Returns vs Growth in Compensation Design

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Introduction

Shareholders are becoming increasingly vocal on the relationship between shareholder interests and management behaviour, particularly in extractive industries. Ontario Teachers' Pension Plan (OTPP) recently released an article entitled, "Is Management Compensation Rewarding the Right Behaviour?". This follows calls by New York hedge fund, Paulson & Co, for major gold investors to form a coalition and pressure Boards and management teams to tackle issues of high executive pay and poor investment decisions. As well, in September 2017, SailingStone Capital met with 11 major shareholders of US shale-oil and-gas producers to discuss methods for focusing E&P companies on generating profits, rather than the aggressive pursuit of growth. OTPP, Paulson and SailingStone argue incentive programs place too much emphasis on aggressive operational growth targets, which leads many management teams to focus on growth at all costs, often to the detriment of shareholder returns. While these shareholders' comments are focused on the natural resource sectors, we believe the messages are important for boards across all sectors.

> *The argument from OTPP, Paulson and SailingStone is that aggressive operational growth targets have management teams pursuing absolute growth of operations, often to the **detriment of shareholder returns**.*

As part of OTPP's research into performance metrics and returns among E&P companies, four recommendations were outlined:

- Change short term growth incentives to include production and reserve metrics that are per share and debt adjusted
- Focus management on achieving company-wide ROE or ROCE financial targets
- Supplement relative TSR with absolute TSR for long-term compensation targets
- Include a Green House Gas (GHG) or closely related emission target to highlight management disruption risks

While OTPP's recommendations are consistent with conventional value investment strategies (i.e., consider per share and return based results) as well as absolute returns and evolving governance trends (i.e., also consider environmental issues), this article is aimed at identifying the practical considerations boards may wish to explore while deciding whether, or how, to implement any changes to incentive programs.

Short-Term Incentive Plan & Green House Gas Targets

We agree with OTPP's sentiment that debt-adjusted per-share metrics are an appropriate way to ensure that growth has been achieved through accretive means while also accounting for changes to capital structure. Interestingly, we understand this change is underway among US exploration and production companies.

While Environmental, Social & Governance (ESG) considerations are growing in importance for shareholders and are increasingly monitored by management teams, we note that companies may be challenged to lower GHG emissions in a material way in the short-term without adopting costly new technologies or reducing the scale of operations, which likely is not the intent of the goal. For this reason, GHG and emission related targets may fit better into longer-term strategic metrics.

Regarding ESG factors and GHG emissions, we understand that Canadian issuers generally perform well compared to companies in other jurisdictions (European companies also tend to be leaders in this area). Boards may wish to consider more detailed disclosure to better communicate their results to shareholders; however, we note many companies have done this through the annual issue of sustainability reports.

Return Metrics

With OTPP, Paulson and SailingStone as examples, we see a strengthening sentiment among the shareholder community that Boards should recognize the value-destroying activity that may result from a growth-oriented mindset in extractive industries. While the spotlight on returns comes at the end of a market downturn, we caution boards on placing the blame solely on the commodity cycle.

> *Boards may wish to consider an appropriate balance between growth and return to better align management to shareholder interests as well as foster a strategy of* ***profitable growth.***

Growth is still an important component of delivering returns to shareholders; however, boards may wish to consider an appropriate balance between growth and return to better align management to shareholder interests. Especially where growth requires significant capital investment, management teams should be appropriately incentivized to make the right decisions for shareholders, whether that is accretive growth through acquisitions or asset development, or returning cash to shareholders through buybacks or dividends or paying down debt.

OTPP has suggested companies focus management teams on achieving company wide ROE or ROCE targets. While Hugessen generally agrees with the concept of shifting more focus to return, we encourage boards to consider whether these metrics are more appropriate measures of short or long-term performance for their company. Generally speaking, return measures are better suited in long-term rather than short-term incentives – particularly when considering the difficulty to manage the denominator (equity or invested capital within a year). In fact, we would argue that return measures are better used indirectly in the annual incentive to gauge annual performance standards (e.g., does the EPS standard support the long-term ROE standard).

Though not addressed by OTPP, we note that some companies have chosen to adjust target levels on operational metrics in light of the E&P industry's recessive environment. Most often, we see target, threshold and maximum values based on mid-term market expectations and recent peer results. This approach may lead to the board paying for performance that may be diminishing company value. For example, we have seen debates over recycle ratio targets in the E&P sector, and whether they should be based on short-term expectations (potentially resulting in compensating management for a ratio less than 1) or based on a longer-term, full-cycle ranges.

We also note that the standard for a given metric is just as important as the use of the metric itself. As such, boards may include strategies in target-setting to strike the balance between achievability and shareholder interests. For example, when setting targets for ROE, issuers should consider the company's cost of equity when setting the target. In a scenario where the macro environment creates large headwinds for annual results, the historic or typical difference between a threshold and target level of performance may result in a threshold that is not economic. For example, a challenging return environment may lead to budgeted threshold performance that is below the company's cost of capital (e.g., a normal year may budget for threshold ROE of 15%, but a down year ROE may be budgeted at 7%, while cost of capital is 10%). In this case, the board may consider raising the threshold level of performance to be at or above a minimum standard of operating performance to avoid compensating executives for results that may hinder shareholder value. In this case the payout curve may be skewed such that the range between threshold and target is smaller than typical.

Finally, it is important to understand the historical performance embedded in the return measures as well as how various accounting items influence returns. For instance, some companies may have high ROE because of strong financial performance; while others may have high ROE because the equity has deteriorated due to poor earnings and write-offs. This is important for both considering the appropriate standard and whether to incorporate high water marks (e.g., add back write-offs and one-time losses to equity). Moreover, there should be an explicit assessment of whether other comprehensive income (e.g., currency adjustments on foreign assets) should be included or not in the equity or capital being counted.

Absolute vs Relative TSR

OTPP recommended replacing relative TSR with absolute TSR for long-term compensation targets, however in recent conversation, OTPP has acknowledged the benefit of supplementing, as opposed to replacing, relative TSR with absolute TSR. Hugessen agrees that weighing incentive payouts solely on relative TSR can be produce unintended outcomes; creating a balance between absolute and relative returns is a practical approach in commodity driven businesses. Incorporating both absolute and relative measures of return can create a system of checks and balances in various return scenarios. For example:

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- Relative TSR can create perverse outcomes in situations where a company is the "best of the worst", outperforming peers while also posting a negative return

    - Goldcorp uses absolute TSR as a cap on their PSU payouts when relative TSR produces an above target result. If absolute return is negative, the payout is capped at target regardless of Goldcorp's positioning relative to peers. This ensures that executives are not excessively rewarded in the event of a negative absolute TSR, but still provides recognition of outperformance relative to peers
- On the other hand, Absolute TSR can prove to be problematic when macro-economic drivers have the potential to significantly influence the performance of an entire industry, creating scenarios where a company may perform exceptionally compared to the broader market, but underperform compared to industry peers ("worst of the best" or "the high tide raises all boats") – we note that this unintended outcome tends to get less attention from shareholders than the scenario above
    - To address this, Emera applies relative TSR as a modifier to the payout of their Performance Share Units (PSUs), which are evaluated based on EPS growth and cash growth from operations. If Emera is also in the top quartile of performance as measured by relative TSR, Emera makes a 25% adjustment upward. Alternatively, Emera makes a 25% adjustment downward if its relative TSR is in the bottom quartile of performance

We note that even though a compensation plan may use a relative TSR metric, the payout to the incumbent remains strongly linked to absolute measures, as the majority of incentive compensation is often paid through equity vehicles, valued at the market share price.

Another opportunity for a balanced incentive design presents itself through the replacement of Absolute TSR with an absolute Return on Equity (ROE) or Return on Capital Employed (ROCE) metric. ROE or ROCE could be an attractive alternative as to Absolute TSR, as both should track TSR, acknowledging the reality of actual return to shareholders but also considering how effectively the company utilizes capital it receives from shareholders.

Conclusion

As boards continue to address the alignment of management incentives with shareholder interests, shareholders are increasingly vocal that boards also the appropriate balance of both short and long-term metrics that measure growth and sustainable returns. Through the appropriate allocation of metrics within short, mid and long-term incentive plans, balance between growth and return metrics and the calibration of metrics through commodity cycles, common ground that considers management interests and shareholder interests can be found. As OTPP is indirectly pointing out, it is vital for organizations to revisit their incentive plans and question whether the right behaviour is being rewarded.

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