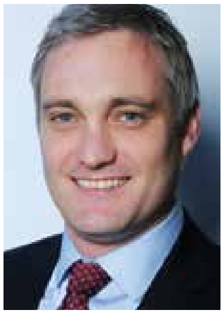
TSR can be a flawed incentive measure

Here is what you really want to measure to drive value-building behavior.

BY GREG ARNOLD AND BARRY SULLIVAN

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The most effective executive compensation programs today strike the balance across key stakeholders — boards of directors, management teams, and shareholders.

For many companies, performance-based equity has become the principal component of executive pay. Roughly 65% of large U.S. companies grant performance-based equity today and half of those use relative total shareholder return (TSR) as a performance measure. At first blush, relative TSR has strong conceptual appeal — executives earn grants only when they create more shareholder value than other companies. Upon deeper review, however, relative TSR has flaws as an incentive measure.

Relative TSR rewards volatility more than steady performance. As they say, every dog has its day, and this is certainly true with relative TSR. We measured TSR for hundreds of companies over the recent 20 years and found that even long-term, bottom-quartile TSR performers can reach top-quartile heights in a given three-year measurement period — generally by 'bouncing' from a low share price.

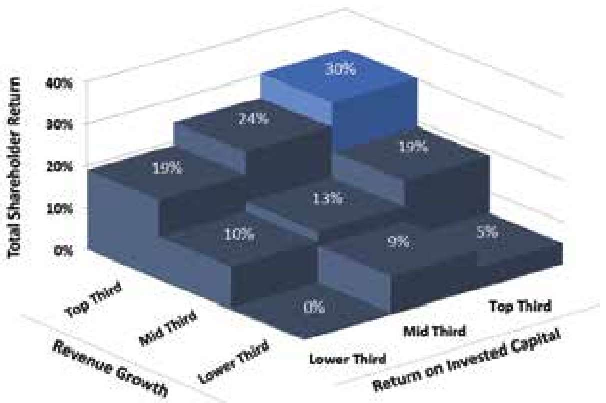
Further, relative TSR does little by way of focusing executives' attention or driving behavior. Executives respond positively to incentive measures that reflect their day-to-day responsibilities. Rewards based on relative TSR are an affirmation of company success but do little to set the path to performance at the outset of a measurement period.

What then to measure? The way forward is simple: measure the clear and controllable drivers of TSR. For many companies, this will mean top- or bottom-line growth and returns on capital. Our analysis demonstrates companies that grow and do so while returning a premium above their cost of capital create superior shareholder value over time.

To the left we show this relationship for a set of 130 or so companies in a high-growth, capital-intensive setting, tested back over 20 years. The top-third of companies along both dimensions (bright blue bar in the graphic) created roughly two times the shareholder value of the 'middling' companies on both dimensions. And the companies in the bottom-third for both were flat for the 20-year period — as in, they created no value for shareholders. We've tested these relationships across industries, and the findings are consistent, no matter the growth and capital levels in the industry. The market will reward companies that outgrow and out-return the competition — and, of course, the shareholder will win in the end.

Exhibit: The Value Growers

Average 3-year total shareholder return segmented by revenue growth and return on invested capital*



*132 high-growth, capital-intensive companies measured over 3-year rolling periods from 1993 to 2013. *Source: Semler Brossy*

Measuring growth and returns requires careful consideration of performance goals. For many companies, performance goals are best linked to strategic plans. Growth goals are usually clearly articulated but capital return goals often receive less attention. The key is measuring each in balance, using the natural trade-offs to drive shareholder value. The market is unkind to those that sacrifice one for the other.

In truth, relative TSR may still play a role for some companies. For example, relative TSR can work well as a back-end modifier on grants otherwise earned based on growth and returns. The way forward need not be for TSR to exit stage left; we simply encourage companies to think of growth and returns as the stars of the pay-for-performance story. ■

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