



ALPHA PERFORMANCE & REWARD

APRIL 2013

ISSUE 1.2

L-R: Mark Jones,
Gerald Whittle,
Denis Godfrey,
Joan Cameron &
Denis Kilroy



GETTING EXECUTIVE REWARD RIGHT

This edition of APR focuses entirely on performance-based executive reward, and specifically on the metrics used to measure performance and reward executives.

Executive reward has been the focus of a lot of attention over the past few years – particularly so since the introduction of the *Two Strikes Rule*.

Some of the discussion has been excellent, including the call to rethink executive incentive programs which came from Pru Bennett of Blackrock.

However a lot of the media debate has been emotive – focusing mainly on the quantum of pay involved. If we are to have a truly meaningful discussion of the issues involved, it is important to begin by separating the quantum of pay from the more foundational issues of incentive plan structure and the metrics used to measure performance.

It is perhaps perplexing that with all the research done on listed companies, we still don't have consensus on how best to measure company performance – let alone what constitutes superior, acceptable or under performance.

We need to get to that consensus, because without it we have a serious problem looming.

Complexity in remuneration practices and lack of standardisation in remuneration reporting means that the *Two Strikes Rule* has ceded quite a lot of power to those who sit in judgment of companies on behalf of shareholders.

Because there is a lack of consensus on company performance measurement, action taken by boards to appease those who sit in judgment may not always turn out to be in the long-term best interest of shareholders.

This concern is not just a remote possibility. It is a reality affecting an increasing number of companies now.

Over the past ten years, boards have been encouraged firstly by some proxy advisors, and more recently by many remuneration consultants, to adopt Relative TSR as a basis for vesting their executives' long-term incentive (LTI) awards.

Over the past year or two, as the serious shortcomings of that metric

have become more and more apparent, the same advisors have begun encouraging companies to try to mitigate its shortcomings by adopting a combination of Relative TSR and EPS Growth.

This advice is seriously flawed.

Separate articles in this edition by Denis Godfrey of GRG and Marvin Schneider of KBA demonstrate both analytically and empirically that such a move is likely to compound rather than mitigate the problems companies have experienced with Relative TSR.

The research outcomes reported in Marvin's article confirm similar findings from research conducted in the US for companies in the S&P 500.

Both authors conclude from two different perspectives that the simplest and most appropriate approach for most companies is to use TSR Alpha™ as a market-based measure to assess vesting of LTI awards, and either Economic Profit (EP) or EP growth as an internal measure to assess short-term incentive (STI) awards.

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1. Performance Related Pay and the Need for Better Performance Metrics
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Marvin Schneider

PERFORMANCE RELATED PAY AND THE NEED FOR BETTER PERFORMANCE METRICS

DENIS GODFREY – GODFREY REMUNERATION GROUP

In a recent newspaper article written by a non-executive director of an ASX-listed company, there were comments that suggested performance related pay (PRP) failed as it generally did not reward executives for great work in tough times and on occasion had resulted in bonuses when outstanding company performance was due to external influences rather than the performance of executives. While these observations were essentially correct, they also demonstrate a fundamental misunderstanding of the role of PRP and the need for an element of board discretion.

What is PRP?

PRP is based on the principle that a significant part of executive reward should be related firstly to company performance, secondly to the performance of the business unit in which the executive works, and both last and least to the performance of the executive. PRP is about rewarding results rather than effort.

PRP is even more pointed in that the performance that should be rewarded is performance as reflected in returns to shareholders. Shareholders are the owners of the company and therefore are the main stakeholders to whom the board and management are accountable.

Board Discretion

Current thinking is that boards should retain a degree of discretion in relation to PRP with a view to ensuring that key management personnel (KMP) do not receive rewards that are inconsistent with performance as perceived by shareholders. KMP are those individuals whose remuneration must be disclosed in Remuneration Reports.

Given proposed changes to the Corporations Act, such discretion may

also be relevant to clawbacks of remuneration overpaid to KMP.

Performance Metrics

The metrics used for short-term incentive (STI) and long-term incentive (LTI) plans should be linked to total shareholder return (TSR). However this does not mean that TSR is the only metric to use for STI and LTI plans. Clearly this would not be appropriate, since share prices can be influenced by external factors that have little if any relationship to a company's performance – particularly over the short term. TSR tends to be a more meaningful indicator of company performance over the longer term.

The TSR required from a particular stock in order to meet shareholder expectations will vary depending upon the level of risk associated with the company. Clearly, the return expected of a low-risk utility will be lower than expected of a high-risk exploration company.

LTI Metrics

LTI plans commonly use two metrics for assessing company performance. They are Relative TSR and Earnings per Share (EPS) growth. However both metrics are flawed.

Relative TSR

Relative TSR is a measure of the TSR achieved by a particular company compared to those achieved by other companies in a comparator group. It is used to determine the extent to which a grant of shares, rights or options vests. Typically there is nil vesting below the median TSR, 50% vesting at the median TSR, 100% vesting at or above the third quartile, and pro-rata vesting between the median and the third quartile.

Relative TSR emerged as an attempt to take account of both company-specific

risk and overall market movement by comparing a company's TSR performance with the TSR performances of companies in a comparator group. It is somewhat useful in taking account of market movement as the share prices of all companies tends to be influenced in a similar way by economic conditions which affect overall market sentiment. However, it fails to take proper account of company-specific risk – a factor which is captured in a company's beta.

The beta reflects the extent to which a company's share price moves in line with market movements. Broadly, a company with a negative beta does not move in the same direction as the market and this rarely occurs. A beta of 1 means that a company's share price moves in line with market movements and therefore has a risk equal to the risk of the overall market. A positive beta of less than one means that the share is a relatively low-risk investment. A positive beta of more than one indicates that the share is a relatively high-risk investment. Put another way the share price of a company with a positive beta of less than one will move in the same direction as the market but to a lesser extent. The share price of a company with a positive beta of more than one will move in the same direction as the market but to a greater extent. Figure 1.1 illustrates this point.

Preliminary analysis of comparator groups used by ASX-listed companies indicates that little or no regard has been paid to company betas or relative risk when compiling comparator groups. For example, in relation to a company examined recently, approximately one-third of the companies in its comparator group had a beta of less than 1.0 compared to the company's beta of 1.4. Assuming they

delivered financial performance broadly in line with market expectations, the TSRs of these companies would almost certainly under perform relative to the company in question in a rising market, and vice versa, making them inappropriate TSR comparators.

Another third of the companies in the comparator group had betas that were at a significant variance (higher or lower) to the company's beta – again making them inappropriate comparators for TSR purposes as well.

Relative TSR could be a useful way to assess company performance if a large group of companies (≥ 30) in the same industry sector and with the same betas (risk) could be selected. However, due to the limited number of ASX-listed companies and the diversity of industries and company betas, it is virtually impossible to select an appropriate group of companies for TSR comparator purposes.

TSR AlphaTM

An alternative approach that does not rely upon a comparator group and therefore is simple to implement is to compare a company's actual TSR performance over a measurement period with the TSR that investors expected at the beginning of the measurement period. This can be done with a metric called TSR AlphaTM, which measures individual company TSR performance relative to the All Ordinaries Accumulation Index, with an appropriate adjustment for risk.

The TSR required to meet shareholder expectations is calculated having regard to market movements over the measurement period and the company's beta at the beginning of the measurement period. It can be thought of as the TSR required in order to preserve the value of the shareholder's investment in the company over the measurement period.

If actual TSR equals the required TSR then performance has been good and should be rewarded. Exceeding the required TSR generally means very good performance and should attract very good rewards.

Detailed knowledge of TSR delivered and TSR required in order to meet

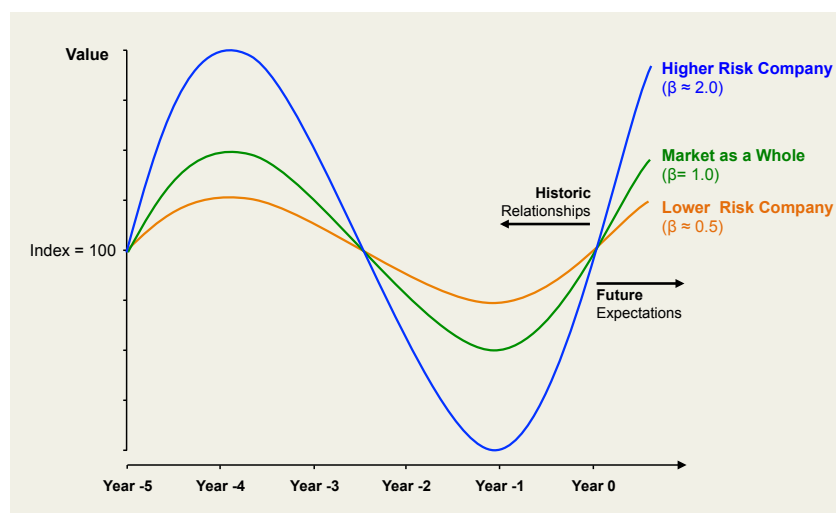


Figure 1.1. Impact of company-specific risk on stock price movements

shareholder expectations is needed when setting the relationship between the extent of performance in excess of expectations and the amount of additional reward that should be provided for such outcomes.

EPS Growth

EPS growth is now used widely as an LTI vesting condition. Unfortunately, it is a poor metric and generally should not be used for the purpose of LTI vesting. There are many reasons for this, including the following.

- Because EPS growth does not contain a standard or benchmark against which to judge whether the increased earnings have arisen from sound decisions that will lead to an increase in shareholder value, its use as an LTI vesting metric can lead to investment decisions that actually destroy shareholder value even when EPS is increasing. Commonly held beliefs about EPS growth and P/E ratios driving shareholder value are incorrect because the capital base and rates of return in excess of the cost of capital are not considered. Observed linkages between EPS and market value via P/E ratios are *not cause and effect* relationships.
- When used as an LTI vesting metric, EPS growth can encourage poor decision making such as retaining profits when inadequate returns will be generated from their re-investment, and rearranging capital investments to maximise short-term

earnings at the expense of longer term growth in shareholder value.

- EPS growth targets are set by boards and should reflect board expectations of company performance in the economic environment that is expected to prevail over the vesting/measurement period. Thus, they should vary with each annual LTI grant. Most LTI plans use the same EPS growth targets repeatedly with the result that they are rarely, if ever, appropriate for the measurement periods to which they relate.
- Many directors are reluctant to tailor EPS growth targets for LTI grants to reflect business plans as they are concerned that such targets may be taken as earnings forecasts particularly when they differ from those released under the continuous disclosure regime.
- Even if EPS growth targets are set by reference to business plans, the EPS growth targets may prove to be inappropriate if the economic environment differs from that expected when the targets were set.

Economic Profit Growth

Economic profit is the profit achieved after a charge for all capital used in a business. Because it takes into account financial outcomes captured in both the P&L and the Balance Sheet, it is free from many of the shortcomings inherent in EPS, which is essentially a P&L measure.

In the first chapter of his book, *The CEO, Strategy and Shareholder Value*, Peter Kontes (Executive-in-Residence at the Yale School of Management) refers to an analysis of S&P 500 companies covering a 10-year period from 1998 to 2007. This analysis indicated that companies that grew economic profit per share faster than they grew earnings per share generated far higher TSRs than companies which grew earnings per share faster than economic profit per share. This analysis suggests that the focus should be on economic profit and economic profit growth, rather than earnings and earnings growth. Similar analysis has just been completed by KBA covering the 500 largest companies by market capitalisation listed on the Australian Securities Exchange. The outcomes of this analysis are entirely consistent with those reported by Kontes, as is evident in the next article by Marvin Schneider.

STI Metrics

With STI plans, it is generally inappropriate to use TSR directly as a performance measure. This is because a company's share price can be affected by many external variables and in the short term this can lead to share price

movements not being directly aligned with changes in the intrinsic value of the company.

Economic profit is a sound metric for performance measurement on an annual basis. Unlike TSR, which reflects overall company performance, economic profit can be used to assess performance at business unit and customer segment levels. Thus, it is much more sharply focused than TSR.

Economic profit scenario analysis can assist in evaluating alternative strategies. Further, once the best strategy for a business unit or customer segment has been decided upon, economic profit outcomes can be used to assess the extent to which the strategy is being successfully implemented. Thus, it becomes an ideal metric for measuring performance at the customer segment and business unit levels as well as at the overall corporate level.

Individual performance can continue to be measured by reference to performance management scores and similar metrics.

To improve the alignment of executive and shareholder interests, it would also generally be desirable to deliver part of

earned STI awards in deferred shares or rights which vest over a period and are subject to trading restrictions. This would encourage longer-term holding of shares by executives and would also accommodate clawbacks should they ever become necessary.

Bridge between STI and LTI

Analysis has shown that over the long term, both TSR and TSR Alpha™ will be aligned with growth in the intrinsic value of a company. Intrinsic value is a function of expected economic profits and growth in intrinsic value can be achieved by growing economic profit. Thus, if economic profit is used as a key metric for STI purposes at corporate, business unit and customer segment levels, it will help drive growth in the intrinsic value of the company which in turn will lead to growth in shareholder value and good TSR outcomes.

A sound combination of performance metrics is to use economic profit for STI purposes and TSR Alpha™ for LTI purposes. Companies that use this combination of metrics will be able to align their STI and LTI plans, and be able to communicate clearly such alignment to shareholders in Remuneration Reports.

KMP Remuneration Briefings

"Why many of the performance metrics used in KMP incentive plans are flawed - and what to do about it"

Thursday 9th May, Sydney | Friday 10th May, Brisbane | Wednesday 15th May, Melbourne | Thursday 16th May, Adelaide | Friday 17th May, Perth

KMP remuneration is the subject of intense scrutiny from many sources, including shareholders, proxy advisors, associations such as the Australian Shareholders Association and the Australian Council of Superannuation Investors, and the ASX Corporate Governance Council. All expect KMP remuneration to be strongly linked to performance.

Obtaining two successive "strikes" may lead to a spill of non-executive director roles and even one "strike" can damage a company's reputation.

It is therefore critical to get KMP remuneration right.

Recent research by KBA suggests that many companies are using performance metrics that neither encourage nor reward value-creating behaviour.

There is a simple way to fix this.

This full-day briefing by Denis Godfrey of GRG together with Denis Kilroy and Marvin Schneider of KBA will provide in-depth coverage of:

- Current market practices for executive KMP incentives
- Results of recent research showing how a group-wide focus on Economic Profit (EP) growth is more likely to deliver higher TSR outcomes than a focus on EPS growth
- Why the combination of TSR Alpha™ and EP growth is so superior to Relative TSR and EPS growth as a basis for structuring KMP incentives
- How to align TSR Alpha™ as a metric for LTI vesting at a group level, with EP growth as a metric for STI awards at group, divisional, business unit and customer segment levels
- How to go about the systematic pursuit of EP growth and intrinsic value uplift – including the capabilities required and the role played by KMP incentives
- Other developments affecting KMP remuneration including new disclosure requirements and clawback provisions

To register, email info@godfreyremuneration.com for a registration form or call +61 (2) 8923 5700



\$2,000 + GST for the first participant from a company
\$1,000 + GST for each additional participant from the same company
Additional briefings can be provided at a company's premises for a total of \$9,000 + GST



CORPORATE PERFORMANCE METRICS – SEPARATING THE FACTS FROM THE MYTHS

MARVIN SCHNEIDER – THE KBA CONSULTING GROUP

The conceptual framework and empirical research presented in this article together provide strong evidence to support the proposition that TSR Alpha™ and Economic Profit (EP) should be adopted as the two primary or “apex” corporate performance metrics for listed companies.

A performance related pay (PRP) structure based on EP for short-term incentive (STI) purposes and TSR Alpha™ for long-term incentive (LTI) purposes will encourage and reward superior economic performance in any listed entity – as Denis Godfrey concluded in the previous article.

The conceptual framework outlined links EP outcomes to strategy selection, intrinsic value uplift to EP growth, TSR to change in intrinsic value, and TSR Alpha™ to the difference between TSR delivered and the TSR required by investors in order to meet their required rate of return.

The research presented shows clearly that a focus on EP growth is more likely to deliver higher TSR and TSR Alpha™ outcomes than the traditional focus on earnings per share (EPS) growth.

Goal Clarification

It is difficult to progress a meaningful discussion about corporate performance metrics unless there is agreement as to an organisation’s goal and the role played by key management personnel (KMP) in pursuing that goal.

In its simplest form, the primary economic objective of any corporation is to produce goods and services that create value for customers (for which they are willing to pay), and while

doing so, provide an appropriate return on the resources consumed.

Most KMP will be familiar with the challenge of creating value for customers in a competitive landscape. An organisation’s ability to create value for customers keeps it relevant in its product and service markets. And failure to do so will result in the organisation’s demise.

The very real challenge involved in creating value for customers on an ongoing basis in a competitive landscape is currently being played out in the market for mobile phones (and increasingly smartphones), previously dominated by Nokia and Research in Motion (makers of Blackberry phones), and now dominated by Apple and Samsung.

However, the requirement to provide an appropriate return on the resources consumed is equally important. It prevents organisations from investing too many resources in the pursuit of customer value creation – and going “broke” in the process.

To illustrate, many would argue that Ansett created exceptional value for its customers. But it couldn’t cover the cost of its high service levels at the prices customers were willing to pay.

If the goal of an organisation is to create value for customers while at the same time providing an appropriate return on the resources consumed, then the role of KMP is to devise and execute strategies that achieve such an outcome.

The Purpose of Strategy

The process of devising and executing strategies represents the effort expended by KMP. But PRP is not about rewarding effort. It is about rewarding results.

How does one measure the results of effective strategy development and execution?

A good strategy effectively implemented will result in an increase in EP over time. And when discounted to take into consideration the “time value of money”, that increase in EP over time will result in an increase in the intrinsic value of the organisation.

This simple understanding identifies two apex performance metrics: EP (with the purpose of strategy being to cause an increase in EP over time), and its multiple period analogue namely the intrinsic value of the organisation or business unit (with the purpose of strategy being to cause an increase in intrinsic value).

EP and its Link to Strategy

The concept of EP is not new. Yet it is surprising how few organisations fully embrace EP as their apex internal measure of corporate performance.

EP is a “period” measure of performance. In that sense, it is similar to the notion of accounting profit in that one can pose and answer the questions: “*How much EP did my organisation or business unit earn this year?*” and “*How much EP is my organisation or business unit expected to earn next year?*”

However unlike accounting profit, EP reflects the cost of all resources consumed in the pursuit of a particular strategy: the cost of external supplies; the cost of labour; AND the cost of capital employed.

It is the inclusion of a charge for the capital employed in the business that makes EP an ideal apex metric with which to measure the effectiveness of strategy development and execution.

Imagine that you are in charge of an organisation that last year earned \$1 billion in revenue, had operating costs of \$500 million and had \$1.5 billion of capital invested in the business. And let's assume for the sake of this illustration that shareholders have provided all of the capital invested in the business.

Traditional accounting measures of performance would recognise an after-tax profit of \$350 million, with a return on sales of 35% and a return on capital of just over 23%.

If the organisation has a cost of equity capital of 10%, the calculation of EP would recognise a capital charge of \$150 million (10% of the \$1.5 billion capital employed).

The resulting EP of \$200 million is illustrated in the base strategy column in Figure 2.1.

Imagine also that in an attempt to gain more market share, the CEO decides to reinvest all of the \$350 million accounting profit generated under the base strategy and by doing so, manages to increase revenues by 2.5% while at the same time keeping total operating costs at the same level.

Is this alternative strategy a good strategy?

According to traditional financial metrics, the answer would be yes.

Accounting profit would increase from \$350 million to \$368 million, and earnings per share (EPS) would increase commensurately since no new shares were issued.

However, accounting profit does not take into account all of the resources invested in the pursuit of the alternative strategy.

When the cost of capital is taken into account, it becomes clear that the revenue benefit from investing an additional \$350 million in capital does not provide sufficient return on the resources committed. EP would fall from \$200 million to \$183 million.

	Base Strategy	Alternative Strategy
Revenue	1,000	1,025
- Costs	(500)	(500)
- Tax	(150)	(158)
= Accounting Profit	350	368
- Capital Charge	(150)	(185)
= Economic Profit	200	183
Capital Invested	1,500	1,850
Return on Sales	35.0%	35.9%
Return on Capital	23.3%	19.9%

Note: All values except percentages are in millions of dollars

Figure 2.1. Illustrating the calculation of economic profit

This simple illustration demonstrates that traditional accounting measures of performance are not up to the task of measuring the effectiveness of strategy development and execution.

EP is a more appropriate metric because:

- It measures the result of customer value creation through the revenue line;
- It takes into consideration the cost of all resources committed in the pursuit of a given strategy;
- It has a natural absolute datum of zero, above which the strategy is providing an adequate return on the resources committed, and below which it is not; and
- It has a mathematical link to the notion of intrinsic value.

The fact that EP has a natural absolute datum is particularly important.

A strategy that produces a sustained level of negative economic performance has failed to deliver an adequate return on the resources committed to it.

Continued pursuit of such a strategy will result in the consumption of resources in excess of the customer value that it generates. Ultimately, a company pursuing such a strategy will go broke, as Ansett did in 2001.

On the other hand, a strategy that results in a sustained level of positive economic performance means that the value created for customers (and recaptured as revenues from an appropriate combination of price and market share) is greater than the resources consumed in the pursuit of that strategy.

While the alternative strategy identified in Figure 2.1 still provides a positive EP, its level of EP is lower than under the base strategy.

So is the alternative strategy a bad strategy?

No, but it is not as good as the base strategy if the EP levels are sustained in both cases.

This understanding brings into sharp focus the dual role that EP can and should play in the strategy selection process.

First and foremost, a strategy should result in a sustained level of positive economic performance.

Secondly, and perhaps more importantly, the implementation of a new strategy should result in a sustained level of EP that is greater than the old strategy, as well as being greater than all of the other strategic alternatives considered by KMP.

Intrinsic Value and its Link to EP

A strategy will generate a series of EP outcomes over time as illustrated in Figure 2.2. So the notion of the “time value of money” can be employed to convert an EP time series into a single number – the intrinsic value derived from the development and successful implementation of a given strategy.

In the example in Figure 2.2, the alternative strategy is a better strategy because the present value of its EP stream is higher than the present value of the EP stream under the base strategy.

Most KMP will be familiar with the concept of “intrinsic value” calculated by discounting expected future cash flows. Not all may appreciate that the notion of discounting a cash flow stream, and the notion of discounting an EP stream, represent opposite sides of the same coin.

The intrinsic value of a strategy is represented by the present value of cash flows expected from that strategy.

Equally, intrinsic value can be calculated by adding the opening book value of capital to the present value of the EP outcomes expected to be derived from the same strategy, as illustrated in Figure 2.3. For simplicity we have assumed a perpetuity with zero growth, so cash flow is equal to after-tax profit.

TSR and its Link to Intrinsic Value

KMP will all be familiar with the concept of total shareholder return (TSR) defined as the change in the market value of a company’s shares plus the dividends distributed over a given measurement period, divided by the market value of the shares at the beginning of the measurement period.

Imagine an environment where the market always prices shares in line with the intrinsic value embedded within the strategy being pursued by each and every listed company.

Another way of saying this is that the market is fully informed and perfectly efficient at all points in time.

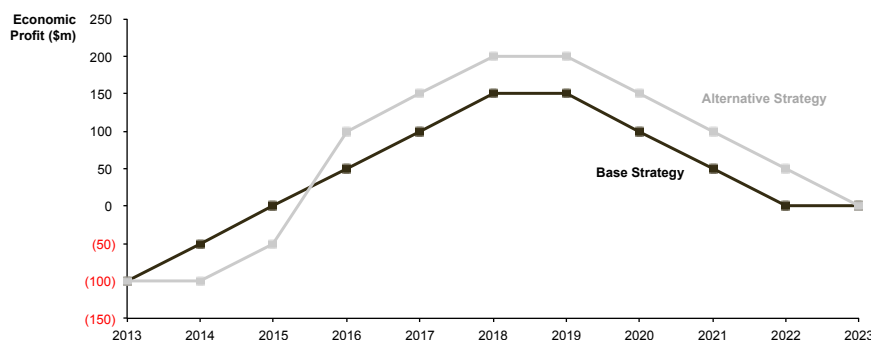


Figure 2.2. Profiles of EP outcomes over time

This might be a fanciful notion, but it is a useful construct through which to explore some concepts that are important in the debate about apex corporate performance metrics.

In such a market, the TSR expected to be delivered by a listed entity will be equal to the change in its intrinsic value over the measurement period, plus the dividends it distributes over that period, divided by its intrinsic value under the strategy being pursued at the beginning of the measurement period.

In the context of a fully informed and perfectly efficient market, this understanding establishes the link between TSR, intrinsic value and the time series of EPs expected to be generated by the strategy being pursued.

TSR Alpha™ – TSR Delivered less TSR Required

The TSR expected to be delivered across all companies in a fully informed

and perfectly efficient market is approximately 12% per annum.

This amount represents the long-run cost of equity capital in the market as a whole. It is made up of a long-run average risk-free rate of approximately 6% plus a long-run average market risk premium of 6%.

Most KMP will be familiar with the idea that shareholders investing in higher risk companies typically require a higher return (higher risk premium), and vice versa. This understanding brings into play the concept of risk-adjusted required rates of return.

Investors in a high-risk company may require a TSR greater than 12% on average in order to adequately reward them for their investment risk.

Investors in an average-risk company may require a TSR equal to 12%. And investors in low-risk companies may require a TSR less than 12%.

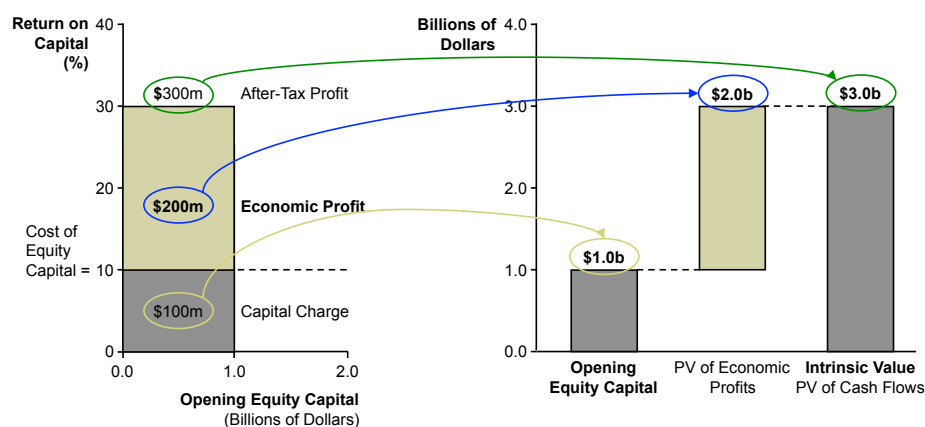


Figure 2.3. Linking cash flow, EP and intrinsic value

This is where TSR Alpha™ comes into the picture.

TSR Alpha™ is the difference between the TSR delivered by a company over a specified measurement period, and the TSR required by investors over that period – having regard to the movement that occurred in the market as a whole and the relative risk profile of the company in question.

In a fully informed and perfectly efficient market, the TSR delivered and the TSR required over a given measurement period will be identical, and TSR Alpha™ should be expected to be zero – so long as the organisation has not implemented a new strategy during the measurement period.

It is worth exploring this a little further.

The TSR expected to be delivered through the effective implementation of a given strategy should be equal to a company's cost of equity capital.

This implies that even at a TSR Alpha™ of zero (representing delivery of expected or required performance), a company's share price should increase naturally at a rate equal to the cost of its equity capital less its dividend yield.

Some KMP and their advisors hold the view that any increase in share price constitutes good performance. *This is simply not true.* To constitute good performance, the increase in share price must be at least equal to the natural increase that occurs when EP expectations are met and TSR Alpha™ is zero.

Drivers of a Positive TSR Alpha™

This discussion gives rise to an important consideration for PRP design.

In a fully informed and perfectly efficient market, a positive TSR Alpha™ can only be generated over time through the ongoing pursuit and successful implementation of higher value strategies.

A higher value strategy is one that will deliver an uplift in EP relative to the

EP profile embedded in the current strategy.

By implication, it must also deliver an increase in intrinsic value over and above that which would have occurred naturally by simply meeting the EP expectations embedded in the current strategy.

Again, it is worth exploring this dynamic a little further.

Imagine that the KMP have developed an alternative strategy that when implemented successfully, will result in an uplift in intrinsic value.

Imagine also that the KMP have convinced the market that they can successfully implement that new and higher value strategy.

A positive TSR Alpha™ will be evident when the market adjusts to reflect the higher performance expectations embedded in the new strategy. Surely this is performance worth rewarding.

As Denis Godfrey points out in his article, a PRP mechanism structured around the pursuit of EP (or EP growth) for STI purposes, and TSR Alpha™ for LTI purposes would encourage and reward such performance.

However, it is important to understand that in the subsequent measurement period, TSR Alpha™ should be expected to return to zero. Why?

Because the market has already priced-in the new and higher value strategy in the preceding measurement period.

Having done so, delivering performance consistent with the expectations embedded in that strategy becomes the “new norm”.

Creating a positive TSR Alpha™ on an ongoing basis is tough. This is because the better you perform, the greater the expectations that you have to exceed.

Delivering a positive TSR Alpha™ every year (or at least on a rolling three-year basis) means continually delivering performance in excess of expectations which are themselves continually increasing.

However, the understanding presented in this article can be used to define the pathway to ongoing superior performance – and to build an organisation capable of continually delivering a positive TSR Alpha™ through the ongoing pursuit and successful implementation of higher value strategies.

Empirical Evidence in Support of TSR Alpha™ and EP

Much of the preceding discussion is based on the premise that the market always prices shares in line with the intrinsic value embedded within the strategy being pursued by each and every organisation.

In reality, this is not always true at all points in time. But it can be expected to be true over the long term.

An empirical analysis linking TSR Alpha™ to growth in EP is complicated by a number of factors, including that:

- The market exhibits volatility around long-run expected averages;
- The risk-free rate changes over time;
- The risk profile of many companies changes over time; and
- Changes in consumer sentiment and the supply and demand for goods and services means that the price achieved in the supply of goods and services is not always in the control of KMP.

Changes in overall market sentiment and changes in company-specific sentiment mean that the TSR observed in the market as a whole over short to medium timeframes can vary significantly from its long-run average of approximately 12%. And for the same reason, the risk premium applied to the market as a whole can vary significantly from its long-run average of approximately 6%.

Nevertheless, and with these empirical complications in mind, KBA has recently completed a comprehensive analysis of the TSR Alpha™ achieved across approximately 500 of the largest ASX-listed companies (by market

capitalisation) over the five years to 31 December 2012.

As part of this analysis, KBA also tested the relationship between TSR Alpha™ and growth in EP, as well as the relationship between TSR Alpha™ and growth in EPS.

A summary of the method employed in the empirical analysis is available from KBA.

The first observation we can make from the empirical analysis is that TSR Alpha™ outcomes are distributed around a mean of zero, as illustrated in Figure 2.4.

This is an important observation since we would expect TSR Alpha™ to converge to 0% over the long term.

But of course the goal is to develop and implement strategies that enable companies to outperform this expectation.

Companies that do outperform expectations over the measurement period will be in the green zone in Figure 2.4, and companies that underperform will be in the red zone.

The second observation is that companies that delivered growth in EP significantly higher than their growth in EPS (whether intentionally or not) also delivered superior TSR and TSR Alpha™ outcomes.

This observation emerged by splitting the companies analysed into three groups:

- An EP-dominant group whose average growth in EP over the five-

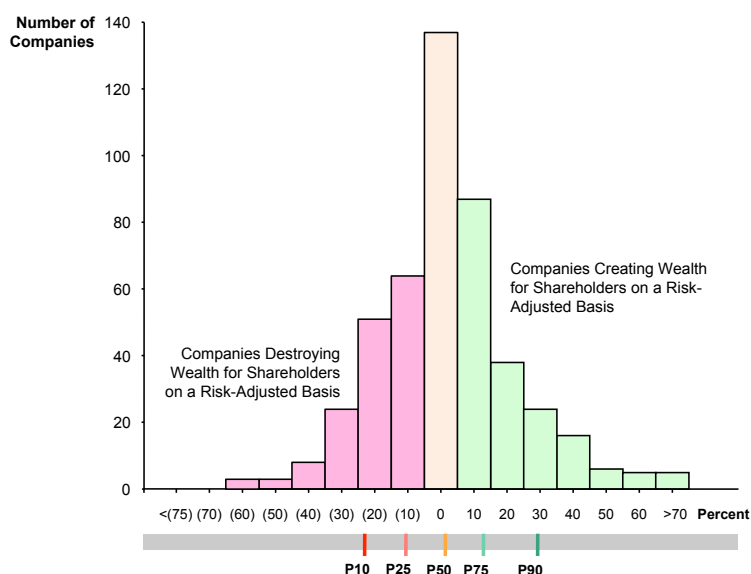


Figure 2.4. Distribution of TSR Alpha™ outcomes for the five years to 31 December 2012

year measurement period was at least 10% higher than their average growth in EPS;

- An EPS-dominant group whose average growth in EPS over the five-year measurement period was at least 10% higher than their average growth in EP; and
- A middle group whose average growth in EP and average growth in EPS fell between these two bounds.

A summary of the research findings for these groups is presented in Figure 2.5 below.

The results are entirely consistent with those from a study of S&P 500 companies reported by Peter Kontes – Executive-in-Residence at the Yale School of Management.

Conclusion

Empirical research demonstrating that EP-dominant companies have considerably higher TSR and TSR Alpha™ outcomes than EPS-dominant ones, combined with a conceptual framework that establishes a clear link between EP growth and TSR Alpha™ outcomes, provides strong evidence in support of the conclusions reached by Denis Godfrey.

A PRP structure based on EP for STI purposes and TSR Alpha™ for LTI purposes will encourage and reward superior economic performance outcomes in any listed entity.

Largest 500 Companies* Categorized by Dominance	Number of Companies	Average Beta	Average Growth in EP	Average Growth in EPS	Five-Year TSR	Five-Year TSR Alpha™
EP-Dominant Group	39	1.21	36.9%	(16.6%)	4.4%	8.2%
Middle Group	155	1.06	1.6%	2.3%	(0.2%)	2.3%
EPS-Dominant Group	252	1.21	(113.3%)	74.5%	(2.3%)	1.5%

* Excluding 54 companies for whom there was not sufficient data to complete the analysis

Figure 2.5. TSR and TSR Alpha™ outcomes of EP-dominant versus EPS-dominant companies

CONTRIBUTING FIRMS



Godfrey Remuneration Group is a specialist remuneration consultancy focused on all aspects of remuneration for key management personnel – covering both Executives and Non-Executive Directors.

Level 9, 56 Berry Street
NORTH SYDNEY NSW 2060
www.godfreyremuneration.com



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Level 25, 123 Pitt Street
SYDNEY NSW 2000
www.johnsonexecutive.com



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Level 3, 650 Chapel Street
SOUTH YARRA VIC 3141
www.kba.com.au



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