

Calibrating bonuses in volatile times

**Remuneration Group meeting
15th March 2011**

Agenda

- The problem: business cycle and performance calibration
Damien Knight, MM&K
- Indexing as a solution to calibrating bonuses
Hermann Stern, Obermatt
- Discussion

The problem: business cycle and performance calibration

Damien Knight – MM&K

All together more rewarding



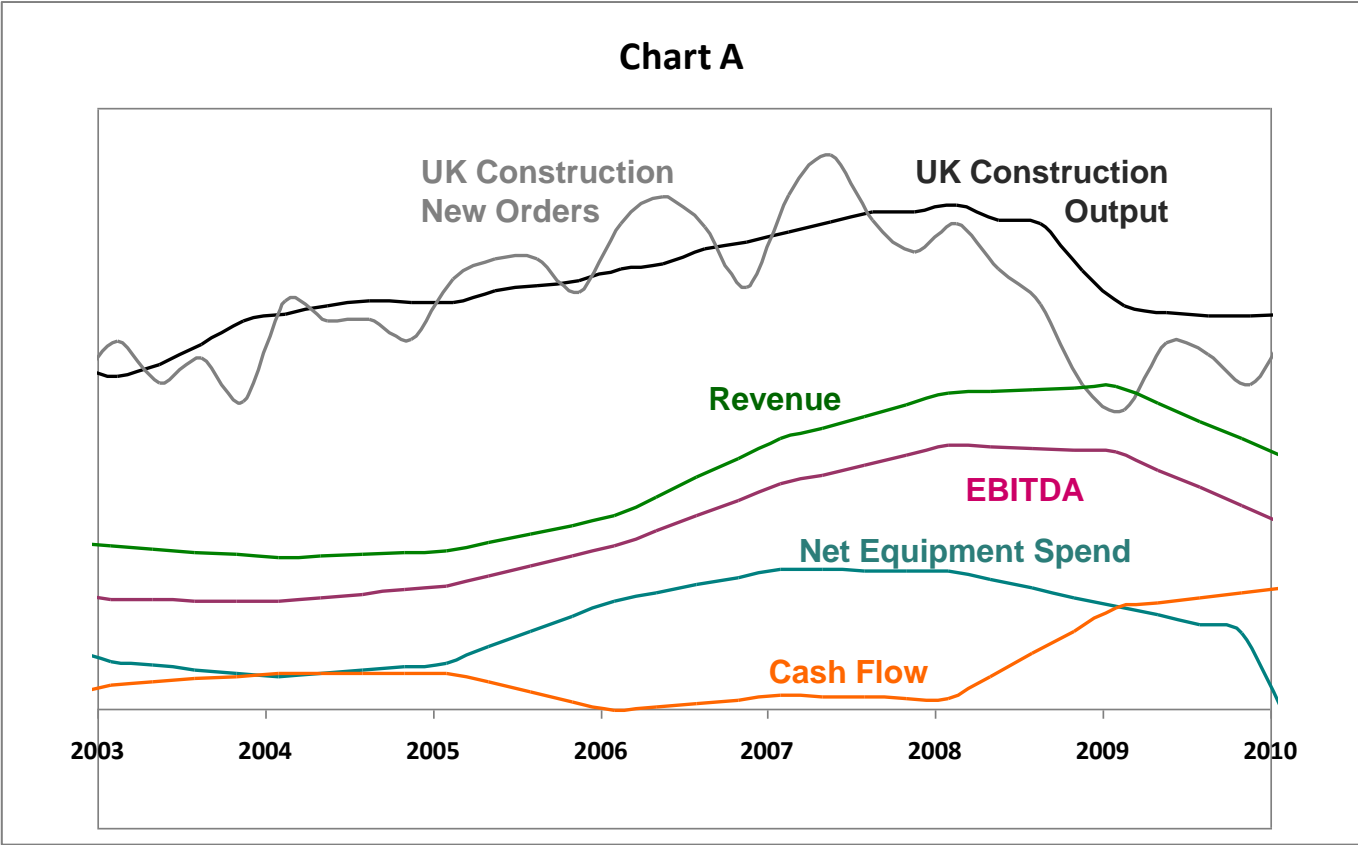
MM&K is an executive remuneration consultancy

- Roots in City of London , founded by Morgan Grenfell
- Leading advisers and data providers to private equity industry
- Integrated share scheme advisors and administrators, with in-house legal, tax and accounting expertise
- Strong focus on financial analysis for scheme design
- Leading non-executive director remuneration and practices survey with data collected from the directors
- Partnership with Manifest for executive director remuneration database in UK listed companies.

Case study: Plant Hire Group

- Construction equipment hire in UK and US c. £1bn revenues
- Highly cyclical company – leverages the business cycle
 - In upturn increase balance sheet gearing – borrowing to fund expansion of network and hire ‘fleet’
 - Anticipates the downturn – extends replacement periods and starts to pay down debt
 - In downturn downsizes to match market, focus on cash
 - At bottom of cycle stays in control (no covenants) and ready to exploit the upturn
- Executives probably stay longer than the shareholders!

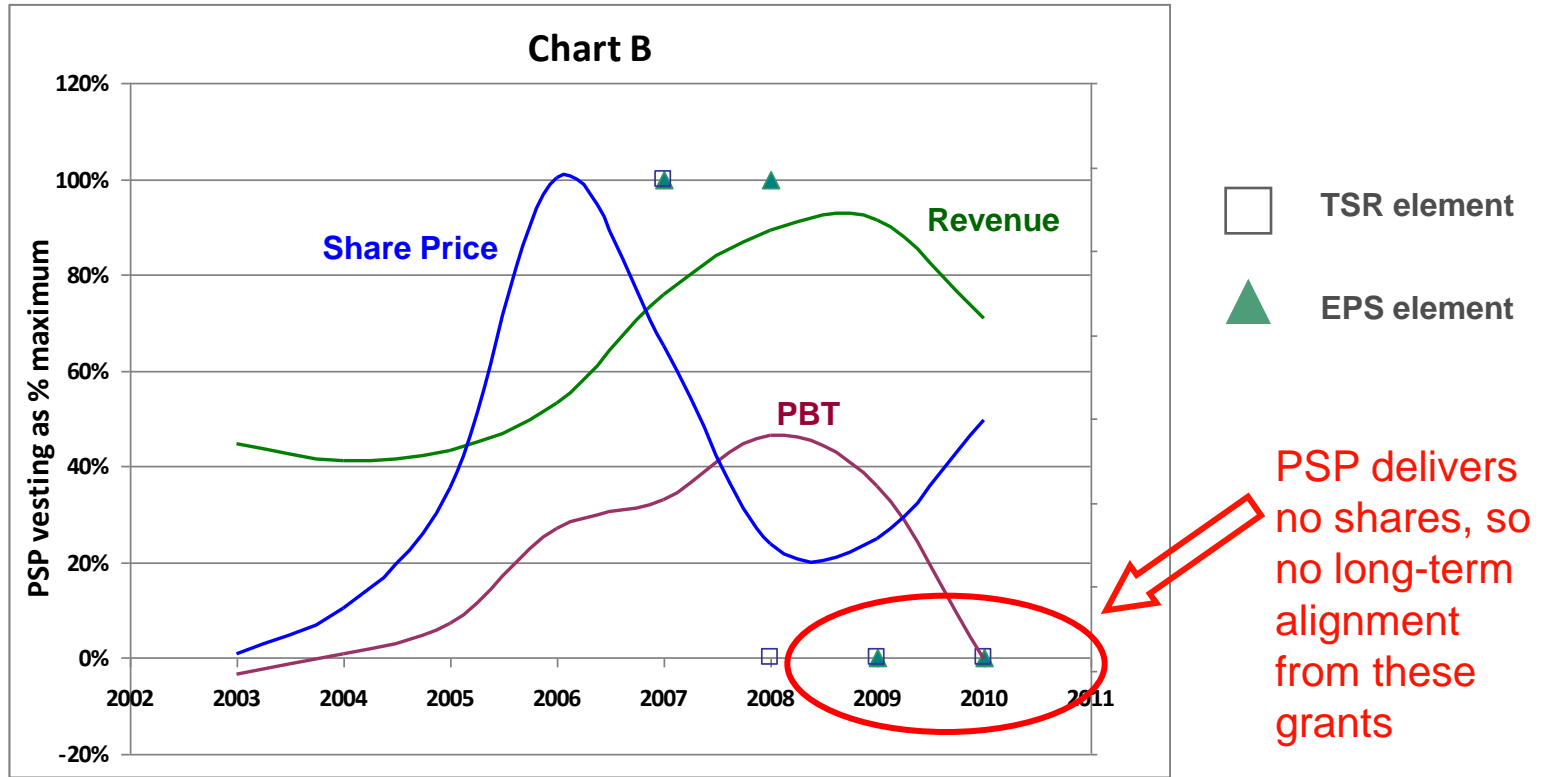
Company seems have managed the cycle well



Right strategy, right levers pulled

Sources: company annual reports;
Office of National Statistics

PSP didn't successfully align the executives

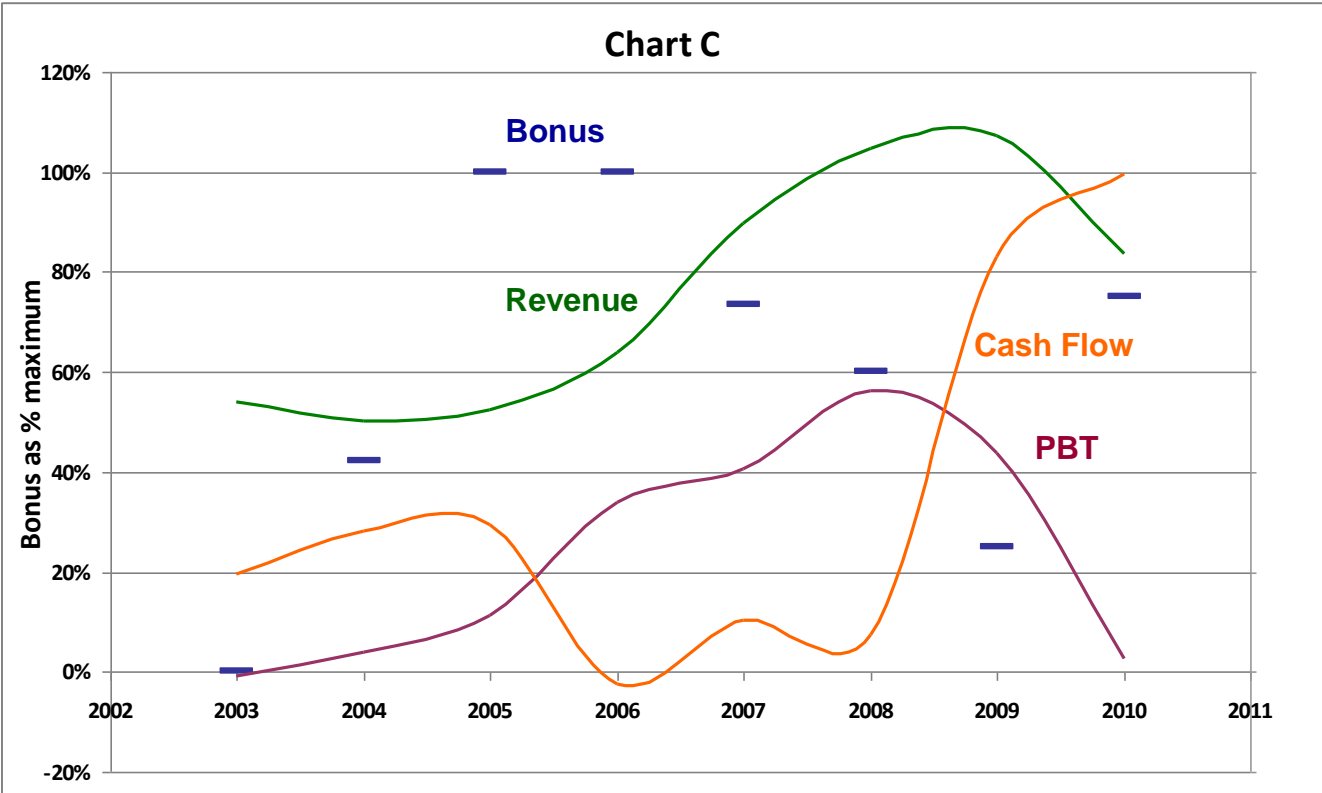


Source: company annual reports

Classic problems with 50% rel. TSR, 50% EPS plan

- FTSE 250 wrong comparator for TSR element
- Growth targets for EPS element don't reflect the cycle

Annual bonus didn't reward performance



Source: company annual reports

Target-setting problem:

- 50% cash flow 50% profitability measures: looks right for cycle management
- But pay outs haven't reflected performance in 'pulling the right levers'

Standard 'FTSE-100 solution' to the problem

Change the TSR index or measure?

- Few if any direct competitors
- Only 16% of non-executive directors favour relative TSR/EPS combination and fewer than 50% like relative TSR at all*.

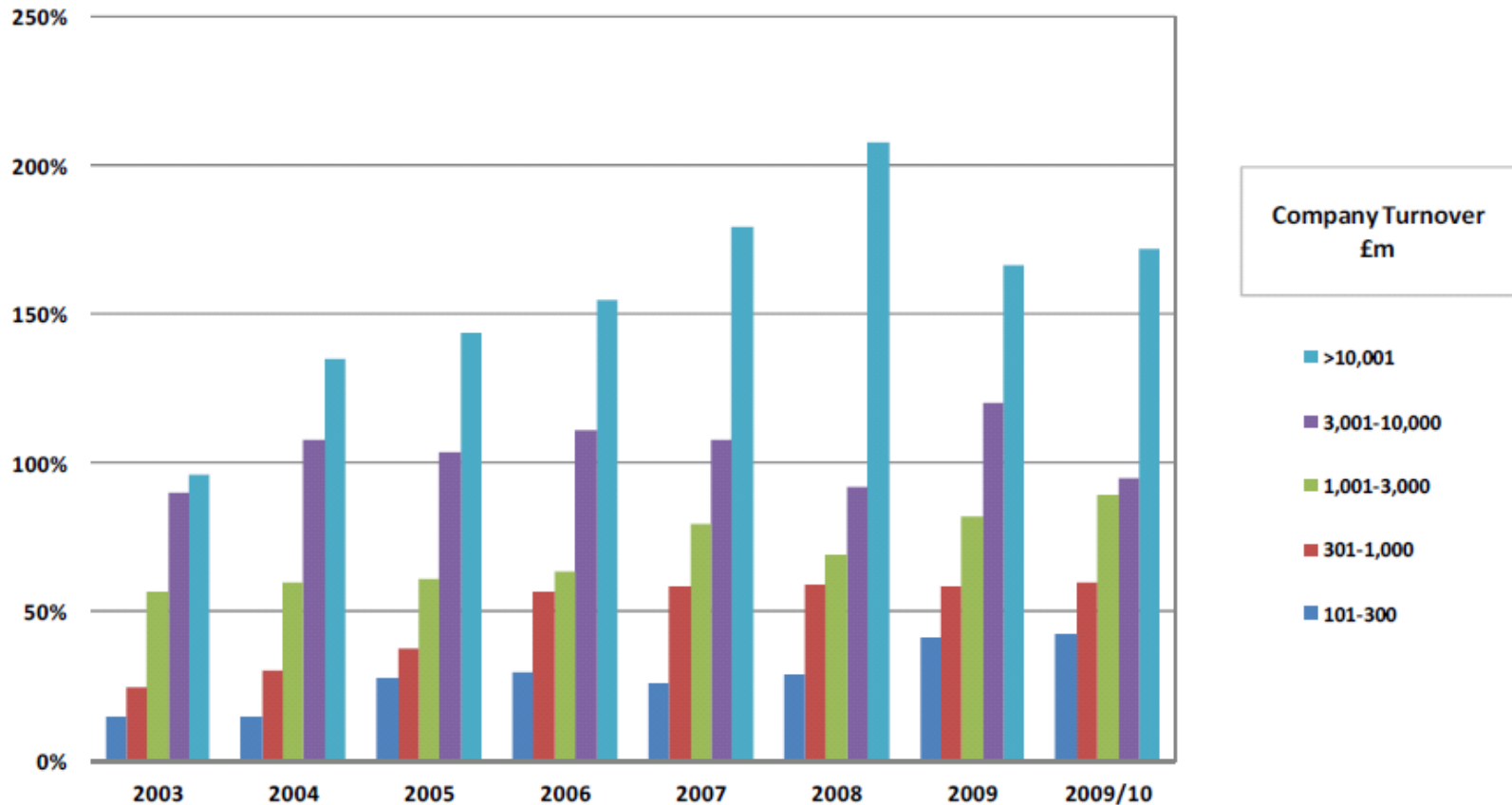
Transfer value from LTIP into a deferred bonus plan?

- Calibrate targets one year ahead rather than three
- Targets set/measured by company rather than shareholders
- Alignment better because executive puts skin in the game and share vesting
- In most recent year 50% of FTSE 100 companies require mandatory deferral of 1/3-1/2 the bonus for 3 years! Clear evidence of the shift...

* Source: MM&K non-executive directors' survey 2011

Corresponding reduction in LTIP grants

Median Expected Value of Options & LTIPS (% Salary)



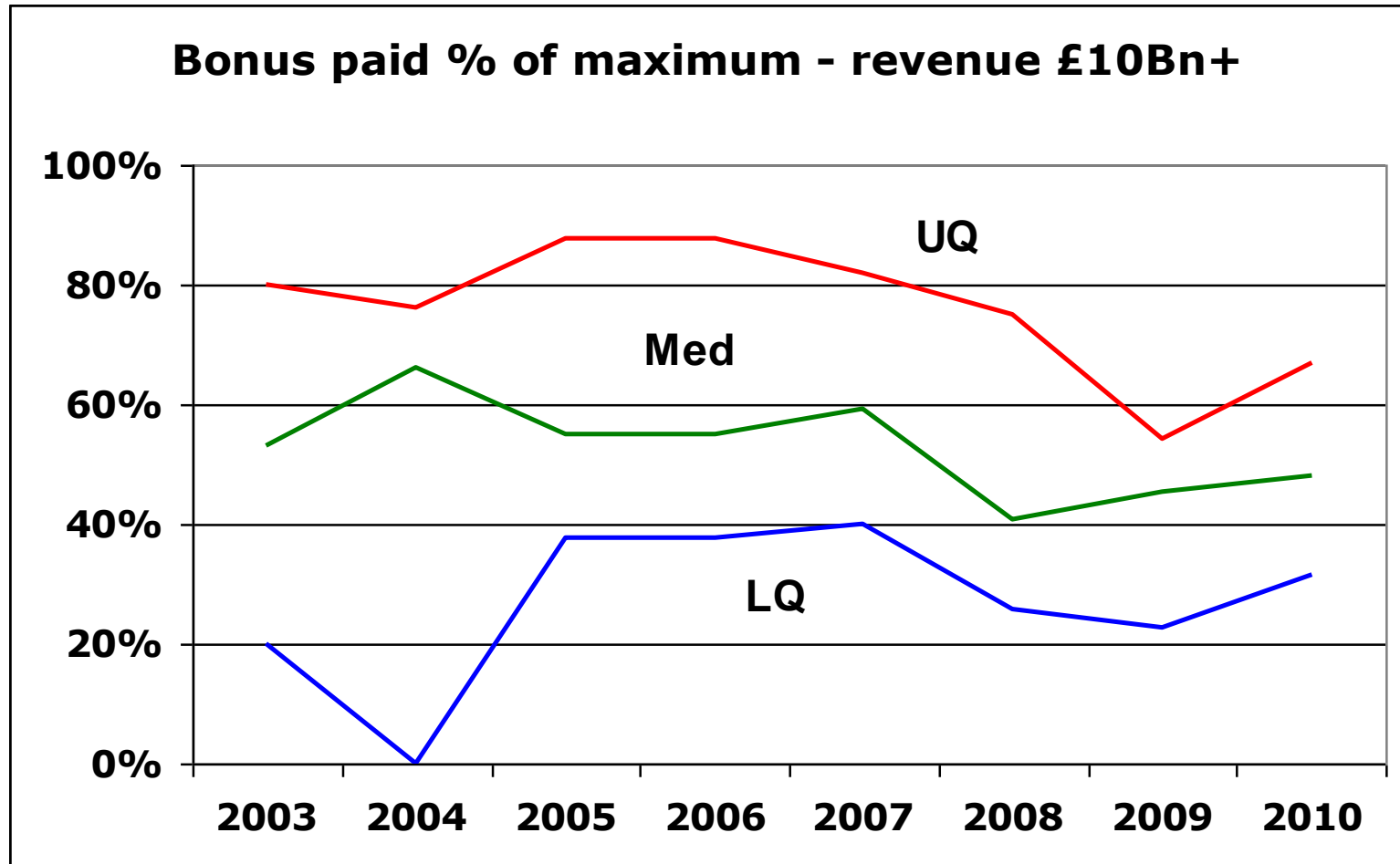
Source: Manifest/MM&K database from company annual reports 2010

‘FTSE-100 solution’ (cont’d)

Use a balanced scorecard for annual bonus?

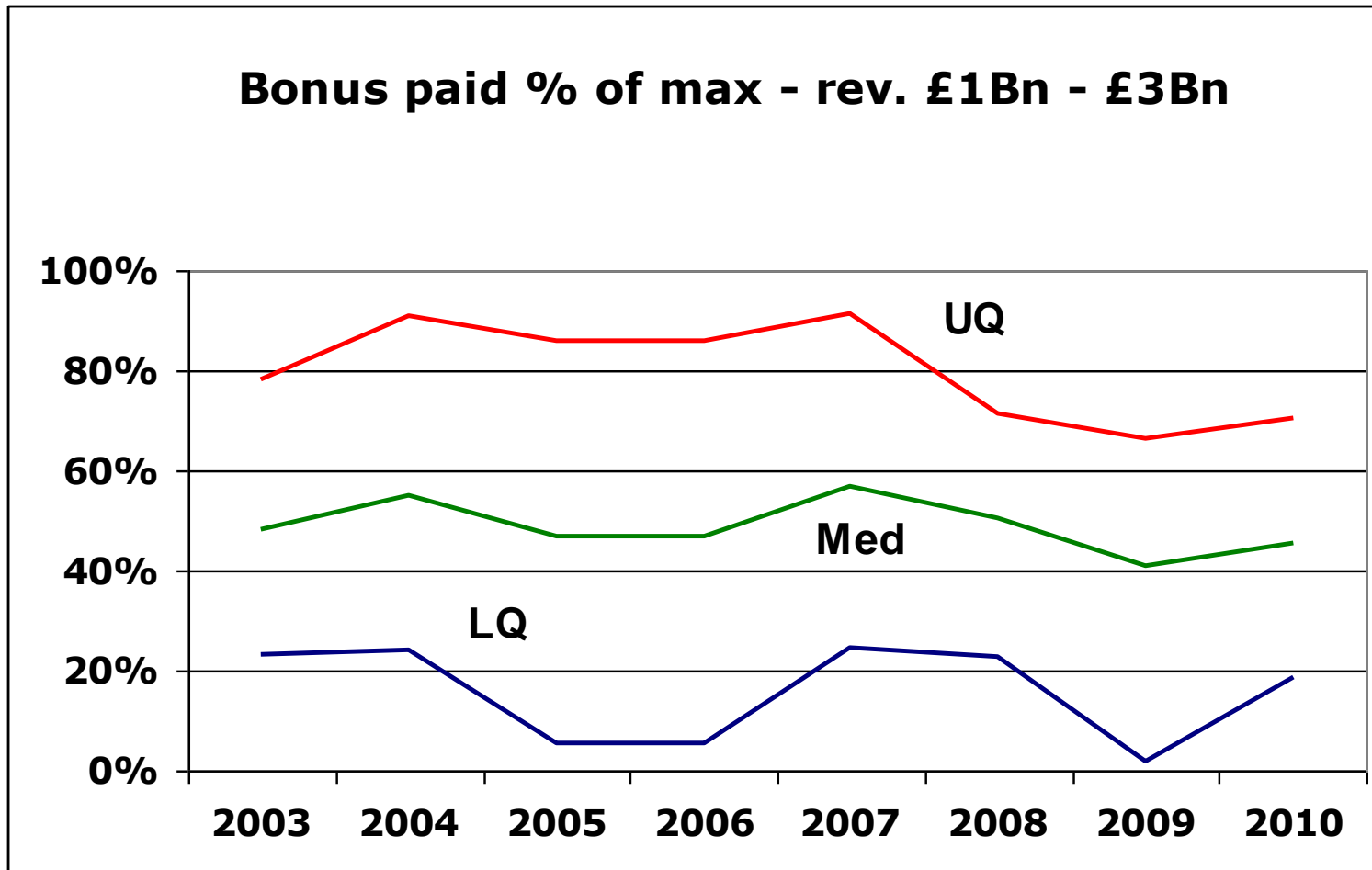
- Company has excellent set of KPIs
- 64% of Top 30 companies now use a scorecard of four or more measures
- Only 24% of FTSE-250 companies have four or more measures
- Balanced scorecard favoured by regulators for risk alignment
- Tends to reduce the volatility of bonus outcomes
- Good for predictable reward delivery
- Remuneration committees and shareholders have concerns about degree of stretch.

Balanced scorecards reduce bonus volatility?



Source: Manifest/MM&K database

Not so evident for midcap companies

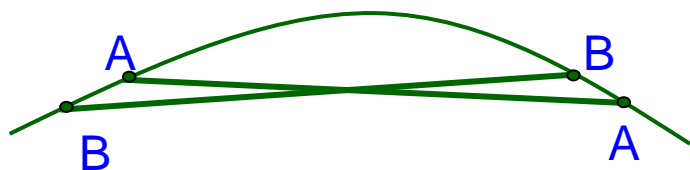


Source: Manifest/MM&K database

Would these changes solve company's problem?

Problem still with PSP

- With EPS growth and relative TSR vesting measures too much hangs on timing of start and finish of measurement period. Annual grants do not iron out this problem well
- Other possibilities include:



A-A results in zero vesting
B-B results in max vesting

- Using a cumulative measure rather than an improvement measure (produces similar outcome for A-A and B-B)
- Restricted stock (no performance vesting measures)
- Measuring relative to a *cycle peer group* (peer group larger than direct competitors).

But would this solve problem? (cont'd)

Problem still with annual bonus

- Need to agree/negotiate targets a year ahead in uncertain market conditions
- Balanced scorecard does not remove the calibration problem
- Other possibilities include:
 - measuring relative to a *cycle peer group*
- Hermann Stern will describe the approach Obermatt takes.

For questions about this document, contact Damien Knight or Cliff Weight:

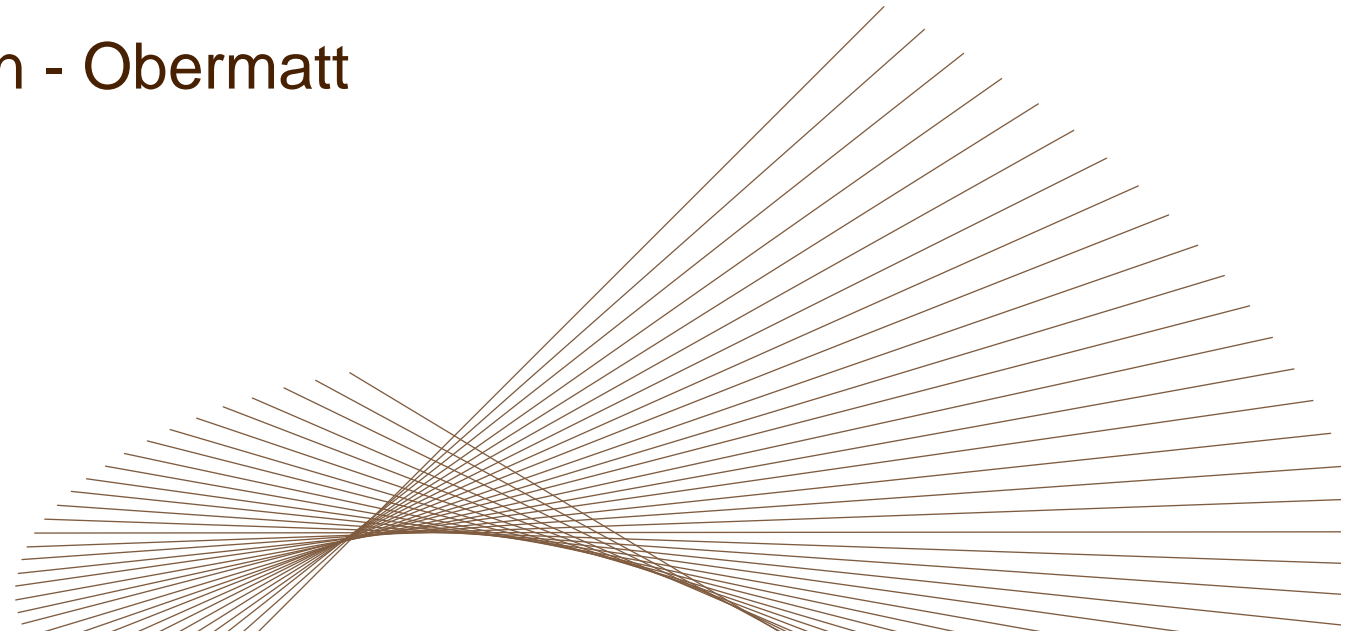
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Indexing as a solution to calibrating bonuses

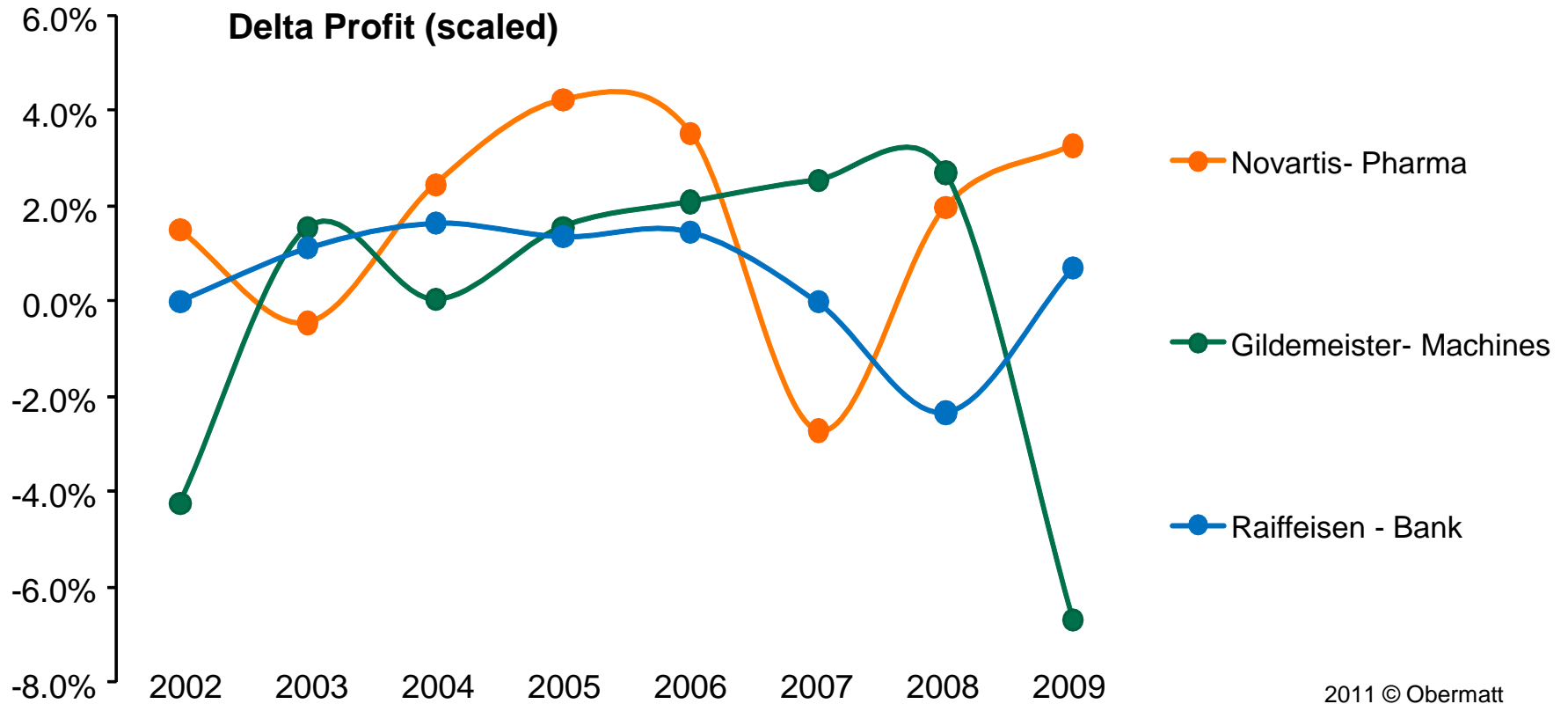
Hermann Stern - Obermatt



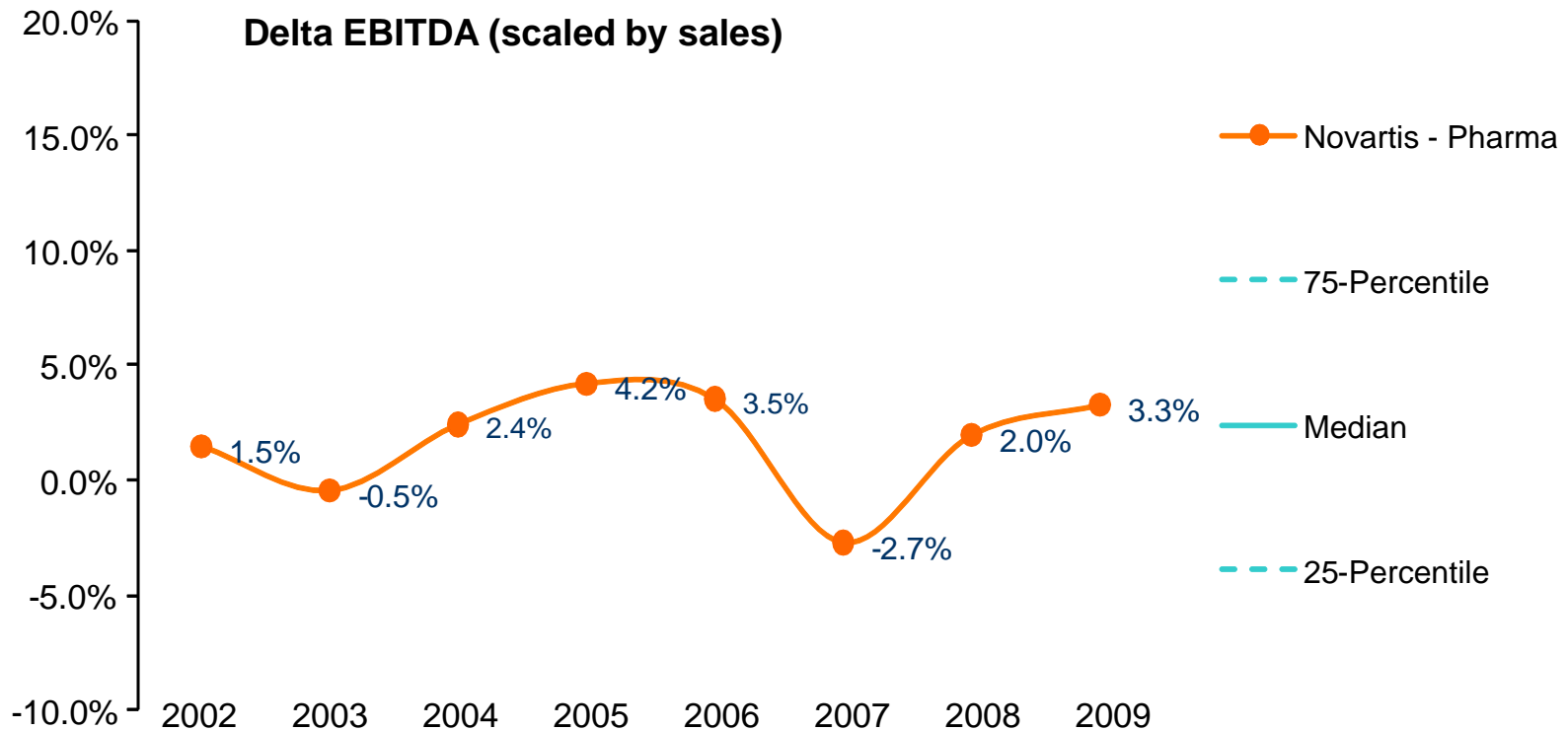
Obermatt is a financial research company

- Obermatt is an international financial research company focused on indexing corporate operating performance to measure, rank and compare key financial ratios standardized and independent of external factors
- We help corporations, private equity firms and investors add value for their shareholders and to their portfolios through products that make innovative use of indexed performance measurement for:
 - Bonus plans that are fairer because they measure operating performance only - independent of economic cycles
 - Strategy planning that uncovers misleading signals and is undiluted by external factors
 - Investment valuations that identify value contributions by value driver, business or division
- The company is employee-owned and has representations in Zurich (Switzerland), London (United Kingdom), Stockholm (Sweden) and Los Angeles (USA).

Which was the best company in 2009?

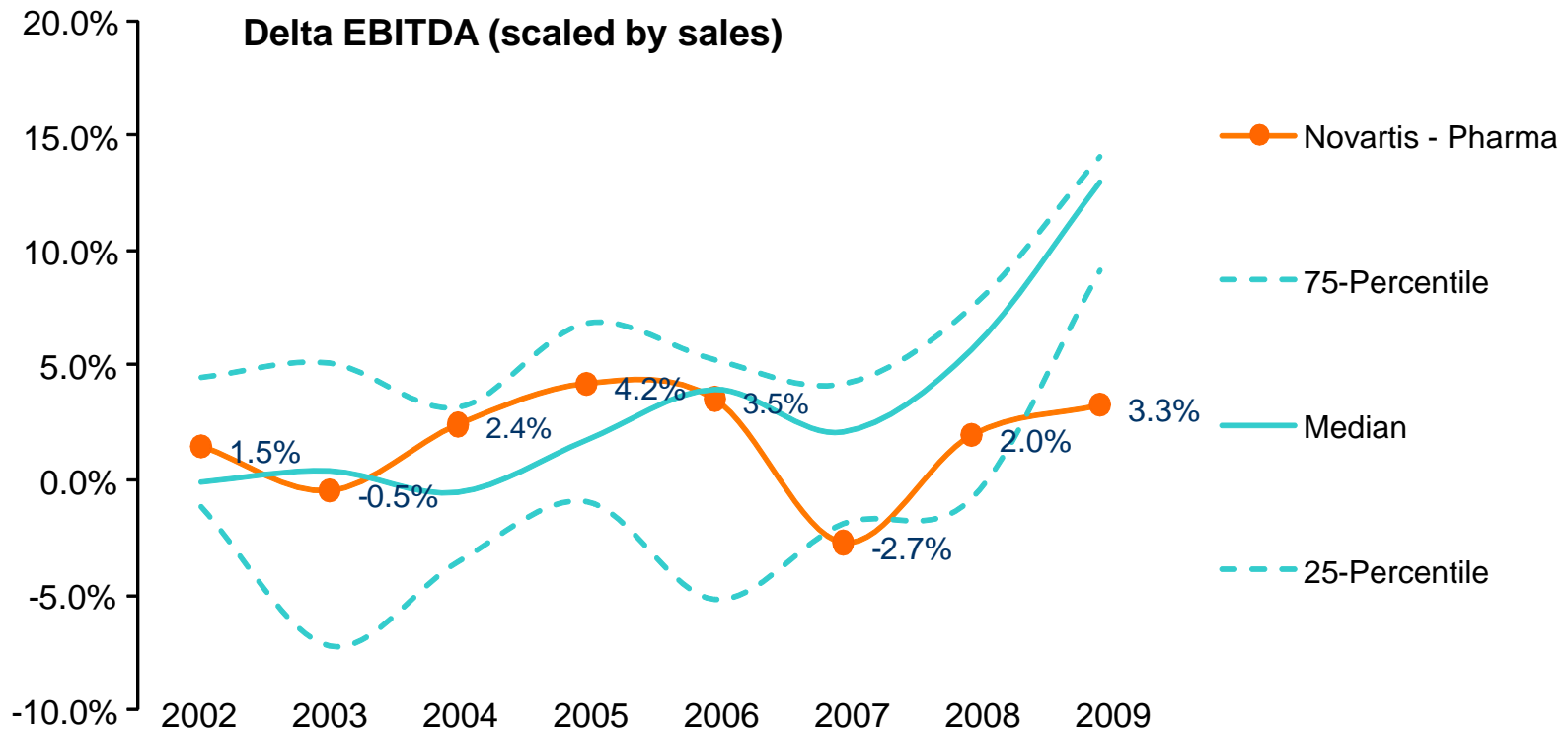


Novartis absolute operating performance



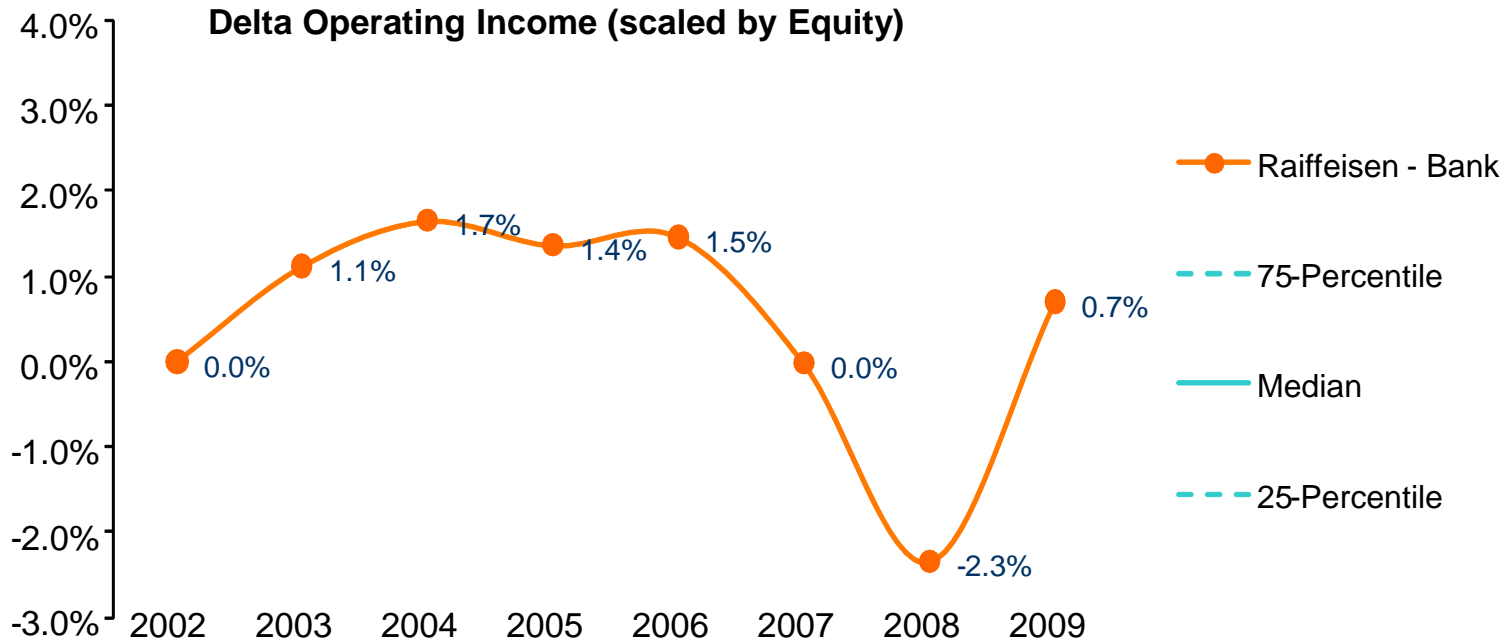
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Indexing performance turns the picture around



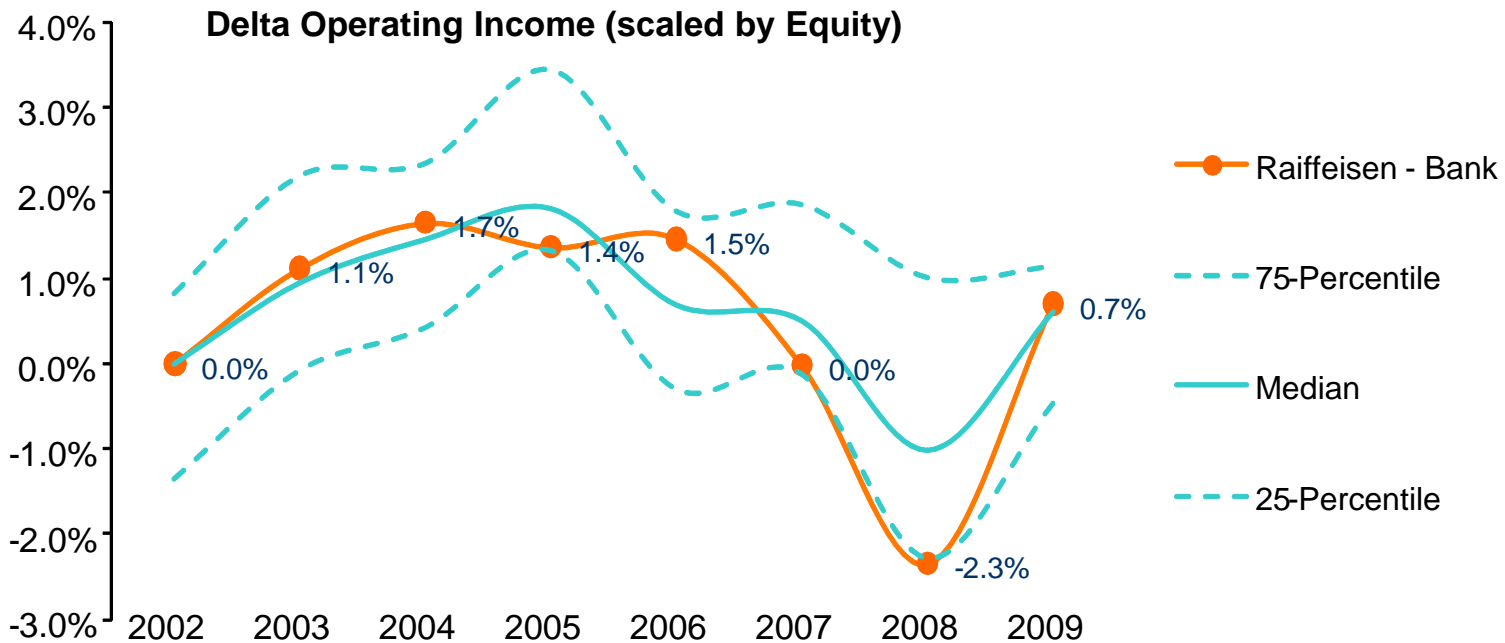
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Raiffeisen Bank absolute operating performance



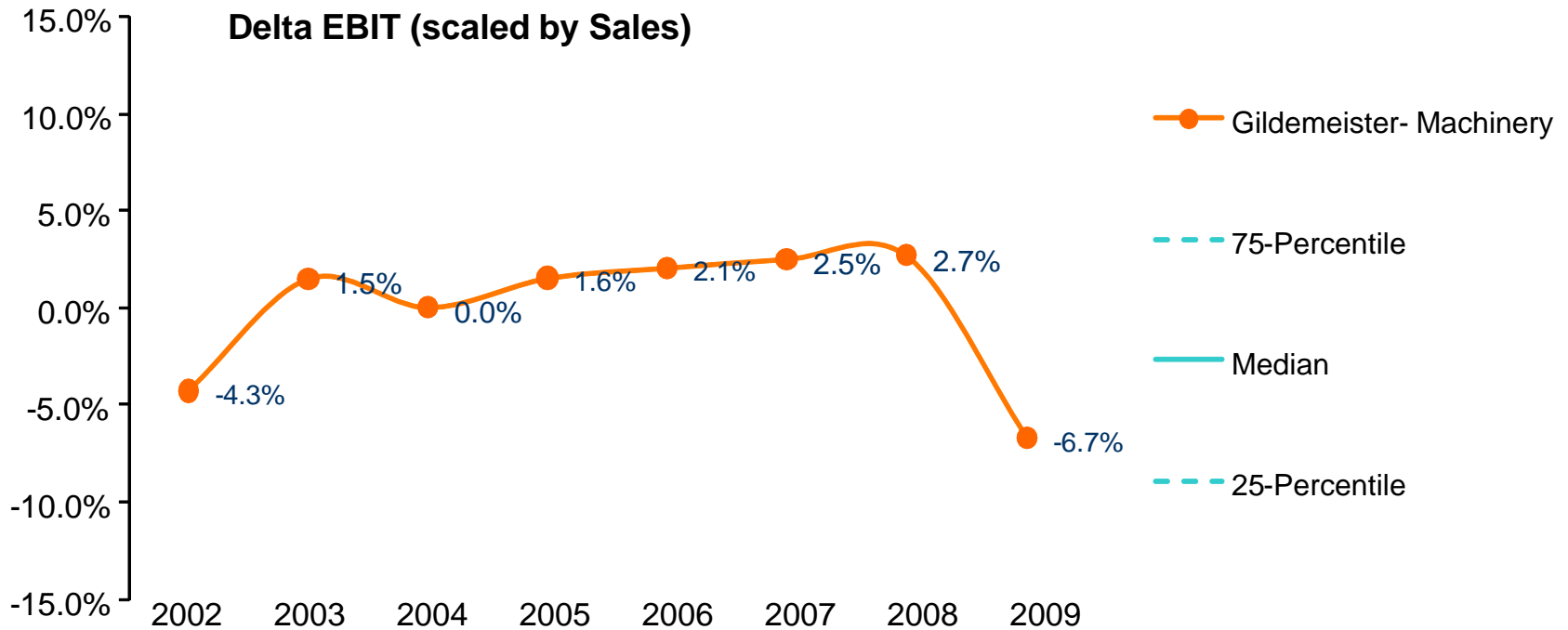
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Indexing neutralizes the cycle



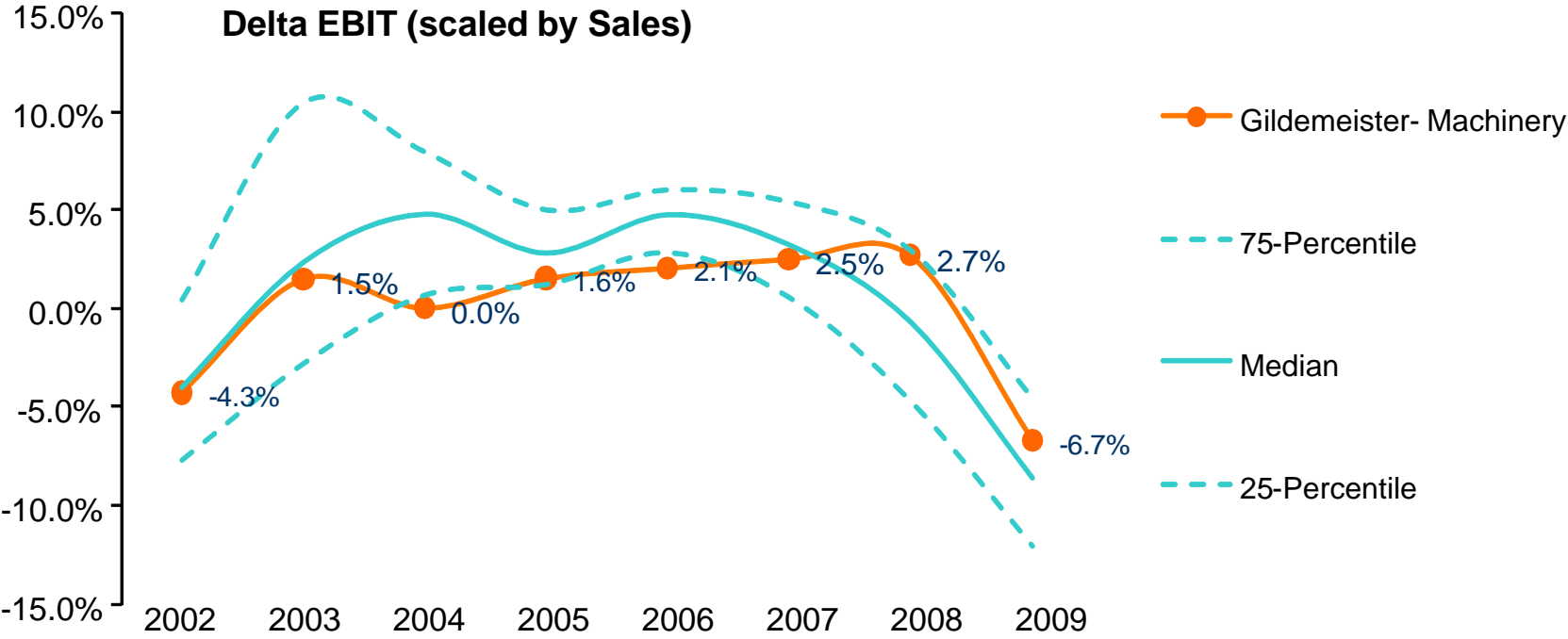
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Gildemeister Machinery operating performance



2011 © Obermatt

Indexing reveals true operating performance



2011 © Obermatt

Summary

- How to index bonus plans
 - Operating ranks are most reliable for managing volatility
 - Add cycle peers to the peer group to increase reliability
 - Metric: Any frequently reported metric can be indexed
- HR and Remco benefits summary
 - Calibration: No need for target setting
 - LTI performance vesting clauses: Much more reliable
 - No confidential data used, completely transparent, trusted
- Business benefits
 - Reduces or even ends bonus debates
 - Fair for executive, fair for shareholders.

A close-up photograph of a tennis player, likely Roger Federer, kissing a large, ornate golden trophy. The player is wearing a white jacket with gold stripes on the sleeves and a silver watch. The background is blurred, showing spectators in a stadium setting.

Your reward?

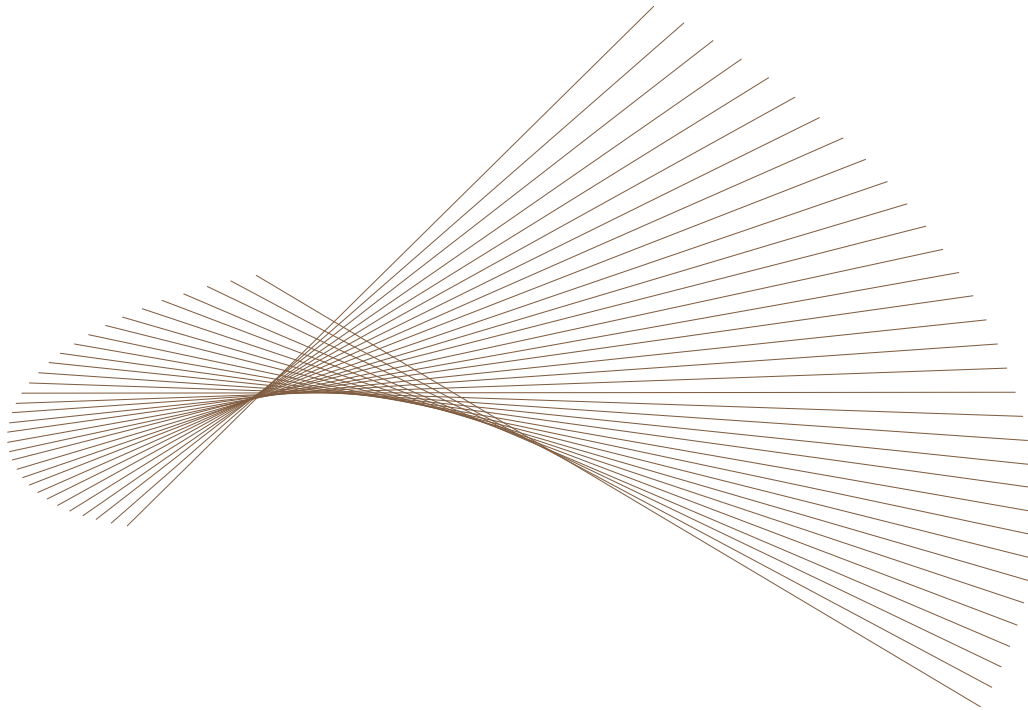
- Ends the
- Bonus debates

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Appendix

Additional information

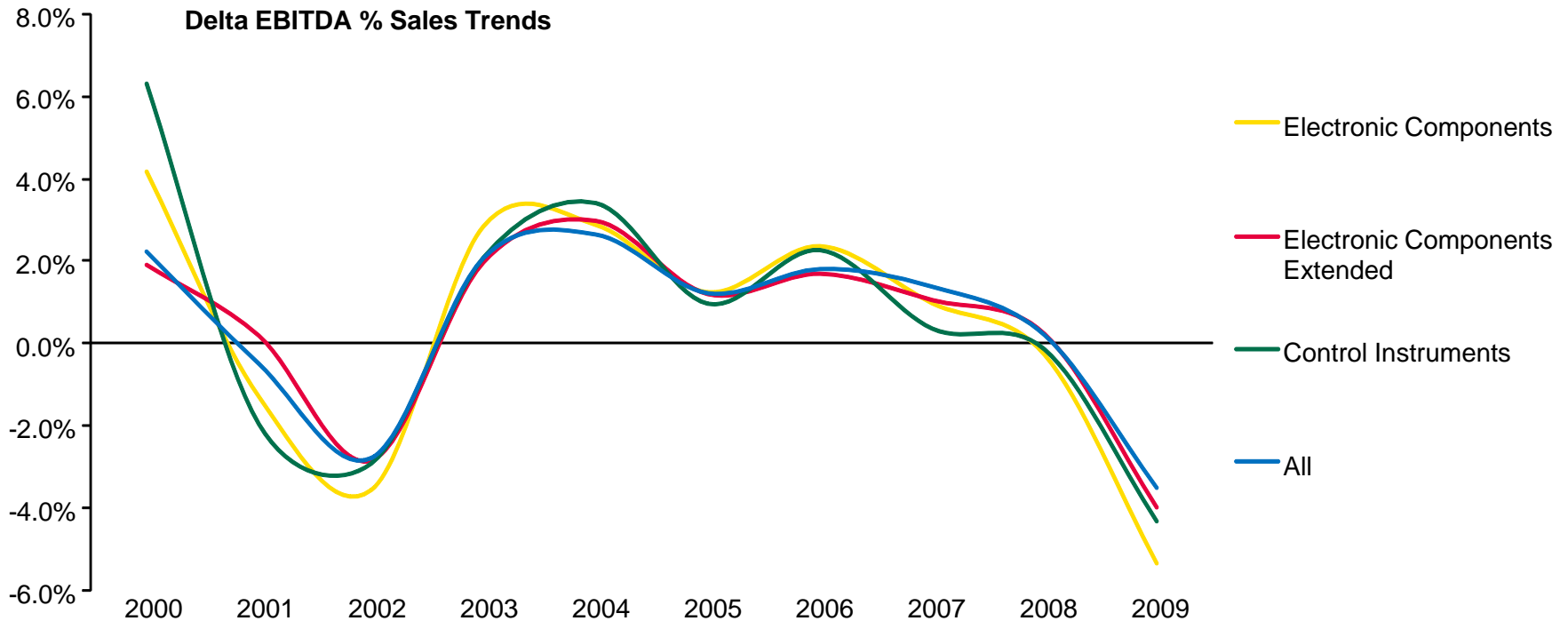
Obermatt index and shareholders

- Manifest, the voting agency, like the Obermatt approach as a way of raising questions about bonus levels prior to the AGM, and other voting agencies have expressed interest. They published a study in December 2010 that indicated that companies who were apparently 'overpaying' bonus were more likely to have high levels of dissent on their remuneration report.
- They studied 33 companies in the FTSE-100 companies who provided information on bonus targets. The measure used for this comparison was the delta EBITDA normalised by sales revenue as ranked against a *cycle peer universe*. The universes selected were mostly international
- The analysis of these 33 companies showed 26 paying their chief executive a bonus above a level that this particular measure would suggest was appropriate. (NB MM&K estimated the average 'excess' was 55% of salary or about £1m)
- Obermatt and MM&K think shareholders and voting agencies will become increasingly interested in cycle peer indexing as a means of checking the reality of company performance as applied to bonuses.

An asset management company view of a cyclical business

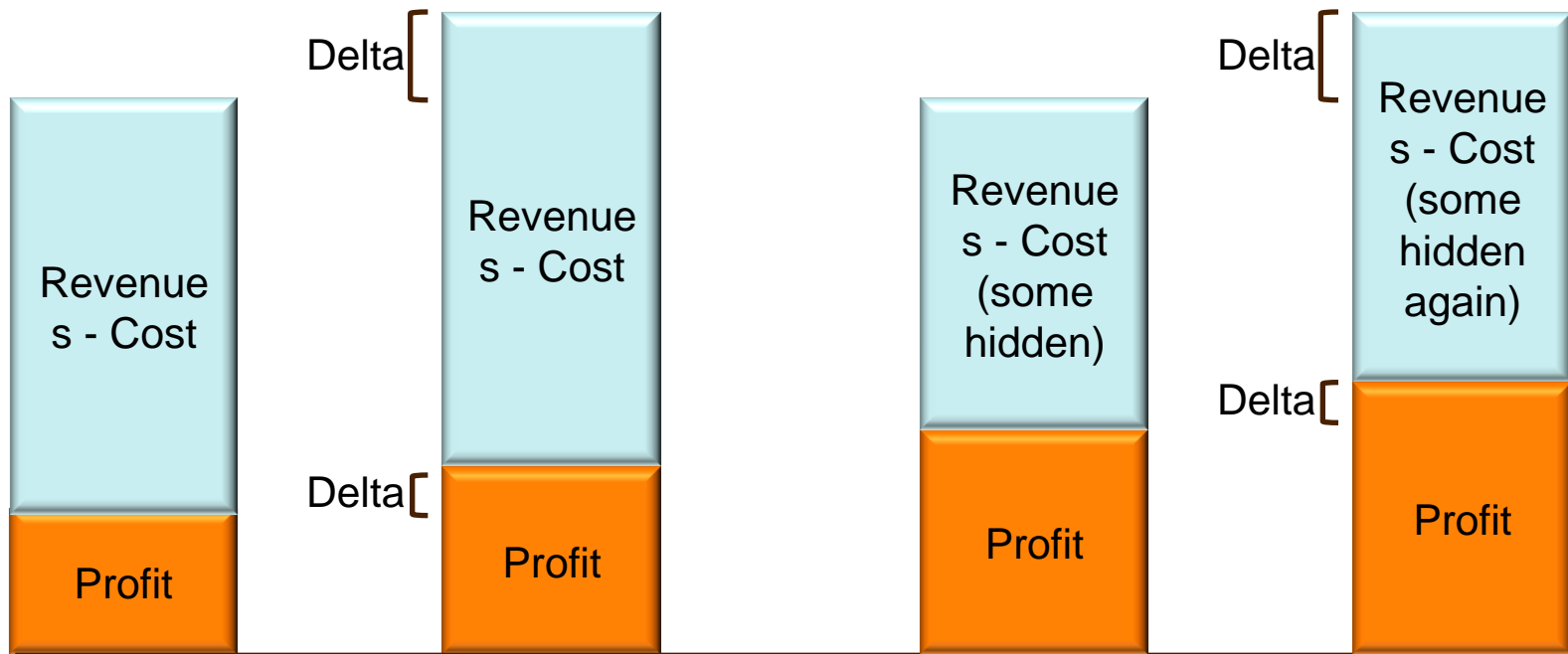
- We will probably sell in down-turn years. However, it is a legitimate strategy for a company to exploit the cycle by managing through it
- Even if profits and/or share prices are falling shareholders will accept some performance pay if the executives are performing well
- For us performing well means well relative to peers in the same cycle. Our fund managers like relative TSR but relative performance could be on financial measures
- But you cannot pay a lot if shareholders are suffering (institutional shareholders have their clients too)
- We find that standard PSP share plans work fine in the up-turn years, but in the down-turn years companies want to change their plan every year. We would be very open to any plan that lasted through the economic cycle
- The answer for a cyclical business should be more deferral for longer periods than 3 years, (although executives are understandable resistant to very long deferral periods).

- Misleading: "We cannot be compared to others"
- Correct: You have more valid peer data than you think.



- Why? Cycle-correlating peers are peers to be considered too.

- Misleading: "Others hide their cost in their books"
- Correct: Different accounting decisions have little impact.



- Why? Delta growth values are marginally affected by profit levels.

The Bonus Index is regarded as best-practice by

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“We at tesa use the Obermatt Bonus Index, because it provides the entire organization with a strategic and long term focus on the competition.”

Jan Christoph Teetz
CFO, tesa SE

“The Obermatt Bonus Index provides us a dependable benchmark for a cycle-independent executive compensation plan.”

René Güntert
CFO, Toyota Textile
Machinery Europe AG

“We use the Obermatt Bonus Index, because it enables fair compensation that is in the long term interest of our shareholders.”

Jörg Zumtobel
Chairman, Zumtobel