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Viewpoint on Executive Compensation

Opinion Research Alert

Executive Compensation in the Manufacturing Sector: "The Rust Belt Transformed"

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Key Takeaways

- *Pay Governance analyzed the executive compensation practices of 175 publicly-traded manufacturing companies*
- *Annual incentive plans focus on profitability metrics and also include individual performance, strategic objectives and citizenship-type metrics*
- *Nearly half of long-term incentive value is now allocated to performance share/cash plans or performance vesting restricted stock*
- *Performance-based long-term incentives most commonly focus on capital return metrics, total shareholder return or profitability metrics*
- *Companies are adopting more rigorous performance standards in their long-term incentive programs*
- *While CIC protection remains prevalent, excise tax gross-up provisions are provided in only 35% of CEO agreements*
- *Clawback and anti-hedging policies have been adopted by a majority of manufacturers*

Introduction

A Pay Governance study of executive compensation programs at 175 publicly-traded manufacturing companies reveals that, despite a "rust belt" reputation, companies in this sector are employing not only contemporary program designs, but also leading edge solutions for ensuring pay and performance alignment. The current post-recessionary era has resulted in increases in pay opportunity and outcomes that are commensurate with an economic recovery. Total shareholder return for these companies has increased by nearly 20% on a compounded annual basis over the last three years. Strong financial and stock price performance has resulted in median increases in target total direct compensation of approximately 25%. These companies have experienced relatively strong Say on Pay support. The key findings of this study are discussed in more detail below.

Annual incentive design focus on profitability metrics. While no single performance metric represents a majority practice, income statement metrics are more common than capital-based metrics such as Returns on Invested Capital, Net Assets or Capital Employed. The most common profitability metrics are Operating Income, EBITDA, EBIT, and Net Income, as well as various forms of cash flow. Some manufacturers also include citizenship metrics, such as Safety and Environmental Compliance, which illustrate companies' philosophy of maintaining a safe workforce as well as being stewards of the environment. Individual performance or company "strategic objective" goals, which include operational metrics, are used by over one-third of companies. Two-thirds of the companies in our study use between two and four performance metrics.

Our study suggests that incentive goals at the target performance level typically reflect the company's business plan for the upcoming year and threshold goals most commonly reflect 80% of the target goal and maximum goals most commonly reflect 120% of the target goal. However, to address volatile economic conditions as well as the use of commodity materials in the

manufacturing process, wider performance ranges (i.e., 70% to 130% or 60% to 140%) are often used, especially for profitability metrics.

Long-term incentives (LTI) are trending toward greater use of performance plans. The use of performance-based LTI vehicles (performance share or cash plans or performance-vesting restricted stock) increased in prevalence from 64% in 2010 to 75% in 2012. The prevalence of companies granting stock options has declined slightly from 71% in 2010 to 68% in 2012. More importantly, the target value delivered through performance-based long-term incentives has increased dramatically from 39% of total LTI value in 2010 to 48% in 2012, as many manufacturers strive to assign at least 50% of the equity value to performance-based LTI vehicles. The shift toward a higher allocation to performance-based vehicles has come at the expense of time vesting restricted stock, as the weighting has slipped from 27% in 2010 to 21% in 2012.

Long-term performance plan designs focus heavily on capital return metrics with more rigorous performance standards. Our study found manufacturing companies typically rely on capital-based performance metrics (defined above) or Total Shareholder Return (TSR) in performance-based long-term incentive plans. While each of these types of metrics garners approximately 40% prevalence, profitability metrics (defined above) and Earnings Per Share are used in 31% and 21% of performance-based plans, respectively. Manufacturing companies are evenly split between using one or two metrics. Performance goals are typically based on internal goals, rather than relative comparisons to peer groups or indexes. When relative comparisons are used, custom peer groups are used more often than a broader index.

When focusing specifically on relative TSR plans, we found a shift toward more rigorous performance standards—performance levels at which threshold, target and maximum awards are earned were all higher than in 2010. For the first time in 2012, threshold performance was most often (65%) positioned at or above the 30th percentile. This reflects a dramatic increase from 2011 when the majority of companies (55%) positioned threshold performance at the 25th percentile. We also noted an increase in the number of companies positioning the target performance standard above the 50th percentile, with 33% of manufacturers targeting the 55th, 60th, or 65th percentiles compared to 21% a year ago. Performance levels at which maximum awards are earned are trending higher—we found 45% of manufacturers now require performance above the 75th percentile to earn a maximum award.

Change-in-Control protection remains highly prevalent in manufacturing companies; however, shareholders continue to pressure companies to adopt "best practices" for CIC arrangements. Approximately 88% of companies continue to provide CIC protection to executives, down from 91% last year. However, we have observed a clear decline in the generosity of CIC benefits. The majority (56%) of manufacturing CEOs continue to have CIC severance multiples equal to 3 times base salary and annual incentives (but down slightly from 59% last year). Excise tax gross-ups are now a minority practice with only 35% of companies (down from 40% last year) providing some form of gross-up to current CEOs. Further, approximately half the companies with an excise tax gross-up provision have disclosed their intent to eliminate the gross-up provision for any new executives or modified agreements. Approximately 60% of the companies accelerate the vesting of unvested equity awards upon a CIC (single trigger), while approximately 40% require both a CIC and termination of employment (double trigger).

CEO stock ownership guidelines are nearly a universal practice and reflect increasingly higher levels of ownership. Approximately 90% of companies currently have a formal stock ownership policy. The majority of companies require their CEO to hold five times their annual base salary; however, we observed an increase in the number of manufacturing companies requiring their CEO to hold six times their base salary or higher. Many companies specify a period of time, most commonly five years, in which to accumulate the ownership required under the guideline and

some companies require executives to retain a percentage of shares upon vesting or exercise (i.e., 50% to 100%) until the guideline is achieved. Relatively few companies have a retention requirement after the guideline has been met.

Perquisites have been rationalized and are no longer a significant component of the compensation package. Approximately 80% of manufacturers provide some type of perquisites to their CEO. Between 40% and 50% of manufacturing companies provide a company car/auto allowance and/or financial and tax preparation services for executives. All other perquisites are provided at less than one-third of companies. Additionally, fewer companies (7%, down from 10% last year) provide gross-ups to cover taxes on perquisites.

Clawback and anti-hedging policies are a majority practice. We found that 68% of companies disclosed some form of clawback policy to recoup or recover compensation due to a financial restatement or other event. Similarly, anti-hedging policies were disclosed by 60% of companies. Larger companies have led the market in adopting these policies and we believe their prevalence will continue to increase in the coming years.

This Viewpoint is intended to inform compensation committees, executives and compensation professionals about developments that may affect their companies and should not be relied on as providing specific company advice, or as a substitute for legal, accounting or other professional advice.

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