Return on Capital Grows in Popularity in LTI Plans

As featured in AgendaWeek
By Gavin Pierce April 7, 2017

Between 2011 and 2015, return on capital (ROC) metrics have increased in popularity among **S&P 500** companies' long-term incentive (LTI) plans, according to a report by **Equilar**. Over the same period of time, earnings per share (EPS) and revenues have declined in prevalence in LTI plans, but have remained important components of annual incentive plans (AIPs). Long-term institutional investors may be playing a role in this trend, according to experts and data. Some investors have even expressed a preference for capital metrics during the current proxy season.

Between 2011 and 2015, ROC was the only metric that consistently became more prevalent in S&P 500 CEO LTI plans. ROC was used in 30.6% of CEO LTI plans in 2015, versus 26.1% in 2011, says Equilar. The data also shows that the usage of total shareholder return (TSR) plateaued at around 57% between 2015 and 2014.

Some compensation experts have started to question the ability of TSR to incentivize CEO behavior and performance, as this metric is not completely under the control of executives, says Equilar.

"Both compensation committees and shareholders are looking for the best links between pay and performance," said **Matthew Goforth**, managing editor at Equilar, in a press release on the report. "Though TSR helps balance executive pay with shareholder returns, profits and return on company investments have emerged as consensus picks for tying day-to-day operations to long-term value creation."

Some investors have also expressed skepticism regarding TSR. **Citigroup**'s 2017 proxy statement said that after engaging with investors it found that there was "minimal support" for retaining the TSR metric.

Incidentally, data shows some firms are assigning higher weights to the ROC metric versus TSR in their LTI plans. Approximately 43% of companies used a 100% weighting for return on capital metrics, versus only 35.9% for TSR, according to Equilar.

"Most compensation committees want to design clear and understandable incentives, so linking one or two performance metrics to a single award is common," said Goforth. "Even when an incentive is tied to one weighted metric, ROC for example, it doesn't preclude a committee from adjusting the award's payout based on TSR performance. Sometimes there is more than meets the eye."

The **Baker Hughes** board uses return on capital as a metric in its LTI plan, which is combined with a TSR modifier. Under this structure, the final number of vested units is modified downward or upward based on the company's three-year TSR performance versus peers.

Meanwhile, there are indications that ROC is starting to be preferred in long-term incentive plans versus earnings per share. Between 2011 and 2015, the prevalence of EPS in LTI plans declined from 34.6% to 29.2%. And although there was a slight rebound in EPS usage in 2015, the figure remained below the 2011 peak, says Equilar.

"Return on capital and its iterations is a proven indicator of companies' ability to generate profits from invested capital over time that differs from earnings per share, which are more exposed to the effects of share buybacks and cost cutting," Goforth tells *Agenda*.

In early December, **Moody's** vice president and senior credit officer **Christian Plath** told *Agenda* that he tends to favor return metrics, as they can be "a more fundamental factor in a board's ability to generate cash over the long term."

Chart Industries is one company that moved to a return on capital metric for its LTI plan after using Ebitda previously. "Measuring return on investment, in the form of return on capital, measures on an absolute basis financial performance that aligns more closely with strong Company financial performance, rather than relative performance. This ties incentives to long-term value creation and rewards focus on the balance sheet as well as the income statement," says its most recent proxy statement.

Investors are also showing a preference for return on capital metrics, even during the 2017 proxy season. In addition to Citigroup, **Masco** also disclosed that its shareholders view return on invested capital (ROIC) as important in assessing long-term shareholder value.

Goforth cites a **Stanford University** study, which showed that investors are favoring return metrics versus other commonly used metrics. In fact, the study revealed that 77% of investors polled saw return on invested capital as "[an] excellent or very good metric linking pay to performance." This compared with only 58% for cash flow and 49% for TSR.

Capital allocation is one of the most important and complex tasks faced by both senior management and the board in maximizing long-term value creation, and is also a driver of activism, according to a global investor poll by **Morrow Sodali**.

Among those surveyed, a healthy return on equity (ROE) was considered the most important factor when judging a company's capital allocation policy, according to the poll, which included institutional investors in the U.K., U.S., Continental Europe and Asia.

"There's certainly a correlation between the timing of more engagement with shareholders in an investor-centric governance landscape and the investor survey data indicating shareholders view return on capital in a highly favorable light, even superior to total shareholder return as a metric linking executive pay with company performance. In turn, we've seen the rise of ROC as a metric in long-term incentive design," Goforth says.

In its Q2 2016 America's Investment Stewardship report, institutional investor **BlackRock** commented on how it decided to support the say-on-pay proposal of a mid-cap health care company after the board decided to add free cash flow and return on invested capital metrics to better align with the medium- and long-term strategy, which focused on debt reduction and free cash flow growth. Before engaging with BlackRock, the company had originally used revenue and earnings metrics in its LTI plan.

EPS and Revenue Metric Remain Important in AIPs

Even still, revenue and earnings metrics have remained important components in annual incentive plans. Approximately a third of companies (31%) used EPS in their AIPs, and 33% used revenues last year, which is up from the prior figures of 29% and 32%, respectively, according to **Meridian Compensation Partners**' 2016 Trends and Developments in Executive Compensation report.

"We've seen metrics like earnings and revenue play more prominent roles in annual incentive plans than for long-term incentives," says Goforth. "AIP metrics tend to be the lead indicators of performance for measures such as ROC, which is typically and appropriately measured over multiple years."

He says this development could be attributed to some form of equilibrium that may be becoming established between some boards and their investors regarding LTI and AIP structures. "Companies and shareholders are consistently working toward equilibrium, and even consensus, on the best metrics to link executive pay with performance over both longer-term and shorter-term horizons," he suggests.

He explains the area of executive compensation involves multiple players, which sometimes engage in a "tug of war" that creates a form of balance or equilibrium between them.

"Those players are all pushing and pulling against one another [and] in sound pay programs we'll see a balance of short-term and long-term interests that account for both top-line growth and the ability to generate return on investments, all while factoring in stock-price performance. Eventually, we see compensation strategy settling into an equilibrium where company and investor objectives are in balance with one another," Goforth says.