Performance Based Plans

Are they worth it?

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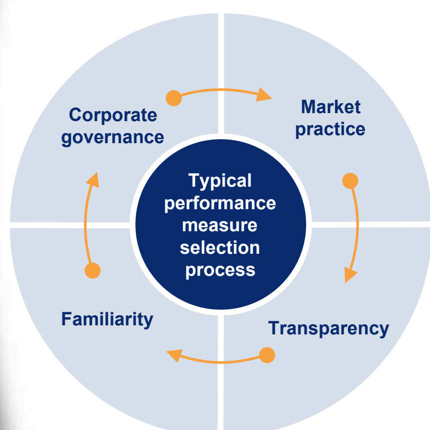
Performance conditions/measuring performance

Characteristics of a good performance target

- Aligned with company strategy and future direction
- Aligned with shareholders' interests
- Clear line of sight
- Measurable
- Internally focused – i.e. not overly influenced by external factors (despite shareholders' preference for comparative targets)
- Not capable of being easily manipulated
- Within the power of the relevant population to influence improved performance against the selected target
- Achievability / immediacy

Measuring performance — what many companies do in practice



Typical performance measure section is driven by:

- Corporate governance
- Market practice
- Transparency
- Familiarity

Process has a tenuous link with:

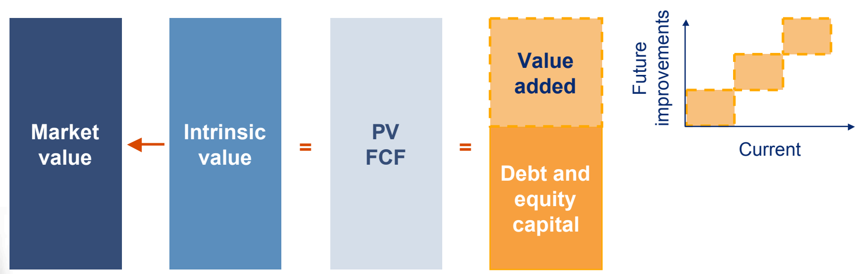
- Business strategy
- Value added
- Key value drivers

Most common measures:

- EPS growth
- TSR

What is value added?

- Managements' primary objective is to create value added for shareholders
- Value added is the value management creates above the cost of capital employed



Measuring performance — how value added is created?

Broadly, management can create value added in four ways…

$$\text{Value added} = \left(\frac{\text{Profits}}{\text{Capital}} - \text{Cost of Capital} \right) \times \text{Capital employed}$$

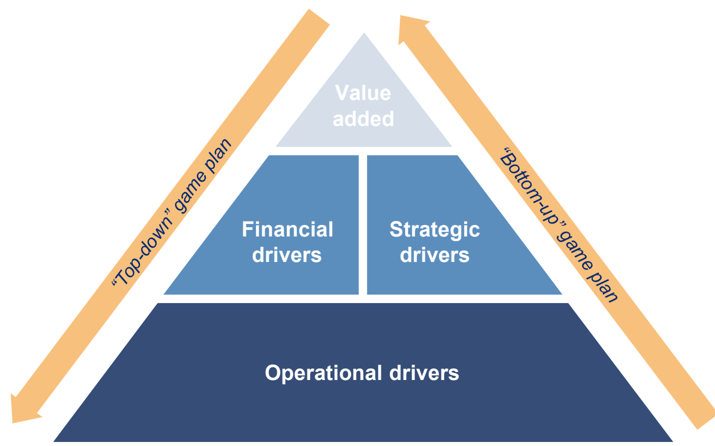
❶ *Improve profits on existing capital* (↑ Profits)

❷ *Reduce the cost of capital* (↓ Cost of Capital)

❸ *Invest where profits exceed the cost of capital employed* (↑ Capital employed)

❹ *Divest if inadequate returns in relation to sale proceeds from capital* (↓ Capital employed)

How to link value added to reward top_down or bottom-up game plan?



Performance measures

Type of measure	Definition / examples	Appropriate for long term	Aligned with stakeholders	Line of sight (All, Division, Exec)	Measurable	Internally focused	Not easily manipulated	Other issues
Volume	• Units sold			All	✓	✓	✓	• Does not take into account margins, so only useful at operational level
Revenues				All	✓	✓	✓	• Ignore costs
Cash flow	• EBITDA • Free cash flow			Div	✓	✓		• Can disincentivise internal investment • More appropriate where operating costs are relatively stable
Proft	• EBIT • NOPAT • Net income • EPS	✓		Div Exec	✓	✓		• Focus is on various aspects of the current business • In the short term, an disincentivise internal investment • EPS not relevant at lower levels of the organisation
Return	• ROCE (capital employed) • ROI (investment) • ROA (assets) • ROE (equity)	✓	ROCE ROI	Div Exec		✓		• Widely used to measure the potential of investments • Focus on profitable growth and efficiency • Can lead to reduction of spending and/or equity, rather than improvement on returns • Not a relative measure (other companies' data not readily available)
Economic profit	• NOPAT — (Capital employed x Cost of capital)	✓		Exec		✓	✓?	• Takes into account the cost of capital (though may be difficult to measure) • Makes adjustments to take into account value creation • Can be difficult to calculate and monitor due to number of adjustments

Performance measures (continued)

Type of measure	Definition / examples	Appropriate for long term	Aligned with stakeholders	Line of sight (All, Division, Exec)	Measurable	Internally focused	Not easily manipulated	Other issues
Share price targets and growth		✓	✓	Exec	✓			• Measurable at any point in time • Ignores differing dividend policies • Influenced to a certain extent by market “noise” (i.e. can have improvement not due to underlying performance) • Can be manipulated through timely announcements
Total shareholder return	• Share price growth with reinvested dividends	✓	✓	Exec	✓			• Takes into account differing dividend policies • Less influenced by market noise and industry cycle if used as relative measure with an appropriate comparator group
Market value added	• Market value — invested capital	✓	✓	Exec	✓			• Ignores opportunity costs of investing • Does not take into account dividends or other returns to investors
Strategic	• Milestones			Exec	✓	✓	✓	• May lack flexibility, e.g. focus on a merger which shareholders no longer think is in their interest
Industry-specific	• Net Asset Value (real estate and investment)	?		?	✓	✓	?	• Will generally be appropriate to the industry • Characteristics will depend on the measure
Other	• Safety goals • Environmental • Customer satisfaction • Brand recognition • Individual goals			All	✓	✓	?	

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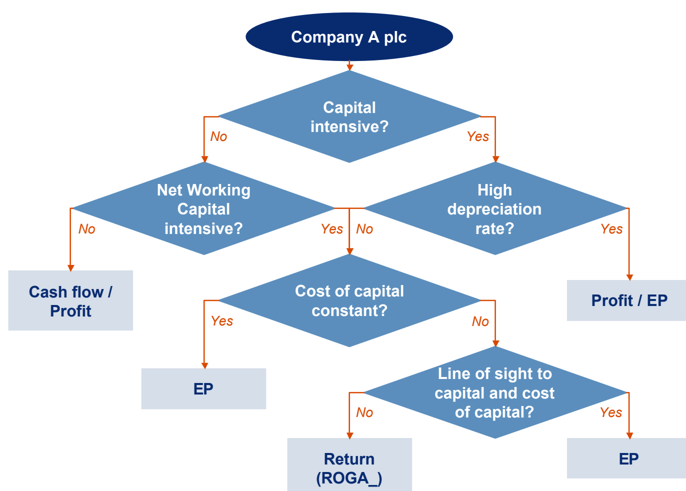
Decision tree

Additional framework for the maturity stage

Companies in the maturity stage of the industry / company / department cycle would further need to analyse their position…



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Measurement

How to measure performance?

- Exclude items?
  - non cash items such as impairment?
  - derivative adjustments?
- But where to stop?
- Is it still valid to exclude some of these items?
- What is being taken into account by the markets?
- What about complexity, line of sight, the original purpose of measuring performance?
- Auditor sign off?
- If not using audited members — independent verification?
- Previous performance benchmarks still appropriate?

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Accenture Case Study

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Accenture case study

Accenture's Business Evolution

How Accenture Delivers High Performance

- New career model
- New performance measures
- New rewards architecture

Performance-based Equity Awards

- Key Executive Example

Lessons Learned

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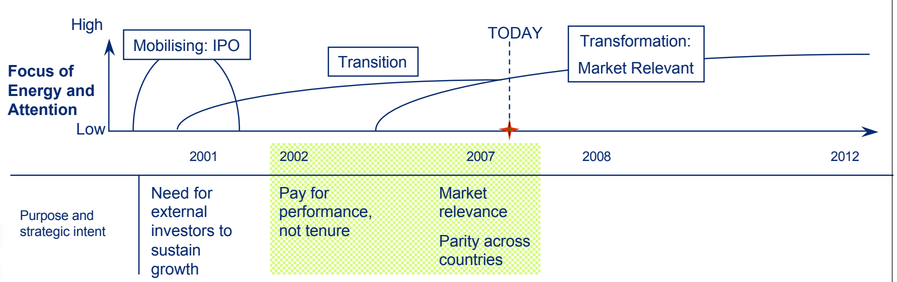
Accenture's Business Evolution



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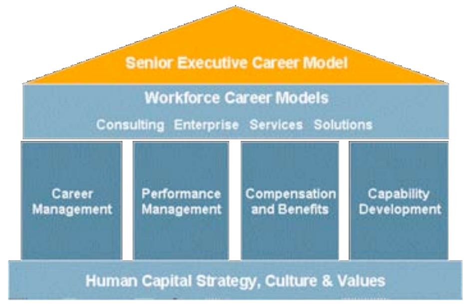
A new career model designed to encourage high performance

Career management: **define entry and advancement criteria**

Performance management: **Supports philosophy of meritocracy; aligns rewards with performance**

Compensation: **Provides fixed and performance-based cash compensation, equity components and incentives**

Capability development: **Aligns professional development and knowledge sharing with Accenture's business strategy**



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New principles to measure performance

- Individual objectives that align to corporate objectives
- Metrics aligned with accountabilities and target behaviors
- Balanced scorecard approach to measurement – focusing on all leadership characteristics
- Annual contribution review process to gauge performance against objectives.
- Provide continuous feedback to encourage high performance

Leadership Contributions

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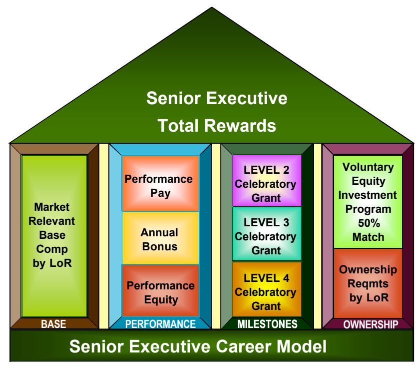
New rewards structure with heavy emphasis on performance

Base compensation:
- Market relevancy is goal

Performance compensation
- Mix of cash and equity
- Short-term & long-term blend

Milestone compensation
- Equity rewards for progressing through Senior Executive Career Model
- Long-term focus

Ownership
- Aligns senior executives with shareholder values



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Three performance-based equity programs

Senior Manager/Senior Executive performance grants
- Funded based on company performance
- Granted based individual performance
- Grants in the form of RSUs

Celebratory promotion grants
- Awarded to recognize promotions
- Grants in the form of RSUs

Key executive performance grants/LTI performance vested
- Targets top executives
- Payout based on company performance – over 3 year time horizon

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Key Executive grant program

Who?

- Top executive leadership

What?

- Restricted share units awarded based on 3 years of performance

Why?

- Improve alignment with market practice
- Focus on company performance over a longer time horizon
- Simple to understand and to administer

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Key Executive grant program

How?

- Two performance metrics determine awards
  - Operating Income - weight of 75%
    - Aligned with the company strategy and internal performance
    - A threshold of was set to ensure it was achievable, but also required strong company performance before vesting occurred
  - Total Shareholder Return – weight of 25%
    - Aligned with the interest of the shareholders
    - Given less weight to ensure it was not overly influenced by external factors
    - A threshold was set and validated to ensure it was achievable and comparable to market practice
- Included upside potential of up to 150% of vesting when performance far exceeded expectations

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Lessons Learned

- Including internal company metrics in the award helped align the award achievement with what the company was experiencing
- It was important for awards to be realistic
- Additional communications were needed:
  - Updates are provided twice a year on how the awards are performing

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Questions?

Thank you for your participation

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Features of different performance conditions (non speaking slides for information only)

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Earnings Per Share (EPS)

Definition
Basic/normalised earnings available to shareholders / Weighted average number of shares outstanding
OR
Adjusted income (basic/normalised) available to shareholders / Weighted average number of shares and potential shares outstanding

Line of sight	• Executives
Difficulty of measuring	• Easy
Focus	• Overall earnings performance
Comparability	• High

- Basic Earnings Per Share is determined by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period (FRS 14 and IAS 33)
- Dilutive Earnings Per Share is calculating by adjusting the net profit attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares (FRS 14 and IAS 33)

Points for consideration

- EPS growth targets (e.g. RPI + 3%) reward managers for growth in earnings. However, EPS growth targets do not provide management with 'line of sight' to the company's cost of capital and required return on investment. It does not take into account the opportunity cost of capital. Growing companies that earn a return on capital that is greater than its cost of capital could also generate attractive EPS growth, but it would in the process destroy value
- EPS is not cash flow and as an accounting measure it ignores time value of money – for two companies which have the same level of EPS over a period of time, the market will typically place a greater value on the company which generates a higher cash-flow on a regular basis
- EPS growth can come from heavy investment or changes in financial structure that do not create value, such as repurchase of shares and increasing leverage, or accretive acquisitions

Impact of accretive acquisitions on EPS

- Company A has EPS of £100 and 100 outstanding shares. EPS is £1. Its shares currently trades at a P/E multiple of 10 (i.e. £10 per share)
- Company B has earnings of £100 and 100 outstanding shares. EPS of Company B is also £1. However, its shares currently trades at P/E multiple of 8 (i.e. £8 per share)
- Company A acquires Company B and issues 0.8 Company A shares for every Company B Shares (total of 80 Company A shares (at £10 each) issued to Company B shareholders)
- Post acquisition earnings of Company A remain at £200 and outstanding shares are 180. Therefore, post acquisition EPS is £1.11, i.e. an increase of 11%

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Total Shareholder Return (TSR)

Definition
Return Index End of performance period – Return Index Start of performance period / Return Index Start of performance period

- Return Index being the average aggregate index value of:
  - the increase (or decrease) in the market value of an ordinary share over a set period; plus
  - the aggregate value of dividends during the same period each such dividend being deemed to be reinvested in the ordinary shares of the company

Points for consideration

- TSR (growth in share price plus dividends reinvested) is usually used to reward management for shareholder return. However, it is important to note that TSR rewards more for performance against market expectation than an absolute level of performance
- Partial 'line of sight' – share price is driven by factors outside the line of control of the management (such as market/sector performance). Accordingly, management can be rewarded or penalised for events outside the control
- The current performance level of companies is factored into the current share price. Accordingly, managers in companies with low performance expectation might find it easier to generate higher TSR then companies that consistently meet high performance standards. Thus managers of extraordinary value creation companies may not be able to consistently deliver high TSR
- Poor TSR results could result from overly optimistic market expectation in the current share price rather than from ineffective management

Line of sight	• Executives
Difficulty of measuring	• Medium
Focus	• Return to shareholders
Comparability	• High

[….]

- XYZ plc (FTSE 100) had excellent performance in Year 1 and Year 2 (beating market expectations) which resulted in excellent TSR growth during Year 1 and Year 2
- The excellent performance for Year 3 is already factored into the share price at the end of Year 2. The performance for Year 3 is merely good rather than excellent (i.e. performance meets market expectation)
- Net result — TSR growth in Year 3 falls as performance is at or below market expectation but underlying performance is still excellent against industry comparators

Return on Invested Capital (ROIC)

Definition
After tax operating earnings / Total assets – Excess cash – Non interest bearing current liabilities

- Ratio of:
  - operating profits of the company less adjusted taxes
  - amount of capital employed by the Company

Points for consideration

- ROIC measures return on investments with the cost of capital used for the investment. ROIC is often used to assess the value creation capabilities of a company. High (absolute/relative) levels are seen as proof of a strong company and/or solid company management. Focus on generating a high ROIC would typically result in generation of attractive growth in EPS
- ROIC can vary widely by industry. Accordingly, relative ROIC targets would need to be benchmarked against industry specific peer group
- It is also important to take into consideration the size of the peer group in benchmarking the Company, i.e. one should take into consideration the magnitude of the value created
- An unbalanced focus on ROIC could lead to poor management due to harvesting behaviour, ignoring growth possibilities and long term value destruction

Line of sight	• Executives
Difficulty of measuring	• Medium
Focus	• Return and cost of capital efficiency
Comparability	• High

ROIC and share price

- A company which earns a ROIC greater than its Weighted Average Cost of Capital (WACC) creates value for its shareholders. It can create more value by focusing on growth rather than earning a higher ROIC
- On the other hand a company whose ROIC is less than its WACC destroys value. The value destruction would be greater if such a company concentrates on growth rather than generating a ROIC at least equal to its WACC
- Studies have shown that for the same level of growth rate, the share price valuation of a company with a bigger spread between ROIC and WACC tends to be much higher than that of a company with a lower spread

Source: Measuring and managing the value of companies by Tom Copeland, Tim Koller and Jack Murrin (3rd edition)

Market Value Added (MVA)

Definition

Market value of debt and equity – book value of capital invested

OR

$$\frac{\text{Market capitalisation of a company's debt and equity}}{\text{Amount of capital invested}}$$

Line of sight	• Executives
Difficulty of measuring	• Medium
Focus	• Value creation
Comparability	• Easy

- Differences between:
  - the market valuation of company's equity and debt; and
  - total debt and equity capital invested in the company

Points for consideration

- MVA and Market-value-to-capital ratios can be used in conjunction with TSR to overcome some limitations of TSR
- MVA and Market-value-to-capital ratios complement TSR by measuring different aspects of a company's capital market performance. TSR measures a company's performance against the financial market's expectation and changes in them. However, MVA and Market-value-to-capital ratios assess absolute levels of performance
- A company that is already growing at a high rate could be creating more value for every pound invested (i.e. it will have a high Market-value-to-capital ratio), however, such a company may find it difficult to beat market expectation to generate higher TSR

MVA and TSR

- During a five year period, Company X has generated a TSR of 5% p.a. while Company Y (a smaller company in size) has generated a TSR of 20% p.a.
- The MVA of Company Z during the same period was £50 billion while Company Y's MVA was £12 billion. Using the Market-to-capitalisation ratio every £1 invested in Company Z was valued at £3 while every £1 invested in Company Y was valued at £1.40
- Company X cannot generate a higher TSR because it is much bigger in size and its share price already factors in a high rate of performance. However, it creates more value than Company Y
- Company Y on the other hand was performing at a lower level and was able to beat market expectation, but it does not create much value

Economic Profit (EP)

Definition

(Return on Capital – Cost of Capital) x Capital invested

OR

After tax operating profit – (Invested capital x Weighted average cost of capital)

Line of sight	• Executives / Senior Management
Difficulty of measuring	• Medium
Focus	• Value creation
Comparability	• Easy

- Spread between:
  - the return on invested capital; and
  - the cost of capital
  - times the amount of invested capital

Points for consideration

- EP links the rewards for the top management to factors over which they have more control – management has more control over return on capital and cost of capital than share price
- EP is influenced by all of the decisions that management have to make within a company – the investment decisions and dividend decisions affect the return on capital and the financing decisions affect the cost of capital
- EP makes an explicit allowance for allocation of capital and makes the cost of capital visible ('line of sight') to managers
- However, EP is still very much outcome based and not forward looking, i.e. it does not involve forecasts of future cash flows. As EP depends on current level of earnings, it may reward managers who take on projects with quick paybacks and penalise those who invest in projects with long gestation periods or projects that are strategically critical to the business

Impact of EP on share price

- ABC plc has net income after tax of £150,000 and equity capital of £2,000,000. The required rate of return (return expected by shareholders) is 10%
- The Economic Profit of ABC plc will be: £150,000 - £200,000 = (£50,000)
- As the required rate of return on equity is 10%, the equity value of ABC plc will fall to £1,500,000. Accordingly the shares will trade at a discount to book value
- However, the shares of a company which earns a positive Economic Profit (i.e. more than the required rate of return on equity) will be expected to sell at premium to book value
- In summary, higher Economic Profit will lead to higher share process, all else being equal

Return on Equity (ROE)

Definition

$$\frac{\text{Net income}}{\text{Average shareholders' equity}}$$

- Ratio of:
  - adjusted / normalised (annualise) net income; and
  - average book value of shareholder's funds

Points for consideration

- ROE is an important summary measure of a firm's profitability and return on investment. It captures the company's efficiency in operation, investments and financing
- ROE can be disintegrated into the following:
- Profitability x Asset Turnover x Leverage ; or

$$\frac{\text{Net income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}}$$

- Accordingly, the company can analyse and determine the contribution of each factor to the change in ROE
- Studies show than in the short term (approximately five years) current levels of ROE persist in the future, however, over the long term ROE tends to revert towards and average economy wide ROE

Line of sight	• Executives / Senior Management
Difficulty of measuring	• Easy
Focus	• Efficiency of operation, investment and financing
Comparability	• Easy

ROE – Profitability x Activity x Leverage

- In Year 1, Company A had a profit margin of 8%, Asset Turnover of 3.27 and Financial Leverage of 3.08. This resulted in a ROE of 80.57 (8% x 3.27 x 3.08)
- In Year 2, the profitability margin reduced to 6.6%, Asset Turnover was 2.75 and Financial Leverage was 2.41. Accordingly, ROE in Year 2 was 43.74% (6.6% x 2.75 x 2.41)
- The lower ROE in Year 2 was as a result of competitive forces reducing the profitability margin and the company not being able to maintain and the company not being able to maintain the same growth rate as in Year (as evidenced by lower Asset Turnover)
- In order to maintain above average performance the company needs to focus on profitability, Asset Turnover as well as using an optimal capital structure and reward managers for above average performance on all aspects

Free Cash Flow to Equity (FCFE)

Definition

Net income + Depreciation + Fixed capital investment – Working capita investment + Net borrowings

- FCFE is the cash flow available to the company's shareholders after all operating expenses, interest and principal repayments have been paid and necessary investments in working and fixed capital have been made

Points for consideration

- FCFE measures the cash-generating ability of the company
- It can be seen as an improvement over EPS, as it measures quality of earnings
- It is commonly used by investors to value the equity capital of the company
- It is a superior measure to Cash Flow per Share (i.e. ration of Cash Flow from Operation and the weighted average number of shares outstanding) as it takes into account the cash required to maintain productive capacity and maximise the long term value of the company
- However, cash flows such as FCFE may not drive the right behaviour. Cash flow can be increased by delaying capital expenditures or cutting back on development and maintenance expenditures

Line of sight	• Executives / Senior Management
Difficulty of measuring	• Easy
Focus	• Earnings quality
Comparability	• Medium

Cash Flow and Share Price

- Company S and Company T have the same level of earnings and cash flow over a period of three years of £3 million
- However, Company S generates most of the cash flow in the earlier years
- Using the discounted cash flows the Cash Flows from Company S would have a higher value than Company T, assuming both companies have the same cost of capital
- Accordingly, investors would value the shares of Company S higher than the shares of Company T