



IRRCi Research Report

The Alignment Gap Between Say on Pay Voting and Creating Value



IRRC
Institute

**Organizational Capital
Partners**

The analysis, opinions and perspectives herein are the sole responsibility of the authors.

The copyright for this report is held by the IRRC Institute. The material in this report may be reproduced and distributed without advanced permission, but only if attributed. If reproduced substantially or entirely, it should include all copyright and trademark notices.

© Copyright 2014, Investor Responsibility Research Center Institute (IRRCi)

For more information, please contact:

Jon Lukomnik, Executive Director
Investor Responsibility Research Center Institute (IRRCi)
40 Wall Street, 28th Floor
New York, New York, 10005,
T: (+1) 646-512-5807
info@irrcinstitute.org
www.irrcinstitute.org

Report authors:

Mark Van Clieaf, Partner
Organizational Capital Partners
3001 North Rocky Point Dr. E, Suite 200
Tampa, Florida, 33607, United States of America
T: (+1) 813-600-5259
mark_vanclieaf@orgcapitalpartners.com
www.orgcapitalpartners.com

Karel Leeftang, Partner
Organizational Capital Partners
14 Rue du Rhône
1204 Geneva, Switzerland
(+41) 76 512-2980
karel_leeftang@orgcapitalpartners.com
[Twitter: @OC Partners](https://twitter.com/OC_Partners)

Table of Contents

Special acknowledgement.....	4
Introduction to the report.....	5
Executive Summary	6
<i>An opportunity for institutional investors.....</i>	<i>7</i>
Chapter 1: Return on invested capital, economic performance and Say-on-Pay alignment	8
1.1. Relevant finance and value creation principles	8
1.2. Understanding enterprise value	9
1.3. A lens to review longer-term value creation.....	10
Chapter 2: Research methodology.....	12
Chapter 3: Analysis of economic performance, return on invested capital and Say-on-Pay voting	14
3.1 Value Quadrant Four: Value destroying performance and Say-on-Pay Voting	14
3.2 Value Quadrant Two: Value creating performance and Say-on-Pay Voting	17
3.3 Value Quadrant One: Value creation potential and Say-on-Pay Voting.....	19
3.4 Value Quadrant Three: Hidden value and Say-on-Pay Voting.....	21
3.5. Value quadrant analysis – a summary	24
Chapter 4: Conclusions.....	25
4.1 ROIC, economic profit and Say-on-Pay voting	25
4.2 The opportunity for longer term investors.....	27
Appendix	28
Asset Owner and Asset Manager List.....	29
Glossary – Key terms	30
List of tables and figures.....	32

Special acknowledgement

This is the second in a series of two reports on performance measurement, value creation, long-term incentive plan design and pay-for-performance. The first report focused on performance measurement, value creation, long-term incentive plan design, and pay for performance. This second report focuses on Say-on-Pay proxy voting.

The research project was made possible by a research grant from the Investor Responsibility Research Center Institute (IRRCi). IRRCi Executive Director Jon Lukomnik played a critical in defining the project, offering feedback, and guiding the development of the work products.

The analysis and the related two reports in this series are unique as it is the first time that multiple databases have been woven together to create integrated insights about:

1. Economic performance and shareholder value
(Data source: *Organizational Capital Partners and Shareholder Value Advisors*)
2. Pay-for-performance alignment and long-term incentive plan design
(Data source: *Incentive Lab and Shareholders Value Advisors*)
3. Proxy voting for Say-on-Pay by institutional shareholders
(Data source: *FundVotes*).

The insights from this research and series of reports for IRRCi would not have been possible without the analytical input, insights, collaborative teamwork of Steve O'Byrne, Shareholder Value Advisors; Jack Zwingli, Incentive Lab; Jackie Cook, FundVotes; Tom Hillman, Credit Suisse HOLT; and members of the team at Organizational Capital Partners: Mark Van Clieaf, Karel Leeftang, Marg Soden, Roland Burgman, Kelly Boyden, Lori Mattes, Al Risdorfer. We thank them all for their collaboration.

Introduction to the report

Early in 2014 the Investor Responsibility Research Center Institute (IRRCi) asked Organizational Capital Partners to research the Standard & Poor's 1500 companies relating to a question it had developed. This question was:

“What is the relationship and level of alignment between company economic performance, shareholder return and executive compensation?”

This seemingly simple question masked a highly complex piece of work to be performed. There are various studies looking at parts of the question, but none that undertake a comparative analysis to look at the level of alignment between:

1. Company performance (strategy development, strategy execution, intrinsic value creation) with a focus on economic profit and return on invested capital
2. Shareholder return performance
3. Executive compensation design and pay-for-performance alignment
4. “Say-on-Pay” voting by institutional investors relative to economic performance

This research has required us to integrate the various databases that do exist in each of these three separate areas. This resulted in a highly complex data set with no obvious connection points. We therefore had to introduce a number of measurement methods and analyses to contrast and compare, so as to create real insight about the level of alignment.

To focus the analysis, the research has been divided into two reports. The first report focused on longer-term value creation fundamentals and whether or not economic value creation is aligned with executive compensation incentive design. The first report also focused on whether the existing metrics and design of executive compensation plans are fit for purpose as key inputs to value creation.

This second report focuses on how and to what extent institutional investors and proxy advisory firms consider economic value creation in their analysis of executive compensation and pay-for-performance alignment testing for Say-on-Pay proxy voting.

The enclosed analysis in this second report will be of most value to institutional investors (including chief investment officers, heads of corporate governance, equity analysts and proxy voting advisors) as an enhanced basis for investment decision-making, performance analysis, and pay-for-performance alignment testing as inputs to Say-on-Pay proxy voting.

It may also be of use to corporate CFOs, investor relations officers, compensation committees and corporate secretaries. Increasingly institutional investors provide feedback on company performance expectations to company management and Boards, and some do so through voting. Consequently, the Say-on-Pay vote is a source of insight as to how investors are evaluating a company's strategy, business model and performance. By understanding Say-on-Pay voting patterns, and investor motivations and behavior better, companies may be able to better interpret and manage interactions with institutional investors.

Executive Summary

Investors, directors and executive management share common interests when it comes to company performance, shareholder return and economic value creation.

The first report in this series identified that return on invested capital (ROIC) and economic profit are enhanced operating performance metrics with a high correlation to sustainable value creation and shareholder returns. In applying these metrics to the companies of the S&P 1500 a surprising finding emerges.

Forty-three percent (43%) of companies, over ten years of observations (2003- 2012), had a ROIC *less than* their weighted average cost of capital and a cumulative economic loss over five-year rolling performance periods. Investors, analysts, directors and executive management of these companies should be concerned about these companies' business strategy, financial and operating performance and prospective future returns. As noted in the first report, 75% of the larger companies in the S&P universe do not disclose balance sheet or capital efficiency metrics to measure executive management effectiveness in deploying invested capital or alignment to long-term incentive plan design, and so do not appear to have the tools to measure or manage creating economic profitability.

In the United States, Say-on-Pay is an advisory vote by shareholders on the executive compensation design of named executive officers, including the CEO. Institutional investors and proxy voting advisory services may consider a broad range of factors in their overall Say-on-Pay voting decision. This might include, for example, compensation policy, change in control provisions, internal pay equity, use of performance metrics, performance analysis and pay-for-performance alignment. Some institutional investors may also use the Say-on-Pay vote as a way to communicate their evaluation of the company's strategy, business model and performance. This report looks at how more than 100 of the largest mutual fund families in the United States cast those votes. In the aggregate, those fund families control more than \$11 trillion in global assets under management. In addition, the data set included 11 of the largest North American pension funds with close to \$2 trillion in assets under management, as well as the voting recommendations of the two largest proxy advisory companies, Institutional Shareholder Services (ISS) and Glass Lewis. In theory, at least, these should be amongst the most resourced and sophisticated Say-on-Pay voters and advisors.

Yet, the analysis in this report of Say-on-Pay votes for a S&P 1500 companies discovered no large Say-on-Pay voting differences (FOR vs. AGAINST) for subsets of companies which created value versus those that destroyed value over five years. Performance was measured using ROIC *minus* weighted average cost of capital (economic profit) and relative TSR. The average Say-on-Pay support was 82% for 32 low-performing and 84% for 32 high-performing companies across a sample of 128 S&P companies. Nor was there much difference in the median vote, at 90% for the low-performing and 96% for the high-performing companies. Neither was there a robust difference amongst the proxy advisor recommendations. ISS recommended for 84% of the pay plans at the value destroying companies and at 81% of the value creating companies. Glass Lewis showed a slightly greater difference, recommending for at 72% of the value destroying companies and 81% of the value creating companies.

Those results suggest that creation of economic value is not currently a major factor in institutional investor Say-on-Pay voting or in the recommendations of the two largest proxy advisors. This finding is consistent with the findings of the first report, which suggested that competitive pay, rather than performance, was the dominant driver of executive compensation, and that TSR, which is a measure of alignment (co-movement of stock price [plus dividend] and executive compensation) rather than a measure of value creation, is the most common metric in long term incentive compensation plans.

An opportunity for institutional investors

The use of value-based performance metrics such as ROIC and or economic profit as part of Say-on-Pay voting analysis would shift the focus of compensation programs from short-term alignment with stock market movement to longer-term company economic performance.

Furthermore, asking for disclosure of balance sheet or capital efficiency metrics in company performance reporting and inclusion of these measures in long term incentive plan design would provide better insight into a company's value creation ability. Doing so would enable institutional investors and proxy voting advisors to enhance voting execution aligned to long-term value creation.

A performance and pay-for-performance analytical model that incorporates fundamental finance precepts (i.e. ROIC *greater than* weighted average cost of capital) would also create a more direct line of sight alignment between operating performance and long-term sustainable shareholder returns at investee companies.

Chapter 1: Return on invested capital, economic performance and Say-on-Pay alignment

1.1. Relevant finance and value creation principles

The first IRRCi report in this series provided a set of principles and a framework for longer-term performance evaluation of a company and value creation for shareholders. As a point of departure, to create sustainable value requires that, over time, the value of the outputs of a company must exceed the total value of the inputs. Therefore, to determine financial value creation a number of principles are important:

- The best measure of economic value creation is economic profit, i.e. net operating profit minus a capital charge for invested capital. Economic profit, unlike conventional profit, subtracts all input costs (including capital) from output value to determine true value creation. Economic profit can also be converted to return on invested capital (ROIC) as a measure of capital productivity and fundamental value creation from operations for investors;
- Economic profit is only positive when the return on invested capital is greater than the weighted average cost of capital; thus executive management, board and investors need to measure and monitor both ROIC and cost of capital to enable longer-term value creation for shareholders;
- Sound business strategy choices sometimes call for sacrificing current economic profit in order to increase future economic profit by an even greater amount. In evaluating business strategy and management performance, directors have to evaluate whether the required future increase in economic profit is reasonably likely to occur;
- Meaningful financial value creation is ideally measured over the longer term. For the purposes of this report, we define this to mean a period of at least five years;
- The market enterprise value of a public company has two components: the current value of capital and economic profit and future value, i.e., the value of expected economic profit improvement;
- Understanding the current and future value components of total shareholder return can help executive management and directors understand the requirements of, and threats to, sustainable value creation, and thereby, do a better job evaluating business strategy and performance.

Mathematically, the key formulas are:

- Economic profit = Net Operating Profit After Tax (NOPAT) *minus* Capital Charge
- Net Operating Profit After Tax = EBIT *minus* Cash Taxes Paid
- Capital charge = Invested Capital *times* Weighted Average Cost of Capital (WACC)
- Current value = Invested Capital *plus* the Present Value of Current Economic Profit
- Future value = Market Enterprise Value *minus* Current Value = the Present Value of Future Economic Profit Improvement

These financial formulas jointly provide the building blocks to compare operating performance between companies and to determine whether economic value is created and if this value creation is sustainable.

For a full discussion of economic value creation and the implications of it, please see the first IRRCI report, available at www.irrcinstitute.org.

Economic value creation analysis provides insight into real company performance over longer time periods, and allows us to determine its alignment with both shareholder value creation (through share price development), total compensation and long term incentive plan design for the most senior executives. This, then, provides a further framework against which to test to what extent Say-on-Pay proxy voting results are in alignment with foundational business strategy, finance and longer-term value creation practices. Note that these fundamentals of value creation are independent of traditional metrics of alignment with short-term stock price movement.

Most companies use capital market and operating measures of performance for both performance measurement and compensation incentive plan design purposes. The most common measures of market performance are total shareholder return (TSR) and relative TSR. Other common measures of operating performance are earnings and earnings per share (EPS) growth.

TSR is significantly affected by market and industry factors, and hence, is not a great measure of management performance or business strategy success. While relative TSR provides a better measure of management performance and business strategy success in that some exogenous factors should affect peers as well as the specific company, it does not provide much insight about the requirements for, and threats to, sustainable value creation.

In addition, relative TSR, as conventionally calculated, also assumes re-investment of all dividends, and hence, doesn't properly capture those situations where value is created by decreasing the level of invested capital in the business. Earnings and EPS do not take into account the level of invested capital, cost of capital or future value built into enterprise valuation. So, for example, a company could boost higher earnings and higher earnings per share following a value-destroying acquisition, if that acquisition were paid for with debt that did not come due during the measurement period. Yet TSR is the dominant performance metric for corporate LTIPs and well may be the dominant or sole performance metric used by institutional investors and proxy advisory services in analyzing Say-on-Pay voting and pay-for-performance alignment analysis.

1.2. Understanding enterprise value

The premise that enterprise value is a discounted cash flow valuation has important implications for effective Say-on-Pay voting:

- Enterprise value can be expressed as the sum of invested capital and the present value of future economic profit. Economic profit is profit after a charge for all capital including equity capital.
- Enterprise value is the sum of current value and future value. Current value is the sum of invested capital and the present value of current economic profit. For this report, we assume that the present value of current economic profit is its perpetuity value, i.e., current economic profit *divided* by weighted average cost of capital. Future value is the difference between market enterprise value and current value. It is also equal to the present value of expected future economic profit improvement. Future value as a percentage of enterprise value for a ten-year

period (2003 – 2012) for the S&P 1500 is 33% of EV at the median and 65% of EV at the 80th percentile for the S&P 1500.

- Investors can achieve a positive return on market value even when economic profit declines. This doesn't mean that positive economic profit and or return on invested capital is unimportant; it just means that it is possible – and sometimes desirable – to sacrifice current economic profit and return on capital for expectations of even greater economic profit improvement and return on capital in the future.
- A sustainable and viable business model must eventually provide consistent positive economic profit and a Return on Invested Capital great than its cost of capital. Without a reasonable expectation of positive economic profit, and a positive ROIC greater than WACC then no amount of sales or earnings growth will create sustainable longer-term shareholder value.

In general, when a business model has a consistently negative performance spread (ROIC minus WACC) over five years or longer, it signals that there is a potential business strategy, economic model and/or strategic leadership problem. Conversely, a longer-term positive performance spread indicates to a board and executive management team that it is providing effective stewardship of invested capital which in return is driving the creation of sustainable value.

Value creation principles dictate that investors, directors and executive management should be very concerned about a firm's business strategy, financial and operating performance and prospective return when that firm has a five-year cumulative economic loss which also means a net negative ROIC (ROIC minus WACC) and/or a five-year economic profit decline over the performance period.

Future value is a significant contributor to enterprise and company valuation, yet is rarely isolated in performance measurement design and executive compensation plan design. As a consequence it is unlikely that the drivers of future value are being explicitly managed.

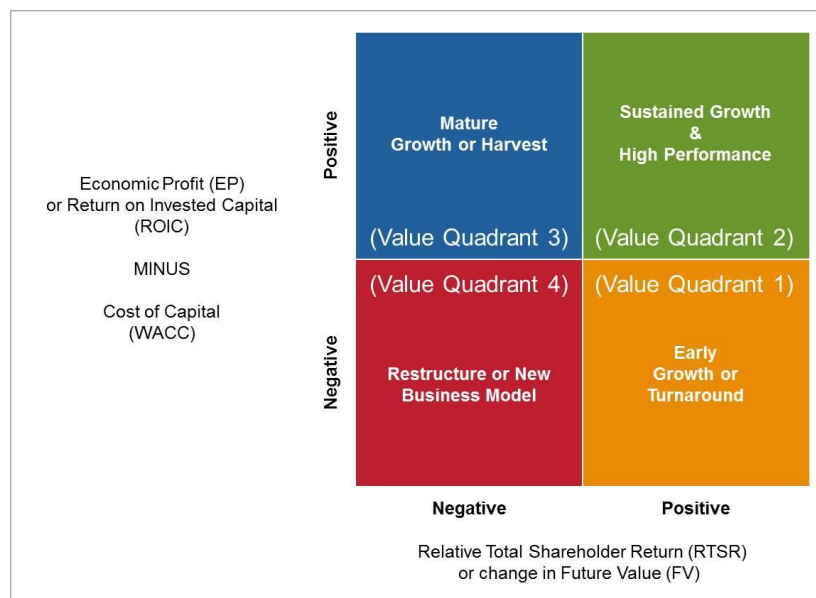
This means a material contributor of the expected value of the firm is about the future strategy, innovation and growth beyond the next two to three years, but there is no direct alignment to disclosed value-building metrics or executive incentive plan design for 85% of listed companies. Consequently, this lack of (disclosed) performance metrics alignment (company valuation, performance measurement design and long-term incentive design) creates a material risk for boards and investors.

1.3. A lens to review longer-term value creation

Investors, directors, and executive management would enable enhanced value creation and shareholder alignment if they applied business value-based performance measurement fundamentals in company performance management and planning, as well as in executive reward structures. While there are numerous ways to interpret the changes in these metrics over time, one interpretation would suggest that there are four key stages that align to this lifecycle (figure 1). The value quadrant model is a simple way for analyzing and segmenting company performance based on two performance metrics for evaluating value creation:

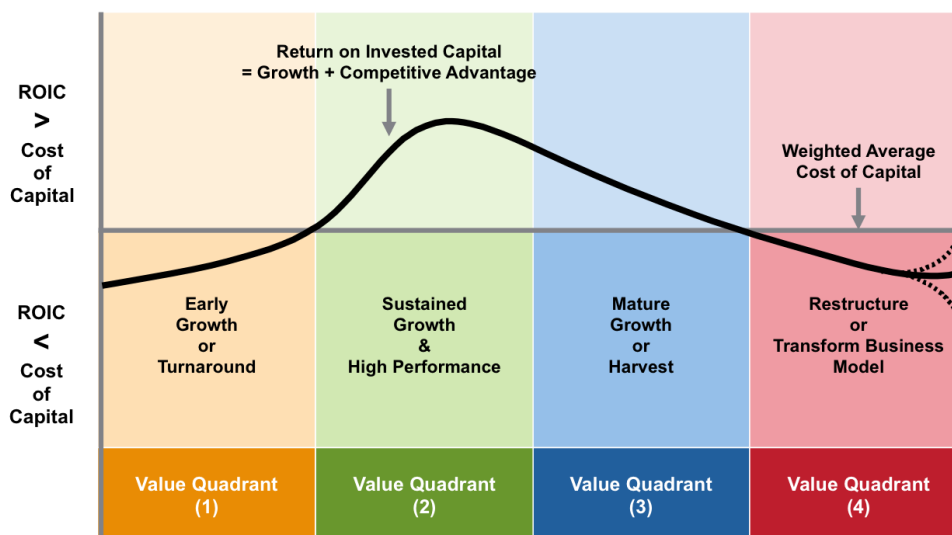
1. Relative TSR (as a proxy for the change in future value)
2. Economic profit (or performance spread = ROIC minus WACC)

Figure 1: Value creation life cycle and value quadrant performance metrics



Sustainability of longer-term value creation is all about the company's ability to achieve economic profit growth and positive return on invested capital over time. Overlaying capital returns on the corresponding life cycle with future value changes and growth in ROIC, results in the following performance cycle and value quadrants as seen in figure 2.

Figure 2: Value creation life cycle



Directors and executive management can enhance shareholder alignment by questioning the desirability of continuing to invest in businesses that fail to earn their cost of capital, and develop a plan to improve returns or exit the business. Directors and investors in creating this alignment would insist on performance measures that:

- Measure capital efficiency and economic value creation over time
- Measure changes in future value
- Measure value based on actual, not hypothetical, re-investment in the business

Chapter 2: Research methodology

We screened the S&P 500 and S&P 400 companies for the 150 largest value creating and 150 largest value-destroying companies, based on five-year cumulative economic profit (2008-2012) and five-year relative TSR (positive versus negative). Figure 3 below outlines the measurement framework applied in the analysis. This group of high- and low-performance companies were further screened to best represent companies across multiple industry sectors (using four-digit GICS codes) to identify a sample 128 companies with 32 companies in each of the four value quadrants outlined.

Figure 3: Value quadrant performance metrics

Value Quadrant	Performance Metrics
1	Positive Relative TSR and Negative Economic Profit (ROIC lower than WACC)
2	Positive Relative TSR and Positive Economic Profit (ROIC exceeds WACC)
3	Negative Relative TSR and Positive Economic Profit (ROIC exceeds WACC)
4	Negative Relative TSR and Negative Economic Profit (ROIC lower than WACC)

(This is the same value quadrant framework, and same set of companies, outlined in the first IRRCI report)

Each of the selected 128 companies was compared to the FundVotes proxy voting database for institutional investors and their Say-on-Pay proxy voting results. This database includes more than 100 of the largest mutual fund families representing over \$11 trillion in global assets under management. The data set also included 11 of the larger North American pension funds with close to \$2 trillion in assets under management. A list of these funds is in the appendix. Organizational Capital Partners also obtained the voting recommendations from ISS and Glass Lewis, the two largest proxy advisory firms, and added those voting recommendations to the analysis.

Please note that the FundVotes analysis and effective average Say-on-Pay support vote “For” is not the same as the aggregate total Say-on-Pay vote from all shareholders. The aggregate vote total includes votes from multiple types of shareholders, including both those sampled by FundVotes (mutual funds and large pension funds) and those not included in the FundVotes database (e.g. individuals, hedge funds, corporate insiders). In some cases there may not be a high correlation between the FundVotes effective Say-on-Pay outcome and the actual outcome from all shareholders, for idiosyncratic reasons. For example, in the case of Viacom, that company has multiple share classes, and only “class A” shares are allowed to vote. That share class is the less liquid, and most funds choose to invest in the more liquid non-voting shares. As a result, only two funds in the FundVotes database invested in the company and executed a Say-on-Pay vote with a combined average support of 0% as both funds voted “against”.

In other cases, the institutional shareholders in the FundVotes database may make up a significant portion of the shareholder base of a specific company. And, as these are amongst the largest institutional investors, in theory, at least, these should be amongst the most resourced and sophisticated Say-on-Pay voters.

Overall, this group of larger mutual funds and pension funds provides a relevant sample of how major institutional investors with fiduciary obligations, analyzed the performance, compensation plans, pay for performance alignment and voted their proxies for Say-on-Pay.

Chapter 3: Analysis of economic performance, return on invested capital and Say-on-Pay voting

A detailed review of the 128 companies (divided into the four quadrants with 32 companies each) that resulted from the screening process outlined in chapter two results in a surprising finding when they are analyzed for economic performance, shareholder return, long term incentive plan design and Say-on-Pay voting results.¹ Simply put, there does not seem to be a material correlation between economic performance and Say-on-Pay voting results.

3.1 Value Quadrant Four: Value destroying performance and Say-on-Pay Voting

The 32 value destroying companies in value quadrant four were all identified as having a negative return on invested capital over the last five years (2008-2012) when compared to their respective industry sector cost of capital and were analyzed as generating some of the larger five-year cumulative economic losses in the S&P 500 and 400. They also had negative relative TSR over five years. The performance statistics for the 32 sample companies includes:

- Median return on invested capital of 5% (below cost of capital);
- Cumulative five-year economic loss of over \$502 billion;
- 24 of a sample of 32 companies collectively generated a greater economic loss (\$62 billion) in 2012 than in 2008; their economic performance worsened over five years;
- Five-year relative total TSR of negative 52%, at the median for the group;
- 84% of these companies (27 of 32) had no disclosed capital-efficiency or balance-sheet performance metrics from which to measure, monitor, reward executive management performance in creating positive economic value and return on invested capital for shareholders;
- Average longest accountable performance period for named executive officers was three years.

Despite all those factors, when the Say-on-Pay voting results² for these 32 value-destroying companies were analyzed:

- Voting support for current disclosed performance, performance metrics, pay-for-performance and incentive design was an average 82% “FOR” from institutional investors
- ISS recommended support at 27 of the 32 (84%) companies.
- Glass Lewis recommended support at 23 of the 32 (72%) companies.
- 3 of 32 (9%) companies received a Say-on-Pay support of less than 50%. The average support at those three companies was 32.7%

¹ The financial data for analysis is provided by subscription data feeds and may be subject to error for some companies.

² In general, voting results for all companies were the 2012 proxy season. In any situation where the company did not hold a say-on-pay vote (some companies have bi-annual or tri-annual cycles), the most recent vote was substituted.

In summary, this group of 32 value destroying companies, while generating a five-year cumulative \$502 billion estimated economic loss; five-year relative TSR of negative 52% at the median; and failing in 84% of cases to disclose capital efficiency metrics in their LTIP design, still received an 82% Say-on-Pay approval “FOR” from institutional investors.

The gap between the level of five-year cumulative economic loss, low return on invested capital, negative relative TSR of these 32 sample companies and their high Say-on-Pay support suggests that return on invested capital and or economic profit type capital efficiency performance metrics are not a material part of the current processes for evaluating enterprise performance, business strategy, economic viability, pay-for-performance alignment as part of Say-on-Pay voting.

Figure 4: Value quadrant four – 32 sample companies with detailed performance metrics

		VQ Sums		VQ Performance Statistics				LTIP & Say-on-Pay Voting			
Company	Ticker	Total Five yr. Economic Profit Growth, yr. Ending 2012, \$millions	Five yr. Cumulative Ecn Profit (2008-2012) \$millions	Total Five yr. Revenue Growth%	Five yr. Median ROIC% with Goodwill	Total Five yr. Relative TSR%	Total Five yr. Absolute TSR%	Capital Efficiency /Balance Sheet Perf Metric in LTIP	Instnl Investors Say-on-Pay Average of Percent Support	ISS REC SAY-ON-PAY	Glass Lewis REC SAY-ON-PAY
HESS CORP	HES	(\$722)	(\$276)	19%	7%	-27%	-16%	No	82%	Against	For
MANPOWERGROUP	MAN	(\$180)	(\$322)	1%	6%	-23%	10%	No	81%	For	Against
HEWLETT-PACKARD CO	HPQ	(\$10,234)	(\$718)	15%	12%	-75%	-60%	No	62%	For	Against
BARNES & NOBLE INC	BKS	(\$381)	(\$873)	26%	-2%	-73%	-36%	No	73%	Against	For
AVNET INC	AVT	\$108	(\$879)	64%	8%	-48%	-27%	Yes	100%	For	For
INGRAM MICRO INC	IM	\$146	(\$1,007)	8%	6%	-17%	24%	Yes	81%	For	Against
SEALED AIR CORP	SEE	(\$997)	(\$1,094)	64%	8%	-6%	9%	No	95%	For	For
JABIL CIRCUIT INC	JBL	\$184	(\$1,273)	40%	5%	-7%	26%	No	94%	For	For
CARNIVAL CORP/PLC (USA)	CCL	(\$1,401)	(\$1,619)	18%	7%	-31%	3%	No	90%	For	For
METLIFE INC	MET	(\$6,240)	(\$1,680)	29%	16%	-36%	-29%	No	90%	For	For
NABORS INDUSTRIES LTD	NBR	(\$649)	(\$1,904)	42%	3%	-58%	-52%	No	10%	Against	Against
TEXTRON INC	TXT	\$305	(\$2,056)	-7%	6%	-53%	-44%	No	93%	For	For
PENNEY (J C) CO	JCP	(\$2,093)	(\$2,705)	-35%	6%	-80%	-57%	No	72%	For	Against
NEWFIELD EXPLORATION CO	NFX	(\$1,451)	(\$2,805)	44%	-7%	-63%	-58%	No	91%	For	For
FREEPORT-MCMORAN	FCX	(\$2,144)	(\$2,807)	6%	20%	-34%	-23%	Yes	53%	Against	Against
ELECTRONIC ARTS INC	EA	(\$295)	(\$3,329)	4%	-3%	-68%	-48%	No	45%	For	For
VALERO ENERGY CORP	VLO	(\$2,372)	(\$3,568)	46%	6%	-10%	2%	No	98%	For	For
E TRADE FINANCIAL CORP	ETFC	\$2,230	(\$3,872)	-2%	-1%	-75%	-72%	No	82%	For	Against
XEROX CORP	XRX	(\$8)	(\$4,270)	30%	5%	-62%	-36%	No	98%	For	For
PFIZER INC	PFE	(\$486)	(\$6,321)	22%	7%	0%	75%	No	96%	For	For
SEARS HOLDINGS CORP	SHLD	(\$622)	(\$6,467)	-21%	3%	-72%	-41%	No	97%	For	For
BANK OF NEW YORK MELLON	BK	(\$2,452)	(\$6,694)	2%	7%	-33%	-26%	No	95%	For	For
DOW CHEMICAL	DOW	(\$2,928)	(\$7,328)	6%	5%	-10%	5%	Yes	95%	For	For
AMERICAN AIRLINES GROUP	AAL	(\$753)	(\$7,719)	9%	-5%	-71%	-54%	No	83%	For	For
ADVANCED MICRO DEVICES	AMD	\$2,060	(\$8,250)	-10%	-4%	-62%	-57%	No	73%	For	Against
MORGAN STANLEY	MS	(\$1,195)	(\$9,535)	-62%	0%	-48%	-44%	Yes	70%	For	Against
DEVON ENERGY CORP	DVN	(\$2,090)	(\$9,800)	-16%	5%	-51%	-43%	No	43%	Against	For
ALCOA INC	AA	(\$2,225)	(\$10,441)	-23%	3%	-78%	-74%	No	96%	For	For
BANK OF AMERICA CORP	BAC	(\$23,785)	(\$60,970)	-16%	3%	-60%	-65%	No	92%	For	For
CITIGROUP INC	C	\$4,562	(\$97,189)	-38%	4%	-74%	-78%	No	92%	For	For
GENERAL ELECTRIC CO	GE	(\$9,753)	(\$97,678)	-15%	4%	-45%	-23%	No	93%	For	For
AMERICAN INTNATL GROUP	AIG	\$3,649	(\$137,246)	-40%	-7%	-95%	-94%	No	96%	For	For
SUM		(\$62,214)	(\$502,694)					% No	Average%	% For	% For
								84%	82%	84%	72%
80th		\$139	(\$1,130)	30%	7%	-24%	3%				
Median		(\$738)	(\$3,449)	6%	5%	-52%	-38%				
20th		(\$2,343)	(\$9,278)	-16%	-1%	-73%	-57%				

3.2 Value Quadrant Two: Value creating performance and Say-on-Pay Voting

The 32 value creating companies in value quadrant two over the last five years (2008-2012) were all identified as having a positive return on invested capital when compared to their respective industry sector cost of capital and generated some of the larger five-year cumulative economic profits in the S&P 500 and 400. They also created significant above median relative TSR. The performance statistics on these 32 high performance companies includes:

- Median return on invested capital of 16% (well above cost of capital) and 4 times greater than the median of value quadrant 4 companies;
- Cumulative five-year economic profit for these 32 companies of over \$605 billion;
- Economic profit growth of \$88 billion from 2008 to 2012; they were generating \$88 billion more economic profit than five years earlier (almost 15% year-on-year improvement);
- Five-year relative total TSR of 24%, at the median;
- 72% of these companies had no disclosed capital-efficiency or balance sheet performance metrics from which to measure, monitor, and reward executive management performance in creating positive economic value for shareholders. This group had 28% of companies using capital efficiency metrics in LTIP design as compared to only 16% in the value destroyer group in value quadrant 4:
- Average longest accountable performance period for named executive officers is 3 years.

However, when the Say-on-Pay voting results for these 32 high performance companies was analyzed:

- The most recent Say-on-Pay voting support for current disclosed performance, performance metrics, pay-for-performance and incentive design was an average 84% “FOR” from institutional investors, not materially different from the 82% for the value destroying companies.
- Both ISS and Glass Lewis recommended support at 26 of the 32 (81%) companies (though they differed on some of the specific companies).
- 6 of 32 (19%) companies received a Say-on-Pay support of less than 50%, though it is worth noting that the average vote at those six companies was 42.3%, suggesting that a switch of just a few funds might have flipped the vote to majority support.

In summary, this group of 32 high-performance and value-creating companies generated a \$605 billion estimated five-year cumulative economic profit, a five-year relative TSR of 24% at the median, along with an increased use of capital efficiency metrics in their LTIP design and received close to the same level of Say-on-Pay approval from institutional investors versus the 32 larger value destroying companies in value quadrant four (84% and 82%, respectively).

There is no material difference in Say-on-Pay voting support between the groups of high and low economic performance companies, despite the significant (positive versus negative) performance contrast between the companies when measured on return on invested capital, cumulative economic profit and relative total shareholder return over five years.

Figure 5: Value quadrant two – 32 sample companies with detailed performance metrics

		VQ Sums		VQ Performance Statistics				LTIP & Say-on-Pay Voting			
Company	Ticker	Total Five yr. Economic Profit Growth, yr. Ending 2012, \$millions	Five yr. Cumulative Ecn Profit (2008-2012) \$millions	Total Five yr. Revenue Growth%	Five yr. Median ROIC% with Goodwill	Total Five yr. Relative TSR%	Total Five yr. Absolute TSR%	Capital Efficiency /Balance Sheet Perf Metric in LTIP	Instnl Investors Say-on-Pay Average of Percent Support	ISS REC SAY-ON-PAY	Glass Lewis REC SAY-ON-PAY
EXXON MOBIL CORP	XOM	(\$207)	\$129,551	17%	20%	8%	20%	No	45%	Against	For
APPLE INC	AAPL	\$40,744	\$103,056	552%	101%	204%	171%	No	47%	Against	For
CHEVRON CORP	CVX	\$6,060	\$66,714	9%	18%	53%	65%	No	94%	For	For
INTL BUSINESS MACHINES	IBM	\$9,405	\$53,810	6%	22%	28%	103%	No	94%	For	For
WAL-MART STORES INC	WMT	\$5,557	\$49,511	24%	15%	23%	50%	Yes	94%	For	For
INTEL CORP	INTC	\$8,814	\$26,164	39%	21%	11%	22%	No	45%	Against	For
AMERICAN EXPRESS CO	AXP	\$1,291	\$18,989	7%	41%	61%	70%	Yes	78%	For	Against
MCDONALD'S CORP	MCD	\$2,511	\$17,138	21%	21%	54%	109%	No	96%	For	For
ABBOTT LABORATORIES	ABT	\$2,641	\$17,079	54%	14%	6%	52%	Yes	79%	For	Against
WELLS FARGO & CO	WFC	\$2,666	\$16,423	70%	14%	109%	44%	Yes	97%	For	For
QUALCOMM INC	QCOM	\$1,639	\$12,752	116%	20%	34%	70%	No	89%	For	For
ALTRIA GROUP INC	MO	(\$756)	\$10,141	-54%	15%	23%	112%	No	97%	For	For
COLGATE-PALMOLIVE CO	CL	\$318	\$9,718	24%	29%	22%	72%	No	94%	For	For
CATERPILLAR INC	CAT	\$1,061	\$8,459	47%	10%	6%	27%	Yes	95%	For	For
WELLPOINT INC	WLP	\$455	\$7,897	1%	17%	8%	56%	No	98%	For	For
UNION PACIFIC CORP	UNP	\$2,282	\$6,886	29%	10%	75%	150%	Yes	95%	For	For
EBAY INC	EBAY	\$1,067	\$6,488	83%	18%	11%	82%	Yes	38%	Against	Against
DU PONT (E I) DE NEMOURS	DD	\$709	\$4,999	15%	9%	14%	30%	No	95%	For	For
DISCOVER FINANCIAL SVCS INC	DFS	\$1,969	\$4,445	40%	22%	170%	170%	No	95%	For	For
MCKESSON CORP	MCK	\$236	\$4,385	20%	15%	40%	115%	Yes	43%	Against	Against
DEERE & CO	DE	\$418	\$4,384	51%	10%	4%	20%	Yes	93%	For	For
GAP INC	GPS	\$646	\$3,954	-1%	28%	8%	126%	No	96%	For	For
CVS CAREMARK CORP	CVS	(\$199)	\$3,818	61%	8%	7%	44%	Yes	98%	For	For
ILLINOIS TOOL WORKS	ITW	(\$286)	\$3,377	11%	13%	21%	46%	Yes	98%	For	For
ROCKWELL AUTOMATION	ROK	\$720	\$3,229	25%	31%	36%	39%	No	95%	For	For
MOODY'S CORP	MCO	\$8	\$3,088	21%	-82%	53%	66%	No	98%	For	For
PNC FINANCIAL SVCS GROUP	PNC	(\$685)	\$2,226	65%	12%	48%	14%	Yes	79%	For	Against
INTUITIVE SURGICAL INC	ISRG	\$401	\$2,082	263%	40%	5%	51%	No	94%	For	For
SIMON PROPERTY GROUP INC	SPG	\$607	\$2,042	36%	18%	39%	106%	No	36%	Against	Against
ALLERGAN INC	AGN	\$756	\$860	47%	8%	15%	101%	No	90%	For	For
MARATHON OIL CORP	MRO	(\$2,531)	\$828	-74%	6%	24%	41%	No	95%	For	For
RAYMOND JAMES FINANCIAL	RJF	\$33	\$175	26%	12%	60%	29%	No	95%	For	For
SUM		\$88,350	\$604,666					% No	Average%	% For	% For
								72%	84%	81%	81%
80th		\$2,615	\$18,619	60%	22%	54%	109%				
Median		\$715	\$6,687	25%	16%	24%	60%				
20th		\$13	\$3,116	9%	10%	8%	32%				

3.3 Value Quadrant One: Value creation potential and Say-on-Pay Voting

The 32 sample companies in value quadrant one illustrate companies with an expectation for growth (positive relative TSR) but with business models that are not currently creating positive economic value. The performance statistics on these 32 companies are:

- Median five-year return on invested capital of 4% (below cost of capital);
- Cumulative five-year economic loss for these 32 companies of over \$147 billion;
- Cumulative economic profit growth of \$3 billion from 2008 to 2012 showing signs of positive value creation trending; the challenge is 12 of 32 companies are generating a greater economic loss in 2012 than in 2008 even though they had a positive increase in relative and absolute TSR. For those 12 companies, stock price is up but the underlying economics are still value destroying and getting worse after five years;
- Five year total relative TSR of 31%, at the median for the group;
- Incentive Lab database identified that 72% of these companies had no disclosed capital-efficiency or balance-sheet performance metrics from which to measure, monitor, and reward executive management performance in creating positive economic value for shareholders;
- Average Longest Accountable performance period for named officers is 3 years.

When the Say-on-Pay voting results for these 32 turnaround companies was analyzed:

- The most recent Say-on-Pay voting support for current disclosed performance, performance metrics, pay-for-performance and incentive design was an average 87% “FOR” from institutional investors;
- ISS recommended support at 29 of the 32 (91%) companies;
- Glass Lewis recommended support at 24 of the 32 (75%) companies;
- 3 of 32 companies (10%) received a Say-on-Pay support of less than 50%. The average support at those three companies was 33%.

In summary, this group of 32 turnaround companies with a \$147 billion estimated cumulative economic loss over five years, five-year positive relative TSR of 31% at the median, and 72% with no capital-efficiency metrics received a slightly higher Say-on-Pay support than the value-creating companies in value quadrant two (87% vs. 84%). Yet, 38% of these companies are destroying more value (economic loss) in 2012 than in 2008, which suggests their turn-around strategies are not yet working even though TSR is positive over the same performance period. Companies where economic profit growth is positive as compared to companies whose economic profit growth is negative, and getting worse, would not appear to be effectively differentiated in the current pay-for-performance alignment testing as part of Say-on-Pay proxy voting.

These companies are, however, above median in relative TSR. The high level of Say-on-Pay support may have been impacted by a dominant use of TSR or relative TSR as key performance metrics used by institutional investors in their Say-on-Pay voting analysis processes.

Figure 6: Value quadrant one – 32 sample companies with detailed performance metrics

		VQ Sums		VQ Perfm Statistics				LTIP & Say-on-Pay Voting			
Company	Ticker	Total Five yr. Economic Profit Growth, yr. Ending 2012, \$millions	Five yr. Cumulative Ecn Profit (2008-2012) \$millions	Total Five yr. Revenue Growth%	Five yr. Median ROIC% with Goodwill	Total Five yr. Relative TSR%	Total Five yr. Absolute TSR%	Capital Efficiency /Balance Sheet Perf Metric in LTIP	Instnl Investors Say-on-Pay Average of Percent Support	ISS REC SAY-ON-PAY	Glass Lewis REC SAY-ON-PAY
ITT CORP	ITT	\$27	(\$116)	-75%	10%	13%	36%	No	100%	For	For
SLM CORP	SLM	\$2,234	(\$137)	-37%	7%	31%	42%	No	97%	For	For
TECH DATA CORP	TECD	\$214	(\$215)	8%	8%	3%	39%	No	95%	For	For
LEGGETT & PLATT INC	LEG	\$255	(\$356)	-14%	7%	55%	186%	No	97%	For	For
GATX CORP	GMT	(\$76)	(\$499)	-1%	5%	31%	58%	Yes	100%	For	For
KEMPER CORP/DE	KMPR	(\$17)	(\$707)	-15%	5%	11%	17%	Yes	93%	For	For
FAIRCHILD SEMICONDUCTOR INTL	FCS	\$20	(\$713)	-16%	0%	4%	19%	No	100%	For	For
OMNICARE INC	OCR	\$27	(\$919)	-1%	4%	60%	131%	No	72%	For	Against
VERTEX PHARMACEUTICALS INC	VRTX	\$485	(\$934)	667%	-38%	31%	130%	No	72%	For	Against
CYPRESS SEMICONDUCTOR CORP	CY	\$177	(\$958)	-52%	0%	76%	101%	No	41%	Against	Against
CINCINNATI FINANCIAL CORP	CINF	(\$18)	(\$975)	-3%	7%	54%	62%	No	97%	For	For
NISOURCE INC	NI	\$336	(\$1,128)	-37%	4%	65%	123%	No	99%	For	For
INTL PAPER CO	IP	\$425	(\$1,181)	27%	7%	79%	104%	Yes	99%	For	For
UNITED RENTALS INC	URI	\$113	(\$1,182)	10%	1%	143%	192%	No	99%	For	For
SANDISK CORP	SNDK	(\$71)	(\$1,285)	30%	10%	64%	144%	No	96%	For	For
CONSTELLATION BRANDS -CL A	STZ	\$266	(\$1,428)	-26%	4%	40%	149%	No	91%	For	For
TENET HEALTHCARE CORP	THC	\$1,442	(\$1,823)	3%	4%	45%	110%	Yes	100%	For	For
CHEMTURA CORP	CHMT	\$135	(\$2,585)	-30%	-8%	158%	198%	No	100%	For	For
MASCO CORP	MAS	(\$393)	(\$3,041)	-34%	-1%	1%	22%	Yes	95%	For	For
JPMORGAN CHASE & CO	JPM	\$878	(\$3,812)	-8%	11%	79%	23%	No	88%	For	For
MONDELEZ INTERNATIONAL INC	MDLZ	(\$2,175)	(\$4,119)	-6%	6%	6%	84%	No	75%	For	Against
HUNTINGTON BANCSHARES	HBAN	(\$428)	(\$4,325)	-12%	-1%	0%	-22%	Yes	96%	For	For
RESOLUTE FOREST PRODUCTS INC	RFP	\$441	(\$4,441)	16%	1%	8%	25%	No	97%	For	For
ALLSTATE CORP	ALL	(\$1,145)	(\$5,586)	-10%	6%	13%	19%	Yes	98%	For	For
CIT GROUP INC	CIT	\$1,446	(\$6,011)	-49%	1%	400%	289%	No	97%	For	For
ANADARKO PETROLEUM CORP	APC	(\$1,631)	(\$6,027)	18%	6%	26%	43%	No	84%	For	Against
COMCAST CORP	CMCSA	\$4,888	(\$6,063)	103%	6%	15%	137%	No	73%	For	Against
XL GROUP PLC	XL	(\$82)	(\$6,361)	-19%	-3%	17%	23%	Yes	96%	For	For
COCA-COLA ENTERPRISES INC	CCE	(\$179)	(\$9,004)	-61%	-4%	36%	137%	No	92%	For	For
MOTOROLA SOLUTIONS INC	MSI	\$293	(\$16,728)	-76%	-5%	19%	77%	No	45%	Against	For
CBS CORP	CBS	\$5,576	(\$23,503)	0%	-4%	16%	141%	No	13%	Against	Against
CONOCOPHILLIPS	COP	(\$10,281)	(\$31,765)	-66%	3%	12%	26%	Yes	78%	For	Against
SUM		\$3,185	(\$147,926)					% No	Average%	% For	% For
								72%	87%	91%	75%
80 th		\$477	(\$754)	10%	7%	65%	140%				
Median		\$124	(\$1,625)	-11%	4%	31%	81%				
20 th		(\$159)	(\$6,024)	-37%	-1%	11%	23%				

3.4 Value Quadrant Three: Hidden value and Say-on-Pay Voting

The 32 sample companies in value quadrant three illustrate mature growth companies where the expectation for growth is lower (negative relative TSR) but where the business model generates significant current value (five-year cumulative positive economic profit and ROIC > WACC). The performance statistics on these 32 mature companies suggest there is hidden value in these companies:

- Median five-year return on invested capital of 15% (well above cost of capital);
- Cumulative five-year economic profit for these 32 companies of over \$281 billion;
- Cumulative economic profit growth of only \$777 million from 2008 to 2012 showing the signs of mature growth; the challenge is 19 of 32 are generating a smaller economic profit in 2012 than in 2008 although still positive. On the flip side, 13 of 32 companies generated more economic profit in 2012 than in 2008. Relative TSR is negative over five years for each company. Nevertheless, the underlying business economics are value creating. This clearly demonstrates that TSR and relative TSR are incomplete measures of longer-term performance and value creation;
- Five-year total relative TSR of negative 19%, at the median, which reflects the slowing growth and value creation relative to their industry peers;
- 66% of these companies had no disclosed capital-efficiency or balance-sheet performance metrics from which to measure, monitor, and reward executive management performance in creating positive economic value for shareholders. The good news is as a mature group of companies, 44% do use some type of balance sheet performance metric in incentive design. This is the highest of the four value quadrants reflecting the maturity and sophistication of these companies;
- Average Longest Accountable performance period for named executive officers is 3 years.

When the Say-on-Pay voting results for these 32 mature companies was analyzed:

- The most recent Say-on-Pay voting support for current disclosed performance, performance metrics, pay-for-performance and incentive design was an average 77% “FOR” from institutional investors;
- ISS recommended support at 26 of the 32 (81%) companies;
- Glass Lewis recommended support at 21 of the 32 (66%) companies;
- 6 of 32 (19%) companies received a Say-on-Pay support of less than 50%. The average vote at those six companies was 25.2%. However, that includes a zero level of support amongst the represented funds on the Viacom Say-on-Pay vote. Viacom features multiple classes of stock, and only “class A” shares are eligible to vote. In general, “class B” shares are more liquid and held by more institutions. Only two funds held “class A” shares, which partially explains the zero vote. The average level of support at the five other companies which received less than 50% (excluding Viacom) was 30.2%.

In summary, this group of 32 mature companies with \$281 billion in estimated cumulative economic profit over five years, five-year relative TSR of negative 19% at the median, and 44% with disclosed capital efficiency performance metrics had Say-on-Pay approval from institutional shareholders slightly lower than the high performance group of companies in value quadrant two (77% vs. 84%).

59% of these companies are generating a smaller positive economic profit in 2012 than in 2008, which suggests many are challenged to innovate and grow as mature companies. This economic profit deceleration may have contributed to the five-year negative relative TSR and thus slightly lower Say-on-Pay approval compared to value quadrant two.

Figure 7: Value quadrant three – 32 sample companies with detailed performance metrics

		VQ Sums		VQ Performance Statistics				LTIP & Say-on-Pay Voting			
Company	Ticker	Total Five yr. Economic Profit Growth, yr. Ending 2012, \$millions	Five yr. Cumulative Ecn Profit (2008-2012) \$millions	Total Five yr. Revenue Growth%	Five yr. Median ROIC% with Goodwill	Total Five yr. Relative TSR%	Total Five yr. Absolute TSR%	Capital Efficiency /Balance Sheet Perf Metric in LTIP	Instnl Investors Say-on-Pay Average of Percent Support	ISS REC SAY-ON-PAY	Glass Lewis REC SAY-ON-PAY
MICROSOFT CORP	MSFT	\$7,793	\$82,975	44%	46%	-21%	13%	No	95%	For	For
COCA-COLA CO	KO	\$3,577	\$31,776	66%	21%	-15%	54%	Yes	44%	Against	For
PEPSICO INC	PEP	(\$1,018)	\$23,463	66%	24%	-31%	27%	No	95%	For	For
PROCTER & GAMBLE CO	PG	(\$2,103)	\$20,605	9%	10%	-24%	14%	No	94%	For	For
SCHLUMBERGER LTD	SLB	(\$924)	\$13,653	81%	16%	-20%	-8%	No	93%	For	For
LILLY (ELI) & CO	LLY	(\$2,339)	\$10,777	21%	11%	-20%	42%	No	97%	For	For
AT&T INC	T	\$3,118	\$10,268	7%	8%	-12%	28%	Yes	95%	For	For
LOCKHEED MARTIN CORP	LMT	(\$51)	\$10,209	13%	15%	-3%	17%	Yes	80%	For	Against
RAYTHEON CO	RTN	\$1,409	\$7,906	15%	17%	-13%	5%	Yes	99%	For	For
GOLDMAN SACHS GROUP INC	GS	(\$5,458)	\$7,672	-53%	13%	-14%	-8%	Yes	76%	For	Against
HALLIBURTON CO	HAL	\$728	\$7,402	87%	18%	-4%	9%	Yes	91%	For	For
DISNEY (WALT) CO	DIS	\$2,199	\$7,366	19%	10%	-4%	65%	No	30%	Against	Against
MEDTRONIC INC	MDT	(\$402)	\$6,728	23%	11%	-27%	18%	Yes	80%	For	For
AFLAC INC	AFL	\$975	\$5,014	65%	21%	-13%	-8%	No	99%	For	For
SCHWAB (CHARLES) CORP	SCHW	\$219	\$4,513	-11%	25%	-7%	1%	Yes	84%	For	Against
OMNICOM GROUP	OMC	\$162	\$3,822	12%	20%	-30%	48%	No	95%	For	For
KELLOGG CO	K	(\$181)	\$3,800	21%	16%	-19%	43%	No	94%	For	For
COACH INC	COH	\$375	\$3,748	82%	73%	-6%	24%	No	79%	For	For
UNITED PARCEL SERVICE INC	UPS	(\$4,111)	\$3,598	9%	12%	-16%	37%	Yes	86%	For	For
ARCHER-DANIELS-MIDLAND	ADM	(\$1,209)	\$3,480	102%	12%	-43%	-9%	No	93%	For	For
VIACOM INC	VIAB	\$1,175	\$3,235	3%	11%	-24%	41%	No	0%	Against	For
AGILENT TECHNOLOGIES INC	A	\$260	\$3,176	27%	19%	-13%	34%	No	97%	For	For
ADOBE SYSTEMS INC	ADBE	(\$162)	\$2,106	39%	14%	-29%	17%	No	76%	For	Against
DUN & BRADSTREET CORP	DNB	(\$64)	\$1,575	4%	48%	-21%	13%	No	97%	For	For
AVON PRODUCTS	AVP	(\$621)	\$1,381	8%	17%	-58%	-38%	No	23%	Against	Against
UDR INC	UDR	\$78	\$406	44%	20%	-12%	33%	No	97%	For	For
NORTHERN TRUST CORP	NTRS	(\$321)	\$401	-22%	10%	-16%	-8%	Yes	76%	For	Against
SPX CORP	SPW	(\$527)	\$385	6%	12%	-32%	-18%	No	79%	For	Against
NUCOR CORP	NUE	(\$1,364)	\$215	17%	7%	-30%	-19%	Yes	77%	For	Against
SL GREEN REALTY CORP	SLG	(\$150)	\$108	34%	8%	-22%	18%	No	36%	Against	Against
CORRECTIONS CORP AMER	CXW	(\$23)	\$103	19%	12%	-5%	45%	No	93%	For	For
ABERCROMBIE & FITCH	ANF	(\$262)	\$92	20%	8%	-65%	-27%	No	18%	Against	Against
SUM		\$777	\$281,960					% No	Average%	% For	% For
								66%	77%	81%	66%
80th		\$925	\$10,256	61%	21%	-12%	40%				
Median		(\$107)	\$3,811	20%	15%	-19%	17%				
20th		(\$999)	\$601	7%	10%	-30%	-8%				

3.5. Value quadrant analysis – a summary

Figure 8: Value quadrant summary 32 companies – performance, LTIP design, Say-on-Pay voting

	Five Year Economic Profit Growth ending 2012	Five yr. Cumulative Ecn Profit (2008- 2012) \$millions	Five yr. Median ROIC% with Goodwill	Five yr. Relative TSR	Five yr. Absolute TSR	Capital Efficiency / Balance Sheet Performance Metric in LTIP	Institutional Investors Say-on-Pay Average of Percent Support	ISS REC SAY- ON- PAY	Glass Lewis REC SAY- ON- PAY
Value Quadrant 1 – 32 companies									
SUM	\$3,185	(\$147,926)				% No	Average%	% For	% For
						72%	87%	91%	75%
Median			4%	31%	81%				
Value Quadrant 2 – 32 companies									
SUM	\$88,350	\$604,666				% No	Average%	% For	% For
						72%	84%	81%	81%
Median			16%	24%	60%				
Value Quadrant 3 – 32 companies									
SUM	\$777	\$281,960				% No	Average%	% For	% For
						66%	77%	81%	66%
Median			15%	-19%	17%				
Value Quadrant 4 – 32 companies									
SUM	(\$62,214)	(\$502,694)				% No	Average%	% For	% For
						84%	82%	84%	72%
Median			5%	-52%	-38%				

Chapter 4: Conclusions

4.1 ROIC, economic profit and Say-on-Pay voting

Economic value creation fundamentals such as ROIC and/or economic profit for performance measurement either are not used in current processes for Say-on-Pay advisory voting by institutional shareholders and in the analysis by the major proxy voting agencies, or they are outweighed by other considerations, such as TSR alignment. If economic value creation factors were primary considerations, there would be greater differentiation in Say-on-Pay voting results, based on economic profit performance and return on invested capital.

Do fundamental business strategy and finance using return on invested capital and economic profit as key performance metrics appear to impact current performance analysis and pay-for-performance alignment testing and the resulting Say-on-Pay voting results? The simple answer appears to be no.

This conclusion is best illustrated when comparing companies in value quadrant four as compared to value quadrant two:

- Value quadrant four includes 32 value-destroying companies:
 - Five year median ROIC of 4% (below cost of capital);
 - Generated a cumulative five year economic loss of \$502 billion;
 - Five year relative total TSR of negative 52%, at the median;
 - Received an average 82% Say-on-Pay approval from institutional investors;
Received five negative recommendations from ISS and nine negative recommendations from Glass Lewis;
 - 3 of 32 companies (13%) received a Say on Pay support of less than 50%, with those companies receiving an average “for” vote of 32.7%.
- Value quadrant two include 32 value-creating companies:
 - Five year median ROIC of 16% (well above the cost of capital);
 - Generated a cumulative five year economic profit of \$604 billion;
 - Five year relative total TSR of positive 24%, at the median;
 - Received an average 84% Say-on-Pay approval from institutional investors;
 - Received six negative recommendations from both ISS and Glass Lewis;
 - 6 of 32 companies (19%) received a Say-on-Pay support of less than 50% (though the average “for” vote at those companies was 42.3%).

While there is a material negative versus positive performance and value creation difference in relative TSR and economic profit over five years, between the sample companies in each of these two value quadrants, both groups received similar Say-on-Pay support in the 82% to 84% average range.³

³ For those value-creating companies in value quadrant two that received less than a 50% Say-on-Pay support, one possible explanation for the lack of support may not be about overall level of performance but the level of premium

Say-on-Pay voting results were similar across all four quadrants ranging from 77% to 87% average support by quadrant, with an average overall support of 82% (see the summary table, Figure 8). As was outlined in the first IRRCI report, 48% of the S&P 1500 generated a cumulative economic loss and thus an average ROIC less than their cost of capital (Figure 9). These companies failed to create economic value over five years or longer and thus may require strategic governance focus including enhanced performance measurement and LTIP design for named officers. Yet the 128 companies illustrated by the sample Say-on-Pay analysis do not appear to be differentiated as value creating versus value destroying based on their level of consistent institutional investor Say-on-Pay support in the 77% to 87% range.

Figure 9: S&P 1500 five-year cumulative economic profit versus five-year relative TSR (period: 2008 – 2012)

			5 Yr Relative TSR	
			Negative	Positive
		Total	47.2%	52.8%
5 Yr Cumulative Economic Profit	Positive	53.3%	17.9%	35.4%
	Negative	47.6%	29.4%	17.3%

compensation at some companies relative to their peer group. Premium compensation analysis was beyond the scope of this report, which focused on economic performance.

4.2 The opportunity for longer term investors

The use of ROIC and/or economic profit type performance metrics in Say-on-Pay voting would enhance the longer-term value creation alignment of the Say-on-Pay process for investors. The first IRRCi report in this series outlined the higher correlation between positive ROIC, economic profit growth and shareholder returns as compared to just net income or net income growth. The use of such metrics as ROIC and or economic profit would allow institutional investors enhanced voting execution aligned to long-term value creation. It would create an ability to go beyond relying on a sub-optimal use of TSR and or earnings as dominant metrics for performance analysis and pay-for-performance alignment testing.

Institutional investors and proxy advisory firms could consider incorporating key business strategy, finance and value creation alignment principles into their Say-on-Pay voting processes by:

- Applying value-based performance metrics such as ROIC relative to weighted average cost of capital (WACC) and or economic profit in their Say-on-Pay processes in evaluating business strategy and business model viability, performance measurement, value creation and pay-for-performance alignment;
- Adding future value improvement metrics (innovation, customer loyalty, employee engagement, environment) to their Say-on-Pay decision process from which to evaluate longer term pay-for-performance and value creation alignment at investee companies;
- Giving credit to companies that extend the longest accountable performance-period for named executive officers beyond 3 years, ideally to the use of five-year rolling performance period as being advocated by some institutional investors.

Appendix

Data providers and sources

Databases and data analytics have been woven together to create integrated insights about:

1. Economic performance and shareholder value
 - a. *Organizational Capital Partners*
 - i. *S&P 1500 with data feed from S&P Compustat and Hoovers and calculations for economic profit, adjusted ROIC and Future Value*
 - b. *Shareholder Value Advisors*
 - i. *S&P 1500 with data feed from S&P Compustat and calculations for economic profit, adjusted ROIC and Future Value*
2. Pay-for-performance alignment and long-term incentive plan design
 - a. *Incentive Lab – with over 1200 companies across the S&P 500, 400 and 600 and their incentive design details including pay mix, short-term vs. long term, performance based vs. time based, performance metrics, performance periods for named officers*
 - b. *Shareholders Value Advisors*
 - i. *Perfect Pay-for-performance model and analytics using the complete S&P 1500 and a broad range of economic profit and relative TSR performance metrics and S&P ExecuComp database*
 - ii. *Model and analytics for Pay-for-performance Alignment, Pay Leverage and Excess Pay relative average peer group performance*
3. Proxy voting for Say-on-Pay by institutional shareholders (mutual funds and pension funds)
 - a. *FundVotes*
 - i. *A database covering mutual fund voting for over 100 mutual fund families representing over \$11 trillion in global assets under management. The top 30 mutual fund groups include \$9.4 trillion in global assets under management and \$3.8 trillion in US domestic equities.*
 - ii. *This analysis also covers 11 of the larger North American pension funds with close to \$2 trillion in global assets under management*

Asset Owner and Asset Manager List

The following is a list of 144 mutual and pension funds in the FundVotes database that were analyzed for Say-On-Pay voting. Their combined assets under management is over \$ 13 trillion dollars.

Asset Manager			Asset Owner
ADVISORS	FMI	OAKMARK	AFSCME
AGF	FRANKLIN TEMPLETON	OCEANROCK/MERITAS	AIMCO
ALGER	GABELLI	OPPENHEIMER	BCIMC
ALLIANCEBERNSTEIN	GE	PARNASSUS	CALPERS
ALLIANZ	GMO	PAX	CALSTERS
AMERICAN	GOLDMAN SACHS	PH&N	CPPIB
AMERICAN BEACON	GREEN CENTURY	PIMCO	OMERS
AMERICAN CENTURY	GUIDESTONE	PIONEER	OTPP
AMERITAS	HARBOR	PORTFOLIO 21	SBAFLA
ARIEL	HARTFORD	PRIMECAP ODYSSEY	SWIB
ARTISAN	HSBC	PRINCIPAL	TIAA-CREF
ASTON	IA CLARINGTON	PRUDENTIAL	
AXA	ING	PUTNAM	
BARON	INHANCE	QUAKER	
BERKSHIRE	INTEGRITY	RBC	
BLACKROCK	INVESCO	ROYCE	
BMO	INVESTORS	RS	
BNY MELLON	JANUS	RUSSELL	
BOSTON COMMON	JOHN HANCOCK	SCHRODER	
BOSTON TRUST & WALDEN FUNDS	JP MORGAN	SCHWAB	
BRIDGEWAY	LAZARD	SCOTIABANK	
CALAMOS	LEGG MASON	SCOUT	
CALVERT	LIBERTY	SEI	
CAPSTONE	LONGLEAF	STANDARD LIFE	
CI	LORD ABBETT	STATE STREET	
CIBC	MACKENZIE	STEWARD	
COHEN & STEERS	MAINSTAY	SUNAMERICA	
COLUMBIA	MANAGERS	T ROWE	
CREDIT SUISSE	MANULIFE	TCW	
DAVIS	MASSMUTUAL	TD	
DELAWARE	MCLEAN BUDDEN	TEMPLETON	
DESJARDINS	MD FUNDS	THORNBURG	
DIMENSIONAL	METROPOLITAN	THRIVENT	
DODGE & COX	MFS	TRANSAMERICA	
DOMINI	MMA PRAXIS	TRILLIUM	
DREYFUS	MORGAN STANLEY	UBS	
DWS	MUNDER	UNITED	
DYNAMIC	NATIONWIDE	USAA	
EATON VANCE	NATIXIS	VALIC	
F&C	NBIM	VANGUARD	
FEDERATED	NEI	VICTORY	
FIDELITY	NEUBERGER BERMAN	VIRTUS	
FIFTH THIRD	NORTHERN	WADDELL & REED	
FIRST EAGLE	NUVEEN	WELLS FARGO	
		WILLIAM BLAIR	

Glossary – Key terms

Term	Definition
Capital charge	Capital charge in dollars = beginning invested capital <i>times</i> weighted average cost of capital.
Cash flow return on investment (CFROI)	The cash flow return on investment (CFROI) measures a company's cash return on invested assets. It is calculated as the internal rate of return assuming the maintenance of the current gross cash flow for the life of the asset base. Transaction CFROI includes goodwill from acquisitions (Credit Suisse HOLT)
Company wealth index	The company wealth index is a cumulative measure of shareholder wealth per share calculated from monthly total returns.
Current value (CV)	The sum of invested capital plus the present value of the current economic profit level. Economic Profit <i>divided</i> WACC <i>plus</i> Invested Capital
Discounted Cash flow valuation (DCF)	Discounted cash flow (DCF) valuation is a method of valuing an asset using the time value of money. DCF value is the present value of expected future cash flows discounted at the cost of capital. It can also be expressed as the sum of book capital <i>plus</i> the present value of expected economic profit.
Earnings per share (EPS)	Net Income available to common shareholders <i>divided</i> by the weighted average number of shares outstanding.
Economic profit (EP)	Economic profit is a non-GAAP measure of true economic profitability and is a measure of profit after minimum return for both invested equity and debt capital. NOPAT <i>minus</i> capital charge equals economic profit.
Enterprise value (EV)	Market value of equity <i>plus</i> the market value of debt <i>minus</i> excess cash. We assume that the market value of debt is equal to its book value. Enterprise value is also made up of two components, which are the current value (CV) and the future value (FV) of the enterprise. Enterprise value can also be calculated as = present value of current economic profit <i>plus</i> current invested capital <i>plus</i> present value of economic profit improvement.
Enterprise value divided by NOPAT multiple	Enterprise value <i>divided</i> by net operating profit after tax. This valuation multiple includes the total value of the company (debt <i>plus</i> equity <i>minus</i> excess cash) versus only the market value of equity in a P/E multiple. This multiple provides a comparison free of capital structure differences of the operating-cash generating capacity of the company; some investment banks find this multiple has a higher correlation with TSR than other valuation multiples; a high enterprise value <i>divided</i> by NOPAT multiple means a high expectation for future growth
Excess cash	Cash, cash equivalents and short-term investments beyond 2% of revenues that are not required to operate the business.
Excess shareholder returns relative to weighted average cost of capital	The dollar difference between actual shareholder wealth and shareholder wealth assuming a cost of capital return. The excess return can expressed as the sum of the future value of capitalized excess economic profit improvement and the dollar change in future value
Future value (FV)	Enterprise value <i>minus</i> current value equals future value. If the current economic profit level is fully sustainable, one can show mathematically that future value is equal to the present value of future economic profit improvement.
Generally Accepted Accounting Principles (GAAP)	Generally accepted accounting principles (GAAP) refer to the standard framework of guidelines for financial accounting used in any given jurisdiction; generally known as accounting standards or standard accounting practice. These include the standards, conventions, and rules that accountants follow in recording and summarizing and in the preparation of financial statements.

Term	Definition
Invested capital	Total asset (including goodwill) minus non-interest bearing current liabilities minus capitalized special items (including discontinued operations) minus excess cash plus capitalized R&D. Positive special items (gains) reduce capital, while negative special items (losses) increase capital
Net Equity Profit After Tax (NEPAT)	Earnings before taxes on the income statement (EBT), adjusted for special items and R&D, minus cash taxes paid from the cash flow statement. Special items (including discontinued operations) and R&D expense are capitalized and amortized over a five-year period.
Net Operating Profit After Tax (NOPAT)	Earnings before interest and taxes (EBIT) on the income statement, adjusted for special items and R&D, minus cash taxes paid from the cash flow statement and minus the tax savings from interest expense, calculated at the corporate marginal rate. Special items (including discontinued operations) and R&D expense are capitalized and amortized over a five-year period.
Non-interest-bearing current liabilities	Non-interest bearing current liabilities including accounts payable and taxes payable.
Performance-based equity compensation	Awards with market and/or performance conditions.
Performance spread	Return on invested capital (ROIC) <i>minus</i> the cost of capital (WACC). A positive performance spread is where ROIC exceeds WACC and results in value creation for shareholders. A negative performance spread is where ROIC is lower than WACC and results in value destruction for shareholders.
Price <i>divided by</i> earnings multiple (P/E multiple or ratio)	Market value of equity divided by the net income for the period. This is usually calculated on a yearly or trailing twelve-month time period. This may be converted to stock price per share <i>divided by</i> earnings per share; the higher the P/E multiple is, the higher is the investors expectation of future growth and innovation from the company relative to current earnings. Conversely, a stock with a low P/E multiple suggests that investors have more modest expectations for its future growth compared to the market as a whole.
Relative total shareholder return	The company's shareholder return relative to that of a specific comparator group, i.e., $[(1 + \text{TSR}) / (1 + \text{peer group TSR})] - 1$. For this report, we use each company's GICS industry group (four digit GICS) as its peer group.
Return on equity (ROE)	Net Income <i>divided by</i> beginning shareholders' equity.
Return on invested capital (ROIC)	A non-GAAP measure of capital productivity and balance-sheet efficiency measured as net operating profit after tax <i>divided by</i> beginning invested capital; a measure of the competitive advantage of a company in creating value for shareholders.
Time-based equity compensation	Awards dependent on a defined time period.
Total shareholder return (TSR)	The point-to-point measurement of the percentage gain or loss to shareholders, i.e., (share price end of period <i>minus</i> share price beginning of period) <i>plus</i> dividends <i>divided by</i> share price beginning of period. TSR for periods longer than one month is calculated by compounding monthly TSR.
Weighted Average Cost of Capital (WACC)	A calculation of a firm's cost of capital in which each category of capital is proportionately weighted. All capital sources (i.e. common stock, preferred stock, bonds and any other long-term debt) are included in a WACC calculation. The median WACC for all S&P 1500 companies for the last 5 and 10 years is 8%.

List of tables and figures

Figure 1: Value creation life cycle and value quadrant performance metrics.....	11
Figure 2: Value creation life cycle.....	11
Figure 3: Value quadrant performance metrics	12
Figure 4: Value quadrant four – 32 sample companies with detailed performance metrics.....	16
Figure 5: Value quadrant two – 32 sample companies with detailed performance metrics	18
Figure 6: Value quadrant one – 32 sample companies with detailed performance metrics	20
Figure 7: Value quadrant three – 32 sample companies with detailed performance metrics.....	23
Figure 8: Value quadrant summary 32 companies – performance, LTIP design, Say-on-Pay voting	24
Figure 9: S&P 1500 five-year cumulative economic profit versus five-year relative TSR (period: 2008 – 2012)	26