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Corporate Governance

Kepler Cheuvreux

ESG

Sustainability Research

Remunerations: Publish why you pay!

Sustainability Research

Remuneration: a proxy for strategy and risk

We see CEOs as risk-takers responsible for defining and executing strategy, but in some cases their remuneration packages can be considered to entail a degree of asymmetry between risk and reward, ensuring they are remunerated even if performance and shareholder value have declined.

Linking management incentives to key sector drivers

In this report we have focused on 12 sectors. Our first step is to identify the key issues driving each sector and the second is to link these drivers to appropriate financial measures that we believe will ensure that management incentives are correctly aligned with corporate strategy and sector key performance indicators.

Our top picks for aligning remuneration and corporate strategy

We highlight three companies: **BMW**, **Munich RE** and **Technip** as examples of companies that in our view demonstrate a consistency between our investment recommendation and management remuneration that is tied to long term sustainable risk and reward.

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Executive summary

Our research suggests that outside of the UK remuneration disclosure across Europe remains sporadic and uneven reducing the ability of shareholders to reach intelligent decisions on whether there is a sufficient correlation between corporate strategy and management performance.

Pay & display: time for transparent remuneration

Too many companies still provide insufficient information on remuneration, in terms of either actual pay out of total compensation (fixed and variable) or the absolute quantum that can be achieved at minimum and maximum target levels under variable award schemes. This lack of disclosure hinders investor understanding of how pay incentivises management to meet key objectives.

Beware of paying for only part of the cycle

In cyclical sectors, paying for performance across the cycle, not just in the upturn, should be a prime concern for investors. Our analysis highlights the difficulties in this regard, but we believe investors should engage with companies to ensure that management are rewarded for real sustainable performance over the cycle. A first step, in our view, would be to introduce longer holding periods post-vesting.

European bonus framework: could it do more damage?

The EU has agreed a cap on bonuses (100% of salary or 200% if shareholders approve) in the banking sector which we believe may have far-reaching consequences. We believe investors may question whether this decision effectively ends their ability (and legitimacy) to discuss and assess remuneration in this sector given the limits imposed by the EU.

Given the importance of the banking sector to the global economy and the use of public money to bail out this sector the decision by the EU to reduce the ability of executives to take excessive risks is understandable. However, the consequences of this proposal are in the first instance easy to comprehend and will involve further escalation in salaries for executives whose bonus capabilities have now been reduced. The consequences of further increasing fixed salaries will inevitably reduce the proportion of pay that is at risk for senior executives in this sector potentially undermining the point of the legislation as salaries become the new bonus?

Top picks for aligning remuneration and mgmt. performance

We consider **BMW, Munich RE** and **Technip** as our three top picks of companies that have incorporated innovative and longer term financial metrics within their remuneration structure that in our view reveals a clear consistency between our investment case and executive remuneration linked to long term sustainable performance.

In the case of BMW we applaud the use of a three year (backward looking) performance period for bonus awards coupled with a transparent simple long term incentive scheme that requires executive to use a proportion of their bonus to fund it with a matching element (20% of bonus) paid out after four years.

We note that Munich RE is the only company within our insurance coverage that uses a risk on adjusted capital (RORAC) target as a part of their remuneration structure and as part of their corporate targets communicated to the market. We welcome the use of RORAC as it not impacted by IFRS/US-GAAP accounting distortions.

Finally we highlight Technip, one of the only companies within our oil and gas services coverage to focus on gross margin on order intake as a part of their CEO's bonus. By focusing on the gross margin on order intake Technip ensures that their CEO will bid on contracts they believe will have a greater embedded margin value therefore ensuring higher visibility of potential contract profitability while reducing the risk of simply chasing contract volume at the expense of margin.

Remuneration: a proxy for strategy and risk

Within the financial sector the risks are clear: excessive remuneration potentially encourages dangerous risk-taking that can destroy shareholder value. However, in our view, remuneration has now become a significant proxy for a company's strategy and risk, and the issue is moving beyond the financial sector propelled by investor demands for clearer links between executive remuneration and corporate strategy.

In this report, we have primarily looked at the remuneration of key executives at board level. Nevertheless, the scandals at UBS and more recently JP Morgan highlight how understanding the pay and risk of employees below board level could help minimise the risk of destructive actions driven by excessive remuneration rewards that lack appropriately integrated mechanisms to reduce such risk taking. In other words, we believe there are a number of sectors where managers below board level are paid significantly more than key executives, while shareholders and the wider market have no visibility on the risks they are taking or on how their remuneration drives long-term value.

Show how you drive management performance

In our view, there is a starting level of discrepancy in disclosure on remuneration, particularly the specific performance measures used for long-term awards and the specific targets that equate to their vesting at threshold and maximum levels. We applaud companies that have taken the initiative to begin to highlight in a thoughtful way the rationale behind key executives' pay, but these companies are significantly limited in number.

Marks & Spencer a model for European companies to follow?

The UK continues to lead the way in remuneration disclosure

Chart 1: M&S variable remuneration policy 2012/13

Variable remuneration	Policy for 2012/13	Delivery in 2012/13
Annual Bonus Scheme: with compulsory deferral into shares	– drive profitability and strategic change across the whole organisation – stretching targets required to achieve maximum payment – Group PBT with an individual performance element linked to delivery of key strategic objectives. – aligned to shareholder interests through annual financial performance as well as delivery of the overall business strategy	– bonus potential of up to 200% of salary for 'maximum' performance – 60% of bonus based on Group PBT targets – 40% of bonus based on individual objectives – compulsory deferral of 50% of bonus earned into shares – deferred shares vest after three years, subject to continued employment
Performance Share Plan	– primary long-term incentive – link individual reward with long-term performance of the Company – aligned to shareholder interests and specifically with the Company's stated strategic objectives. – targets based on cumulative EPS (Earnings Per Share), ROCE (Return on Capital Employed), and Revenue growth across UK, International and Multi-channel business segments	– annual awards – plan provides for an individual awards of up to 300% of salary, although the Committee's intention is that awards will conventionally be referenced to 250% of salary. – awards may vest after three years subject to achievement of performance targets – each element of performance will be assessed independently

Source: M&S Annual Report 2012

In our view, M&S's level of disclosure on remuneration goes beyond what investors might typically see in other European markets. The table below shows the specific EPS and ROCE performance targets required to achieve pay-out under M&S's long-term incentive plans. This is the kind of disclosure we would like to see in other European markets.

Chart 2: M&S disclosure of long-term incentive award metrics

Performance Share Plan Awards 2012/13

For awards made in 2012/13, the performance metrics and targets are as follows:

Performance metric	Commercial rationale	Basis of measurement
EPS	Ensure focus on bottom-line performance	Based on cumulative underlying basic EPS over the three-year performance period.
ROCE	Rewards efficient use of capital	Vesting based on average ROCE (%) over the three-year performance period against pre-determined targets.
Revenue	Encourage top-line growth in line with business strategy	Based on strategic growth targets: – 10% on UK – 10% on Multi-channel; and – 10% on International

				Revenue (FY15 – £m)		
	% Vesting[1]	Cumulative EPS (p)	ROCE (%)	UK[2]	Multi-channel[3]	International[4]
Weighting (% of total award)		50%	20%	10%	10%	10%
'Threshold' performance	20%	110p	15.0%	£8,900m	£800m	£1,300m
'Maximum' performance	100%	130p	18.5%	£9,600m	£1,000m	£1,700m

1) % Vesting is a straight line between 'threshold' and 'maximum' performance.
2) Excluding Multi-channel.
3) Net of VAT/gross of returns.
4) Excluding Multi-channel/including Republic of Ireland.
The above targets do not take into consideration the change in the Group's accounting treatment referred to in note 29 to the financial statements on page 106 as this event occurred after the reporting period.

Source: M&S Annual Report 2012

Tell us what you've paid and to whom!

Outside the UK disclosure on remuneration varies in quality and quantity across Europe, with Spain and Italy being particularly problematic for those striving to ascertain the specific quanta paid to key executives. In our view, it would be helpful if companies simply disclosed a table showing the total remuneration (fixed salary, bonus, variable awards, pensions and other benefits) for key executives over the last five years. We believe this would provide a transparent and user-friendly guide with which investors could begin to assess remuneration.

Furthermore, we continue to believe that disclosure on remuneration paid to senior management below board level is a necessity that is frequently lacking, although we note that Spanish companies do regularly disclose this information in their annual reports (not always very prominently).

Regulation looms: empowerment or prohibition?

On Sunday 3 March 2013, Swiss voters opted to pass Europe's most stringent restrictions on executive compensation. The proposal was originally put forward by Thomas Minder.

Table 1: Minder proposals

Binding annual vote for shareholders on executives and board members
Elimination of golden hellos (sign-on bonuses) and severance packages
Elimination of extra incentives (departing or joining) for managers completing merger transactions
Sanctions for violations of rules: fines equal to 6 years' salary and prison sentences up to 3 years.

Source: Bloomberg

Despite some negative reaction to the Minder proposals, we see them as an appropriate response to shareholder concerns about remuneration in Switzerland. We believe that the decision by Novartis to pay out approximately USD78m to its departing CEO probably boosted support for these proposals in the eyes of investors and the Swiss populace as a method of curbing and providing more oversight over remuneration.

Furthermore, the Minder law empowers shareholders by giving them a binding vote on remuneration, while giving Swiss companies an opportunity to explain why they believe their remuneration policy to be appropriate and aligned with shareholder interests.

This is in stark contrast to the EU's recent decision to place absolute restrictions on the pay out of bonuses that can be made to employees in the banking sector at 1:1 or 2:1 subject to shareholder approval. We explain our view on this in the chapter on the banking sector later in this report, but we would highlight that, by doing this, the EU is reducing the power of shareholders in the banking sector to determine, monitor and reward executives for their performance. In fact, in our view shareholders may potentially view the cap as essentially removing them from the discussion on pay in this sector.

Investors may question whether the EU prohibition on bankers bonuses essentially removes them from the discussion on pay in this sector

Fixed vs variable: no common approach for remuneration at 'risk'

A key consideration for investors looking at remuneration is the proportion between fixed salary, short-term and long-term awards; this proportion is important because it highlights the level of remuneration that is truly at risk from poor performance. Generally, a good remuneration plan should load the majority of remuneration between the bonus and long-term awards, preferably with the long-term awards making up the bigger proportion to ensure that management and shareholder interests are focused on long-term profitability and performance.

Outside the UK, disclosure on the proportion of fixed and variable pay is limited and it is clear that greater transparency on this would be a useful indicator for investors seeking to understand the extent to which executive pay is truly risk-adjusted across Europe.

Linking sector drivers to mgmt. performance

In our view, the remuneration debate needs to become more expansive particularly given the introduction of binding say on pay votes in a number of European jurisdictions. As such, we believe this report is a first step in helping investors to achieve a much broader discussion with companies about how their strategy and risk are reflected through management compensation.

The point of this report is not to focus on quanta paid to management, though that is important. Instead, we believe that by highlighting for investors the key risks and drivers facing the sectors where their companies operate will help them to initiate a much needed broader dialogue with companies concerning the rationale behind the management incentive measures used to drive bonus and long-term performance.

The intention of this note is to sketch out broad themes with which to assess companies…

Furthermore, we believe that by focusing on the key drivers facing companies and sectors it is easier for investors to identify where there are potentially disconnects between what the company is telling the market and the incentives that it is using to drive performance and reward for management.

…but some themes may not always be appropriate

Nevertheless, companies all have their own specific circumstances and the intention of this note is to provide broad themes that could be applied to companies, while bearing in mind that some themes may not always be relevant.

A framework for remuneration…

In our view, the types of remuneration measures used by management can be divided into six categories:

Top-line criteria. In accounting terms, revenue essentially represents the line reported at the top of an income statement. Measures that drive top-line performance include organic growth, return on sales targets, etc.

Profitability criteria. Measures such as EBIT, EBITDA, ROE, are essentially encouraging management to grow profits as well indicating to investors and the market a view of the value-creation capabilities and underlying performance of a company.

Operational targets. Cost cutting, debt reduction.

Shareholder value creation. ROCE, FCF, TSR: these measures indicate management efficiency in terms of capital and acquisitions, total return to shareholders and ability to pay remuneration to shareholders via dividends based on free cash flow.

Risk mitigation criteria. Typically non-financial measures designed to reduce management capabilities to take risks such as deferred periods for bonus and share awards, malus and claw-back provisions.

Sustainability criteria. This can be viewed as a proxy for sustainable long-term performance and extra financial risk mitigation. They include measures such as health & safety targets, environmental performance, employee satisfaction, etc.

Commonly used measures

Table 2: Key financial measures: definitions

Measure	Comment
Earnings before interest & tax (EBIT)	Also known as operating profit: a company's earnings at a particular time minus interest payments on its debt and payment of tax.
Earnings before interest, tax, depreciation and amortisation (EBITDA)	A measure of a company's operational profitability over time while excluding potential distorting effects of changes in interest, taxes, depreciation and amortisation, which can all be manipulated by financing and accounting decisions. Or to put it more simply, earnings before the effects of financing and capital investment decisions
EBIT margin/operating margin	Also known as operating profit margin. How much money a company makes before interest and taxed on each dollar, euro, pound of sales.
Earnings per share (EPS)	Proportion of a company's profit allocated to each outstanding share of common stock.
Free cash flow (FCF)	Cash that a company is able to generate after spending the capex required to maintain or expand its asset base
Economic value added (EVA)	The profit earned by a company minus the costs of financing its capital.
Internal rate of return	The rate of growth a project is expected to generate. The higher a project's rate of return the more likely it is that the project will be chosen as it is likely to provide stronger growth.
Net debt	Debt held by a company after subtracting cash and cash equivalents from long and short-term borrowings.
Net profit (net income)	Profit after deducting all costs and expenses. This profit can then be reinvested to grow the company (retained earnings) and/or used to pay a return to the company's owners or shareholders (dividends).
Operating cash flow	A measure of the amount of cash generated by a company's normal business operations
Operating earnings	Profit earned after subtracting non-operating income or more simply subtracting from revenue those expenses that are directly associated with operating the business (e.g. cost of goods sold, administration, marketing + other general operating costs).
Organic growth	Growth rate that a company can achieve by increasing output and enhancing sales excluding any profit from takeovers, acquisitions or mergers.
Price to earnings ratio (P/E)	The P/E ratio highlights how much investors are willing to pay for a share relative to a company's earnings.
Return on capital employed	Measures how efficiently management are generating earnings from their capital investments.
Return on equity (ROE)	The proportion of net income returned as a percentage of shareholders' equity. ROE essentially measures how much profit a company is generating from the money shareholders have invested.
Return on investment	RIO is the ratio of money gained or lost on an investment relative to the amount of money invested.
Return on invested capital	Calculation of a company's efficiency at allocating capital it controls to profitable investments.
Total shareholder return (TSR)	TSR combines share price appreciation and dividends (the portion of corporate profits paid out by a corporation to its shareholders) to show the total return to shareholders. Or to put it another way, TSR is essentially a measure of how the market evaluates the overall performance of a company over a specified period.
Weighted average cost of capital	WACC measures a company's cost to borrow money given the proportional amounts of debt and equity a company has taken on (essentially the company's capital structure which can include bonds, preferred and common stock). Generally the higher the WACC the less likely it is that a company is creating value as it has to overcome higher borrowing costs to make a profit.
Working capital	A balance sheet term that is used to indicate the capital used in the company's ordinary operations and includes trade receivables, inventories, and the net of other receivables and payables, less trade payables.

Source: Kepler Cheuvreux

Table 3: Key management drivers identified in our research

Sector	Short-term variable key mgmt indicators	Why do we think it's important?	Long-term variable key mgmt indicators	Why do we think it's important?
AUTOS	Free cash Flow & ROCE	Free cash flow directly correlated to the ability of a company to generate cash and therefore profits. Added upside is the potential for dividends while highlighting the effective strength of the balance sheet. The use of ROCE focuses management on capital efficiency, which is important given the cyclical nature of the sector	Return on sales & EBIT	In this sector increasing profitability without sacrificing pricing power will increase return on sales and therefore free cash flow which potentially means a higher sustainable dividend for shareholders.
BANKS	Malus, claw-back system	Given complexity of sector we believe investors should focus on measures designed to reduce risk by ensuring that money earned for unsustainable behaviour can be recouped in future years.	Return on equity (ROE), Capital ratio	Forces banks to outline to investors net income generated based on the equity provided by shareholders. In addition, we would propose some form of capital ratio measure to ensure that management do not take risks by leveraging their balance sheet in order to generate returns.
CAPITAL GOODS	ROCE, Sales/Operating profit and net profit typical measures for short term incentive awards	Visibility on operating profit, return on sales, net profit and return on investment are important for investors. Also, investors are paying more attention to efficiency of capital employed.	Organic growth Cash conversion (FCF/EBITDA) or (FCF/Ebit) Cash return on capital employed (FCF/Capital employed)	Highlights growth achieved by increasing output and enhancing sales but excluding profit from takeovers, acquisitions or mergers. How much operating profit is converted into free cash flow. Highlights the extent to which capital employed (investment required for a business to function) is converted into free cash flow.
CHEMICALS	ROCE	Ensures that management are more disciplined with capital expenditure in a sector where investment projects have a long cycle (2-5 years).	Share price appreciation	Longer-term incentive awards are typically driven by share price in this sector. We believe investors should highlight to companies the need for management to use their own money or a proportion of their bonus as entry to share incentive plans to better align the interests of management and shareholders.
INSURANCE	Operating profit	Most commonly used measure under bonus and long-term incentive schemes in this sector but has no definition under IFRS which means it can be manipulated by companies and it not externally audited. However, introduction of IFRS 2 will allow for a common approach.		

Source: Kepler Cheuvreux

Table 4: Key management drivers identified in our research (continued)

Sector	Short-term variable key mgmt indicators	Why do we think it's important?	Long-term variable key mgmt indicators	Why do we think it's important?
LEISURE	Room rate growth/franchise growth (Hotels)	The new model for hotels is franchising so the number of new rooms and hotels under franchise are key metrics that we believe should be integrated into management remuneration	ROCE (Hotels)	Given new franchise model disposal of assets is key and ROCE is a good measure to use to ensure management are doing this in a way that doesn't destroy value.
	Return on renewal of contracts (Gaming), Return on Capital (Gaming)	Efficient capital allocation is vital given the cyclical nature of the gaming business. Return on renewal of contracts would highlight management's ability to maintain and win profitable contracts while return on capital would focus management on capital allocation efficiency.	EBITDA (Gaming),	Good indicator of management's ability to generate cash given the significant upfront capital investment required. We note that EBITDA is typically used in long-term incentive plans.
			Debt (Gaming)	Given the cyclical nature of the business, we suggest debt as an additional measure to ensure management are not overly focused on generating cash through excessive returns that are not sustainable over the longer term. As such, management taking on concession agreements with a high EBITDA based on a high capital expenditure would be highlighted in the net debt.
LUXURY GOODS	Return on Investment	Good way to assess profitable top line growth that is sustainable with less capital expenditure; e.g. possible to compare capex spent with growth in network.	Share price appreciation	Shares are not widely used in the luxury goods sector especially at the larger companies, as family owners typically do not want to dilute their stakes.
METALS & MINING	Working Capital Efficiency	We believe companies in this sector need to integrate working capital into management incentives. In our view, improving working capital is a much more transparent measure of what management are doing to improve receivables and payables (being tougher on suppliers, etc) and improving credit lines, which in our view highlights good management.	ROCE	Given investor expectations for capital efficiency, ROCE is clearly a measure that should be incorporated into management incentives particularly for longer-term share-based awards in this sector.
	Net debt	Shareholders are focusing on shareholder returns in the form of dividends. As such, net debt reduction targets should also be integrated into management compensation (particularly steel producers) to ensure that dividends are sustainable and can be covered from earnings and cash flow.		
	Safety	In addition, safety targets should be clearly integrated into management compensation as increases in fatalities can have a reputational risk.		

Source: Kepler Cheuvreux

Table 5: Key management drivers identified in our research (continued)

Sector	Short-term variable key mgmt indicators	Why do we think it's important?	Long-term variable key mgmt indicators	Why do we think it's important?
OIL & GAS	Operating cash flow margin	The margin on oil produced (another way to think about it is net income per barrel of oil produced). We believe the movement towards operating cash flow margin targets improves visibility for investors as the previous production targets (based on volume production) were often overoptimistic in their oil production guidance, and the market was therefore often sceptical over whether companies would actually meet production targets.	Mid-cycle ROCE Target	We believe investors should therefore be encouraging companies in this sector to provide a cleaner ROCE target that removes external effects that cannot be influenced by management. In our view, a ROCE target that is tracked over a five-year average period and that has had certain external effects such as oil price movement and FX removed would provide a cleaner mid-cycle ROCE that would assess management's ability to complete capital projects on time and on budget.
OIL SERVICES	Gross margin on order intake (Engineering and Construction)	A clear danger for investors in this sector is companies chasing contract volume that does not earn back the cost of capital over the course of the contract. Looking at gross margin on order intake (the growth in embedded margin of the contract backlog) essentially allows visibility on the quality of the backlog, which may reduce contract volume but ensures that such contracts are profitable over the long term.	EBITDA, EBIT, net income growth, cash flow from activities, ROCE, safety (TRCF) and TSR	Operational profitability and cash flow/capital efficiency are useful and valid metrics. However, we note that for investors EBITDA is the key metric for appraising the profitability of a company given that it's linked to cash generation.
	EBIT & free cash flow (seismic companies)	Here backlog visibility on contracts is limited given that contracts typically last an average of 5-6 months. As such, EBIT progression and free cash flow are more useful metrics.		
PHARMA	In-licensing	Allows investors to assess management performance over a shorter scale. In-licensing allows management to buy or licence products from third parties that may be underestimated by the market, e.g. Bristol Myers.	Share based awards	We are not sure whether long-term incentive awards are appropriate in this sector given the long cycle for drugs, which means that executives may be overly rewarded at the upper part of the cycle.
	Out-licensing	Out-licensing allows pharma companies to reduce the risk of drug failure by sharing costs (R&D, marketing) with other companies. However, while costs can be shared so will any resulting profits.		
SEMI CONDUCTORS	EBIT margin (manufacturing) EBIT margin & free cash flow (fab-less)	Good view of operational profitability and cash generation/profits. In our view, a 3-year rolling average performance cycle dampens the effect of management benefitting to the full extent from one-off (top-of-the-cycle) performance. This would ensure that the effects of a one-off (bumper) year are dampened to an extent.	ROCE, FCF & Operating profit margin	We consider ROCE, FCF and operating margin to be three important measures for manufacturing companies in this sector. They potentially focus management attention on: 1) capital efficiency; 2) shareholder remuneration in terms of the potential dividends payable if sufficient cash generation or profits are achieved; and 3) core profitability (by focusing on operating margin) across the 4-5 year cycle.

Source: Kepler Cheuvreux

Watchlist

Table 6: Remuneration watchlist

Sector	Company	Momentum	Comment
Auto	Daimler	Neutral	**Overly generous payout at maximum may potentially encourage short-term management behavior** Bonus awards based on a 2 year performance period with an overly generous payout at maximum (200%), which in our view could encourage short-termism. Long-term awards are linked to average return on sales which utilises a weak peer group, in our view.
Auto	VW	Neutral	**Bonus payouts may not be as challenging given VW's exposure to China** Bonus awards partly based on operating profit from China JV, which could be viewed as too easy given that VW has significant revenue exposure to its Chinese JV. Long-term awards potentially over-encourage management to chase volumes, but we believe that the 2018 pre-tax return target of 8% essentially acts as a safety valve by ensuring management are not overly focused on volumes at the expense of pricing, which would reduce pre-tax returns.
Capital goods	Legrand	Neutral	**Unclear bonus rules given margin expectations** Bonus rules are unclear to outsiders. However, there is an interesting long-term aspect in the stock performance plan. Group performance targets are defined annually (no multi-year programme), usually targeting growth and margin performance. However we expect margins to be flat between 2011 and 2013E and it is unclear whether this will be reflected in bonus payouts.
Capital goods	Rexel	Negative	**LTIP could be viewed as a little short-term given two-year performance period** Interesting mix of different criteria for free shares, but many not specified for the bonus awards. Performance criteria under the long-term incentive plan looks quite short-term focused given the two year performance period.
Chemicals	DSM	Positive	**Integration of CO2 target into long-term compensation** DSM is the only company that integrates a greenhouse emissions target into its long-term incentive plan. This performance target equates to 50% of the award, which ensures that key management are likely to take it seriously given its impact on the vesting of share awards.
Chemicals	Wacker Chemie	Neutral	**No evidence of a performance-related share plan** Based on the company's disclosure, there does not appear to be a performance-related share plan in place at Wacker Chemie. Instead, directors are required to use their annual bonus (15%) to purchase shares, which must be held for two years.
Construction	FCC	Negative	**Low correlation between operating performance, share price and compensation** We have concerns over the way in which management are incentivised at FCC, particularly the low correlation between operating performance, share price and compensation. We highlight management's recent remuneration, whereby they earned more in FY 2011 (EUR11.4m) than in FY 2008 (EUR10.6m) despite the substantial earnings decline from EUR337m in 2008 to EUR108m in 2011.

Source: Kepler Cheuvreux

Table 7: Remuneration watch list continued

Sector	Company	Momentum	Comment
Construction	Fraport	Negative	**Use of ROCE under LTIP to force management to think about capital efficiency** We believe the ROFRA performance measure (return on Fraport assets), basically a ROCE-type performance measure used under the LTIP, is too small a measure, with too much orientation on peer groups, which we believe may be a concern for some investors. As such, we believe that ROCE should account for a larger proportion under the LTIP as it would force management to consider more carefully how it will generate returns on the capital invested before such investments are made by Fraport (i.e. encourage them to be more efficient with capital allocation decisions) particularly as it is increasingly keen to invest abroad.
Luxury Goods	Swatch and Hermes	Negative	**Black box concerning management remuneration** Both companies in our view offer a black box in terms of investor communication from senior and top management on remuneration, which makes it impossible for investors to understand how management are remunerated according to specific performance measures.
Metals and Mining	Anglo American	Neutral	**Investors should be cautious on safety and capex** After several years of favourable trends in key health and safety indicators we saw a negative trend in fatal-injury frequency rate (FIFR), lost-time injury frequency rate (LTIFR) and the total recordable case frequency rates notably due to a deterioration in activities in South Africa. Furthermore, in terms of capex, we note that the mega project in Brazil Minas-Rio was over budget and management should therefore be cautious about taking on any future mega projects of this type.
Oil & Gas	Royal Dutch Shell	Positive	**Bonus awards linked to sustainable development and capital efficiency** Bonus awards are split between three components: cash flow (30% of score card), sustainable development (20%) and operational excellence (50%). Investors should note that the sustainable development measure for 2011 includes explicit references to safety, energy efficiency and water use. Furthermore, under the operational excellence performance measure, we welcome the mention of project delivery in term of Shell's
Oil & Gas	ENI	Negative	**Use of EBITDA may make management performance less challenging** In our view, the use of an EBITDA target for long-term awards in this sector is a surprise, given that it potentially allows an oil company to switch to a higher-tax region, which should reduce profits (given the higher tax); however, by using EBITDA, the tax implications are ignored, meaning that executives are more easily able to achieve their EBITDA targets even if performance hasn't actually improved because the reported profitability is not reflective of the actual tax implications.
Oil & Gas Services	Technip	Positive	**The only company to include a measure assessing backlog quality as part of CEO bonus** A key concern for investors in this sector is the chasing of volume (contracts) at the expense of cost of capital. Technip's integration of backlog quality into performance measure for the CEO's bonus via the use of gross margin on order intake is an interesting and unique concept, on which investors are now focusing.
Oil & Gas Services	Saipem	Negative	**Lack of assessment of backlog quality as part of management remuneration a key concern for investors** The absence of backlog quality as a metric within management compensation should be a concern for investors, given the recent announcement concerning the quality of the backlog, which comprises a number of low-margin projects given their focus aggressive focus on volume of contracts.
Semiconductors	ASML	Positive	**Despite lack of disclosure on remuneration, we believe management awards are aligned sufficiently with shareholder interests** Despite the lack of disclosure, we believe that management remuneration is aligned sufficiently with shareholder interests. Our view is based on two facts: first, management compensation has not been excessive in peak years at the top of the cycle; second, compensation has remained reasonable despite significant share price developments.

Source: Kepler Cheuvreux

Autos & Suppliers

Main drivers

Cyclical

The autos sector is rather like the banking sector in terms of its cyclicality, which means that companies within the sector may make profits in one year and lose money the following year.

Regulatory

We believe that additional regulatory standards on emissions and safety will increase fixed costs. In our view, the main regulatory driver for this sector will be in emissions reduction, primarily the carbon footprint of fleet vehicles.

Management key performance indicators

Value creation metrics: FCF, ROCE, EBIT and margins

We recommend that investors focus on value creation metrics when assessing management performance. We believe free cash flow (FCF) and return on capital employed (ROCE), EBIT and margins are the main performance measures. We think that variable remuneration should take into account historical performance (look-back) when making awards. Our research suggests that the three biggest operators in this sector, BMW, Daimler and VW, have begun to take this issue seriously.

Short-term variable awards

FCF and ROCE are optimal performance measures for short term variable awards.

We believe that both FCF and ROCE should be used in the annual bonus element of variable compensation as well as the long-term element preferably over a five-year rather than a three-year period. In our view, FCF is probably the most difficult metric to manipulate and this is evidenced by the record cash returns in the form of dividends set to be paid out in this sector during 2013. As such, the level of cash returns highlights the effective strength of balance sheets within the Autos sector.

Investors look at margins, although in our view they are an easy metric to manipulate, as management can manipulate the P&L by removing things they don't like from margins. As such, we believe investors should be concerned about companies that have very strong margins but don't generate cash: Daimler is a good example of this.

Long-term variable awards

Focusing on FCF ties management and shareholder interests over the longer term

A key component for investors when looking at the autos sector is the return on sales or the margin. In our view, there is a logical progression from margins to total shareholder remuneration, reflecting how shareholders can participate in the increasing value of a company.

At its simplest, managers who are able to sell more cars profitably without sacrificing pricing power will grow their free cash flow by increasing their return on sales, which means they can pay a higher sustainable dividend to shareholders. Furthermore, we recognise that EBIT margin also serves as a (P&L) surrogate for free cash flow margin and is viewed as a key metric by the capital market in order to judge a company's operational performance in its sector and hence to price shares.

Therefore, the two key elements that drive shareholder return, stock appreciation and dividend, can be balanced alongside management incentives. As such, we consider that remuneration policies that focus longer-term variable remuneration on return on sales and EBIT margin, while incorporating a dividend component, are positive for establishing sustainable long-term performance.

Keep an eye on...

BMW, Daimler and VW, the three big players

In our view, it's worth looking at BMW, Daimler and VW as the three most prominent companies in the European autos and suppliers sector. We believe investors should be aware of the need to focus remuneration over the entire cycle and not just in the upturn.

BMW

BMW has two sub-elements for its variable bonus based on corporate and personal performance, both of which are equally weighted. The corporate performance element is linked to group net profit and post tax return on sales and the level of the dividend with actual pay out based on multiplying the target amount fixed for each member of the board of management by the earnings factor and by the dividend factor. We note that the personal performance-related bonus is based on sustainable and long-term business development.

Variable awards: bonus targets set over 3 years and integrate sustainability

What is innovative, in our view, is that the performance targets set for the bonus have been set in advance over three years with pay out derived by looking back at the historical target vs. the actual target achieved.

The key risk for investors is the potential for excessive focus on volumes in order to achieve pay outs under the bonus. However, the short-term risk of favouring volumes above all else is hedged by the three-year delay before success is judged. As such, the use of essentially a three-year target period means that management must focus on the long term in order to achieve pay outs over the three-year target period under the annual bonus. In essence therefore, the bonus scheme is operating as a quasi-long-term incentive plan encouraging management to focus on the medium term. More importantly, the use of sales and dividend metrics under the bonus clearly establishes a congruency between shareholders and management via total shareholder return.

Share-based remuneration not linked to specific performance targets despite four-year holding period

Share-based awards are not linked to specific performance targets: instead, management is required to invest 20% of bonus awards in AG common shares, which are matched after a four-year holding period. After this period, participants can receive an additional share for every three common shares held.

In our view, the four-year holding period and the requirement for a 20% contribution from management via their bonus establishes an additional long-term performance element that investors should consider as positive.

VW: bonus award based on two years' performance – positive

Variable awards: bonus linked to operating profit in China

We view as positive the introduction of a minimum performance floor below which no bonus is paid (via a capping mechanism that is not really explained) and maximum theoretical cap for bonus awards.

Variable short-term awards are linked to the two-year average operating profit, including VW's share of operating profit from its joint venture in China, which contributed c.30% of operating profit (EUR 3.7bn) in 2012[1].

In our view the bonus element used by VW is a little more short-term orientated than that used by BMW, given its two-year reference period and the fact that VW has significant revenue exposure to China via its joint venture.

Under its long-term incentive system (LTI), VW deploys a number of benchmarks to award shares, including customer satisfaction, unit sales growth and the 'return index', which is derived from the evolution of the return on sales (which is derived from overall 2018 strategy: pre-tax return target of 8%) and dividend per ordinary share.

We presume there must be a set of internal milestones that are used to determine whether performance targets under the LTI are on target to meet the objectives of the 2018 strategy. We note that under this strategy, VW declared its intention to sell at least 10m units and be the biggest OEM.

The LTI is potentially overly focused on chasing volumes...

In our view, the problem with the LTI is that it is overly focused on chasing volumes (size). This doesn't necessarily tally with sustainable performance, as volume may come at the expense of pricing. Chasing volume is relatively easy, but building up a sustainable price point for VW's cars is much harder.

... However the 2018 group pre-tax return target of 8% essentially acts as a safety valve...

...By making it more difficult for mgmt. to sacrifice pricing for volume

Nevertheless, we note the potential safety mechanism in the 2018 target which is the pre-tax return of 8% for the group as stipulated under VW's 2018 strategy. In our view, this is essentially a capping valve for management as it ties the volume target to a returns target (which implicitly ties into the ability to pay out dividends) making it much more difficult for management to sacrifice pricing for volume, as lower prices reduce pre-tax returns in the long term and hamper the company's ability to pay out a dividend and achieve the pre-tax return target of 8% by 2018. As mentioned previously, this again aligns management and shareholder interests by ensuring that management is not overly focused on volume at the expense of pricing.

[1] The revenue from the Chinese JV has not been fully consolidated, so the calculation for the bonus award utilises an economic rather than accounting (consolidated) scope.

Daimler: weakest remuneration scheme of the three, especially bonus

Variable bonus awards are 29% of total remuneration with pay outs linked to whether the actual EBIT performance achieved, met the target and was ahead of the previous financial year. As such, the bonus element has two checks given the look-back element, which operates as a malus to ensure sustainable performance. However, we note that the two reference points, current financial year and the previous financial year, relate to half the bonus, allowing for awards of up to 200% of salary. In our view, this gives management a much higher incentive to pursue short-termist strategies to achieve the higher bonus pay out even with the attached malus.

Daimler's variable compensation is much too short-term orientated

Under the performance plan, 50% of awards are based on a comparison of the average return on sales over a three-year period compared with the sales of a group of competitors: BMW, Fiat, Ford, Honda, Paccar, Renault, Toyota, Volvo and Volkswagen.

The remaining 50% is based on the group's return on net assets in relation to the cost of capital or value created by the group. Upon pay out under this plan, 50% of the award has to be reinvested in Daimler shares and held for four years.

In our view, the inclusion of Fiat, Ford, Honda and Renault may make the peer group far too easy for Daimler management to achieve their return on sales target, as they bring down the average, making the hurdle too low. We believe these three companies should be removed, to create a more robust return-on-sales target.

Daimler's long-term performance plan utilises a very weak peer group

As such, despite the additional requirement to reinvest 50% of the cash derived from the performance plan into shares, the weakness of the peer group under the performance plan should be a significant concern for investors.

Table 8: remuneration matrix BMW, Daimler and VW

Company	Bonus	Stock performance plans performance period
BMW	The bonus is made up of two components, each equally weighted: **a corporate earnings-related bonus** and **a personal performance-related bonus.** The target bonus (100 %) for the Chairman of the Board of Management is EUR 3 million p. a. and upper limits for the amount of the bonus are in place for all Board of Management members (250 % of the relevant target bonus). The corporate earnings-related bonus is based on the BMW Group's net profit and post-tax return on sales (which are combined in a single earnings factor) andthe level of the dividend (common stock). The corporate earnings-related bonus is derived by multiplying the target amount fixed for each member of the Board of Management by the earnings factor and by the dividend factor. In exceptional circumstances, for instance when there have been major acquisitions or disposals, the supervisory Board may adjust the level of the corporate earnings-related bonus. The personal performance-related bonus is derived by multiplying the target amount set for each member of the Board of Management by a performance factor. We note that performance factor criteria includes: innovation (economic and ecological, e.g. reduction of CO_2 emissions), customer focus, ability to adapt, leadership accomplishments, contributions to the Company's attractiveness as an employer, progress in implementing the diversity concept and activities that foster corporate social responsibility	Share-based remuneration plan: Cash remuneration component Requirement for board of management members to each invest an amount equivalent to 20% of their total bonus (after tax) in BMW AG common stock. Earmarked cash remuneration equivalent to the amount required to be invested in BMW AG shares, plus taxes and social insurance contributions. Share-based remuneration component (matching component) Once the four-year holding period requirement is fulfilled, board of management members receive for each three common stock shares held either – at the company's option – one further share of common stock or the equivalent amount in cash, unless the employment relationship was ended before expiry of the agreed contractual period.
Daimler	Annual bonus is linked to the operating profit of the Daimler Group (EBIT). For the past financial year, the annual bonus was also linked to the target for the respective financial year determined by the supervisory board (derived from the level of return targeted for the medium term and the growth targets), the actual result compared with the prior year, the individual performance of the board of management members and the achievement of compliance targets. **Primary reference parameters annual bonus:** – 50% relates to a comparison of actual EBIT in 2012 with EBIT targeted for 2012. – 50% relates to a comparison of actual EBIT in 2012 with actual EBIT in 2011. **Range of target achievement** 0 to 200%, that is, the annual bonus due to EBIT achievement has an upper limit of double the base salary and may also be zero (see below). Both primary reference parameters, each of which relates to half of the bonus, can vary between 0% and 200%.Once again in 2012,the complete or partial non-achievement of individual compliance targets can be reflected by a deduction of up to 25% from the individual target achievement. However, the compliance targets cannot result in any increase in individual target achievement, even in the case of full accomplishment.	Performance Phantom Share Plan (PPSP) – Phantom share plan means awards (between 0% and 200% of granted shares) paid essentially in cash with 50% reinvested into Daimler shares after the four-year performance period. 50% relates to the group's average return on sales over three years compared with a group of competitors (BMW, Fiat, Ford, Honda, Paccar, Renault, Toyota, Volvo and Volkswagen). Target achievement is 200% if Daimler's return on sales is two percentage points or more above the calculated average. Target achievement is 0% if Daimler's return on sales is two percentage points or more below the calculated average. 50% relates to the group's return on net assets in relation to the cost of capital. This criterion stands for the value created by the group. The extent that Daimler's return on net assets deviates over a period of three years by plus or minus two percentage points from a target of 8% is deemed to be the range of target achievement. As of PPSP 2013, the supervisory board has decided that target achievement of 200% will only be achieved with a return on net assets of 16% or more.
VW	The bonus is paid out based on average operating profit which includes a share of the operating profit in China over a two year period. For 2012/13 a calculation floor below which no bonus is paid was introduced and set at EUR5bn for 2012/13. In addition, a cap limiting theoretical bonus payouts was established limiting the CEO to EUR6.75m for 2012/13.	**Awards** under the long-term incentive system (LTI) are dependent upon: **Top customer satisfaction** measures using the customer satisfaction index **Top employer measured** using the employee index **Unit sales growth** measured using the growth index **Increase in the return on sales** measured using the Return index. Each year the supervisory board can set a new LTI target on the basis of a four-year average of the overall indices. During 2012 the LTI target was EUR6.25m for the CEO.

ource: Kepler Cheuvreux

Banks

The US provided an example but Europe did not follow...

Forcing the largest European banks to take government equity...

In our view the most decisive moment of the financial crisis was the decision by the then US treasury of State Hank Poulsen to force all the US banks to take public money. This decision was designed to reduce the stigma of taking public money, but it also allowed the government to impose strict restrictions on what these banks could pay in bonuses and salaries.

would have given governments more control over pay in the banking sector...

We believe that if European governments had followed suit and forced the largest European banks to take money, this would have given them much more control over remuneration initially. Instead, banks who could get capital elsewhere such as Barclays, HSBC and Deutsche Bank, were allowed to opt out and continue to pay sizeable compensation to executives despite benefiting from a de-facto guarantee from their respective governments.

... while removing incentives for banks to seek capital elsewhere to avoid government intervention on pay

This view may be controversial, but we believe that had more of the larger European banks been forced to take government money, remuneration would have been reduced (via government pressure) in the initial years following the financial crisis, which would have reduced public anger towards this sector while depriving some of the larger European banks of their ability to continue to pay significant compensation for activities that may have entailed excessive risk.

Main drivers

Cost control

In our view, most European banks are engaged in some form of restructuring in order to cut costs.

Asset repricing

Many investors are likening the banking sector to the utilities, with basically zero growth plus a dividend. We disagree with this view. First, utilities are regulated on both margins and prices and are typically unable to charge customers what they want. Nevertheless, they are able to leverage up their business, meaning they can deliver a pretty good return on equity as long as the regulator believes that margins and prices are in check. Second, banks have pricing power in terms of loans and deposit rates, meaning there are no limits on margins but there are limits on leverage. Therefore, increasing the barrier to leverage via capital requirements means compensation is more based on margins (particularly loan margins). In our view, banks that are better positioned on savings will be the winners in the current deleveraging environment.

Regulation: risk taking and compensation

The bonus cap may help some banks to moderate their compensation policy...

Banks are facing increased pressure to lower leverage by holding more capital on their balance sheets through higher capital ratio requirements. However, the European Commission's recently approval of a bonus cap on executive salaries may have unintended consequences.

Under the new rules, due to come into force on 1 January 2014, bankers may not receive a bonus of more than 1x their fixed salary, or 2x if shareholders have given prior approval.

Nevertheless, it's too early to assess the impact of the bonus cap on the CIB business of EU banks, which will affect the highest earners of each bank. The most sensitive banks are of course Deutsche and Barclays, and to a lesser extent, because of the relatively lower share of profits coming from this business, BNPP, SG, Natixis and CASA, in descending order. The impact for Swiss banks is uncertain at this stage, because we think their EU subsidiaries might be subject to the cap, whereas we understand that an EU branch would not, but this remains to be confirmed.

On the one hand, the cap will probably help the banks apply some moderation in their compensation policy, but the risk of losing high earners to non-EU banks, especially in the non-EU operations, and the unwelcome incentive to raise the fixed salary to provide headroom for bonuses, are serious threats.

... but the risk of losing high earners to non-EU banks may lead to the unwanted incentive of raising fixed salaries

Nevertheless even if the eventual outcome of the EU bonus cap is counter-productive in that it may lead to raised salaries leading to higher fixed costs for banks, public anger and regulator concern over remuneration at banks means there is little credibility within the sector to argue the case against these proposals.

Management key performance indicators

Political pressure to regulate European banks has been a continuing presence since the financial crisis of 2008 and in our view has now become a social issue, given the bailout of many large European banks by governments and the belief by society at large that bankers are overpaid and don't have its interests at heart.

Conforming to the new reality...

...pay in this sector is a social issue!

Return on equity: a good performance assessment metric

In our view, ROE is a good metric as it requires banks to outline to investors the net income they have generated based on the equity provided by shareholders. However, this needs to be combined with another metric that captures risk; we believe that the capital ratio or non-performing assets (loans, etc) could provide a partial answer here, as they would ensure that management do not take risks by leveraging up their balance sheet in order to generate returns.

The financial crisis has highlighted to investors the urgent need for some way to better integrate risk into the remuneration plans of large banks to ensure that profit taking by executive management is sustainable and based on long-term performance.

Malus and clawback provisions

One of the key remuneration outcomes of the financial crisis was the introduction of malus and clawback provisions. UBS is a good example as it was one of the first banks to implement this. However, very few banks in our view have applied robust clawback provisions to operators below the top management (board) and as such we do not believe that the use of clawback provisions here has been granular enough to ensure that individuals who have engaged in excessive risk-taking (or are considering it) are held accountable and responsible.

Hybrid incentive awards: toxic assets, contingent convertible bonds

A number of banks have opted to use non-typical financial instruments in order to more closely tie management remuneration to sustainable long-term performance as well as reducing risk. However, investors need to understand whether hybrid awards are actually loss-absorbing to ensure that where failures do occur these losses are incurred by management and not by shareholders and wider stakeholders.

The real issue for investors is how to integrate risk into management incentives

Barclays: contingent convertible bonds. Barclays (not covered) introduced the concept of contingent convertible bonds, which would be triggered if the bank's tier 1 ratio fell below a certain level, allowing the bank to sell the bonds in order raise capital and therefore avoid a government bailout.

However, in our view the weakness of CoCos having the tier 1 capital ratio as a trigger is the potential loss of some alignment between the interests of shareholders and those of managers, since the latter now have an incentive to dilute shareholders by pursuing tactics such as rights issues in order to avoid triggering the capital ratio.

Credit Suisse: linking bonus awards to toxic asset pool. Credit Suisse paid its executives from a pool of toxic assets sitting on its balance sheet, which allowed it to preserve capital as well as align shareholder and management interests since management remuneration was now tied to the regeneration of assets that essentially had no value which in turn would benefit shareholders who would gain upside in the event of these assets becoming profitable without the risk of losing capital.

Key considerations for investors

Addressing the asymmetry between key management and traders

It is clear that CEOs and other key managers operate under similar remuneration schemes to those in place for traders and other operators within banks. This is despite the potential for much greater risk-taking below senior management level without necessarily a greater scrutiny of risks.

Alignment of compensation and risk

In our view, when engaging with banks, investors should focus on whether the remuneration policy discloses how the remuneration paid to executives reflects and integrates the risks that the bank is taking over the longer term.

JP Morgan's USD6bn loss in 2012 as a result of London CIO trades highlights that banks are still taking significant risks

For example, in 2012 JP Morgan paid a bonus to Jamie Dimon despite the proprietary trading blunder at its London Chief Investment Office, which lost approximately USD6bn as a result of 'exotic investment strategies'. Essentially, the CIO office was involved in proprietary trading, whereby they essentially used the bank's money to engage in risky trades to make money. In our view, the subsequent losses were clearly a big blow for JP but more seriously they highlighted the fact that management did not have control over the business or and failed to understand the risks being taken by this business. This suggests that globally banks have yet to learn lessons of the 2008 crisis.

We note that two reports released by JP Morgan, one by bank executives and one by the board of directors, highlighted some startling conclusions:

Executive report: traders and executives in the CIO office did not understand the risks they were taking, didn't adequately question risky decisions and didn't properly report ballooning losses.

Clear lack of oversight in terms of risk-taking at JP Morgan's London Chief Investment Office

Board of directors report: executives did not keep them adequately informed of potential problems and used unapproved models for calculating risk.

However, Mr Dimon's bonus was cut by only 50% to USD11.5m for 2012 vs USD23m in 2011. In our view, given the significant losses and lack of oversight over the CIO in London, if ever there was a time for a CEO to forfeit his bonus as a signal that risk-taking that leads to heavy losses and failure should not be rewarded, then this was it.

This was a big management failure for JP Morgan

Performance targets for key management and below

The remuneration policy should highlight the specific targets and key drivers that the bank has set for key management, for example return on capital equity, revenues or profits. For many banks under our coverage, although actual payouts are disclosed the specific performance criteria they are based on are often unclear.

HSBC: detailed disclosure of score card for key management bonuses a new standard?

While it could be argued that Stuart Gulliver was not on the main board when many of the recent offences (money laundering for the Mexican drug cartels) took place and for which HSBC received a GBP1.2bn fine, investors may believe that bonus awards for key executives should have been suspended to highlight the seriousness with which HSBC views the previous actions taken by management.

Nevertheless, what is clear is that despite potential shareholder ire over the GBP2m bonus paid to Mr Gulliver, the methodology for determining this award is reasonably transparent and (in some ways) easy for investors to follow.

Table 9: HSBC scorecard for CEO Stuart Gulliver's 2012 bonus

Metric	Weighting	% achieved	Comment
Financial	60%	32%	The committee continued to judge capital strength (10%) and dividend payout (10%) as critically important reflections of financial performance as they encapsulate a number of key factors of importance to shareholders. In essence, these elements demonstrate a combination of profit generation, control of capital usage, cash availability at the holding company and regulatory satisfaction with the preceding factors sufficient to support HSBC's progressive dividend policy. In essence, these elements are important indicators of the sustainability of shareholder reward. Reflecting a higher dividend in 2012 and a stronger core tier 1 capital ratio, the committee awarded full weighting of these elements of the scorecard. An opportunity of 15% was available in respect of delivering pre-tax profit improvement and this was judged to have been substantially met with the Committee awarding 80% of the available opportunity (12% award). Driving this assessment were the strong performances across the faster growing markets, particularly in Hong Kong, the turnaround in GB&M's performance in Europe, the delivery of above target sustainable cost savings and lower loan impairment charges driven by marked improvement in the US. Return on equity (15%) did not meet the benchmark return. The cost efficiency ratio (15%) also fell outside the required measure, in large part attributable to the significant regulatory and law enforcement fines and penalties incurred in the US and customer redress costs suffered in the UK.
Non financial	40	20%	25% of the available opportunity in this area related to strategy execution and 80% was judged to have been achieved (20% awarded). This strong performance reflected a combination of growing capital deployment into targeted areas of opportunity, particularly into faster growing markets, strategic cost efficiency initiatives successfully deployed, evidence of further benefits from global business integration, progress on building wealth management revenues and personal commitment to developing client relationships. The final opportunity under non-financial measures (15%) related to risk and compliance and in light of the US regulatory and law enforcement fines and penalties and further customer redress in the UK, no award was made under this element

Source: HSBC Annual report 2012

We welcome the level of disclosure...

...not just in terms of performance targets...

... but explicitly Mr Gulliver's performance in achieving or not achieving them and why

Capital Goods

Main drivers

Organic growth

Fully comparable (or like for like) growth usually includes volume and price, but also all acquisitions and foreign exchange. This is now viewed as an important measure of sector performance, as it highlights:

1. Companies that are well positioned in the capital goods space that can take advantage of growing sub-segments of the market; and
2. Companies that are basically broad conglomerates and that are not really catering to any really attractive sub-segments.

Companies that do not have enough organic growth may come under increased pressure to find the best possible acquisitions in order to acquire growth. This may lead to overpaid acquisitions that may prove disappointing in the long term.

Clean restated operating margin

This enables companies to highlight the underlying profitability of the business by stripping out intangible depreciation, particularly when related to acquisitions.

Cash generation

Capital goods companies are mostly classical manufacturing companies, so not capital-intensive, and are able to generate cash each quarter. In recent quarters, cash generation has become more volatile, making it harder to predict (not the case 5-8 years ago).

Return on capital employed (ROCE)

In the mid 2000s, companies in this sector began to pay more attention to capital employed and to reveal ROCE targets to investors. The challenge for laggards in terms of ROCE (10-12%) is to bring this up to more performing levels; but the difficulty for these companies is that their balance sheets contain legacy assets that are hard to sell, or they are engaged in M&A activity that dilutes capital.

Management key performance indicators

Historically performance targets for key management were based on sales growth and operating margin, cash generation and capital employed.

Short-term variable awards

Typically based on ROCE, Sales/operating profit and net profit measures

We note that a range of measures are typically used for short-term variable awards in this sector. Generally we believe that a combination of measures such as ROCE, return on sales, operating profit and net profit are suitable for bonus awards.

Long-term variable awards

Very often improvement programs used by management in this sector are based on a three-year plan:

- **Year 1:** assets are written off and provisioned based on earnings or free cash flow.
- **Year 2:** performance starts to improve, but remains "mid-way".
- **Year 3:** management potentially reap the benefits of internal measures but this does not mean that this performance is sustainable over the next decade.

Performance based on improvement programs may not be sustainable in the long term...

Thus, while management can launch improvement or reorganisation programmes that can deliver some performance in the early years, it is difficult for investors to assess whether this performance is actually sustainable over the cycle.

Long-term performance should be measured over five years, in our view

We believe management incentives in this sector should at the very least be measured over a five-year performance period. In addition, we would suggest that three-year average growth and cash generation given that companies in this sector are heavily involved in manufacturing and therefore must generate cash every quarter. For cash generation investors should focus on free cash flow/ EBITDA or EBIT which highlights how much operating profit is converted into free cash flow.

A very simple method to achieve this would be to keep the typical 3-year performance period but add a subsequent holding period of 2-3 years

Alternatively free cash flow / capital employed could be a useful performance metric in that it highlights the extent to which capital employed is converted into free cash flow. In our view, average growth (organic sales) and some combination of cash conversion or a cash return on capital employed metric over a five-year period would be positive.

In reality we acknowledge that the longer performance period plus management changes over this period may make this difficult, but we believe this is the best way to capture performance that is really measurable and continues over the cycle.

However, a very simple method to achieve this would be to maintain a three-year performance period but add an additional holding period of 2-3 years, which would preserve existing structures but establish a stronger link in terms of sustainable performance over the cycle.

Keep an eye on...

Legrand: interesting long-term plan but unclear bonus rules

In our view, there is an interesting long-term aspect in the stock performance plan, but bonus rules are unclear for outsiders. Group performance targets are defined annually (no multi-year programme), usually targeting growth and margin performance. Margins are likely to be flat between 2011 and 2013E, and it's unclear to us whether this will this be reflected in bonus payouts.

Nexans: correlation between management action and performance?

The company uses clear value creation criteria for bonuses and stock options. Unfortunately, its margin and FCF history is very volatile, thus the correlation between management action and performance over the longer term is not well established.

Philips: share-based awards more to do with timing than performance

Stock options are based on TSR, which does not directly reflect underlying economic performance. Current management took over when PHIA shares were already quite low, which is likely to boost their compensation more than could be achieved on the basis of economic performance.

Rexel: LTIP based on two-year performance period

There's an interesting mix of different criteria for free shares, but many are not specified for the bonus awards. Performance criteria under the long-term incentive plan look fairly short-term-focused, given the two-year performance period.

Saft: performance measures could be viewed as too narrow

Compensation criteria seem to be based on very narrow measures: they do not factor in the botched electric / hybrid JV and the dilutive capital increase associated with it.

Schneider: one of the few to include extra-financial criteria

There is a clear set of targets to be attained. Schneider is one of the few companies to include extra-financial criteria for compensation calculation, which is likely to help long-term performance. Alignment of compensation and group targets needs to be checked.

Table 10: Remuneration matrix: capital goods sector (snapshot)

Company	Bonus	Stock performance plans	Stock performance plans performance period	Comment
ABB	Weighted group measures: – Orders received 12.5% – Revenues 12.5% – Operational EBITDA(2) 25% – Ratio of operating cash flow to operational EBIT(3) 25% – Net Promoter Score (NPS)(4) 10% – Cost savings 15%	EPS	EPS over a 3-year performance period. In addition there is a retention component which awards additional shares that are awarded after 3 further years for CEO = 100% salary.	EPS replaces relative total shareholder return (TSR), which was the performance measure used in previous LTIPs. EPS growth (based on net income excluding acquisitions) is one of the financial targets of ABB's 2015 strategy and is therefore better aligned with published goals.
Alstom		2012 LTI Plan	Operating margin and non-negative free cash flow targets over a 3-year performance period.	
Arreva	Undisclosed quantitative and qualitative targets	No long term incentive plan	No long-term incentive plan	No long-term incentive plan

Source: Kepler Cheuvreux

Table 11: Remuneration matrix: capital goods sector (snapshot) (CONTINUED)

Company	Bonus	Stock performance plans	Stock performance plans performance period	Comment
Legrand	Bonus split into two parts. First part no disclosure of performance measures. Second part: three qualitative criteria: 20% linked to organic growth (sales growth, innovation and increased market share), 15% linked to external growth policy and 15% linked to general criteria such as sustainable development and labour relations concerns.	Stock option plan	First performance criterion thus makes the vesting of the full initial allocation conditional upon an increase in economic income over a four-year period preceding the vesting of performance shares, thereby providing evidence of sustainable value creation. Should this criterion not be met, however, a second criterion would be examined to determine whether the group's performance, as measured by economic margin, was above that of a panel of peers over the same period.	
Nexans	The quantitative objectives used to determine the variable compensation payable to the group's senior managers, including the Chairman and CEO, comprised three financial objectives weighted as follows: 1) operating margin, 60%; 2) working capital requirement, 30%; and 3) return on For 2013 - The quantitative objective component which will be applied for the determination of the variable portion of the compensation of the group's senior managers, including the Chairman and CEO, will be increased to 70% and will comprise three financial objectives weighted as follows: 1) operating margin, 50%; 2) working capital requirement, 30%; and 3) free cash flow 20% and capital employed, 10%.	Stock option plan	Two performance measures: 1) a stock market performance condition, consisting of measuring the evolution of the Nexans share price over 3 years compared with the same indicator calculated for a reference panel; and 2) a financial performance condition consisting of measuring the evolution of the operating margin over sales ratio (at real metal prices) over 3 years, compared with the same indicator calculated for the same reference panel as the one applicable to the stock market performance condition. Depending on the performance rates achieved at the end of the vesting period, the number of shares to be acquired by the Chairman and CEO may vary between 0 and 17,000.	

Source: Kepler Cheuvreux

Table 12: Remuneration matrix: capital goods sector (snapshot) (CONTINUED)

Company	Bonus	Stock performance plans	Stock performance plans performance period	Comment
Phillips	Payouts based on above target performance: 1) a stock market performance condition, consisting of measuring the evolution of the share price over 3 years compared with the same indicator calculated for a reference panel; 2) A financial performance condition consisting of measuring the evolution of the operating margin over sales ratio (at real metal prices) over 3 years, compared WITH the same indicator calculated for the same reference panel as the one applicable to the stock market performance condition. Depending on the performance rates achieved at the end of the vesting period, the number of shares to be acquired by the Chairman and CEO may vary between 0 and 17,000.	Stock options/ restricted share awards	Stock options vest 3 years from grant with exercise price set as share price at date of grant. Restricted share awards vest in three equal tranches annually over a three year period. In addition, an additional 20% of restricted shares are deferred for an additional 3 years after vesting. Both stock option and restricted awards are based on TSR against a peer group of Electrolux, Emerson, General Electric, Hitachi, Honeywell International, Johnson & Johnson, Panasonic, Philips, Scheider, Siemens, Toshiba & 3M. However, actual pay-out is determined by a multiplier (different for both options and restricted shares) based on ranking over 3-year period.	
Rexel	Undisclosed but payout is based quantitative 75% and on qualitative criteria for 25%	Free shares	Two-year performance period based on four performance measures: – EBITA margin increase over two years, – Free cash flow before interest and tax/EBITDA level over a two-year period, – EBITA level, – Free cash flow before interest and tax level.	
Saft	Bonus awards based on: revenue growth, the EBITDA margin as a percentage of revenue (EBITDA defined as operating profit before amortisation and depreciation, restructuring costs and other income and expenses) and the level of operating working capital at the end of each quarter, as measured at the level of the consolidated financial statements of Saft Groupe SA.	Stock options granted in 2012	Annual grants capped at 35% of total compensation and upon vesting 15% of said shares must be kept throughout their term in office. Vesting of options based is split 50:50 between EBITDA & ROCE performance measures over a 3-year performance period.	
Schneider Electric	70% is determined by the group's overall performance, as measured in terms of operating margin, organic growth, cash generation ratio, customer satisfaction rates, corporate social responsibility and people development); 30% on the attainment of measurable personal performance targets set by the supervisory board.		50% of the shares/100% for the management board and executive committee - 2012 and 2013 (4) operating margin and change in the Planet & Society barometer to the end of 2013. Performance period is 2 years and 3 months with an additional 2 year holding period.	

Source: Kepler Cheuvreux

Chemicals

Main drivers

Organic growth

1. GDP growth in general

2. Capex investments

Investment projects generally take between two and five years with cash flow coming back over a three to five year period to justify investment.

3. Innovation: long-term driver for next decade

The chemicals sector is moving away from being capital-intensive towards a science-led process and is expected to be long-term driver for this sector over the next decade. The problem, however, is that the definition of what is innovation in this sector differs from company to company, making it difficult to measure in terms of indicators for management performance.

4. Key customer industries

Identification of key customers with strong growth rates makes a significant difference. For example, in the autos sector VW and Daimler are likely to have stronger lines of growth than Renault, Peugeot and Fiat.

External growth

M&A in this sector is mostly through bolt-on acquisitions, which in most cases take place in mature markets due to the lack of opportunities in emerging markets. As such, very big transitional deals are rare in this sector.

Earnings growth / top-line growth

- Cost synergies – (reducing overlap from M&A)
- Top-line synergies – (new customers from acquired product lines)
- Cost savings – (restructuring via closing of plants, redundancies)
- Efficiency enhancement (in-house ideas/proposals to improve efficiency of production through payments or additional benefits.

Management key performance indicators

Generally, we do not believe that management incentive awards for companies in this sector are sufficiently linked to key drivers. Typically, remuneration in the chemicals sector is based on performance targets such as EBITDA, EVA or ROCE, ROA (return on assets), which are used for short-term variable awards.

Short-term variable awards

ROCE the ideal performance measure

We believe that all companies should focus part of their remuneration structure on ROCE, which we consider a very good measure for investors as it helps to discipline management in terms of capital expenditure and acquisitions (particularly in their pricing). Nevertheless, in our view ROCE is probably more effective as a year-to-year management performance indicator under a bonus plan.

Long-term variable awards

Mainly driven by share price, but there are some surprises….

We note that in most cases long-term variable awards are linked to share price performance targets typically relative to peers. In our view, investors may have concerns over the use of share price appreciation given the potential incentives for key management to pursue short-term business decisions designed to boost the share price.

BASF, Lanxess and Linde require participants to invest their own money in shares as a condition of participating in stock performance plans

In addition, a number of companies ask participants to use their own salary or bonus to purchase a number of shares as an entry requirement to the share plan. We applaud this approach as it realigns and strengthens the interests of management and shareholders since these participants have a significant personal economic stake that may reduce the incentive to pursue short-term strategies that are value-destructive over the long term.

On the next page, we highlight a selection of 12 companies from our chemicals universe with a specific focus on the mechanics of their long-term incentive plans. We note that for the most part companies use a three-year performance period with only three companies opting for a four-year period: BASF, Arkema, Lanxess and Linde.

Furthermore, only three companies require a commitment in shares from participants in order to gain entrance to their share-based award plans: Lanxess, Linde and BASF. In our view such requirements are positive because they strengthen and align the interests of management and shareholders.

Keep an eye on…

Akzonobel: sustainability is a measure used for performance share plan

Half of the shares granted under the performance share plan are linked to Akzonobel's relative sustainability performance via its average score in relevant Dow Jones Sustainability Index (DJSI).

DSM: integration of CO2 target as part of long-term compensation

DSM is the only company in our selection to specifically integrate a greenhouse emissions target into its long-term incentive plan. This performance target equates to 50% of the award, which ensures that key management are likely to take it seriously given its impact on the vesting of share awards.

Fuchs Petroleum: bonus targets not related to mgmt. compensation

The yearly targets set by the company (sales growth, EBIT growth) are not related to management's variable remuneration. There are no aggressive actions to be expected by management despite 3/4 of remuneration is variable. CEO belongs to the Fuchs family, who hold 51.7% of the voting right shares worth c. EUR1bn. Thus, in our view the conservative approach in strategy is likely to continue.

Lanxess: clear alignment of management and shareholder interests

The new long-term incentive plan requires outperformance against the Dow Jones Stoxx 600 Chemicals Index with a personal annual commitment from each participant of 5% of annual salary. Vesting occurs only after four years and is subject to an average five-year lock-up period.

Henkel: use of ROCE is positive alongside deferral of bonus

Incorporates an ROCE target in addition to which 25% of the bonus award is deferred into the long-term share performance plan. In addition we appreciate the required investment in Henkel shares and the holding period of three years to participate to a full amount in the LTI programme, suggesting management is interested in the long-term development of the company. Furthermore aggressive strategic decisions are very unlikely given the influence by the Henkel family via supervisory board. A special incentive has been paid to management for achieving its 2012 targets set in 2008. It amounted to 50% of annual variable income; split of payment: May 2013 (60%) and May 2014 (40%).

Wacker Chemie: no evidence of a performance-related share plan

Based on the company's disclosure, there does not appear to be a performance-related share plan in place at Wacker Chemie. Instead, directors are required to use their annual bonus (15%) to purchase shares, which must be held for two years.

Table 13: Chemical sector: snapshot of performance criteria for long-term incentive awards

Company	Option plans	Performance period
AkzoNobel	50% Dow Jones Sustainability Index and 50% TSR defined peer group 10 companies	Three-year performance period
Arkema	First Performance Plan grants options subject to ROCE. Second performance plan grants options based on EBITDA margin.	First performance plan utilises a two-year performance period. Second performance plan is based on a four-year performance period.
BASF	Mandatory commitment of 10% of bonus in shares with a four-year holding period. Vesting based on stock price with options split into two parts: part A is an absolute performance measure requiring 30% price appreciation for vesting; part B is relative with options vesting based on 2x outperformance of the MSCI Chemicals index on exercise date.	Four-year performance period
DSM	Split 50:50 between two performance targets: ▪ comparable total shareholder return (TSR) performance versus a peer group of 12 companies; ▪ greenhouse gas emissions (GHGE) reduction over volume related revenue (the definition of greenhouse gases under the Kyoto Protocol includes carbon dioxide and methane):	Three-year performance period
Fuchs Petroleum	Performance-related component based on sustainability (undisclosed), annual profit and capital employed	n/d
H&R AG	The annual bonus contains a long-term incentive component which provides for a variable bonus based on ROCE over a three-year rolling period.	Three years
Henkel	Long-term incentive awards linked to EPS performance target with 25% of award coming from executive's variable bonus and 10% from company.	Three years
K+S	Long-term incentive awards based on: value creation which = EBIT + interest income of the financial year - cost of capital (before taxes) of the financial year.	To determine the result of an LTI tranche, two four-year periods are compared (a “reference period” and a “performance period”). The reference period covers the four years before the commencement of the particular LTI, while the performance period covers the four years of the particular LTI term.
Lanxess	Long-term awards require a 5% investment each year from annual base salary. Awards vest based on the performance of Lanxess stock against the Dow Jones STOXX 600 ChemicalsSM reference index.	Four-year performance period
Linde	Long-term awards are based on a matching requirement from the participant with awards vesting according to the achievement of two equally weighted performance measures: EPS and relative TSR.	Four-year performance period
Syngenta	Long-term incentive awards are split 50:50 between stock options and restricted stock awards. Both awards vest based on share price performance with RSU's vesting at nil cost.	Three years
Wacker Chemie	No evidence of long-term plan. Executive board members are obliged to purchase Wacker Chemie AG shares equal to 15% of their annual gross bonus. A holding period of two years is in effect for these shares.	n/a

Source: Kepler Cheuvreux

Insurance

Main drivers

The insurance sector can essentially be split into three segments:

Life insurance covers on one hand risk products such as term life or medical insurance and on the other savings products, often with some tax benefit or as part of a pension scheme which will ultimately pay an annuity.

Non-life insurance combines property and casualty which comprises both commercial and personal lines insurance, like private car insurance with other classes like healthcare.

Reinsurance companies provide additional protection to insurers, usually against catastrophe events.

Non-life insurance

Investment income

Changes in interest rates can have a long-lasting effect as property and casualty insurers generate a large portion of revenue from the investment of premiums before paying claims. Therefore, lower interest rates can mean less investment income, which can reduce revenue for non-life business.

Combined ratio

This is a key measure for non life business. The combined ratio measures the profitability of an insurer's underwriting operations. The ratio combines incurred losses and underwriting expenses as a percentage of revenue earned from premiums. A ratio below 100% indicates that an insurer is making an underwriting profit, while a ratio above 100% indicates a loss (costs exceed premiums).

Life insurance

Embedded value

This is a very long-term business, meaning that the net profit stream from writing of new policies can take up to 25 years to emerge. As a result, significant commission must be paid to compensate the seller of a very good life policy, which means that cash from the first year will be strongly negative. Nevertheless, the insurance company has added value as it has a very good long-term insurance contract.

For this reason, all insurance companies particularly those in life insurance, use 'embedded value', which is the sum of net asset value plus the value of the life portfolio; or put another way, the net present value of the future earnings of the life portfolio. Unfortunately, this measure is often significantly manipulated by insurance companies in order to maximise the figure, creating a lot of uncertainty for investors.

Interest rates

This is a key component of a life insurer's business model, driving investment returns and providing a benchmark for pricing annuities and insurance policies with savings features. Because most insurance products extend over many years, small changes in net interest spreads may have an extended effect on profits and returns.

Reinsurance

Interest rates

Typically higher interest rates are more favourable, while lower interest rates are negative.

Climate change

This is an increasingly important factor for reinsurers, who are having to make ever-increasing payouts as a result of more frequent events such as hurricanes, flooding, etc, that are increasingly being linked to climate change.

Management key performance indicators

Remuneration polices tend to be similar for the largest companies in the sector. Short-term variable remuneration (bonus awards) is based on one year (maximum three years) and performance measures are typically linked to operating profit (which excludes volatility of financial markets) or underlying earnings. Long-term incentive awards are typically made in shares or phantom awards to avoid dilution.

Short and long-term variable awards

Operating profit common measure for ST and LT awards, but open to manipulation.

Most of the largest companies in this sector use operating profit as one of the components of their remuneration policy, either for bonus or long-term incentive awards. Investors should note that for most companies operating profit excludes the volatility of financial markets. This means that executives should not be overly rewarded when markets are higher nor severely penalised when markets are very volatile.

No common definition for operating profit

Nevertheless, IFRS accounting for insurance companies could be considered misleading as it involves a mix of new rules introduced in 2004/2005 and local accounting rules and principles. For this reason, in order to introduce some visibility and transparency of results, many companies have opted to use their own definition of operating profit.

On the downside, this introduces the potential for manipulation by management (to possibly boost their performance) given the lack of sector consensus on this measure; and the lack of external auditing, which means that management can make changes to it without having to inform the market.

Introduction of IFRS second phase should introduce a common approach for determining operating profit

In the long term, we note that the introduction of IFRS second phase (however it is still unclear when this is happening) should provide more transparency as it would allow for a common definition of operating profit given a common approach to accounting across the sector for European stocks as well as increased transparency for investors, as the new IFRS measure would be audited externally.

Should capital management be integrated into management incentives?

Solvency 1 is the regulator's main framework used to assess the capital position or capital management of a company. Solvency 1 is based on a percentage of top line and balance sheet size but could be considered as misleading given that it does not make a distinction between asset classes. So under Basel 1 an insurance company invested just in equities would be treated the same as one invested entirely in bonds, despite the differing risk profiles of the two asset classes; as such, we see Solvency 1 as a weak regulatory framework.

We believe that the introduction of Solvency 2 will be more positive for investors as it will operate in a similar fashion to the Basel 3 approach and will require that all assets held by insurance companies are measured according to the real risk profile of the assets.

Furthermore, all insurance companies have their own internal insolvency capital model, which must operate in a similar way to the proposed Solvency 2 model although in practice these internal models are likely to be more sophisticated.

Remuneration targets focusing on capital ratio could be negative for medium term investors

We note that Generali is the only insurance company to clearly state that it integrates a solvency ratio into its remuneration policy for top management. This is not surprising given that Generali had an extremely weak capital position in 2012 when its share price fell dramatically in response to the bond crisis, leading to the departure of the CEO and the appointment of Mario Greco in August 2012.

Lower payout (dividend) and perhaps issuance of more subordinated debt would penalise shareholders. As such, this could be useful for long-term, but not medium-term investors.

Keep an eye on...

Allianz and AXA both use a three-year net profit measure

Both Allianz and AXA use performance measures that look at the net profit capacity over a three-year period. This ensures that payouts are based on a good average of net profit and avoid overpaying executives for performance when interest rates are high and there is lower volatility, and significantly penalising them when financial market volatility is high.

Topdanmark: incentive pay structure aimed at creating long-term value

The Board of Management and the "Friday Team"(a group of executives and heads of departments) are awarded up to 10% of fixed pay in share options, provided that certain conditions are fulfilled. Other employees who have had extraordinary performance are subject to the same variable payment treatments. Other aspects of performance-related pay, including one-off cash payments, and warrants are also granted, depending on the employee's contribution to corporate value creation.

Any other type of variable payment is currently not present within the corporate remuneration framework. At the end of 2012 the total amount of options held by the Executive Board represented 0.9% of total number of outstanding shares. The company implicitly remains open to the possibility of introducing variable pay, but for now entails a high degree of trust in the concordance of executives' intentions. We believe the build-up of share ownership by management provides sufficient certainty that long-term shareholder value creation is a prime focus of the top management.

Munich Re: the company to use return on risk adjusted capital (RORAC)

Munich Re is the only company that has a RORAC target. This is driven by the risk capital allocated to the business, based on the risk appetite of the management and also on achieving an appropriate return on capital deployed. Munich Re is the only company using this metric, which we regard as one of the best key figures for steering a reinsurance company. We see a RORAC target as superior to a RoE target as RORAC is not impacted by IFRS/US-GAAP accounting distortions. The management incentivisation is also based on RORAC and therefore aligned with the company targets.

Hannover Re: use of return on equity (ROE) may not be appropriate

In addition to IVC (intrinsic value creation), a key parameter for Hannover Re, the company uses RoE, which we do not regard as an appropriate key performance indicator as it is driven by accounting distortions and different accounting treatment between various asset types and overall liabilities. While the remuneration includes medium-term components of three years, we would stress that this period is probably slightly too short for a reinsurer, whose liabilities have durations of five years on average.

Leisure

For the purposes of this report we split this sector into two segments: Hotels and Gaming.

Hotels: main drivers

Move towards global branded hotels

Hotel groups like Accor and Intercontinental are increasingly seeking to expand into the European budget market, where local hotels are unbranded. The key to growth in the budget market is via the globalisation of brands, for example Intercontinental (Holiday Inn) and Accor (Ipis or Novotell), to act as a catalyst to convince local budget hotels to take on the brands of the bigger hotel chains through franchise agreements.

Intercontinental is viewed as one of the most advanced in the use of the franchise strategy through its Holiday Inn brand. Typically through franchise agreements, Intercontinental either manages the hotel by putting in its own top manager who runs the hotel, while all other staff and personnel are paid and controlled by the owner of the franchise; or alternatively, it makes its brand and booking system available to the franchisee for a fee.

The importance of moving towards a franchising model is evident in Accor's recent appointment of a former McDonald's executive as CEO; McDonald's is exclusively built around the franchise model.

Hotels: management key performance indicators

Short-term variable awards

Room rate growth / franchise growth useful measures

In our view, management performance incentives should incorporate a clear metric linked to growth in the number of rooms / room rate as well as growth in number of hotels under franchise agreements by a certain date.

In terms of franchise agreements, the quality of the hotel and service has a clear impact on hotels wanting to sign up to franchise agreements based on consumer demand. We believe that hotels managing franchise agreements generally use customer surveys to gather customer reviews to build up a customer base that provides a consistent view on the brand network. We believe hotels using an efficient and timely customer review system will have an advantage over peers as they will be able to tackle problems faster.

Long-term variable awards

Release of capital employed via asset disposals.

The move towards a franchise model means that the bigger hotel chains no longer need to physically own a large number of hotels. Instead, they sell their brand, including the booking software and brand name, to the local hotel participating in the franchise while taking a portion of the profit. This allows for a steadier income stream and more rapid expansion. As such, hotels within the sector are heavily engaged in selling off their physical assets (hotels) in order to reduce their capital employed via the release of capital once a hotel has been sold.

The sale of Motel 6 by Accor highlights how selling assets to quickly fund a franchise strategy can potentially destroy shareholder value

Accor has been relatively late to this strategy and still has a lot to do to reduce the number of physical assets it owns in order to increase its asset-light / franchising strategy. Nevertheless, in our view investors need to consider the potential costs for hotels of implementing a new asset-light or franchise strategy.

We believe Accor's sale of Motel 6 highlights why it is important to look at ROCE when hotels dispose of assets. Accor was selling its US Motel 6 business to a US private equity business. The market initially reacted positively to the sale, but this perception changed when investors and the market realised the costs involved in closing the fixed leases and associated hidden losses on the balance sheet (that were not booked). As such, for investors, the Motel 6 deal changed from being profitable to a potentially dilutive deal, as it was realised that the sale of Motel 6 went through at a multiple far below the multiple of the stock and what investors believed to be the variable value of the asset.

We believe that investors should question how management ensures that the disposal of assets is done in a way that does not reduce the potential for value creation.

Gaming: main drivers

The gaming segment of the leisure sector is typically a market based on cash generation, as companies operate a concession business. Where they make upfront investments in the form of high capex spends followed by a period where they generate cash, this allows companies to subsequently lock in their internal rate of return. Given the cyclicality of the business, investors should be aware of how management balances and avoids overspending in terms of capex at the beginning of the cycle and under spending during the profitable stage of the cycle.

Gaming: management key performance indicators

Short-term variable awards

Renewal of contract / return on capital useful measure for bonus awards.
Visibility on the performance criteria used to measure bonus awards is limited. We believe that efficient capital allocation is an important measure for investors given the cyclical nature of the gaming business. As such return on renewal of contracts (concession) and return on capital would be appropriate measures of management performance in terms of how management are improving capital allocation.

Long-term variable awards

EBITDA used to measure management ability to generate cash over the long term.
Given the requirement for upfront investment of capital before cash generation, companies involved in gaming will often have years of zero cash generation. As such, investors seeking to measure cash generation will typically use earnings before interest tax depreciation & amortisation (EBITDA), which is often used by companies to determine awards under variable compensation, typically over a three-year performance period.

Lottomatica's management performance awards utilise EBITDA ...

... with net debt as a counter-balance to ensure management do not overly maximise EBITDA through capital expenditure

Debt an additional check on management's long-term performance?

In our view, the main risk in terms of management incentives is that the cyclical nature of the business could create a conflict where management is overly focused on generating excessive returns when the business is generating cash.

We believe investors should want management to be paid reasonably well over the cycle (even in periods where they are not generating so much cash) so that they are not incentivised to take excessive risks to maximise their compensation by maximising the EBITDA through massive capital expenditure.

This is why debt is often used as an additional measure of management performance because if a concession agreement is made based on a very high EBITDA and a very high capital expenditure then this will show up in the net debt.

For example, in its incentive scheme, Lottomatica provides stock options and restricted share awards to executives based on a three-year performance period with option grants linked to EBITDA and net financial debt at the end of the three year period.

Internal rate of return (IRR) would be the optimal management measure!

Given the key driver is cash generation from the concession businesses, investors would clearly be interested in having management incentives linked to the internal rate of return of their investment projects, as this should help ensure that such projects create strong value and thus cash generation potential. Nevertheless, for companies in the gaming segment to comply they would have to provide information that would be commercially sensitive, as competitors would know what the IRR of a project was; as such, the disclosure of IRR targets for projects would be potentially damaging to gaming businesses. This is why IRR project targets tend to be a black box for both investors and the market.

Keep an eye on...

Accor: bonus maximum based on reference amount not actual salary

The salary of the CEO Mr Hennequin is currently set at EUR0.83m (despite the commitment of the board to raise it to EUR1m by 2014) following Mr Hennequin's request for it to be capped to respect the company's 100 million cost savings plan. However, we note that his bonus, which is capped at 150% of salary, is not based on his current salary but a reference amount of EUR1.25m. This reference amount will be kept in place until 2014, although the actual bonus paid depends on performance; in our view, the proportion of bonus awards should be linked to his salary and not an arbitrary financial figure.

Intercontinental: clear alignment of remuneration measures to strategy

Annual performance plan is based on three measures: brands (guest satisfaction), people (employee engagement) and delivery. Each of these measures has a clearly disclosed threshold, target and maximum triggers. Furthermore, we note that delivery is essentially EBIT performance, which the company explains factors in critical measures such as fee revenue, margins, RevPAR growth (success of growing rates for rooms) and net room growth.

Finally, long-term incentive awards for the 2013/15 cycle are linked to: cumulative annual growth in net rooms, cumulative annual like for like RevPar growth and IHG's TSR relative to the DJGH index. In our view, the long-term performance measures appear to be aligned with the company's corporate strategy and cycle.

Gameloft: excluding stock options CEO has no real variable compensation

Executives receive a fixed salary which for the CEO is in our view significant compared with the size of the company. There does not appear to be a policy on annual bonus pay outs, although stock options and performance shares are granted.

Luxury Goods

Companies in the luxury goods sector are typically owned by families, who are often members of top management.

Main drivers

For division/brand managers and the corresponding CEOs of these divisions, the main drivers are clear. For most companies, the main drivers are centred around retail and wholesale growth.

Retail growth

- **Top line (revenue) growth retail**
- **Profitability retail sector:** generating profitable growth with little capital expenditure

The appointment of specific country CEOs is becoming the norm in order to protect performance at regional level

Most brands have a CEO in charge of key specific countries to reduce the possibility of poor performance due to a lack of focus within a specific geographic region. For example, Gucci performed very badly in South Korea in 2011/12 as it only had a CEO for Asia Pacific (excluding Japan). The fact is if you are CEO of Gucci Asia Pacific then you are only interested in China, Hong Kong, Macau and Singapore. As such, the resulting poor performance in South Korea, which was down by double digits, was visible at the regional level, as the performance of China (Asia Pacific region) was reduced by poor performance of South Korea. We believe that most of the larger luxury brands now appoint CEOs at country level, and this is already the case at Louis Vuitton.

Ability to manage working capital

Ability of senior management to manage working capital is obviously different on a country basis and this has a clear impact on senior management remuneration. A CEO who is responsible for China will have a clear mission to develop, and as such will be paid on store openings (find the best store at best price, open on time) and ROCE in new stores, etc. By contrast, a CEO of France is remunerated more on the profitable growth of the existing retail network, as store openings are not really involved, and this would also apply to a CEO responsible for the US. As such, the way executives are remunerated contrasts significantly between emerging and developed markets.

Evolution of brand equity / brand awareness (not always common)

This is difficult to quantify, but essentially it concerns the ability of management to grow a brand. For example, LVMH took the brand Céline, where brand awareness was fairly weak four years ago. Over the last four years, management has multiplied sales by 2.5 and profitability has increased by 15-18% alongside brand awareness (calculated by number of pages in magazines over the last 12 months.) Céline is viewed as one of the greatest success stories of the last few years.

Management key performance indicators

Companies within this sector don't follow the typical traditional structure for executive remuneration: fixed, variable and a longer-term share based element. Performance measures typically agreed in private for senior management and executives are rarely rewarded in shares, but mainly in large salary and smaller bonus.

Transparency on CEO remuneration is frequently poor, as CEOs are often owners (e.g. LVMH, PPR, Hermes).

Lack of share awards use and low pay helps maintain high profitability

In other sectors, a significant amount of money is spent every year on share plans to give to top management. In this sector, the dispersal of family owners within management (including the CEO) means that typically very few shares are awarded to management and this, coupled with the low level of variable pay bonuses, ensures a high level of profitability for companies within the sector.

Short-term variable awards

Return on investment might be useful

Generally in the luxury goods sector senior management needs to generate profitable growth in line with targets and with little capital expenditure. For example, if at the end of the year senior management has reported 20% top-line growth alongside good margin improvement, then the following year the CFO may allow them to spend millions of euros on capex and further millions on non-recurring opex (non recurring additional spending on advertising, etc).

LVMH holds special sessions each February to measure the performance of each employee and set targets

However, the following year the CFO will look at that return on investment. Therefore, if management is allowed to spend millions of euros on capex to double the network, but generates only 20% growth, this would not be viewed as a good performance.

Long-term variable awards

Long-term performance not really a factor

Long-term performance awards or performance shares are not widely granted in the luxury goods sector especially at the larger companies as typically the family owners do not want to dilute their stakes. In fact, bonuses for senior management below executive level (CEO) are relatively low, typically 20-25% of salary. Salaries are generally fairly high at the larger companies, with a welcome bonus paid to executives upon appointment. However, share awards are not commonly paid to executives on an annual basis at the larger companies.

Larger companies do not use shares to incentivise management...

At smaller companies, share awards are used to attract talent and encourage more of an alignment between management and shareholders. For example, one of the main reasons for the IPO of Brenello Cucinelli last year according to the CEO, was to make it easier to attract talent. The IPO allowed the CEO to offer entrepreneurial experience to new executives whose performance would have direct visibility at company level.

... but smaller ones use shares as a way of attracting talented senior executives

Management attention focused on dividends and share buybacks...

Given the family ownership in this sector, the controlling family owners are clearly interested in dividends and share buybacks. In fact, most of the luxury goods companies are cash-rich, which means that for minority investors the main concern is what these in the next few years, or even a special dividend. In addition, for LVMH, we understand that a share buyback programme was potentially under review for 2013.

For minority shareholders the main concern is what companies will do with their cash

We note that Hermes launched a massive share buyback programme last year (0.8-0.9% share capital) in order to provide shares for top management, most of whom are members of the Hermes family, and to increase the ownership of the Hermes family stake to 51% given the entrance of LVMH as a significant shareholder via its use of equity swaps.

CEO performance metrics are a black box!

In the luxury goods sector, the CEOs of the larger companies are mostly the owners, which means that the visibility on how they are paid is essentially unclear, because as owners they can pay themselves what they want.

Metals & Mining

Main drivers

Management changes to signal a new era (Mining)

Over the last decade when commodity prices were rising the remuneration plans of the larger mining companies were, in our view, essentially designed to encourage an increase in production growth, mega projects via higher capex spend and M&A.

Over the last decade with rising commodity prices remuneration plans essentially encouraged capex spend…

However, many of the big miners (Anglo, Rio Tinto & BHP Billiton) are now managing a series of new CEO appointments. In our view, this new crop of CEOs will face shareholders who are increasingly focused on capital allocation efficiency, which is in turn forcing boards to rethink their capex spend as well as shareholder returns.

Please note that in this sector we split companies into either mainly mining or steel producing companies where there is no denomination our analysis applies equally to both types of company.

Commodity price volatility (Mining)

The volatility of commodity prices in the past meant it was very easy for management to make money simply through capex, with no real thought given to returns. However, in the current economic environment, with margins in commodities set to fall due to oversupply, there is a clear need to improve the efficiency of the capital base and return more money to shareholders via regular secured dividends.

Cost control and capital allocation efficiency

Companies will need to focus on cost control and capital spending as well as asset disposals. For example, Anglo American's iron ore project in Brazil (Minas-Rio) is one of the largest iron ore projects in the world. Anglo American initially reported that the capex for Minas-Rio would be USD2.8bn, then revised this up to USD5bn and finally USD8bn with an impairment of USD4bn. In our view, cost overruns of this nature will increasingly be viewed negatively by shareholders, who may want companies to delay costly mega projects in order to focus on reducing costs.

Closing capacity (steel producers)

Banks are no longer willing to lend to steel producers on future production capacity alone. Therefore in the next 5-10 years, steel producers need to close steel mills to reduce overproduction in Europe and China, where it currently stands at 25%.

Steel producers are overproducing and therefore need to close capacity in order to grow earnings

However, steep producers can face societal pressure from governments who are keen to continue to subsidise under-economic mills because they maintain employment, even if harmful to earnings for these companies in the long term. As such, many steel companies lack pricing power, which can only recover when production is reduced.

Gearing (steel producers)

Steel producers need to reduce their debt by cutting costs via closing production and by using smarter technology to reduce their production and environmental costs, which can lead to operations that are less destructive to the environment. For example, Japanese steel producers are experimenting with hydrogen gas, which would have zero environmental impact.

Management key performance indicators

Investors are focused on key issues like capital efficiency and stable dividends, but these issues are unlikely to disappear when commodity prices rebound

We do not believe management should be rewarded for performance based on production growth, cash flow generation or commodity prices, as these factors are clearly linked to the commodity price cycle and are therefore outside management's control. As we have noted, the current economic environment and commodity price volatility has resulted in investors moving away from capex spend and production growth to capital efficiency and cost cutting.

However, investors should continue to focus on these themes even when commodity prices begin to rise again, to ensure that corporate performance and management payouts continue to operate sustainably via efficient capex spend and secured dividend payouts.

Short-term variable awards

Working capital efficiency, net debt and safety targets are suitable for bonus awards.

We believe companies in this sector need to integrate working capital into management incentives. In our view, improving working capital is a much more transparent measure of what management are doing to improve receivables and payables (being tougher on suppliers, etc) and improving credit lines which in our view highlights good management.

Greater focus on net debt should ensure dividends are sustainable

Dividends should be covered by earnings and cash, which is not always the case for a number of companies in the metals & mining sector

Shareholders are clearly focusing on shareholder returns in the form of dividends. As such we believe net debt reduction targets should also be integrated into management compensation particularly for steel producers to ensure that dividends are sustainable and can be covered from earnings and cash flow. In our view, investors should be concerned by companies in this sector paying out unsecured dividends (particularly steel producers given their high gearing) to satisfy shareholders where underlying earnings are essentially flat or declining.

Table 14: Anglo American unsecured dividend given collapsing earnings

Year	Underlying earnings (USD bn)	Dividend
2010	4.13bn	65 USD cents
2011	5bn	70 USD cents
2012	2.3bn	85 USD cents

Source: Kepler Cheuvreux

In our view, paying unsecured dividends could be viewed as counter-intuitive since companies (particularly steel producers, who increasingly have high gearing year on year) that pay out dividends may do so off the back of a subsequent rights issue that is dilutive to shareholders.

Safety becoming important component for bonus awards

We also believe that safety targets should be incorporated into bonus awards (particularly for mining companies) to ensure management are focused on reducing their annual fatal-injury frequency rate (FIFR) and lost-time injury frequency rate (LTIFR).

Long-term variable awards

Return on capital employed (ROCE) is a necessity for long term awards

Given investor expectations for capital efficiency, ROCE is clearly a measure that should be incorporated into management incentives particularly for longer-term share-based awards in this sector. In our view, given the cyclicality of the sector, commodity prices should not be linked to share awards as this is essentially out of the control of management. We believe it could be preferable for share awards to management to be paid out over a much longer period of 5-10 years to ensure that they are smoothed out over the cycle. We believe this will ensure that management are not over-rewarded during the cycle when prices are high with no subsequent downside when commodity prices fall.

Keep an eye on...

Anglo American: safety and capex

After several years of favourable trends in key health and safety indicators saw a negative trend in fatal-injury frequency rate (FIFR), lost-time injury frequency rate (LTIFR) and the total recordable case frequency rates notably due to a deterioration in activities in South Africa. Furthermore the mega project in Brazil Minas-Rio was over budget and management should therefore be cautious about taking on any future mega projects of this type.

Arcelor Mittal: dividend payouts

A rights issue off the back of a subsequent dividend payout could be viewed as counter-intuitive as it dilutes shareholders in order to pay for future dividend payouts.

Xstrata: risk-taking is somewhat controlled

The overall bonus pool is determined according to return on capital employed (ROCE) targets and net profits. Individual awards are dependent on a holistic assessment of individual performance criteria, which incorporate a wide range of financial and non-financial measures, including health and safety, employee development, environment and sustainability, profit and cash generation, volume, project execution and other criteria agreed in advance and evaluated by the Remuneration Committee.

The Remuneration Committee takes into account the outlook for the business and the broader market environment as well as achievements during the year. It also makes a judgement on how performance is achieved as well as the outcomes, for example, by assessing the robustness of processes and management actions. In our view, since part of the remuneration is tied to return/profitability measurements rather than growth/revenue-measurements risk-taking is somewhat controlled.

Oil & Gas

Main drivers

Oil price

Investor attention in this sector focuses on how management can reach oil price targets in terms of the assumptions included in their annual budgets.

Switch from volume growth to value growth

The last five years have seen a shift from volume-based oil production (barrels of oil produced) irrespective of cost to a strategy that is more focused on profitability driving value. This shift is the result of national oil companies driving out international companies and forcing them to pursue projects in harsher environments where the potential capex costs are higher given the increased products costs or political regime and potentially harsher and unfamiliar environments.

Improving capital management process.

The Oil & Gas sector is really a project industry. As such, a key issue right now is the shift towards more efficient capital management of projects. The main driver for this shift is the increasing need for external funding for Oil & Gas project financing. Traditionally Oil & Gas companies would partner up with other sector companies to share the risks of projects. However, the increased cost of operating in new harsher environments means that projects, with costs of USD30bn-40bn, can only be financed by external partners such as banks. These new partners are much more focused on project efficiency or capital projects delivered on time and on cost. As a result, Oil & Gas companies are under increased pressure to deliver on time and on budget.

External funding of oil & gas projects is driving increased need for capital management efficiency

Moving from schedule-driven to capex-driven.

The move to increased capital efficiency means that capital projects are increasingly moving away from being schedule driven to capex-driven. As a result, projects are no longer driven by delivery date at any cost but increasingly by cost alone, which means keeping project costs under control even at the expense of delivery.

Management key performance indicators

Short-term variable awards

Safety is an indicator but is not always visible within management performance. Safety targets are incorporated into the annual budgets for oil companies in the form money allocated for training on safety at projects and plants. Furthermore, safety is tracked on a regional basis by senior executives but it is unclear whether safety is directly linked to management incentives for key executives.

Operating cash flow margin is a first step for short term variable awards

Royal Dutch Shell, Statoil and Repsol have begun to use operating cash flow margin targets

We are now seeing a shift to operating cash flow targets as performance measures for bonus awards under remuneration plans, rather than a pure production growth target such as increasing oil production by 10% year on year. In our view, this move is positive given management's ability to manipulate production targets. We believe operating cash flow margin is basically looking at the margin on the oil produced (another way to think about it is net income per barrel of oil produced).

Royal Dutch Shell provides an example of this growing trend. The company has set an operating cash flow target of USD175bn-200bn over four years (2012-2015) at an oil price assumption of USD111. In fact, we note that several other companies such as Statoil & Repsol, have also implemented operating cash flow performance targets notably for bonus awards, which wasn't the case one to two years ago.

We believe the movement towards operating cash flow margin targets improves visibility for investors as the previous production targets were often overoptimistic in their oil production guidance, and the market was therefore often sceptical over whether companies would actually meet production targets.

Moving towards an operating cash flow margin in essence provides investors with visibility on the cash flows that companies are seeking to generate from their production based on the oil price.

Long-term variable awards

Mid-cycle ROCE target would allow investors visibility on management's capital efficiency

In our view, it is difficult for investors to assess whether management in this sector are being paid for performance across the entire cycle. Investors would naturally look to a returns measure such as ROCE as a way of assessing the ability of management to complete capital projects on time and on budget.

Investors should be questioning why companies haven't integrated a mid-cycle ROCE target into their long-term variable awards for key management

However, the ROCE targets currently in use by companies in the sector can easily be manipulated, in our view. For example, the board can from the outset reduce oil price assumptions within the budget process to make it easier to achieve ROCE targets. In addition, management can manipulate certain costs to increase ROCE targets attached to variable awards under remuneration plans.

We believe investors should therefore be encouraging Oil & Gas companies to provide a cleaner ROCE target that removes external effects that cannot be influenced by management.

We believe that Oil & Gas companies, under their long-term incentive plans, should utilise an ROCE target that is tracked over a five-year average period and that has had certain external effects such as oil price movement and FX removed, to provide a cleaner mid-cycle ROCE that clearly highlights three things for investors:

1. how efficiently management dealt with capital employed;
2. how effective management was at bringing projects on stream by the date promised;
3. how much volume was brought on stream.

As such, we believe that unless Oil & Gas producers show more visibility on capital efficiency they won't get the funding for future capital projects. Therefore, this kind of visibility is a future necessity because, while production levels were previously often below expectations and came with a higher capex, the capital projects were smaller and the oil was more easily obtainable via onshore exploitation.

However, companies in the sector are increasingly having to implement capital projects offshore where the risks are much greater – environmental (spills), technical (more complex and expensive projects) – and where the fiscal regime is tighter, so host governments want a greater share of profits.

Change is coming because external funding will demand better capital efficiency

All these risk factors reduce profitability leaving management with only really one factor that they can influence sufficiently, which is their capital expenditure. This is precisely what external funders (such as banks) will be interested in as part of the funding process for large-scale capital projects.

Keep an eye on...

Royal Dutch Shell: Sustainable development and capital efficiency

For Shell, long-term incentives make up 52% of target pay for executives, with salary making up the smallest component (22%). We note that bonus awards are split between three components: cash flow (30% of scorecard), sustainable development (20%) and operational excellence (50%). Investors should note that the sustainable development measure for 2011 includes explicit references to safety, energy efficiency and water use. Furthermore, under the operational excellence performance measure, we welcome the mention of project delivery in terms of Shell's ability to deliver projects on stream, on time and on budget.

Repsol: Vague performance targets for bonus awards

Under the remuneration plan we consider the strategic targets for bonus awards to be very vague and not really defined.

Total: focus on return on equity does not show capital efficiency

For Total, the main driver of the CEO's bonus (50%) is return on equity, which in our view is not really aligned with the company's performance, given that it is easily manipulated by management and does not reflect their capital efficiency. Furthermore, 50% of share awards made under both share award plans (2011 share subscription plan and 2011 share performance plan) are based on return on equity, which essentially means that if the CEO & Chairman is meeting his ROE targets under the bonus scheme, then he's more than likely to meet them under the long-term incentive awards.

ENI: Use of EBITDA may make mgmt performance less challenging

Variable long-term awards are based on an undisclosed EBITDA target with a three-year vesting period with payout based on a sliding scale between 0% and 170% of the granted amount. In our view, the use of an EBITDA target for long-term awards in this sector is a surprise given that it potentially allows an oil company to switch to a higher tax region, which should reduce profits (given the higher tax); however, by using EBITDA, the tax implications are ignored meaning that executives are more easily able to achieve their EBITDA targets even if performance hasn't actually improved, because the reported profitability is not reflective of the actual tax implications.

BP: safety is a key component of bonus awards

BP is one of the few companies to visibly integrate safety into its remuneration structure. The annual bonus for executives comprises three components: safety and risk management (30%), rebuilding trust (20%) and restoring value (50%). We note that value creation is linked to operating cash flow, which we view as a positive even though we would prefer to see a mid-cycle ROCE target.

Oil Services

Main drivers

The oilfield services industry supplies Oil & Gas producers with an array of products and services spanning the life cycle of a well, from initial production to abandonment. Diversified and specialty oilfield services offer product lines, such as pressure pumping, drill bits, chemicals and fluid control. Subsea companies provide offshore-related services and equipment such as trees, umbilicals and flow lines. Seismic companies provide data acquisition and processing services and equipment.

The ability of companies to acquire new contracts is a key consideration for this sector. However, investors must not underestimate the impact of spending growth (exploration and production) by oil producers who are the clients of the companies in the sector.

Oil services sector can be split into segments that reflect our coverage:

1. Engineering & Construction (Technip, Saipem, Subsea 7)
2. Seismic (CGG, PGS)
3. Pipe makers (Vallourec, Tenaris)

Exploration and production spending

This is the capex from the investing of the oil producers whose activities are interlinked with backlog growth. Essentially, oil services companies' backlogs (contract growth) increases or decreases based on the capex spend of the oil production companies.

Backlog growth

The backlog growth concerns how the order book (contracts) of oil and services companies are growing year on year or essentially, is the company in a position to take on more contracts. Therefore growth in order intakes can be viewed as an early indicator of the future financial performance of companies in this sector. However, given the black box nature of disclosure where it is impossible to determine the profitability of such contracts, the quality of contracts and not the volume is the key factor when assessing backlog growth. As such, management needs to think about the embedded operating margin within the order backlog to ensure that the focus is not primarily on chasing volume (in terms of contracts) at the expense of margin or profitability.

Contract volume is important but over focusing on volume may come at the expense of margin or profitability.,

Management key performance indicators

Companies in this sector will all focus on a range of financial measures including: EBITDA, EBIT, net income growth, cash flow from activities, ROCE, safety (TRCF) and TSR when considering management compensation.

Short-term variable awards

Engineering & Construction: focus on gross margin on order intake (backlog quality) for short term variable awards.

This performance measure is key for companies within the engineering & construction segment of the oil services sector.

While most companies in this segment disclose some of the performance metrics they use for management compensation, they use a black box approach when it comes to assessing the quality of contracts they have won, which can cover up to two years of revenue and therefore will have a significant impact on returns.

Saipem failed to increase the quality of its backlog between 2009 and 2011

Saipem does not disclose whether it considers the quality of the backlog as a factor when assessing management compensation. We think it probably doesn't, in the light of its significant recent announcement this year that it had taken on at a lot of poor low-margin projects between 2009 and 2011, which meant that it had perhaps bid too aggressively on projects previously. In fact, Saipem acknowledged that in 2012 it specifically won a project in Brazil despite knowing that it would generate poor margins because it wanted to gain entry to this market.

Investors are increasingly keen to understand the quality of the backlog...

In our view, Saipem's recent announcement, coupled with the huge impact a poor-quality backlog can have on financial returns, means that investors will increasingly focus on the quality of the backlog (rather than simply volume).

We note that Technip is the only company that integrates this measure into the bonus consideration for its CEO. Previously the former CEO of Technip had a bonus that incentivised him based only on backlog growth, which meant that although the backlog provisions for Technip grew in 2004 and 2005, the quality of these contracts was poor, leading to big provisions on some of them.

... which our view should be a factor in the CEO's bonus...

The reason for this was that the former CEO was incentivised to grow the backlog at the expense of margin or profitability with no consideration for the quality of the contracts. The appointment of the current CEO Thierry Pilenko led to a change, with the introduction of a new metric as part of his bonus, which is focused on the quality of the order backlog represented as a growth margin percentage on the order intake or more simply the embedded operating margin in the backlog. As such, for Technip, the focus is now on having quality contracts (by being selective on the contracts bid for) that have a greater embedded margin value, which will ensure higher profitability.

Technip discloses that the share of the variable portion linked to backlog quality represents only 20% of the CEO's bonus. Investors may consider that the proportion of this measure should be higher, perhaps 50%, given its impact on financial returns.

... but assessing order backlog quality does not necessarily include potential cost of overruns on these projects

However, it is important for investors to understand that the quality of the backlog is measured when the contract is awarded and companies will then have their own expectations in terms of the expect margin of completion for the project.

Furthermore this metric doesn't factor in the cost overruns that may occur once the project has started nor does it consider the quality of execution. As such, increasing the proportion of this metric to 50% of a CEO's bonus could be unfair. Nevertheless, we believe a proportion of the CEO's bonus within this segment should be linked to backlog quality.

Seismic companies: EBIT progression more relevant for short-term variable awards.

Within this segment the backlog visibility on contracts is limited given that contracts typically last an average of five to six months. As such, key management measures should be EBIT progression and free cash flow. In our view, companies within this segment such as

CG Veritas and PGS are fairly aligned in terms of main metric and management compensation.

Pipe makers: safety and quality are key factors here for short-term variable awards

Here backlog visibility is also again fairly limited with contract lengths averaging six months. In our view, the key themes in this segment are safety, given that there are lots of manufacturing sites, and product quality, as the products are used in drilling and are therefore a critical part of the oil industry business. We note that Vallourec is the only company in this sector that has a specific metric for safety, although it's unclear what specific proportion this measure has in terms of the overall annual bonus for senior management.

Safety and product quality should be key components for management compensation

Long-term variable awards

Long-term performance: a blend of metrics, but EBITDA is a key one

Given the cyclical nature of the oil serves sector, focusing on margin progression is key. As such, companies in this sector use a blend of metrics such as: operating income, FCF, revenue growth, EBITDA, EBIT and ROCE. In our view, a combination of these measures would ensure that management incentives are in line with the indicators driving the sector. However, we note that for investors EBITDA is the key metric for appraising the profitability of a company in this sector.

Keep an eye on...

Technip: assessment of quality value of backlog is significant

Integration of backlog quality into performance measure for the CEO's bonus (20%) is an interesting and unique concept that investors are now focusing on.

Vallourec: incorporation of safety under bonus is positive

The main criteria for the incentivisation of management are net income, working capital, safety, cost cutting and internationalisation. In our view, the incorporation of safety within the annual bonus plan for senior management should be viewed as a positive.

Saipem: absence of backlog quality measure a concern

Absence of backlog quality as a metric within their management compensation should be a concern for investors, given their recent announcement concerning backlog quality.

Pharma

Main drivers

The key driver is revenue related to success in research and development (R&D), which in our view can depend significantly on development cycles that can take well over 10 years and to some extent on serendipity.

Research and development

Pharmaceutical companies invest considerable cash into the research and development of new drugs over a 10-year plus period. During this time, scientists study thousands of compounds of which a very small number (4-5) may be suitable for development into an eventual drug.

Over the last few years there has been a tendency for companies (such as GlaxoSmithKline) to cut their R&D spending; however, companies cannot afford to significantly cut their spending on new drugs as there has to be a balance in R&D spend, which is necessary to develop drugs that can be moved through the pipeline to offset drugs that are coming to the end of their patent life.

Pipeline progress: very difficult to gauge and assess

Extremely difficult to measure pipeline progress

Chart 3: Pharma pipeline overview

Source: Bayer

Pipeline progress concerns the number of candidates (drugs or molecules) that are being developed along the different phases of a typical pharma pipeline. However, only a small number will be taken through to eventual drug approval. As such, pipeline progress is fairly difficult for the market to measure, as most disclosure from pharma companies typically outlines the many compounds they have moving through their various development phases (e.g. phase 1 to phase 2), but this does not tell you anything about the quality of the compounds. The only real measure of success is the number of drugs that have achieved regulatory and commercial success. In our view, three factors are critical to assessing the value of a drug in the pharma pipeline:

1. the size of the potential market for the drug;
2. the market share the new drug can gain; and
3. the risk that it will not be approved.

In our view, sheer luck can play a big part in the success approval of new drugs

We believe Roche's spin-off of Actelion provides a good example of how difficult it is to assess the first two factors. Roche spun off Actelion as it believed the drug it was developing (tracleer) would achieve peak sales of only USD50m-100m. However, this drug became a blockbuster because Roche's underestimated the patient population. In this scenario, Roche management undoubtedly took a risk that backfired with the success of the Tracleer drug that they sold off as part of the spin-off of Actelion.

This highlights how difficult it is to always accurately assess both the size of the market as well as the market share of a new drug. Finally, we believe there is a huge amount of serendipity going into and out of the commercial phase (approval) for new drugs.

Pricing pressure: cost of healthcare

Healthcare cost inflation is above general cost inflation in all major markets, particularly the US. Furthermore, increasing pressure on reimbursement prices and reimbursement listing is likely, but so far manageable by the industry, which still enjoys strong margins.

In our view, price control in the US would be bad news, though and we do not believe the Democrats will continue to introduce bills to implement such measures in vain forever (a new bill has just been reintroduced, but is likely to be rejected this time again).

But even if price controls were to come in the US at some stage, it is reasonable to assume that volume gains from emerging markets are likely to compensate for this in the long term.

Management key performance indicators

Typically, companies in the pharma sector use cash flow and earnings measures to measure management performance.

Short-term variable awards

Short-term variable awards should be determined on long-term performance using in-licensing and out-licensing.

In our view, bonus awards should be paid out over a long time period with a proportion of the award paid out over the cycle; this would ensure that pay is linked to the longer cycle of the sector.

Integration of in-licensing and out-licensing into management performance would allow investors to assess quality over a shorter time scale

It would be easier to assess the ability of management to make good deals on in-licensing where pharma companies can buy or license products (in phase 2 or phase 3) from third parties which are underestimated by the market and the company that is selling them. Bristol Myers is a company that has been very successful at this and out-licensing.

Out-licensing allows companies to spread risks across their product portfolio by collaborating on projects (that are deemed to be risky) with larger pharma players who share the risks of the project not achieving approval; however, revenue will need to be shared if the drug does make it to the market.

As such, the integration of in-licensing and out-licensing as a part of management performance would allow investors to assess the quality of management over a shorter time scale of two years or so rather than the typical 10-year cycle.

Long-term variable awards

Linking efficiency of capital investment to long-term management incentives is difficult. In our view, ROCE as a performance measure in the pharma sector is not particularly useful in terms of gauging the success of management because any assessment of management's use of capital cannot really be fully assessed until after the 10 year development cycle.

Share-based awards, rewarding performance or timing?
We believe stock options are overused in this sector to reward executives for performance that has yet to be proven over the cycle.

As such, we think that paying executive in shares in the pharma sector is counter-intuitive due to the cyclical nature of the sector and (to some extent) serendipity in R&D and drug development.

In fact, it doesn't make sense to pay executives based solely on three years' performance when it can take 10 years to see whether their decisions (R&D spend, pipeline progress etc) were correct.

As such, long-term incentive plans that pay out significant numbers of shares annually cannot possibly capture whether management has actually been paid for delivering success and can actually just depend on stock market movements.

Typically, share awards are based on share price appreciation compared with a number of peers in the sector. In our view, these awards should have much longer performance periods, e.g. five years, to reflect the longer cycle of the sector. Failing that, we believe a much longer holding period (three years post vesting) would ensure that executives are paid for performance across the sector.

Human Genome Sciences (HGSI): a CFO in the right place at the right time
David Southwell was appointed CFO of Human Genome Sciences at the height of the financial crisis in 2010 and was granted 275,000 options with a vesting price of USD31.16 while expectations for Benlysta, the first new lupus drug launched in 50 years, were high.

However, the following year Glaxo bought HGSI out for USD15 per share as the market had now discovered that the drug did not behave as favourably as they thought (lack of impact on quality of life, artificial clinical trial settings).

Given the change in control at HGSI, all of his options vested in full immediately, which in our view highlights the counter-intuitiveness of awarding executives in the pharma sector with options, as in this example the CFO was able to benefit significantly despite not being involved in the success/failure of Benlysta.

Semiconductors

Main drivers

The sector can essentially be split into two segments: manufacturers and fabrication-less (fab-less) operators. Manufactures are typically capital-intensive companies, as they own factories and physically build chips. While fab-less companies are typically involved just in research and development, marketing and outsourcing of IP, while outsourcing chip manufacturing to other companies.

In our view, this is a highly cyclical industry making persistent return on capital more difficult compared with other industries. We believe investors are increasingly happy for companies to discuss their performance range throughout the cycle. In other words investors don't want companies to burn cash at the top of the cycle; instead, it is more important to have a good range of performance across the cycle (typically 4-5 years) rather than just the highest peak in terms of performance at the top of the cycle.

Investors are interested in sustainable performance across the cycle...

Research and development (manufacturers & fabrication)

R&D to ensure that the right products are developed at the right time.

Efficiency of return on capital (manufacturers)

For manufacturing companies the use of non use of capex is a significant issue in order to ensure satisfactory returns on the capital invested.

Earnings margin and earnings growth (fab-less)

For fabrication companies it's a mixture of maximising revenue growth and operating returns given the lack of capital involved (since they don't manufacture). As such, by looking at earnings margins and earnings growth investors gain an insight into growth and the quality of earnings of these companies.

For fabrication companies growth and the quality of earnings are key issues

Management key performance indicators

A full cycle in the semiconductor typically takes around five years, but we do not believe management performance is really measured across the entire cycle. Instead, managers are for the most part rewarded for what they deliver in an individual year, which in our view encourages them to maximise the peak of the cycle to cash in even if performance is unsustainable going forward.

In this sector, we believe investors must pay special attention to fab-less companies where there is less volatility and therefore return on capital and free cash flow are higher. In our view, investors need to ensure that management are not being overpaid in a good year because of their model, where huge returns correspond to significant management remuneration that is in our view not sustained by management performance but is merely a reflection of the cycle.

Investors should give special attention to remuneration for fabrication-less companies

As such, we believe remuneration in this sector essentially follows the cycle with companies tailoring performance measures to match the particular cycle rather than establishing performance measures that apply over the cycle, thereby encouraging sustainable long-term performance to the benefit of long-term investors.

Short-term variable awards

EBIT and free cash flow lead the way!

We believe EBIT margin is an appropriate measure for assessing management performance for manufacturers. For fab-less companies we believe EBIT and free cash flow are appropriate measures.

However, we believe that bonus awards within the sector should be measured against a three-year rolling average in order to dampen the effect of management benefitting to the full extent from one-off (top-of-the-cycle) performance. This would ensure that the effects of a one-off (bumper) year are dampened to an extent.

Long-term variable awards

Return on capital employed, **free cash flow** and **operating earnings margin** (how much a company is making on each euro of sales) are three measures that we believe should be incorporated into management incentives designed to measure long-term performance via share-based awards for manufacturing companies in this sector. These three measures essentially focus management attention on capital efficiency (when are they going to spend the money and are they focused on return), shareholder remuneration in the form of potential dividends if free cash flow is sufficient and the company's ability to generate money from everyday operations.

For fab-less companies, ROCE would be less vital given the absence of significant capex; as such, we believe earnings growth and earnings margin would be appropriate measures as they give investors a valuation for the shares, or to put it another way, the multiple (essentially the P/E of the stock or what investors are willing to pay per euro/dollar of earnings). We believe understanding the multiple is key, given that these stocks tend to move in line with the multiple.

Introducing rolling provisional share awards that are continually adjusted over the five-year cycle...

However, we believe a five-year performance period is more sustainable in this sector as it ensures that management performance is measured over the entire cycle. In addition, rather than significant annual share grants, we believe management should be required to utilise a proportion of their bonus to purchase shares in order to fully align management interests with those of shareholders.

...would reintroduce sustainable performance...

Furthermore, share awards should be granted on a provisional rolling basis that can be adjusted based on their actual sustainable performance . This would re-introduce a penalty or malus provision to ensure that management is paid in shares for their performance over the cycle. In our view this would mean that share based awards made to executives would be continually adjusted over the cycle depending on their performance.

... plus downside risk for management

This would ensure that an executive whose performance in years four and five was relatively poor would then have his/her entire provisional share awards (from years 1-3) readjusted; likewise an executive whose performance was poor in the first three years would not be able to substantially benefit from significant outperformance in years 4 and 5. This would give investors confidence that remuneration is measured appropriately across the entire cycle, while also reintroducing downside risk for executives, who must now sustain their performance over the entire cycle.

Questioning the removal of share price development from remuneration plans

We believe investors should be aware of companies that opt to change their remuneration scheme after a few years, particularly where the share scheme is initially linked to share price development. Typically, such companies may have enjoyed substantial share price growth over a number of years, but are now opting to switch performance measures away from share price to EBIT margin.

In our view, these companies have taken advantage of multiple expansion where higher share prices were more likely, while seeking to avoid multiple compression, potentially lower share prices on the downside. As such investors may question whether remuneration is appropriately aligned with their interests.

Keep an eye on...

ASML: Mgmt incentives are aligned with shareholder interests

Despite the lack of disclosure we believe that management remuneration is sufficiently aligned with shareholder interests. Our view is based on two facts: first, management compensation has not been excessive in peak years at the top of the cycle; second, compensation has remained reasonable despite significant share price developments.

Dialog Semiconductor: Long term performance criteria changed

We understand that investors are of the opinion that management are rewarded far too generously on the upside but not punished significantly for downside performance. In fact, executive performance was originally mainly measured against the share price; however, recently share price has become one of a number of measures used to measure management performance. In fact share price growth represents only one quarter of performance with EBIT and revenue performance targets accounting for the remaining 75%.

Infineon: Integration of ROCE and FCF performance targets

Infineon is one of the few companies in this sector who are currently moving to integrate ROCE and free cash flow (FCF) performance targets into its long-term incentive plans as part of its remuneration policy given its shortfall in capital. We note that Infineon utilises a medium-term incentive plan which incorporates ROCE and FCF performance targets to measure management performance over a three-year period with awards paid in cash at the end of the three-year term.

ST Microelectronics: Governance part of bonus performance metrics

Under the annual bonus scheme for the CEO performance criteria include: new product introductions, market share, financial targets (sales, operating income, RONA) and corporate governance initiatives. For long-term performance, stock awards are linked to sales, operating income and RONA with vesting split into three thirds over three years. In our view, the compensation structure, criteria and amounts appear adequate and there is a balance between short-term and long-term incentivisation. Remuneration appears to be in line with drivers and strategy, although a longer-term "over-the-cycle" (5-year) element may be supportive.

Research ratings and important disclosures

Disclosure checklist - Potential conflict of interests

Stock	ISIN	Disclosure (See Below)	Currency	Price
ABB	CH0012221716	nothing to disclose	CHF	21.42
Accor	FR0000120404	nothing to disclose	EUR	26.99
Actelion	CH0010532478	nothing to disclose	CHF	56.85
AkzoNobel	NL0000009132	nothing to disclose	EUR	48.45
Allianz	DE0008404005	nothing to disclose	EUR	117.10
Alstom	FR0010220475	nothing to disclose	EUR	28.87
Anglo American	GB00B1XZS820	nothing to disclose	GBP	1,556.50
Areva	FR0011027143	nothing to disclose	EUR	12.40
Arkema	FR0010313833	nothing to disclose	EUR	77.53
ASML	NL0006034001	nothing to disclose	EUR	62.70
AXA	FR0000120628	nothing to disclose	EUR	14.76
Barclays	GB0031348658	nothing to disclose	GBP	302.63
BASF	DE000BASF111	nothing to disclose	EUR	73.45
BHP Billiton	GB0000566504	nothing to disclose	GBP	1,825.00
BMW	DE0005190003	nothing to disclose	EUR	70.88
BNP Paribas	FR0000131104	nothing to disclose	EUR	44.22
BP	GB0007980591	nothing to disclose	GBP	476.40
CGG	FR0000120164	nothing to disclose	EUR	19.65
Crédit Agricole	FR0000045072	2, 6, 17, 19	EUR	7.12
Daimler	DE0007100000	nothing to disclose	EUR	47.41
Deutsche Bank	DE0005140008	nothing to disclose	EUR	34.95
Dialog Semiconductor	GB0059822006	6	EUR	11.60
DSM	NL0000009827	nothing to disclose	EUR	47.42
ENI	IT0003132476	14, 16, 18	EUR	17.75
FCC	ES0122060314	nothing to disclose	EUR	7.39
Fraport	DE0005773303	nothing to disclose	EUR	46.11
Fuchs Petrolub	DE0005790430	nothing to disclose	EUR	64.20
Gameloft	FR0000079600	nothing to disclose	EUR	5.52
Generali	IT0000062072	nothing to disclose	EUR	14.21
H&R	DE0007757007	nothing to disclose	EUR	9.40
Hannover Re	DE0008402215	nothing to disclose	EUR	57.12
Henkel	DE0006048432	nothing to disclose	EUR	76.60
Hermès	FR0000052292	nothing to disclose	EUR	275.00
HSBC	GB0005405286	nothing to disclose	GBP	380.60
Infineon	DE0006231004	nothing to disclose	EUR	6.25
InterContinental Hotels Group	GB00B85KYF37	nothing to disclose	GBP	1,912.00
K + S	DE000KSAG888	nothing to disclose	EUR	31.90
Lanxess	DE0005470405	nothing to disclose	EUR	56.45
Legrand	FR0010307819	6, 14, 16, 18	EUR	38.03
Linde	DE0006483001	nothing to disclose	EUR	152.05
LVMH	FR0000121014	nothing to disclose	EUR	137.50
Marks & Spencer	GB0031274896	nothing to disclose	GBP	475.00
Munich Re	DE0008430026	nothing to disclose	EUR	143.35
Natixis	FR0000120685	nothing to disclose	EUR	3.50
Nexans	FR0000044448	nothing to disclose	EUR	38.14
PGS	NO0010199151	nothing to disclose	NOK	88.15
Philips	NL0000009538	nothing to disclose	EUR	22.53
Repsol	ES0173516115	nothing to disclose	EUR	17.73
Rexel	FR0010451203	nothing to disclose	EUR	17.76
Rio Tinto	GB0007188757	nothing to disclose	GBP	2,337.05
Roche	CH0012032048	nothing to disclose	CHF	253.10
Royal Dutch Shell	GB00B03MLX29	nothing to disclose	EUR	25.95
Saft	FR0010208165	nothing to disclose	EUR	18.04
Saipem	IT0000068525	nothing to disclose	EUR	21.21
Schindler	CH0024638212	nothing to disclose	CHF	138.70
Société Générale	FR0000130809	nothing to disclose	EUR	30.64
STMicroelectronics	US8610121027	nothing to disclose	USD	9.28
Subsea 7	LU0075646355	nothing to disclose	NOK	125.40
Swatch Group	CH0012255151	nothing to disclose	CHF	572.50
Syngenta	CH0011037469	nothing to disclose	CHF	387.20
Technip	FR0000131708	6	EUR	85.90
TopDanmark	DK0060477503	nothing to disclose	DKK	146.50
Total	FR0000120271	nothing to disclose	EUR	39.48
Vallourec	FR0000120354	nothing to disclose	EUR	42.33
Volkswagen	DE0007664039	nothing to disclose	EUR	166.60
Wacker Chemie	DE000WCH8881	nothing to disclose	EUR	54.22
Xstrata	GB0031411001	nothing to disclose	GBP	960.50

Source: Factset closing prices of 24/05/2013

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Reduce	17%	0.0%
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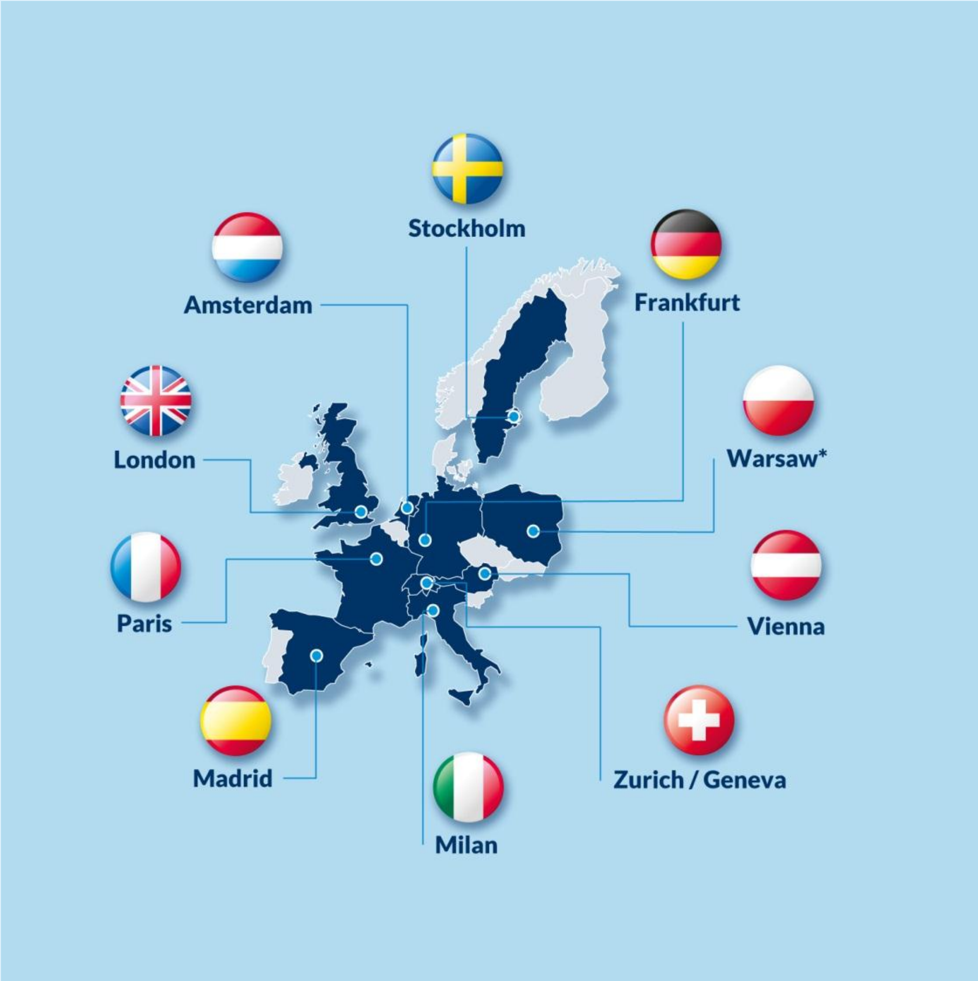

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