

GRG Remuneration Insight 103

Rethinking Executive Reward

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Overview

The following *Remuneration Insight* is perhaps the most valuable ever released by GRG – for both Boards and senior executives. While the content is more expansive than that contained in a typical *Insight*, it is potentially of great significance for those that take the time to engage with it.

In view of the depth of the material contained in this *Remuneration Insight*, we would like to **offer readers a follow-up meeting to discuss the thinking it contains**. Such meetings have been a key step towards the “ah-ha” moment for those clients that have already been briefed. The following points capture eight particularly significant insights from among the many contained in this paper. They are offered to inspire deeper engagement with the material.

- The current executive reward paradigm built around relatively high STIs together with LTIs linked to **Ranked Relative TSR (rTSR) and EPS has failed both shareholders and executives**.
- Attempts to mitigate the **lottery-like outcomes of rTSR** with accounting measures like EPS made the situation worse due to the widely held “**EPS Myth**”. **“Creating shareholder wealth is not the same as maximising short-term profits. Companies that confuse the two often put both shareholder wealth and stakeholder interests at risk.” Paul Polman, CEO, Unilever Plc**
- The use of EPS in combination with rTSR prevented any meaningful bridge being built to link product and service market performance with capital market performance. This led to the false belief that capital market outcomes (TSR) were largely outside the control of executives.
- A breakthrough in understanding makes it possible to **isolate and quantify the contribution to capital market outcomes (TSR) attributable to management** (even at the business unit level). This lets us align the economic interests of executives with the long-term best interests of their company, its shareholders and its many other legitimate stakeholders.
- **This allows for true alignment to be built into executive remuneration design**, counter to the false/anti-alignment created by many of the recently announced “single incentive plans” (SIPs).
- This breakthrough also lets us understand truly successful listed companies. Sustainable wealth creation does not occur through simply exceeding financial performance targets. This calls into question the use of aggressive stretch targets – particularly in STIs.
- **The case study focused on Wesfarmers unlocks new insights** by observing its performance through an economic performance lens. While there is much to be admired and even imitated by other companies when it comes to Wesfarmers, its recent decision to go down the SIP path is not one that other companies should follow, unless they first acquaint themselves fully with the material contained in this *Remuneration Insight*.
- **Better alternatives to the SIP approach, and to executive remuneration design**, are discussed in depth, giving a way forward for companies that want to consider something new, and valid.

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1. INTRODUCTION AND SUMMARY

Over the past 25 years, the major global remuneration consultancies have led the Boards of listed companies on quite a journey when it comes to the design of executive reward plans that seek to align the economic interests of executives, with the long-term best interests of their company and its shareholders.

Unfortunately, the course they set initially, and the primary course corrections they made along the way, were all grounded in an incomplete understanding of the principles of applied corporate finance. For example, when it became necessary to propose a metric that would provide a benchmark against which to assess *capital market* performance, and at the same time adjust for the impact of market movements, the major remuneration consultants put forward the idea of using *Ranked Relative TSR (rTSR)*.

Ranked Relative TSR failed badly on both counts. Worse than that, because it quantified *capital market* performance in statistical terms using percentile rankings within a comparator group, it introduced a lottery-like dimension to vesting outcomes. ‘False positive’ vesting outcomes where executives benefit at the expense of their company and its shareholders, or ‘false negative’ ones where companies and their shareholders benefit at the expense of executives, now occur more than half the time in LTI Plans that award performance rights which vest based on *rTSR*.

Attempts to mitigate the now widely recognised lottery-like aspects of *rTSR* by augmenting it with accounting measures like *EPS growth*, also failed. This initiative had its roots in a misunderstanding which some refer to as the *EPS Myth* – the widely held but nonetheless incorrect belief that enhancing short-term *EPS* will create shareholder wealth. It also introduced an unintended incentive to engage in behaviours now referred to collectively as *short-termism* and put the perceived interests of shareholders well ahead those of other legitimate stakeholders. As Unilever’s Paul Polman puts it: “*Creating shareholder value is not the same as maximising short-term profits. Companies that confuse the two often put both shareholder value and stakeholder interests at risk.*”ⁱ

Recent moves by the global remuneration consultancies to overcome this and other problems associated with conventional LTI Plan design, by discarding LTIs in favour of *Single Incentive Plans (SIPs)* centred on much larger STIs, look like the beginning of another stage in this journey of discovery. Once again, it is a step that appears to be grounded in an incomplete understanding of applied corporate finance. It should be viewed with caution and approached with a healthy degree of scepticism – even though some of Australia’s most respected companies have already moved in this direction. The research presented in this paper suggests this new approach may be vulnerable to many of the same problems that plague the schemes it seeks to replace.

The irony is that a sound mechanism to determine benchmark *capital market* performance, adjust for the impact of market movements, and link *product and service market* performance with *capital market* outcomes, has always existed within the principles of applied corporate finance. This mechanism was thrown into stark relief by a breakthrough in understanding achieved recently.

This breakthrough provides the basis for a simple and transparent approach to both performance measurement and executive reward, that makes it easy to align the economic interests of executives with the long-term best interests of their company, its shareholders, and its many other legitimate stakeholders. The alignment made possible with this approach is much better than that achievable with the SIP approach adopted recently by Wesfarmers, Telstra, ASX Limited and several other respected companies.

The approach to performance measurement and reward advocated in this paper, relies on economic measures to assess both *product and service market* performance and *capital market* performance – and to build a strong conceptual and analytical bridge between them over any given measurement period. This bridge lets us unlock crucial information which could not be accessed before. It lets us describe clearly how the overall performance produced by management in the market for their

company's products and services, translates into the *capital market* outcome experienced by shareholders. We can then use this understanding to define the *product and service market* performance that must be delivered by management to preserve wealth in the *capital market*, and which must be exceeded in order to create shareholder wealth.

We can also quantify the two fundamental sources of wealth creation that exist for every listed company over any measurement period. The first is the wealth creation consequence of meeting, exceeding or underperforming the expectations in place at the beginning of a given measurement period. The second is the wealth creation consequence of management actions during the measurement period, that lead the establishment of a new and higher set of expectations to be delivered beyond the measurement period. The sum of these two figures is the total wealth created.

Finally, we can separate the total wealth created for shareholders over the measurement period, into that arising from market movements, and that created through the market's reaction to the actions or the decisions of management.

The ability to access this information has profound consequences for both listed company performance measurement and executive reward plan design.

The foundation for the approach outlined in this paper lies in the use of economic performance metrics in both the *product and services market* and the *capital market*. The bridge linking the performance achieved in these two markets cannot be built using traditional accounting metrics to measure *product and service market* performance, and non-economic metrics like rTSR to measure *capital market* performance.

It is important that business leaders familiarise themselves with the thinking and the research findings presented in this paper, before considering following the lead set by companies like Wesfarmers, Telstra and ASX Limited.

The remainder of this paper is structured in four main parts.

Section 2 outlines the breakthrough achieved in applied corporate finance that provides a new and more powerful lens through which to observe how wealth is created in listed companies. This section also includes the results of research which reveal how wealth is really created in listed companies, and particularly how it is created *on an ongoing basis* in truly successful listed companies. It also calls into question a core premise underpinning conventional financial performance measurement frameworks, and the closely related practice of using stretch targets in executive reward plan design. Until now, most business commentators have argued that improving short-term *product and service market* performance will lead to improved *capital market* outcomes. This belief continues to underpin an intense focus on quarterly, half yearly and annual *Earnings* and *EPS* outcomes. However, the research presented in *Section 2* shows that for a listed company to improve *capital market performance* over the short, the medium and the longer-term, its management team must focus primarily on establishing the ability to deliver better long-term *product and service market* performance – not better short-term performance.

Section 3 chronicles the journey that global remuneration consultants have taken the Boards of listed companies on over the past 25-years – ending in the latest 'iteration' in the form of Single Incentive Plans.

Section 4 outlines a two-stage process through which to refocus executive reward on encouraging the ongoing creation of both customer value and shareholder wealth.

Section 5 looks closely at Wesfarmers Limited, a much respected Australian company that has chosen to adopt the SIP approach now being advocated by some major remuneration consultants (as a means through which to overcome the many problems associated with the approaches to executive reward plan design that they themselves advocated in the past).

2. A NEW UNDERSTANDING

In September 2017, *Palgrave Macmillan* published *Customer Value, Shareholder Wealth, Community Wellbeing*, which included a foreword written by Westpac CEO Brian Hartzler.

The purpose of this book was to provide a roadmap for those leaders of listed companies that were seeking to build truly enduring institutions capable of creating value for their customers and wealth for their shareholders *on an ongoing basis* – and so prosper well beyond the tenure of any one executive leadership team.

The path laid out for business leaders also included the option to pursue this goal in a way that deliberately sets out to enhance the wellbeing of all legitimate stakeholders, including the wider community and the environment.

Central to the thinking presented in the book was a breakthrough in applied corporate finance. This breakthrough had two mutually supportive aspects. One was conceptual. The other was research-based.

The conceptual aspect centred on the realisation that there exists a *Bow Wave of Expected Economic Profits* embedded in the share price and market capitalisation of every listed company at every point in time. This *EP Bow Wave* construct provided a clear and actionable bridge linking the *product and services market performance* produced by management with the *capital market outcomes* experienced by shareholders.

The research aspect of the breakthrough made use of the *EP Bow Wave* construct to firstly explore and then establish the mechanism by which wealth was being created *on an ongoing basis* by truly successful companies listed on the *Australian Securities Exchange (ASX)*, the *New York Stock Exchange (NYSE)* and the *London Stock Exchange (LSE)*. The conclusions were clear and consistent across the three markets.

The remainder of this section outlines the conceptual breakthrough that has been achieved, before presenting the principal research findings that arise from its application. Fundamental to the thinking presented and to a successful path forward, is the adoption of economic performance measures.

An Economic Approach to Performance Measurement

True commercial success for a listed company means succeeding in two markets — the market for the company's products and services and the market for shareholder capital. Good performance in the first ultimately leads to success in the second.

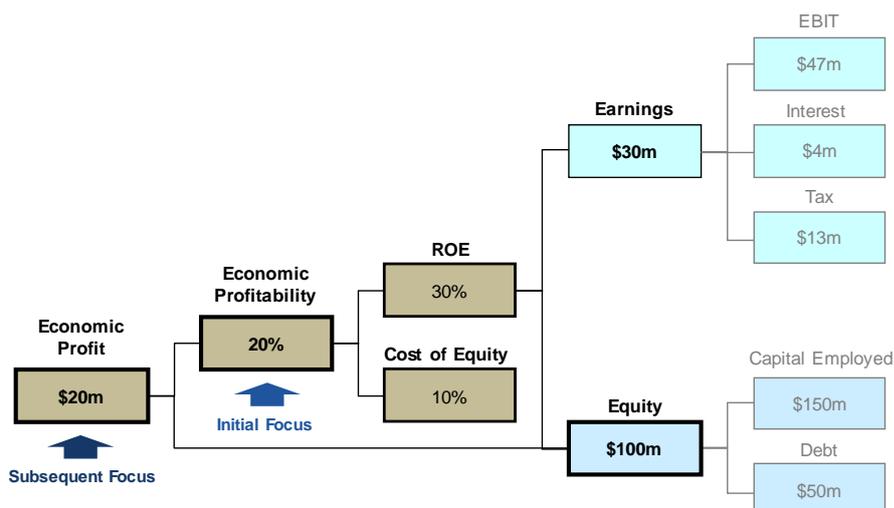
Success in the Products and Services Market

Success in the market for a company's products and services initially means being economically profitable — by producing a *return on equity (ROE)* greater than the *cost of equity capital (Ke)*.

As illustrated in Figure 1, once a business becomes economically profitable, the criterion for success transitions to delivering a growing stream of *economic profit (EP)*.

True success in the *product and service market* cannot be assessed in terms of meeting specific *Earnings*, *Earnings per Share (EPS)* or *EPS growth* outcomes. Such measures don't take account of the amount or the cost of the capital required to deliver a given level of *Earnings* or *EPS*. As a result, *Earnings* or *EPS* outcomes can quite literally be bought at any price – and they often are, as we discovered when completing research for *Customer Value, Shareholder Wealth, Community Wellbeing*.ⁱⁱ

Figure 1. Defining Success in the Market for Products and Services



Success in the Capital Market

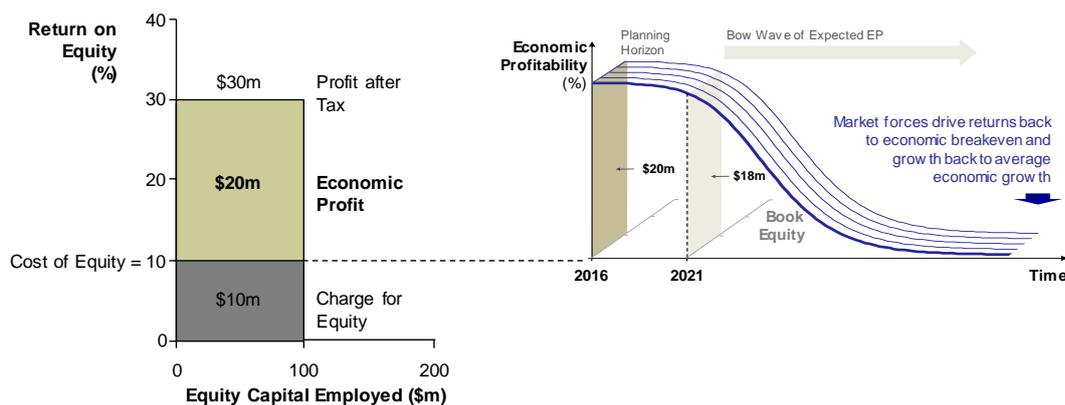
Success in the *capital market* means producing a *total shareholder return (TSR)*, in the form of dividends and share price appreciation, that exceeds K_e .

K_e is the long-term return on market value that shareholders require to preserve wealth from an investment in a specific company. When *TSR* exceeds K_e , shareholder wealth is created. When *TSR* is less than K_e , shareholder wealth is destroyed. When *TSR* equals K_e , shareholder wealth is preserved.ⁱⁱⁱ

Linking Product and Capital Market Performance Using the EP Bow Wave

It is a fundamental tenet of business economics that market forces erode *EP* to zero over time, as returns are driven back to the cost of capital and growth recedes to average economic growth. This gives rise to the notion of a *Bow Wave of Expected Economic Profit*, as illustrated in Figure 2.

Figure 2. EP Bow Wave Construct



Shaped like a child’s ‘slippery dip’ or ‘slippery slide’, the *EP Bow Wave* is analogous to the bow wave of a ship moving through the ocean. A bigger bow wave denotes a ship that has built up greater momentum. The height of the *EP Bow Wave* is economic profitability ($ROE - K_e$). The width is the level of investment, or the equity capital base on which the economically profitable return is being earned. Growth or further investment makes the *EP Bow Wave* wider. The length of the *EP Bow Wave* is the sustainability of a positive *EP* stream.

The left-hand side of Figure 2 presents the same *EP* outcome shown in Figure 1. The vertical axis is *ROE*. The horizontal axis is equity capital employed – and in this example, that figure is \$100 million.

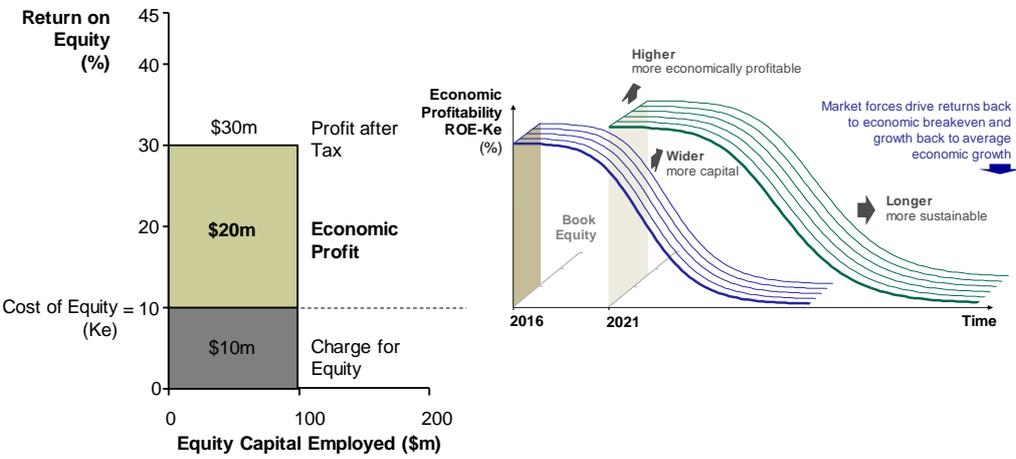
The area of the large rectangle is *Profit After Tax (PAT)*. The charge for equity capital at a K_e of 10 per cent is \$10 million, and the residual *EP* is \$20 million.

The right-hand side of Figure 2 shows the dynamics of the *EP* stream over time. The three dimensions of **returns** (or economic profitability), **growth** and **sustainability** illustrated in Figure 2 constitute the metrics that define the *EP Bow Wave* for any company at any point in time.

When we put all three dimensions together, the ‘volume under the slippery slide’ represents the expected *EP* stream. We can value this *EP* stream by discounting at the cost of equity.

Shareholder wealth will be preserved in the *capital market*, and *TSR* will equal K_e over the long term, when a company begins to deliver, and investors believe it will continue to deliver, an *EP* stream consistent with the *EP Bow Wave* that was embedded in its share price at the beginning of a given measurement period. Wealth will be created ($TSR > K_e$) when management finds a way to enhance the shape of their *EP Bow Wave* – making it higher with enhanced return expectations, wider through greater growth expectations, or longer through actions that make the business more sustainable, as illustrated in moving from the blue to the green bow wave in Figure 3.

Figure 3. Enhancing the Shape of the EP Bow Wave



One of the important realisations that emerges from the *EP Bow Wave* construct is that wealth is not created in the *capital market* simply by making returns higher in the *product and services market*. In a mechanistic sense, the objective is to increase the ‘volume under the slippery slide’ in Figure 3. This is not the same as simply making the *EP Bow Wave* higher with higher returns. Making it wider and especially longer can sometimes be more important – particularly for companies that are already economically profitable. Focusing solely on increasing *ROE*, or *ROE-Ke*, can sometimes result in a narrower and/or shorter *EP Bow Wave*, and lead to the destruction of shareholder wealth.

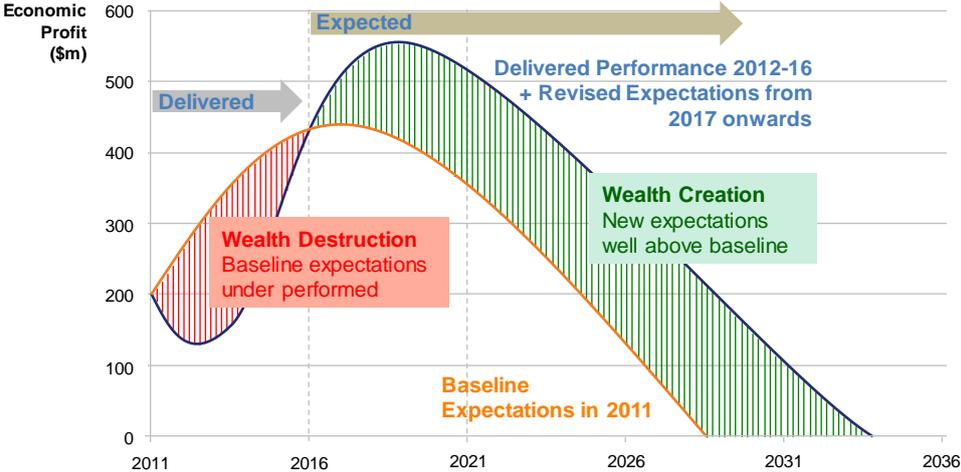
The Pair of EP Bow Waves

A key analytical step in linking product and *capital market* performance using the *EP Bow Wave* construct, is to introduce the notion of a *Pair of EP Bow Waves*. Figure 4 shows a *Pair of EP Bow Waves*, with one representing *EP* expectations at the beginning of a five-year measurement period and the other showing *EP* expectations at the end.

The *Pair of EP Bow Waves* in Figure 4 is constructed in two dimensions rather than three, so that we can overlay them. The y-axis is *EP* in dollars. It corresponds to the shaded planes in Figures 2 and 3.

The amber line in Figure 4 represents the *EP* expectations embedded in the share price at the beginning of the measurement period (which in the case illustrated covers five years beginning in 2011). The blue line represents current expectations from 2016 onwards, plus the *EP* outcomes that were delivered over the measurement period from 2011 to 2016.

Figure 4. A Pair of EP Bow Waves



The red area on the left-hand side and the green area on the right in Figure 4, represent the two potential sources of wealth creation that exist for every listed company over any measurement period. They are:

- The wealth created from the delivery of an EP stream that exceeded the expectations in place at the beginning of a given measurement period, and
- The wealth created from any increase in expectations during that measurement period, in relation to the EP to be delivered beyond the measurement period.

The hypothetical company portrayed in Figure 4 failed to meet expectations over the five-year measurement period. But the resultant wealth destruction was more than offset by wealth created from an increase in expectations in relation to the EP to be delivered beyond the measurement period.

Measuring Wealth Creation Using the Pair of EP Bow Waves

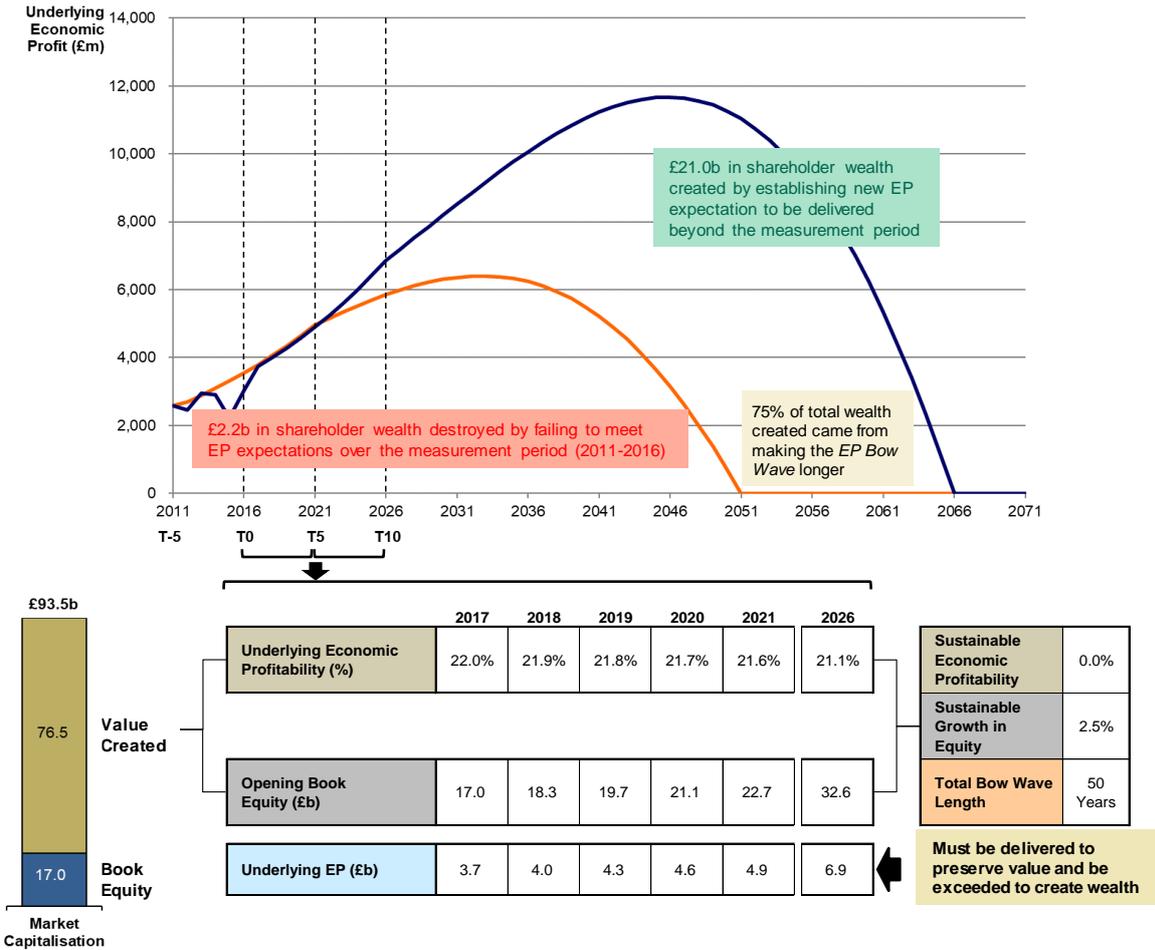
Figure 5 illustrates a Pair of EP Bow Waves for London Stock Exchange listed Unilever Plc over the five years to 31 December 2016. The bottom half of the figure details the EP expectations that needed to be delivered to preserve wealth as at 31 December 2016.

Unilever created £18.8b in shareholder wealth over the five years to 31 December 2016. This was made up of wealth destruction of £2.2b from failing to meet existing EP expectations over the measurement period, and wealth creation of £21.0b from establishing new EP expectations to be delivered in future. Of the £21.0b arising from new expectations, £14.4b came from extending the length of the EP Bow Wave from 40 to 50 years.

It is important to note that Unilever’s wealth creation profile is typical of that which we see in more successful listed companies, as will be evident when we cover research outcomes under the heading ‘Understanding How Wealth is Really Created’.

To preserve wealth and justify the share price in December 2016, Unilever would need to deliver the EP expectations shown in the lower half of Figure 5. This would mean sustaining a level of economic profitability (ROE-Ke) between 21 and 22 per cent until 2026, having a capital base almost doubling in size over the same period, and generating an underlying EP outcome that would increase from £3.7 billion in 2017 to £6.9 billion by 2026, and remain positive until 2066.

Figure 5. The Pair of EP Bow Waves for Unilever over the Five Years to December 2016



A Bridge between the Product and Capital Markets

The Pair of EP Bow Waves provides both a conceptual and an analytical bridge between the product and service market performance produced by management, and the capital market outcomes experienced by shareholders.

To build such a bridge we must use economic measures. This is because with economic measures, the ultimate performance benchmark in both markets is the same – the cost of equity capital (Ke).

Book value is preserved in the product and services market when ROE matches Ke. Market value is preserved in the capital market when TSR matches Ke. In both cases, market forces drive returns back to Ke over time.

For many years, business commentators have focused largely on Earnings or EPS, or sometimes ROE, as the primary measures of the financial performance achieved by management in the market for a company’s products and services. They then applied an ‘earnings multiple’ or ‘PE Ratio’ to bridge to a capital market outcome. In this way, an incremental value or share price outcome was inferred from an incremental Earnings or EPS outcome.

However, this thinking is flawed, as is explained later as part of a discussion of research outcomes in a section entitled The EPS Myth. It is addressed in more detail in an address to the annual conference of the Governance Institute of Australia in 2015, and in Section 2 of Customer Value, Shareholder Wealth, Community Wellbeing.^{iv}

The Pair of EP Bow Waves reveals quite a different relationship between product and capital market performance to that which most business leaders, investors and commentators assume exists. Its strength lies in its accuracy and in the amount of information that it reveals.

The full power of the *Pair of EP Bow Waves* as both an analytical tool, and as a platform upon which to construct a comprehensive economic performance measurement framework that can support a Board and its executive team in building an enduring institution, is brought to life in the Wesfarmers case study in Section 5.

Measuring Wealth Creation in Terms of TSR-Ke and TSR Alpha

The *Pair of EP Bow Waves* provides a means with which to measure the wealth created for shareholders over a given measurement period from both a *product and service market perspective* and from a *capital market perspective*. It also enables the performance achieved in both markets to be reconciled.

From a *product and service market perspective*, the wealth created over a given measurement period is the sum of the wealth created by delivering an *EP* stream that exceeded the expectations in place at the beginning of the period (i.e. the left-hand side of the *Pair of Bow Waves*); and the wealth created from any increase in expectations during the measurement period, in relation to the *EP* to be delivered beyond the measurement period (i.e. the right-hand side of the *Pair of Bow Waves*).

To use the *Pair of EP Bow Waves* to understand wealth creation from a *capital market perspective*, we need to introduce the concept of *TSR Alpha*. *TSR Alpha* is the economic return on market value over the short-to-medium term, in the same way that *TSR-Ke* is the economic return on market value over the long term.

We know that when *TSR* exceeds *Ke*, shareholder wealth is created. When *TSR* is less than *Ke*, shareholder wealth is destroyed. When *TSR* equals *Ke*, shareholder wealth is preserved. However, the challenge with *TSR-Ke* as a performance metric is that it is a long-term measure. This is because the shareholders' required rate of return *Ke* is essentially constant over the long term. Over the short term, if equities markets are rising across the board, it is relatively easy to produce a *TSR* greater than *Ke*. But when equities markets are falling, it can be very difficult.

Underlying movements in the equities market have nothing to do with the efforts or the performance of management. So, when measuring performance from a *capital market perspective*, we need to be able to strip out the impact of underlying market movements to reveal management's contribution to wealth creation. When we do, what remains is *TSR Alpha*. Over any given measurement period, *TSR-Ke* and *TSR Alpha* are linked by the following relationship:

TSR-Ke = 'Risk-Adjusted Impact of Short-Term Market Movements' + TSR Alpha.

Shareholders always experience *TSR-Ke* – with a positive outcome signifying wealth creation and a negative one indicating wealth destruction. The *TSR-Ke* outcome will always be the sum of the '*Risk Adjusted Impact of Short-Term Market Movements*' which have nothing to do with the performance of management; and *TSR Alpha*, which is driven largely by the *capital market's* reaction to the decisions made and the actions taken by management during the measurement period.

These two elements comprise the *capital market perspective* on wealth creation, which is illustrated in the case of Unilever on the right-hand side of Figure 6. The product and services market perspective on the left-hand side contains the same information that was in the top half of Figure 5.

The numerical outcomes in the right-hand panel in Figure 6, and particularly the *TSR Alpha* outcome, can be derived either directly from observable *capital market* data, or from an analysis of the *Pair of EP Bow Waves*. The direct approach, where *TSR Alpha* is calculated from observable *capital market* data, can only be done at a Group level. But the calculation based on the *Pair of EP Bow Waves* can be done at a Group, Divisional or Business Unit level. Being able to calculate *TSR Alpha* at a Divisional, Business Unit and potentially even at a customer segment level, is particularly helpful in performance measurement and executive reward applications.

Figure 6. Two Perspectives on Wealth Creation for Unilever Plc

Wealth Creation from the 'Pair of EP Bow Waves'		Wealth Creation from 'Capital Market Measures'	
	£b		£b
• Wealth created by meeting, exceeding or failing to meet EP expectations during measurement period	(2.2)	• Wealth created from movements in the market as a whole, which are unrelated to management effort	(17.1)
• Wealth created by establishing new EP expectations to be delivered beyond the measurement period	21.0	• Wealth created from TSR Alpha – the market's reaction to management action over measurement period	35.9
Total	18.8	Total	18.8

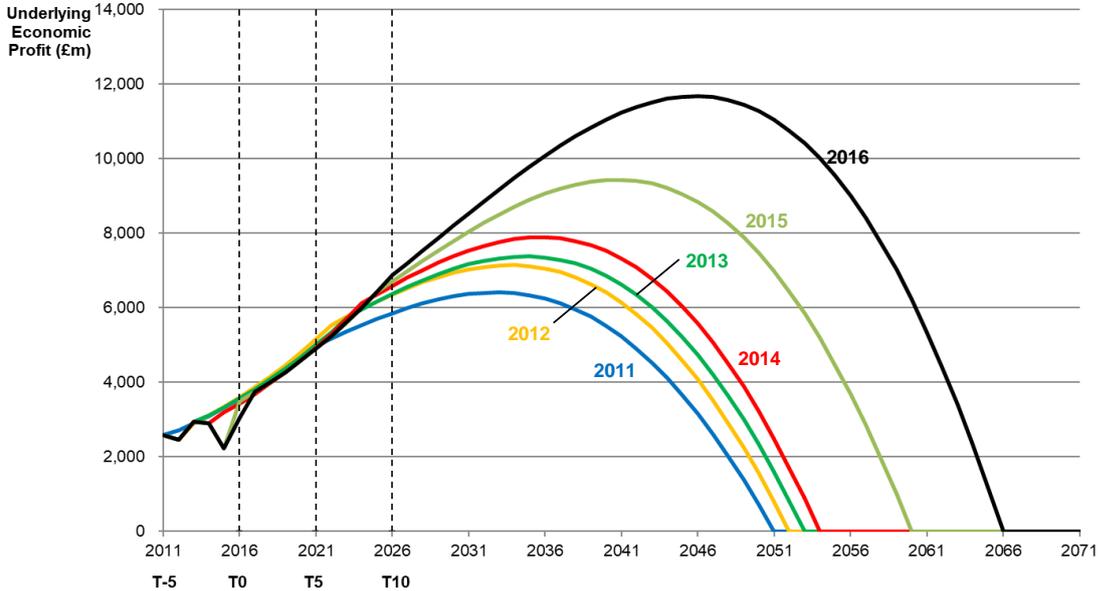
When working with *TSR-Ke* and *TSR Alpha*, it is important to remember that the benchmark performance for both metrics is always zero, indicating a level of performance commensurate with wealth preservation. A *TSR-Ke* of zero means wealth was preserved for shareholders, but it incorporates the impact of short-term market movements. A *TSR Alpha* of zero means that management's contribution tended to preserve shareholder wealth, irrespective of the impact of market movements.

The Progression of Annual EP Bow Waves

Businesses that succeed in creating wealth for shareholders *on an ongoing basis* tend to systematically enhance the shape of their *EP Bow Wave* over time – by making it higher, wider and especially longer. They do this by meeting (or going close to meeting) *EP* expectations in the short term, while at the same time creating new and higher *EP* expectations to be delivered in the future. They then deliver the new expectations, while creating a further series of new and even higher *EP* expectations to again be delivered in the future. And then they do this again, and again, and again.

This behaviour is evident in the *Progression of Annual EP Bow Waves* for Unilever Plc illustrated in Figure 7. It is even more apparent in the research outcomes that will be summarised later.

Figure 7. Progression of EP Bow Waves for Unilever over the Five Years to 31 Dec 2016



The change or progression in the shape of a company's *EP Bow Wave* each year provides a unique perspective on how the market is reacting to the actions and the performance of the company and its management team. An *EP Bow Wave* that improves steadily over a long period of time is a good indicator of the extent to which a company is succeeding in institutionalising the ability to innovate – to create value for its customers and wealth for its shareholders *on an ongoing basis*.

The *Progression of EP Bow Waves* for Unilever over the five years to 31 December 2016 as illustrated in Figure 7, shows that in general, Unilever tended to either meet, slightly exceed, or slightly underperform *EP* expectations each year. More importantly though, it was continually taking action that led to the establishment of new *EP* expectations to be delivered in the future.

It is important to appreciate that the *EP Bow Wave* tends to have a natural maximum length of around 60 years (or 50 years beyond an explicit 10-year forecast period). Beyond that, the value of incremental *EP* is negligible due to the compounding effect of discounting at K_e .

The *EP Bow Wave* also tends to erode naturally over time – unless management acts to maintain it. For better-performing companies, maintaining a strong existing *EP Bow Wave* is a wealth-creating endeavour in its own right. Unilever’s *EP Bow Wave* was 50 years in December 2016 – well above its sector peers. The ability to maintain this, rather than to just deliver embedded *EP* expectations and allow the *EP Bow Wave* to erode by one year with each passing year, would be worth an additional £5.0b in wealth to the shareholders of Unilever over the three years from 31 December 2016 to 31 December 2019.

In a general sense, the goal is to either maintain or enhance the shape of the *EP Bow Wave* – depending upon the shape of the existing *EP Bow Wave* and where a company’s *EP Bow Wave* profile sits relative to others in its sector.

Linking the Progression of Annual EP Bow Waves to Wealth Creation and TSR Alpha

There is a direct relationship between the progression in a company’s *EP Bow Wave*, the level of wealth created ($TSR-K_e$) and the extent to which a company delivers a positive *TSR Alpha* outcome over a given measurement period.

Initiatives pursued by management in the *product and services market* that result in the shape of their company’s *EP Bow Wave* improving, and its intrinsic value increasing over time, manifest in the *capital market* as positive $TSR-K_e$ outcomes over the longer term, and as positive *TSR Alpha* outcomes over the short-to-medium term.

As is evident in Figure 7, the *capital market* reacted favourably to the actions of Unilever’s management over the period from December 2011 to December 2016, resulting in a steadily improving *EP Bow Wave* profile. As a result, Unilever created a significant amount of wealth over each of the rolling three-year measurement periods ended December 2014, 2015 and 2016, as well as the five-year measurement period ended December 2016. This is apparent from the $TSR-K_e$ outcomes in Figure 8.

Figure 8. *Wealth Creation and EP Bow Wave Progression for Unilever*

	Three Years Ended			Five Years Ended
	31 Dec 2014	31 Dec 2015	31 Dec 2016	31 Dec 2016
Total Shareholder Return (TSR)	11.3%	11.7%	13.9%	12.8%
Cost of Equity Capital (K_e)	8.7%	8.7%	8.7%	8.7%
Long-Term Economic Return on Market Value ($TSR-K_e$)	2.6%	3.0%	5.2%	4.1%
Risk-Adjusted Impact of Market Movements	(0.1%)	(3.2%)	(5.6%)	(4.4%)
TSR Alpha	2.7%	6.2%	10.8%	8.5%

Looking back over the measurement period, the change in the shape of Unilever’s *EP Bow Waves* follow the movements in $TSR-K_e$, the long-run economic return on market value. This is the ultimate indicator of shareholder wealth creation or destruction. But once again, $TSR-K_e$ is made up of two components, the risk adjusted impact of movements in the market as a whole across the measurement period (which created a ‘headwind’ for the company) and *TSR Alpha*.

The impact of management’s efforts is captured in *TSR Alpha*, whereas the return shareholders experience is captured in $TSR-K_e$.

Looking forward, management should be seeking to enhance the profile of the *EP Bow Wave* through the actions they take in the *product and services market*. Succeeding in this will create wealth and

produce a positive *TSR-Ke* outcome over the long term. However, market ‘headwinds’ or ‘tailwinds’ can distort this over the short term. So, looking backwards for performance measurement purposes, it is always necessary to strip out the impact of short-term market movements, to isolate that component of wealth creation that arose largely from the market’s reaction the actions of management. This is captured in *TSR Alpha*.

Insights Derived from Research

There is an extensive body of research that underpins the understanding we have just outlined.

Understanding How Wealth is Really Created

When we examine performance over time using the *Pair of EP Bow Waves*, we find that for more successful companies, the wealth created from establishing new and higher *EP* expectations to be delivered in the future, is far more important than that arising from exceeding existing expectations.

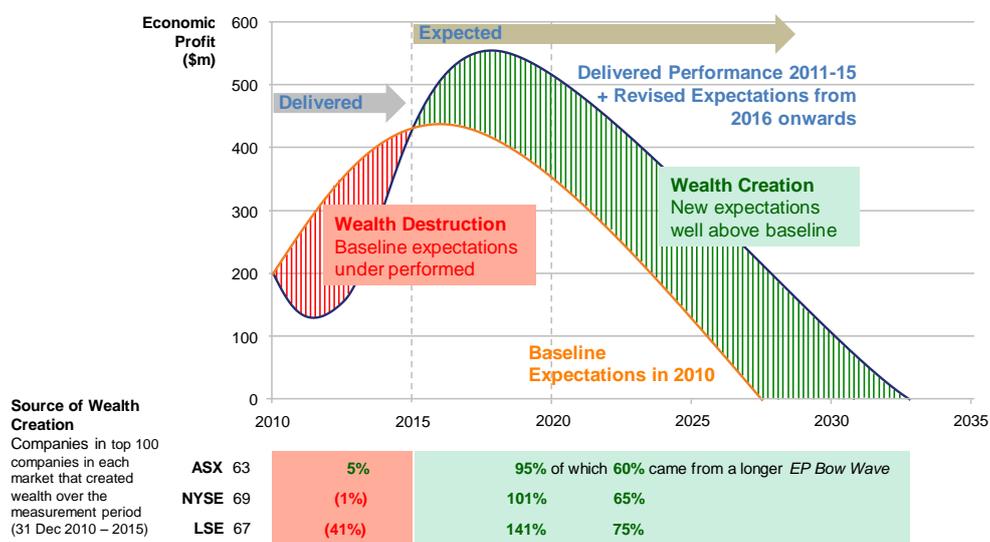
Successful companies create wealth by establishing capabilities and harnessing innovation to devise better customer value propositions and to develop higher value strategies. These lead to a series of new and higher *EP* expectations to be delivered in the future. Successful companies then deliver, or go close to delivering, these new and higher expectations. But our research suggests that they tend not to exceed existing *EP* expectations over the short-to-medium term – and certainly not to any great degree.

We have observed this in each of the studies we have conducted in the ASX, the NYSE and the LSE. They all showed that in general:

- The more successful a company was in continually creating shareholder wealth, the higher the proportion of the wealth they created that came from establishing new and higher *EP* expectations to be delivered in the future; and
- The greater the proportion of the wealth created in this way that came from making their business more sustainable, with a longer *EP Bow Wave*.

This is evident in Figure 9, which summarises the results of a research effort involving the construction of *Pairs of EP Bow Waves* for the 100 largest companies by market capitalisation in the ASX, the NYSE and the LSE. This research was completed while writing *Customer Value, Shareholder Wealth, Community Wellbeing*.

Figure 9. *Wealth Creation in Successful ASX, NYSE and LSE Companies – Five Years to 31 Dec 2015*



In the case of the ASX, just over 60 per cent of the wealth created by the 63 companies that managed to create wealth for their shareholders over the five-year measurement period, arose from actions

that led to an increase in the sustainability of their businesses and the associated economic profit streams. Roughly 35 per cent of the wealth these companies created arose from improvements in the underlying economics of their businesses, which were evident in the form of increased expectations in relation to future economic profitability and/or future growth. Just 5 per cent of the wealth created by these top-performing companies, came from outperforming market expectations over the five-year measurement period.

For companies listed on the NYSE and the LSE that created wealth for their shareholders over the five years to 31 December 2015, the picture was even more skewed towards wealth being created from enhanced expectations in relation to longer-term performance, together with an increase in the sustainability of the associated economic profit streams.

Figure 10 summarises the results of a more recent and quite detailed study of the largest 120 ASX-listed companies by market capitalisation (excluding resources companies and real estate investment trusts). In this case, we looked at the aggregate wealth creation for five rolling three-year periods over the seven years to 31 December 2016. The table shows each of the components of the aggregate wealth creation outcome in percentage terms.

There were three groups of companies clearly identifiable based on their management’s contribution to wealth creation (*TSR Alpha*):

- Top-performers that achieved an annualised *TSR Alpha* greater than 10 per cent;
- Good performers whose annualised *TSR Alpha* was positive but less than 10 per cent; and
- Other companies whose annualised *TSR Alpha* was zero or below.

The first column is 100 per cent in every case. Green shading in this column means 100 per cent of a positive number (meaning wealth was created). Red shading means 100 per cent of a negative number (meaning wealth was destroyed).

Figure 10. Sources of Wealth Creation in 120 ASX Listed Companies– Seven Years to 31 Dec 2016

		Left Hand Side of Pair of EP Bow Waves		Right Hand Side of Pair of EP Bow Waves		
		Aggregate Wealth Creation Outcome	Component Arising From Exceeding EP Expectations	Component Arising From Establishing New EP Expectations	Component Due to EP Bow Wave Extension	Component Due to Improvement in Underlying Economics
Significantly Outperformed Market on a Risk Adjusted Basis (TSRA > 10%)	49	100%	(1%)	101%	52%	49%
Outperformed Market on a Risk Adjusted Basis (TSRA >0%, <10%)	26	100%	7%	93%	51%	42%
Matched or Underperformed Market on a Risk Adjusted Basis (TSRA <0%)	45	(100%)	(62%)	(38%)	5%	(43%)
All Companies	120	100%	(31%)	131%	84%	47%

For the 49 ‘top performing’ companies, all the wealth created came from establishing new *EP* expectations to be delivered in the future – or from the right-hand side of the *Pair of EP Bow Waves*. More than half of this came from enhancing the sustainability of the business, or from increasing the length of the *EP Bow Wave*.

For the 26 ‘good performers’, 93 per cent of the aggregate wealth creation came from the establishment of new *EP* expectations. Again, more than half of this came from an increase in the length of the *EP Bow Wave*.

The Problem with Stretch Targets

The understanding which flows from this research calls into question the focus on ‘stretch targets’ that underpins budgeting, performance management and executive reward in many listed companies.

In most cases, stretch targets challenge management to extract more performance from a business (and particularly more short-term performance) than its strategy was intended to deliver. In imposing stretch targets, and then asking management to pursue them, a Board runs the risk of inadvertently encouraging the destruction of shareholder wealth by encouraging *short-termism*. This often involves either under-investing in the business or taking action that supports the pursuit of stretch financial performance targets in the short term; but erodes the value of the company’s franchise with its customers and at the same time harms other non-shareholder stakeholders. Such actions run the risk of eroding the shape of the *EP Bow Wave*, and so can destroy shareholder wealth over the longer term.

In companies that are working towards becoming enduring institutions that create value for customers and wealth for shareholders on an ongoing basis, non-shareholder stakeholders need to be seen as allies in creating customer value and shareholder wealth over the long term, not as adversaries in the pursuit of stretch target outcomes over the short term.

The problem with stretch targets is exacerbated by the fact they are usually expressed in terms of accounting measures. *Earnings*, *EPS* and *EPS growth* are the most common measures used. Their use further increases the risk of *short-termism*, due to the existence of the *EPS Myth*.

The EPS Myth – A Driver of Short-termism and an Impediment to Ongoing Wealth Creation

There is a widely-held belief throughout the business and investment communities (and particularly within the financial press), that enhancing short-to-medium term *Earnings* and *EPS* will enhance shareholder wealth. Many have researched this question over the years and the evidence is clear. It is simply not true.^v

Worse than that, widespread adherence to this belief has been a major driver of *short-termism*. It has also been a significant impediment to the building of enduring institutions that can create value for customers and wealth for shareholders on an ongoing basis.

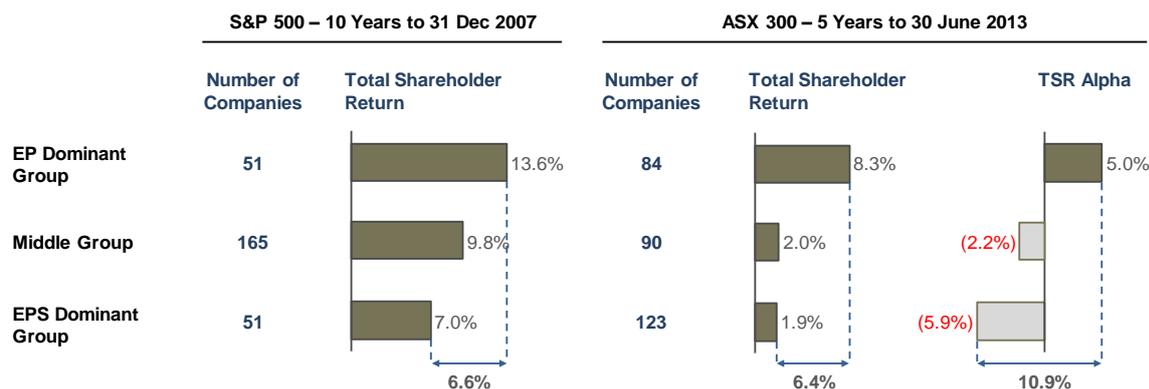
Over the years, there have been many studies also demonstrating that *Earnings* and *EPS* are poor indicators of management performance because they can be ‘bought at any price’. Their use in justifying acquisitions because they are ‘earnings accretive’ or ‘*EPS* accretive’ can be particularly problematic. Being *Earnings* or *EPS* accretive says nothing about the impact of an acquisition on shareholder wealth.

The fundamental problem with *Earnings* and *EPS* is that the amount and the cost of the capital required to underpin an *Earnings* or *EPS* outcome is not captured in *Earnings*, *Earnings growth*, *EPS* or *EPS growth*. Similarly, the widely held view that expressing *Earnings* on a per share basis as *EPS* will normalise it for the additional capital required, is also not true. New shares required to fund growth are issued at market value, not book value. Consequently, *Earnings* and *EPS* will generally move in lock step – as is demonstrated in Appendix 1 of [Customer Value, Shareholder Wealth, Community Wellbeing](#). To the extent that there is any divergence at all between *Earnings growth* and *EPS growth*, it arises because new shares might at times be issued at a slight discount to market value in a placement. But the impact of this is not significant.

There have also been many studies demonstrating that the relationship between *EP growth* and *TSR* is much stronger than the relationship between *EPS growth* and *TSR*. Our research shows that the relationship between *EP growth* and *TSR Alpha* is much stronger again – as shown in Figure 11 below.

Figure 11 captures the results of two studies. One was completed by former Marakon Associates CEO Peter Kontes (*dec.*) and a team from the *Yale School of Management*. It covered S&P 500 companies over the ten years to 31 December 2007. The second was done by KBA and covered ASX 300 companies over the five years to 30 June 2013.

Figure 11. The Strong Relationship Linking EP per share with TSR and TSR Alpha



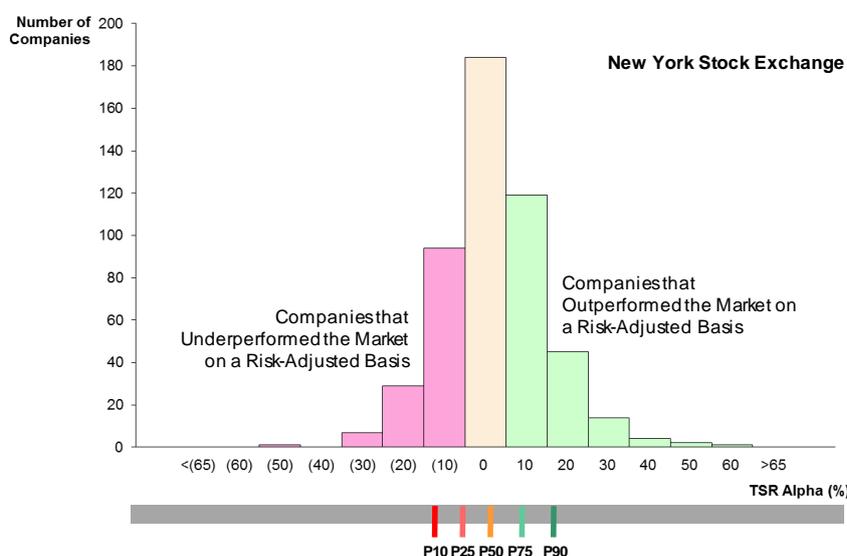
Source: Kontes, Peter; *The CEO, Strategy and Shareholder Value*, Wiley, NJ, 2010; KBA Analysis

In both cases, the difference in *annualised TSR* between companies whose *EP per share growth* was significantly greater than their *EPS growth*, and those companies whose *EPS growth* was significantly greater than their *EP per share growth*, was more than six percentage points. The difference expands to nearly 11 percentage points when we use *TSR Alpha*, which is a much more appropriate indicator of relative performance over the five-year timeframe of the ASX study.^{vi}

TSR Alpha – The Metric that Captures Management’s Contribution to Wealth Creation

Figure 12 illustrates the distribution of annualised *TSR Alpha* outcomes on the NYSE for the S&P 500 over the five years to 31 December 2015. The distribution is centred around zero as we would expect.

Figure 12. Distribution of 5-Year *TSR Alpha* Outcomes for S&P 500 – Five Years to Dec 2015



We have already established that *TSR Alpha* constitutes management’s contribution to *TSR-Ke* – the *capital market* outcome experienced by shareholders over any given measurement period.

Benchmark *capital market* performance is zero for both *TSR-Ke* over the long term (when short-term market movements are no longer a factor), and for *TSR Alpha* over the short-to-medium term. These benchmarks correspond to wealth preservation.

It is important to appreciate that it is difficult to continually deliver a positive *TSR Alpha* outcome.

If a company puts in place a performance improvement initiative, or a new and higher value strategy is adopted that is well received by the market, a positive *TSR Alpha* outcome will ensue. If over the next measurement period, the company delivers the enhanced expectations associated with that strategy but does nothing new beyond that, *TSR Alpha* should revert to zero. In order to once again produce a positive *TSR Alpha*, the company must do something further that is both new and wealth

creating. It must do this again and again if it wants to produce a positive *TSR Alpha* on an ongoing basis.

Figure 12 suggests that it is relatively difficult to produce a *TSR Alpha* outcome of 10 per cent or more over one five-year period, let alone do it on an ongoing basis. This performance threshold is also supported by other research outcomes. But a small number of companies are able to do it – and those that do tend to have a quite a disciplined approach to innovation. In our experience, this is best done by focusing the strategy development and strategic planning process at a disaggregated level – the most productive generally being a customer segment level.

Synthesis

The breakthrough in understanding we have documented tells us many things that both individually and collectively, offer a new way of thinking in relation to the way wealth is created in listed companies. Seven are particularly important from the perspective of performance measurement frameworks and executive reward plan design.

1. The goal is not to maximise shareholder value or even to create shareholder wealth *per se*. It is to build an enduring institution that can create value for customers and wealth for shareholders *on an ongoing basis*. In an economic sense, success in this endeavour stems from continually finding ways to make the company's *EP Bow Wave* higher, wider and/or longer over time.
2. Most of the improvement in the shape of the *EP Bow Wave* we observe in successful listed companies (and therefore the wealth they create) comes from establishing new and higher *EP* expectations to be delivered in the future, and then meeting those expectations over time.
3. Successful listed companies tend not to exceed existing expectations over the short-to-medium term – and certainly not to any great degree. They understand (at least intuitively) that to improve *short-term capital market outcomes*, they need to focus on developing the ability to deliver better *long-term product and service market outcomes*. This understanding calls into question the strong emphasis on short-term 'stretch targets' that underpin the budgeting, performance management and executive reward processes in many listed companies.
4. The *EPS Myth* means the focus on 'stretch targets' is even more problematic when the target is expressed in terms of *Earnings growth* or *EPS growth* outcomes.
5. For companies that are already economically profitable, increasing the width of the *EP Bow Wave* (through growth) and increasing its length (by taking action that makes individual businesses and their *EP* streams more sustainable) can be much more important than improving returns.
6. We can split the wealth created for shareholders over any measurement period (the *TSR-Ke* outcome) into that attributable to movements in the market as a whole, and that attributable largely to the efforts of management. The latter is captured in *TSR Alpha*.
7. *TSR Alpha* is a particularly important *capital market* performance metric that can be used to encourage systematic enhancement in the shape of the *EP Bow Wave* over time. Once its dynamics are understood by a management team, it will help focus their attention on creating wealth by enhancing the right-hand side of the *Pair of EP Bow Waves*. This means pursuing initiatives that lead to the establishment of new and higher *EP expectations* to be delivered in the future, and then meeting those expectations over time.

3. AN OVERVIEW OF CURRENT AND EMERGING REWARD PRACTICE

Executive reward is a bit of a mess – particularly long-term incentive (LTI) plan design. The primary reason it is a mess is a lack of clear thinking on the part of large global remuneration consultancies dating back more than twenty years.

Over the past 20-25 years, there have been several significant shifts in the design of executive reward plans, and particularly in the design of LTI plans. Each has sought to deal with a specific problem, weakness or shortcoming that has surfaced. However, while well-intentioned, these changes have mostly been dealing with symptoms. They have not tackled the primary underlying problem.

Contrary to what many believe, the underlying problem with executive reward is not related to quantum or structure. While they attract a great deal of attention, these are both secondary issues. The real problem is more fundamental. It relates to a deep-seated misunderstanding in relation to how wealth is created *on an ongoing basis* in more successful listed companies, and how the performance achieved by management in the *market for their companies' products and services*, translates into the *capital market* outcomes experienced by shareholders.

We can resolve this misunderstanding by making use of the analytical and conceptual breakthrough outlined in Section 2. Properly applied, this new understanding can provide a solid platform upon which Boards can structure executive reward plans that encourage behaviours which are demonstrably beneficial to their company and its many stakeholders, and at the same time are fair to both shareholders and executives. Crucially, it can also be used to help align an executive team with its true purpose. This, we believe, is to build an enduring institution that will prosper well beyond the executives' own tenure as leaders – and deliver significant benefits to all their company's stakeholders along the way.

Such institutions must have the ability to create value for their customers and wealth for their shareholders *on an ongoing basis*. They also need to be prepared to pursue these two joint goals in ways that at minimum preserve and wherever possible enhance, the wellbeing of all legitimate stakeholders, including the wider community and the environment. The recent pronouncement by BlackRock Chairman Larry Fink, suggesting that unless companies contribute to society they risk losing BlackRock's support, lends significant additional weight to this contention.

Ranked Relative TSR and the Evolution of LTI Plan Design

Ranked Relative TSR emerged as a performance metric roughly a generation ago, largely in response to concerns about the outcomes of LTI Plans that paid out based on *Absolute TSR*.

Absolute TSR has two fundamental flaws when employed as a performance metric in an LTI Plan. Firstly, if used in isolation, it lacks a meaningful benchmark that can establish what constitutes acceptable *capital market* performance. Secondly, it can be influenced by market movements that have nothing whatsoever to do with the efforts or the performance of management.

Those responsible for introducing *rTSR* argued that it could deal effectively with both these issues. But they were wrong. It failed to deal effectively with either of them.

LTI Plans based around *capital market* performance measured with *rTSR*, typically allocate rights to shares at the beginning of a measurement period, which then vest based on a company's *TSR* performance relative to that of a defined group of comparators. In most cases, no shares vest if the *rTSR* is below the 50th percentile (P_{50}) within the comparator group; 50 per cent vest at a *rTSR* at the P_{50} threshold, and 100 per cent vest at P_{75} or above, with a linear vesting scale between the two thresholds.

The implicit intention in LTI Plans that vest based on *rTSR*, is to deliver a 50 per cent vesting of performance rights to executives when a company 'meets *capital market* expectations'. However, meeting *capital market* expectations is incorrectly assumed by most major remuneration

consultancies, proxy advisors and other business commentators, to be equivalent to achieving a P₅₀ *rTSR* outcome. The correct definition of meeting market expectations is a *TSR Alpha* of zero. This can be and often is very different to a P₅₀ *rTSR* outcome.

Ranked Relative TSR was and remains a flawed metric. Perhaps its greatest flaw is that LTI Plans built around vesting thresholds and performance benchmarks expressed in percentile terms using *rTSR*, tend to produce lottery-like vesting outcomes. This was widely recognised at least ten years ago. But the use of *rTSR* still persisted.

To demonstrate the lottery-like nature of LTI Plans built around *rTSR*, we conducted a 1,000 iteration *Monte Carlo Simulation* of the vesting outcomes of the LTI of a typical ASX 20 company.

A *Monte Carlo Simulation* is a technique that involves simulating the outcome of a process, when the key input variables are defined in terms of probability distributions to reflect a degree of randomness or uncertainty. It is particularly useful in simulating the outcomes of LTI Plans that vest based on *rTSR*. The *Monte Carlo Simulation* we undertook was constructed around a company with a *Beta* of 1.0, and 20 comparator companies each with different *Betas*.

We know from the equation on Page 8 in Section 2 that *TSR-Ke* comprises the sum of the ‘*Risk-Adjusted Impact of Short-term Market Movements*’ and *TSR Alpha*. So, for any company, we can express *TSR* in the following terms.

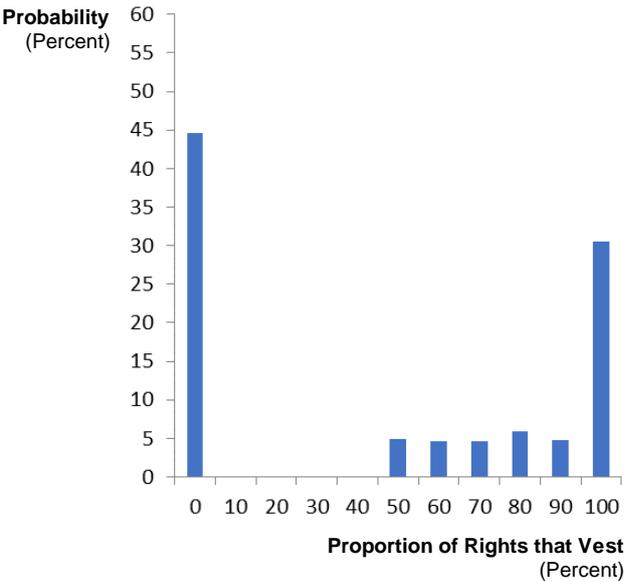
$$TSR = Ke + \text{‘Risk-Adjusted Impact of Short-term Market Movements’} + TSR\ Alpha.$$

This expression enables us to simulate *TSR* outcomes in terms of a constant *Ke* for each company, and two variables defined in terms of probability distributions.

In every iteration in the simulation, the *TSR Alpha* for each company was drawn randomly from a separate company-specific normal distribution centred around zero. Market movements were also simulated using random inputs from a normal distribution centred around zero. And while these market movements affected the *TSR* outcome for all 21 companies in the simulation, each individual company was affected differently, depending on its *Beta*. This simulation showed there is serious flaw in *rTSR* – as many have observed in the past but have not been able to prove.

Figure 13 shows the outcome of the *Monte Carlo Simulation* in terms of the probability of achieving various vesting outcomes. It demonstrates that executives can expect zero vesting 45 per cent of the time, full vesting 30 per cent of the time, and partial vesting 25 per cent of the time.

Figure 13. Vesting Based on Relative TSR Derived from Monte Carlo Simulation



These vesting outcomes are quite binary in nature, with a high probability of zero vesting and a reasonably high probably of 100 per cent vesting – giving the process a lottery-like characteristic.

This is despite *TSR Alpha* outcomes being drawn from a normal distribution centred around a mean of zero, which is a level of performance equivalent to meeting market expectations.

There are several factors that contribute to this situation. They include the fact that companies with higher risk profiles (or higher *Betas*), which require higher *TSR* outcomes to preserve shareholder wealth, tend to 'win' in terms of *TSR* and *rTSR* performance in a rising market but lose in a falling one (and *vice versa*), irrespective of management performance. But, the main problem is the probabilistic nature of the *rTSR* metric, and the way that target performance and vesting thresholds are expressed as percentile levels within a comparator group.

Expressing performance benchmarks and vesting thresholds as percentile levels within a comparator group may have seemed a logical approach to remuneration consultants who were used to providing salary information to clients in statistical terms – as quartiles, deciles or percentiles. Such an approach was part of their mindset. But it has led to many problems.

To begin with, it can be difficult to identify a meaningful comparator group for a listed company. Even if one can be found, in calculating *rTSR*, the performance of each individual comparator is just as important as the performance of the company itself. To make matters worse, the statistically defined P_{50} and P_{75} vesting thresholds within the comparator group are poor indicators of underlying *capital market* performance. They have no discernible relationship whatsoever to the wealth created for shareholders over any given measurement period (i.e. *TSR-Ke*), or to that component of the wealth created that might be attributable to the actions of management (i.e. *TSR Alpha*). As we have already pointed out, a P_{50} *rTSR* outcome does not signify that expectations have been met or that shareholder wealth has been preserved. This becomes clear when we overlay the extent to which vesting outcomes are consistent with underlying *capital market* performance.

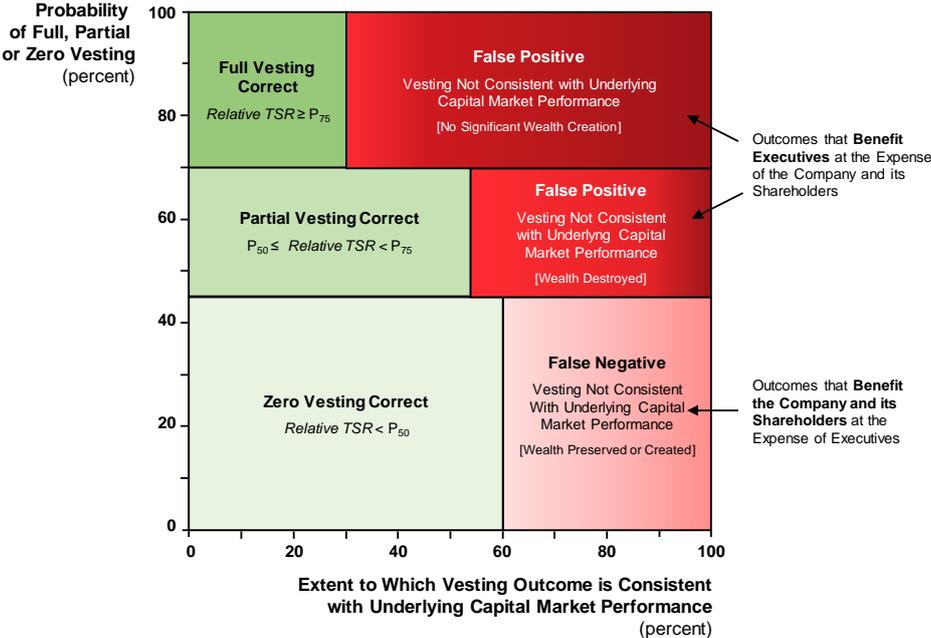
We are only able to do this because of the breakthrough in understanding presented in Section 2. This breakthrough, which lets us identify management's contribution to wealth creation by stripping out the impact of short-term market movements, enables us to use the *Monte Carlo Simulation* output to answer two crucial questions.

- When *rTSR* performance is below P_{50} and the vesting outcome is zero, how often does the underlying *capital market* performance imply a positive contribution to wealth creation that can be attributed largely to the efforts of management?
- When the *rTSR* performance is P_{50} or above, and some vesting is warranted under the LTI Plan, how often does the underlying *capital market* performance imply a negative contribution to shareholder wealth creation that can be attributed largely to the efforts of management?

It turns out that vesting based on *rTSR* produces an incorrect outcome in the form of either a 'false positive' where executives benefit at the expense of their company and its shareholders, or a 'false negative' where the company and its shareholders benefit at the expense of executives, a little over half the time. As can be seen from the graphic in Figure 14, the simulation produced slightly more 'false positives' than 'false negatives'.

- Of the 45 per cent of occasions when the *rTSR* outcome was less than P_{50} and a zero-vesting outcome ensued, two out of five were 'false negatives'. In other words, *rTSR* was below P_{50} but management's contribution to wealth creation was positive (i.e. *TSR Alpha* was greater than zero).
- Of the 25 per cent of occasions when the *rTSR* outcome was at least P_{50} but less than P_{75} , and a partial vesting outcome ensued, just under half were 'false positives'. In other words, *rTSR* was between P_{50} and P_{75} , but management's contribution to wealth creation was negative (i.e. *TSR Alpha* was less than zero).
- Of the 30 per cent of occasions when the *rTSR* outcome was P_{75} or above and a full vesting outcome ensued, three quarters were 'false positives'. In other words, *rTSR* was P_{75} or above, but management's contribution to wealth creation was below a conservative benchmark for good capital market performance (i.e. *TSR Alpha* < 2.5 per cent).

Figure 14. Vesting Outcome Based on rTSR versus Underlying Capital Market Performance



This finding presents a serious problem and a significant challenge for the Boards of listed companies that use *rTSR* as a vesting criterion in their company’s executive reward plans.

Augmenting Ranked Relative TSR Through the Introduction of Accounting Metrics

In an attempt to mitigate the lottery-like nature of vesting outcomes based on *rTSR*, roughly ten years ago, remuneration consultants began to introduce secondary LTI vesting metrics. These were all accounting-based financial metrics. By far the most common were *Earnings per Share (EPS)* and *EPS growth* – although some schemes used *Return on Capital (ROC)* or *Return on Equity (ROE)*. Occasionally quite unusual metrics like *Compound Annual Growth in ROE* were used.

Under these new schemes, allocated performance rights were typically split into two tranches. In most cases, 50 per cent of performance rights vested based on *capital market performance* assessed using *rTSR*, and 50 per cent vested based on *product and service market performance* measured using an accounting metric such as *EPS growth*.

Target *EPS growth* was generally set at a level considered appropriate given past performance (say 8 per cent), and a *stretch target* was typically set at a level 50 per cent higher (say 12 per cent per year).

Unfortunately, this ‘solution’ not only failed to overcome the lottery-like nature of that element of the LTI that continued to vest based on *rTSR*, it created another problem. This was the risk of encouraging *short-termism* as executives switched their focus to meeting the stretch *EPS growth* targets that underpinned the new and more controllable part of their LTI.

By splitting the available performance rights into two tranches, with a high probably of a zero outcome for the tranche that vested based on *rTSR* (irrespective of executives’ true contribution to their company’s *capital market* performance), scheme designers triggered an unintended outcome. They inadvertently introduced an incentive for executives to “go for broke” in relation to meeting stretch *EPS* or stretch *EPS growth* targets.

Most executives could achieve a good LTI outcome with a reasonable degree of certainty through the pursuit of stretch *EPS* or *EPS growth* outcomes.

Transitioning Away from LTIs to Much Larger STIs

Over the past twelve months, at least in part because of problems with LTI plans centred on performance rights that vest based on *rTSR*, several companies have chosen to do away with existing LTI structures altogether and place the entire “at-risk” component of executive reward within a modified STI framework.

These Single Incentive Plan or SIP schemes are still in their infancy, and there is some variation in the structures employed by early-adopters. However, the scheme described in the 2017 remuneration report of Wesfarmers Limited provides a useful case study with which to explore some of the dynamics of these schemes.

The Wesfarmers scheme involves a cash component and a STI component, with the STI being a similar order of magnitude to the combined STI and LTI under a conventional *Base + STI + LTI* plan. Its structure is summarised in Figure 15.

Figure 15. Structure of Wesfarmers’ Key Executive Equity Participation Plan

	Component	Performance Measure	At Risk Scaling	Form of Payment
	FIXED ANNUAL REMUNERATION (FAR)	Approximately \$2.5 million per annum for Rob Scott	Guaranteed remuneration during KMP tenure	Cash
+	AT RISK AWARD (KEEPP) Restricted Shares (50%) Performance Rights (50%)	Financial (60%): Group NPAT and Group ROE; Divisional EBIT and Divisional ROC Strategic and Cultural (40%): Including diversity, talent management, safety and agreed key objectives	Target: 200% of FAR Maximum: 300% of FAR (no details are provided about the targets and thresholds that drive KEEPP awards below target, at target, or between target and maximum)	Restricted Shares (50%): Issued in two tranches. 50% of shares are restricted for 5 years and 50% are restricted for 6 years Performance Rights (50%): Vesting based on <i>Ranked Relative TSR</i> against ASX 50 peer companies measured over four years
=	TOTAL REMUNERATION	The remuneration mix is “designed to reflect the diversified nature of Wesfarmers’ business and is structured to reward executives for performance at the Group level and Divisional level, and to align executive and shareholder interests through share ownership”		

Under the Wesfarmers ‘Key Executive Equity Participation Plan’, base salary or Fixed Annual Remuneration (FAR) is paid in cash.

The STI pays out based on a series of conventional single period financial performance metrics, as well as strategic and cultural measures, with the quantum of payment being 200 per cent of FAR for meeting target performance, and 300 per cent of FAR for meeting stretch performance.

Fifty per cent of the STI award takes the form of restricted shares, half of which are held for five years and half for six years. The other fifty per cent of the STI award takes the form of performance rights that vest based on *rTSR*, assessed against ASX 50 peers over a four-year measurement period.

This remuneration plan feels like a further step in the process of remuneration consultants trying to fix the problem created twenty years ago when *rTSR* was first introduced as a vesting mechanism for performance rights in LTI plan design.

It is now an accepted fact that *rTSR* did not work well. It introduced a lottery-like dimension that global remuneration consultants simply did not foresee. Subsequent augmentation with accounting metrics like *EPS growth* in an effort to mitigate this lottery-like effect, failed to fix the original problem and at the same time introduced further problems.

The new SIP schemes now being promoted by several major remuneration consultants are purported to be simpler and more transparent, however this is not true. While the simplest versions that just comprise an STI with deferral may indeed be simpler, they are not more transparent. STIs are generally less transparent than LTIs, primarily because companies don’t disclose much detail. The more complex SIPs are very complicated when compared to traditional *Base + STI + LTI* approaches.

It is also claimed that they are capable of being implemented at a Divisional level – something that was difficult with previous LTI plan designs. However, under a SIP approach, awards related to Divisional performance are based almost entirely on short-term performance (with a significant stretch element). They are then exposed to group level *capital market* outcomes. In many respects, this is just a Divisional level STI that is retained and ‘amplified’ by Group *capital market* performance.

Unfortunately, these new schemes are quite poorly aligned with what we now know about how wealth is created on an ongoing basis in successful listed companies.

- There is a large incentive to maximise short-term *product and service market* performance. This puts a great deal of focus on the left-hand side of the *Pair of EP Bow Waves* illustrated in Figures 4, 5 and 10; when it is more important to emphasise the right-hand side to encourage ongoing wealth creation.
- There is no explicit focus on the right-hand side of the *Pair of EP Bow Waves* in any element of the new approach (although it is possible that achievement of some cultural metrics or performance targets may impact the right-hand side in a positive but indirect way).
- There is a much greater level of ‘stretch’ than was evident in previous STI plans. This development also runs counter to the research findings presented in Section 2.
- While restricted shares do tend to create a quasi-LTI effect, it is as much a retention effect as a performance one. The shares are still awarded based on short-term performance, and particularly on stretch short-term performance.
- The performance rights component is still subject to the vagaries and attendant problems of *rTSR*, which were identified previously.
- While the new approach does provide a basis upon which to establish a quasi-LTI at a Divisional level, once again the performance that determines the size of that incentive is short-term in nature and involves a significant stretch component.

Research completed recently by Godfrey Remuneration Group (GRG) and summarised in a paper entitled *Does Deferred or Held Equity Give Better Alignment than LTI*, indicates that SIPs provide a high level of ‘false positive’ outcomes when there is good short-term *product and service market* performance but poor long-term *capital market* performance. This is not surprising, because the primary payment mechanism is short-term *product and service market* performance. Quite simply, SIPs simply do not discriminate based on long-term *capital market* performance.

The research also shows that traditional *Base + STI + LTI* plan designs provide the best outcome for executives and the best alignment with the interests of shareholders, when there is good long-term *capital market* performance irrespective of short-term *product and service market* performance.

Wesfarmers is not the only company to have embraced SIPs. Telstra, ASX Limited, ANZ, QBE and several other ASX Listed companies have all taken steps in this direction. However, it is not a step that should be taken without a thorough understanding of the concepts and research findings presented in this paper.

The principles of applied corporate finance always offered the potential to link *product and service market* performance with *capital market* performance, in a way that would underpin a sound approach to performance management and a more stable approach to executive reward plan design. Unfortunately, this potential went unrecognised for many years.

4. ENCOURAGING AND REWARDING ONGOING WEALTH CREATION

In the last two sections, we introduced two new streams of thought that offer a new way to think about listed company performance measurement and executive reward plan design.

In Section 2, we outlined a breakthrough in applied corporate finance in the form of the *EP Bow Wave* construct, which provides a new and more powerful lens through which to observe how wealth is created in listed companies. In Section 3, we chronicled how the major remuneration consultancies appear to have led the Boards of listed companies on a 25-year journey of discovery in relation to how executive reward plans might be designed to align the economic interests of executives with the long-term best interests of their company. Sadly, the course they set initially, the primary course corrections they made along the way, and the latest iteration involving the adoption of SIPs, all appear to have been grounded in an incomplete understanding of the principles of applied corporate finance.

SIPs do not address the fundamental issue of aligning the economic interests of executives with the long-term best interest of their company, its shareholders and its many other stakeholders. They also risk exacerbating any inclination that might exist within a particular executive team to engage in *short-termism*. They should be viewed with great caution. Before any decision is made to adopt a SIP, the potential impact should be evaluated in the light of the understanding and the research findings presented in Sections 2 and 3.

Rather than embrace a SIP as a reaction to the many problems inherent in traditional *Base + STI + LTI* plans that employ LTI's which vest based on *EPS growth* and *rTSR*, it is instructive to consider potential paths forward from a more fundamental perspective.

There are two fundamental ways in which executive reward plans (and particularly LTIs) could be improved in the light of community concerns and the material we have presented. The first is to encourage a greater and more explicit focus on the long term, or on building an enduring institution that creates value for customers and wealth for shareholders on an ongoing basis. The second is to build in more transparency.

We can address the first issue by transitioning to the use of economic performance metrics and the second by revising the structure of executive reward plans.

A Focus on the Longer Term

The research we have presented suggests that, whether consciously or not, the leaders of successful listed companies tend to build enduring institutions that create value for their customers and wealth for their shareholders *on an ongoing basis*. In doing so, they continually create capabilities and harness innovation in such a way as to progressively improve the shape of their *EP Bow Waves*.

Most of the improvement in the shape of the *EP Bow Wave* seen in successful listed companies – and the primary source of *ongoing wealth creation* – comes from establishing new and higher *EP* expectations to be delivered in the future. Successful companies then meet (or come close to meeting) those expectations over time.

From both a conceptual and an empirical perspective, the key to creating wealth for shareholders *on an ongoing basis* is to focus much more on the long term than on the short term. It is therefore important to direct management attention to the right-hand side of the *Pair of EP Bow Waves* introduced in Figure 4.

While it is important to meet *EP* expectations over any given measurement period (most of which will generally be either one or three years in length), there is no conceptual, empirical or practical reason for there to be any incentive at all for management to exceed these expectations to any significant degree – and particularly not through the pursuit of short-term initiatives designed to meet stretch targets.

There are two *principal performance metrics* that should play a pivotal role in executive reward plans that seek to encourage and reward *ongoing wealth creation* over the long term. In the *product and services market*, the principal metric is the *EP* delivered over a given measurement period, relative to the *EP* expectations embedded in the share price at the beginning of the measurement period. In the *capital market*, it is *TSR Alpha*, which is the component of wealth creation (*TSR-Ke*) largely attributable to the actions of management.

Traditional *product and service market* performance metrics like *Earnings, EPS, EPS growth, ROE* and *growth in ROE* are all components of either *EP* or *EP growth*. However, each of these accounting metrics is an incomplete measure of the financial performance achieved by management in the market for their company's products and services. As standalone measures, none can be linked directly to shareholder wealth creation.

In the *capital market*, there is a direct link between both *TSR-Ke* and *TSR Alpha*, and the change in the shape of a company's *EP Bow Wave* over time. However, no such link can be established when using *Absolute TSR* or *Ranked Relative TSR* to measure *capital market* performance.

If *EP* delivered versus expectations is adopted as the *principal financial performance metric* in the *product and services* market, and *TSR Alpha* is adopted in the *capital market*, then existing reward plan structures with *Base + STI + LTI* can be used to encourage a focus on the long term, consistent with the understanding and the research findings presented in Sections 2 and 3.

With a traditional *Base + STI + LTI* structure, a focus on the long term and an incentive to build an enduring institution that creates value for customers and wealth for shareholders on an ongoing basis, could be achieved with four simple adjustments to current practice.

1. The *STI* would be somewhat smaller than current practice, with either no stretch target, or a very limited stretch target.
2. The *LTI* would be larger than current practice, offsetting the reduction in the *STI*.
3. The use of *Earnings* or *EPS* outcomes in the *STI* would be replaced with *EP* outcomes – ideally with the benchmark being the *EP* expectations embedded in the share price at the commencement of the measurement period.
4. The vesting metric for performance rights in the *LTI* would be changed from *rTSR* to *TSR Alpha*.

This would not constitute a radical shift in remuneration plan design.

Once executives come to understand the dynamics of *EP* and *TSR Alpha* used in this way, their use would actively encourage the ongoing creation of customer value and shareholder wealth. This would in turn encourage the building of an enduring institution.

The idea of encouraging management to build an enduring institution highlights an important issue that relates to incentives of any kind. Incentives should always be part of a holistic performance management framework. Such frameworks include development processes that involve tracking and co-ordinated discussions regarding how managers can influence those levers that are expected to drive the targeted outcomes. This is far more effective than allowing the incentive itself to serve as the primary performance management tool.

The one downside with simply changing to economic metrics is that it would not overcome the lack of transparency that currently exists within traditional *Base + STI + LTI* remuneration plans.

Enhanced Transparency

There is view beginning to emerge in some quarters in Australia and the UK suggesting that the total quantum of executive remuneration should always be transparent to investors and other external observers. There is also a view that the 'at risk' component should have a strong link to *capital market* performance, as well as to factors like culture and values, which are likely to impact *capital market* performance over the longer term.

At the same time, it is generally acknowledged that while the quantum of reward for various levels of performance should be competitive to attract and retain Key Management Personnel (KMP) talent, reward outcomes should also be (at least to some degree) consistent with community expectations. This tends to amplify the need for transparency.

One of greatest impediments to transparency is the practice of issuing options or making grants of performance rights at the beginning of a measurement period, which then vest over time using poor proxies for *capital market* performance – such as *rTSR*.

Actual *capital market* performance can be measured very easily using *TSR Alpha*, which can then be used as a basis for an LTI payment according to a predetermined payout schedule. If the payment took the form of restricted shares issued at the end of a measurement period, with the face value of the award being converted into restricted shares at the prevailing share price at the end of the measurement period, the LTI payment mechanism would be completely transparent.^{vii}

This approach could help avert some of the angst that arises in relation to executive reward plan outcomes when payments are either not transparent, or inconsistent with community expectations. However, going down this path would require a different reward plan structure to the traditional *Base + STI + LTI* approach, in addition to the adoption of economic performance metrics to ensure focus on the longer term. It would also require an adjustment to the way LTI payments were made.

We will now outline one potential new structure that takes advantage of the unique nature of *TSR Alpha* as a *capital market* performance metric.

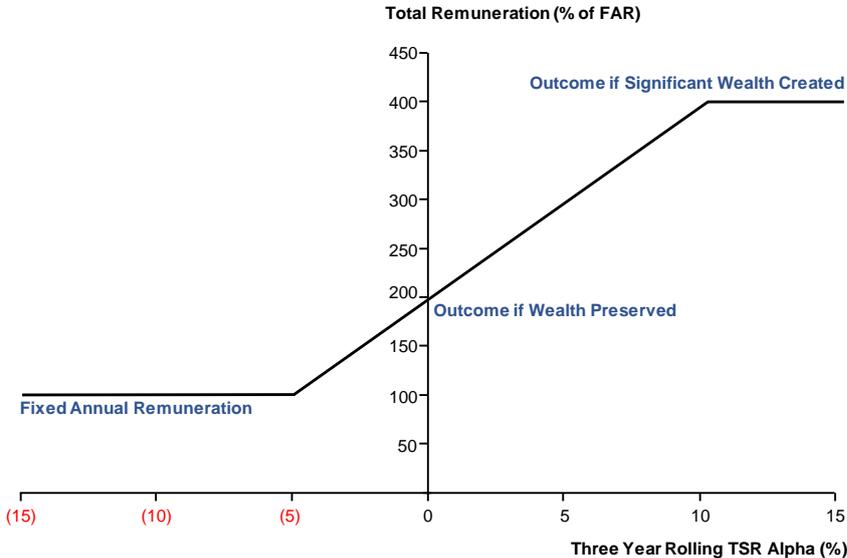
TSR Alpha: A Mechanism to Align Reward with Ongoing Wealth Creation

TSR Alpha can play a central role in the design of a reward plan that aligns the interest of management with the *ongoing creation of shareholder wealth*, and at the same time do so in a way that is completely transparent

TSR Alpha has two attributes that are both unique and crucial. The first is it captures management’s contribution to the *capital market* outcome experienced by shareholders. The second, is it captures the *capital market* consequences of a change in the shape of the *EP Bow Wave* – something that occurs largely through management establishing capabilities and harnessing innovation to enhance value for customers and then create wealth for shareholders.

This means we can use *TSR Alpha* as the foundation for a more transparent approach to executive reward plan design that aligns the economic interests of management with the ongoing creation of shareholder wealth – using a remuneration structure characterised by the illustration in Figure 16.

Figure 16. Remuneration Outcomes Linked to *TSR Alpha*



Designing and calibrating such a plan requires answers to four simple questions.

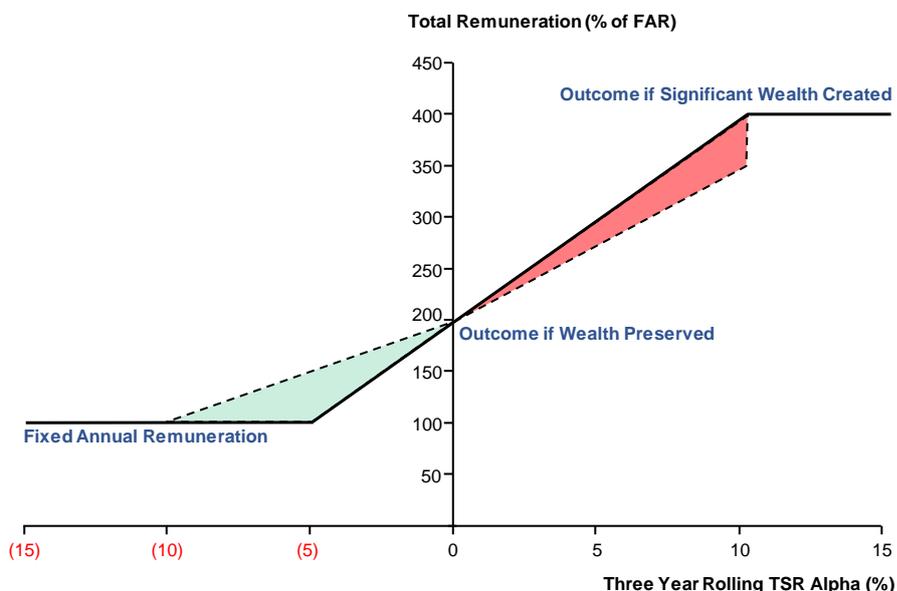
1. What is the appropriate Fixed Annual Remuneration (FAR)? *This corresponds to the horizontal line on the lower left in Figure 16.*
2. What multiple of FAR should be paid if executives preserve shareholder wealth (or to be correct technically, make a contribution to the *capital market* outcome experienced by shareholders that is consistent with wealth preservation, i.e. a *TSR Alpha* of zero)? *This corresponds to the Y intercept, which for the purposes of illustration has been set at 200 per cent of FAR.*
3. What multiple of FAR should be paid if executives deliver outstanding performance (consistent with the upper bound on a *sustainable level of ongoing wealth creation*, which our research suggests is an annualised *TSR Alpha* in the order of 10 per cent)? *This corresponds to the horizontal line on the upper right-hand side of Figure 16, which for the purpose of this illustration has been set at 400 per cent of FAR.*
4. How much reward should be surrendered if wealth is not preserved (or management’s contribution is below that required for wealth preservation), and at what point should reward revert to FAR? *This corresponds to the upward inflection point in the line on the lower left of Figure 16, which for this illustration corresponds to a *TSR Alpha* of negative 5 per cent.*

If we were to then layer in a component of reward linked to short-term performance like a conventional STI, with a financial component and non-financial strategic and cultural elements, the structure would look like that illustrated in Figure 17.

The shaded areas in Figure 17 represent situations where the component of reward linked to short-term performance outcomes in any one year, might be counter-cyclical or out of alignment with *TSR Alpha* outcomes. For example, if *TSR Alpha* were negative, but annual performance outcomes were positive, the overall outcome would lie somewhere in the green shaded area.

Equally, if the *TSR Alpha* outcome were positive, but annual performance targets were not met in full, the overall outcome would lie somewhere in the red-shaded area.

Figure 17. Remuneration Outcomes Linked to *TSR Alpha* and Annual Performance



Four Elements of Reward Linked to Wealth Creation

One way to implement a reward system with a payout profile like that illustrated in Figure 17, is outlined in Figure 18. It has four elements: a ‘Fixed Annual Remuneration’ component (FAR) and three ‘at risk’ components. *[This is only an example and the quantum and mix of remuneration should be linked to market benchmarks and a formal policy objective, e.g. market median or P50 for*

Target performance, and P75 at Stretch or maximum.]

Figure 18. Illustration of a Potential Reward Plan Structure Based on the New Understanding

	Component	Performance Measure	At Risk Scaling	Link to Performance
	FIXED ANNUAL REMUNERATION (FAR)	Determined by the Board with input from its remuneration consultant.	Guaranteed remuneration during KMP tenure	<p>These three components represent the total expected remuneration for meeting annual performance targets and preserving wealth with downside risk for failing to meet expected performance.</p> <p>Determine and declare the total quantum of expected reward.</p> <p>The composition of the total expected reward in terms of its three components is determined by the Board with input from its remuneration consultant.</p>
+	AWARD FOR ANNUAL PERFORMANCE (with downside risk)	<p>Financial (40%) EP versus expectations.</p> <p>Strategic and Cultural (60%) Metrics specific to the business and strategy with annual targets agreed with the Board as part of the strategic planning process.</p>	<p>Maximum 50% of FAR for achieving target outcomes (16.7% of total incentive)</p> <p>Minimum 0% of FAR for failing to meet targets, with some tolerance for EP underperformance</p>	
+	AWARD FOR WEALTH PRESERVATION (with downside risk)	<p>Annual TSR Alpha (or TSR- Ke less 'Risk Adjusted Impact of Market Movements')</p>	<p>Maximum: 50% of FAR for TSR Alpha outcome $\geq 0\%$ (16.7% of total incentive)</p> <p>Minimum: 0 for TSR Alpha outcome \leq minus 5%</p>	
+	AWARD FOR WEALTH CREATION (with upside benefit)	<p>Three Year TSR Alpha (or TSR- Ke less 'Risk Adjusted Impact of Market Movements')</p>	<p>Maximum: 200% of FAR for TSR Alpha outcome $\geq 10\%$ (66.7% of total incentive)</p> <p>Minimum: 0 for TSR Alpha $\leq 0\%$</p>	<p>The maximum reward for outstanding wealth creation is determined by the Board with input its remuneration consultant</p>
=	TOTAL REMUNERATION	The total maximum remuneration, the mix of remuneration between, as well as the exposure of the "at risk" components as a percentage of FAR is designed to reflect the unique characteristics of the company		

The first two 'at risk' components of reward would be structured to pay out a pre-determined percentage of the FAR for achieving a target level of performance, with some downside risk for under-performance. The third 'at risk' component would be structured to pay out a pre-determined maximum percentage of the FAR, representing the total potential upside benefit for significant wealth creation.

In the 'Award for Annual Performance', the short-term financial metric would be EP delivered over the measurement period, and the benchmark would be the EP expectations in place at the beginning of the measurement period. The EP Bow Wave construct makes this benchmark completely transparent, as is evident in the lower half of Figure 5.

In the 'Award for Wealth Preservation', the performance metric would be annualised TSR Alpha measured over rolling three-year periods – with the targeted performance being a TSR Alpha of zero.

For the 'Award for Wealth Creation', the performance metric would again be annualised TSR Alpha measured over rolling three-year measurement periods – with a performance benchmark of zero.

The structure and resultant payout dynamics shown in Figures 16, 17 and 18 are only illustrative. However, in the case shown they have been set to deliver a maximum payout of 400 per cent of FAR if plan participants deliver an annualised TSR Alpha outcome of 10 per cent or more (measured over rolling three-years periods). To achieve this outcome, executives would also need to meet all annual performance targets.

The structure would deliver a payout of 200 per cent of FAR in the event that all short-term targets were met and management's contribution to capital market performance was consistent with wealth preservation (i.e. a TSR Alpha of zero).

The minimum pay outcome would be the Fixed Annual Remuneration. This would only occur if targets were missed to a material degree, and executives' contribution to wealth creation was below a suggested TSR Alpha threshold of negative 5 per cent.

Practical Considerations

The executive reward plan structure illustrated in Figures 16, 17 and 18 is just one way to move forward consistent with the understanding articulated in Sections 2 and 3, and the design principles outlined earlier in this Section.

While the design parameters would need to be tailored to meet the unique circumstances of each individual company, it would also be important to consider the extent of the wealth creation challenge when setting the percentage or multiple of the FAR that would represent the maximum reward for outstanding performance. Equally, it will be important to consider the behaviours likely to be encouraged when setting the sensitivity of the reward outcome to downside risk.

For example, the maximum payout might be set as low as 300 or as high as 600 per cent of FAR in some situations, and the amount payable when annual targets are met, and wealth is preserved, might be set at one half or one third of that figure, depending on the circumstances of the company and the challenges being faced by its leadership team.

Of course, the actual settings for these design parameters would need to be considered in the context of the market in which the company participates, and its remuneration policy. Designing incentive awards so that total remuneration outcomes fall between P₅₀ and P₇₅ in the market when expectations have been met, should be considered reasonable (noting that application of accounting standards mean the data released to the market tends to understate actual packages). However, the key point is that to be transparent, these settings all need to be agreed in advance.

Dealing with Mispricing of Shares

One of the risks associated with equity-based payments linked to share price performance is that the share price at the beginning or end of the measurement period, may be higher or lower than the underlying intrinsic value of the company at that time. There is a reasonable chance this could happen when the number of options or performance rights granted is based on the share price at the beginning of a measurement period, and the vesting outcomes are determined on the basis of the share price at the end of the measurement period.

The structure illustrated in Figures 17 and 18 envisages that the quantum of reward is determined at the end of each measurement period, based on the performance achieved over the measurement period. The amounts to be paid in equity would be converted into restricted shares using the share price at the end of the measurement period.

This mechanism mitigates a good deal of the mispricing risk inherent in traditional equity-based approaches. To illustrate, if a relatively high quantum of 'at risk' pay was justified on the basis of an inflated share price at the end of the measurement period, it would result in a reduced number of restricted shares being issued. If the shares were restricted for a minimum of two years, it is likely that by the time they were transferred to management, any mispricing would have washed through and the share price would have fallen back towards intrinsic value – thereby correcting any potential overpayment.

This mechanism would also deal fairly with a situation in which the share price was artificially depressed at the end of a measurement period.

Rewarding Divisional KMP

When designed with the understanding contained in Section 2, either the structure illustrated in Figures 17 and 18, or a traditional approach using *Base + STI + LTI*, can be used for Divisional and Business Unit level KMP as well as for Group executives. This is because the metrics that underpin both approaches can all be derived from *EP Bow Waves*, *Progressions of EP Bow Waves*, and *Pairs of EP Bow Waves*.

While *TSR Alpha* can be observed directly at Group level from capital market outcomes, it can also be calculated quite easily at Group, Divisional and Business Unit level once the *Progression of EP Bow Waves* and *Pair of EP Bow Waves* has been constructed for each Division or Business Unit.

EP Bow Waves can and probably should be constructed at a Divisional and a Business Unit level as part of the annual strategic planning process. Divisional and Business Unit *EP Bow Waves* can then be aggregated to Group level, and at the same time reconciled with the share price and market capitalisation of the Group as a whole. The same applies with *TSR Alpha*.

There are many benefits to doing this that go well beyond performance measurement for the purpose of executive reward. Such an understanding is fundamental to the effective operation of an integrated strategic planning, resource allocation and performance management framework focused on the ongoing creation of both customer value and shareholder wealth.

At the same time, it is possible to make clear in a Remuneration Report exactly how much wealth was created at Group, and in each Division or Business Unit, over a given measurement period – and reconcile it to observable capital market outcomes. In each case, this can be broken down even further into the wealth created by exceeding *EP* expectations over the period, and that created by establishing new *EP* expectations to be delivered beyond the measurement period. It could also be shown how this aligned with individual KMP remuneration.

The ability to apply the same executive remuneration structure to both Group KMP and Divisional KMP is potentially very valuable. It is not necessary to move toward the kind of SIP remuneration structures that companies like Wesfarmers have recently adopted, simply to get a greater focus on Divisional performance in Divisional KMP remuneration outcomes. In fact, a much better and more meaningful focus on Divisional level performance can be achieved with the traditional *Base + STI + LTI* structure, so long as the metrics used are *EP* delivered versus expected and *TSR Alpha*.

5. CASE STUDY: WESFARMERS

Wesfarmers Limited is a much-admired Australian company. It is considered by many to be a true exemplar in terms of core business processes including strategy development, business planning, resource allocation, performance management and leadership succession planning.

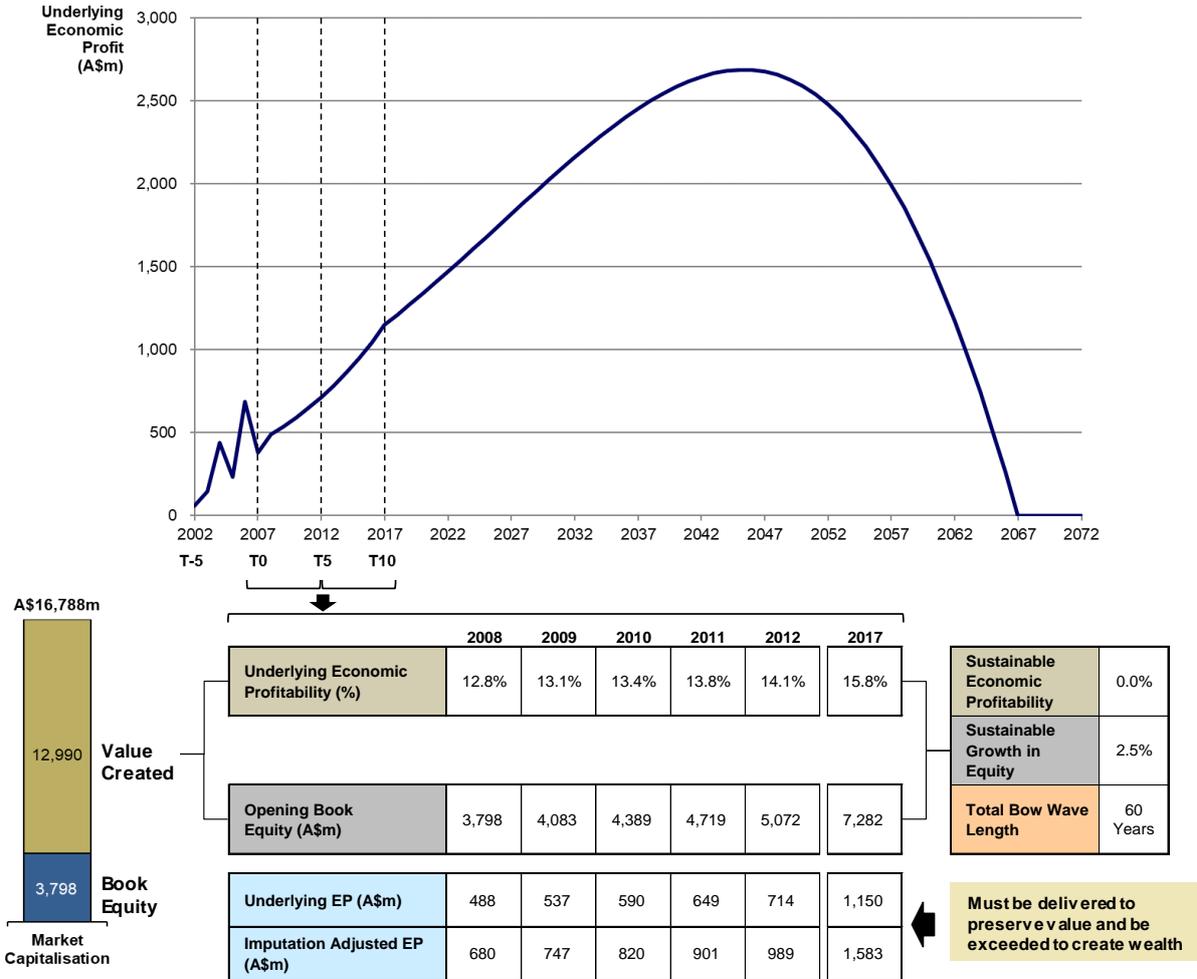
In the second half of 2017, Wesfarmers appointed a new CEO from within its management ranks. At the same time, it moved away from an approach to executive reward plan design with a traditional *Base + STI + LTI* structure and became an early adopter of a new SIP approach centred on a much larger STI with deferred equity – as described at the end of Section 3.

Wesfarmers Before the Coles Acquisition

Most observers would agree that in many respects, Wesfarmers Limited is a vastly different company today to that which existed in 2007, prior to its acquisition of Coles Limited.

Prior to its acquisition of Coles in November 2007, Wesfarmers was a stable, highly economically profitable business with a long and strong *EP Bow Wave* indicating that investors believed it had the ability to sustain a positive *EP* stream for many years, as illustrated in Figure 19.

Figure 19. Expectations Embedded in the Wesfarmers Share Price as at 30 June 2007



Wesfarmers had an underlying *economic profitability (ROE-Ke)* of 10.8 per cent in the year to June 2007, and an expectation embedded in its share price at that time suggesting this would increase to nearly 16.0 per cent by 2017. It also had an *EP Bow Wave* in June 2007 of 60 years.

Performance Imperative Post the Acquisition of Coles

Everything changed with the acquisition of Coles in November 2007. This is particularly evident when we examine Wesfarmers through an economic performance lens.

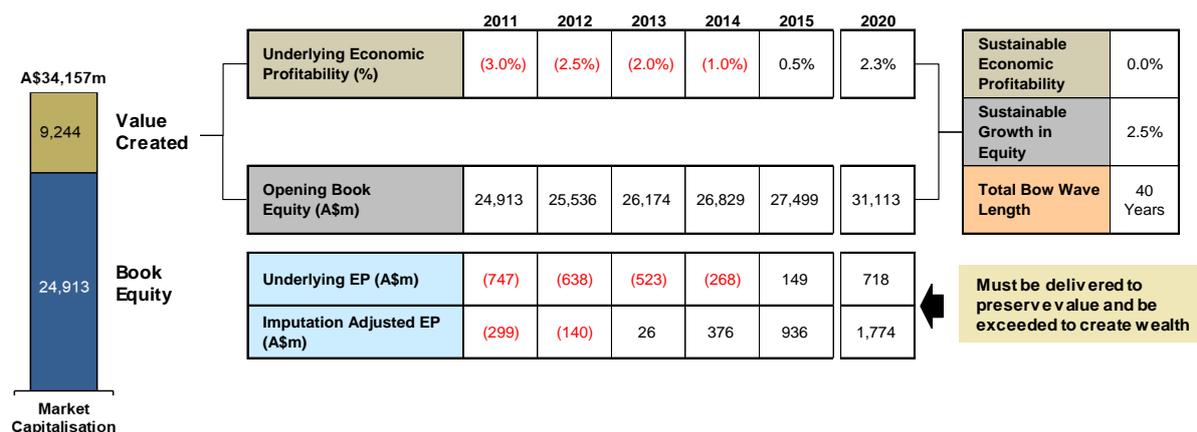
Wesfarmers went from being highly economically profitable prior to the acquisition of Coles, to being quite economically unprofitable after the acquisition of Coles. This was to be expected, given the size of the Coles acquisition and the amount of goodwill included in the purchase price that formed part of the new and much larger Wesfarmers' capital base.

In the year to 30 June 2010, Wesfarmers had an underlying economic profitability of negative 5.2 per cent – a full 18.6 percentage points lower than the economic profitability of 13.4 per cent that prior to the acquisition of Coles, was expected to be achieved in 2010.

Importantly, the share price as at 30 June 2010 indicated the market was expecting Wesfarmers to become economically profitable by 2015, as well as lifting economic profitability to approximately 2.3 per cent by 2020 and remaining economically profitable for a further 40 years after that. These expectations are illustrated in Figure 20.

Getting back to economic profitability and then meeting the market's expectations beyond that, posed a significant challenge for the Wesfarmers executive team. It was an economic imperative that appears to have been a major factor in shaping the company's executive reward plan post the acquisition of Coles.

Figure 20. Expectations Embedded in the Wesfarmers Share Price as at 30 June 2010



Wesfarmers' CEO Reward Plan – 2011-2017

The executive reward plan in place at Wesfarmers for the period 2011 to 2017 was a typical *Base + STI + LTI* plan. However, it did have some characteristics that set it apart from the plans employed by most ASX listed companies.

- It made limited use of stretch targets in the STI, but it imposed quite a significant penalty for failing to meet planned short-term performance.
- It had a conservative approach to the granting of performance rights in the LTI. While the plan provided an award of up to 200 per cent of Fixed Annual Remuneration (FAR), in most years it only made grants representing 100 per cent of FAR.
- There was a strong focus on improvement in ROE in both the STI and the LTI, with the LTI including a quite unusual metric, namely *Compound Annual Growth Rate in ROE*, measured in terms of a percentile outcome versus comparators, in a similar manner to *rTSR*.
- LTI vesting was on a combination of *Ranked Relative CAGR in ROE* (75 per cent weighting for most awards) and *rTSR* (25 per cent weighting).

The overall structure of the plan is illustrated in Figure 21.

Figure 21. Structure of Wesfarmers' Executive Reward Plan (2011-2017)

	Component	Performance Measure	At Risk Scaling	Link to Performance
	FIXED ANNUAL REMUNERATION (FAR)	Approximately \$3.3 million per annum for Richard Goyder	Guaranteed remuneration during KMP tenure	Based on role, business and individual performance, internal and external relationships, and competence and capabilities
+	ANNUAL INCENTIVE (STI) Cash for target performance Restricted shares for performance above target	Financial (60%): Group NPAT and Group ROE / Divisional EBIT and Divisional ROC Strategic and Cultural (40%): Including diversity, talent management, safety and agreed key objectives	Target: 100% of FAR Maximum: 120% of FAR	The financial performance measures were chosen because "NPAT and ROE should drive dividends and share price growth over time"
+	LONG-TERM INCENTIVE (LTI) Performance rights	Relative to companies in the ASX 50 index Ranked Relative TSR (25%) CAGR in ROE (75%)	Target: Grant of rights representing 100% FAR Maximum: Grant of rights representing 200% FAR	<i>Ranked Relative TSR</i> was chosen because "it provides a relative, external market performance measure having regard for Wesfarmers' ASX 50 peers" <i>CAGR in ROE</i> was chosen because it "is used by Wesfarmers to measure the returns on the portfolio of businesses, and is a key metric to measure Wesfarmers' long term success as it contains clear links to shareholder value creation"
=	TOTAL REMUNERATION	The remuneration mix is "designed to reflect the diversified nature of Wesfarmers' business and is structured to reward executives for performance at the Group level and Divisional level, and to align executive and shareholder interests through share ownership"		

The absence of a strong incentive to pursue stretch target outcomes was a positive given the research findings presented in Section 2. However, the fact that the STI paid out 100 per cent of FAR if planned performance was met and zero if the outcome was below 95 per cent of plan, would have amplified the focus on meeting short-term targets. While a focus on meeting planned performance is important, our research suggests some more tolerance of underperformance over the short term might be helpful in encouraging the ongoing creation of shareholder wealth.

The focus on improving ROE evident in both the STI and LTI, was almost certainly a reflection of the imperative to get the business back to economic profitability (ROE > Ke) by 2015 – a goal that was already embedded in the share price. However, meeting this expectation would not 'create shareholder value' as was asserted in Wesfarmers' 2016 Remuneration Report. It was necessary simply to preserve shareholder wealth.

An explicit and aggressive focus on ROE improvement may have been appropriate for Wesfarmers in the period post the Coles acquisition. However, in most cases it is not appropriate for other companies. For most companies, increasing ROE or ROE-Ke over a given measurement period will not create shareholder wealth *per se*, unless it is achieved without causing future growth expectations to fall, or the length of the EP Bow Wave to contract.

Brian Hartzler makes exactly this point when writing about the approach adopted by Stephen Hester at Royal Bank of Scotland in his forward to *Customer Value, Shareholder Wealth, Community Wellbeing*. The focus needs to always be on increasing the volume under the EP Bow Wave in Figure 2, not just making the vertical dimension higher. Wesfarmers was something of an exception because its market value was so dependent on a return to economic profitability.

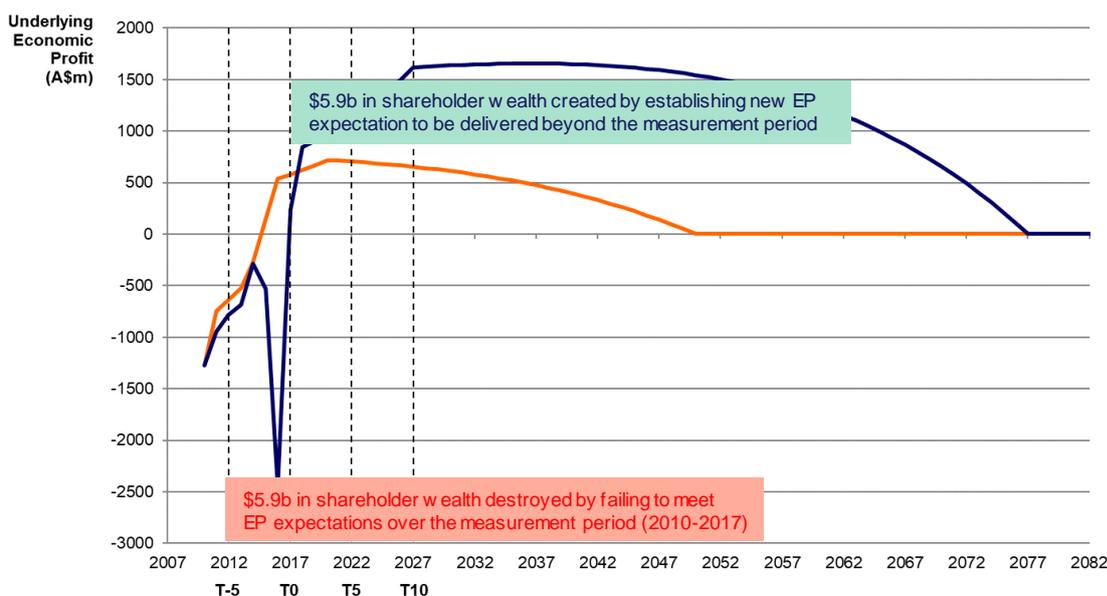
The fact the LTI grants were designed to vest on a combination of *rTSR* and *Ranked Relative CAGR in ROE* against ASX 50 peers (another metric that quantifies performance in statistical terms using percentiles), was not only unusual, but almost certainly would have amplified the lottery-like nature of the vesting outcome – albeit inadvertently.

Economic Performance Achieved – 2011-2017

Perhaps the most powerful way to demonstrate the economic performance of Wesfarmers over the period from June 2010 to June 2017 is with a *Pair of EP Bow Waves* constructed to span that period, and to then examine what happened on a rolling three year or rolling five-year basis.

Figure 22 compares the *EP Bow Wave* for Wesfarmers in June 2010 with that in June 2017 – and uses the change in profile over the intervening period to understand what happened in terms of shareholder wealth creation.

Figure 22. A Pair of EP Bow Waves for Wesfarmers – 30 June 2010 to 30 June 2017



Despite having done what most fair-minded observers would consider an excellent job in turning around Coles, restoring the group to a positive *EP*, and getting it on to a strong *EP growth* trajectory, the fact is Wesfarmers did not create any wealth for its shareholders over the seven years to June 2017. Instead it preserved their wealth.

\$5.9 billion in shareholder wealth was destroyed by failing to meet the *EP* expectations in place as at 30 June 2010 – with the bulk of the underperformance being concentrated in 2016, due to the impairment of goodwill associated with Target and an impairment to the carrying value of the Curragh coal mine, which was subsequently sold. This was offset by a commensurate increase in shareholder wealth arising from the establishment of new *EP* expectations that the market believed would be delivered beyond 30 June 2017. Of course, these are yet to be delivered.

Wesfarmers became economically profitable in the year ended 30 June 2017 when its *ROE-Ke* reached 1.0 per cent. This was two years later than our analysis suggests the capital markets expected. Nevertheless, they formed the view that the fundamentals of the business were good.

We can observe the outcome evident in Figure 22 from a capital market perspective in Figure 23.

Over the seven-years to June 2017, Wesfarmers' *TSR* just met that needed for investors to preserve wealth from their investment in the company. In other words, *TSR-Ke* was zero. But there is more to the story.

When we strip out the impact of market movements, the annualised *TSR Alpha* over the period was 2.5 per cent – and at times it was much higher on a rolling three-year or five-year basis. This was a good outcome given the size of the task that the management team set for itself when it acquired Coles. However, it is all predicated upon the ability of the business to deliver the *EP* expectations that were embedded in (and therefore underpinned) its share price as at 30 June 2017.

Figure 23. Wealth Creation (TSR-Ke) and TSR Alpha Outcomes for Wesfarmers

	Three Years Ended					Five Years Ended			Seven Years Ended
	30 Jun 13	30 Jun 14	30 Jun 15	30 Jun 16	30 Jun 17	30 Jun 15	30 Jun 16	30 Jun 17	30 Jun 17
Total Shareholder Return (TSR)	17.1%	15.0%	15.6%	6.5%	5.2%	12.5%	11.1%	12.9%	11.5%
Cost of Equity Capital (Ke)	11.5%	11.5%	11.5%	11.5%	11.5%	11.5%	11.5%	11.5%	11.5%
Long-Term Economic Return on Market Value (TSR-Ke)	5.6%	3.5%	4.1%	(5.0%)	(6.3%)	1.0%	(0.4%)	1.4%	0.0%
Risk-Adjusted Impact of Market Movements	(3.5%)	(1.9%)	2.8%	(2.9%)	(4.2%)	(2.0%)	(4.0%)	0.2%	(2.5%)
TSR Alpha	9.1%	5.4%	1.3%	(2.1%)	(2.1%)	3.0%	3.6%	1.2%	2.5%

While we can observe the outcomes in Figure 23 directly from capital market data, we can also derive them from the EP Bow Wave construct. The full suite of information that can be derived from EP Bow Waves, Pairs of EP Bow Waves, and Progression of EP Bow Waves is illustrated in Figure 24 for Wesfarmers over the seven-years to 30 June 2017. The percentages in Figure 24 are the same as those in the right-hand column of Figure 23. Similar information can be generated over any measurement period.

Figure 24. The EP Uplift plus TSR Alpha Construct for Wesfarmers – Seven Years to 30 June 2017

Sources of Wealth Creation from Bow Waves	
Wealth Created During Measurement Period	(5,883)
Wealth Created Post Measurement Period	5,905
Total Wealth Creation	22
Cost of Equity	11.5%
Total Shareholder Returns	11.5%
TSR -Ke	0.0%
Wealth Creation from Market Movements and TSR Alpha	
Long Run ERP	6.5%
Measurement Period ERP	4.0%
Measurement Period minus Long Run ERP	(2.5%)
Risk Adjusted Market Movement	(2.5%)
TSR Alpha	2.5%
TSR-Ke	0.0%
Wealth Creation from Market Movements	(10,742)
Wealth Creation from TSR Alpha	10,763
Total Wealth Creation	22
Components of Wealth Created Post Measurement Period	
WC from Delta Bow Wave Length	1,748
WC from Delta Returns / Growth	4,156
WC Post Measurement Period	5,905

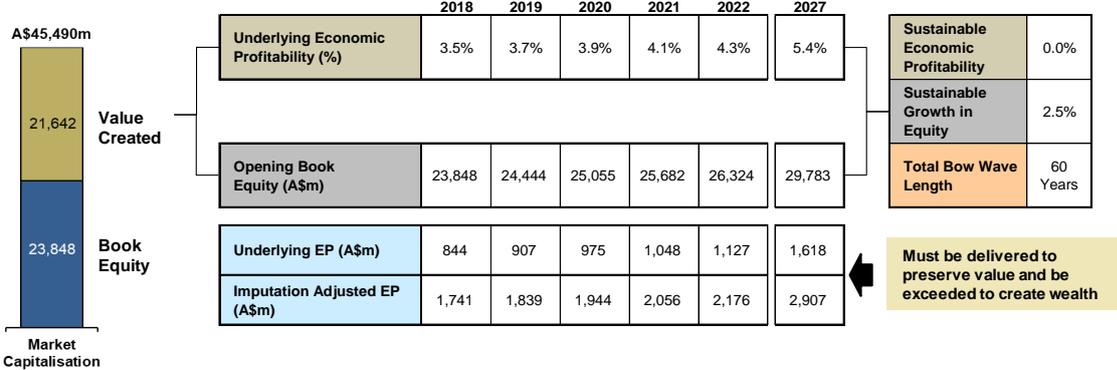
Importantly, over the seven-year measurement period ending 30 June 2017, the dollar quantum of wealth creation arising from a positive *TSR Alpha* of 2.5 percent is \$10.7b. It is useful to be able to compare this contribution to wealth creation to the total remuneration paid to KMP over the measurement period.

One of the consequences of the performance summarised in Figures 22, 23 and 24 is the challenge it poses for Wesfarmers’ new CEO. In order to justify its share price as at 30 June 2017, the company must deliver the economic performance shown in Figure 25. Simply to preserve wealth for shareholders as at 30 June 2017, Wesfarmers must increase its economic profitability from 1.0 per

cent in 2017 to 4.3 per cent by 2022 and to 5.4 per cent by 2027. This could be a challenge given the changes occurring in the retail sector in Australia and the UK.

These same expectations will probably need to be met or exceeded for the remaining performance rights awarded to the previous CEO and his team to vest.

Figure 25. EP Expectations Embedded in the Wesfarmers Share Price as at 30 June 2017



CEO Reward Plan Outcomes – 2011-2017

Over the period from 2011 to 2017, the Wesfarmers executive reward plan delivered the following outcomes for its CEO Richard Goyder.

The STI payout was on average, roughly equivalent to 100 per cent of FAR, although it fell to 30 per cent in 2016 when some significant write-offs occurred. Performance rights were granted under the LTI with a face value of approximately 120 per cent of FAR. Both outcomes suggest that the Board exercised a fair degree of restraint in approving STI payments, and in making LTI grants.

Of the seven tranches of performance rights granted over the period from 2011 to 2017, only four grants had been tested for vesting conditions as at 30 June 2017. Approximately 235,000 shares vested out of a total possible vesting of 495,000 shares, representing a vesting ratio of approximately 48 per cent. The value of the vested shares at the share price on 30 June 2017 was approximately \$9.5 million. It is difficult to know at this point how many of the performance rights in the three remaining tranches will ultimately vest.

If we were to assume that none of the untested performance rights will vest (a conservative but not unrealistic assumption given recent developments), the total value of Richard Goyder’s remuneration over the period from 2011 to 2017 would have been approximately \$55.1 million (an average of around \$7.9 million per annum). If we were to assume that 50 per cent of the untested performance rights will vest, the value of Richard Goyder’s remuneration over this period would have been approximately \$59.9 million (an average of around \$8.6 million per annum).

What Can We Learn from the Wesfarmers Case Study?

The Wesfarmers situation gives rise to some interesting questions.

- Is a figure of between \$7.9 million and \$8.6 million an appropriate annual remuneration outcome for what was achieved over the seven years to June 2017 – a period during which shareholder wealth was preserved, and more importantly management’s contribution to that outcome was positive (with a *TSR Alpha* outcome contributing \$10.7 billion over seven years)?
- To what extent is the share price that existed at the end of the CEO’s tenure, dependent on the achievement of economic performance in the future that is somewhat greater than is being achieved today; and is the Board satisfied that such performance will be achieved?

- To what extent might the relatively 'lean' outcomes from the LTI plan over the seven years to 30 June 2017, have contributed to the decision to move to a new executive reward plan that does not contain an LTI component, and is geared heavily towards short-term *product and service market* performance metrics that are more controllable than the *capital market* performance metrics used in the previous LTI Plan design?

There is a widely held view that while management can exercise a good deal of control over most metrics used to gauge *product and services market* performance, *capital market* outcomes are largely if not entirely outside their control. This misguided belief has been reinforced for many years by the unclear thinking that most remuneration consultants have employed in LTI plan design – using statistical *capital market* performance metrics like *rTSR*, for which there can never be any link back to *product and service market* performance.

Sections 2, 3 and 4 demonstrate in principle that management can and does influence both *product and service market* performance and *capital market* outcomes. Figures 23 and 24 show by how much capital market outcomes were influenced by management in the case of Wesfarmers. However, to do this it is necessary to use the correct performance measures. These are economic profitability (*ROE-Ke*), *EP* and *EP growth* in the product and services market, and *TSR Alpha* in the capital market.

There were a number of measurement periods during Richard Goyder's tenure at Wesfarmers where the company produced a positive *TSR Alpha*, but the LTI Plan delivered minimal vesting. Similarly, in the case of Unilever used as an illustration in Section 2, the LTI plan delivered zero vesting to the CEO Paul Polman from capital market performance measured with *rTSR* over the three years to 31 December 2016, despite delivering outstanding capital market performance with an annualised *TSR Alpha* of 10.8 per cent.

If Wesfarmers had employed an LTI Plan consistent with that put forward in the second part of Section 4, the outcome for its CEO Richard Goyder would have been somewhat different. Instead of earning somewhere between \$55.1m and \$59.9m, he would have earned closer to \$65.0m. And throughout his entire period as CEO, his team and his Board would have been aware at every point in time, how the *product and service market* performance they were producing was impacting the *capital market* outcome being experienced by their shareholders.

Wesfarmers is a company with many important and admirable attributes that other companies look to as a role model. However, in relation to how they approach executive reward, it is important that other don't follow Wesfarmers' lead before giving serious consideration to the thinking presented in Sections 2, 3 and 4.

6. SYNTHESIS AND CONCLUDING REMARKS

In this paper, we have demonstrated how a breakthrough in applied corporate finance has provided us with a new and more powerful lens through which to observe how wealth is created in listed companies, and particularly how it is created *on an ongoing basis* by truly successful companies.

Our research suggests truly successful companies tend not to exceed short-term financial performance expectations – and certainly not to any great degree. Instead they create new capabilities and harness innovation leading to the establishment of new and higher expectations to be delivered in the future. They then deliver these expectations while at the same time continuing to establish new and even higher expectations which they again deliver over time.

Emulating the performance of such companies will best be achieved by focusing explicitly on the long term and adopting economic performance metrics in both the *product and services market* and the *capital market*. The two principal economic performance metrics are *EP* versus expectations in the *product and services market* and *TSR Alpha* in the *capital market*.

We have also drawn on extensive research to question a core premise underpinning conventional performance measurement frameworks, and the related practice of using stretch targets in executive reward plan design. If not used with great care, the incorporation of stretch targets in STI Plan design can lead to *short-termism* and the destruction of shareholder wealth – as well as damaging the interests of other stakeholders.

We have also looked closely at *rTSR* – a flawed metric used widely in LTI Plan design. And we have observed how a new Single Incentive Plan approach to executive reward has emerged in response to problems with existing LTI Plan designs centred on *rTSR*, and calls for greater transparency.

SIPs appear to have all the hallmarks of simply being the next step in the journey of discovery that listed company Boards have been taken on over the past 25 by major global remuneration consultancies – a journey that has not been grounded in a proper understanding of the principles of applied corporate finance. As a result, there is every chance that SIPs, with their enhanced focus on short-term performance, will be vulnerable to many of the problems inherent in the incentive plan designs and structures that they are seeking to replace.

For companies that have already taken the step of transitioning to a SIP, the option exists to refocus on the long term by using *TSR Alpha* instead of *rTSR* in that element of their incentive plan that still involves performance rights that vest over time.

The research we have presented shows that for a listed company to improve *capital market performance* over the short, the medium and the longer-term, its management team must focus primarily on establishing the ability to deliver better long-term *product and service market performance* – not better short-term performance. That appears to be the opposite of the direction that the SIP initiative seeks to move companies.

NOTES

- i @PaulPolman 31 December 2017, 1.44am AEST
- ii The idea that both *Earnings growth* and *EPS growth* can be 'bought at any price' is explained in detail in *Customer Value, Shareholder Wealth, Community Wellbeing* and illustrated in [an address by Denis Kilroy](#) to the *Governance Institute of Australia* annual conference in 2015.
- iii Wealth is preserved with management meet market expectations by delivering the EP expectations embedded in their company's share price at the beginning of the measurement period. Of course wealth preservation generally means that shareholder value increases. For example, for wealth to be preserved in a business with a Ke of 10 per cent, the value of the shares in the company must increase by 10 per cent if no dividends are paid, and by 10 per cent less the dividend yield if dividends are paid (assuming no new shares are issued and no shares are bought back).
- iv <https://www.youtube.com/watch?v= aHRWKuLr1E>
- v Most recently, this research has been conducted by KBA, and by Peter Kontes (dec), the former CEO of Marakon Associates who conducted the research in conjunction with a team from the Yale School of Management. In the past (mainly in the 1990s) work was done on this topic by Marakon, Alcar, LEK, McKinsey & Co, HOLT Value Associates, Stern Stewart and A.T. Kearney. All studies reached much the same conclusions.
- vi There is a much more detailed examination of the *EPS Myth* in Chapter 2 of *Customer Value, Shareholder Wealth, Community Wellbeing*, and in an easily accessible form in [this address to the Governance Institute of Australia](#) annual conference in 2015. <https://www.youtube.com/watch?v= aHRWKuLr1E>
- vii It is recognised that in the current remuneration environment, executives are accustomed to any increase in the share price underpinning performance rights to flow as an additional benefit to them. Consequently, this approach may be seen as less generous. Some degree of modification to deliver comparable value outcomes for executives may need to be considered as a transitional step towards this approach.