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Five Investor Trends Driving Say-on-Pay Votes in 2017

Although the strong stock market in 2017 has provided a helpful start to the year for many companies, it has not curtailed investor focus on improving the corporate governance practices – from sustainability to board composition – of their portfolio companies. With 2017 annual meeting results already rolling in, early data suggests that one perennial topic remains top of mind for shareholders: executive pay. As the contours of this year's proxy season take shape, here are five compensation trends that boards and management teams should be aware of as they approach their annual meeting.

1. Relative Total Shareholder Return still matters to investors, but additional financial metrics are increasingly being considered

In the early years of advisory votes on executive compensation mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the evaluation of a company's relative Total Shareholder Return (rTSR) to CEO compensation became the primary metric by which investors determined alignment between executive pay and company performance. A major reason investors gravitated toward rTSR as a proxy for company performance was because of its relative durability as a metric that could be compared across companies, industries and market caps.

After seven years of say-on-pay votes, relative TSR is still the main yardstick for investors to evaluate company performance. However, today, there is a broad recognition that rTSR does not paint a full picture of how company performance informs compensation decisions. Corporate governance teams are looking at underlying operating and financial performance metrics such as revenue growth, EPS, and return on capital to better identify potential pay and performance misalignment. Proxy advisors have also changed their evaluation methods – beginning in 2017, ISS is including analysis of key financial metrics in its reports, including cash flow growth, EBITDA growth and several return metrics, in addition to the rTSR analysis.

2. Investors are seeking greater disclosure of company-specific context

As investors and proxy advisors apply more sophisticated techniques to evaluating pay and performance, it is increasingly important for companies to disclose more detailed contextual information about corporate performance and strategic direction in engagement meetings and public filings. In particular, investors want to see that incentive metrics are aligned with broader strategic goals and that performance goals and targets are appropriately rigorous. While many companies have shifted toward more formulaic incentive program models, institutional investors and proxy advisors alike are continuing to focus on compensation committee discretion in incentive payouts. Companies that maintain significant discretion over pay should ensure they are providing investors with clear and detailed disclosures about how performance drives compensation decisions.

3. Pay quantum has become a focus for more investors

Recently, some institutional investors have highlighted the total amount of executive compensation, and in particular CEO compensation, as an important factor in how they evaluate a company's pay program.

Historically, excellent performance provided significant latitude for companies to compensate executives at higher levels. In 2017, that dynamic appears to be changing. While this sentiment is beginning to be reflected in vote outcomes, there is not a broad consensus among investors as to how much is too much pay. For companies at risk of investor scrutiny of overall compensation levels, engagement and disclosure can give important clarity about the business context and performance rigor behind a pay package.

4. Environmental and social metrics are increasingly being included in compensation plans

The rising investor focus on environmental and social (E&S) factors has been accompanied by questions about how management teams are incentivized to achieve sustainability goals. This is particularly true in industries where E&S issues are considered material such as in the extractive, industrial, financial and technology sectors. Compensation committees that are considering incorporating sustainability into an incentive plan structure should think through which E&S issues are most relevant for their industry, which metrics to measure and how to evaluate and weight those metrics within the context of their broader compensation plan. Effectively communicating each of these elements, both in the annual proxy statement's Compensation Discussion and Analysis section and in engagement with company stakeholders, remains a key to successful vote outcomes.

5. Investor engagement remains critical, particularly in complex situations

Governance teams at large institutional investors receive thousands of requests to engage and meet with hundreds of companies per year. Given the volume of requests these teams receive, companies can no longer expect guaranteed meetings with all of their large institutional investors. Companies with complex business performance and strategy narratives, and those at risk of a challenging say-on-pay vote, need to be creative and diligent in their attempts to secure meetings with top investors. Direct engagement remains the best avenue for companies to communicate complex facts to their investors.

When it comes to executive compensation, boards of directors and senior management teams are well served by tracking these changes in investor sentiment and taking action to stay ahead of potential vulnerabilities. In 2016, more than 200 U.S. companies received say-on-pay votes below 70 percent. To help mitigate and avoid the potential for say-on-pay challenges in 2017 and beyond, companies should consider how investor trends may apply to them and continue to focus on strong disclosure, communication and engagement.

Christopher Wightman is a Partner at CamberView Partners.

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