

**Stern Stewart & Co.**  
**Management Consultants**  
London

20<sup>th</sup> anniversary

Introduction to peer **Relative Wealth Added™ (RWA™)**

## **A New Performance Measurement and Incentive Compensation Platform**

*Context is all*

- Improves upon benchmarks using Total Shareholder Return (TSR)
  - Adjusts for funding over period
  - All drivers of value included
  - Takes account of financial risk
- Incorporates a benchmark for global peer-relative performance
  - Pulls out macro-economic and industry effects on profits, prospects and financing
  - Highlights changes in value due to management and company factors
- Provides market-based incentive or performance tests similar to indexed options
- Allows for clear, concise and comprehensive ranking and comparison
- Related to Wealth Added Index™ (WAI™)

*UK remuneration practices analysed within*

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## PERSPECTIVES ON BUSINESS

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## Executive summary

This latest *Perspectives on Business* introduces a new performance measurement and incentive compensation platform, Relative Wealth Added™, so called because it gives an objective measure of how a company has performed against its peer group. For RWA™, context is all: it compares the share price performance of a company over a chosen period against that of a defined set of peers, taking into account new share issues and levels of financial risk.

Total Shareholder Return (TSR – percentage return from both share price growth and dividends) is the traditional method of measuring ‘peer-relative’ performance. However, there are key weaknesses to TSR: it does not adjust for financial risk, and it does not reflect the value experiences of all outstanding shareholders over the period in question.

Relative Wealth Added builds on TSR to address these drawbacks. It follows, and takes much intellectual inspiration from, Stern Stewart & Co’s Wealth Added Index™, the benchmark for which is not peer performance but investors’ required return.

The search is on for a metric which comprehensively covers the performance of companies relative to their peers, against a background of increased shareholder activity and public concern in the US and UK, resulting from economic downturn. Similar shareholder activity is likely to start on the Continent with the adoption of International Accounting Standards.

A study by Stern Stewart & Co of the remuneration policies of the FTSE100 suggests that disclosure of the details of how incentives plans operate by UK companies is poor, so that investors cannot adequately assess whether such plans are fully aligned with their interests.

Such alignment is almost perfect in an activity such as sport. In football, for instance, it is clear to all members of a team, their support staff and supporters, what ‘victory’ is. Relative Wealth Added aims to replicate this clarity, transparency, and alignment. It is true ‘performance in context’. Key to its effectiveness will be a measure of agreement, or at least transparency, among all stakeholders in a company, including shareholders, managers, analysts, etc, on the constituents of a peer group.

Using RWA, managers of and shareholders in a company will be able to construct easy-to-follow and real-time ‘league tables’ of how the company is performing.

RWA is a natural tool for use in incentive schemes, particularly with the failure of traditional metrics. Companies should consider using both WAI and RWA: RWA for the short term and WAI for the longer term, encouraging executives to outperform their peers over the business cycle, but not lose sight of the cost of equity over the longer term. Maximising long-term Economic Value Added (EVA®) is consistent with improving Wealth Added, and also should be considered as the basis for incentives plans, particularly for employees below board level.

RWA is also useful to judge the relative performance of asset managers, investors, equity analysts, and other members of the investment community.

## Introduction

The clock is ticking, and the hour of transparency is near. If the European Commission has its way, European companies, from the Atlantic to the far borders of the expanded European Union, will adopt International Accounting Standards (IAS) in 2005. Investors will be able to scrutinise the profit and loss for executive remuneration. Continental counterparts to shareholder activists, such as the UK's Hermes and PIRC, and US-based TIAA-CREF and CALPERS, will identify and expose any weakness in the link between pay and performance.

They will have had a lot of practice. Since 2001, they have been pressuring UK and US firms, which have to provide compensation reports, although not yet wholly transparent financial statements. When IAS arrives, they will turn to their Continental investments. Already, US corporations have begun to change, "volunteering" to expense options in 2003 and considering guidelines recommended or demanded by the Conference Board and the New York Stock Exchange. European firms listed on the NYSE will additionally have to comply with these and at least some of the requirements of Sarbanes-Oxley. AGMs in the US may become as lively as their counterparts in the UK. Furious shareholders will compel their representatives actively to question the motives and decisions of senior executives and non-executive directors. Equity analysts may offer harsher critiques to demonstrate their independence.

Shareholders and executives will see renewed alignment. In 1989, Professor Michael Jensen deplored how few executives had significant ownership stakes and proposed the Leveraged Buyout as a way to eliminate the diverging interests of managers (agents) and owners (principles) in *Eclipse of the Public Corporation*<sup>1</sup>. Subsequently, partly in response to Clinton tax policies, share options became the favoured method of payment and alignment. The bull market spawned a slew of new millionaires. Silicon Valley built entire technology companies on the back of options. European corporations followed the US's lead. Unions encouraged corporate-wide shares issues, despite the minimal link between shop floor performance and share price. Options, like the capital raised for investment in telecoms, media and technology companies, were thought to be free. Now, in the collapse, options have lost much of their lustre, and it is widely accepted that alignment was always a myth. In the UK, performance tests were meant to improve upon "plain vanilla" options, but gaming of the parameters diluted their purpose.

During the boom, remuneration committee directors in the US and UK had less incentive to police compensation policy and to ask tough questions of chief executives and their compensation consultants. Things have now changed. If remuneration directors fail to ask the right questions, and investors do, or if pay and performance fall out of sync on their watch, they will be held accountable. The repercussions may stretch beyond a stain on their reputation.

For Continental firms, 2005 may appear far away, but the interim will not be easy. A downturn provides a clean slate. Just as options emerged from the last recession, alternatives may arise now. Opportunity beckons. The clock is ticking loudly.

## UK remuneration practices update

Our study was based on an analysis of the annual reports of FTSE 100 companies, as of December 27, 2002. Companies generally offered short-term bonuses, usually for performance over a single year, and long-term equity incentives, either in the form of options schemes, or shares plans.

### Short term incentives

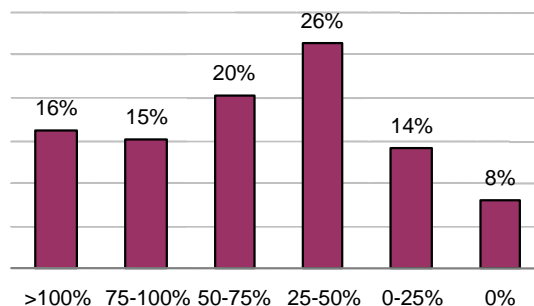
Disclosure on how these short term plans operate was generally poor. One explanation for this is that they do not require shareholder approval. However, in our survey, FTSE100 companies paid an average 86% of base salary as annual bonus, so such payouts are clearly material (Exhibit 1). Because of this, and because such bonuses clearly affect the day-to-day behaviour of managers, remuneration committees should focus more on their design.

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<sup>1</sup> Harvard Business Review, 1989.

More than half of bonuses paid out were between a quarter and three-quarters of base salary. A total of 16 companies paid more than 100% of base salary as bonus, while half that number paid no bonus at all.

*Exhibit 1: Distribution of annual bonus as % of base salary<sup>2</sup>*



In the past, we have found a majority of bonuses were paid at or near the maximum permissible under the plan. Our current study found that distribution is more as we would expect; most executives received a bonus around the mean rather than the maximum.

The majority of short-term bonus schemes focused on performance over a single year, encouraging short-term thinking and actions. We found that only 25% of companies deferred part of their annual bonus to await future performance, encouraging a longer-term focus. For the 58% with a one-year focus, the temptation may have been for managers to goal-seek targets. A single-year focus may also discourage exceptional performance within the period.

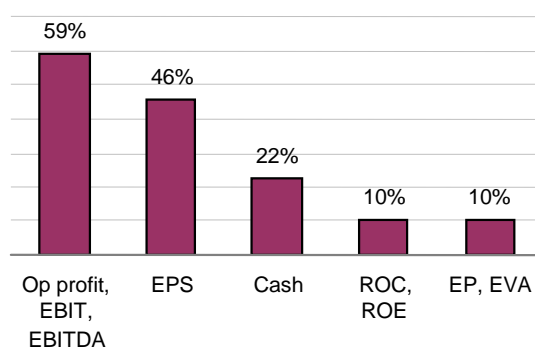
A total of 65% of companies disclosed that they capped bonus payments. Of those, 26% disclosed a target for, and cap to, bonuses. Those companies which did cap bonuses may have mistrusted the efficiency of their incentive schemes. However, where incentive schemes are rigorously focused on value creation, capping bonuses, like a single-year focus, may discourage the very performance which the incentive plans are intended to encourage.

Surprisingly, 41% of companies failed to disclose the financial metrics on which their annual bonus plans are based. Of the 59% which did (Exhibit 2), more than half chose either operating profit, Earnings Before Interest and Tax (EBIT), or Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA).

These, and other metrics, have significant disadvantages. A critique is included as Appendix A.

<sup>2</sup> Information on FTSE100 newcomer Xstrata not available in 2001 annual report.

Exhibit 2: Metric used in bonus plan<sup>3</sup>

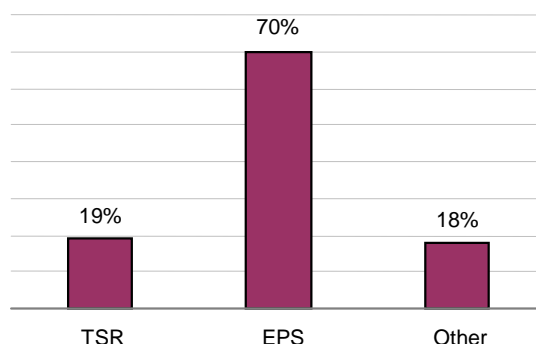


### Long term incentives

When it comes to long-term equity incentives, a total of 83% of companies had executive option schemes, and 72 companies had long-term incentive (ie. shares) plans – many had both, in line with International Corporate Governance Network guidelines. A third of FTSE100 companies had a single scheme. We understand why there was a bias towards multiple schemes, but we believe this results from a lack of confidence in chosen incentives – pick many schemes, and one is sure to work. However, a single scheme which effectively motivates behaviour should be enough.

Earnings Per Share (EPS) was the most popular test for long-term options schemes among FTSE100 companies, used in 70% of plans. Total Shareholder Return (TSR) was used by 19% of the FTSE100 companies in options schemes.

Exhibit 3: Performance tests for options schemes<sup>4</sup>

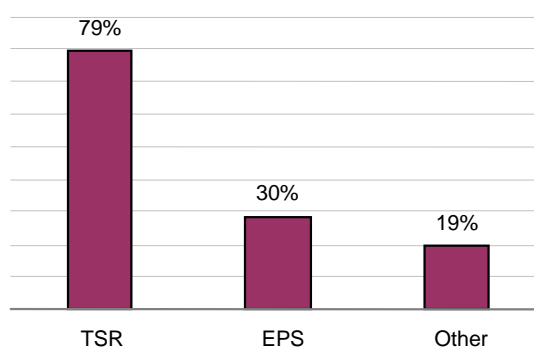


TSR and EPS were also popular as performance tests for long-term shares plans. TSR was the test in 79% of cases, and growth in EPS in 30% of cases (Exhibit 4).

<sup>3</sup> Of those companies which disclose their short-term metric. Percentages do not add up to 100 as some companies use more than one metric.

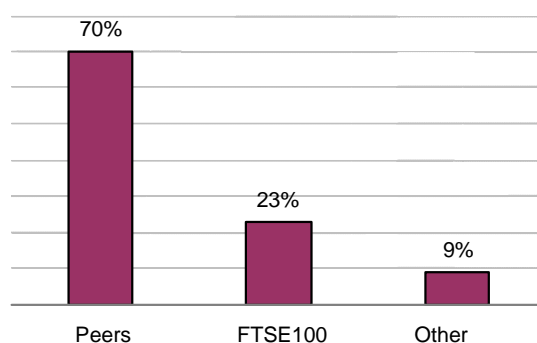
<sup>4</sup> Percentages do not add up to 100 as some companies have more than one performance test. 'Other' performance tests include EVA, ROC, no test, etc.

Exhibit 4: Performance tests for long-term shares plan<sup>5</sup>



Of companies which used TSR as their performance test for long-term incentive plans, 70% used peers as a benchmark (Exhibit 5). However, there is no standard for determining peers, and in periods with M&A activity, companies have been known to change peers in their favour. The remaining companies used either the FTSE100 or market indices to test performance. However, if they exhibited more or less investment risk than the index with which they compared themselves, then such a comparison makes no sense. Significantly, 57% of the companies benchmarking TSR against their peers failed to disclose their chosen peers in their annual report, which means investors could not verify performance.

Exhibit 5: Comparison basis for TSR tests in long-term shares plans...<sup>6</sup>



Disclosure on grant mechanisms (eg. annual fixed value awards, annual fixed number awards, discretionary awards, etc) of equity awards was poor, in particular when it came to options plans. This does not enable investors to make an assessment of the economic value of an award. Surveys and statistics provided by remuneration consultants of average levels of equity awards (normally communicated as multiples of salaries) are misleading. This is because the economic value of the award is determined by the time horizon of the equities granted, the toughness of the performance tests and any other restrictions attached. In other words, despite the contention of many remuneration consultants, disclosure of chosen performance tests is much more important than simple – and misleading – estimates of salary multiples potentially yielded.

## What is victory?

Sport, for example football, shows the benefits of clarity. Each member of the team, like each employee in a corporation, has a different role and job description and performs a particular task. One takes the goal, while others play defence and offence. Three play on each side and four play through the middle. A few are brilliant strikers. Superstars exist, but the team wins as one. They have a common goal, and their performance is transparent. All have their own responsibility and

<sup>5</sup> Of those companies which disclose their short-term metric. Percentages do not add up to 100 as some companies use more than one metric. 'Other' performance tests include EVA, ROC, no test, etc.

<sup>6</sup> Percentages do not add up to 100 as some companies have more than one performance test. 'Other' includes FTSE250, FTSE350, UK Retail Price Index, etc.

accountability, and clearly know what is victory – to score more than the opposing team. One team may win through defence. Another succeeds through stronger offence. The ends justify the means.

Sport additionally clarifies the performance of teams over a season. Year-end standings list football teams by the number of points accumulated over a season. Each victory, tie, and loss is clear, aside from a few possible disagreements over referee calls. All are accumulated to show where each team finishes. The winner of the Premier League sits on top. The three lowest teams are relegated to the First Division. From number one to number twenty, each team has its designated, undisputed place. Manchester United and Arsenal are truly peers. Their positions show their relative performance over a season. They are ranked according to metrics that not only affect both but also subtract what they do not influence. The difference in place highlights performance, as influenced by the players. Coaches that fail to raise their team's position are fired. Those that improve their team's standing enhance their esteem and win higher pay. Sports sections nationwide ensure transparency and responsibility, whilst ensuring accountability.

If a new metric is to be more successful than those which have gone before, it should replicate this simplicity without sacrificing clarity. The aim must be to replicate, for employees of a company, the clarity of 'winning' a football game through a well-designed internal reporting and forecasting architecture, built on a comprehensive yet simple, transparent, and clear metric that indicates victory. For the company itself, this same clarity comes from benchmarking its place against peer companies. For example, in the airline industry, we would measure British Airways against peers such as KLM and Singapore Airlines. Where BA finishes, in terms of relative share price performance, tells us to what extent BA has won, and if on top, that BA is the clear victor.

The main difference between football and business is that in football the number of goals or even wins may not matter as much as the place in the league. But in business, the extent of victory, or the improvement in market value, makes a real difference to investors.

## Performance in context

In our monograph on the Wealth Added Index™ (WAI™),<sup>7</sup> we sought to make the case for the cost of equity as the minimum benchmark, and for including all external financing costs in an adjusted TSR.

For example, let us look at two companies:

	TSR	Cost of Equity
A.	11.5%	12.5%
B.	8.5%	7.5%

The cost of equity includes business risk and financing. Who is the winner here? A has a higher TSR than B, but investors require a greater return since A is riskier than B. A does not meet investor expectations. B beats investor expectations. Hence, taking required return as the benchmark, B has performed better than A.

However, comparing companies A and B in this way still has a drawback, in that it only considers TSR from the beginning of the period. If the TSR is to be relevant to all shareholders, it needs to be adjusted for all new equity issued throughout the period, to take all shareholders into account. In the above example, TSR is not adjusted for capital raised through the period. Once we adjust for all investor expectations, including those of investors purchasing equity throughout the period, we have a robust way to define share performance. This is WAI.

$$\text{WAI} = \text{Beginning MVEq} \times [\text{Adjusted TSR} - \text{cost of equity}]^8$$

However, should we take account of industry performance? For example, let us look at two further companies, in different industries:

<sup>7</sup> *Perspectives on Business: Introduction to the Wealth Added Index™ (WAI™)*, August 2002.

<sup>8</sup> The TSR and (effectively) Market Value of Equity are adjusted to include, as a weighted average, the performance of shares issued in the period and other capital changes

	TSR	Peer TSR (average)
C.	25%	35%
D.	-15%	-25%

Who is the winner? Company C pleases investors with a positive and very high TSR, probably well above its cost of equity. D disappoints investors with a negative TSR, clearly below its cost of equity. However, C has underperformed its peers, perhaps in a rising market: the share price has risen as the market rises, but investors think less highly of C than its competitors. D has beaten its peers during a tough period. Investors have discounted their previous expectations for the industry, and perhaps also the economy, but they voted in favour, relatively, of D. In peer-relative terms, managers in C have performed worse than those in D ie. 10 per cent below the average for the industry, rather than 10 per cent above average. Of course, over time, if D continues to have a negative relative TSR (or TSR relative to the cost of equity), managers and shareholders should fret. However, if investors compare with industry peers, they would be pleased. The best companies beat their cost of equity and peers over time. The worst underperform both until they are acquired or go out of business.

## Introducing Relative Wealth Added

Relative Wealth Added (RWA) objectively measures how a company has performed against a peer group.

RWA compares the share price performance of a company over a chosen period against that of a defined group of peers, taking account of new share issues and levels of financial risk. It compares the shareholder value created by the company with the average of its peers. This can either be expressed as in absolute or monetary terms (RWA) or as a percentage of the initial Enterprise Value (%RWA)<sup>9</sup>.

$$\begin{aligned} \text{RWA} &= \text{Beginning MVEq} \times [\text{Adjusted TSR} - \text{Peer-group Average Adjusted TSR}]^{10} \\ \% \text{ RWA} &= \text{RWA} \div \text{Enterprise Value} \end{aligned}$$

The traditional approach to “peer-relative” performance has been to compare a company’s TSR against those of its peers. RWA structures this approach by using the performance of the peer set to create a specific benchmark. It also addresses two key weaknesses of TSR. First, TSR does not adjust for financial risk, but if a company has relatively high debt then shareholders will expect a higher return. Second, TSR looks only at shares that were in issue at the start of the period. If a company issues substantial new equity part of the way through the period then the performance after the equity issue is clearly relevant<sup>11</sup>.

Benchmarking against peers separates the performance of the company from overall economic and stock-market effects, which cannot be influenced by individual managers. So-called “bubbles” are caused by very high, and ultimately unsustainable, expectations of future earnings creating valuations that with hindsight appear excessive. Benchmarking against peers evens this out. Any rise or fall in the share price compared with peers is a company-specific movement.

If a company is going to measure its performance against peers, it must select a representative set of peer companies in advance and agree these with investors. Selecting peers requires some judgement; ideally the peer set in aggregate will be exposed to the same economic and market forces as the measured company. In practice, of course, the match between the company and its peer set will not be exact. The temptation will be for companies to choose peers which promise to be easier than others to beat<sup>12</sup>. Here, investors need to lay down the line. There will be disagreements, but once the peers are

<sup>9</sup> RWA and % RWA are described in more technical terms in Appendix B

<sup>10</sup> The TSR and (effectively) Market Value of Equity are adjusted to include, as a weighted average, the performance of shares issued during the period, and other capital changes. The peer group TSR also includes an adjustment for leverage to make it comparable to the measured company.

<sup>11</sup> For example, a five-year TSR for Vodafone does not take account of the large number of shares that were issued – and fell dramatically in value – during the period.

<sup>12</sup> However, for a peer company to be easy to beat implies that its shares are overvalued; second-guessing share prices is not so easy!

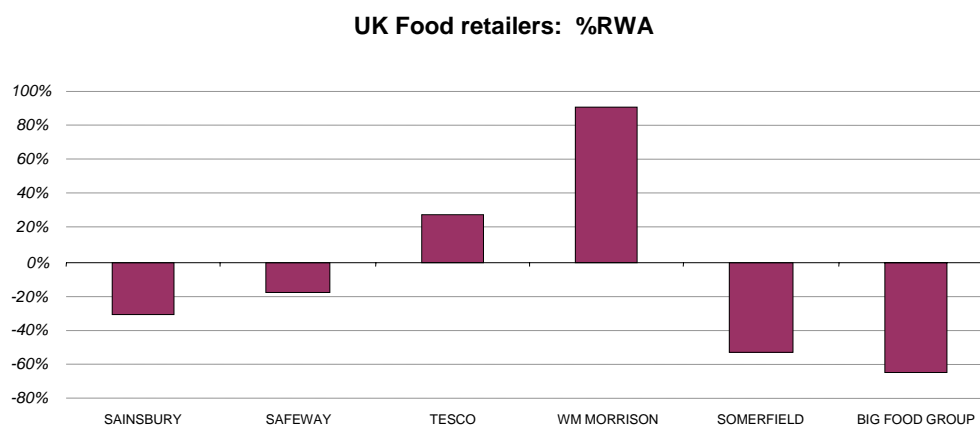
chosen, the key thing is for them to remain unchanged<sup>13</sup>. In this case, clarity may be more important than precision.

*Exhibit 6: %RWA league table of listed UK football clubs*

FOOTBALL CLUBS	%RWA 30 JUNE 2002	LEAGUE PLACE
BIRMINGHAM CITY	7%	-
CHELSEA	3%	6
ASTON VILLA	2%	8
LEEDS UNITED	2%	5
NEWCASTLE UNITED	2%	4
MANCHESTER UNITED	1%	3
CELTIC	-5%	-
TOTTENHAM HOTSPUR	-6%	9
SUNDERLAND	-9%	17
LEICESTER	-19%	20

This clarity is illustrated in Exhibit 6, a %RWA league table of listed UK football clubs. Top of the table is Birmingham City, with a %RWA of 7%, more than twice the %RWA of the runner-up, Chelsea. Of the ten peers, six have positive %RWA and the rest are negative – in the case of Leicester, at -19%, particularly so. The table also list their place in the football league, for comparison.

*Exhibit 7: Comparison of %RWA of UK food retailers*



From a global perspective, a standard set of peers for each company maximises simplicity, clarity, and transparency. Winners and losers are obvious. Standardised peers for, say, global oil and pharmaceutical firms may be easier than for retailers, but investors will have their own ideas. Equity analysts may split their focus geographically, say European only, or based on size. For conglomerates such as Unilever or GE, the exercise becomes more complicated. The goal generally is to pull out macroeconomic and industry effects. Expressing RWA as a percentage facilitates comparison between businesses of different size, as illustrated in Exhibit 7.

A frank discussion about which companies are peers and which are not will tell investors much about corporate strategy, and will reveal to managers how investors and analysts judge their prospects. Maintaining similar peers over time, unless major changes in geography or industry occur, should provide clarity. Up-to-date comparative share price performance graphs on web sites should alert investors to where companies stand. Fund managers should similarly display their record, showing their pick versus peers chosen earlier. Equity analysts should show the companies they follow, and where they stand. All lists should additionally show how companies perform against their cost of equity capital, in other words, their Wealth Added Index. If companies continually finish near or at the top of their industry set, and their peers do too, then investors should ask serious questions. On average,

<sup>13</sup> Of course, M&A activity will make it necessary at times to adjust the peer set. In this case, it is important that a company does not seem to be changing its peers simply to cast itself in a more favourable light.

companies should average around their required rate of return with some deviation of performance. Business risk, and thus the cost of equity, should derive from the same set of peers. Company, analyst, and fund manager presentations should benchmark company performance against the same peers, or they may establish different sets of peers starting with a simple set where each peer measures itself against the same, and a larger and more comprehensive list with a greater universe and accuracy.

Whatever the detail, RWA objectively measures how a company has performed compared with its peers, and the activity of choosing those peers is a useful additional benefit to RWA.

## The goal of incentive compensation

In terms of corporate governance, one of the primary roles of the board, on behalf of investors, is to agree an incentive contract with the Chief Executive of the company that consistently motivates and aligns the Chief Executive's interests with investor expectations. Similar contracts will subsequently be agreed with other top executives, and so on throughout the organisation. For each group, the choice of incentives will differ, but they should maintain the alignment of the recipients with investors throughout.

With this in mind, do we want to motivate senior executives over the short term or long term, on improving profitability, on increasing the share price, or on all of these? Multiple plans based on multiple metrics may confuse and diffuse focus. If managers have incentive plans that encourage them to balance short-term profits and long-term performance, in the form of share price, there is a risk of emphasising the short term to the detriment of shareholders. Share performance is clearly the goal for investors. If managers additionally focus on a profitability metric that strongly drives the share price upwards so much the better, but value drivers must be balanced in the effort to maximise the share value of the firm.

Maximising the share price means beating the required rate of return or the cost of equity capital – rewarding shareholders for taking on the risk of investing. Shareholder value is destroyed if the chief executive does not, at the same time, deliver profitability and build the opportunities for future profitability which justify a sufficient increase in the share price to cover the risk of investing.

Share prices include many market factors outside the influence of management. This will lead to quite volatile performance movements around the cost of equity benchmark. Delivering on profits, and building prospects, will lead to success. But over the shorter term, consistently holding managers accountable for beating the required rate of return is unfair. Changes in macroeconomic or uncontrollable industry factors affect their record too often. Hence, an incentive plan geared entirely toward beating the cost of equity may not motivate value-creating decisions.

Maximising share price improvement against peer improvement accomplishes this goal. If the management team, at the same time, deliver profitability and build the opportunities for future profitability more than their peers, their share price improvement will beat their peers. In good times, most will beat their cost of equity, but the winners will beat their peers. In bad times, none may beat their cost of equity, but the winners will still beat their peers.

In this regard, we believe that the chief executive, and possibly other senior executives and even non-executive directors, should have one incentive scheme, based on RWA, with the aim of maximising their share price to beat their peers. (Over time, the leverage-adjusted average returns from an appropriate peer set will correspond to their cost of equity.) Some companies will wish to include WAI to ensure that the maximum bonus is paid out only if the cost of equity is beaten during the period.

Naturally, because WAI and RWA benchmark against different factors – the cost of equity and the performance of a peer group respectively – they yield different results. In an adverse market, companies will generally have a higher RWA than WAI. Using a sample set of peers for British Airways, Exhibit 8 illustrates this. EasyJet has a negative WAI – it has underperformed its cost of equity – but a positive RWA, because it has outperformed the average benchmark of its peers.

Exhibit 8: Sample of WAI and RWA for airlines over five years (£m)

	WAI	RWA
RYANAIR	1,505	2,553
CATHAY PACIFIC	279	1,735
SINGAPORE AIRLINES	197	1,401
EASYJET	-187	107
SAS	-640	-244
KLM	-896	-528
ALL NIPPON AIRWAYS	-1,773	-1,469
BRITISH AIRWAYS	-4,463	-3,555

What does the attraction of share-price-based metrics mean for operating metrics such as EVA? EVA and future EVA are the key drivers of RWA and WAI. Maximising long-term EVA is consistent with maximising share price and thus RWA/WAI.

Clearly, EVA is an accounting metric, and RWA / WAI are affected by share price. Since senior executives are not only expected to deliver profits over the short and medium term but also required to create long-term opportunities, RWA and WAI have the edge over EVA since the latter could drive managers to focus on profits and not the higher ideal of share price improvement. However, in low- and medium-growth industries where short- and medium-term profitability is the key driver of share price performance, an incentive programme using both EVA and RWA or WAI together is not inconsistent. Effective design of EVA-based incentive schemes<sup>14</sup> can lengthen management horizons from short-term to medium, and possibly even the long term. RWA keeps managers focused on EVA and its drivers, stripping out luck. WAI reminds them that capital has an explicit cost.

## Using RWA for incentive compensation

RWA is a natural tool for use in incentive schemes, especially as the drawbacks to conventional approaches are becoming increasingly apparent.

There are two types of financial metric generally used for incentive schemes. The first type includes the accounting based metrics such as Earnings Per Share (EPS), Return On Capital Employed (ROCE) or Economic Value Added (EVA). The second type includes share-performance-related metrics such as Total Shareholder Return (TSR).

The advantage of accounting-based measures is that they are based on audited figures and that they measure an “actual outcome”. However, this latter aspect is also a disadvantage, since the role of senior management also includes securing future earnings. Naturally, future earnings are impossible to measure, but investors incorporate estimates into the share price and this is the rationale for the use of share-based performance measures.

One common way of incorporating share performance into incentives is to grant share options. Options link managers’ rewards to share price performance but may not be the ideal way of doing this. There is a variety of other equity linked incentive schemes, including grants of restricted stock and phantom share schemes.

Share option schemes have come under much criticism recently. They had become very popular, driven at least in part by accounting and tax advantages. One criticism is that executives have made large amounts of money almost independently of company performance by owning large numbers of options in a rising market.

<sup>14</sup> Detailed discussion of EVA incentive programmes is a feature of *The EVA Challenge*, by Joel M. Stern and John S. Shiely with Irwin Ross, John Wiley & Sons, 2001.

In the UK, executive share options normally require certain performance criteria to be met. These performance criteria are normally based on Total Shareholder Return (TSR) performance compared to peers, or Earnings Per Share (EPS). This approach prevents executives at poorly-performing businesses from benefiting from a general stock market rise, but it still has its drawbacks. Performance tests are rarely used in other countries.

Another set of issues arose with the collapse of internet stock prices. The options became worthless and ceased to operate as incentives. This was particularly important since for some of these companies a vast proportion of employees' reward was to come from such variable compensation. Management sought new or "rebased" options but investors naturally balked.

Hence, share options can reward managers just for being employed during a bull market and they can cease to function as an incentive following a market crash.

Starting with the sadly unrealistic "clean sheet", would we promote share option schemes? Probably not, but we should not forget the objectives that such schemes were designed to fulfil:

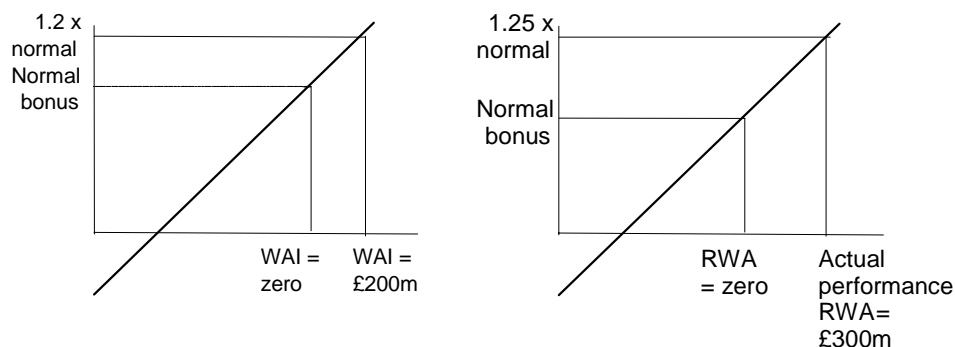
- To allow managers to share in some of the wealth they create.
- To encourage managers to strive harder, with rewards for doing so successfully.
- To align the interests of the managers and owners of a business, encouraging managers to take decisions that are optimal for owners.
- To encourage managers to focus on the long-term prospects of a business, which are reflected in the share price, rather than short-term profitability (which would be the alternative type of measure for incentive plans).

One of the drawbacks of conventional thinking on incentive plans, at least in Europe, is that the standard philosophy is one of "bonuses" rather than of "variable pay". Compensation philosophy is often that "fixed pay is compensation for normal performance, bonuses are awarded for exceptional performance". Under such a philosophy, investors naturally object to bonus payments, or share option gains, if a company performs below average.

The drawback of such a philosophy is that it only provides limited incentive for the managers of below-average companies. No reward is on offer for improving performance from, say, the 25th percentile to the 45th percentile. If incentives are to work, they should work across the full performance spectrum.

Stern Stewart is a strong proponent of incentive schemes that reward performance improvement across the full spectrum – and, as a necessary corollary, that penalise poor performance. We argue that there should be a straight line relationship between sustained performance improvements and reward; there are, of course, many important design aspects of such a scheme, one of the most important being the partial deferral of bonus payments, held at risk against future performance.

*Exhibit 9: Illustrative WAI and RWA incentive plans*



Given a "clean sheet" and as tax and accounting advantages are being eroded, we would suggest making incentive payments based on the following principles:

- A straight-line relationship between performance improvement and reward, with no kinks or (even worse) sudden jumps that distort behaviour.

- Partial deferral of bonus payments, held at risk in a “bonus bank”.
- Use of a strong performance metric, a market-based metric such as RWA and/or WAI for top managers, and the accounting-based measure of EVA for other managers

If accounting-based measures are used, we consider it vitally important to separate the bonus criteria from the budgeting process and to design the system to ensure a long-term view.

RWA incentives reward managers for beating their peers, WAI incentives for beating the cost of equity. In the long term, successful companies will do both; over a short period of time the cost of equity is not necessarily a suitable benchmark but over the long term it is. One should therefore consider using both metrics. If remuneration committees choose a market-based performance metric, they should choose RWA for the short term and WAI for the longer term.

Conventional equity incentive schemes, based on share options or restricted stock, are an established part of the corporate world and can be expected to continue. The UK practice of applying performance tests, normally linked to EPS or peer relative TSR, overcomes concerns about large payments to undeserving managers, but does have certain drawbacks:

- If Earnings per Share growth is used this is normally coupled with a requirement that it should exceed inflation, for many companies an undemanding target.
- Use of EPS as a performance test may encourage companies to emphasise short-term profitability over long-term value creation.
- EPS can be manipulated; the binary nature of many tests – managers pass or fail depending on whether they hit a particular number – encourages manipulation. The fact that “retesting” is frequently permitted can also encourage manipulation.
- Peer-relative TSR tests do not take account of leverage and can encourage companies to opt for debt finance.
- Because of the way they work, peer-relative TSR tests do not discriminate between third- and fourth-quartile performance, but they particularly reward top quartile performance; this can encourage risk taking, with little downside for managers if the risk fails.
- In general, the use of one mechanism as a test, and another (share price) as a variable reward creates a complex incentive effect which may not work as intended. When TSR tests are used, the maximum number of share options is available at the same time as these options have maximum value, creating a doubling-up effect.

We advocate RWA as a superior parameter for performance tests over peer-relative TSR as it adjusts for leverage and new share issues. If it is considered desirable to use an accounting-based test (and there is a case for this, particularly in mature industries) then EVA as a complete economic performance measure is far superior to EPS.

## Using RWA in the investment community

Using RWA, the stock selection decisions of asset managers and investors can be judged more accurately. Their performance as the stewards of other people’s money can be compared with the performance of other asset managers and investors, who entrusted their money to other members of the peer group. The clarity with which managers’ performance can now be viewed is transferable to investors’ performance. Once standards – in other words, the performance of the peer group – have been chosen, then performance can be easily assessed. Those investors which make the right decisions will be seen as the winners.

The same peer group can be used to assess the performance of equity analysts. Currently, there is a lack of transparency and information on agency costs. There are also opportunities for analysts to manipulate the system. Using agreed peer groups creates a common language. Investment bankers who recommend a merger with or takeover of a peer will change the relative balance of the peer group. That will affect the potential performance of the acquisitive company, and create extra cost in terms of financing, which in the case of an expensive acquisition may drive down Relative Wealth Added.

The RWA framework for performance measurement (and incentives) demands standards in terms of peers and holds users accountable for additions to the capital base. The proliferation of data sources – Bloomberg, Datastream, FTSE, MSCI, SIC codes – confirms that there is no standard for choosing industry classification and thus peer sets. Equity analysts choose their own list either by geography (for example, North America, Asia, and Europe), size or other criteria. Fund managers decide their own indices against which to their performance. Companies have theirs. Although the differences allow outsiders to ask useful questions – why does X include Y and you do not, yet you include Z? – this allows companies as well as City players to choose different criteria. Like a scorecard approach, all look for the group that makes them look good. Manipulation of share price is not as easy as EPS, but many can claim victory when there is no precise definition. Companies and City players should at least start with a common standard and then make simple adjustments as necessary.

Transparency introduces rigour. If the City and the Street, for example, decide one set of international oil majors, then all of the equity analysts could choose where each would finish relatively, as sports writers do before the baseball season in America. They would follow the same, and their differentiating factor would be how they determine the winners. Transparency would separate the best analysts from the rest. Investors could measure fund managers based on their choice of oil companies. If a fund manager chooses Shell, expecting Shell to be among the winners, investors could judge the performance of the fund manager based on how Shell performs compared to peers. Managers, analysts, and fund managers would have a similar benchmark. Clear winners and losers will emerge. Transparency raises the stakes.

## Conclusion

Non-executive directors must complete a number of significant tasks to meet their governance requirements. The most important is to write an incentive contract which aligns the Chief Executive and other executive directors with investors.

Few challenged the quality of compensation contracts while the markets marched upwards. Our study of the FTSE 100 arguably demonstrates a failure of alignment between investors and executives. A study of Continental practices, were information available, would probably elicit similar lack of discipline. As a result, all parts of corporate governance, including incentive contracts, are now open to scrutiny. Investors, politicians, and the press have questioned the role and *curriculum vitae* of non-executive directors in general. The public demands greater oversight and activity. Responsibility and accountability have risen dramatically. Non-executives must ask tougher questions and understand the implications of the choices they, and members of the executive board, take. Failure to take on greater responsibility will be punished.

In this climate, an opportunity exists to re-evaluate, and make genuine changes to, current remuneration policy and compensation contracts. This document made the case for an alternative remuneration philosophy based a new metric called RWA. Unlike shares or share options (with or without performance tests), RWA measures the value created for investors having stripped out market factors that can lead to inappropriate gains during bull markets and rebasing during bear markets. Peer performance is a realistic benchmark which over the long term corresponds to the cost of equity. As a result an incentive contract with RWA at its core aligns the Chief Executive and other executive directors with investors. With that, any credibility gap, or governance discount, should erode. Non-executives would fulfil their key governance goal.

## Appendix A Critique of individual metrics

Traditional measures display a range of drawbacks which damage any alignment between executives and investors.

**Operating profit** and **profit margin** may be significant drivers of value, but unless each is reviewed alongside capital efficiencies, they do not provide a true picture of economic profitability.

A focus on growing **EBIT** (Earning Before Interest and Tax) or **EBITDA** (the same, subtracting also depreciation and amortisation) encourages companies to overinvest. It also takes no account of the capital employed to drive that growth, and in particular investors' required return. As the *Financial Times* (January 6, 2003) put it, EBITDA obviously includes neither depreciation nor capital expenditure, so misleads any company which needs to reinvest in its business. It also ignores changes in working capital, so can mask, for example, a sharp increase in stock levels or deterioration in customer defaults.

Maximising **cash flow** may be appropriate for companies that are in financial distress, but as a measure, cash flow is not optimal for most companies. It mixes operating and financing decisions, can be very difficult to operationalise, and does not adequately reveal the true economic profitability of a business.

A focus on maximising **ROC** (Return on Capital) or **ROE** (Return on Equity) encourages companies to underinvest if their current return on capital is higher than their cost of capital or equity, or overinvest if their current returns are lower than their cost of capital or equity. Although both improve on a focus on purely profitability measures, it is very difficult to operationalise, and identify trade-offs between operating results and capital efficiencies. In other words, ROC and ROE can be increased by investing in projects with a negative present value. Such return measures help to create capital discipline, but on their own cannot ensure profitable growth.

**EPS** (Earnings Per Share) can be increased by using debt to invest in projects that return more than the cost of interest but less than the weighted average cost of capital. Also, if EPS is low, it can be increased by equity-funded investments that need not cover the weighted average cost of capital.

If designed correctly, **EVA** (Economic Value Added) or **EP** (Economic Profit) overcome many of the problems deriving from the measures above.

## Appendix B Relative Wealth Added in more detail

The basic definition of RWA is

$$\text{RWA} = \text{Beginning MVEq} \times [\text{Adjusted TSR} - \text{Peer-group Average Adjusted TSR}]$$

This is similar to Wealth Added (WAI) except the Peer-group Average Adjusted TSR is used instead of the cost of equity.

To construct the peer group average we calculate the total return to both equity holders and lenders as a percentage of enterprise value for the whole peer group. We then construct a weighted average. This weighted average is then used to calculate the benchmark return to shareholders that is consistent with the measured company's leverage ratio.

A key effect of leverage is to accentuate a company's performance – whether it is positive or negative. The Peer-group Average Adjusted TSR is thus generally higher for companies with higher levels of debt. However if the industry stock-market performance is in decline, or is growing at less than the “risk free rate”, then the benchmark will actually be lower for a leveraged company.

One of the principal features of RWA is that it takes account of changes in a company's capital. In practice, we accomplish this by calculating RWA on a daily basis and then accumulating the daily RWA to give the total. A straightforward addition introduces a systematic path dependency (ie. the result would depend not just on the starting and ending values of the company, but also the route taken) and in order to avoid this, the accumulation is weighted by an industry growth factor. This gives an answer that is consistent with a direct calculation of RWA over the whole period under evaluation, except for the effects of capital changes.

The definition of the percentage measure is:

$$\%RWA = \text{RWA} \div \text{Enterprise Value}$$

The Enterprise Value used would be the opening Enterprise Value, except that changes in capital again need to be taken into account; clearly if the company doubled its equity base on day one the opening Enterprise Value would not be the appropriate figure. We therefore construct an “average opening Enterprise Value” that takes account of capital changes but does not include the effects of growth (or contraction) due to market movements.

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