

2010 to 2011 now 2012 – Which Companies are “Really” Performing Well?

By Gary Finch and Amy Yang

The last several months have seen us attending AGM (Annual General Meeting) after AGM. Our primary purpose was to see how companies disclosed corporate performance and how their company related to this in terms of executive pay. We were interested in the financial metrics used, the acknowledgement of time-syncing of data, reference to both absolute and comparative performance, and linkage of pay to performance. This became especially interesting in the current light of recent Dodd-Frank disclosures in the USA recently signed in by President Barack Obama on July 21st, 2010. This document also includes recent *Say-on-Pay* issues and requirements when they arise.

In order to research corporate performance, we reviewed the largest companies in each geographic and market sector to compare the results across these markets. As we started accessing the local Canadian market we became slightly concerned with what we found.

After discussions with attendees and graduates at both The Directors College and Institute of Corporate Directors we were asked to share some of the results we found. This *Edutorial* is a summary.

Given your response to our document, we will produce a quarterly document on issues we see (or have been raised), and give the Board of Directors and Executives some insight on performance-based compensation and performance-based pay at risk.

Compensation Components for the Board of Directors

In the broadest sense, the Board of Directors has three primary concerns in pay delivery. These three components are all inter-related:



While there are rules, guidelines and protocols to help drive compensation design, it is known that the

components of strategy, risk and CEO remuneration/tenure /succession /retention and motivation, are key issues in all companies.

Understanding the role of the Board in your company on corporate strategy, corporate risk, and impact on risk-based compensation delivery to the CEO is critical. Boards must understand this role and be able to link CEO pay to direction, decisions, and support by the board.

The board must understand where the company is now, where it is strategically heading, and how it is going to get there. The pay delivery system must address these issues. In this *Edutorial* we have looked at two different groups: (i) TSX 60 and (ii) Large Canadian Companies.

Historical CEO Pay and Performance: TSX 60 (2007 – 2010)

The CEO is partially responsible for strategy development and implementation. The CEO is also responsible for corporate performance.

Across the TSX 60, the average compensation components (base + bonus (STIP) + mid-term + long-term incentives (LTIP)) have been calculated and shown below. (Interesting to note that component percentages are +/- 4% each year by year since 2007. We find this surprising given the stock market volatility and reduction in share price over this period in time.)

Within this CEO pay framework, the incentive plans deliver over 80% of CEO average pay. Within this timeframe, the STIP has delivered approximately 20% while the LTIP delivers approximately 60%.

As the Board is responsible for this approach to pay they must feel comfortable in delivering this level of pay. Continually the Board members must consider the following:

- 1) Is the approach still reasonable given there may be a possible change in strategy?
- 2) Are incentives appropriate and aligned with the direction of the company?
- 3) Do incentive metrics foster higher corporate risk?
- 4) Are metric targets in the incentive plans appropriate for performance expected?
- 5) Do targets consider both absolute and comparative performance?
- 6) Will payout make sense to major stakeholders?

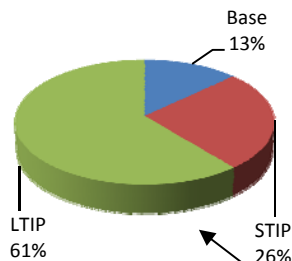
One would think these answers are easy to determine - but are they?

To test our thoughts, we plotted a number of TSX companies to determine component value from fiscal year end (FYE) 2007 to 2010. Despite the financial crisis, we found the results and pay mix quite surprising.

AVERAGE PAY BY PAY COMPONENT 2007 to 2010

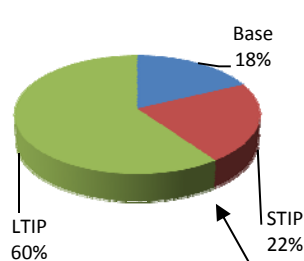
TSX 60 2007/2008

Total Pay: \$7,064,808



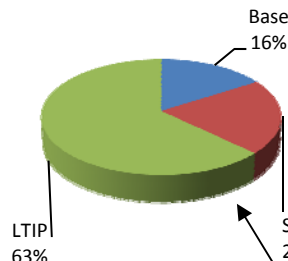
TSX 60 2008/2009

Total Pay: \$5,418,245



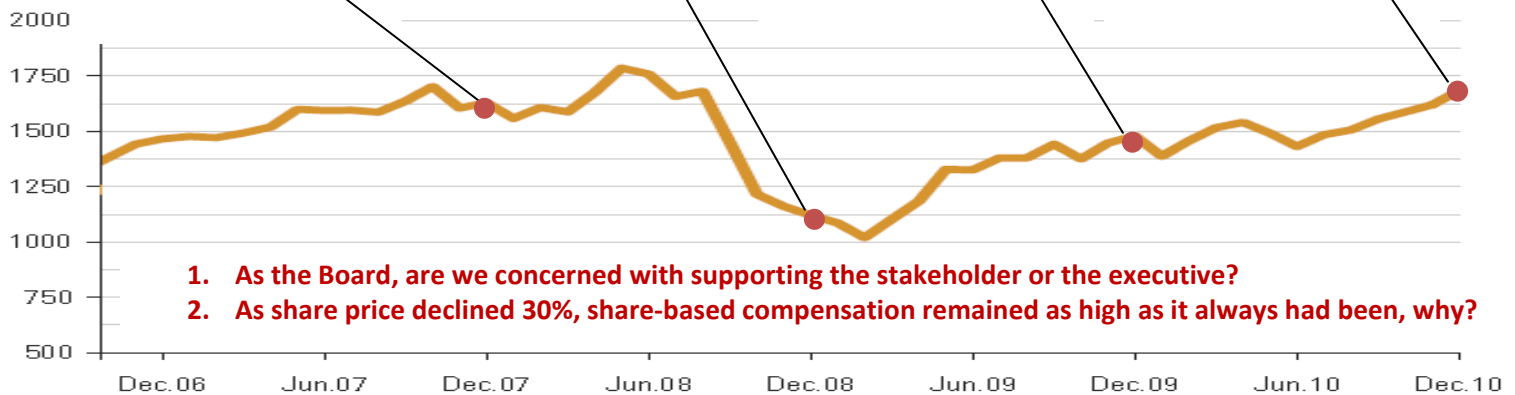
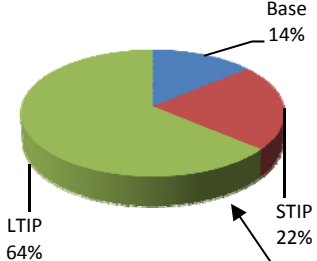
TSX 60 2009/2010

Total Pay: \$6,232,996



TSX 60 2010/2011

Total Pay: \$7,906,451



1. As the Board, are we concerned with supporting the stakeholder or the executive?
2. As share price declined 30%, share-based compensation remained as high as it always had been, why?

Absolute Performance of Large Public Corporations in Canada

The chart above produces a couple of significant issues to answer. Let's assume our Board's decision has been fair. The next stage is comparing our performance to key targets.

In the following charts we have chosen the largest Canadian companies by market capitalization. We then assessed CEO tenure to ensure that the CEO has been with the company for at least 3-years. This is not the ultimate length of tenure but it gives a certain degree of time for the CEO to impact the company. It was interesting to note that 62% of CEO's have been with the company 3-years.

As noted above, CEO's get a majority of pay remunerated based on total shareholder return (TSR – is capital appreciation plus dividend yield). Instead of a 1-year look-back on TSR we have compiled a 3-year review on TSR. This timeframe better represents the direction of a mutual fund, pension or non-speculative investor; it also complies with CRA

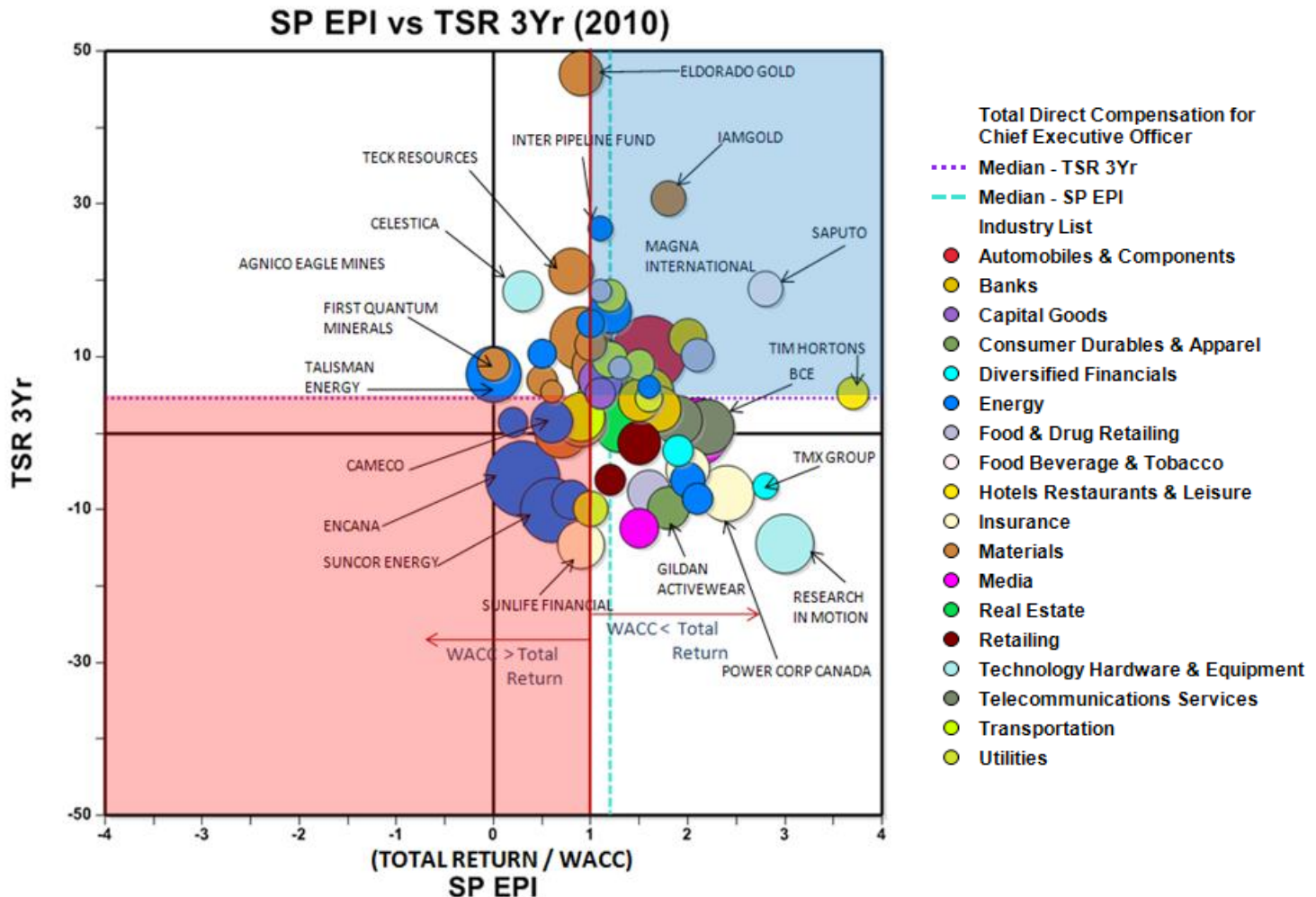
(Canada Revenue Agency) guidelines on mid-term plans,

In plotting these charts we wanted to look at two financial metrics.

(i). **TSR** (share price appreciation plus dividend yield rate) has been compared with the Canadian risk-free bond rate (10-year Canadian flat bond rate is 3.4%). To miss this rate-of-return over 3 years would be quite questionable.

(ii) **EPI** (economic performance index – it is the rate of return on capital over the weighted average cost of capital). If a company does not deliver returns to exceed its cost of capital it will diminish its working capital.

In this following chart we have determined 3-year TSR percentage at fiscal year end. This 3-year TSR was then compared with other companies along with the external benchmark of 3.24% (the Canadian flat bond rate). To make the chart more interesting, we also included EPI (economic performance index) and compared this return to the cost of capital within the company. Those companies that could not beat the cost of capital are noted as WACC > total return. Those that exceed the cost of capital are noted as WACC < total return. If the returns were less than "1" then the company is destroying corporate capital. This should be perceived as a negative by stakeholders.



Note: Those companies in the **blue section** had 3-year return above the risk free rate (3.24%) and delivered more than a “one” on EPI. (Ensuring returns beat the WACC – EPI calculated by *StockPointer*). Those in the **red section** had 3-year return below the fixed bond rate and were destroying capital based on EPI – not good unless it is part of strategy

Who is your company really “interested” in? (Executive, Board or Stakeholders)

Are you fully aware of 1-year and 3-year performance, (approximately 10% of companies could not beat 1-year or 3-year fixed bond rate)

In terms of pay, is your Board weighing strategy and risk?

In review of the CD&A (proxy circular) disclosures, and discussion with both Board and executives, there are a number of public companies where review of the Board pay delivery is really a review of the executive HR pay practice disclosure. This is not a Board pay assessment as it **rarely includes** any form of corporate strategy, corporate risk, corporate appetite and/or CEO tenure/succession/retention and motivation. This assessment is typically an executive pay assessment performed by an executive compensation firm. The format of the design has

usually come from the CEO and CFO process and policies. The Board may be interested in the results, but the design is not their ownership.

In reading through CD&A's and assessing corporate financials there appeared to be a number of design issues the Board needs to consider. In brief these are clarified below.

1. Design of Performance-based Incentive Plan Targets.

All incentive plans designs must have developed targets that the company can use inside the incentive plan. Exceeding a “realistic target” should allow the company to grow and offer more incentive payout. Not achieving the target has the opposite impact!

In some reviews it appeared that targets were almost guaranteed payout while performance was questionably low (unless approach was hooked to strategy). When extra research was engaged it was found the plan would almost inevitably payout!

When setting incentive-based targets it is important that the Board of Directors know what these targets are set, how they are set, and how the incentive plan pays out around these targets. The targets should be approved by the Board (as is the Plan), before the incentive plan is implemented.

We have been asked to cover this in our next issue of *Board Edutorial*.

2. Timeframe for Performance Review

As most board members are aware, the majority of pay is set through the long-term incentive. The use by “proxy companies” of using a 1-year performance assessment inside a mid-term or long-term incentive plan raises some serious questions on the board-determined pay approach, and board-determined pay-for-performance and pay-at-risk approach?

What significance of data can be determined over 1-year on a 3-year, 5-year or 10-year plan?

In connection with the time-frame of performance is the value of the plan to recipients. Recipients should understand that this plan should not be a “give away”, however; it should deliver value if the recipients are able to build the value of the company to its stakeholder. (The reverse is also true!). This relies on the fact that the incentive plan actually works.

If the assessment of the value ultimately relies on share-price, then there should be some directly attributable internal measure to equate for improving shareholder value. While we would not remove all equity based incentives, there must be a better way to deliver this value. The plan should be driven off corporate performance-based value drivers. The plan should pay well if the corporation exceeds performance. The plan should not pay if corporate performance is questionable.

3. Absolute versus Comparative Assessment

Should the Board compare its CEO and executive pay and performance to a proposed peer group, or should they be compared with fixed external metrics (such as Canadian fixed bond rate or ratio to WACC)? Should the Board compare the company performance with direct competitors?

Is internal corporate data the appropriate target or should the Board using comparative pay-and-performance comparison?

With issues such as “say-on-pay” in place should the Board assess the pay-for-performance with direct competitors to substantiate performance-based-pay and Board litigation on decision making? Does absolute and comparative assessment make sound sense to the Board?

Conclusion

As governance and disclosure guidelines increase in number, all pay decisions will need to be justified to shareholders by the Board. The degree and role of performance-based compensation decisions is becoming increasingly important.

When we started this article, the objective was to compare a number of major markets and review what was happening at the Board level on executive pay-for-performance. After initial review in Canada with two simple broad-based corporate performance measures (3-year TSR versus the 10-year bond rate, and Return above the WACC); 45% of the TSX 60 were not beating the 10-year Canadian fixed bond rate (3.24%) and just over 28% were destroying working capital. While it is possible that strategy decisions may impact the assessment of these results, these numbers were astounding – especially as these numbers were for the TSX 60.

The use of recent disclosure guidelines such as “say-on-pay” validation was presumed positive. Unfortunately, in the USA as of June 2011, 39 companies have issues against them. As Boards are involved in further assessment of executive pay it is starting to become way more than simply reviewing the current HR plan. For cognizant Boards, the issue of appropriate pay delivery needs to be tightly tied to corporate strategy, corporate risk, and CEO performance-based pay.

As Boards start focusing on 2011 performance-based pay and look at 2012, please review your performance and advise your thoughts. We have already been asked to review a couple of companies; these will be reviewed in the Fall Edutorial.



This Editorial was prepared and assisted by two Canadian Board Members:

Mr. Bryan Held ICD.D. Bryan is a current Board Member and sits on the ICD Ontario Chapter.

Mr. Victor Wells ICD.D. Victor works on Boards across North America and has a strong focus on Board Governance.

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Below are 2010 FYE Financial Metrics

Summary Intrinsic Table

Company	Year	TSR 3Yr (%)	SP EPI	Industry Group
AGNICO EAGLE MINES LTD	2010	12.407	0.9	Materials
AGRIUM INC	2010	8.7	1.1	Materials
ATCO LTD	2010	4.613	1.6	Utilities
BANK OF MONTREAL	2010	4.321	1.5	Banks
BANK OF NOVA SCOTIA	2010	5.258	1.6	Banks
BCE INC	2010	0.831	2.2	Telecommunications Services
BOMBARDIER INC	2010	6.932	1.1	Capital Goods
BROOKFIELD ASSET MGT	2010	0.967	1.3	Real Estate
CAMECO CORP	2010	1.519	0.6	Energy
CANADIAN OIL SANDS LTD	2010	-6.122	2	Energy
CP RAILWAY LTD	2010	2.109	0.9	Transportation
CANADIAN TIRE CORP	2010	-1.262	1.5	Retailing
CANADIAN UTILITIES	2010	8.964	1.5	Utilities
CELESTICA INC	2010	18.563	0.3	Technology Hardware & Equipment
CI FINANCIAL CORP	2010	-2.286	1.9	Diversified Financials
ELDORADO GOLD CORP	2010	47.078	0.9	Materials
EMERA INC	2010	18.005	1.2	Utilities
ENBRIDGE INC	2010	15.885	1.2	Energy
ENCANA CORP	2010	-5.954	0.3	Energy
ENERPLUS CORP	2010	1.439	0.2	Energy
FIRST QUANTUM LTD	2010	9.036	0	Materials
FORTIS INC	2010	9.643	1.2	Utilities
GILDAN ACTIVEWEAR INC	2010	-9.766	1.8	Consumer Durables & Apparel
IAMGOLD CORP	2010	30.724	1.8	Materials
IMPERIAL OIL LTD	2010	-8.567	2.1	Energy
INTER PIPELINE FUND	2010	26.794	1.1	Energy
KINROSS GOLD CORP	2010	1.59	0.9	Materials
LOBLAW COMPANIES LTD	2010	8.554	1.3	Food & Drug Retailing
MAGNA INTERNATIONAL INC	2010	10.428	1.6	Automobiles & Components
METHANEX CORP	2010	6.888	0.5	Materials
METRO INC	2010	10.223	2.1	Food & Drug Retailing

Company	Year	TSR 3Yr (%)	SP EPI	Industry Group
NATIONAL BANK CANADA	2010	12.485	2	Banks
PAN AMERICAN SILVER CORP	2010	5.461	0.6	Materials
PASON SYSTEMS INC	2010	6.065	1.6	Energy
PENN WEST PETROLEUM LTD	2010	10.409	0.5	Energy
POTASH CORP SASK INC	2010	2.864	1.5	Materials
POWER CORP CANADA	2010	-7.883	2.4	Insurance
POWER FINANCIAL CORP	2010	-4.661	2	Insurance
PRECISION DRILLING CORP	2010	-8.708	0.8	Energy
RESEARCH IN MOTION LTD	2010	-14.471	3	Technology Hardware & Equipment
RONA INC	2010	-6.092	1.2	Retailing
ROYAL BANK OF CANADA	2010	3.193	1.7	Banks
SAPUTO INC	2010	18.892	2.8	Food Beverage & Tobacco
SHAW COMMUNICATIONS INC	2010	0.08	2.1	Media
SHOPPERS DRUG MART CORP	2010	-7.671	1.6	Food & Drug Retailing
SUN LIFE FINANCIAL INC	2010	-14.604	0.9	Insurance
SUNCOR ENERGY INC	2010	-10.053	0.6	Energy
TALISMAN ENERGY INC	2010	7.718	0	Energy
TECK RESOURCES LTD	2010	21.227	0.8	Materials
TELUS CORP	2010	1.677	1.9	Telecommunications Services
THOMSON-REUTERS CORP	2010	0.839	2.1	Media
TIM HORTONS INC	2010	5.24	3.7	Hotels Restaurants & Leisure
TMX GROUP INC	2010	-6.92	2.8	Diversified Financials
TOROMONT INDUSTRIES LTD	2010	5.232	1.1	Capital Goods
TORONTO DOMINION BANK	2010	5.061	1.2	Banks
TRANSALTA CORP	2010	-9.884	1	Utilities
VERESEN INC	2010	14.356	1	Energy
WEST FRASER TIMBER CO	2010	11.584	1	Materials
WESTON (GEORGE) LTD	2010	18.632	1.1	Food & Drug Retailing
YAMANA GOLD INC	2010	0.415	0.7	Materials
YELLOW MEDIA INC	2010	-12.425	1.5	Media

Note: Financial data at FYE. Validated with 'Bloomberg and Standard & Poors'. EPI data validated through StockPointer.

Note: 3-Year TSR is for end of fiscal year end (FYE) 2010. EPI data is for April 2011.

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