Incentive Design Guiding Principles and Trends

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BILLY SCHULTZ | TOWERS WATSON
SENIOR CONSULTANT, EXECUTIVE COMPENSATION
DIRECT: +1 703 258 7719
william.schultz@towerswatson.com
www.towerswatson.com
Agenda

- Incentive Design Guiding Principles
- Incentive Plan Risk Assessment
- Enduring High Performing Company Incentive Design Trends
Towers Watson’s EC Guiding Principles – Incentive Design

Performance-based pay design is one of the most fundamental and, arguably, the most important aspects of EC

- It encompasses a wide range of considerations — from establishing incentive objectives and the mix of incentives (e.g., annual, long term) to selecting incentive vehicles and, ultimately, to determining incentive payouts
  - Given the range of considerations, their complexity and the potential trade-offs among various decisions, effective performance-based pay design belies simple conclusions (e.g., “options are not performance-based,” “the same incentive measures should not be found in multiple incentive plans”). The assessment of incentive program effectiveness requires in-depth analysis.

- Beyond design, pay-for-performance assessment (i.e., how actual total pay compares with actual performance on an absolute and relative basis) is an issue that continues to gain increased attention, as it’s becoming a key focal point for shareholders in organization disclosures.
  - We view this as a positive development because it has helped to crystallize relationships between relative pay and relative performance, while also expanding the definitions of pay being considered by organizations and shareholders (e.g., “realizable pay”).
  - This growing attention to alternative definitions of pay not only yields insights for shareholders and stakeholders about EC program structure and effectiveness but also can provide important insights that promote better pay program design.
  - We believe we’re still relatively early in the evolution of pay-for-performance measurement and encourage organizations to explore and embrace the emerging analytics to help enhance program designs for all senior executives and pay disclosures in applicable jurisdictions.
Towers Watson’s EC Guiding Principles
We believe that certain components of performance-based pay design warrant particular attention

- Specifically, we believe that organizations with above-median pay philosophies have a responsibility to consider pay-for-performance analyses to ensure that pay outcomes are appropriate across all levels of performance, especially poor performance. The lack of such analyses can perpetuate scenarios in which pay levels outpace actual performance.
- Additionally, organizations should be more thoughtful about their determination of incentive objectives (e.g. line of sight, shareholder alignment, retention), which should support the selection of more effective vehicles and performance measures.
- Finally, organizations should also seek to improve the rigor in certain design areas that often receive too little attention, namely target and range setting, testing of incentive payouts relative to performance and the effective use of discretion.
Towers Watson’s EC Guiding Principles
Mix, Measures and Funding

1. **Favor line-of-sight and alignment rewards:** For senior executives, a majority of total rewards should be in the form of incentive compensation, a majority of incentive compensation should be in the form of long-term incentives, and a majority of long-term incentives should be focused on shareholder alignment and/or line of sight (i.e., retention-focused incentives should be the smallest LTI component). [Engagement]

2. **Align incentives with organizational level:** The proportion of total rewards allocated to target/expected levels of variable compensation should increase with each executive level within the organization. [Accountability]

3. **Balance incentives:** The incentive plan design should reflect the organization’s desired balance of shareholder alignment and line-of-sight-related objectives through the selection of LTI vehicles and the weighting and selection of incentive measures. [Trade-off between Alignment and Engagement]

4. **Three or more years:** For long-term performance plans, the performance measurement period (as distinct from the vesting period) should be at least three years. [Accountability]

5. **Align to strategy:** Performance measures, while subject to periodic validation, should be selected in light of the organization’s long-term strategy. [Purpose]

6. **Measure holistically:** Organizations should include multiple measures across their incentive plans to promote a holistic view of organization performance. [Alignment]

7. **Weigh pros and cons:** Organizations must consider the strengths and weaknesses of each performance measure, including TSR. [Trade-off between Alignment and Engagement]
Towers Watson’s EC Guiding Principles
Mix, Measures and Funding (cont.)

8. **Consider individual performance:** Individual performance should be considered in performance-based pay decisions at all organizational levels. [Engagement]

9. **Consider relative performance:** For variable compensation plans, relative performance must be considered implicitly through incentive target setting or explicitly through performance measurement. [Accountability]

10. **Multiple funding considerations:** While there is no predefined set of measures that are appropriate for a particular type of organization, incentive plan funding and design must consider each of the following types of financial measures: (i) earnings, (ii) revenue growth, (iii) balance-sheet-linked financial returns, (iv) cash flow and liquidity, and (v) cost of capital. [Accountability]
Towers Watson’s EC Guiding Principles
Targets, Ranges and Discretion

11. **Rigorous target setting:** A rigorous process must be applied in setting performance targets and ranges that should consider: (i) the organization’s long-term strategic plan, (ii) enduring standards reflecting historical norms of financial performance for the organization, industry and relevant peer organizations, (iii) analyst/economic forecasts and (iv) the organization’s budget. [Purpose]

12. **Tailored incentive curves:** The incentive payout curve and range should vary based on the volatility/sensitivity of the underlying performance measures, probability of achievement, affordability of outcomes, and how corresponding payouts will compare with market and historical results. [Accountability]

13. **Include circuit breakers:** For senior executives, a reasonable minimum level of organization-level financial performance (i.e., circuit breaker) must be achieved before incentives can be funded. [Accountability]

14. **Apply informed discretion:** Discretion is a critical tool for ensuring a holistic assessment of sustainable performance and quality of outcomes, and should be applied to incentive funding and allocation decisions based on a predefined framework. Compensation committees should consider how best to disclose and explain their use of discretion. [Accountability]
Towers Watson’s EC Guiding Principles
Pay-for-Performance Assessment & Incentive Program Review

15. **Annual and retrospective:** Organizations must annually review pay-for-performance alignment. [Alignment]

16. **Assess impact of changes:** To inform compensation program design changes, organizations must review the pay-for-performance alignment of proposed changes on a retrospective and prospective basis. [Alignment]

17. **Broad scope:** For purposes of assessing pay-for-performance alignment and EC program design changes, pay-for-performance analyses must: (i) include NEOs, (ii) be conducted over a multiyear basis, (iii) include both the direct market reference group for compensation benchmarking and a broader market perspective, (iv) consider both percentile ranking and sharing-rate analyses versus peers, (v) consider TSR as well as the financial performance measures used in the organization’s incentive plans and (vi) use either earned or realizable pay frameworks. [Alignment]

18. **Justify above-market positioning:** Organizations that effectively target compensation above the market median must demonstrate how this positioning will vary across different business cycles and levels of performance. A prospective pay-for-performance analysis (reflecting percentile rank and sharing ratio) should be conducted to help support target positioning. [Accountability]

19. **Frequent:** Organizations must assess incentive programs frequently (at least every two years) using a clearly defined market perspective (custom peer group, industry or broader market perspective). [Accountability]

20. **Multiple analyses:** In benchmarking and reviewing incentive payout levels, organizations should not only consider payouts as a percentage of target on an aggregate and job-specific basis but should also compare payouts as a percentage of value created (i.e., a sharing-rate analysis). [Alignment]
Typical phases in the design process

- Setting Priorities
  - Executive interviews
  - Employee focus groups
  - Incentive philosophy and guiding principles

- Business and Competitive Analysis
  - Competitive pay analysis
  - Design element benchmarking
  - Shareholder value driver analysis
  - Financial performance analyses

- Design Element Development
  - Conceptual and detailed design
  - Conduct aggregate and incumbent level modeling to illustrate cost and sensitivity
  - Consensus around design concept?

- Calibration
  - Probability analysis
  - Peer analysis
  - Budget analysis
  - Investor expectations analysis

- Implementation
  - Goal setting/cascade
  - Stakeholder analysis
  - Communication planning

Evaluation and redesign
- Pay-for-Performance
- Realized Pay Assessment

- Although the overall design process follows these broad phases, each phase and step can be iterative based on the scope and complexity of the project

- Every situation will be different and some steps and activities may be more important or require more rigorous analysis than others
### Prioritize the oversight

It is important to identify those pay plans that relate to the highest-risk businesses and positions.

<table>
<thead>
<tr>
<th>Risk Area</th>
<th>Sample Details</th>
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</table>
| Compensation Committee has oversight over pay plans for highest-risk businesses/positions | • Determines and approves, with input and recommendation from the Chairman of the Management Committee, compensation paid to managing directors and executive officers  
• Establishes annual and long-term performance goals and objectives  
• Reviews the CEO Basket, which is the share pool used by the CEO to grant shares below the executive level  
• Makes recommendations to the Supervisory Board regarding the adoption of cash-based and equity-based compensation plans  
• “All-in” review of compensation and use of multiple market data sources — including custom survey data — are strong examples of the committee’s oversight practices |
| Compensation Committee has discretion in modifying pay outcomes | • Incentive plan payouts are not formulaic. CEO presents recommendation based on performance against established measures with the Committee having final authority for determining payouts under the plans |
| Board has ability to recapture compensation earned due to misconduct | • Company XYZ has a clawback policy that provides the ability to recapture incentive compensation from a Covered Employee (M4 and higher) earned due to misconduct  
• Anti-hedging policy also in place |
## Compensation Philosophy

Avoid the extremes; balance the mix between fixed and variable pay, cash and equity, short- and long-term incentives, and corporate, business unit and individual goals

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| Fixed pay is an appropriate portion of the pay mix | - Mix is balanced; cash pay is delivered through base salary and annual cash incentives; equity-based pay is delivered through stock options, restricted stock and performance shares  
- Base salaries are reviewed based on job responsibilities, experience, individual performance and market competitiveness; CEO fixed pay is 17% of total; fixed pay for other NEOs range from 19% to 31% of total* |
| Variable pay is a balance of short and long-term incentives | - Appropriately balanced between short- and long-term incentives as a result of the prior MTI opportunity moving to a long-term payout opportunity |
| Performance measured at the appropriate organizational level with complementary STI and LTI metrics | - EBITDA (also trigger for STI/LTI), Costs and HSE are STI metrics  
- Balance between corporate, business unit and individual goals under the STI  
- LTI tied to shareholder value creation via stock options, restricted stock and performance shares (3-yr ROA and 3-yr Costs) |
| Target pay opportunities and actual pay outcomes are appropriate when compared to appropriate industry survey data | - Annual executive compensation review assesses pay both on a target and actual basis; actual pay outcomes are aligned with actual performance  
- Overhang and run rate are reviewed to balance needed share pool with sustainability of spend rate (both overhang and run rate are below the industry median) |
| Incentive plans are stress-tested for multiple scenarios under realistic assumptions to ensure that potential payouts are reasonable relative to potential results | - Specific goals for varying levels of performance are not set or disclosed (ISS/Glass Lewis concern)  
- However, management conducts robust analysis of results via multiple lenses that include historical performance, peer performance, business environment, etc. (risk mitigated through payout caps) |
Ensure well-designed plans
Look for red flags that are not offset by other risk-mitigating factors

<table>
<thead>
<tr>
<th>Risk Area</th>
<th>Sample Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appropriately leveraged incentive curves (i.e., not excessively steep or flat)</td>
<td>• Incentive curve does not exist due to lack of goal-setting</td>
</tr>
<tr>
<td>Performance and retention incentives are balanced</td>
<td>• Long-term incentives balance performance orientation (50% performance shares, 25% stock options) with retention considerations (25% restricted stock)</td>
</tr>
</tbody>
</table>
| Executive “handcuffs” reinforce long-term retention         | • NEOs have a significant amount of unvested equity  
• New employment agreement with CEO offer significant portion of pay in equity                                                                                                                                  |
| Capped incentive payouts                                    | • Annual incentive plan payouts cannot exceed 300% of target opportunity  
• Performance shares capped at 200% of target opportunity                                                                                                                                                    |
| Formulaic awards with consideration for plan affordability   | • Awards are not formulaic; however, executive awards are contingent upon a minimal level of EBITDA performance  
• Maximum payout values are evaluated during planning phase                                                                                                                                                    |
| Appropriate timing of awards and payouts                   | • Payout timing is consistent with applicable performance periods; equity grants are timed appropriately relative to material disclosures                                                                   |
| Executive stock ownership guidelines                        | • Ownership requirements as a multiple of salary are in place for executives and are market competitive                                                                                                       |
| Change-in-control (CIC) excise tax gross-ups per IRC § 280G  | • No CIC tax gross-ups for NEOs                                                                                                                                                                                |
## Get performance metrics right

Reflect risk and use of capital, quality and sustainability of results, and employee line of sight

<table>
<thead>
<tr>
<th>Risk Factor</th>
<th>Sample Details</th>
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<tbody>
<tr>
<td>Value creation for the enterprise in terms of risk-adjusted return</td>
<td>• Metrics focused primarily on delivery of outcomes rather than inputs to business processes</td>
</tr>
<tr>
<td></td>
<td>• Annual incentive plan performance metrics are focused on growth and/or improvement</td>
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<td></td>
<td>• Annual equity grants provide an incentive to grow the stock price sustainably over the long-term</td>
</tr>
<tr>
<td>Thorough and informed qualitative assessment of how results were achieved</td>
<td>• Management and finance teams review incentive outcomes to ensure sustainability and fairness of results</td>
</tr>
<tr>
<td>and the quality and sustainability of the results</td>
<td>• Results are presented and discussed with the Compensation Committee before the approval of payouts with the Committee retaining discretion to modify payouts</td>
</tr>
<tr>
<td>Validation of pay-for-performance relationship</td>
<td>• Annual pay review process considers historical performance versus budget and payouts relative to targets</td>
</tr>
<tr>
<td>relative to peer companies and market expectations</td>
<td>• ISS CEO pay for performance analysis indicates general alignment (slightly underpaid relative to performance); Glass Lewis’ C-rating indicates alignment</td>
</tr>
<tr>
<td>Appropriate use of top-line vs. bottom-line metrics; incorporation of</td>
<td>• Annual incentive plan includes bottom line metric (EBITDA) and top line metric (Costs)</td>
</tr>
<tr>
<td>relevant metrics from the balance sheet, income statement and cash flow</td>
<td>• Performance shares heavily weighted towards ROA</td>
</tr>
<tr>
<td>statement</td>
<td>• Stock price measurement via stock options and restricted stock holistically considers performance</td>
</tr>
</tbody>
</table>
Define pay plan governance processes
Clearly define oversight roles throughout the organization to ensure that pay plans are aligned with business goals and risk tolerances

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</tr>
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</table>
| Compensation Committee    | • Responsible for determining and approving executive compensation  
• Oversees the development, evaluation and approval of incentive compensation, equity-based pay and other benefit plans for all employees  
• Establishes and reviews total rewards philosophy and objectives  
• Oversees the design and competitiveness of compensation plans for executive officers |
| Executive Leadership       | • Recommends incentive goals and payouts  
• Makes recommendations to Committee on all compensation related issues within the company (broad-based) as well as those specific to executive officers |
| Human Resources            | • Considers market trend information and other specific data, as needed, to ensure pay and incentive levels are at market competitive rates consistent with the compensation philosophy expressed by the Committee  
• Makes recommendations to management on compensation related issues based on internal and external factors  
• Prepares all items to be included in the Committee book with assistance of other departments |
| Legal                      | • Reviews plan documents to ensure compliance  
• Ensures safeguards are in place in all plan documents to protect Company XYZ |
| Finance                    | • Provides financials for annual incentive plan and maintains accruals  
• Ensures plans can be supported financially within the total expenses of the company and divisions while maintaining profitability |
| External Consultants       | • Committee uses external consultant to support its duties noted in the Charter  
• Reviews pay practices, total direct compensation and incentive plans against appropriate market data sources and trends  
• Makes recommendations to the Committee |
Study Overview

- Towers Watson has conducted a detailed study of executive pay design among 50 U.S.-based companies with sustained high performance — and what these companies do differently from broader corporate America in how they design their pay programs.

- Enduring high performing companies (“EHPs”), like the broader market, use a wide array of compensation designs.

- At the same time, this examination highlighted some important findings on EHP practices, including the:
  - Importance of company size/life cycle on compensation plan design
  - Enhanced long-term orientation through LTI vehicle design
  - Impact of LTI vehicle choice on realizable pay
  - Inadequacy of a “one-size-fits-all” approach
EHP and Market Overview

- EHPs reflect those 50 companies within the S&P 1500 with the most sustained outperformance in TSR vs. the S&P 1500 over a fifteen year period
  - Revenues of the EHPs range from approximately $500M to $150 B

- Within this study, references to the market reflect a subset of approximately 500 S&P 1500 companies with a size and industry profile comparable to that of the group of EHPs

- In addition to analyzing EHPs versus the market overall, comparisons were also examined based on the following size cuts:
  - Revenues $500M - $2B
  - Revenues $2B - $5B
  - Revenues >$5B
Analytics Overview

- This analysis covered the following compensation program elements:

<table>
<thead>
<tr>
<th>Structure and Philosophy</th>
<th>Annual Incentive Plan Design</th>
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<tbody>
<tr>
<td>Compensation Philosophy</td>
<td>Number of Performance Measures</td>
</tr>
<tr>
<td>Use of Compensation Peer Groups</td>
<td>Performance Measures Used</td>
</tr>
<tr>
<td>Say-on-Pay</td>
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<table>
<thead>
<tr>
<th>LTI Design</th>
<th>Pay Levels and Mix</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Vehicles</td>
<td>Current pay opportunity and mix</td>
</tr>
<tr>
<td>Vehicle Type</td>
<td>3-year aggregate actual vs. target pay</td>
</tr>
<tr>
<td>Vehicle Combinations</td>
<td>3-year realizable pay vs. performance</td>
</tr>
<tr>
<td>Stock Option Characteristics</td>
<td>LTI mix</td>
</tr>
<tr>
<td>Time-vested Restricted Stock Characteristics</td>
<td></td>
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<tr>
<td>Long-term Performance Plan Characteristics</td>
<td></td>
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</tbody>
</table>
Detailed Findings: Annual Incentive Plan Design

- Number of Performance Measures
- Performance Measures Used
Annual Incentive Plan Design

Overall Summary – Performance Measures

- Consistent with market practice, EHPs are most likely to use four or more measures in their annual incentive plans.
- Unlike market practice, EHPs are also very likely to use only one performance measure in their annual incentive plan.
- EPS is the most frequently used performance measure among high performers; EPS is also widely used in the market.
- EHPs are much less likely than market to use operating income as a measure.

# of Performance Measures

<table>
<thead>
<tr>
<th># of Measures</th>
<th>EHPs</th>
<th>Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Four of More</td>
<td>36%</td>
<td>48%</td>
</tr>
<tr>
<td>Three</td>
<td>13%</td>
<td>28%</td>
</tr>
<tr>
<td>Two</td>
<td>21%</td>
<td>16%</td>
</tr>
<tr>
<td>One</td>
<td>7%</td>
<td>30%</td>
</tr>
</tbody>
</table>

Performance Measure Prevalence

<table>
<thead>
<tr>
<th>Performance Measure</th>
<th>EHPs</th>
<th>Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Op Inc</td>
<td>27%</td>
<td>55%</td>
</tr>
<tr>
<td>EPS</td>
<td>41%</td>
<td>49%</td>
</tr>
<tr>
<td>Revenue</td>
<td>24%</td>
<td>35%</td>
</tr>
<tr>
<td>Cash Flow</td>
<td>12%</td>
<td>24%</td>
</tr>
<tr>
<td>Net Income</td>
<td>14%</td>
<td>22%</td>
</tr>
<tr>
<td>ROC/ROIC/ROCE/ROE</td>
<td>4%</td>
<td>12%</td>
</tr>
<tr>
<td>EVA</td>
<td>4%</td>
<td>3%</td>
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Detailed Findings: Long-Term Incentive Plan Design

- Number of Vehicles
- Vehicle Type
- Vehicle Combinations
- Long-term Performance Plan Characteristics
Long-Term Incentive Plan Design

Overall Summary – LTI Vehicles

- While the use of two LTI vehicles is most prevalent among EHPs and the market, EHPs are much more likely to only use one LTI vehicle than market.
- EHPs are generally less likely to use performance plans than the market, instead preferring the use of stock options.
Long-Term Incentive Plan Design
Vehicle Combinations

- The use of stock options as the sole LTI vehicle is much more common among high performers than the market

### Vehicle Combinations – Revenues > $5B

<table>
<thead>
<tr>
<th>Cut</th>
<th>SO Only</th>
<th>RS Only</th>
<th>PP Only</th>
<th>SO &amp; RS</th>
<th>SO &amp; PP</th>
<th>RS &amp; PP</th>
<th>All three</th>
</tr>
</thead>
<tbody>
<tr>
<td>EHPs</td>
<td>21%</td>
<td>7%</td>
<td>7%</td>
<td>0%</td>
<td>29%</td>
<td>14%</td>
<td>21%</td>
</tr>
<tr>
<td>Mkt</td>
<td>3%</td>
<td>2%</td>
<td>13%</td>
<td>3%</td>
<td>31%</td>
<td>19%</td>
<td>28%</td>
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### Vehicle Combinations – Revenues $2B - $5B

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<th>All three</th>
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<tbody>
<tr>
<td>EHPs</td>
<td>29%</td>
<td>7%</td>
<td>7%</td>
<td>14%</td>
<td>14%</td>
<td>21%</td>
<td>7%</td>
</tr>
<tr>
<td>Mkt</td>
<td>3%</td>
<td>0%</td>
<td>9%</td>
<td>15%</td>
<td>27%</td>
<td>17%</td>
<td>29%</td>
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### Vehicle Combinations – Revenues $500M - $2B

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<td>29%</td>
<td>10%</td>
<td>14%</td>
<td>10%</td>
<td>29%</td>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td>Mkt</td>
<td>8%</td>
<td>0%</td>
<td>8%</td>
<td>13%</td>
<td>11%</td>
<td>18%</td>
<td>42%</td>
</tr>
</tbody>
</table>
Long-Term Incentive Plan Design

Overall - Long-Term Performance Plan Characteristics

- Consistent with market practice, EHPs are most likely to use only one measure in their long-term performance plans
- TSR is the most prevalent LTPP measure among EHPs and the market
- EHPs are much more likely to use ROIC than the market
Long-Term Incentive Plan Design
Long-Term Performance Plan Characteristics – Metric Prevalence

- Among EHPs using only one performance measure, Relative TSR is the most prevalent.