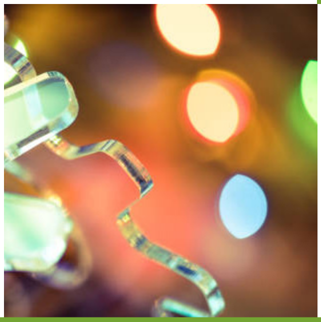
Pearl Meyer

RESEARCH REPORT

Overlap of Executive Incentive Plan Performance Measures: Is the Concern Warranted?



THANK YOU TO OUR RESEARCH COLLABORATOR:

Cornell University

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Introduction

The selection of goals and metrics related to incentive plans is a core element of effective executive compensation plan design. Pearl Meyer advises clients to identify their unique combination of goals and metrics that will drive value creation for the organization, both in the short term and in the long term. In some cases, that might necessitate the use of one particular measure across multiple time horizons.

However, over the past six to seven years, there has been an increase in scrutiny from both major proxy advisors, Glass Lewis and ISS, when the same performance measures are used in both short- and long-term incentive plans. There is some concern that this practice may allow for a high level of pay-out (or lack thereof) for performance against similar metrics or may overly focus executives on a single dimension of performance.

Given the criticality of performance measure selection in compensation plan design and the absence of data on the issue from the proxy advisors, we felt it was important to understand if this idea of “redundant metrics” or “performance measure overlap” is in fact a problem or a fallacy.

Relying on data from Main Data Group and working with the Institute for Compensation Studies (ICS) at Cornell University’s Industrial & Labor Relations School, we set out to answer whether or not investors should be concerned with what we refer to as performance measurement overlap. At a high level, this research study focuses on four specific questions:

1. How has performance measurement overlap changed over time?
2. Is there any difference in pay based on the use of overlapping performance measures?
3. How much pay is actually tied to overlapping performance measures?
4. Are there any differences in firm performance based on the use of overlapping performance measures?

Our hypothesis was two-fold: first, that statistical modeling would not support the proxy advisors’ position that this practice is potentially problematic and second, that we would find no statistically significant difference in firm performance for companies who used overlapping performance measures.

Brett Herand
Principal, Pearl Meyer

Summary Findings from our Study

- **Prevalence of Performance Measure Overlap:** The number of companies with performance measure overlap steadily increased over the 2012- 2016 time period but leveled off in 2017, with data suggesting that almost half of companies have some performance measurement overlap across their short- and long-term incentive plans.
- **More Overlapping Metrics = More Pay?** Companies with the highest target pay *opportunities* had more overlapping performance measure categories, suggesting that there may be some kernel of validity to the proxy advisors' positions. However, this does not account for the portion of pay *delivered* in overlapping metric categories which actually declined.
- **A Decline in the Percent of Pay Tied to Overlapping Metrics:** For those companies with overlapping performance measures, approximately 55% of variable pay is delivered in overlapping performance measures and slightly more than 30% of total pay is delivered in overlapping performance measures. The percent of both variable pay and total pay tied to the overlapping measures has declined, which could suggest that perhaps companies have been responding to the proxy advisors' critiques by reducing the portion of pay tied to a similar set of measures.
- **No Impact on Relative TSR Performance:** The study evaluated the effects of performance measurement overlap on several dimensions of firm performance. Most interesting: no relationship of performance measurement overlap on total shareholder return was observed. A modest but statistically significant correlation of performance measurement overlap to lower operating income growth in future years was observed. No other meaningful relationships between performance measure overlap and firm performance were observed.

Implications on Executive Pay Design

Findings from this study do not affect the existing principles of sound incentive plan design and executive pay decision-making. In reality, the findings underscore what Pearl Meyer has long known and advised our clients: there are no silver bullets and to this point, we espouse several foundational incentive design principles:

- Plans must support the company's compensation philosophy, leadership strategy, and cultural foundations;
- Incentive designs must balance simplicity with accuracy to ensure clarity of message and provide rough justice between pay and performance; and
- Performance measures must reinforce key organizational messages, demonstrate vertical and operational line of sight, and should align with key drivers of value.

> "Plans must support the company's compensation philosophy, leadership strategy, and cultural foundations."

Business leaders know there are multiple paths to value creation and that some of those paths may intersect. This can result in using similar performance measures across the measurement framework. It is also understood that certain measures have different value propositions when measured over different time periods. It is this idea that should lead companies through the performance measure selection process and allow the company to identify, on balance, the right combination of performance measures to drive performance and execute against strategic objectives.

Study Methodology

The data set for this exercise was provided by Main Data Group and covered CEOs at 459 companies from the current S&P 500. This longitudinal study covers pay and performance for 2012 through 2017, which includes the time period before and after the proxy advisors began commenting on overlapping performance measures. For each company, the portion of target variable pay, and the portion of target total pay tied to each performance measure was analyzed.

The proxy advisors' narratives generally focus on instances in which a company uses the same measure in both a short- and long-term incentive (STI and LTI) plan. In practice, companies can and do work around the performance measure overlap issue by using different measures that essentially track the same dimension of performance. Using EBITDA in a short-term plan and then using operating income in a long-term plan is an example of this. We captured this work-around by grouping performance measures into categories based on the dimension of performance that is measured.

Main Data Group tracks 59 different performance measures, each of which is classified into one of 12 categories based on the dimension of performance measured. Those 12 categories included:

BALANCE SHEET	ECONOMIC PROFIT	OTHER
BOTTOM-LINE PROFITABILITY	MARGIN	RETURN
CASH FLOW	MARKET (INCLUDING TSR)	TOP-LINE
DRIVER	MID-STREAM PROFITABILITY	WORKING CAPITAL

If a company had a measure in its short-term plan and a measure in the long-term plan that were in the same category, then that company was considered to have "performance measure overlap," even if the measures were not identical. For example, a company that measured one-year pre-tax income in their STI plan and three-year EPS in their LTI plan would be considered to have performance measure overlap, as both measures capture bottom-line profitability.

We calculate the percentage of pay considered to overlap as follows:

- As a percentage of variable pay: target total pay tied to overlapping measures as a percent of target variable pay. In this definition, variable pay only includes cash or equity-based opportunities tied to a specific performance measure (i.e., does not include stock options or RSUs).
- As a percentage of total pay: the target total pay tied to overlapping measures as a percent of target total pay.

A sample calculation of performance measure overlap:

ELEMENT	OPPORTUNITY	PERCENTAGE OF TARGET VARIABLE PAY	PERCENTAGE OF TARGET TOTAL PAY
Base Salary	$1,000,000	-	20%
Target STI	$1,000,000	-	
1-year pre-tax income	$500,000	20%	10%
1-year ROE	$500,000	20%	10%
Stock Option Fair Value	$1,000,000	-	20%
Restricted Stock Unity Fair Value	$500,000	-	10%
Performance Share Fair Value	$1,500,000	-	-
3-year cumulative EPS	$750,000	30%	15%
3-year relative TSR	$750,000	30%	15%
TARGET VARIABLE PAY	**$2,500,000**		
PAY	**$5,000,000**		

50% of target variable pay is delivered in overlapping performance measures: 20% from pre-tax income in the STI plan and 30% from 3-year cumulative EPS in the PSU plan

25% of target total pay is delivered in overlapping performance measures: 10% from pre-tax income in the STI plan and 15% from 3-year cumulative EPS in the PSU plan

Relative performance measures are a special case and were generally not considered to overlap with absolute performance measures in the same category, as funding on a relative performance measure can diverge from funding on an absolute performance measure (i.e., funding on one can go up while funding on the other can go down). As such, even though a company may use the same measure in both a short-term and long-term plan, it may not overlap if one of the measures is used on a relative performance basis.

Finally, statistics regarding the use of overlapping performance measures were modeled against various measures of firm performance over different time periods to understand whether there was anything to be gained (or lost) from the use of performance measurement overlap. Data on firm performance was sourced from CapitalIQ.

Detailed Findings

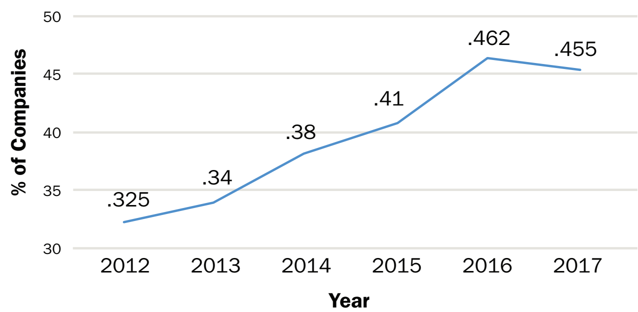
Prevalence of Performance Measure Overlap

As shown in Figure 1, the number of companies with any performance measure overlap steadily increased over the 2012 – 2016 time period but leveled off in 2017. The data suggest that almost half of companies have some performance measurement overlap across their short- and long-term incentive plans. Both the increasing and absolute prevalence of performance measure overlap is not surprising. We attribute this to the following:

1. While annual incentive plans generally have more performance measures and incorporate broader dimensions of performance, nearly every company has some type of profitability metric in their annual incentive plan;
2. For various reasons, the prevalence of performance shares has steadily increased to the point of near total saturation amongst large cap companies and is now the most common LTI vehicle;
3. Companies have pulled back and changed the way that total shareholder return is used, changing relative total shareholder return from a weighted metric to a modifier metric or reducing the weight of relative total shareholder return and introducing new metrics; and
4. Long-term incentive plans generally have fewer performance measures than annual incentive plans and those measures cover fewer dimensions of performance, generally focusing on key profitability metrics, return metrics, or total shareholder return.

This has naturally resulted in increased use of performance measure overlap and the proxy advisors should not be surprised by this shift.

Fig. 1: Percent of Companies with Performance Measure Overlap



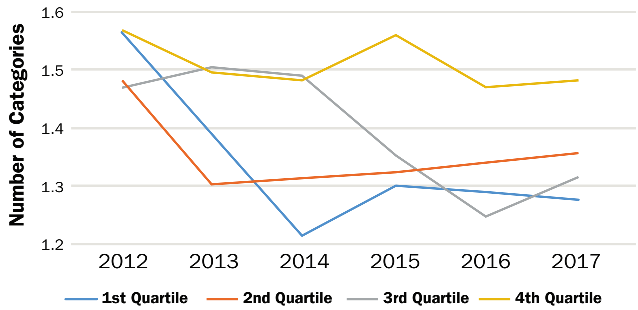
More Overlapping Metric Categories = More Pay?

Figure 2 shows the relationship between the number of performance measure categories with overlap and levels of CEO target total direct compensation. It shows that for each year covered by the study, the companies with the most categories with performance measure overlap had the highest target total direct compensation.

This exhibit is interesting not for what it proves but for what it does not prove. One might conclude that this proves the proxy advisors are correct and that performance measure overlap may lead to higher pay; however, this argument ignores two important pieces of data:

1. Most importantly, it does not consider how much pay is delivered in the category with overlapping performance measures. The proxy advisors do not differentiate in their commentary between a company that delivers 5% of pay in overlapping performance metrics from a company that delivers 50% of pay in overlapping performance metrics.
2. It does nothing to control for performance goal degree of difficulty. Companies with higher target CEO pay and more categories for which we observed overlap could have more aggressive performance goals which could result in the same level of pay as those companies without performance measure overlap.

Fig. 2: Average Number of Metric Categories with Overlapping Performance Measures by Company



A Decline in the Percent of Pay Tied to Overlapping Metrics

Figure 3 fills in one of the missing data points and looks at the percent of variable pay and percentage of total pay delivered in overlapping performance metrics at companies with performance measure overlap.

It shows:

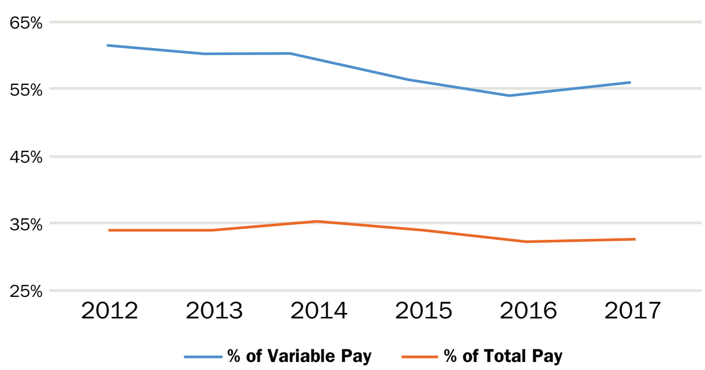
1. That in 2017, approximately 55% of variable pay is delivered in overlapping performance measures and slightly more than 30% of total pay is delivered in overlapping performance measures; and
2. A gradual but meaningful decline in the percentage of pay delivered in overlapping metric categories, suggesting increased performance measure diversification and reduced overlap.

This increased performance metric diversification may be due to:

1. Companies being exceedingly thoughtful when making changes to the measurement frameworks and identifying and selecting new metrics, and/or;
2. Companies responding to proxy advisor scrutiny around the use of the same or similar performance measures.

In any case, the proxy advisors' approach to considering performance measure overlap is overly simplistic. Should shareholders be concerned if only 5% of total pay is delivered in overlapping performance measures? That the proxy advisors do not explicitly consider this in their commentary is troubling.

Fig. 3: Percent of Pay Delivered in Overlapping Performance Measures for those Companies with Performance Measure Overlap



No Relationship to Firm Performance

Using advanced statistical modeling tools, Cornell's ICS team quantified the relationship between performance measure overlap and firm performance. This relationship was tested across a number of performance measures and over various time periods to understand whether there was anything to be gained (or lost) on a relative performance basis from performance measure overlap.

As part of this process to test for relationships between performance measure overlap and firm performance, ICS controlled for certain variables and tested the link on both a concurrent basis and with one-year and two-year time lags to understand whether the presence of performance measure overlap would have an impact on firm performance in future years.

The table below covers, in total, the time lags, the control variables, measures of firm performance, and length of period for which firm performance was assessed for each statistical model specified. When all is said and done—and after accounting for all dependent, control, and independent variables—ICS tested the relationship between performance measure overlap and firm performance across 210 different statistical models.

Focusing on total shareholder returns first, ICS found no evidence that there is any type of relationship between performance measure overlap and total shareholder return.

In moving to the assessment of firm performance using the non-TSR performance metrics, the statistical models showed uncompelling evidence of any kind that there is any type of relationship between performance measure overlap and firm performance. Four out of 210 models (less than 2%) demonstrated statistically significant relationships between performance measure overlap and firm performance; however, based on 1) the absolute number of regression pairs tested and 2) the only common themes across the full battery of regression tests was that there was no relationship between firm performance and performance measure overlap, the ICS team believes this to be an issue of spurious correlation (i.e., correlation due to chance).

Pearl Meyer generally finds ICS's statistical conclusions to be reassuring in that we did not expect to find much, if anything, that would suggest a link between performance measure overlap and firm performance.

TIME LAGS	CONTROL VARIABLES	MEASURES OF FIRM PERFORMANCE	PERFORMANCE ASSESSMENT PERIOD
CONCURRENT	CEO tenure	Total shareholder return	1-year
1-YEAR LAG	CEO new in role	Revenue growth	2-year
2-YEAR LAG	Market capitalization	Free cash flow growth	3-year
	Year-fixed effects	Operating income growth	
	Firm-fixed effects	Net income growth	
		Return on equity	
		Return on invested capital	

In Closing

We continue to view the proxy advisors' positions on this issue with more than a heavy dose of skepticism and we believe our clients should as well. The one-size-fits-all approach that proxy advisors generally take with respect to executive compensation continues to break down when subjected to a high degree of analytical scrutiny and in the boardrooms where real decisions are made around compensation plan designs as tools of strategy execution.

It bears repeating that Pearl Meyer does not view overlapping performance measures as an issue, as business leaders understand there are multiple paths to value creation and that certain measures, when assessed over different time periods, provide multiple signals as to underlying firm performance. In any case, the incentive design process should be supported by a rigorous assessment of key performance drivers and the time period over which that performance should be assessed.

“There are multiple paths to value creation and certain measures, when assessed over different time periods, provide multiple signals as to underlying firm performance.

Appendix

The Research Teams

Numerous individuals contributed to this investigation. Pearl Meyer's team included Brett Herand as the project lead, along with David Swinford, Beth Florin, Mark Rosen, Jan Koors, Steve Van Putten, Pete Lupo, Greg Stoeckel, David Bixby, and Terry Newth. Hassan Enayati and Linda Barrington of the Institute for Compensation Studies at Cornell University's Industrial & Labor Relations School provided invaluable research and analysis. Main Data Group provided all data for the study.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, Raleigh, and San Jose.

About Main Data Group

Main Data Group is a provider of executive compensation benchmarking and corporate governance analytics. Its mission is to empower executive compensation professionals with comprehensive total rewards and corporate governance information in an affordable, easy-to-use online service.

About ICS

The Institute for Compensation Studies™ (ICS) is an interdisciplinary center housed jointly in the ILR School and the SC Johnson College of Business at Cornell University. Founded in 2010 by Professor Kevin F. Hallock, its mission is to improve the teaching, research, practice and public discourse around compensation and rewards to work.

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