The New ISS Pay-for-Performance Methodology – A Closer Look at the Gathering Storm

As the 2017 proxy season winds down, it is becoming evident that one of the more pressing challenges companies are likely to face in the years ahead centers on how Institutional Shareholder Services, Inc. ("ISS") intends to evaluate the perceived correlation between a company's performance and its senior executives' compensation. Just as companies were becoming comfortable with the mechanics of its existing "pay-for-performance" methodology, ISS has introduced a new assessment tool that has the potential to radically alter how it evaluates the alignment of pay and performance. While at this time it is unclear how this tool will be incorporated into the "pay-for-performance" methodology in its 2018 proxy reports, our experience offers some intriguing clues as to its possible impact.

Five Things That Technology and Life Sciences Companies Should Know About the New ISS Pay-for-Performance Methodology

1. **Methodology Likely to be Added to Quantitative "Pay-for-Performance" Analysis for the 2018 Proxy Season.** While introduced in the 2017 proxy season on an "informational" basis, ISS is considering incorporating the methodology as part of its relative assessment of the degree of alignment between CEO and company performance.

2. **Methodology Adds Up to Six Financial Metrics to Current Relative Assessment of CEO Pay and Company's Financial Performance.** The new financial metrics are ROIC, ROA, ROE, EBITDA, cash flow growth, and revenue growth, plus TSR.

3. **Methodology is Opaque.** While ISS disclosed the rankings of the new financial metrics for each GICS code-defined industry group during the 2017 proxy season, it did not disclose their weighting. Absent this information, companies will be unable to forecast their likely standing under the new methodology. Instead, they will need to engage ISS for this information.

4. **Rankings of Financial Metrics May Vary Significantly from Metrics Used in Incentive Plans.** ISS' rankings for the 2017 proxy season emphasized return metrics. For many technology and life sciences companies, which tend to use top-line metrics (such as revenue, bookings, and TSR) in their LTI programs to promote growth, this may lead to perceived pay and performance "misalignments."

5. **Methodology Likely to Necessitate Additional Disclosure in CD&A.** ISS' long-standing "one-size-fits-all" approach reflected in its analytical tools will likely compel companies that don't emphasize ISS-prioritized financial metrics to explain – and justify – why. Further, as a result of the highlighting of these seven metrics, companies may feel pressure to address their financial performance (whether strong or weak) across multiple measures to respond to the additional perspectives that will now become a standard component of an ISS analysis.

Background

To date, ISS has evaluated the executive compensation programs of Russell 3000E index companies largely on the basis of whether the program demonstrated a strong alignment of pay with performance using a two-part test. This methodology consists of an initial quantitative assessment (or "screen") involving two relative and one absolute measures of alignment:

- **Multiple of Median ("MOM") Test** – a relative measure that calculates the CEO's compensation for the most recent fiscal year as a multiple of the median CEO compensation of an ISS-defined peer group for the most recent fiscal year;
- **Relative Degree of Alignment ("RDA") Test** – a relative measure where the magnitude of the compensation paid to the CEO

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and the degree of alignment with the company's total shareholder return ("TSR") is evaluated by reference to the ISS-defined peer group over the most recent three fiscal years; and

- **Pay-TSR Alignment ("PTS") Test** – an absolute measure, where alignment is evaluated by comparing CEO pay and the company's TSR over the most recent five fiscal years.

ISS then conducts a qualitative review (which can be extensive if the results of the quantitative "screen" indicate a "high" or "medium" level of concern about pay-for-performance alignment) to determine either the likely cause of any perceived pay and performance disconnect, or factors that mitigate the initial assessment.

Starting in the 2017 proxy season, in response to concerns about the growing use of TSR as the predominant measure in incentive compensation plan design, as well as growing criticism of its key role in the pay-for-performance analysis, ISS introduced a new standardized methodology comparing a company's CEO pay and financial performance ranking (based on up to six financial metrics as well as TSR) relative to the competitive market (as defined by an ISS-constructed peer group).

Going forward, we believe that ISS may incorporate this multi-factor relative CEO pay and financial/TSR assessment into its quantitative "screen" in 2018 (perhaps replacing the RDA test). To prepare for the potential heightened impact of this new methodology, we recommend that companies familiarize themselves with its intricacies.

The New "Pay-for-Performance" Methodology

During the 2017 season, ISS disclosed the results of its new relative CEO pay and financial/TSR assessment in its proxy analysis and voting recommendations reports. Where a perceived misalignment between pay and performance has been identified, ISS factors the new assessment into its qualitative review of an executive compensation program. In our experience, however, the assessment has had a relatively minor impact on the outcome of this qualitative review to date.

Financial Metrics to be Evaluated

The new methodology compares a company's reported financial and operational performance versus its ISS-defined peer group across up to six financial metrics and TSR:

- Return on invested capital ("ROIC");
- Return on assets ("ROA");
- Return on equity ("ROE");
- EBITDA growth;
- Cash flow (from operations) growth;
- Revenue growth; and
- Total shareholder return.

Assessment Mechanics

More specifically, the methodology operates as follows:

- **Metrics used vary by industry** – The relative ranking of each metric varies among industry groups (as defined by their four-digit Global Industrial Classification Standard-generated ("GICS") codes). Moreover, not all industries will use all metrics. Each company is ranked against its ISS-defined peer group across each applicable metric.
- **Performance measured over three-year period** – The performance reviewed for each company will generally be measured using the 12 most recent trailing fiscal quarters (16 quarters for growth metrics) as of ISS' quarterly data download from Compustat (for example, March 1st, June 1st, September 1st, or December 1st of each year depending on the timing of the company's annual meeting of shareholders). Consequently, assessed company performance will generally differ from the company's performance in its most recent fiscal year. In no event will the measurement period be less than two years.
- **Only GAAP metrics used** – To provide for a comparison across all companies, the assessment uses GAAP (as reported by Standard & Poor's), rather than adjusted, performance results. Consequently, results may differ materially with how companies measure their own performance.
- **Rankings combined into weighted-average performance rank** – The rankings and related weightings of each performance metric are based on a com-

pany's industry, as developed by ISS using an historical analysis of certain pre-determined company factors.

- **Performance rank then compared to CEO pay rank** – Similar to the current RDA test, this exercise produces a numerical score ranging from -100 to +100, with -100 representing "high" perceived pay for "low" perceived performance (as in the RDA test). A negative result indicates that the CEO pay rank is greater than the weighted average financial performance rank. Conversely, a positive score means that the CEO pay rank is below the company's weighted average financial performance rank.
- **Relative financial performance result compared to a historical industry group** – For 2017, ISS also compares the financial performance result to the universe of companies that are in the company's industry group and that have received the same quantitative concern level in the existing quantitative pay-for-performance screen. The resulting assessment displays the percentage of companies the subject company performed "better than," based on a comparison to these companies.

Impact on Technology and Life Sciences Companies

While the introduction of the new relative CEO pay and financial/TSR assessment addresses a number of the criticisms of ISS' exclusive use of TSR to evaluate company performance, it is not without its own issues. In the case of technology and life sciences companies, we believe that the methodology will present the following challenges:

- **Forecasting assessment results will be difficult** – As currently presented, the assessment does not disclose the relative weighting of each of the financial metrics actually used in determining a company's overall ranking. Consequently, companies are unable to forecast their likely standing under the assessment. For companies that are concerned about how they are likely to fare under the new methodology in 2018, it may be advisable to retain ISS and purchase access to their advisory services to run the calculations in advance of making CEO pay decisions and/or filing their proxy statement.
- **Ranking of metrics may differ significantly with incentive plan metrics** – For 2017, ISS discloses the current rankings of each of the seven enumerated financial metrics, but not their weighting. For 2017, ISS ranks the performance measures for technology and life sciences companies as reflected in the table at the bottom of this page.

  Several of these rankings are at odds with the financial metrics that many technology and life sciences companies use in their incentive programs. For example, numerous small, mid, and large-cap companies, use top-line metrics such as revenue, bookings, and TSR in their incentive plans consistent with their growth profiles and business strategy. These metrics are currently ranked at the bottom of the list for technology and life sciences companies. Conversely, in our experience, ISS' favored metrics (ROIC, ROE, and ROA) are not commonly used by technology companies. In a recent Compensia review of the performance share award practices of approximately 130 public technology companies, only one of these companies used one of these return metrics, 36% disclosed the use of revenue, and 55% used relative or absolute stock price goals (either as the sole metric or in combination with other metrics).

GICS – Industry	Total Shareholder Return	Return on Equity	Return on Assets	Return on Invested Capital	Cash Flow Growth	Revenue Growth	EBITDA Growth
3510 – Health Care Equipment & Services	7	4	3	2	5	6	1
3520 – Pharmaceuticals, Biotechnology & Life Sciences	6	4	3	1	5	7	2
4510 – Software & Services	6	3	2	1	5	7	4
4520 – Technology Hardware & Equipment	1	4 (tied)	2 (tied)	2 (tied)	6	7	4 (tied)
4530 – Semiconductors & Semiconductor Equipment	5	3	2	1	4	6	N/A

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While ISS may change these rankings in 2018, it is important to note that, in any given year, ISS' view on the relative importance of these metrics may not match a Board of Directors' long-term objectives for its executive team, creating obvious potential for a disconnect.

- **CD&A disclosure may need re-thinking** – Accordingly, it will be incumbent on the company to draft disclosure that clearly and persuasively explains the reasons for its incentive program design and why ISS' analysis may or may not be relevant in understanding its pay-for-performance alignment. It may also be necessary to provide more detail about the company's overall financial performance (for example, growth strategy, reasons for focusing on top-line results, rationale for weaker bottom-line results, etc.), which could shift the principal message of the executive summary of the Compensation Discussion and Analysis from one of compensation to one of performance.
- **Rankings of metrics do not vary within industry designations** – The new methodology does not consider a company's stage of development, size, value, or growth profile, all factors which are often critical when selecting the performance metrics for an incentive plan. For example, an S&P 500 software company will be evaluated using the same ranked metrics as a much smaller Russell 3000 software company. Thus, while ISS' ranking decisions may be more appropriate for large companies within an industry group (for example, ROIC/ROA/ROE (which are currently ranked first, second, and third) for a large software company), they may be much less relevant to other segments of the group. In sum, a "one size fits all" approach here is likely to lead to many anomalous outcomes.
- **Exclusive reliance on GAAP financial results** – An additional feature of the new methodology is ISS' rigid adherence to GAAP results for each of its selected performance metrics. As a result, the conclusions reached by the ISS' assessment may not correspond to how a Board of Directors evaluates a company's financial results (where the use of non-GAAP financial metrics is commonly considered to be a more accurate gauge of the company's performance). Inevitably, this may lead to a significant disconnect between the perceived performance outcomes as determined by ISS versus a company's own management, Board of Directors, and shareholders.
- **Exclusive reliance on self-defined peer group** – Since the relative comparison under the new methodology is made against ISS' self-constructed peer group, the current concerns with how ISS selects these peers may be magnified by the new assessment.

Final Observations

Several of the decisions that ISS made in crafting a streamlined (but increasingly opaque) process for implementing a new relative CEO pay and financial/TSR methodology that can be applied to every company may turn out to be problematic. For example, the absence of any differentiation based on company size or development stage will likely force companies to explain – and defend – why they have selected financial metrics for their incentive plans that vary from or are on the low end of the range of the published ISS rankings. In addition, given the influence that ISS wields today, companies may feel pressure to justify their metric choices against each of the ISS-selected metrics irrespective of their ranking. Finally, just as ISS was a catalyst in the move to TSR, it's entirely possible that Boards of Directors will be reluctant to select company-specific metrics, such as non-GAAP financial measures or strategic performance objectives, for their incentive plans if they believe that they are likely to be second-guessed or, even worse, saddled with a high level of concern for an alleged pay-for-performance "disconnect."

Each of these scenarios raises the need for additional disclosure – either to justify the performance metrics selected or to provide the broader context in which these decisions were made. While, in a few instances, this may facilitate a better understanding of how a company's incentive plan has been designed to drive the organization's key business objectives, it is more likely to force companies to burden their disclosure with responses to ISS' analytics instead of explaining their compensation decisions.

Need Assistance?

Compensia has significant experience in helping companies understand and address ISS' corporate governance and executive compensation policies. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance is assessing how the policies are likely to affect your executive compensation program, please feel free to contact us. ■

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