Annual Pay-For-Performance and Long-Term Sustainable Results

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Introduction

By most indications, the economy is showing signs of strengthening at the time of this research. The Gross Domestic Product (GDP) in the United States expanded at an annual rate of 2.0% percent as of the end of the third quarter 2013, with the national unemployment rate hovering at 6.7%, and home sales improving, albeit at a sluggish rate.

In tandem with this growth, we are seeing some executive pay-for-performance plans result in payouts above target. This paper will examine the magnitude of these payouts relative to the longer term sustainable performance indicator of the three-year Total Shareholder Return (TSR). Medium sized companies, with market capitalization of $1 billion to $5 billion across all industry segments, are the basis of our analysis. As part of the analytics rigor, mean and median Non-Equity Incentive Plan (NEIP) payouts are compared between two groups - the 100 companies with the highest NEIP payouts and the remaining mid-cap companies referred to as "Other." Financial analytics from 10-K filings are calculated and reviewed as part of the holistic compensation research conducted for this paper. We also provide insight into the performance measures used by these Top 100 companies.

Payout Levels

The sample size included for this research was 352 companies. The Top 100 companies were segmented based on the highest above-target NEIP payout as disclosed in the Summary Compensation Table (SCT) for year-end 2012. The 2013 proxy statements are not all available at the time of this research, as companies generally make them available three to six months after their fiscal year end. For this reason, we chose 2012 being the most "complete" year we could analyze. For the purpose of this analysis, "above-target" refers to a measure of NEIP payout relative to the plan target values disclosed in the Grants of Plan-Based Awards Table (GPBAT). The Top 100 NEIP payouts were compared by calculating the percentage difference for each CEO as follows:

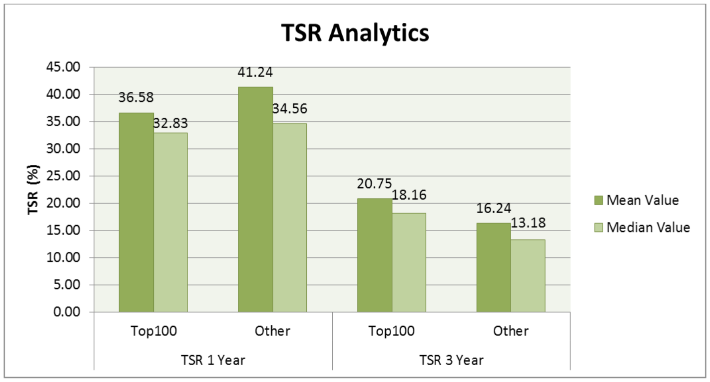
$$\frac{\text{(Actual 2012 NEIP Value from SCT) minus (NEIP Target from GPBAT)}}{\text{(NEIP Target from GPBAT)}}$$

Since cash incentive payouts directly affect the bottom line, many companies will have a net income (or similar) financial target tied to the funding of the NEIP before any payouts are made. The table below summarizes the NEIP payouts relative to Target and Net Income.

The research shows that median CEO NEIP payout in 2012 for the Top 100 companies was 90.18% above target, and the mean was 150.01%, with $1,598,860 and $1,821,588 payout amounts respectively. The median CEO NEIP payout for the rest of the mid-caps was exactly at the target, while the mean was 4.46% below target. The percent difference between the median and mean results for the NEIP payouts and Net Income were greater for the Other group, -20.62% and -22.35% respectively. The Top 100 companies NEIP actual payout as a percent of net income has a median value 1.33%, almost double the 0.70% median value for the Other companies. A similar result was observed for the mean value, except at lower percentages (e.g. 1.25% and 0.68% respectively).

Long-Term Sustainability

When analyzing the TSR for both one year and three years as of fiscal year end 2012, research showed that the Top 100 companies achieved slightly smaller TSR values over one year than the Other group of companies. Yet the Top 100 achieved higher TSR values over the longer three year period.

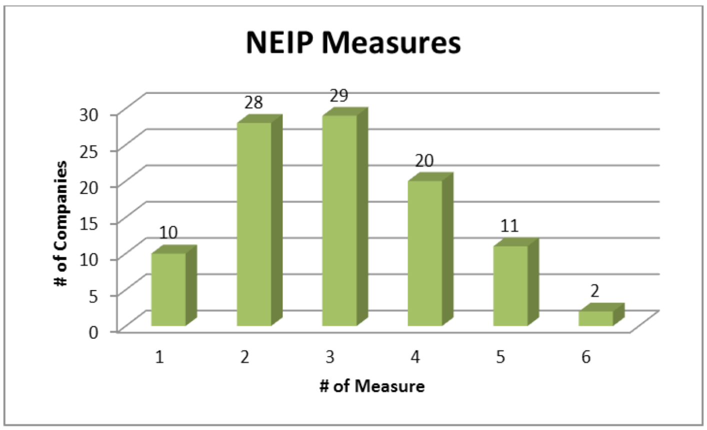


	Median		Mean		% Difference	
	Top100	Other	Top100	Other	Top 100	Other
Nonequity Incentive	$ 1,598,860	$ 638,790	$ 1,821,588	$ 804,705	-12.23%	-20.62%
Net Income	$ 119,773,000	$ 91,263,500	$ 145,508,700	$ 117,524,472	-17.69%	-22.35%
% Payout Relative to Target	90.18%	0%	150.01%	-4.46%		
NEIP Payout as % of NI	1.33%	0.70%	1.25%	0.68%		

The percentage difference for medians for one year TSR was slightly higher by 5% for the Other group of than the Top 100 companies. The median three year TSR for the Top 100 group was 18.16, while the median value for the Other group was 13.18, resulting in a percentage difference that was 38% higher. This analysis supports investors' preferences and board members' need to demonstrate short-term results to be directly linked to long-term sustainability of business performance. The higher annual NEIP payouts for the Top 100 companies are accompanied by corresponding higher 3 year TSR results based on this study.

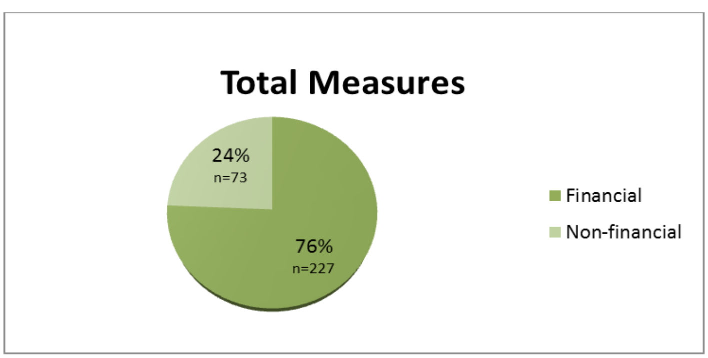
Performance Measures

A number of factors affect the alignment of incentive plans and business performance. The long standing adage pertaining to pay-for-performance plans is to keep them simple and provide a direct line of sight to the results (e.g., those participating in the plan should have "control" in achieving the results). For the Top 100 companies in this study, we analyzed how many measures were used in the NEIPs and which measures were the most prevalent.

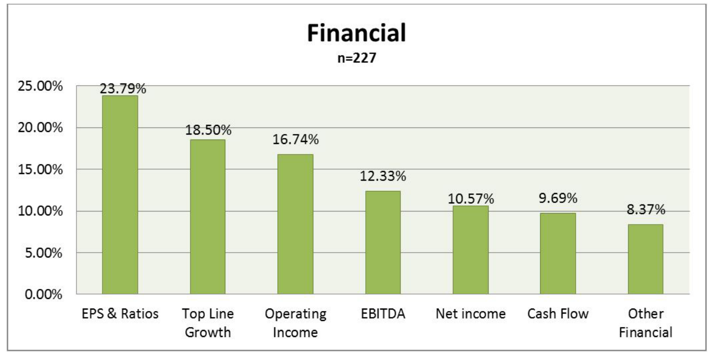


Of the Top 100 companies, three was the number of NEIP measures most commonly used (29 of the 100 companies) and two measures was the second most common (28 companies). Companies need to strike a balance between having too many and too few measures, as either extreme can lead to misalignment or business results.

There were a total of 300 measures extracted from the proxy statements of the Top 100 companies. In reviewing the specific measures, we segmented them into financial and non-financial categories.



The non-financial measures were generally characterized as individual and/or strategic goals, which included goals like IT infrastructure, succession planning, customer service, research and development, or safety and quality. For the financial measures, we further clustered them into more granular categories.



The most prevalent type of financial measure is EPS* and other ratios like ROIC, ROE and ROA, followed by revenue or sales that focused on top line growth, operating income, EBITDA , net income, and cash flow. In the Other Financial category, the measures were industry-specific or unique to a company's short-term goals, such as expense/unit to working capital as % of sales, access to capital markets, and balance sheets. Surprising in these overall findings is the use of EPS and ratios for short-term results since they generally are more effective for measuring longer term performance over multiple periods.

Summary

The Top 100 Mid Cap companies with the highest NEIP payouts also achieved higher three year TSR values than the Other 252 companies included in the study. Organizations that have effective short-term measures that correlate with long-term metrics like TSR can be invaluable in demonstrating to key constituents that executive compensation programs are aligned with their interests.

For more information about executive compensation analytics, please contact ERI Economic Research Institute at 1-800-627-3697 or visit www.erier.com.

*EPS = Earnings Per Share

ROIC = Return On Invested Capital

ROE = Return On Equity

ROA = Return On Assets

EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization