

# TSR Assessment for LTI Purposes

Denis Godfrey and James Bouchier | October 2012

## Introduction

Total shareholder return (TSR) is the most frequently used metric for assessing vesting of grants under long term incentive (LTI) plans. Yet boards have great difficulty in selecting the approach to be applied to assessing TSR performance. This GRG Remuneration Insight canvasses many of the alternative approaches and comments on them.

In this regard it is important for the TSR assessment approach selected to be directly aligned with shareholder/investor expectations so that vesting can be calibrated to those expectations. This should be demonstrated in the Remuneration Report where vesting of LTI grants and company performance need to be discussed as required by the Corporations Act and should be shown to be in alignment.

## What is TSR?

TSR is the return received from share price movement and dividends by a shareholder from an investment in a company's shares over a specified time period, expressed as a percentage of the investment at the beginning of the period.

An often overlooked fact is that there are two approaches to the calculation of TSR with:

- a) one taking account of the actual dividends as a dollar value, and
- b) the other assuming that the dividends are reinvested into the company's shares on an ex-dividend basis.

The first, (a), is expressed as the following formula:

TSR	=	$((\text{Share Price at End of Period} - \text{Share Price at Beginning of Period}) + \text{Dividends During the Period}) \div \text{Share Price at Beginning of Period} \times 100$
e.g.		$((240 \text{ cents} - 200 \text{ cents}) + 30 \text{ cents}) \div 200 \text{ cents} \times 100$
	=	$(40 \text{ cents} + 30 \text{ cents}) \div 200 \text{ cents} \times 100$
	=	$70 \div 200 \times 100$
	=	35%

While (a) is simple to express and calculate it is perhaps less accurate as it ignores the time value of money. While share price continue to be subject to company performance during the period, dividends are frozen in value and isolated from company performance for the remainder of the period. The other approach which assumes that dividends are re-invested into a company's shares is consistent with the approach applied to accumulation indices. When TSR was first used for vesting of LTI grants of shares and options (rights were rarely used at that time) it was the accumulation indices that the ASX produced for individual companies that were used to determine TSR outcomes. Of the two approaches, it is GRG's view that the second, (b), is the better reflection of company performance. Of course, over a short period there is usually little difference between the two approaches.

## Absolute or Relative TSR

Traditionally there have been two broad approaches to assessing the TSR performance of a company. These are absolute and relative TSR.

The difference between these two approaches for LTI plan purposes is whether the targeted performance is expressed as an absolute or relative outcome. Either may be expressed as a binary (100% or 0% achieved) or scaled range.

Examples of binary hurdles are:

- Company's TSR must exceed 40% over the three year measurement period, and
- Company's TSR must exceed the 50<sup>th</sup> percentile of TSRs of companies in the S&P/ASX Accumulation Index over the three year measurement period.

Examples of scaled ranges include:

### Absolute TSR

Performance Level	Absolute TSR of Company	Vesting % of Grant
Below Threshold & Target	<40%	0%
Threshold & Target	40%	50%
>Target & < Stretch	>40% and <80%	Pro-rata
Stretch	≥80%	100%

### Relative TSR

Performance Level	Relative TSR of Company	Vesting % of Grant
Below Threshold & Target	<50 <sup>th</sup> Percentile	0%
Threshold & Target	50 <sup>th</sup> percentile	50%
>Target & < Stretch	>50 <sup>th</sup> and <75 <sup>th</sup> percentiles	Pro-rata
Stretch	≥75 <sup>th</sup> percentile	100%

Generally stakeholders tend to prefer companies to use relative rather than absolute TSR. This is because it is usually impossible to predict at the beginning of the measurement period which levels of absolute TSR will be challenging and which will not, having regard to the circumstances that will unfold during the measurement period. Thus, absolute TSR targets may prove, with the benefit of hindsight, to be too difficult or too easy. However, absolute TSR may be justifiable:

- for resources, biotechnology and other start-up companies when they may produce acceptable returns to shareholders given their risk profiles even if they produce relatively poor TSR performances when compared to their peers (for example if all are successful but some more so), and
- when overall stock market performance during the measurement period reflects the performance expected at the beginning of the measurement period i.e. no windfall gains or losses from overall market movement, and
- when absolute TSR goals are set at high levels.

The reason that relative TSR is generally preferred over absolute TSR is that there is no need to forecast general market, sector or company performance. It is expected, by using relative TSR, that sector and general market influences on TSR performance will be neutralised as they will affect all companies in a comparator group equally. Thus, relative TSR should better reflect the performance of the company over the measurement period than absolute TSR. Of course, relative TSR suffers from various imperfections that make it less than an ideal performance measure. Some of these are discussed in the next section.

## Index or Comparator Group for Relative TSR?

There are two main approaches to assessing relative TSR. One is against an index which may be an industry related specific index e.g. S&P/ASX300 Health Care or a broad index e.g. S&P/ASX300 where each company does not have an equal weighting as the size of each company in terms of market capitalisation affects their impact on index movements. The other is against a group of companies that are treated as individual companies with each company having an equal weighting, often referred to as a peer group or comparator group.

Using indices is problematic for reasons including:

- they lend themselves to binary outcomes rather than scaled outcomes e.g. company's TSR exceeds the index movement or not,
- when they are used in relation to scaled outcomes e.g. target = index growth for 50% vesting and stretch = index + 20% for 100% vesting, reference is usually made to past performance so as to assess the stretch level, for example the stretch level could be set equivalent to the 75<sup>th</sup> percentile in prior years,
- the company being assessed is often part of the index, therefore the company is being compared to itself,
- often there are few companies represented in an index, perhaps too few for a sound sample,
- the criteria used to select companies to be admitted to indices mean that indices are unlikely to be appropriate for companies including start-ups that are not included in indices,
- companies of different sizes in an index have different weightings in terms of their impact on the index, often it is a few large companies that determine the index movement, if the intent is to compare against those few companies then why use the index?

Using comparator groups of companies is also problematic for reasons including:

- it is rarely possible that a comparable group of ASX listed companies may be selected that are of similar size, in the same industry sector and at very similar stages in terms of strategy development or implementation, thus the comparator group would be unlikely to be homogeneous which is necessary for there to be confidence that the TSR outcomes are reflecting different management performances rather than other factors,
- The high level of de-listings mainly due to mergers and acquisitions means that comparator groups need to be of a large size at commencement so that those remaining at the end of the measurement period represent a reasonably sized sample,
- The need to commence with a large number of companies in the comparator group generally means that it is necessary to include companies from industries other than the one in which the company operates,
- If a small number of different industry sectors are represented then the TSR outcome for the measurement period may be affected by industry sector differences,
- A method that is used to address the industry sector problem is to use companies in highly diversified industry sectors, but this approach does not protect a company if it is in a sector that performs less well than other sectors over the measurement period,
- Generally, companies with large market capitalisations produce lower TSRs than smaller companies, thus comparator groups with a predominance of companies larger than the company will tend to produce a higher ranking of the company and vice versa,
- Share prices tend to be affected by market acceptance of strategies that offer the opportunity for higher value for shareholders, when a new strategy is announced or commenced the market may bid up the share price in

the expectation that the higher value strategy will be delivered. Once that expectation has flowed through to the share price, the company needs to deliver to the expectation in which case the share price will be maintained, whereas if it fails to deliver the expectation the market will reduce the share price – detailed data of this nature is difficult to capture.

- In selecting companies to comprise a comparator group it is usual for the broad parameters to be outlined and applied so that the company would be unlikely to face criticism for “cherry picking” the companies in the comparator group – this approach means this point cannot be addressed even if the relevant company information could be obtained,

Although neither an index nor a comparator group is an ideal approach it is GRG’s view that comparator groups are to be preferred over indices.

## Linking TSR With Company Performance

The Corporations Act (s300A(1)(b)) requires Remuneration Reports to include a discussion of the board policy for determining the nature and amount of remuneration of KMP and the relationship between such policy and company performance including the consequences of company performance on shareholder wealth. It also goes on to require detailed disclosures in relation to performance conditions when they are attached to elements of remuneration.

A statutory requirement is that company earnings and TSR over the financial year and the prior 4 financial years must be included as part of the coverage of company performance. However, what is more relevant is the company’s TSRs over the measurement periods for grants under the LTI plan. Such measurement periods are typically 3 years and create overlapping cycles.

The TSR in which investors are most interested is the one that compares the actual TSR achieved with the TSR that they were expecting given the specific risk profile of the company. Not all companies have the same risk profile even if they are in the same industry sector. Most shareholders are not necessarily concerned about whether they have done better or worse than average. If they have invested in a high risk company then they are looking for returns that are well above average and conversely if they have invested in a low risk company they expect modest/marginally below average returns.

Absolute TSR, a TSR accumulation index or a comparator group of companies do not provide shareholders with the information they need. Further, if these approaches are not providing shareholders with the information they need then the question needs to be asked as to why are companies using them? The simple answer is that until recently a better alternative has not been available.

## TSR Alpha™

A new approach to calculating TSR has been developed by The KBA Consulting Group. It is called TSR Alpha™. It seeks to overcome the problems with absolute and relative TSR by assessing company performance over a period compared to assessed shareholder expectations at the beginning of the measurement period.

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