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Meridian Client Update

ISS Issues Technical Document on Financial Performance Assessment

Institutional Shareholder Services (ISS) for the first time will be evaluating a company's performance relative to peer group performance against a broad spectrum of financial metrics. ISS will compare how a company's CEO pay stacks up against the company's relative financial performance. This assessment is now part of ISS's qualitative analysis of CEO pay and company performance, which we previously reported on in our Client Update dated November 21, 2016.

Recently, ISS issued extensive guidance on the manner in which it will conduct this new comparative financial analysis, which is summarized below.

Background on ISS CEO Pay and Performance Evaluation

For Russell 3000 companies, ISS uses the following two-part analysis to assess the relationship between CEO pay and company performance:

- a quantitative analysis ("Quantitative Analysis") which compares CEO total pay and company performance, as measured by total shareholder returns, over various time horizons on both a relative and absolute basis, and
- a qualitative analysis ("Qualitative Analysis") in which ISS considers eleven unweighted factors to determine whether a company's pay practices mitigate or facilitate a pay-for-performance misalignment identified by the Quantitative Analysis.

Generally, ISS will perform the Qualitative Analysis in cases where the Quantitative Analysis yields a medium or high concern level regarding a potential misalignment of pay and performance.

If ISS finds that a pay-for-performance misalignment exists at a company (and which is not sufficiently mitigated by the factors assessed under the Qualitative Analysis), ISS will likely recommend that shareholders vote AGAINST such company's Say on Pay proposal.

ISS added the comparative financial analysis to the factors included in its Qualitative Analysis effective for annual shareholder meetings occurring on or after February 1, 2017.

Overview of Comparative Financial Analysis

For 2017, ISS will expand the Qualitative Analysis to include a new factor under which ISS considers a standardized comparison of a CEO's pay and company financial performance ranking relative to its ISS-determined peer group based on a weighted average of up to seven financial metrics, which are listed below.

- Return on invested capital (ROIC)
- Return on assets (ROA)

- Return on equity (ROE)
- Revenue growth
- EBITDA growth
- Cash flow (from operations) growth
- Total shareholder return (TSR)

For this purpose, a company’s financial metrics (and their applicable weighting) will be based on the company’s industry (see Appendix A, which shows by industry applicable financial metrics and relative rankings of each metric).

ISS has not disclosed its methodology for determining the weighted average of the financial metrics considered in a given company’s comparative financial analysis.

Calculation of Financial Metrics

ISS will calculate a company’s and its peer group’s financial metrics over a three-year period or a two-year period if a company has less than three years of trading history or financial data, but at least one year of such data (ISS will not conduct the comparative financial analysis with respect to a company that has less than two years of trading history and/or financial data). ISS will use data from Compustat to calculate each metric based on the following definitions.

Metric	Methodology for Calculating Metric
Three-Year Average ROIC	$(ROIC[0Y] + ROIC[-1Y] + ROIC[-2Y]) / 3$
Three-Year Average ROA	$(ROA[0Y] + ROA[-1Y] + ROA[-2Y]) / 3$
Three-Year Average ROE	$(ROE[0Y] + ROE[-1Y] + ROE[-2Y]) / 3$
Annualized percentage growth in revenue over a three-year period	$(Revenue[0Y]/Revenue[-3Y])^{(1/3)} - 1$
Percent change in EBITDA over a three-year period	$(EBITDA[0Y] - EBITDA[-3Y])/ABS(EBITDA[-3Y])$
Percent change in operating cash flow (ONCF) over a three-year period	$(OANCF[0Y] - OANCF[-3Y])/ABS(OANCF[-3Y])$
TSR	Same methodology as the relative degree of alignment component of ISS’s quantitative pay-for-performance test based on a different measurement period, as described below

Determination of the foregoing financial metrics will be based on reported GAAP financial results to provide for a reasonable comparison across all companies (**ISS will not take into account adjusted GAAP financial results**).

Measurement Period

Generally, ISS will measure financial metrics over a three-year period. However, this three-year period will not reflect a company’s most recent three fiscal years. Rather, the three-year period will be based on a company’s shareholder meeting date, as described in the below chart.

Shareholder Meeting Date		ISS Data Download Date*	Applicable Three-Year Measurement Period
From	To		
3/1/2017	5/31/2017	December 1	Twelve calendar quarters ending on 9/30/2016
6/1/2017	8/31/2017	March 1	Twelve calendar quarters ending on 12/31/2016
9/1/2017	11/30/2017	June 1	Twelve calendar quarters ending on 3/31/2016
12/1/2017	2/29/2018	September 1	Twelve calendar quarters ending on 6/30/2016

*ISS Data Download Date refers to the date on which ISS downloads company data for purposes of performing various analyses under its proxy voting policies.

In the case of material merger or spinoff activity during the measurement period, ISS’s analysis will exclude revenue growth, EBITDA growth, and cash flow growth for the quarterly periods impacted by the corporate action. One or all of these metrics will still be used if sufficient data exists following the merger or spinoff activity so that ISS can calculate a minimum two-year measurement period (through the calculation date), excluding the impacted quarters. If a metric is excluded from the assessment, the original weight that was assigned to the excluded metric will be redistributed proportionately to the remaining metrics. ISS will not exclude from its analysis capital productivity measures (ROIC, ROA and ROE) or TSR in the foregoing situations.

Determination of a Company’s Relative Financial Performance Result

A company is ranked against its ISS-selected peers across each of the applicable metrics. The performance ranks of the financial metrics are then combined into a weighted average performance rank relative to the ISS-selected peer group. ISS has not disclosed its methodology for determining this weighted average performance rank.

The weighted average performance rank is compared to the subject company’s CEO pay rank (relative to peer company CEO pay) to yield a relative financial performance result. ISS has also not disclosed its methodology for determining relative financial performance result. A company’s financial performance result may range from -100 to +100, with -100 representing high pay for low performance.

A negative result indicates that the CEO’s pay rank is greater than a company’s weighted average financial performance rank, which suggests a **misalignment** between CEO pay and relative company performance. Conversely, a positive score means that the CEO pay rank is below the weighted average financial performance rank, which suggests CEO pay is **aligned** with relative company performance.

Finally, ISS will compare a company’s relative financial performance result against companies in the same industry (i.e., same four digits GICS industry group) that have received the same quantitative concern level (e.g., medium level of concern) under ISS’s Quantitative Analysis.

Attached Appendix B shows a sample ISS report on relative pay and performance assessment under the new qualitative factor.

Meridian Comment. The inclusion of a new qualitative factor to the pay-for-performance test is consistent with ISS's ongoing preference of adding complexity to existing proxy voting policies in the area of compensation. ISS indicated that it added this new factor in response to institutional shareholder comments on its pay-for-performance test. However, given the opaqueness of the factor, we wonder whether it will deliver meaningful information to shareholders or if it is an appropriate tool from which to gauge the relationship between CEO pay and company performance.

Further complicating matters from a corporate perspective is that ISS has chosen **not** to fully reveal its methodology for computing a company's relative financial performance results. Therefore, a company will be unable to determine independently the accuracy of ISS's calculation of these results.

Finally, we believe that ISS is likely taking the relative financial performance measure out for a test drive this proxy season and perhaps next before including it as part of the Quantitative Analysis. This will significantly raise the stakes regarding the importance and effect of ISS's relative financial performance assessment on determining whether a pay misalignment is present.

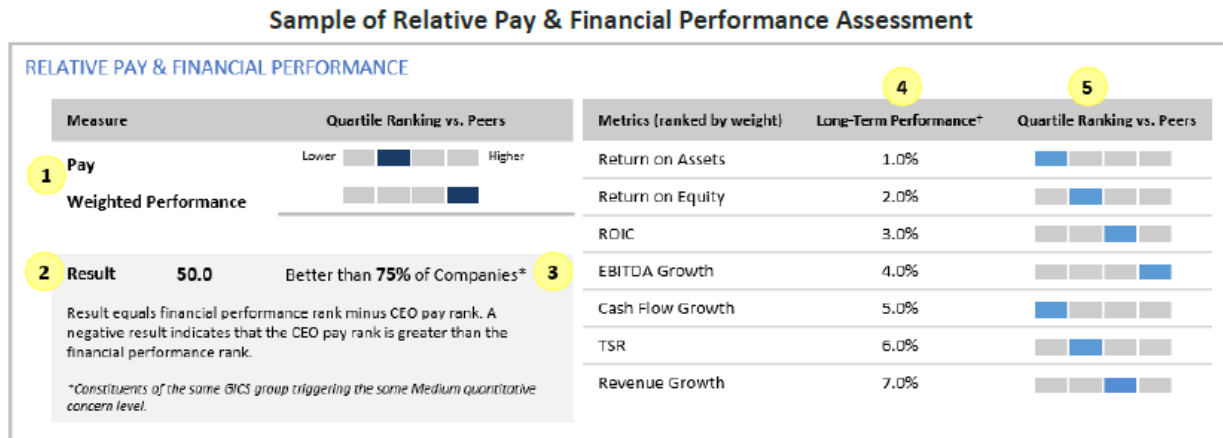
Appendix A: Relative Ranking of Performance Metrics – All Industries

GICS	TSR	ROE	ROA	ROIC	Cash Flow from Ops	Revenue Growth	EBITDA Growth
1010 - Energy	1	4	3	2	6 (T)	6 (T)	5
1510 - Materials	5	2	1	7	3 (T)	6	3 (T)
2010 - Capital Goods	6	3	2	1	5	7	4
2020 - Commercial & Professional Services	6	2	3	1	4	7	5
2030 - Transportation	2 (T)	4	2 (T)	1	6	7	5
2510 - Automobiles & Components	3 (T)	5	2	1	3 (T)	7	6
2520 - Consumer Durables & Apparel	1	4	3	2	5 (T)	7	5 (T)
2530 - Consumer Services	2	5	4	3	6	7	1
2540 - Media	5	3	2	1	4	7	6
2550 - Retailing	5 (T)	1	3	2	5 (T)	7	4
3010 - Food & Staples Retailing	7	2 (T)	1	2 (T)	5	6	4
3020 - Food, Beverage & Tobacco	7	2 (T)	1	2 (T)	5	6	4
3030 - Household & Personal Products	7	2 (T)	1	2 (T)	5	6	4
3510 - Health Care Equipment & Services	7	4	3	2	5	6	1
3520 - Pharmaceuticals, Biotechnology & Life Sciences	6	4	3	1	5	7	2
4010 - Banks	1	3 (T)	2	3 (T)	–	–	–
4020 - Diversified Financials	1	3 (T)	3 (T)	2	–	–	–
4030 - Insurance	4	5	2	1	3	6	–
4510 - Software & Services	6	3	2	1	5	7	4
4520 - Technology Hardware & Equipment	1	4 (T)	2 (T)	2 (T)	6	7	4 (T)
4530 - Semiconductors & Semiconductor Equipment	5	3	2	1	4	6	–
5010 - Telecommunication Services	5	2	1	3	6	7	4
5510 - Utilities	5 (T)	3	2	1	5 (T)	7	4
6010 - Real Estate (formerly 4040)	4	3	2	1	5	6	–

Metrics that are not currently used for a particular industry are denoted by a dash. Metrics with a tied ranking within a particular industry are denoted with "(T)".

Appendix B: Display in ISS Proxy Research Report

The relative pay and financial performance assessment appears below the ISS peer group analysis. A description and sample of the fields displayed are included below:



1. Visual representation of the subject company's CEO pay rank and weighted average performance rank.
2. Relative Financial Performance Result, which equals the financial weighted average performance rank minus the CEO pay rank.
3. Comparison of the result versus companies in the same industry with the same quantitative concern level.
4. Performance value for each metric (three-year or two-year scope), with the metrics sorted by order of importance (i.e., weighting) applicable to subject company's GICS industry group.
5. Visual representation of the subject company's performance rank for each metric as compared to the ISS peer group.

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The **Client Update** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

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