-Term Incentive Metric			RTSR as Long-Term Incentive Modifier
	GICS Sector	% Using RTSR	% Using	Median % of Performance Share Units	Mode % of Performance Share Units	
Core RTSR	Utilities	97%	97%	65%	50%	3%
	Energy	86%	97%	100%	100%	3%
	Real Estate	77%	94%	100%	100%	6%
	Materials	59%	94%	50%	50%	6%
	Core RTSR	**81%**	**96%**	**70%**	**100%**	**4%**
Non-Core RTSR	Industrials	48%	71%	50%	50%	29%
	Health Care	47%	77%	50%	50%	23%
	Consumer Staples	45%	72%	75%	100%	28%
	Information Technology	41%	85%	67%	100%	15%
	Consumer Discretionary	38%	59%	50%	100%	41%
	Financials (Excluding Real Estate)	37%	83%	50%	50%	17%
	Telecommunication Services	83%	60%	N/A	N/A	40%
	Non-Core RTSR	**43%**	**73%**	**50%**	**50%**	**27%**
	S&P 500	**52%**	**82%**	**50%**	**100%**	**18%**

Peer Group

The selection of an RTSR peer group is a critical factor in the establishment of an RTSR program. Broadly speaking, there are three categories of peer groups used by companies to benchmark RTSR:

- Multi-sector index—a broad-based index comprising multiple sectors such as the S&P 500 or two or more sectors within a broad-based index (e.g., S&P 500 excluding Financials).
- Single-sector index—an index comprising a single sector, such as an S&P sector index or non-S&P index such as the MSCI US REIT Index; other examples include the S&P 500 Utility Index or S&P 1500 Utility Index.
- Custom peer groups—the custom compensation benchmarking peers or custom performance peers.

Across the S&P 500, one-half of companies use a peer group defined by a third party (e.g., S&P 500 or a sector index) and the other half use a customized peer group. Most Core companies (90%) use a focused peer group to benchmark RTSR by using either a single-sector index or custom group of companies. Notably, few Core companies, other than Materials companies, benchmark RTSR relative to multi-sector indexes. Non-Core companies, but especially consumer-oriented companies, are more likely to use a broad index such as the S&P 500.

	GICS Sector	% Using RTSR	Multi-Sector Index	Single-Sector Index	Custom Group	
					Compensation Peers	Performance Peers
Core RTSR	Utilities	97%	—	55%	14%	31%
	Energy	86%	3%	11%	35%	51%
	Real Estate	77%	18%	71%	6%	6%
	Materials	59%	35%	6%	29%	29%
	Core RTSR	**81%**	**10%**	**33%**	**23%**	**34%**
Non-Core RTSR	Industrials	48%	32%	19%	26%	23%
	Health Care	47%	8%	35%	42%	15%
	Consumer Staples	45%	44%	17%	17%	22%
	Information Technology	41%	50%	27%	8%	15%
	Consumer Discretionary	38%	59%	3%	16%	22%
	Financials (Excluding Real Estate)	37%	17%	13%	30%	39%
	Telecommunication Services	83%	60%	20%	—	20%
	Non-Core RTSR	**43%**	**37%**	**19%**	**22%**	**22%**
	S&P 500	**52%**	**26%**	**24%**	**23%**	**27%**

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.*

Among Energy companies, a large majority benchmark against custom groups due to the differing impacts oil prices have on companies within various sectors in the overall industry. For example, a rise (or fall) in global oil prices will affect exploration and production companies differently than oil transportation companies or oil refining companies. Because Utilities are not subject to the intra-sector variances that impact Energy companies, they tend to benchmark to a single-sector index group (e.g., S&P 1500 Utilities or the Dow Utilities Index).

Nearly all S&P 500 companies with RTSR plans use the traditional ranking method for benchmarking relative performance (e.g., percentile rank or numerical rank versus the peer group). An alternative to the traditional ranking method is to measure RTSR relative to an index composite (such as the S&P 500 Index). A company employing this method compares its TSR to that of the index composite figure and adjusts payouts based on the spread between the two figures. For example, if the company's TSR is 15% and the index composite TSR is 5%, then the company beat the index by 10 percentage points. This method is common among REITs, with roughly 40% measuring RTSR against an index composite figure, but is less than 10% prevalent across the S&P 500.

Other Design Elements

Pay/Performance Leverage

Unlike other design elements of RTSR plans, pay/performance leverage varies less across industries.

	Performance				Payout			
	Median		Mode		Median		Mode	
	Thresh.	Max.	Thresh.	Max.	Thresh.	Max.	Thresh.	Max.
Core RTSR	25%	90%	25%	90%	35%	200%	50%	200%
Non-Core RTSR	25%	80%	25%	75%	37.5%	200%	50%	200%
S&P 500	25%	80%	25%	75%	35%	200%	50%	200%

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%.*

Stock Price Averaging

Since RTSR is a naturally volatile incentive metric, companies commonly employ stock price averaging to smooth out the impact of daily stock price movements on relative performance at the beginning and end of the performance period. Stock price averaging periods range from 5 trading days to 90 calendar days (e.g., 4th quarter average), with the most common time frame approximating one month (e.g., 30 calendar days or 20 trading days).

Discussion

The data reflects that S&P 500 companies use a variety of methods to deploy RTSR in their long-term incentive programs. Notably, new entrants to the community of RTSR users did not follow the lead of Energy and Utilities companies with regard to peer group selection. Rather, many have chosen to benchmark RTSR against the S&P 500 as a measure of the broader stock market, as opposed to any one particular industry. Companies benchmarking RTSR to multi-sector indexes such as the S&P 500 may seek to compare their returns to a broader array of potential investment choices a hypothetical investor may possess.

Interestingly, many companies have apparently determined that usage of a broad index is inappropriate due to the low correlations between their stocks and stocks in other industries (e.g., an electric utility versus a technology company, a restaurant versus an oil drilling company).

The recent rise in RTSR prevalence may have many roots, from the impact of say on pay to the increasing influence of proxy advisors. Companies finding it challenging to set reasonable long-term goals but feeling pressure by proxy advisors to implement performance-based long-term incentives may turn to RTSR as the solution: it demonstrates a commitment to performance-based pay (i.e., “checks the box” for ISS), requires no goal setting (outside of relative ranking), is ostensibly objective, and is intended to align executive wealth with the shareholder experience. However, as a backward-looking metric, RTSR does little to motivate executive behaviors and is often viewed as a “lottery ticket” by participants—especially in instances where peer group companies poorly correlate with the sponsor. Regardless, RTSR is widely perceived as a “shareholder-friendly” metric, as it aligns with relative shareholder returns. In our view, RTSR is shareholder-friendly insofar as it may be expected to reasonably and reliably reflect a company’s relative overall performance via market performance.[3]

If a company does not trade similarly to, and exhibits market characteristics out of line with, its RTSR peers, the peer group cannot be expected to reasonably gauge the sponsor company’s relative performance. In such a case, relative performance outcomes are more likely to result from chance—the antithesis of shareholder-friendly pay-for-performance alignment.[4] Determination of relative market comparability is difficult to surmise without a rigorous analysis.

The SEC’s forthcoming pay-for-performance rules place a great deal of emphasis on relative market performance, which could further encourage use of RTSR. From our perspective, RTSR is a metric to be approached with care. We think companies currently using or contemplating RTSR should consider the approach taken by Core RTSR users, who tend to use focused sets of peers against whom relative performance may be more reliably measured. We would strongly encourage companies to assess their relative market characteristics—using an objective analysis such as Exequity’s Market Analytics—early on in the process of deciding whether or how to use RTSR or when reviewing the appropriateness of their current RTSR peer groups. Market Analytics helps determine if RTSR is a reasonable metric to use and, if so, which index or peer group of companies can be expected to best measure a company’s relative performance and drive the relative pay-for-performance outcomes shareholders expect.

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[3] There are other design elements that may not be considered shareholder-friendly, such as the potential for above-target payouts when shareholder returns are negative.

[4] For example, let us assume measurement of relative performance versus the S&P 500: Is it meaningful if a restaurant company outperforms most Utilities? If a retailer outperforms most Energy companies? In our view, the likely answer is “no” in each of these cases.

S&P 500 RTSR Prevalence and Design Results Detail

	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	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 (Excluding 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 (Excluding 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 (Excluding 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.

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