

Relative Total Shareholder Return Performance Award Report

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EXECUTIVE SUMMARY

Since 2010, performance-contingent awards have been the most widely used long-term incentive (LTI) grant type among the Top 250 companies¹ and are now in use by 89% of the sample. The prevalence of performance awards and investor preferences have spurred considerable interest in relative total shareholder return (TSR) as a performance metric. Relative TSR measures a company's shareholder returns² against an external comparator group and eliminates the need to set multi-year goals. Use of relative TSR performance awards among the Top 250 companies has increased from 29% in 2010 to 49% in 2014, and relative TSR is now the most prevalent measure used to evaluate company performance for performance awards.

The recent surge in relative TSR performance awards has been a topic of much discussion among the executive compensation community. Relative TSR plans are favored by proxy advisory firms, and proponents tout that such plans have strong shareholder alignment, are objective and transparent, permit multi-year measurement of performance, and do not require long-term goal setting. However, critics assert that relative TSR is not without its drawbacks. They highlight that TSR outcome is not entirely within management's control as external factors often affect stock price and that TSR and financial performance are not always strongly correlated, particularly over shorter measurement periods.³

In light of the growing focus on relative TSR performance awards, this report explores current relative TSR award design practices in the market. Key findings are as follows:

- Prevalence of relative TSR awards among the Top 250 companies has increased by 71% in the last five years (from 29% of the Top 250 companies in 2010 to 49% in 2014). However, companies that grant relative TSR awards tend to diversify their performance measures, with 71% of companies using relative TSR in combination with another financial performance metric.
- Relative TSR is predominantly used as an independent metric in performance share plans (85%), with only 15% using relative TSR as an award modifier.
- When used as a modifier, relative TSR typically adjusts the final performance award payout by between 15%-25%, with the majority of companies using a $\pm 25\%$ modifier.
- Eighty-eight percent of relative TSR awards use a component rank approach, with the most common threshold, target, and maximum goal levels set at the 25th percentile, 50th percentile, and 75th percentile of the comparator group, respectively.
- Performance leverage among companies using a composite index varies, but target payouts are typically earned for achieving TSR that is aligned with the index performance.
- A significant majority of relative TSR awards measure TSR over a three-year period (93%), with earned awards typically paid out at the end of the performance period (only 12% of plans have additional time-vesting restrictions). Among awards with multi-year performance periods, 93% measure TSR over the full performance period, 4% measure TSR in annual increments, and 3% use both an annual and cumulative measurement period.
- Approximately half of the relative TSR awards measure performance against an existing stock index, while the other half are split between using the company's compensation peer group or a custom relative TSR peer group. A few companies also use both an index and the compensation or custom peer group.

¹ The Top 250 companies represent the largest U.S. companies in the Standard & Poor's 500 Index by market capitalization.

² Reflects stock price change plus assumed reinvested dividends.

³ As shown on page 11 of this report, the correlation between TSR and financial performance is moderate in any given three-year period, but alignment between the two measures increases significantly over longer periods.

Overview and Background

This report presents information on relative TSR award design practices currently in use for executives of the 250 largest U.S. companies in the Standard & Poor's 500 Index (Top 250 companies) as of mid-2014. These companies are selected annually based on market capitalization, i.e., share price multiplied by total common shares outstanding as of February 28, 2014, as reported by Standard & Poor's Research Insight (see Appendix for complete list of companies).

All information was obtained from public documents filed with the Securities and Exchange Commission (SEC), including proxy statements and 8-K filings.

Methodology

Relative TSR awards are considered to be in use at a company if such grants have been made in the current year or prior year and there is no evidence that the grant practice has been discontinued, or if the company indicates that the grant type will be used prospectively. Findings in this report do not differentiate between LTI awards that are denominated in cash, shares, or share units.

Total shareholder return, or TSR, measures the return an investor receives by purchasing one share of common stock at the beginning of the period and then selling his or her stock at the end of the period, while potentially accumulating dividends during the period. More simply, it is stock price appreciation plus dividends.

For purposes of this report, relative TSR awards are grouped into two categories: relative TSR as a "**metric**" or as "**modifier**."

- Relative TSR as a **metric** is used to determine the potential funding of performance award payouts, either alone, or in conjunction with other financial or operational performance measures.
- Relative TSR as a **modifier** is a secondary performance measure, used to adjust the final payout of performance awards that were earned based on achievement of other performance metrics. Modifiers are typically expressed as a percent of the final payout.

Two approaches to calculating relative TSR are covered in this report:

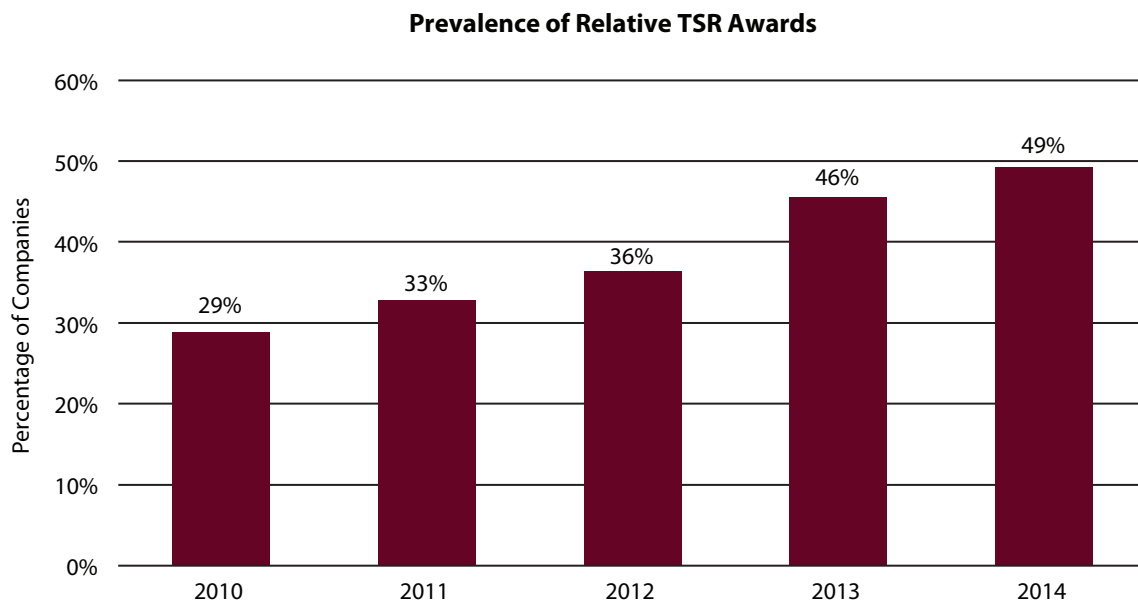
- Under a **component rank** plan, performance award payouts are dependent on the company's TSR as a percent rank of the comparator group (e.g., target TSR at the 50th percentile of the peer group).
- Under a **composite index** plan, the company's shareholder return growth, or contraction, is evaluated against the comparator group as a whole (e.g., target TSR is 10% above the index).

PREVALENCE

Use of relative TSR awards for executives has steadily increased in prevalence among the Top 250 companies over the last five years. Nearly half of the Top 250 companies (49%) currently grant relative TSR awards, representing a 71% increase since 2010, when only 29% of the Top 250 companies granted such awards. Prevalence is expected to remain high for the foreseeable future as relative TSR awards continue to be advocated by proxy advisory firms and have strong external optics.

Among the Top 250 companies that currently provide relative TSR awards:

- 85% use relative TSR as a metric and 15% use relative TSR as a modifier
- 88% measure TSR using a component rank approach, while only 12% use the composite index method
- 71% combine relative TSR with another performance measure to determine award payouts



PREVALENCE

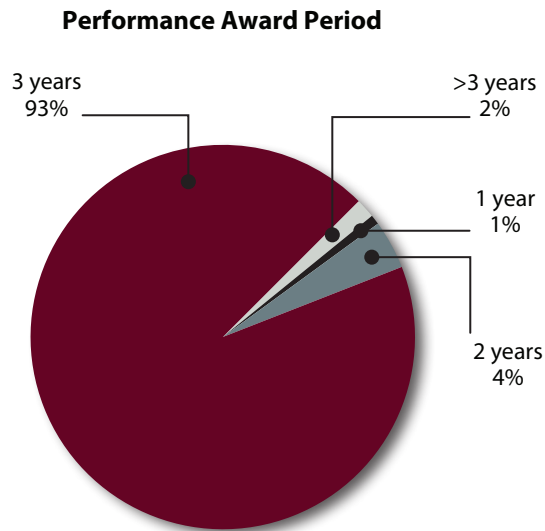
Grant type prevalence by industry sector, as categorized based on the Standard & Poor's Global Industry Classification Standard (GICS), is shown in the table below. Use of relative TSR awards tends to be widespread across industries, with at least one-third of all industry sectors providing such awards. The Energy, Utilities, and Telecommunication Services sectors exhibited the highest use of relative TSR awards, while prevalence was lowest among the Consumer Discretionary sector.

Prevalence of Relative TSR Awards by Sector		
Sector	Number of Companies	Percentage of Companies with Relative TSR Awards
Financial Services	49	41%
Health Care	36	44%
Consumer Discretionary	32	34%
Industrials	30	43%
Information Technology	30	50%
Consumer Staples	24	42%
Energy	23	78%
Materials	12	42%
Utilities	11	100%
Telecommunication Services	3	100%
Total	250	49% (122 companies)

Performance Period

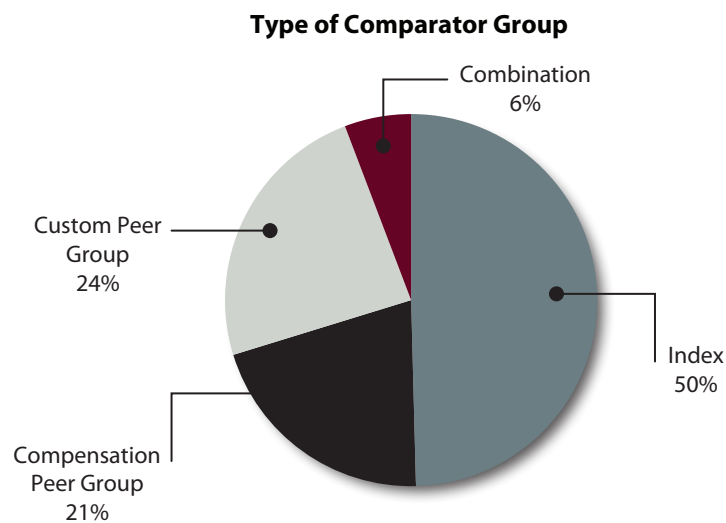
A significant majority of the Top 250 companies with relative TSR awards measure performance over a three-year period (93%). For companies with multi-year performance periods, relative TSR is most commonly measured on a cumulative basis over the entire measurement period, with only 4% using intermediate annual measurement periods and 3% using both an annual and a cumulative measurement period. The finding is not surprising given that relative TSR awards do not face the same long-term goal-setting challenges as plans that are based on operational performance objectives.

The most common practice is to distribute earned awards at the end of the performance period, although 12% of plans require additional time vesting after the end of the performance period before awards are paid out.



Comparator Groups

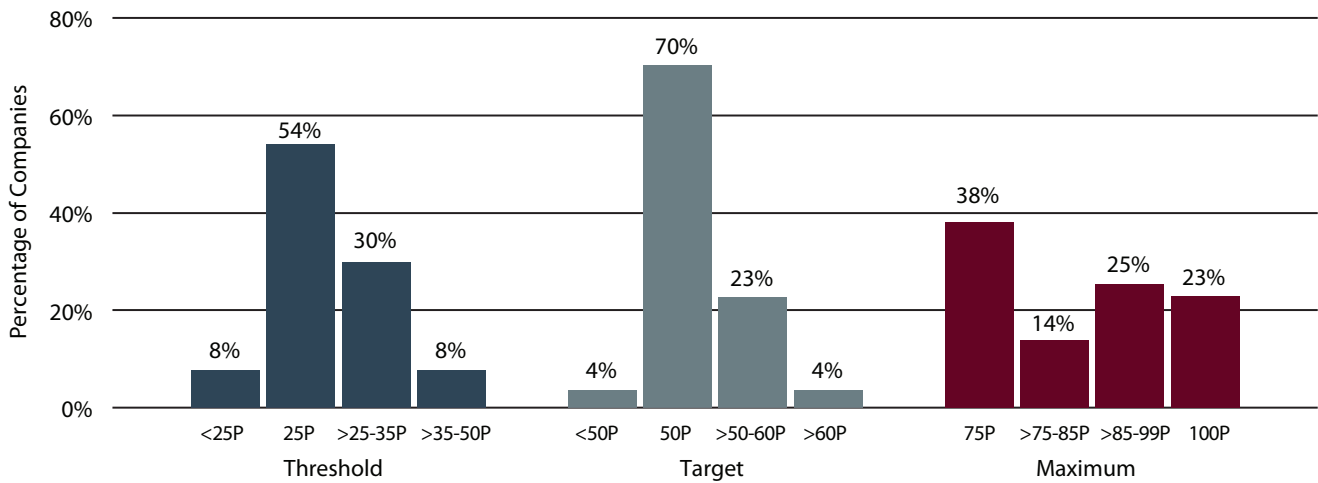
One of the challenges when designing relative TSR awards is developing an appropriate comparator group. Comparator groups typically consist of either an established market stock index or a predefined set of similar peer companies. Among the Top 250 companies, roughly half of relative TSR awards use a market stock index as the comparator group, while the other half are split between using the company's compensation peer group versus a broader custom relative TSR performance peer group. A handful of companies (6%) also measure performance against both an index and the compensation or custom peer groups. The most common index used by the Top 250 companies is the S&P 500, which is used by 50% of plans that measure relative TSR versus an index (of the companies that measure relative TSR versus the S&P 500, about half use an industry-specific cut of the S&P 500).



Component Rank Performance Goals

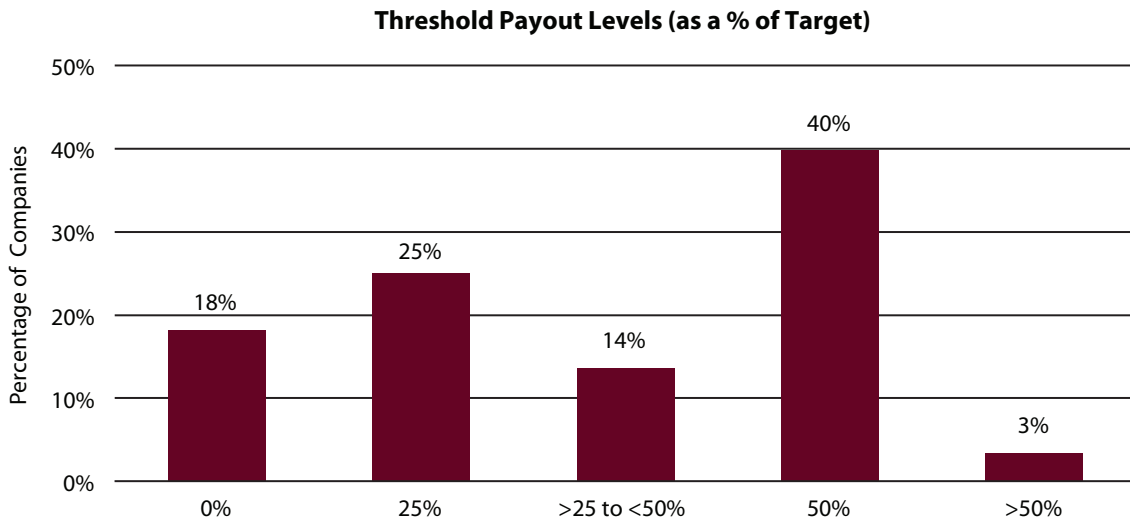
Relative performance goal levels used in the component rank approach vary by company, but the most prevalent levels for threshold, target, and maximum goals are set at the 25th, 50th, and 75th percentiles of the comparator group, respectively. Threshold and target goals are predominantly set within a tight range, with 84% of plans setting threshold goals between the 25th and 35th percentiles, and 93% of plans setting target goals between the median and 60th percentile. Practices are more varied for maximum performance goals, although all plans required top quartile performance to earn the maximum payout.

Performance Goals (Percentile Rank)

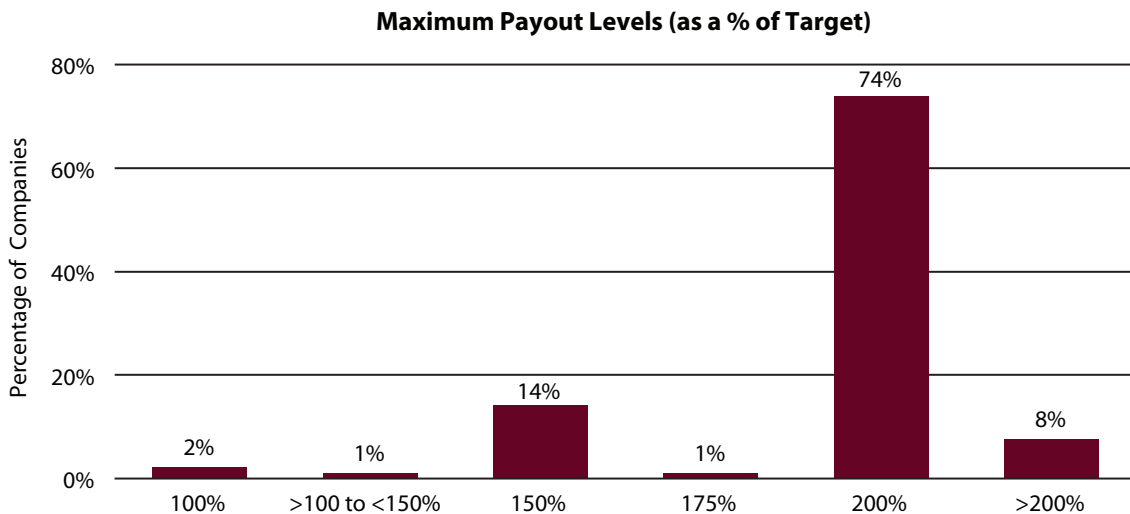


Performance Award Payout Levels

The majority of relative TSR awards among the Top 250 companies (79%) set threshold payout levels between 25% and 50% of target, with an overall average threshold payout level of 33% of target.

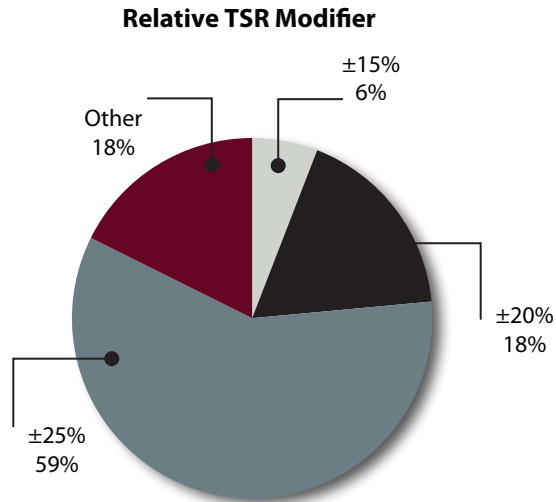


Just under three-quarters of relative TSR awards used by Top 250 companies (74%) set maximum payout levels at 200% of target. A maximum payout of 150% was the second most prevalent payout level at 14% of companies.



Relative TSR Modifiers

Relative TSR is used as a modifier in 15% of relative TSR awards in the Top 250 companies. For the vast majority of awards, relative TSR adjusts the final performance award payout up or down by 15% to 25%, with the most common modifier being $\pm 25\%$ (59%).



Changes to the Comparator Group

One of the key considerations when designing relative TSR awards is to determine how to treat mid-cycle changes to the comparator group. The treatment of peers that are acquired or go bankrupt during the performance period should be established upfront to avoid adverse accounting. Additionally, companies that measure TSR relative to an index will also need to determine how to handle changing index components due to reconstitution.

Peers that stop trading on a public market due to acquisition or privatization are often removed from the comparator group, while companies entering bankruptcy are generally maintained with TSR calculated as “-100%,” which reflects the true return for a shareholder that invested in the company prior to its bankruptcy filing.

For companies that measure performance against a market stock index, common practice is to define the comparator group as the index components at the start of the measurement period. Under this design, new entrants to the index are excluded, and peers that fall out of the index mid-cycle, but continue trading, are not removed from the group.

Stock Price Definition

A common design practice is to use an averaging convention when determining the beginning and ending stock prices used for TSR calculations. This helps neutralize or smooth the effect of daily stock price volatility as TSR is measured point-to-point and results can be misleading depending on the date of measurement. The most common practice among the Top 250 companies is to average stock prices over 30 calendar days.

Absolute TSR Cap

A growing design trend is to cap or reduce earned performance award payouts if a company’s absolute TSR performance does not meet a predetermined threshold level (27% of the Top 250 companies disclose the use of an absolute TSR cap). This is used as a mechanism to prevent excessive payments for executives if absolute shareholder return is poor, regardless of relative performance. Among the Top 250 companies, the most common design is to cap performance award payouts at target if absolute TSR is negative.

Capped Gain

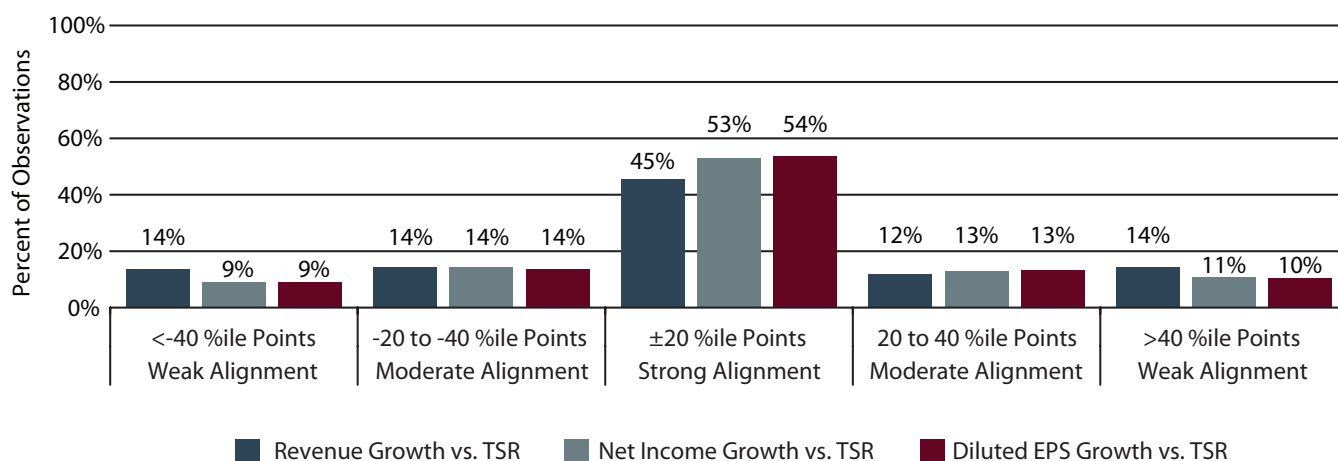
While still uncommon, “capped gain” provisions have started to emerge as a method to help control the accounting cost of relative TSR awards. This feature limits the payout value of earned performance awards to a multiple of the target award value, regardless of stock price at the end of the performance period (e.g., an LTI award with a target award value of \$1 million and a capped gain multiple of 5x is limited to a payout of \$5 million). Capped gain provisions are only triggered in extremely high growth scenarios, but work to reduce the P&L expense of awards.

RELATIVE TSR VS. FINANCIAL OPERATING PERFORMANCE⁴

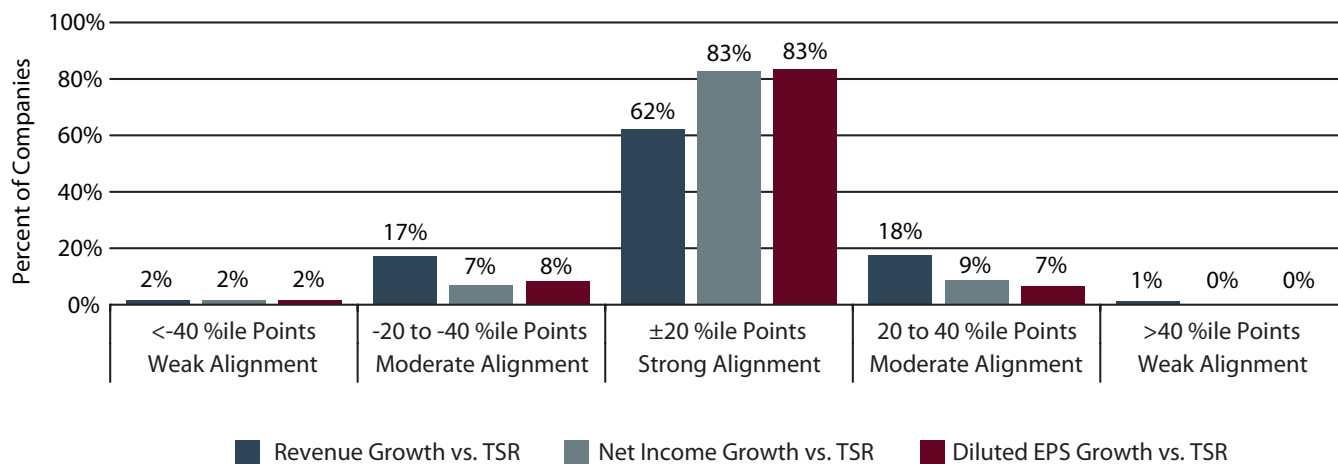
A review of relative TSR versus relative financial operating performance (defined as GAAP revenue, net income, and diluted earnings per share growth) over the last ten years indicates that, among the Top 250 companies, alignment between TSR and financial performance can be disconnected when measuring over shorter finite periods, but over time tend to be strongly correlated. When observing individual three-year performance cycles (top chart below), only about half of the observations show strong alignment. However, if rolling three-year periods over the last ten years are averaged for each company (bottom chart below), nearly all of the Top 250 companies exhibit at least moderate to strong alignment between TSR and financial performance.

The charts below measure the difference between the percentile rank of TSR among the Top 250 companies versus the relative ranking of revenue growth, net income growth, and diluted earnings per share growth.

Relative Operating Performance vs. TSR (Independent 3-Year Periods between 2003 to 2013)



Relative Operating Performance vs. TSR (Average of Rolling 3-Year Periods from 2003 to 2013)



⁴ Financial and TSR data gathered from Standard & Poor's Research Insight.

APPENDIX – COMPANIES WITH RELATIVE TSR PERFORMANCE AWARDS IN THE 2014 TOP 250

Accenture PLC	Delphi Automotive PLC	National Oilwell Varco Inc.
Adobe Systems Inc.	Devon Energy Corp.	Nextera Energy Inc.
Agilent Technologies Inc	Walt Disney Co.	Noble Energy Inc.
Alexion Pharmaceuticals Inc.	Dominion Resources Inc.	Norfolk Southern Corp.
Altria Group Inc.	Dow Chemical	Northrop Grumman Corp.
American Electric Power	E.I. DuPont De Nemours	Occidental Petroleum Corp.
American Express Co.	Duke Energy Corp.	PepsiCo Inc.
American International Group	Edison International	Pfizer Inc.
Ameriprise Financial Inc.	EMC Corp.	PG&E Corp.
Amgen Inc.	EOG Resources Inc.	Phillips 66 Co.
Anadarko Petroleum Corp.	Exelon Corp.	Pioneer Natural Resources Co.
Apache Corp.	Express Scripts Holding Co.	PPG Industries Inc.
Apple Inc.	Fifth Third Bancorp	PPL Corp.
Applied Materials Inc.	Forest Laboratories	Prologis Inc.
AT&T Inc.	Franklin Resources Inc.	Public Service Enterprise Group Inc.
Avalonbay Communities Inc.	Freeport-McMoRan Copper & Gold	QUALCOMM Inc.
Baxter International Inc.	General Electric Co.	Raytheon Co.
Becton Dickinson & Co.	Gilead Sciences Inc.	Rockwell Automation
Boeing Co.	HCP Inc.	Sempra Energy
Boston Properties Inc.	Hershey Co.	Simon Property Group Inc.
Boston Scientific Corp.	Hess Corp.	Southern Co.
Broadcom Corp.	Hewlett-Packard Co.	Spectra Energy Corp.
Brown-Forman Corp.	Ingersoll-Rand PLC	Suntrust Banks Inc.
Carnival Corp. PLC	Intel Corp.	Sysco Corp.
Caterpillar Inc.	IntercontinentalExchange Grp.	Target Corp.
Celgene Corp.	International Paper Co.	Time Warner Inc.
Centurylink Inc.	Intuit Inc.	Twenty-First Century Fox Inc.
Chesapeake Energy Corp.	Johnson & Johnson	Tyco International Limited
Chevron Corp.	Kraft Foods Group Inc.	United Technologies Corp.
Chubb Corp.	Lockheed Martin Corp.	Valero Energy Corp.
Cigna Corp.	Macy's Inc.	Verizon Communications Inc.
Cisco Systems Inc.	Marathon Oil Corp.	VF Corp.
Citigroup Inc.	Marathon Petroleum Corp.	Viacom Inc.
CME Group Inc.	MasterCard Inc.	Visa Inc.
Coca-Cola Co.	McDonald's Corp.	Vornado Realty Trust
Colgate-Palmolive Co.	Merck & Co.	Waste Management Inc.
ConocoPhillips	MetLife Inc.	Western Digital Corp.
Covidien PLC	Mondelez International Inc.	Weyerhaeuser Co.
Crown Castle International Corp.	Morgan Stanley	Williams Cos Inc.
CVS Caremark Corp.	Motorola Solutions Inc.	YUM! Brands Inc.
Deere & Co.	Mylan Inc.	

COMPANY PROFILE

Frederic W. Cook & Co., Inc. is an independent consulting firm specializing in executive and director compensation and related corporate governance matters. Formed in 1973, our firm has served more than 2,900 corporations, in a wide variety of industries from our offices in New York, Chicago, Los Angeles, San Francisco, Atlanta, Houston, Boston, and Tarrytown. Our primary focus is on performance-based compensation programs that help companies attract and retain business leaders, motivate and reward them for improved performance, and align their interests with shareholders. Our range of consulting services includes:

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- Change-in-Control and Severance
- Compensation Committee Advisor
- Competitive Assessment
- Corporate Governance Matters
- Corporate Transactions
- Directors' Compensation
- Incentive Grants and Guidelines
- Long-Term Incentive Design
- Ownership Programs
- Performance Measurement
- Recruitment/Retention Incentives
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- Restructuring Incentives
- Shareholder Voting Matters
- Specific Plan Reviews
- Strategic Incentives
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