

## From Lottery to Well-Structured Incentive

### A better approach to long term incentive plan design

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*Most LTI Plans reward executives for their company's capital market performance based on relative TSR outcomes. But many consider relative TSR to be a flawed metric, the use of which produces lottery-like outcomes. In this month's KBA Insights, we confirm the lottery-like nature of relative TSR. Plus we outline a practical, two-step solution through which Boards can transform their company's LTI Plan from a lottery into a well-structured incentive that encourages behaviours consistent with the long-term best interests of all stakeholders.*

#### Some Background

Last month, we highlighted how the power inadvertently ceded to proxy advisors through the introduction of the *Two Strikes Rule*, had helped drive the adoption of an approach to LTI Plan design that was inconsistent with the long-term best interests of listed companies and their many stakeholders. We also showed that the LTI design preferred by certain proxy advisors, and which is now in use in most ASX-100 companies, can encourage very different behaviours to those intended.

#### The Problem

Most LTIs employed in ASX and LSE-listed companies have performance rights that vest on a combination of *relative TSR* and *EPS growth* (or another accounting metric). They are generally structured with the intention that in aggregate, half the available rights vest at 'target' performance.

A series of *Monte Carlo Simulations* we have run demonstrates that this 'expected outcome' of 50 percent vesting at target performance tends not to manifest – particularly for that component of the 'incentive' that vests based on *relative TSR* outcomes. It is possible that those who came up with this LTI Plan design did not appreciate that it would produce a bimodal stochastic outcome, over which executives have little control. Nevertheless, what eventuates is more like a lottery than a structured incentive. It stands little if any chance of systematically encouraging desired behaviours.

There are many quite serious and deleterious consequences that flow from this. One of particular concern is that executives can be tempted to focus largely if not entirely on that part of their LTI Plan that vests on *EPS growth* (or another accounting metric), and then pursue the *stretch target* for that metric in order to secure their overall 'expected LTI' outcome. Compared with *relative TSR*, accounting metrics are more deterministic in nature. They can be influenced directly by executives. Nevertheless, there is a significant risk that in going down this path, executives will be tempted to engage in behaviours that have come to be known collectively as *short-termism*. This can destroy shareholder wealth by eroding the value of the company's franchise with its customers and at the same time, harm other non-shareholder stakeholders.

The immediate challenge is to find a way for executives to systematically 'beat the odds' in terms of *capital market performance* assessed using *relative TSR* (thereby obviating its lottery-like nature), yet do this in ways that benefit the company, its shareholders and its other stakeholders.

### Three Questions ... and a Two-Step Solution

The problem outlined on Page 1 gives rise to three important questions for Boards.

1. Is our company's LTI Plan operating as an incentive or as a lottery?
2. Given certain proxy advisors' preference for the current approach, what can we do to prevent a flawed LTI Plan design from encouraging behaviours like *short-termism* that do not serve the long-term best interest of either our shareholders or our other stakeholders?
3. What changes to our LTI Plan should we be making when the opportunity arises?

**The answer to Question 1** can be determined relatively easily using a *Monte Carlo Simulation*.

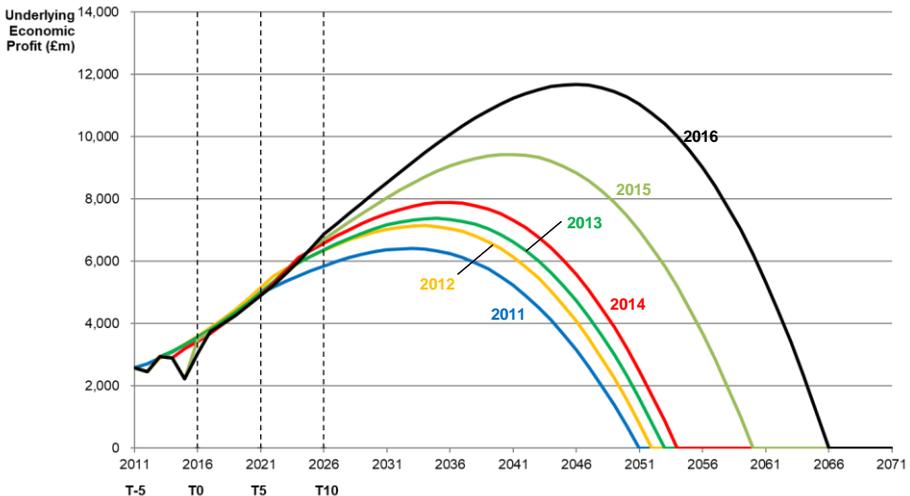
**The answer to Question 2** lies in being able to systematically deliver a positive *TSR Alpha* outcome. **Succeeding in this represents the first step in a two-step solution.**

We can use *Monte Carlo Simulation* to show that delivering a positive *TSR Alpha* outcome over a typical three-year measurement period will enable executives to 'beat the odds' in terms of capital market performance as measured with *relative TSR*. And setting out to achieve this on an ongoing basis will benefit all stakeholders. But before proceeding we need to revisit the concept of *TSR Alpha*.

*TSR Alpha* is an important capital market performance measure that is covered in detail in [Customer Value, Shareholder Wealth, Community Wellbeing](#). It is the economic return on market value over the short-to-medium-term, or the short-to-medium-term analogue of *TSR-Ke* (the long run economic return on market value where *Ke* is the cost of equity capital). **From a Board's perspective, the key attribute of *TSR Alpha* is that it arises largely as a result of actions that lead to changes in the intrinsic value of a business and is the only component of *TSR* that executives can and do influence.**

Over any measurement period, the market expects a company to deliver a *TSR Alpha* of zero. This means when capital market expectations are met, *TSR Alpha* will be zero. It will also be zero, if a company meets the *Economic Profit* expectations embedded in its *EP Bow Wave*, and convinces the capital market it will continue to do so. Good performing companies produce positive *TSR Alpha* outcomes by taking action to enhance the shape of their *EP Bow Waves*. Top performers like *Unilever Plc* are able to do this on an ongoing basis – as is evident in Figure 1.

**Figure 1.** Progression of *EP Bow Waves* for *Unilever* over the Five Years to 31 December 2016



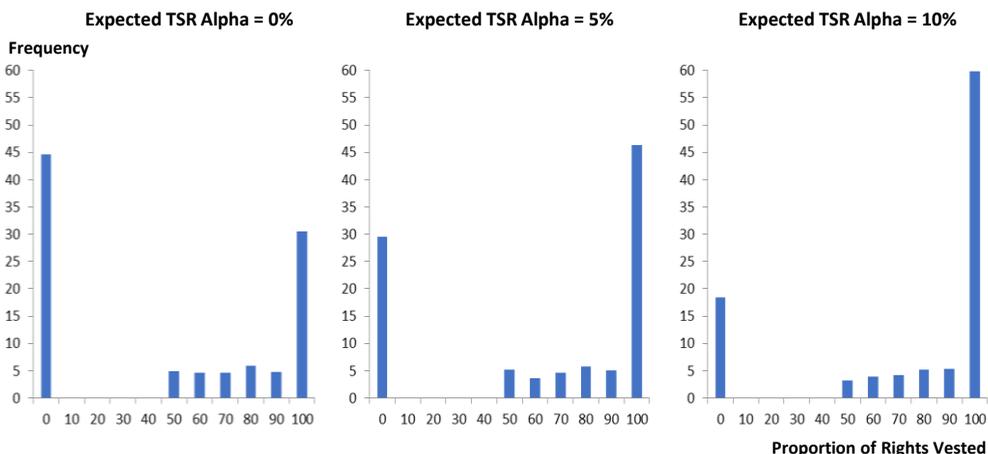
If a company has business processes in place that seek to enhance intrinsic value in a systematic manner, then the profile of its *EP Bow Wave* will tend to improve steadily over time, and *TSR Alpha* will tend to be positive.

Enhancing the *EP Bow Wave* profile means taking action that leads to a higher, a wider or a longer *EP Bow Wave*. This corresponds to an increase in expected returns, growth or sustainability. In the case of *Unilever*, which is an exemplar in terms of *EP Bow Wave* progression, a total of £18.8b in shareholder wealth was created over the five years to December 2016. £14.4b of this came from adding 10 years to the length of its *EP Bow Wave*, or making the business more sustainable. This tends to suggest *Unilever* created wealth in ways that enhanced the wellbeing of all stakeholders.

Over the same five-year timeframe, *Unilever's* annualised *TSR Alpha* outcomes for the three rolling three-year periods to December 2014, 2015 and 2016 were 2.7, 6.2 and 10.8 percent.

When a company meets expectations and convinces the capital market it will continue to do so, thereby producing a *TSR Alpha* of zero, its executives have every right to expect their LTI will deliver 50 percent vesting. But in the typical ASX-20 company we have modelled, *Monte Carlo Simulation* shows that because of the bimodal nature of the stochastic process involved, they can expect to get zero vesting 45 percent of the time. This is an issue we highlighted in the October *KBA Insights*. It is also evident on the left hand side of Figure 2.

**Figure 2. Monte Carlo Simulation of LTI Vesting Outcomes for a Typical ASX-20 Company**

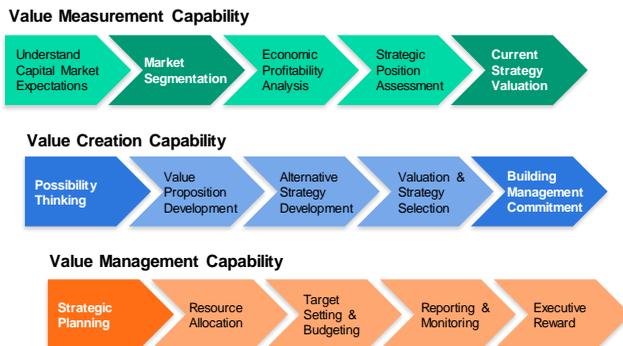


Crucially, the probability of zero vesting reduces to 30 percent, and the probability of 100 percent vesting increases to 46 percent, if a *TSR Alpha* averaging 5 percent can be maintained. The probability of zero vesting reduces to less than 20 percent if a *TSR Alpha* averaging 10 percent can be achieved, while the probability of 100 percent vesting increases to 60 percent.

So how can a company achieve such an outcome? There may be several ways to go about this. But the process described in Part Three of [Customer Value, Shareholder Wealth, Community Wellbeing](#) and illustrated in Figure 3 provides a systematic way to drive intrinsic value uplift, enhance the shape of the *EP Bow Wave* and produce a positive *TSR Alpha*. It is centred on the ongoing pursuit and successful implementation of higher value strategies at a disaggregated level, with the primary focus in the first instance being on building capabilities and harnessing innovation to find ways to enhance the value delivered to customers. If a company succeeds in this endeavour, customers will benefit, the company will benefit, shareholders will benefit; and executives will enjoy a fair reward despite a flawed LTI Plan design. The *EPS* outcome should also be satisfactory – for those still concerned about this metric.

On the other hand, work done by Peter Kontes and a team from Yale documented in *The CEO, Strategy and Shareholder Value*, together with research completed for our book, suggest that if executives were to seek to maximise *EPS* as a standalone objective, they would likely underperform *EP* expectations, erode the *EP Bow Wave*, and produce relatively poor *capital market* outcomes over time. This means that the incentive for executives to pursue *stretch EPS targets* in response to a flawed LTI Plan design, could work against the company and its executives over the medium to long term.

**Figure 3. Systematic Pursuit and Implementation of Higher-value Segment-level Strategies**



**The answer to Question 3** involves changing the approach to LTI Plan design. **This is the second step in a two-step solution.**

Enduring institutions that succeed over the long term, don't create wealth by trying to exceed expectations under their current strategy. They do it by building capabilities and harnessing innovation to develop higher value strategies at a disaggregated level – focusing on perhaps 20 percent of the business (or one in five customer segments) each year. This results in an ongoing series of new expectations which they either deliver, or go very close to delivering.

The LTI Plan must encourage this behaviour. It should also encourage the associated performance expectations to be met. But it should not encourage those expectations to be exceeded to any great degree. To do so puts pressure on management to extract more value from a given strategy than it was designed to produce. This is one of the primary drivers of *short-termism*.

A sound LTI Plan should also have strong alignment between the metrics used to gauge *product and service market performance* and those used to assess *capital market performance*. This alignment is not possible with *relative TSR* and *EPS growth*. It can only be achieved with economic metrics, such as *EP growth* in the *product and services market*, and *TSR Alpha* in the *capital market*. Both measures are consistent with executives focusing on innovation and capability creation to drive intrinsic value uplift and so enhance the shape of the *EP Bow Wave*.

### Synthesis

The key insight emerging from this work is that it is possible to make flawed LTI Plans work – by focusing on the ongoing delivery of positive *TSR Alpha* outcomes. This **first step in a two step solution** provides a natural segue to the second and final step in fixing flawed LTI Plan designs.