Performance Metrics in Annual Incentive Plans

2014

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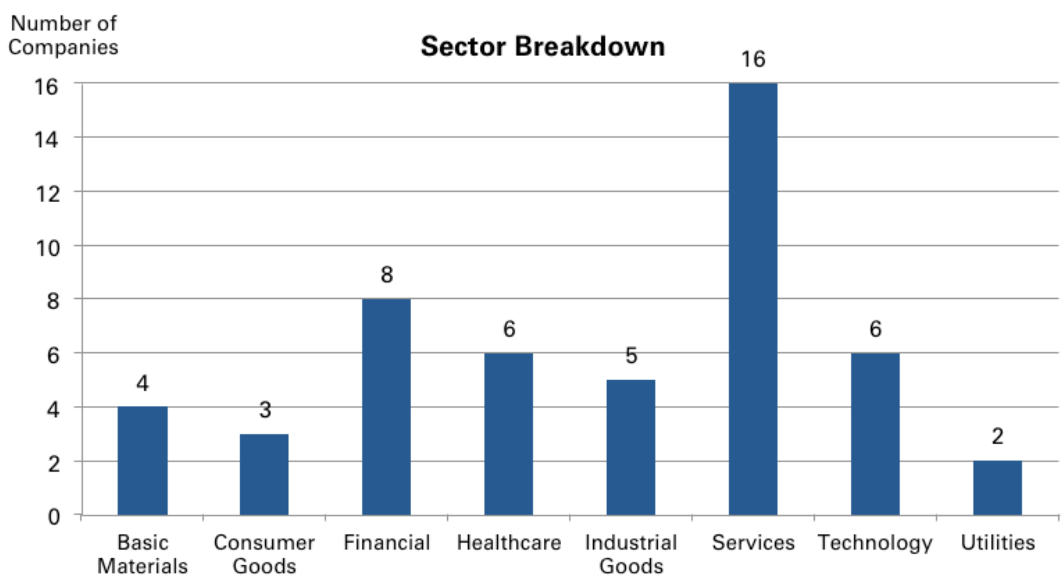
Introduction

As companies face more pressure to align pay and performance, variable pay constitutes an increasingly large portion of executive pay packages. The incentive plans that define the conditions attached to this pay are important tools for companies to reward effective management, and annual non-equity incentive plans in particular are a critical means of delivering cash payouts to executives and setting appropriate short-term goals. Companies utilize a number of different strategies to set performance goals, from allowing discretion of the compensation committees to choosing from a wide array of quantitative financial metrics.

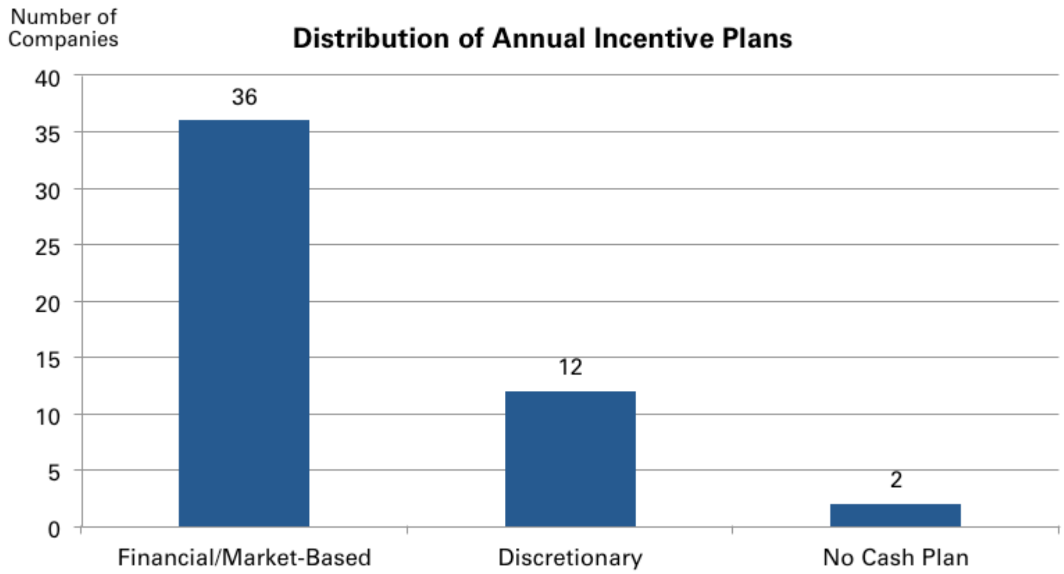
In order to illustrate how companies use performance metrics, Equilar analyzed a random sample of 50 companies from the S&P 500 that filed their proxies between January 1 and April 30, 2013. The data spans the two most recent fiscal years and concerns annual incentive plans for CEOs who have served in that capacity for both years. The analysis focused on companies that had plans with concrete financial metrics, rather than ones with discretionary plans.

In this sample of companies, service was the most prevalent industry, with 16 companies. The financial industry followed with eight, and the healthcare and technology industries each had six companies. The following graph shows the industry breakdown of the 50 companies analyzed in this article.



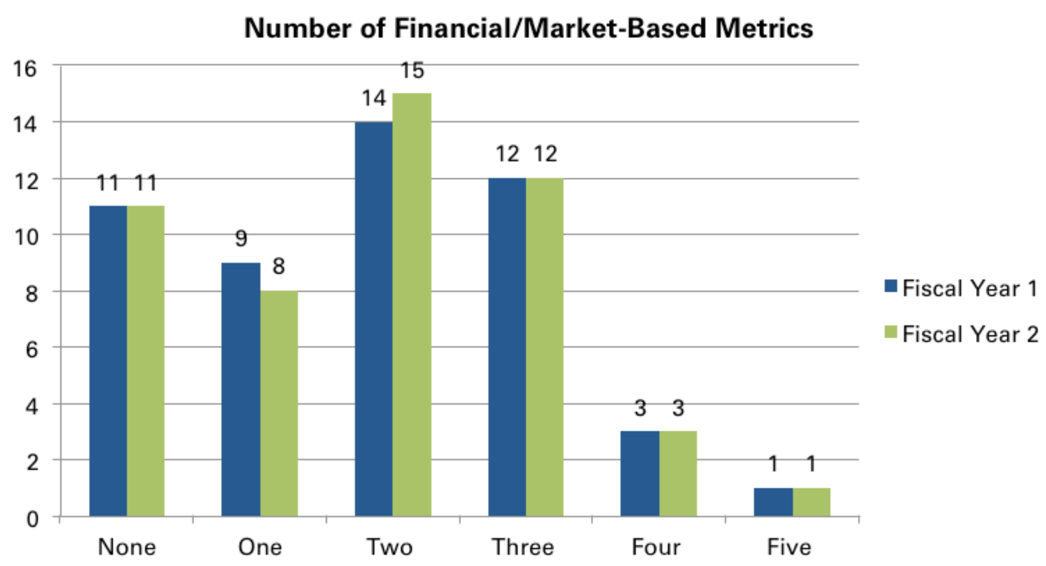
Plan Types

There are two general types of annual cash incentive plans: those based on financial or market-based metrics, and those that require compensation committee discretion. Of the sample companies, 72.0% had a quantitative plan that included at least one financial or market-based performance metric. At companies with these plans, executives must achieve pre-established metric targets in order to receive cash payouts. Discretionary plans, on the other hand, do not have strictly measurable financial goals, and the final payout of the plans depends on judgments made by each company's compensation committee. Of the companies in this analysis, 24.0% utilized discretionary plans. Only two companies out of the 50 observed had no annual cash incentive plan.



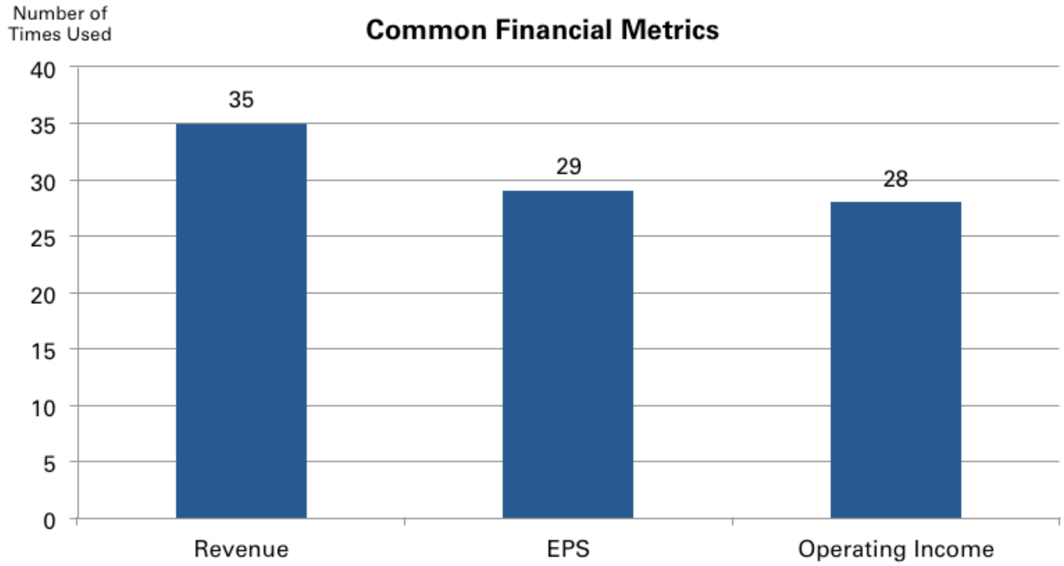
Metrics Overview

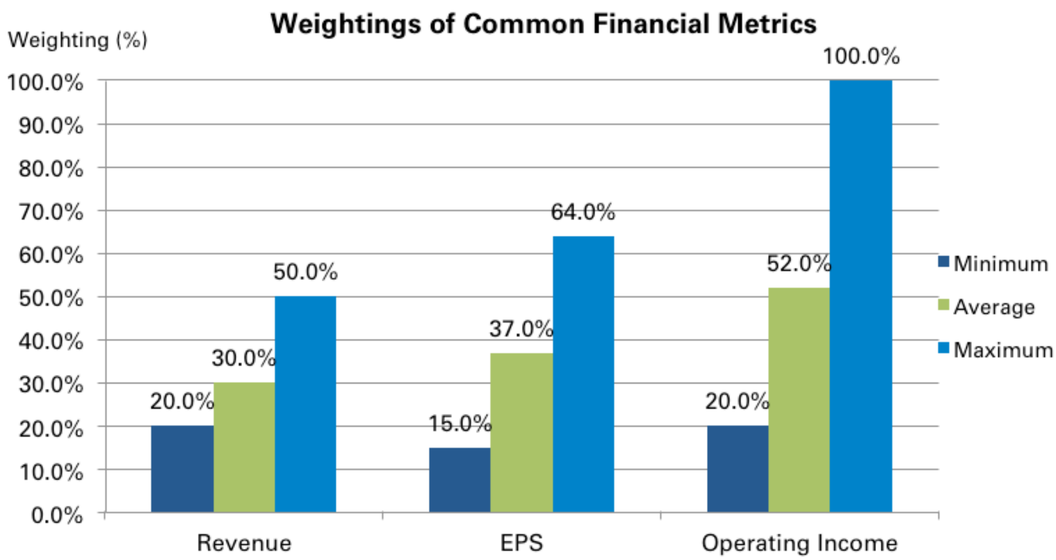
Across all companies, having two or three financial metrics was most common. Below is a chart of the number of combined financial and market-based metrics these 50 companies used in the last two fiscal years.



Common Financial Metrics

The most commonly used financial metric in our sample was revenue. Revenue accounted for 20.2% of all the financial metrics implemented within the various annual incentive plans over the two fiscal years, ranging from 20.0% to 50.0% overall. Earnings per share (EPS) and operating income followed as the second and third most commonly used financial metrics, respectively. Although operating income was less common than revenue and EPS, it tended to be weighted more heavily than revenue or EPS, with an average weighting of 52.0%. Overall, a total of 19 companies used revenue or operating income as one of their financial metrics in either year, and 15 companies used EPS. Below are two charts detailing how many times the three most common financial metrics were used across both years, as well as the minimum, average and maximum weightings for each.





The following is an industry breakdown showing the most commonly used financial metrics for all the sectors included in this article. The percentage breakdown column represents the number of companies that used each metric in their annual incentive plans during either fiscal year divided by the total number of companies that used the metric in either fiscal year.

Sector	Most Common Financial Metric	Percentage Breakdown
Basic Materials	EPS	50.0% (2 of 4)
Consumer Goods	EVA, Revenue	66.7% (2 of 3)
Financial	EPS	37.5% (3 of 8)
Healthcare	Revenue	100.0% (6 of 6)
Industrial Goods	EPS, Cash Flow	60.0% (3 of 5)
Services	Operating Income	50.0% (8 of 16)
Technology	Operating Income	66.7% (4 of 6)
Utilities	Net Income	50.0% (1 of 2)

Performance Leverage

One of the most important decisions of plan design is where to set performance goals relative to a given year's annual budget (i.e., target performance). The minimum performance that yields a payout is referred to as "the threshold," while the highest level of performance beyond which no additional incremental payments are made is "the maximum." Companies strive to strike a balance between setting sufficiently rigorous targets that satisfy shareholders and having realistic goals that are achievable for the executive team and aid in retaining talent. In addition, the company must consider the volatility of performance and the potential effects of unforeseeable events. The result of these considerations is the range of performance for various metrics that determine the range of payouts. The range of performance is referred to as "performance leverage," where more narrow ranges may cause more volatile payouts, while broader ranges are potentially too lenient.

We calculated both the performance and payout leverages for each metric when it was disclosed. Performance leverage includes both the minimum performance as a percentage of the target and the maximum performance as a percentage of the target. The charts below show the performance leverage for the five most common metrics in the analysis.

Minimum Performance Leverage					
Metric	**Minimum**	**25th Percentile**	**Median**	**75th Percentile**	**Maximum**
Revenue	75%	92%	95%	98%	98%
Operating Income	41%	80%	88%	95%	97%
EPS	25%	88%	90%	91%	98%
Cash Flow	79%	82%	90%	93%	97%
Net Income	65%	87%	90%	95%	95%

Maximum Performance Leverage					
Metric	Minimum	25th Percentile	Median	75th Percentile	Maximum
Revenue	101%	103%	105%	107%	150%
Operating Income	105%	105%	110%	120%	150%
EPS	102%	110%	115%	120%	277%
Cash Flow	107%	111%	118%	120%	122%
Net Income	100%	105%	108%	110%	154%

Year-Over-Year Changes

No company in our analysis switched from a discretionary plan to a financial/market-based plan or vice versa. Of the 36 companies in our sample that implemented financial/market-based annual cash incentive plans, only six adjusted their metrics from the last fiscal year to the current fiscal year. There was not an obvious pattern across the six companies that made changes in the most recent fiscal year, though three of the six companies switched to the use of operating income from other metrics, such as net income and revenue. Two companies switched to net income, one from operating income and the other from EPS. The last company switched from economic value added (EVA) to earnings before interest, taxes, depreciation and amortization (EBITDA).

Metric Used Last Fiscal Year	Metric Used This Fiscal Year
Net Income and Revenue	Operating Income
Revenue	Operating Income
Net Income	Operating Income
Operating Income	Net Income
EPS	Net Income
EVA	EBITDA

Disclosure examples

Clearly disclosed metrics

- TE Connectivity Ltd. (TEL)
  DEF 14A filed on January 15, 2014

This table is an example of an annual incentive plan with clearly outlined metric weightings and goals. The company provides information regarding achievement levels of each metric in comparison to executives' targets, as well as the overall payout percentage per metric.

Corporate Level				
Performance Measure (% weighting)	**Target**	**Results**	**Performance % to Target**	**Bonus Score****
EPS (20%)	101%	103%	105%	107%
Operating Income (20%)	105%	105%	110%	120%
Free Cash Flow (20%)	102%	110%	115%	120%
OI Margin (20%)	107%	111%	118%	120%
Key Performance Indicator Metric (20%)	100%	105%	108%	110%
Corporate Level Earned Award:				**127.2%**

- Spectra Energy Corp. (SE)
  DEF 14A filed on March 21, 2013

  "The amounts set forth below show the target amounts for achieving the threshold, target and maximum levels established for each financial goal as well as the actual result. For each category, achievement of the threshold, target and maximum amounts would result in the payment of 50%, 100% and 200%, respectively, of the target level. For instance, the short-term incentive payment for an executive associated with our Spectra Energy Transmission EBIT results was calculated as 25% of such executive's target cash incentive opportunity multiplied by the actual percentage achieved, which was 101.99%. Actual Spectra Energy Ongoing EPS for 2012 was $1.43 which was below the $1.70 threshold primarily as a result of lower than expected commodity prices, resulting in no payment for EPS results.

2012 Target STI Payment Measures	
Measures	**Percentage**
Spectra Energy Ongoing EPS	101%
Spectra Energy Transmission EBIT	105%
Spectra Energy Transmission ROCE	102%
Environmental, Health and Safety Scorecard	107%
Operational and Capital Project Scorecard	100%

  The Environmental, Health and Safety Scorecard achieved a payout percentage of 133.20% and the Operational and Capital Project Scorecard achieved a payout percentage of 115.30%."

In addition to performance targets, this company also provides the threshold and maximum values for each metric. Then, the final payout percentages are determined by directly comparing each metric's target levels to actual performance results. Note that this company's plan has a combination of both measurable financial goals and qualitative, non-financial goals.

Discretionary

Measures	Threshold	Target	Maximum	Actual	Percentage Achieved
Spectra Energy Ongoing EPS	$1.70	$1.90	$2.20	$1.43	0%
Spectra Energy Transmission EBIT (in millions)	$1,762	$1,834	$1,975	$1,836.8	101.99%
Spectra Energy Transmission ROCE	10.2%	10.6%	11.4%	10.7%	112.50%

- Franklin Resources (BEN)
  DEF 14A filed on January 23, 2014

  "Accordingly, early in the fiscal year, the Compensation Committee established a maximum bonus pool under the KEIP funded in an amount equal to 1.25% of PBOI for the year, approved the participation of Mr. G. Johnson and granted him a maximum target award under the KEIP equal to 40% of the pool. Although the Committee's decisions are not dictated by a specific formula, the profitability of the firm, as reflected in PBOI, is the determining performance-based measure in establishing award maximums for Mr. G. Johnson and the other named executive officers.

  [...]

  The Committee believes that this bonus structure is in the best interests of stockholders because it enables the most prudent use of Company assets by maximizing the deductibility of performance-based compensation while empowering the Committee to pay only those amounts it determines are necessary to appropriately compensate executives."

  This company utilizes an annual incentive plan in which the company's operating income levels limit the maximum amount that the CEO can earn. Although the company does not have a specific set of metrics with distributed weightings, its bonus plan structure still ties the bonus payouts to overall company performance.

Payout adjustment

- MeadWestvaco Corp. (MWV)
  DEF 14A filed on March 20, 2013

  "While the weighted payout based on actual 2012 company performance against these goals exceeded target performance and reached the 128% performance level, it was management's recommendation, with which the Committee concurred, to adjust payouts to the 110% of target performance level."

- MeadWestvaco Corp. (MWV)
  DEF 14A filed on March 21, 2012

  "While the weighted payout based on actual 2011 company performance against these goals exceeded target performance and reached the 183% performance level, it was management's recommendation, with which the Committee concurred, to adjust payouts to the 155% of target performance level (subject to adjustment for individual executive performance)."

In both fiscal years 2012 and 2011, this company's management team recommended lowering the final payout percentage, even though the company performance resulted in a higher percentage bonus payout, according to the formula. The proxy goes on to say that the committee overseeing payouts agreed to implement the management team's suggestion and that an adjustment to the final payout percentage was made before individual performance was taken into account.

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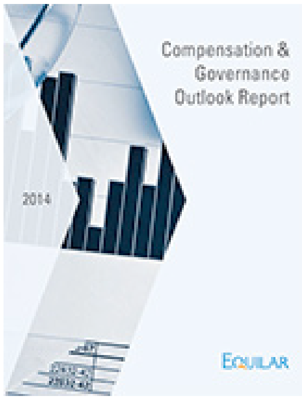

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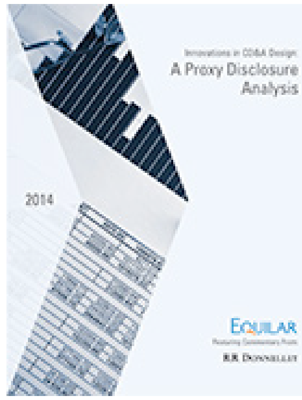

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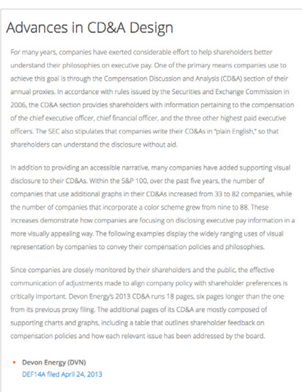
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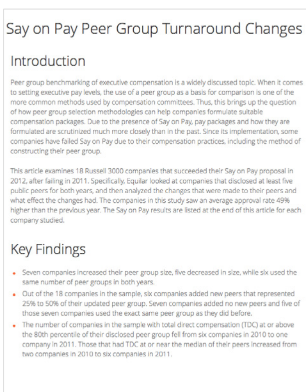
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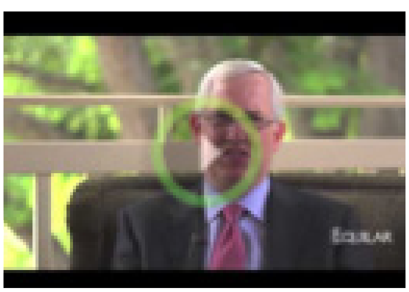

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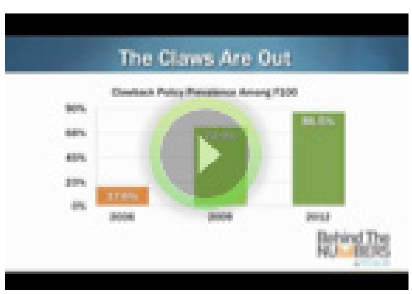

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