Revisiting Relative TSR

Over the last several years, we have witnessed a dramatic increase in the prevalence of equity awards with vesting tied to relative total shareholder return ("TSR"). Although relative TSR performance shares only emerged as an equity compensation alternative within the last decade, they are now widely used. Our own client experience as well as broader market research suggests that relative TSR is now the most common measure used for performance-based equity awards, with prevalence approaching 50% among mid-cap and large-cap public companies.

This trend has been driven by some key benefits of relative TSR plans , which we previously discussed in our May 2012 Thoughtful Pay Alert, Executive Long-Term Incentives.

In particular, relative TSR plans:

- Are less fragile than stock options and traditional performance share awards, satisfying motivation and retention objectives in both rising and declining markets
- Provide an unambiguous link to shareholder value, with outcomes that are not driven by overachievement against low expectations
- Do not require long-term financial projections, , which is particularly useful for less predictable, growth-oriented technology and life sciences companies
- Can deliver stock option levels of leverage
- Offer a performance measure that is distinct from those included in most annual cash incentive plans

Relative TSR plans also have critics, however. Both publicly and in compensation committee meetings, we hear the following objections:

- Executives can't control shareholder return
- Reliance on "point-in-time" measurement of shareholder return leaves outcomes exposed to randomness
- Relative total shareholder return rewards volatility more than sustained performance
- Companies that underperform long-term can spike on a relative basis when starting from a low point

There is merit to these concerns and it is clear that relative TSR is not always a perfect approach. In addition, it would not be appropriate to implement a relative TSR plan simply because it is popular, easy to understand, or viewed favorably by the major proxy advisory firms (particularly Institutional Shareholder Services, Inc. ("ISS")). Having said that, we believe there are situations where, when designed appropriately, relative TSR plans can be an effective component of the executive total reward profile.

With that in mind, this Thoughtful Pay Alert revisits the role of relative TSR in executive compensation and considers the key design choices that can make for a more or less successful plan. In particular, we focus on two broad questions, which are critical points to address for any company currently granting or considering the addition of relative TSR performance share awards:

1. Are we granting relative TSR performance share awards for the right reasons?
2. Does our design minimize unintended outcomes and maximize the alignment of pay and performance for the desired time horizon of performance measurement?

Understanding the Objectives

An important starting point with relative TSR is to recognize that it will not serve as a roadmap for decision-making. In addition, relative TSR is not a measure that works well for "shoot-the-moon" strategies, or "big hairy audacious goals," to borrow a phrase from Jim Collins' *Good to Great*. Put differently, "outperforming the S&P 500" may not have the same ring as "we're going to double revenue in three years!"

However, for these situations and objectives, we also have short-term incentive plans and companies can grant more than one form of equity award. In addition, leadership teams do not always manage this way and company goals can be reinforced outside of incentive compensation plans. Finally, it is worth noting that there can be risk in micromanaging executive decision-making through precise incentives, particularly over a long-term time horizon.

Among many examples, we most recently learned this lesson watching the financial services sector push for earnings and return on equity while the underlying quality of its loan portfolios crumbled. There are also less extreme examples of incentives that end up working against desired behavior. Consider a plan that calls for increasing profit margins over a multi-year time horizon for a company that later chooses to change its product mix. These examples highlight the potential for relative TSR as an effective approach for measuring performance with the benefit of a more open-ended view on how results are achieved over time.

Getting the Design Right

If the program objectives are reasonable and expectations are clear, the second key step for success with relative TSR is calibrating the design features correctly. The most important considerations for ensuring that your company's program is suited to supporting long-term objectives are discussed below.

Selecting the Benchmark for Performance Measurement

The first critical component of relative TSR plans is the benchmark. Companies in a clear and well populated industry sector can often rely on a transparent industry index or ETF. Companies without an obvious benchmark frequently rely on a broad market index such as the Standard & Poors' 500 or Russell 3000. The choice here can matter a great deal, although not always as much as we might expect. In the two examples to the right, we look at companies included in the software and biotechnology/pharmaceutical sectors of the Russell 3000, focusing on each company's relative performance within its sector as well as among the full Russell 3000.

Companies that fall above the 45 degree line performed better when compared to the broad market than to their industry peers. Put differently, their industry outperformed.

For the three years ending December 31, 2015, the difference in outcomes is relatively minor in the software sector (*see Chart 1*). For example, a company that fell at about the 50th percentile among software companies falls roughly at the 50th percentile among all companies. In other words, the distribution of outcomes for software companies generally mirrors the broader market.

As depicted below, the story is very different in the biotechnology and pharmaceuticals sectors (*see chart 2*). This more

Chart 1

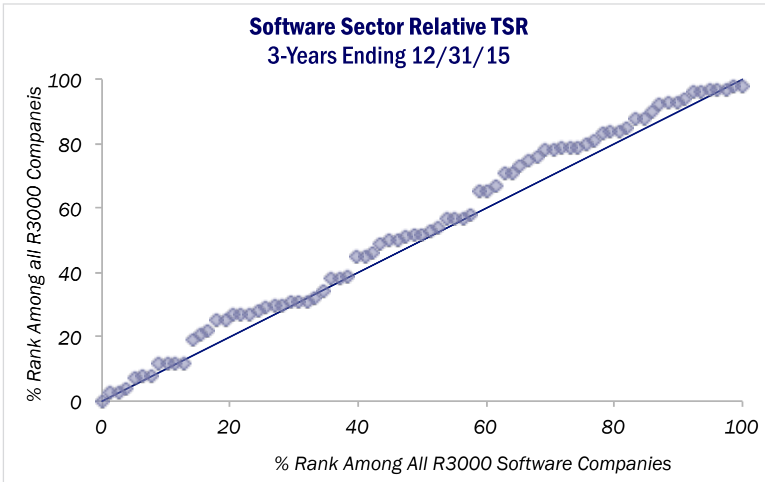
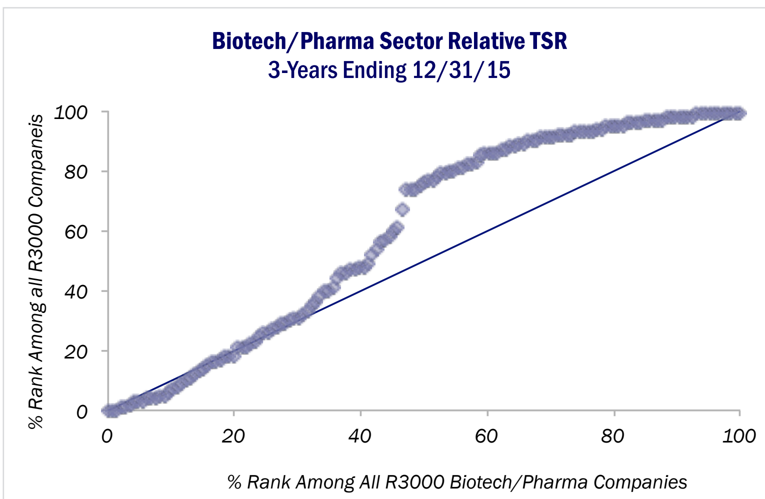


Chart 2



We have analyzed the TSR for each Russell 3000 company in the software and biotech/pharma sectors. Each point on the graph represents a unique company, with the positioning on the vertical access representing TSR percent rank relative to all other Russell 3000 companies and the positioning on the horizontal access representing TSR percent rank relative only to companies within the industry.

Revisiting Relative TSR (continued)

Chart 3

Industry Group	Approx. Prevalence in Russell 3000	Average Volatility	Average Div. Yield
Industries with Similar Investment Profiles			
Consumer Discretionary	15%	36%	1.5%
Consumer Staples	4%	32%	1.7%
Health Care ex. Biotech/Pharma	7%	38%	0.5%
Industrials	13%	35%	1.5%
Information Technology	15%	38%	0.7%
Materials	5%	39%	2.0%
Telecommunication Services	1%	39%	1.8%
Industries with Distinct Investment Profiles			
Financials	23%	26%	3.3%
Utilities	3%	26%	3.4%
Energy	6%	58%	1.9%
Biotechnology	6%	72%	0.1%
Pharmaceuticals	2%	58%	0.3%

Average volatility reflects annualized one year volatility as of December 31, 2015. Average dividend yield data provided by the S&P Compustat Research Insight database.

volatile segment of the public market is characterized by significant outperformance for many companies during the three-year time horizon, with the median performing company falling at approximately the 75th percentile among all Russell 3000 companies. As you might expect, this is a pattern that reverses if we shift the timeline forward by a few months to capture the industry decline in early 2016.

There is also a third, less common, approach for selecting a benchmark that falls in between the industry specific and broad index methodologies. Companies can begin with a broad index, but make general exclusions based primarily on industry classification. For example, companies in the technology sector might start with the full Russell 3000 list and exclude industries with investment profiles that are unique relative to the subject company. This may include, by way of illustration, financials (including banks, REITs and insurance), utilities, and telecommunications.

Several of the industries we could consider excluding consist of less volatile, dividend-focused companies (***see Chart 3***). At the other extreme, companies in the biotechnology/pharmaceuticals sectors may also be considered for exclusion along with the energy sector. These are comprised of more volatile stocks, and returns of the components within each industry are often highly correlated. As a result, returns for companies within these industries are more likely to be concentrated at either the top or bottom of the market range for a particular time horizon. This correlation and volatility can distort our understanding of relative performance for a more established company.

Selection of Measurement Dates

Measurement dates are another critical design component. The anniversary of the grant date and the end of the company's fiscal year are commonly used as end dates for performance periods. However, the anniversary of the grant date has no particular significance and as of the last day of a company's fiscal year, shareholder return represents what the market expects rather than what the company has actually achieved.

An alternative is to push the measurement date past the expected earnings release, giving the market time to incorporate the company's performance into its assessment of valuation. This can give added weight to the notion that the plan is designed to measure performance through the end of a particular fiscal year.

Time Horizon of Performance Measurement

The "all-or-nothing" performance measurement that comes with the common three-year performance period can be a source of frustration for executives participating in the plan. Their concern is motivated by the possibility – which is very real – that short-term volatility can introduce randomness in the outcome. One potential remedy is to divide the award into tranches and measure performance for one-year, two-year, and three-year time horizons.

While this is a reasonable alternative, it is important to highlight potential unintended consequences. During the shorter performance periods, the distribution of returns among market participants is much narrower. For a per-

Revisiting Relative TSR (continued)

Chart 4

TSR Among S&P 500 Companies (ending 12/31/15)		
	1-Year	3-Year
90th	25%	135%
80th	18%	105%
70th	11%	77%
60th	4%	65%
50th	0%	54%
40th	-6%	43%
30th	-13%	28%
20th	-21%	7%
10th	-33%	-15%

centage rank plan (that is, where payouts are based on the company's ranking among components rather than over/underperformance relative to a benchmark), a poorly-timed short-term swing in share price can drive a more substantial change in the payout than would be the case with a longer-term performance period.

As illustrated in ***Chart 4***, using the period ending December 31, 2015 as an example, we find that an approximate 10% increase in shareholder return would move a company from the 50th to 70th percentile among the components of the Standard & Poors' 500 when measured over a one-year period. Over three years, this same 10% increase in return would generate only a 10 point change in percentile ranking, from the 50th to 60th percentile.

There are similar consequences for plan designs with TSR measured relative to the return of an index rather than the percentage rank among peers. Some plans will "top out" for performance that is 50% greater than the benchmark regardless of the length of the performance period, but this is more difficult to achieve in one year than in three years.

Slope of the Payout Curve

If you have read a proxy statement lately, there is a good chance you have encountered a table or tables similar to those depicted in ***Chart 5*** and ***Chart 6***.

Companies have clearly been drawn to these common payout curve approaches, which is not random. In the index comparison approach in ***Chart 6***, we recommend the alignment of +50% relative TSR with the maximum payout or a three-year performance period for many companies. On average over time, this level of performance for the individual components of the Standard & Poors' 500, measured relative to the returns of the S&P 500 Index itself, is aligned with the 75th percentile.

Moving away from these standards, some plans are designed as "outperformance relative TSR" plans, which require above median performance for target payouts. An alternative to consider, which we have yet to see, moves in the opposite direction. Why not replace time-based restricted stock unit ("RSU") awards with a flatter curve for relative TSR performance shares? This would eliminate payouts below the 10th percentile and modest upside for above-median results. Although the major proxy advisory firms (particularly ISS) may view this as a performance plan that lacks rigor, the reality would be that this approach increases pay-for-performance alignment when compared to time-based RSU awards. This could be an interesting design with compelling upside for executives and a sufficiently flat payout curve to mitigate concerns about randomness resulting from market volatility.

Conclusion

Executive compensation continues to evolve with each passing year. This includes the delivery of pay as well as the ways that we measure value and levels of pay and performance alignment. Relative TSR plans are both new

Chart 5

Percent Rank	Payout (% of Target)
>75th	200%
50th	100%
25th	50%
<25th	0%

Chart 6

Relative TSR	Payout (% of Target)
+50%	200%
0%	100%
-25%	50%
<-25%	0%

and complex, with design choices that may seem insignificant at first but can have a meaningful impact of the outcomes of the plan over time. Our goal as an advisor is to support a thoughtful plan design process that starts with a clear understanding of a company's objectives and carries through with a thorough evaluation of alternatives.

About the Author

The author of this Thoughtful Pay Alert is Greg Loehmann, a principal at Compensia. If you have any questions about this Thoughtful Pay Alert, relative TSR plans, or executive incentive plan design generally, Greg can be reached at 408.907.4319 or gloehmann@compensia.com.

Need Assistance?

Compensia has had significant experience in advising technology and life science companies on designing performance-based incentive compensation programs. If you have any questions on implementing a performance-based incentive compensation program, please feel free to contact us. ■

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

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