Executive Reward Briefing: November 2018

FIT Remuneration Consultants

Total Shareholder Return – an imperfect perfect measure?

In the UK, relative Total Shareholder Return (**"TSR"**) remains one of the most common metrics used to measure company performance in long-term incentive plans.

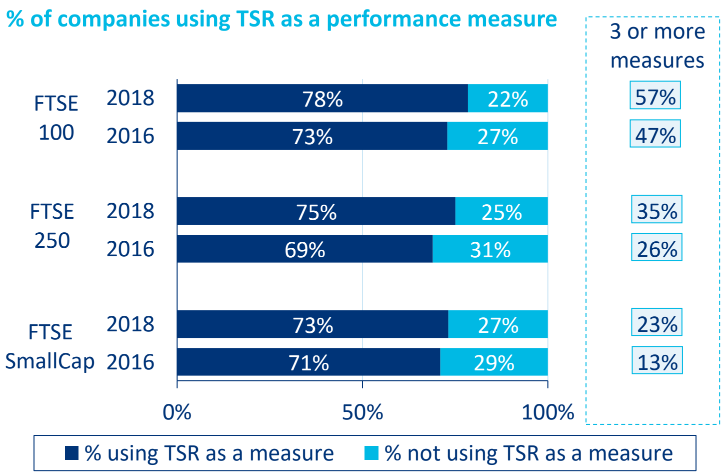
However, the efficacy of relative TSR as an effective measure continues to divide opinion among key stakeholders, not least company boards, LTIP recipients and institutional investors.

As companies are being increasingly urged by investors to take a more holistic approach to the choice of incentive plan performance measures, we have seen a clear trend towards the use of a wider portfolio of metrics being used in long-term incentive plans in recent years. Many investors remain fairly ambivalent about the use of relative TSR and, while the decision to include or exclude it as a measure is unlikely to be a voting issue in isolation, some investors do take a more rigid position. For example, Aberforth has a strong preference for TSR, requiring it for at least 50% of LTIP performance criteria while BlackRock tends to be more sceptical. At the other end of the spectrum, some investors are questioning whether the pay-for-performance model works effectively at all and are pushing for the use of restricted shares (i.e. awards of shares with no performance measures attached) to replace traditional performance-linked LTIP awards.

The adjacent chart demonstrates that the majority of FTSE All-Share companies continue to use TSR as a long-term incentive performance measure. Indeed, the number of companies using TSR has actually increased slightly between 2016 and 2018 although, as companies have tended to introduce a greater number of measures, its weighting has reduced.

It is interesting to note that in respect of those companies IPOing on the main market in the last three years, over two thirds have used relative TSR in their long-term incentive programmes. On the basis that companies coming to market usually want to adopt vanilla "inoffensive" remuneration policies, this statistic shows that TSR is still very much considered to be a mainstream measure although this may, to some extent, also reflect the above average growth aspirations of newly IPO'd companies leading those companies to consider that they have a higher prospect of out-performing more established companies.

TSR measures the growth in a company's share price plus dividends reinvested, typically against a basket of other companies or constituents of a sector or index.



The case for and against TSR

TSR is usually structured as a relative measure comparing a company's performance over a three-year period relative to a basket of other companies or an index. In a small minority of cases, it is measured on an absolute basis although most mainstream UK institutional shareholders are sceptical of absolute TSR due to the possibility for management to be rewarded primarily as a result of the impact of general stock market movements rather than company-specific performance unless the scale is clearly stretching.

Advocates of TSR generally like the fact that (i) it is an objective measure, (ii) it reduces the focus on setting long-term financial targets, which can be problematic, particularly in periods of medium-term uncertainty, and (iii) if a meaningful group of peers is chosen, in theory, it should only reward executives if they deliver returns at or above the norm for comparator companies, with general market movements being screened out.

So why are some companies and investors disgruntled with TSR? The common reasons cited include:

- outcomes can be at odds with long-term sustained (out)performance. This could be due to the choice of peer group, the measure benefitting more volatile companies or simply market timing (with performance measured over a fixed three-year period);
- delivering pay-outs when the shareholder return is flat or even negative. This is particularly important given recent investor guidance and the requirement in the new UK Corporate Governance Code for Remuneration Committees to apply judgement and discretion when authorising remuneration outcomes;
- providing poor line of sight for participants, particularly those lower down in the organisation and less able to influence the share price performance of the company (although this can be mitigated to an extent through more regular updates on performance – see later);
- the requirement to take an accounting charge, even if the performance targets are not met; and
- small variations in calculation methodology such as the choice of averaging period and treatment of currency fluctuations can lead to significant differences in vesting.

Designing a relative TSR measure

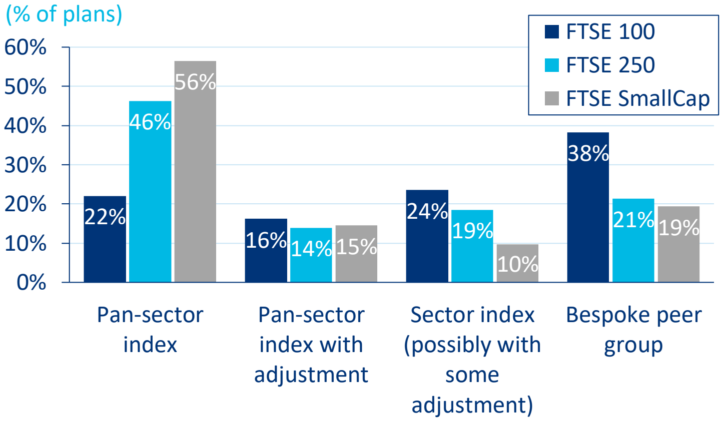
However, some of the above shortcomings are controllable and there are companies that use relative TSR to great effect to underline the company's objective of superior performance for shareholders. Ensuring TSR is being measured appropriately (with sufficient flexibility to adjust the outcomes in exceptional circumstances) will help maximise the effectiveness of the LTIP and, at FIT, we have significant expertise in helping companies achieve this objective.

The choice of peer group

The choice of comparator group is arguably one of the most important considerations as a poorly selected group can introduce significant volatility and lead to scepticism internally (e.g. from participants) and externally (e.g. from investors) as to the appropriateness of pay-out outcomes.

The most common obstacle for UK companies, as compared with, say, US companies, is the lack of a sufficient number of listed direct peers. When faced with this challenge, our research shows that many FTSE 250 and FTSE SmallCap companies opt for the simple choice and measure performance against the constituents of a broader index (e.g. the FTSE 250 or SmallCap constituents) or against the index itself (which is driven most heavily by companies with the largest market capitalisations – for example a large FTSE 250 company influences the index over 5 times more than one of the smaller ones).

Comparator groups and indices for relative TSR measurement
(% of plans)



Remuneration Committees should ask themselves how appropriate is it for executives to be rewarded against a general market peer group containing different sectors which are influenced in different ways when faced with external macroeconomic and industry specific influences? Some feel that, over the long run, any "windfalls" or "narrow misses" will iron themselves out. However, when you consider the average tenure of a chief executive is closer to five years, this results in just three possible LTIP vesting opportunities. Getting the TSR group right matters.

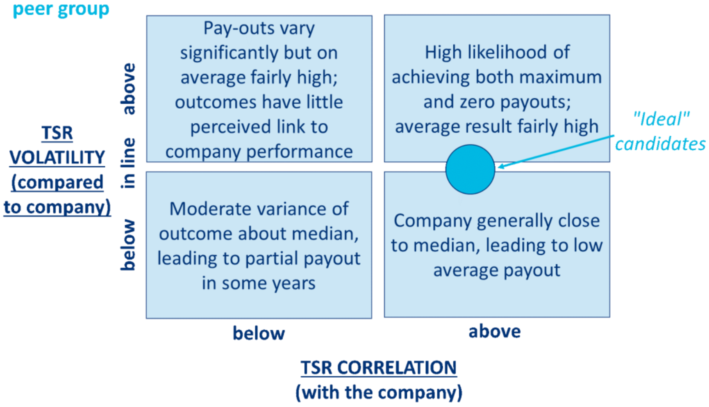
We often take a statistical approach to inform the selection process by using correlation and volatility analysis.

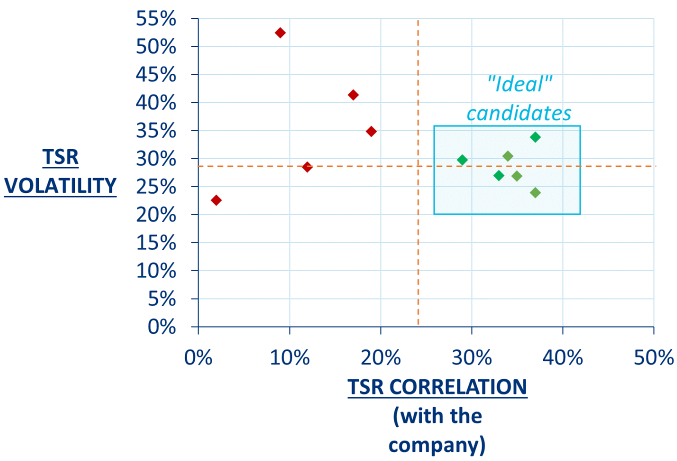
Correlation analysis can help identify whether companies will make suitable peers as it shows which share prices tend to respond in a similar way to general market movements or changes in the economic environment. When companies are closely correlated, it means outperformance of the peer group is more likely to be the result of company-specific performance than external factors impacting the company.

Volatility measures the relative size of movements in the share price and reflects how likely the share price is to outperform other comparators. Highly volatile companies can distort results for the rest of the group and lead to results with little perceived link to overall performance.

Therefore, correlation and volatility are best balanced so that incentive outcomes are not "all or nothing". The diagram below demonstrates an example of how to interpret volatility and correlation analysis.

How correlation and volatility analysis can help with selecting an appropriate peer group





That said, while these are useful tools and introduce a level of rigour, clearly, they should never be the sole determinant of a peer group.

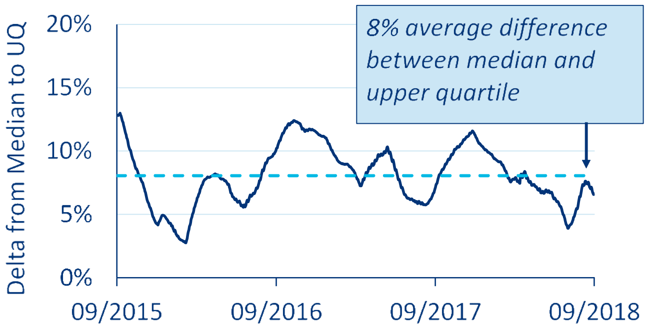
It is also worth noting that some companies start with a broad index but then remove those sectors which are least like them, e.g. removing those companies particularly exposed to commodity price volatility (such as miners). Given the relative movement between high and lower yield stocks since the Global Financial Crisis and the potential that this may reverse (to some extent) as and when bank base rates increase, such considerations should also include analysis of the relative yields across a peer group. Another consideration for companies with a global peer group is the impact of currency fluctuations and whether to compare peer group returns on a local currency basis or translate returns using a common currency.

TSR for small peer groups

As a rule of thumb, for larger peer groups (say, 15 or more companies), the typical median (up to 25% vesting) to upper quartile (full vesting) vesting schedule continues to be the norm although some companies have adopted upper quintile or upper decile performance for full vesting.

However, for smaller groups, where companies delisting can have a significant impact on the results (by narrowing the range between median and upper quartile), creating a bespoke index of the peer group is often an alternative approach taken. Matching the index would typically result in 25% vesting and full vesting for achieving an agreed level of outperformance of the index (for example, Index plus 8% per annum).

Example of historic analysis



When selecting the level of outperformance required for full vesting, it can be helpful to run historic back-testing looking at the average difference between median and upper quartile performance of the proposed group using daily average three-year returns.

However, while this may suggest that, for example, Index to Index+8%p.a. and median to upper quartile are broadly equally stretching, they will not be identical and the absolute level of out-performance is also likely to be impacted by volatility levels (8% outperformance may be easier to achieve in a bull market than a bear market whereas 25% of companies will always achieve the upper quartile). As most indexes are size-weighted and the outliers (both good and bad), are included within an index (but essentially ignored in a median), they are inherently different approaches.

Another consideration in smaller groups is the treatment of delistings. Removing a company from a small peer group can significantly impact the index. Solutions vary but might include retaining the company at its delisting price (although this may lock in a takeover premium), replacing with the acquirer or replacing the company altogether with a pre-agreed substitute.

Communication

Employee share awards are only effective when they help retain and motivate people and incentivise performance. If employees have insufficient visibility of how their company is performing, there is a danger they will discount or even dismiss entirely the value of their share awards. For this reason, we provide many of our clients with regular TSR performance monitoring updates covering all outstanding share awards. The updates should ideally set out in a clear and concise manner how a company is performing against its peer group and what is required to maintain or improve the vesting outcome.

Reviewing your approach to using TSR

If your company is using TSR and you are not entirely satisfied in respect of its operation or the approach has not been reviewed recently, FIT would be happy to discuss what changes could be made to ensure that TSR is working as effectively as possible. On the basis that most remuneration policies are flexible in respect of the comparator group used and approach to calculation, it could be an opportune time to consider any changes in advance of setting the 2019 performance criteria.

CEO Pay ratio

We are helping a number of companies to calculate CEO pay ratios in advance of the first compulsory disclosures in a year's time, with companies at least wanting to see the CEO pay ratio numbers from 2018 data for internal review. Most companies are approaching these calculations using the permitted method of sampling from the gender pay gap dataset to identify the comparator employees at each of lower quartile, median and upper quartile positions. There are, however, a number of technical points which could make the use of the gender pay gap data problematic and may mean that some adjustments are required to the dataset (including incompatible definitions of "employment" between two different sets of legislation); this could make using a different approach to the CEO pay ratio more appropriate. If you would like to explore the CEO pay ratio methodologies with us, please ask your usual contact.

Updated 2019 Glass Lewis guidelines just released:

There are no significant changes to Glass Lewis's guidelines from a remuneration perspective. It should be noted, however, that they have updated their guidelines to include CEO pay ratios but state that the ratio will not have a material impact on voting recommendations at this time. Glass Lewis also clarifies that it assesses realised pay received by executives over at least three years when evaluating a link between pay and company performance.

If you would like to know more, please contact:

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November 2018