Performance criteria in long-term incentive programmes

Trends, best practice and effectiveness

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Building a better working world

What is driving change

Environment

- Financial crisis – reward for risk and reward in bailed-out institutions in Europe and US
- Challenging economic environment
- Public concern that austerity is not being shared equally
- Increased scrutiny and regulations

Shareholder concerns

- Shareholders are taking pain while execs get rewarded
- Board discretion to reward even when key performance indicators (KPIs) have not been met
- Quantum of awards not aligned to performance
- Large termination payments for poor company performance
- Performance targets that are not stretching

Output

- Say on Pay (SOP), UK and EU directives
- Emphasis on alignment of ‘Pay to Performance’ and long-term value creation
- UK regulations: disclosure, transparency, clarity, accountability, binding vote on pay policy and penalties where vote fails

Likely impact on Ireland

Trickle down vs. permeate and become norm

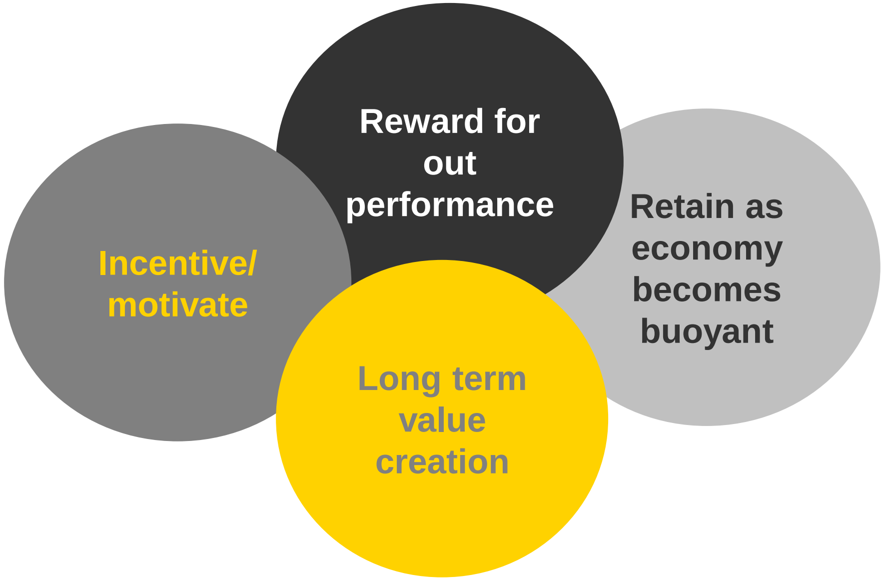
Trends: Measures and Design

Before we look at these we need to recall the purpose of long-term incentive programmes (LTIPs)

Overall purposes: ‘Pay for Performance’ or ‘Pay for Pulse’

Align interests with those of shareholders

- Create sustained long-term value
- Incentivise/motivate for long-term value creation
- Reward for value created in line with the role and over and above expectations
- +/- retain and increasingly used for retention as the economy becomes buoyant



Overall purposes: ‘Pay for Performance’ or ‘Pay for Pulse’ (cont’d)

What is really meant by performance?

- Challenging – challenging performance conditions should govern the vesting of awards or the exercise of options under any form of long-term incentive programme
- The chosen criteria should demonstrate the achievement of a level of performance which is demanding in the context of the prospects for the company and the prevailing economic environment in which it operates
- Performance conditions should incorporate absolute and relative measures and include leading indicators and predictive measures of financial performance (market share vs. sales, sales pipeline, customer satisfaction, engagement etc.)
- Timeframe should tie in with the business cycle and for LTIPs be >/= 3 years

Trends: Measures and Design – what these trends are leading to

Trends	Measures	Result	Concern	Solution
▸ Organisations are reacting to external pressure with little consideration of unique organisation needs is resulting in formulaic frameworks ▸ Measures and Design can focus too much on external pressures, what others do: peers, proxy advisor firms (ISS or Glass Lewis) or what ‘seems logical’	▸ Relative Total Shareholder Return (TSR) and Earnings Per Share (EPS) are expected to remain dominant for some time ▸ A sameness in approach avoids the spotlight and avoids the risk of a negative shareholder vote	▸ Sameness, formulaic reward frameworks ▸ Similar approach to measures i.e., TSR, peer group, and design i.e., setting ▸ +/- threshold, target and maximum pay out triggers and quantums of reward at each of these points are similar	▸ Where is the business strategy, business context – pay for business performance but in line with delivering the strategy/long term value creation ▸ Where are executive preferences, incentive and retention elements	▸ An alternative is to design LTIPs that incorporate measures that support strategy in line with the business context ▸ Incorporate exec preferences/ synergies between their preferences, shareholders and proxy advisors ▸ Reach out to shareholders to socialise the strategy

What performance measures are used and how do these support the purpose of LTIPs?

Preferred measures: TSR and EPS

The advantages of TSR are its transparency, simplicity and strong alignment with shareholders over time, its disadvantages include:

rTSR is not an incentive, it is a reward	► Incentive implies line of sight to the goal – with rTSR the individual does not know what actions to take to create shareholder value at a rate that will beat the peer group over the next few years ► rTSR result is not known until the final day of the measurement period and it fluctuates in the meantime
rTSR is not the best measure of individual performance (unless over the very long term)	► It's a point to point measure and so great performance in an intervening period has no effect on the TSR calculation ► The market's expectation of future performance can have a larger impact on rTSR than current performance
rTSR levels the playing field by removing overall market movements from the evaluation of performance	► Peer group matters only if it is valid (organisations in the group operate in similar economic conditions and in the same sector) ► Needs to be statistically reliable

What performance measures are used and how do these support the purpose of LTIPs? (cont'd)

Preferred measures: TSR and EPS (cont'd)

The advantages EPS are that it increased with ROIC and growth; however:

EPS	► It can be manipulated – an increase can be due to an increase in debt ► An organisation that has lower invested capital can have the same EPS as one with high invested capital ► An organisation can fund operations with debt, generate a positive EPS and yet the operations will not generate a positive return

Can these drawbacks be addressed

1

Continuum

- As there is an imperfect correlation between rTSR and corporate operating or financial performance a more robust approach is to use 3-4 strategic and milestone measures that appropriately balance growth and return and are proven to link to value

2

Modifiers

- Adjust earned amounts down if absolute performance is not achieved
- If organisation has negative TSR while it has outperformed Peer TSR then limit pay out
- Dial up or down in fringe situations +/- 25% if rTSR is in Q3 vs. Q1
- Provide an additional award if a financial metric exceeds a predetermined level of absolute performance

3

- Trigger the rTSR plan when a series of other absolute measures covering strategic objectives are achieved – this achieves line of sight and incentive to focus on the activities that create value

4

- Award annual grants with overlapping cycles to address attraction and retention issues that can occur if plans do not payout

Can these drawbacks be addressed (cont'd)

Calibrating the measures

- What are the different performance levels and what do they generate
- Are the norms sound

Norms

- Threshold performance generates 50% of target pay out
- Maximum performance generates 200% of target

However all performance opportunity is not created equally, (sector, maturity, market volatility and performance history play a role

	Challenging conditions	Focus on out performance	Historic poor performance
Threshold	20%	10%	20% @ 25% threshold
Target	50%	30%	50% @100% Target
Maximum	75%	100%	75% @ Max 150%

Absolute versus Relative Measures

	Absolute	Relative
What is it	Based on internal plans or standards	Based on external references, peer groups and indices
Advantages	▶ Good to communicate goals and focus efforts ▶ Can be tailored to the orgs unique requirements ▶ Provides line of sight, therefore motivational	▶ Can achieve better performance over the long-term ▶ Creates competitive awareness
Disadvantages	▶ Requires long-term goal setting which can be difficult when climate is volatile ▶ Can disclose competitive advantage	▶ Can give false indicator of performance if volatility is different to peer group
When best to use	▶ In orgs with robust goal setting processes ▶ In orgs where long-term performance standards have been developed, accepted and understood ▶ In orgs with specific long-term outcomes	▶ In orgs with credible peer sets ▶ In orgs subject to variables beyond their control i.e. economic cycles, commodity prices ▶ In orgs with volatility comparable to their peer set

UK regulations: reporting and voting on policy and practice

- Regulations will apply to listed companies for financial years ending on or after 30 September 2013
- Major change in how directors remuneration is reported
- Legal requirement to have an approved policy by the beginning of the financial year following the year in which the new regulations first applied
- Binding shareholder vote on pay policy every three years or sooner where changes are proposed or the policy fails vote

Policy report – key requirements

- For each component of reward: detail how it operates, what its measures are, how these support strategy, how below threshold, target and maximum performance is modelled, what are the timeframes and claw back provisions
- Statement of principles for new recruits re variable pay
- Statement of principles for loss of office and its impact on variable pay

UK regulations: reporting and voting on policy and practice (cont'd)

Practice report – key requirements

- Total remuneration paid to each exec in current and preceding year, relevant performance measures, relative weighting, performance targets and actual performance vs. targets
- New awards with face value, threshold and minimum vesting value and associated performance measures and targets
- Tabular comparison of total CEO rem vs. company TSR
- Comparison of % change in remuneration of the CEO vs. all employees or an appropriate comparator group
- Relative comparison between all employee pay and distributions to shareholders during the year

Johnson and Johnson: a turnaround re Say on Pay vote 2012 vs. 2013

2012	▶ Barely passed the SOP vote at 57%
2013	▶ Achieved a 94% SOP vote ▶ Achieved turnaround via meetings with institutional investors and proxy advisors to discus the company's executive reward and to better understand the underlying reasons for the poor vote in 2012
	In 2013, addressed the concerns identified in the feedback: ▶ Provided compensation highlights and changes to compensation in an easy to understand manner ▶ Revised the CEO's pay to a more appropriate level ▶ Reduced annual performance bonuses for execs by 10% ▶ Eliminated positioning pay at an above median target ▶ Eliminated all non-relocation tax gross ups ▶ Implemented a new performance-based LTIP with payouts contingent on the achievement of specific financial goals ▶ Revised stock ownership such that CEO must own 6 x base ▶ Added share retention requirements ▶ Introduced claw back

Trends in Ireland

- Among the ISEQ organisations, share option plans are the most common LTIP vehicle in place however for 2011/2012 , PSPs were the most common granted share plan (63% vs. 38% via share option plans)
- Performance conditions linked to vesting are predominantly TSR and/or EPS
- Performance measures include industry specific measures (health and safety), ROIC, cash flow measures, ROCE and share price growth

What next

Back to basics

- Overall pay philosophy
- Consider each of the 4 elements of reward
- Identify variable pay link to business strategy
- Consider holistic approach to performance – financial and non financial criteria
- Include relative and absolute performance
- Include internal and external performance
- Achieving milestones and measures to capture returns
- Ensure pay in practice linked to business performance

Thank you

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