Own the pay-for-performance narrative

A board's best defence in the say-on-pay era? Conduct an independent pay-for-performance assessment, then communicate it to your shareholders

By Ken Hugessen with Lisa Oldridge

Shareholders are interested in ensuring compensation is aligned with performance, and they use say-on-pay votes and director elections to express concerns where this is not seen to be the case. Unfortunately, many issuers fail to provide compelling evidence of a strong link between pay and performance beyond making aspirational statements, which do little to demonstrate that pay outcomes are indeed aligned with performance

Proxy advisers have naturally moved to fill this vacuum, providing their own approaches to evaluating pay for performance (P4P). While many observers are critical of proxy advisers' methodologies, their P4P tests do address shareholders' needs for an independent assessment of whether a company is aligning pay with performance.

For boards, a practical response is to conduct their own assessments, and then engage with shareholders on the results. But to be effective, it is critical that boards take ownership of the pay-for-performance "storyline" by forming and expressing an opinion early on.

Proxy season is not the time to start building support for your approach to P4P. Reacting to a negative recommendation from a proxy adviser may be too little, too late to prevent a hit on say-on-pay voting and director elections. Even a convincing refutation of a "vote against" recommendation may be in vain if no engagement work has been done in advance, as the cumbersome machinery of the institutional investors' governance process can be too large and slow moving for the message to reach the right people in time. On the other hand, proactively engaging with shareholders well ahead of the proxy season not only allows the board to take control of the narrative, it also provides intelligence on investors' voting expectations for the upcoming season, voting guidelines and voting process, permitting a faster response to any negative sentiment.

Boards need to understand the critical issues in conducting a P4P assessment: i) choosing the performance peers and ii) considering what performance measures to use to compare performance (e.g., Total Shareholder Return, EPS growth, ROE, etc.). These two elements drive the conclusions of the P4P test, and give rise to many of the concerns about the proxy adviser recommendations.

Much of the criticism of the proxy adviser P4P tests stems from their methodologies for creating peer groups. In response, companies should take ownership of peer group creation, and provide a basis for the choices made. If compensation peers are distinct from performance peers, this should be clearly stated and why.

In assessing and presenting relative performance, metrics should be selected based on their ability to influence shareholder value. In addition to relative Total Shareholder Return (TSR), other measures, particularly those that are easily comparable among peers, can be useful. Boards should be able to explain their selections.

The next step is to conduct an independent analysis and interpretation of the results. The board should be aware it may not be entirely comfortable with the results. Some adjustment of the incentive plan performance conditions, or an application of board discretion (potentially negative), may be called for. In these cases, timely dialogue with shareholders may also be appropriate and warranted.

Even assuming the analysis shows a good alignment of pay outcomes with performance results, there is a final (and critical) step.

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Clear and candid disclosure of the board's assessment in the circular is essential, especially where stock performance has suffered due to an unfavourable business or commodity cycle, and the pay-for-performance linkage may not be obvious. That the board is demonstrably concerned with this issue will not be lost on shareholders—nor on the proxy advisers, who will think twice before making a recommendation that contradicts a well-reasoned, effectively communicated demonstration of strong alignment of pay with performance.

There is no substitute for well-designed incentive plans. But unless you demonstrate their effectiveness and communicate this with shareholders, a good story can be lost...or worse.

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