Hot Topic: Pay-for-Performance
Getting Alignment Right

Hot Topics in Executive Compensation Webinar Series
Hot Topics in Executive Compensation
Webinar Series

www.aon.com/hottopics_execcomp

July 17  Getting an “Early Read” on the Coming Year
August 7  **Hot Topic: Pay-for-Performance—Getting Alignment Right**
August 28  Hot Topic: More Effective Long-Term Incentive Plans
September 18  Hot Topic: Assuring Effective Disclosure
Today’s Speaker

Richard Harris
Partner, Aon Hewitt
Objectives for Today

- Pay-for-Performance Questions In Need of Answers
- Why You Should Care
- Principles for Pay-for-Performance Alignment
- Uses of Pay-for-Performance Analysis
- Framing Pay
- Framing Performance
- Now What?
Pay for Performance Alignment Can Seem Jumbled

Purpose of today is to put things in order
Alignment Requires Answers to 5 Questions

1. What is the best definition of pay for pay-for-performance alignment?
2. Should performance be defined only by TSR?
3. Are all incremental percentiles created equal?
4. Is “middle 50” too broad to determine alignment?
5. Are these the right peer companies for pay and performance alignment?
Why You Should Care

- **Shareholders care** (and proxy advisors care)
  - Good governance
  - The largest single factor in votes against a Say-on-Pay (SOP) proposal

- **Compensation committee members care**
  - Want to set proper performance standards
  - Want to pay fairly for performance delivered
  - Want no surprises

- **Executives care**
  - Don’t understand why pay is “average” (median)
  - Want fair compensation for performance delivered
  - Impact both a motivation and retention

- **Everyone’s doing it**
  - 75% of companies have or are planning to review realized and/or realizable pay
  - 14% of S&P 500 companies reported realized and/or realizable pay in 2013
Why Evaluate Pay-for-Performance Alignment?

Look Backwards: Communicate With Shareholders

Plan Forward: Assess, Test and Verify/Modify
Principles for Pay-for-Performance Alignment

Pay Principles

- The same time period for measuring pay and performance
- Pay to be based on performance delivered for the period (financial performance and share price change)
- Pay should be comparable across companies—requiring comparability across pay elements—especially equity
- Data for pay calculations is publicly available and easy to access
- Straight forward to enhance understanding

It is not possible to satisfy all principles 100%—trade-offs are inevitable.
Principles for Pay-for-Performance Alignment

Performance Principles

- Use both share-based and financial measures
- Provide clear rationale for measures used
- Use measures comparable across companies
- Assess percentile rankings AND absolute differences
Framing Pay

- Alternative pay definitions
- Deep dive on realizable pay
## Comparing Executive Pay Definitions

<table>
<thead>
<tr>
<th></th>
<th>Primary Purpose</th>
<th>Usefulness for Assessing Pay-for-Performance Alignment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Target Pay</strong></td>
<td>Provide pay structure linked to market</td>
<td>Limited. Target positioning above/below 50th percentile will impact pay-for-performance.</td>
</tr>
<tr>
<td><strong>Proxy Pay</strong></td>
<td>Meet regulatory requirement</td>
<td>None. Mix of actual and accounting values.</td>
</tr>
<tr>
<td><strong>Realized Pay</strong></td>
<td>Provide an alternative view to proxy pay</td>
<td>Limited. Timing differences between grant and realized dates invalidates cross-company comparisons.</td>
</tr>
<tr>
<td><strong>Realizable Pay</strong></td>
<td>Provide reasonable comparisons of pay and performance relative to peers</td>
<td>High. Best comparability of pay and performance over common timeframe.</td>
</tr>
</tbody>
</table>
Comparing Executive Pay Definitions

<table>
<thead>
<tr>
<th>Definition of Compensation</th>
<th>Base Salary</th>
<th>Bonus</th>
<th>Nonequity Incentive</th>
<th>Stock Awards</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Annual Incentive</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Multiyear Performance Cash Plan</td>
<td>Restricted Stock</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Multiyear Performance Plans</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Option Awards</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Change in Pension Value</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>All Other Compensation</td>
</tr>
<tr>
<td>Target Pay</td>
<td>Actual</td>
<td>N/A</td>
<td>Target at grant</td>
<td>Target</td>
</tr>
<tr>
<td>Proxy Reported</td>
<td>Actual</td>
<td>Actual</td>
<td>Actual received, granted previously</td>
<td>Grant value</td>
</tr>
<tr>
<td>Realized Pay</td>
<td>Actual</td>
<td>Actual</td>
<td>Actual in year paid</td>
<td>Vested shares at price when vested</td>
</tr>
<tr>
<td>Realizable Pay</td>
<td>Actual</td>
<td>Actual</td>
<td>Actual</td>
<td>Value at period-end target</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>a) Actual paid during period</td>
<td>Option pricing model at period end</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>b) Actual</td>
<td>or spread at period end</td>
</tr>
</tbody>
</table>

Proprietary & Confidential  | Hot Topics in Executive Compensation Webinar  | August 7, 2013
Realizable Pay Deep Dive

Consensus
Base Salary: Total for period
Annual Incentive/Bonus: Total for period
Restricted Stock: Total shares granted × price at end

Alternative Values
Options: Total options granted × ???
Performance Plans: Total performance shares earned versus 1 earned/ 2 @ target grant × price at end
(If cash units, same issue on counting number of units)

Open Questions
Change in Pension Values: Part of realizable pay or addressed separately
Other Income: Part of realizable pay or addressed separately
## Realizable Pay Deep Dive

<table>
<thead>
<tr>
<th>Form of LTI</th>
<th>Alternatives</th>
<th>Comments</th>
</tr>
</thead>
</table>
| **Restricted Stock (Awards/Units)** | **A. Current Value.** Shares/units awarded during performance period \times price at end of period—regardless of vesting. | ▪ Performance reflected in change in share price since grant  
▪ Broad acceptance                                           |
| **Stock Options**               | **A. Intrinsic Value.** Options awarded during period multiplied by market value at period end less exercise price; no value lower than zero.  
**B. Period End Black-Scholes.** Black-Scholes using facts at end of period  
▪ Exercise price at grant  
▪ Market value at end of period  
▪ Term/expected life at end of period | The period end Black-Scholes approach has the following disadvantage and advantage:  
▪ **Disadvantage.** Includes an estimate of value rather than a final performance value.  
▪ **Advantage.** Includes providing intrinsic gains while values more comparable to other equity vehicles. Otherwise, option-heavy companies would appear to provide lower pay. |
| **Performance Shares**         | **A.** Performance share/units earned for period plus target # granted during period—shares/units earned; price at end of period  
**B. Performance shares/units earned during the period—regardless of grant date; price at end of period | Using shares/units earned has the following disadvantages and advantages:  
▪ **Disadvantage.** Pay philosophies or market values may have changed since grants made.  
▪ **Advantages.** Using earned values better reflects pay for performance. |

---

*Aon Hewitt recommended*
## Equity Alternatives: Principles

<table>
<thead>
<tr>
<th>Stock Options</th>
<th>Intrinsic Value</th>
<th>Period End Option Model</th>
<th>Performance Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares Granted</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Shares Earned</td>
<td>+</td>
<td>+++</td>
<td>+</td>
</tr>
</tbody>
</table>

### Table:

<table>
<thead>
<tr>
<th></th>
<th>Same Time Period</th>
<th>Pay Reflects Performance Delivered</th>
<th>Compatibility Across Companies</th>
<th>Data Publicly Available</th>
<th>Straight Forward</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intrinsic Value</td>
<td>+</td>
<td>+++</td>
<td>+</td>
<td>+</td>
<td>++</td>
</tr>
<tr>
<td>Period End Option Model</td>
<td>+</td>
<td>++</td>
<td>+++</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Shares Granted</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Shares Earned</td>
<td>+</td>
<td>+++</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

---

Intrinsic Value + + ++ ++
Period End Option Model + ++ + +
Shares Granted + + + +
Shares Earned + +++ + +
Intrinsic Values Understate in Short Term

Aon Hewitt Study of Share Prices Versus Black-Scholes Values

- 45 companies
- Intrinsic values discounted to grant data at risk-free rate

<table>
<thead>
<tr>
<th>Years From Grant</th>
<th>Intrinsic Value % of Black-Scholes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50.9%</td>
</tr>
<tr>
<td>2</td>
<td>69.2%</td>
</tr>
<tr>
<td>3</td>
<td>81.1%</td>
</tr>
<tr>
<td>4</td>
<td>94.7%</td>
</tr>
<tr>
<td>5</td>
<td>102.8%</td>
</tr>
</tbody>
</table>
Realizable Pay Deep Dive

Change in Pension Values

- Values in summary compensation able do not reflect annualized value of retirement pay
  - Can be large numbers distorting pay-for-performance alignment
  - Values not related to performance

- Address separately total retirement value (DB & DC) in terms of current value, early retirement and normal retirement

Other Compensation

- Address separately in C,D&A
  - Typically, there are reasons if the reported number is material
Why Evaluate Pay-for-Performance Alignment?

Look Backwards: Communicate With Shareholders
- Wait to add to C,D&A unless…
  - Company has already begun
  - Need it to help pass SOP
- Wait because…
  - Lack of a clear standard
  - Once start no stopping
  - Lack of shareholder buy-in to concept

Plan Forward: Assess, Test and Verify/Modify
- Start now, can modify later if needed
- Pick the best definition for longer-term decision making
- Need not be same as proxy definition
- Test with proxy advisor peers as well as company-selected peers
Framing Performance

Look Backward
- TSR
- Incentive measures
  - Supporting rationale

Plan Forward
- 4 Box Evaluation Framework
  - Internal/External
  - Qualitative/Quantitative
Why Not TSR Only

- TSR measures return to shareholders…but only if measured to infinity
- Measures expectations as well as performance
- TSR measured point-to-point
  - Ignores performance between beginning and end
  - 10-30 day averages at tails help modestly
- Relative TSR is highly peer group dependent
- Hard to stay in upper quartile consistently
  - Same companies not always in top quartile
  - Bad to good can lead to top quartile TSR
4 Box Evaluation Framework

- Similar to approach for selecting incentive measures
- Process builds rationale for any external communications

<table>
<thead>
<tr>
<th></th>
<th>Qualitative</th>
<th>Quantitative</th>
</tr>
</thead>
</table>
| **External Perspective** |  Value Creation Theory  
                          |    Investor/Analyst Input                  |    Statistical Correlations              |
|                          |    Peer Practices                          |    Peer Historical Performance            |                                          |
|                          |                                            |    Analyst Expectations                    |                                          |
| **Internal Perspective** |  Strategies/Tactics  
                          |    Value Tree                              |    Business Plans                        |
|                          |    Company Incentive Measures               |    Historic Trend                          |                                          |
Drivers of returns and growth differ by industry/company

Return on Capital

Maximize value by maximizing area above ROC-COC line

ROC = COC

Growth

An acquisition may lower ROC but increase total value

New products/financial restructuring can change ROC-COC spread

Value Creation

Value Destruction

Growth with poor ROC

Proprietary & Confidential | Hot Topics in Executive Compensation Webinar | August 7, 2013
Statistical Correlations/Peer Historical

- Joint compensation/finance project
- Expect modest R/R$^2$ values
  - Relative as important as absolute
  - TSR has been volatile
  - 2008–2010 financials/TSR mismatch
- Review long-term trends
  - At least 5 years
  - 3-year as well as 1-year
- Use best definitions for financial performance
  - Comparability across companies
  - Comparability across time
- Review base data and output in detail
Strategies/Tactics

- Identifies any differences from overall industry
  - Performance improvement situation
  - Performance leader
  - Strategic transformations
  - Acquisitions/divestitures
- Part of peer company selection
- Reinforces links between investor presentations and pay structures
Percentiles vs. Absolute Differences

<table>
<thead>
<tr>
<th>Decile</th>
<th>TSR</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>188%</td>
</tr>
<tr>
<td>90th</td>
<td>57%</td>
</tr>
<tr>
<td>80th</td>
<td>42%</td>
</tr>
<tr>
<td>70th</td>
<td>33%</td>
</tr>
<tr>
<td>60th</td>
<td>23%</td>
</tr>
<tr>
<td>50th</td>
<td>18%</td>
</tr>
<tr>
<td>40th</td>
<td>15%</td>
</tr>
<tr>
<td>30th</td>
<td>9%</td>
</tr>
<tr>
<td>20th</td>
<td>2%</td>
</tr>
<tr>
<td>10th</td>
<td>-10%</td>
</tr>
<tr>
<td>Min</td>
<td>-61%</td>
</tr>
</tbody>
</table>

**Absolute Difference in TSR by Decile**

1 S&P 500 Consumer Discretionary 1-Year TSR ending 12/31/2012
I Have All This Data…Now What?

What If: Pay
- Pay mix
- Pay positioning
- Pay curves flatter/steeper
- Realizable pay/target pay ratio

What If: Performance
- Stock price was/will be ± X%
  - Company
  - Industry
- Financial performance was/will be ± Y%

What If: Pay and Performance
- Δ pay for Δ performance
What Are We Trying to Address?

Shareholder
- High pay is ok as long as performance is high
- Pay and performance need to be aligned

Executive
- We pay average yet we hire great people and high performance
- We set tough performance targets
- Performance bar goes up every time we have a great year

Compensation Committee
- Incentive plans are working if we average 1.0 × target
- We need to pay at the 50th percentile
Answers to the Five Alignment Questions

Q1. What is best definition of pay in pay-for-performance alignment?
   A. Realizable pay with:
      ▪ Option valuation
      ▪ Performance plans awarded
      ▪ Change in pension value and other compensation addressed separately

Q1. Should performance be defined only by TSR?
   A. No—use verified financial measures in addition to TSR

Q3. Is each incremental percentile of equal value?
   A. No—assess absolute differences as well as percentiles

Q4. Is middle 50 too broad to determine alignment?
   A. May be ok for proxy—not for planning forward

Q5. Are these the right peer companies for pay and performance alignment?
   A. Test company peers and those of proxy advisors
Questions
Hot Topics in Executive Compensation
Webinar Series

www.aon.com/hottopics_execcomp

July 17  Getting an “Early Read” on the Coming Year
August 7  Hot Topic: Pay-for-Performance—Getting Alignment Right
August 28  Hot Topic: More Effective Long-Term Incentive Plans
September 18  Hot Topic: Assuring Effective Disclosure
Contact Us

If you have any questions or comments about today’s presentation, please reach out to us at humancapitalconsulting@aonhewitt.com.
About Aon Hewitt

Aon Hewitt empowers organizations and individuals to secure a better future through innovative talent, retirement and health solutions. We advise, design and execute a wide range of solutions that enable clients to cultivate talent to drive organizational and personal performance and growth, navigate retirement risk while providing new levels of financial security, and redefine health solutions for greater choice, affordability and wellness. Aon Hewitt is the global leader in human resource solutions, with over 30,000 professionals in 90 countries serving more than 20,000 clients worldwide. For more information on Aon Hewitt, please visit www.aonhewitt.com.

© 2013 Aon plc

This document is intended for general information purposes only and should not be construed as advice or opinions on any specific facts or circumstances. The comments in this summary are based upon Aon Hewitt's preliminary analysis of publicly available information. The content of this document is made available on an “as is” basis, without warranty of any kind. Aon Hewitt disclaims any legal liability to any person or organization for loss or damage caused by or resulting from any reliance placed on that content. Aon Hewitt reserves all rights to the content of this document.