GRG Remuneration Insight 57

Informing Board Discretion on LTI Vesting Using Economic Performance Measures

Marvin Schneider & Denis Kilroy | February 2014

INTRODUCTION

In last month's GRG Remuneration Insight 56, Denis Godfrey and James Bourchier highlighted the need for Boards to be able to exercise discretion almost as a matter of course in relation to long term incentive (LTI) vesting. This article examines the same question from a different perspective.

Our conclusion is consistent with the view that Denis and James formed – namely that the exercise of board discretion should be a feature of all LTI plans. We came to this conclusion from an analysis of the performance of 300 ASX listed companies over the five years to 30 June 2013. This analysis showed that the use of relative total shareholder return (rTSR) as the primary vesting metric for LTI awards resulted in vesting outcomes that were inconsistent with the true economic outcomes experienced by investors in 25% of cases when rTSR is calculated against a broad market index and in 40% of cases when calculated against sector peers. In both cases the bulk of the remainder were either clear outperformers or clear underperformers irrespective of how performance was assessed.

ANALYSIS OF ASX 300 COMPANIES

The data presented in Figure 1 relates to the 300 largest ASX listed companies by market capitalisation. Two sets of outcomes are considered for rTSR. The blue shaded outcomes relate to rTSR calculated against a broad-based market index. The amber shaded outcomes relate to rTSR calculated against the performance of ASX-listed sector peers.

Figure 1. Comparing TSR Alpha™ and Relative TSR for ASX Companies – 5 Years to June 2013

	Based on Broad Based Index Peers			Based on Narrower Sector Peers		
	Total	Resource Companies	Industrial Companies	**Total**	Resource Companies	Industrial Companies
Clear Winners	**76**	10	66	**70**	10	60
Clear Losers	**116**	45	71	**92**	27	65
TSR Alpha™ indicates materially better performance	**75**	11	64	**73**	0	73
TSR Alpha™ and relative TSR produce similar outcomes	**33**	4	29	**21**	4	17
TSR Alpha™ indicates materially worse performance	**0**	0	0	**44**	29	15
Total	**300**	**70**	**230**	**300**	**70**	**230**

Companies that are clear winners or losers can be identified using either rTSR or TSR Alpha™ (see GRG Remuneration Insight 55 for information on TSR Alpha™). For these companies, it doesn't matter what metric is used. Over the five years to 30 June 2013, they comprised just under 65% of the 300 companies in the dataset.

However for the remainder that were not clear winners or clear losers under both rTSR and TSR Alpha™, metric selection matters a lot – particularly if their sector is underperforming.

Over the period of this study, the resources sector underperformed the market as a whole. Of the 70 resources companies in the data set, there were 45 clear losers based on rTSR performance against a broad-based market index, but only 27 clear losers against sector peers (as would be expected). Focusing on the analysis versus sector peers, of the 33 out of 70 resources companies that were neither clear winners nor clear losers, 29 delivered materially worse TSR Alpha™ performance than rTSR performance versus their sector peers. BHP Billiton was a particularly interesting case. Its senior executive LTI plan would have delivered full vesting under its actual LTI plan, even though its shareholders lost value in absolute terms. It would have delivered zero vesting using TSR Alpha™.

There are three important insights embedded in this analysis. The first is that rTSR is a poor proxy for shareholder wealth creation – something that became abundantly clear to the shareholders of BHP Billiton last year (see GRG Remunerartion Insight 56). As all professional investors know, shareholder wealth is created when a company's annualised TSR is greater than its shareholders' long-term cost of equity capital (Ke).

The second insight is that TSR Alpha™ is a good proxy for TSR-Ke. This is because TSR Alpha™ is like a shorter-term version of TSR-Ke. Over the long term, TSR Alpha™ is identical to TSR-Ke.

The third insight arises from the first two – namely that there is a clear need for board discretion in LTI vesting across a large number of companies. This discretion should be informed by a thorough economic performance analysis. Central to that analysis is proper understanding of how the company performed in both the market for its products and services, and the market for shareholder capital.

ALIGNING TWO PERSPECTIVES ON PERFORMANCE

The intention of value-based incentive compensation as it was called when first introduced in the USA, or incentive-based executive reward as it is known in Australia, is predicated on the idea that management should be encouraged and rewarded for doing those things that are considered likely to lead to shareholder wealth creation, and also be rewarded for the wealth creation outcomes that they either oversee or deliver.

Underpinning this concept is an important principle that is often forgotten. The principle is that true commercial success for every listed company means succeeding in two markets. The first is the market for the company's products and services. The second is the market for shareholder capital. Success in the first leads to success in the second. However this truth is only evident when viewed through the lens provided by economic performance measures. In fact, it is only with economic measures that a listed company can establish a meaningful link between its strategic decisions and its financial performance, as well as be able to observe how that performance (in the market for its products and services) affects the capital market outcomes experienced by shareholders.

This linkage between strategic position, product and service market performance, and capital market performance, is almost completely obscured by the use of traditional accounting measures like earnings, earnings per share (EPS) and EPS growth to assess product and service market performance; and the use of non economic measures like rTSR to assess capital market performance.

That may seem a strong statement, particularly since rTSR and EPS growth are the two metrics used most commonly in determining LTI vesting outcomes in Australia. But it is true nonetheless – and this is why.

While measured in the capital market, shareholder wealth is really created in the products and services market, through the appropriate pricing and efficient delivery of products or services that create value for customers. Success in this endeavour manifests as a financial outcome that can be thought of in two ways. The first is as a growing stream of economic profits (EP). The second is as combination of a return on equity greater than the cost of equity (or a return on capital greater than the cost of capital), and growth in the capital base on which that economically profitable return is earned.

Whenever there is a positive EP stream from participation in the market for the company's products and services, the market value of the business will be greater than its book value. In other words, its market to book ratio (M:B) will be greater than 1.0x.

If the EP stream delivered is consistent with market expectations, shareholder wealth will be preserved and over time, the annualised TSR will be equal to its cost of equity capital (Ke) and the long-term economic return on market value (TSR-Ke) will be zero. If the EP stream delivered is greater than market expectations, or if the capital market forms the view that it will exceed current market expectations at some point in the future, then shareholder wealth will be created.

The best way to illustrate EP expectations embedded in a company's share price is with a bow wave like that shown in Figure 2. If a company exceeds the EP expectations embedded in its share price, by making its EP bow wave higher, wider or longer than expected, then it will create shareholder wealth. Over the longer term, its TSR-Ke will be positive – and over the short to medium term, its TSR Alpha™ will be positive.

A powerful application of the bow wave concept is the idea of a pair of EP bow waves constructed at the beginning and the end of a measurement period (and potentially at regular intervals in between if we want to be able to understand and quantify the impact of company-specific sentiment).

With this pair of bow waves, we can align the way management measures performance internally with the way investors measure performance externally. We can also demonstrate how performance in the market for a company's products and services translates into performance in the market for shareholder capital. Two illustrations of the pair of EP bow waves are provided in Figures 3 and 4.

Figure 2. The Bow Wave of Expected Future Economic Profits

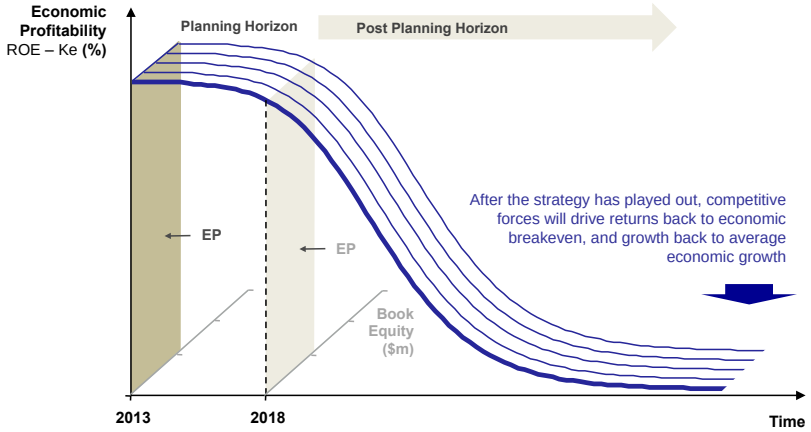


Figure 3. The Pair of EP Bow Waves Highlighting the Two Components of Value Uplift

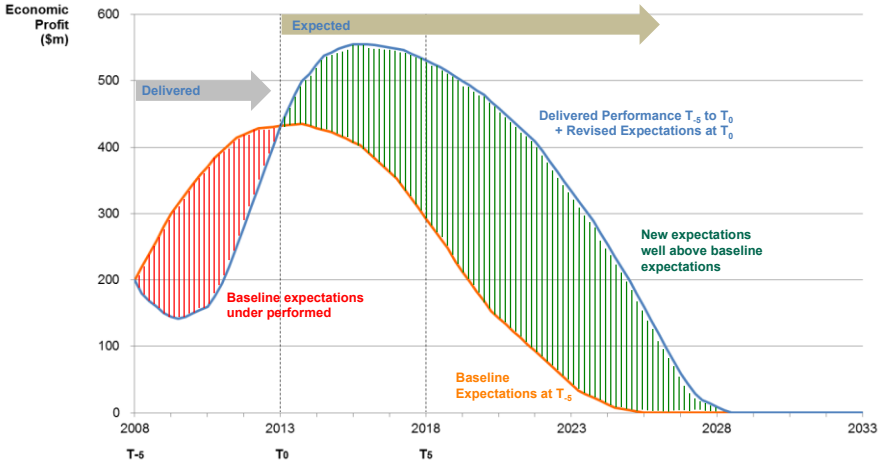
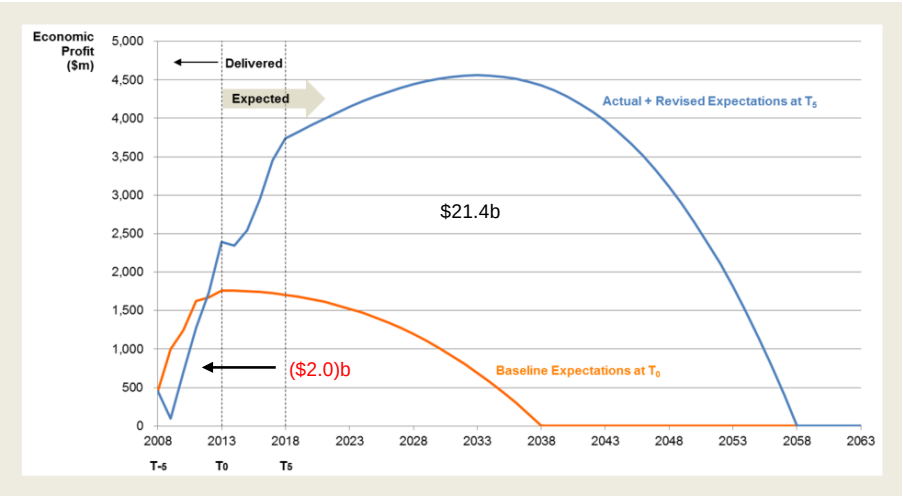


Figure 4. A Pair of Intersecting EP Bow Waves for the ANZ Banking Group



In Figures 3 and 4, the amber line represents baseline EP expectations in place as at 30 June 2008. The blue line represents actual performance over the five-year measurement period to 30 June 2013, together with the revised market expectations embedded in the share price as at 30 June 2013.

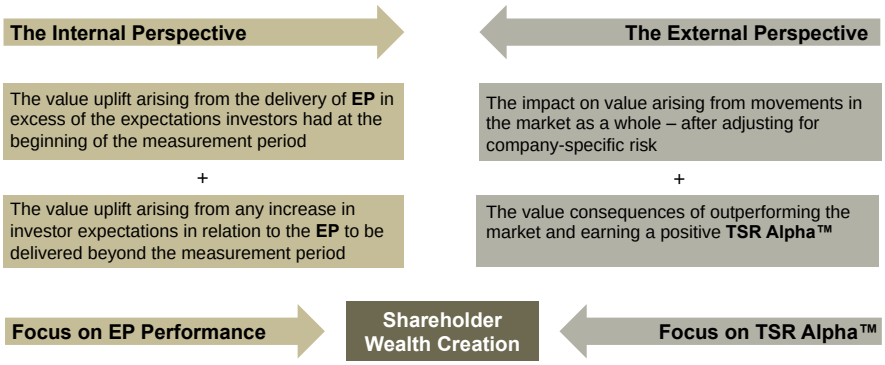
Over any specified measurement period, shareholder wealth will be created when management either delivers performance in excess of expectations, or it convinces the capital markets that it has put a strategy in place that will enable it to do so. In terms of an EP stream, this means:

- The value uplift arising from the delivery of an EP stream in excess of the expectations that investors had at the beginning of any given measurement period; plus
- The value uplift arising from any increase in investor expectations in relation to the EP to be delivered beyond that measurement period (which normally stems from the adoption of a new and higher value strategy during the measurement period).

The red and green shaded areas in Figure 3 represent these two components. In the case of the ANZ in Figure 4, they amounted to negative $2.0b and positive $21.4b – a net position of $19.4b.

We can arrive at essentially the same conclusion (i.e. value uplift or shareholder wealth creation of $19.4 billion) entirely from market data. This symmetry is central to what KBA calls *The EP Uplift + TSR Alpha™ Construct* illustrated in Figure 5.

Figure 5. The EP Uplift + TSR Alpha™ Construct



From an internal perspective, value uplift arises from the extent to which a company either delivers EP performance in excess of expectations, or it convinces the capital market it has the ability to do so. From an external perspective, it is the sum of the value impact of movement in the market as a whole and the value consequences of outperforming the market and delivering a positive TSR Alpha™.

The value impact of market movements on the ANZ over the five years to June 2013 was negative $26.1b – after adjusting for company-specific risk. The value consequences of outperforming the market and producing a positive TSR Alpha™ was $45.5b – giving a net position of $19.4b.

KBA has developed the ability to calculate the dimensions of an EP bow wave, and how much it has changed over a particular measurement period, so as to produce the pair of bow waves. It is then relatively easy to then check this by calculating TSR Alpha™. Our methodology for both the internal and external analysis has now been refined slightly through the input of Dr. Steven Bishop – a former colleague[1].

THE EXERCISE OF BOARD DISCRETION

There are a number of factors that need to be considered in the exercise of board discretion in relation to LTI vesting which is coming under increasing scrutiny. However from a purely economic perspective, there are two measures that need to be considered in context. The first is EP performance versus expectations in place at the beginning of the measurement period (the red area in Figure 3). The second is TSR Alpha™, which captures the combined impact of the red and the green areas in Figure 3.

The context is provided from an understanding of economic performance across the sector, within the market as a whole, and compared to other players in multiple peer groups. This can be achieved easily using KBA's *Economic Performance Database*.

Denis Kilroy and Marvin Schneider are partners with The KBA Consulting Group. They are both experienced value-based management practitioners, and are also co-authors of two of a series of three books that will be published this year focused on how to build organisations that seek to create customer value, build shareholder wealth and at the same time enhance community wellbeing. The first in the series, The Legacy of Good Leadership, will be released in the next few months.

[1] *Steven is an author of a corporate finance text used widely in Australian business schools over a period of some 20 years. (Bishop, S.R., Crapp, H. R., Faff, R.W., and Twite, G.J., Corporate Finance, Prentice Hall, 5th Edition, Frenchs Forest, 2003)*