GRG Remuneration Review

Encouraging and Rewarding Ongoing Shareholder Wealth Creation Using TSR Alpha

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Remuneration Review No 30

August 2011

PREAMBLE (By Denis Godfrey, Managing Director Godfrey Remuneration Group Pty Limited)

The following article provides an introduction to a new concept that may be used in relation to vesting of executive long term incentives. For many years both clients and consultants have recognised that total shareholder return (TSR) whether measured on an absolute or relative basis is not a perfect measure of company performance. Denis Kilroy has come up with a variation which represents a significant step forward.

GRG is pleased to be able to present this article as part of GRG's contribution to thought leadership on top executive remuneration.

INTRODUCTION

A three tiered structure comprising Base Package + Short Term Incentive (STI) + Long Term Incentive (LTI) has long been a feature of executive remuneration. Within that structure, the most common performance metric upon which vesting of LTI awards have been based is Relative TSR.

There are a number of problems associated with this metric – not least of which being the fact that some executives feel LTI plans built around it can sometimes behave more like a lottery than a well-structured incentive. In recent years, attempts to overcome some of the shortcomings of Relative TSR have led to the introduction of additional plan complexity, including the use of multiple comparator groups and supplementary performance metrics.

The shortcomings associated with Relative TSR all stem from one fundamental issue. To be truly meaningful as a measure of wealth creation performance, TSR should be compared to the required rate of return or cost of equity capital (Ke) – a datum or benchmark unique to each company. If TSR is equal to Ke, then expectations have been met and wealth has been conserved. If TSR exceeds Ke, then expectations have been exceeded and wealth has been created.

Structuring LTI plans around TSR-Ke (referred to in this article as TSR Alpha) offers an alternative to the current approach that potentially provides much better incentive alignment. In principle, it can also eliminate the need for comparisons with other companies, although a Board will probably take comfort in understanding where its company sits in relation to true wealth creation performance by reviewing TSR Alpha across a meaningful peer group.

From a practical perspective, switching to TSR Alpha can:

- Give greater clarity and certainty to Boards and their senior executive teams,
- Offer an opportunity to reduce plan complexity by a significant degree, and
- Provide a path to STI-LTI convergence, should a Board wish to move towards a single, integrated reward plan incorporating elements of traditional STI and LTI plans.

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APPLYING A VALUE-BASED LENS TO LTI PLANS

From a value-based perspective, the primary economic objective of the Board and senior executive team of any good listed company is to build an organisation that can create wealth for shareholders on an ongoing basis. This means being able to continually exceed market expectations, which is no easy task since for successful companies, the expectations themselves are continually increasing. There are however systematic ways to go about this and assisting companies to do so is the core business of The KBA Consulting Group.

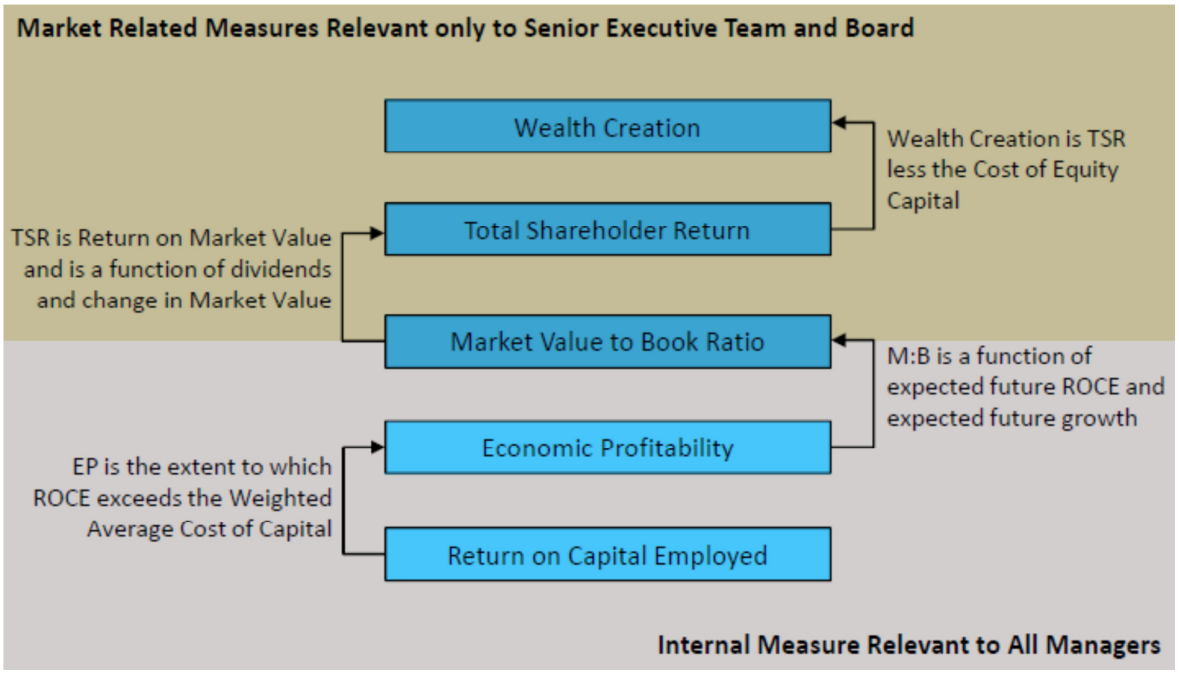
More importantly in the context of reward, is the recognition that exceeding market expectations does not mean delivering a TSR greater than the median TSR of a group of peer companies. It means delivering a TSR greater than Ke.

Peer companies might be comparable on many characteristics such as size, industry and geographic footprint. But the real issue of comparability is the risk-reward profile. What is the risk associated with investing in a particular company relative to the market as a whole? This boils down to the market's assessment of both the business risk and the financial risk associated with a particular company. This is in turn derived from the nature of the product or service markets in which it participates, its competitive position in each case, its operating configuration and its capital structure.

Given that risk, what return do investors require? What they require is Ke. So whether or not a company has delivered an adequate return is captured in TSR Alpha, not in TSR itself or in TSR versus a peer group median.

Again from a value-based perspective, STI plans should encourage behaviour and reward performance that is expected to lead to shareholder wealth creation, and LTI plans should reward shareholder wealth creation when it occurs. This suggests a high degree of alignment between STI and LTI plans at least from an economic standpoint – similar to that shown in the hierarchy of performance measures illustrated in Figure 1.

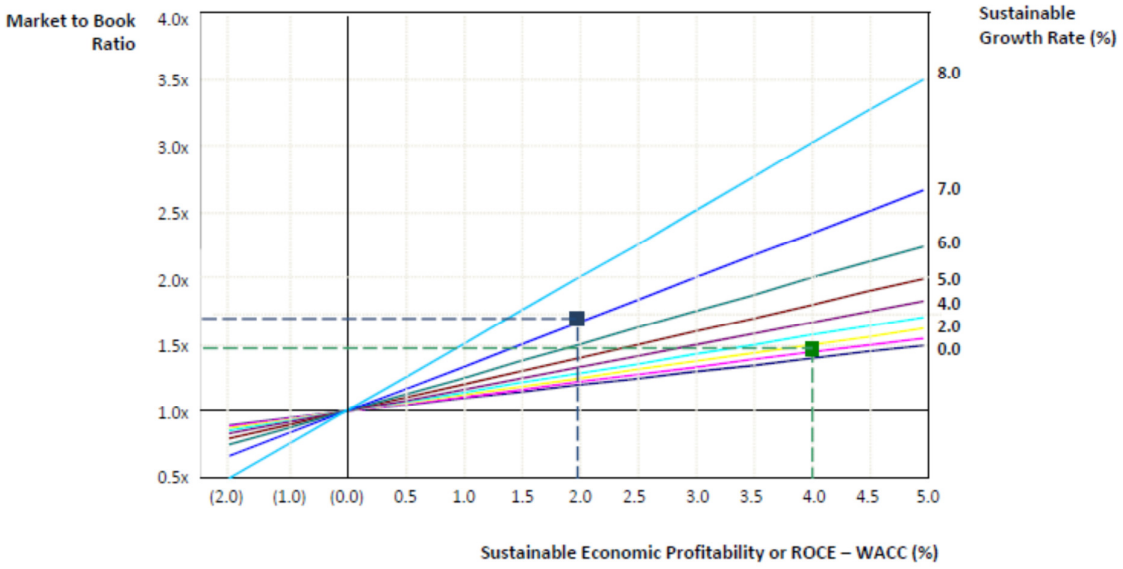
Figure 1. Hierarchy of Performance Measures



Each financial performance measure illustrated in Figure 1 is a function of the measure below plus one or two other variables. For example, Figure 2 illustrates the link between Economic Profitability and Market to Book Ratio. Market to Book Ratio measures the extent to which a strategy being pursued by

management has added value to the capital with which they have been entrusted by shareholders. It is driven by expectations in relation to two variables: return on capital relative to the cost of capital (or economic profitability); and growth in the capital base on which those returns are earned.

Figure 2. Market to Book Ratio as a Function of EP and Growth



These two figures demonstrate that there is an economic linkage between the ultimate goal of Wealth Creation as evidenced by TSR Alpha, and the single period metrics like Return on Capital Employed (ROCE) that are often the focus of financial performance for an STI plan. However the linkage is lost when we use Relative TSR as the measure of wealth creation.

UNDERSTANDING TSR

Before presenting an alternative path forward, it is important to understand the real dynamics of TSR.

TSR is the return that investors receive on the market value of their investment over a given period in the form of dividends plus share price appreciation.

We can think of TSR from both historical and forward-looking perspectives. However most observers only consider it from a historical perspective – such as to rank performance relative to a group of peers.

Ke defines the TSR that shareholders expect to earn on their investment in a company at the prevailing share price. This means that regardless of the level of TSR that has been delivered in the past, successfully delivering the expectations embedded in today's share price will result in a TSR equal to Ke. When this happens, shareholder wealth is conserved. When TSR exceeds Ke, shareholder wealth is created.

This forward looking dynamic is very important in the context of executive reward. If a company meets investor expectations, it will deliver a TSR equal to Ke. If expectations increase and the share price rises, it will only rise to the point where a new investor will earn a TSR equal to the cost of equity. In effect, as expectations increase, share prices are bid up such that TSR tends to fall back to Ke. This is why so few companies generate year-on-year TSR in excess of Ke over extended periods of time.

To illustrate this point, consider a company that is expected to generate a cash flow stream of $12m per annum into perpetuity. The price that investors are willing to pay for this cash flow stream depends on the return they expect to earn on their investment. Investor A, who is expecting to earn a TSR of 10 percent, should be willing to pay a share price equivalent to a market value of $120m. Having paid that price, he will earn a TSR equal to 10 percent if the $12m cash flow stream is delivered consistently year-on-year.

If at a later date, the company is able to convince the capital market that it has put a strategy in place that will deliver a cash flow stream of $15m per annum into perpetuity, its share price will increase to a level equivalent to a market value of $150m. The increase in share price means Investor A will have earned a TSR in excess of Ke. But Investor B who bought in at a price equivalent to a market value of $150m will again earn a TSR of 10 percent – the Ke used to value the company at $150m in the first place.

Whenever a company's share price is bid up, the very nature of TSR means that in the future, it will fall back to the company's Ke. So if an executive team has convinced the market that performance will improve, and the market has fully factored that performance improvement into the current share price, then as we look backward, the TSR will have exceeded Ke. But as we look forward, delivery of that performance will result in a TSR equal to Ke – or wealth conservation.

IMPLICATIONS FOR LTI PLANS

The dynamic driving TSR back to Ke has important implications for its use in executive reward plans.

Value reflects the expectations of future financial performance arising from the successful implementation of a strategy devised by management. Value uplift stems from an expected improvement in future financial performance. Usually this flows from the adoption and successful implementation of a higher value strategy.

Higher value strategies are not developed and implemented every year. Many stem from strategic initiatives developed at a segment or line of business level. Most take months to develop and implement, and some take years to play out. So if a company does develop and implement a higher value strategy, and the market is fully informed and valuing the company accurately, then the very nature of the TSR metric means that after the initial value uplift has been captured in the share price, TSR will tend to fall back to the point where it meets or matches market expectations (Ke) rather than exceeds them. When this occurs, good management performance can mean conserving shareholder wealth rather than creating it – by delivering the expectations embedded in the new and higher share price. This is really the economic linkage between the development of higher value strategies and their execution.

This dynamic has a number of implications for reward plan design. The main one is that the only way to derive any real understanding of relative company performance when using TSR is to examine it over a period long enough to expect management in each company being compared to have developed and successfully implemented a higher value strategy. In a practical sense, this would have to be three to five years or more. A period shorter than this might capture some companies in wealth conservation mode having developed and implemented a higher value strategy a few years earlier, and others in wealth creation mode having just developed and implemented a higher value strategy.

But why bother with such comparisons at all? If we shift to TSR Alpha as the primary metric, then there is no real need to compare with other companies, except to provide comfort to Boards as to how their company is performing relative to peers that investors might consider true alternative investments. With TSR Alpha, we can determine whether wealth was created, conserved or destroyed in any given year or period of years. However since companies move naturally from wealth creation mode as new and higher value strategies are developed and adopted, to wealth conservation mode as these strategies are firstly implemented and then played out, to create a truly meaningful incentive, the overall reward plan would need to span sufficient time for a higher value strategy to be developed, adopted, implemented and played out.

SHIFTING TO TSR ALPHA

Most executives think of Ke as the cost of the equity component in their determination of the weighted average cost of capital used to value investments, strategies or projects. In calculating Ke, they take a forward-looking perspective.

However just as we can think of TSR from both a forward-looking and a backward-looking perspective, it is possible to do the same with Ke.

It is possible to calculate the Ke of a company in any given historical year by using the actual market risk premium that applied in that year, not the long run forward-looking average of around 6% that is generally used. This lets us determine whether a company created, conserved or destroyed wealth in any given year or period of years. That information is extremely powerful as a building block in executive reward.

Figure 3 gives an illustration of this concept. Companies with a β greater than one require a higher return than that delivered by the market as a whole to conserve wealth in a rising market, and the opposite in a falling one. Companies with a β less than one need a lower return to conserve wealth in a rising market, and the opposite in a falling one.

Figure 3. Annual Return Required to Conserve Wealth

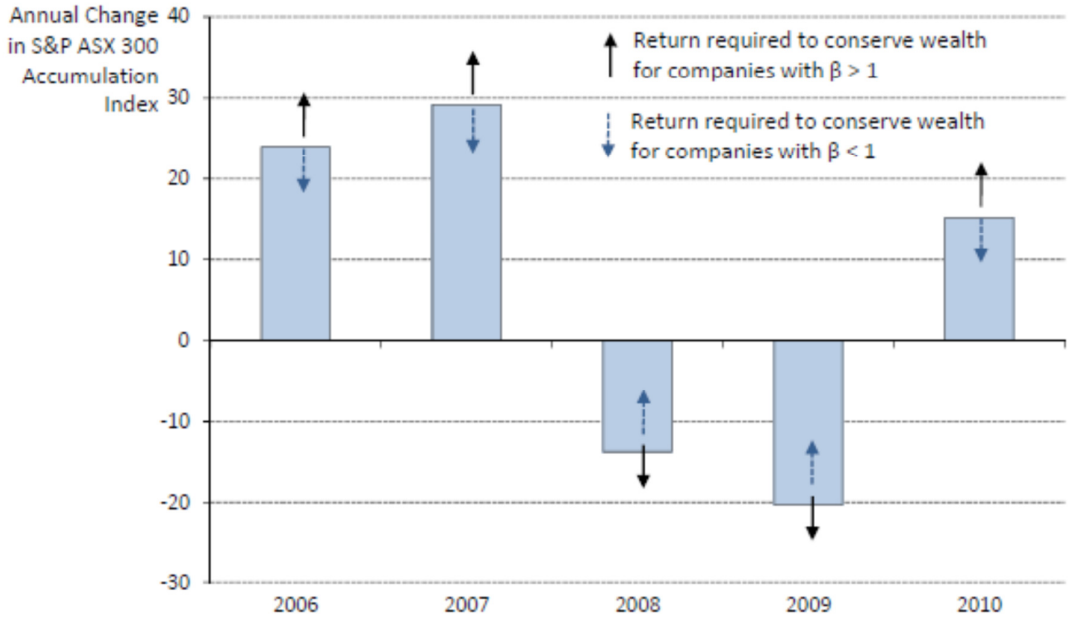


Figure 4 illustrates the type of reward plan that could be put in place building on the understanding presented above. In principle, executives would receive:

- A market competitive Base Package;
- A reward for meeting expectations and thereby conserving wealth (this could be paid as either a short or medium term incentive); and
- A bonus for exceeding expectations and thereby creating wealth (this could be paid as a long term incentive).

A reward plan structured in this way would motivate and reward executives to drive value uplift by continually seeking to develop and implement higher value strategies.

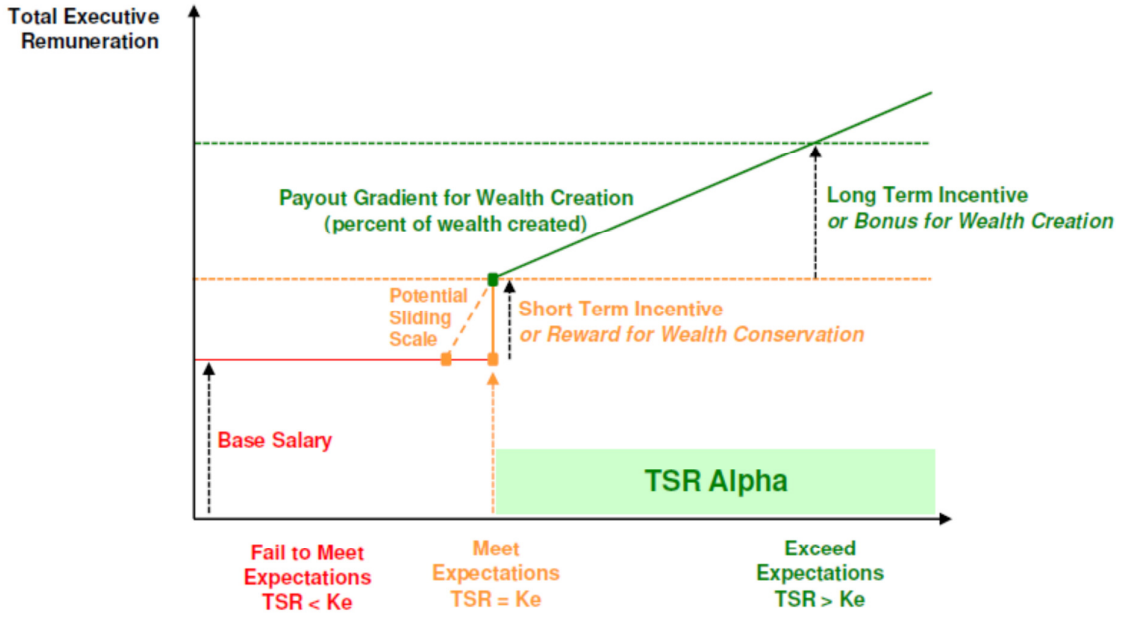
There are potentially many different and equally viable ways to bring this concept to life.

The short to medium term reward for meeting expectations (Reward for Wealth Conservation) could be similar to existing STI plans, with the additional requirement that wealth needed to be conserved. Or it could simply be paid from a total pool available to the executive team equating to a percentage of opening

market capitalisation. Participation in the pool could be determined by a combination of individual and group hurdles or goals, but with the payment being contingent upon wealth being conserved or expectations being met. If considered appropriate, a sliding scale could be employed to cover "near miss" outcomes. Vesting conditions could also apply if the Board considered it appropriate.

The longer-term bonus for exceeding expectations (Bonus for Wealth Creation) could be paid in shares or performance rights, with the total pool available to executives being built up from a fixed percentage of the wealth created for shareholders each year. The Board would determine vesting conditions.

Figure 4. Structuring an Alternative Approach to Executive Reward



It is important to point out that conserving wealth does not mean the share price stands still. It means expectations are met. If the market is fully informed, this means meeting budget or plan. It also means delivering a TSR equal to Ke. If Ke was 10%, and dividend yield was 4%, the share price should rise naturally by 6% over the year in question. But this increase in share price would only justify a reward for wealth conservation. There would be no bonus for wealth creation.

SUMMARY

Basing executive rewards around true wealth creation – or TSR Alpha as we have chosen to call it – is simple in concept. It removes any reliance on the use of Relative TSR, it measures wealth creation performance in a way that is meaningful for all companies, and it provides a clear economic linkage all the way from Wealth Creation back to commonly used single period financial performance measures like Return on Capital Employed. It also provides three quite explicit benefits for Boards.

Firstly, it can enable Boards to link the LTI plan, and potentially the STI plan as well, to the behaviour required to drive continuous value uplift.

Secondly, it provides a path to STI-LTI convergence if a Board wants to move in that direction. Both the longer term Bonus for Wealth Creation, and the shorter term Reward for Wealth Conservation can be linked to the true determinant of wealth creation or wealth conservation.

Finally, reward plans can be designed in such a way that Boards can communicate in advance with shareholders and executives as to exactly how much of the wealth created for shareholders over a given period will be shared with the executive team through the LTI plan. If desired, this proportion or percentage can be a primary element in the overall reward plan design from the outset.

NOTE: Please feel free to call Denis Kilroy on (03) 9024 8239 should require more information on TSR Alpha.

Key Management Personnel Remuneration Advice

GRG is a specialist advisor on remuneration for key management personnel (KMP) i.e. non-executive directors, executive directors and other top executives. To facilitate its independent advisory function GRG mains two remuneration databases with one concentrating on non-executive directors and the other on top executives. This data analysis allows GRG to remain up to date with current trends and developments and to be able to benchmark company practices against market practice. The increased focus being placed on KMP remuneration makes it more important than ever for Boards to be satisfied that they are adopting practices that are consistent with market practice and appropriate to their company's circumstances.

If you would like an independent review of the market competitiveness of your company's remuneration practices for KMP then GRG will be pleased to assist.

Please call Denis Godfrey or James Bourchier on (02) 8923 5700 or Mike Carroll on 0416 226 131.