Pearl Meyer

AS WE SEE IT

Total Shareholder Return: It's Not the Magic Metric

As We See It: The widespread and growing use of total shareholder return (TSR) as an incentive measure is not the panacea many believe it to be. To test our point of view we wanted to explore one critical question: *Does the inclusion of TSR measures in long-term incentive plans result in improved firm performance?*

To find out the answer, Pearl Meyer collaborated with the Cornell University ILR School's Institute for Compensation Studies to conduct original research on the use of TSR by S&P 500 companies over a ten year period.

The Era of TSR

The meteoric rise of TSR as a long-term incentive plan metric might be one of the most significant and long-lasting trends in executive compensation program design. Over the past decade, many Compensation Committees have changed long-term incentive plan designs to include TSR, jumping from roughly 17 percent of the S&P 500 in 2004 to almost 50 percent in 2013[1]. At the same time, the most prominent proxy advisory firms have consistently used TSR to define performance in the CEO pay-for-performance relationship, and very recently the SEC has proposed new disclosure rules that would mandate proxy disclosure of the link between pay and performance solely in terms of TSR. Naturally, shareholders want to see a strong link between executive compensation levels and investment returns, and they often rely in part on their analysis of TSR.

The assumed benefits of linking pay to TSR have received considerable media attention and widespread boardroom discussion over the past few years. Some of the common assertions include:

- Measuring TSR on a relative basis levels the playing field by removing overall market movements and industry cycles from the evaluation of executive performance.
- The use of TSR ensures incentive awards are aligned with shareholders' interests.
- The use of relative TSR allows a company to avoid use of hard-to-set multiyear financial goals.

[1] *TSR, Executive Compensation, and Firm Performance A Brief Prepared by the Institute for Compensation Studies*, ILR School, Cornell University, September 24, 2015
http://www.ilr.cornell.edu/institute-for-compensation-studies/insights-research

But a funny thing happened along the TSR path. In practice, it wasn't clear that using TSR in a long-term incentive program actually improved company performance. Further, TSR cannot communicate anything to a management team regarding *how* to improve performance.

What Did Our Research Uncover?

Our research with Cornell provided substantial insights and strongly suggests TSR is not a complete solution. We first set out to understand the real numbers behind the apparent trend of including TSR as an incentive measure and the breakdown of its use by industry. To get to the heart of the matter, we also had to look closely at the weight of incentive plan awards with a TSR measure and the relative performance of companies that used the metric versus those who did not. Additionally, it was important to understand if there was data to show that the introduction of TSR had an effect on financial or TSR performance and whether or not the weight of a TSR plan likewise impacted those same results. Our research:

- Validates the rise in the prevalence of TSR plans across all industries, with data indicating a twofold increase between 2004 and 2013 and a particularly large uptake in Consumer Staples and Information Technology;
- Shows firms with TSR plans are typically larger (based on market cap and revenue), yet less profitable (based on 10 year Compound Annual Growth Rate [CAGR]);
- Demonstrates that including TSR in a long-term incentive plan does not lead to improved company financial performance;
- Shows a weak negative relationship between the use of TSR and revenue growth in the year following implementation of a TSR-based incentive plan; and
- Finds there is no evidence that using the metric in an incentive plan actually improves future TSR.

Interestingly, our research also shows that companies using TSR for the first time are putting less weight on the metric than those who have been using TSR longer. Does this imply some companies have recognized the potential shortfalls of using TSR as an incentive plan metric, yet feel pressure to incorporate it given external pressures? We think so. In fact, recent survey results[2] show a number of outside influences are cited as "somewhat" or "very important" reasons for using TSR as an incentive measure. An astounding 75% of respondents cited peer practices, while 56% said investor concerns play a role and more than half say proxy advisory groups are influencing this choice.

Frankly, we are not surprised by these findings. Over the years, various studies have sought to link improved corporate performance to the use of particular incentive metrics. **The secret: there is no single magic metric.** Compensation Committees would be well served by evaluating other non-TSR metrics for use in their company's incentive plans to drive company performance. It's our experience that the most effective incentive plan metrics reflect the company's business model, economic cycles, and any unique

[2] *Pearl Meyer On Point: Looking Ahead to Executive Pay Practices in 2016,* September 2015
www.pearlmeyer.com/executive-pay-practices-2016

challenges and opportunities facing an organization. In short, **metrics must be chosen on a company-by-company basis and ensure they provide the ever elusive line of sight.**

Then Why Use TSR?

As we see it—and the research validates this—TSR does not lead to improved performance and does not improve line of sight. If so, then why use it? Many companies feel the need for an incentive program that aligns well with the proxy advisory policies that use TSR to measure the CEO pay-for-performance relationship. This approach also satisfies external pressures and aligns with market norms, whether or not it is effective. Unfortunately, this pressure may only become more intense with the SEC's proposed rules to mandate disclosure of pay-for-performance through the TSR lens. Finally, TSR can be a helpful tool for rewarding participants for outperformance against peers, which promotes accountability to shareholders. However, fundamentally, it is by no means an effective *incentive* metric.

It is important to understand these reasons for the popularity of TSR as an incentive plan metric. But when the primary objective of an executive compensation program is to better enable strategy execution through incentives, proxy advisory policies and external pressures should be secondary considerations.

If Not TSR, Then What?

In our experience, maintaining internal focus on the following strategy-based guidelines creates effective long-term incentive plans that ultimately drive sustainable value creation for the company—a result that certainly aligns with shareholder interest.

- **Select metrics that are understandable and actionable.** Using highly-customized metrics or metrics that are only known and controllable by a select few participants may not pass this first step.
- **Focus on strong centerpiece financial metrics.** These metrics define profitable growth and returns for your company/industry. Do the homework necessary to identify these centerpiece metrics.
- **Include driver/lead measures.** Strive to include leading indicators of success or strategic milestone metrics that are believed to be drivers of future value and help communicate how success can be achieved.
- **Ensure performance objectives are calibrated fairly and correctly.** Use a full complement of tools and resources to arrive at incentive goals. Using budgets and Wall Street expectations can help calibrate goals, but this approach is no replacement for a comprehensive goal calibration analysis.
- **Educate and communicate.** Don't assume all plan participants understand the goals, metrics, incentive plan design, or what specific actions individuals should take to support company performance. Educating and communicating can be invaluable and is often a critical missed step.

At its core, the success of incentives lies in creating programs that participants can understand and feel they can influence. Perhaps this statement is the most damning of TSR-focused programs, which typically are associated with weak understanding and a weak ability to influence.

As We See It: TSR as a corporate metric provides strong alignment with shareholder interests, but lacks two critical aspects of a successful incentive: clear line of sight linking an executive's actions to a specific business goal and information on what it takes to successfully influence that end result. We recommend that Compensation Committees would be well served to conduct a thorough review of the effectiveness of their TSR-based incentives and work to discover the right balance of alignment and line of sight by using TSR in combination with appropriate incentive metrics for their business and strategy.

About Pearl Meyer

Pearl Meyer is the leading advisor to Boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.

NEW YORK
570 Lexington Avenue, 7th Floor
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, NE, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON
93 Worcester Street, Suite 100
Wellesley, MA 02481
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
123 N. Wacker Drive, Suite 860
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LONDON
3rd Floor
58 Grosvenor Street
London W1K 3JA
+44 (0)20 3384 6711
london@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

SAN FRANCISCO
595 Market Street, Suite 1340
San Francisco, CA 94105
(415) 651-4560
sanfrancisco@pearlmeyer.com

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