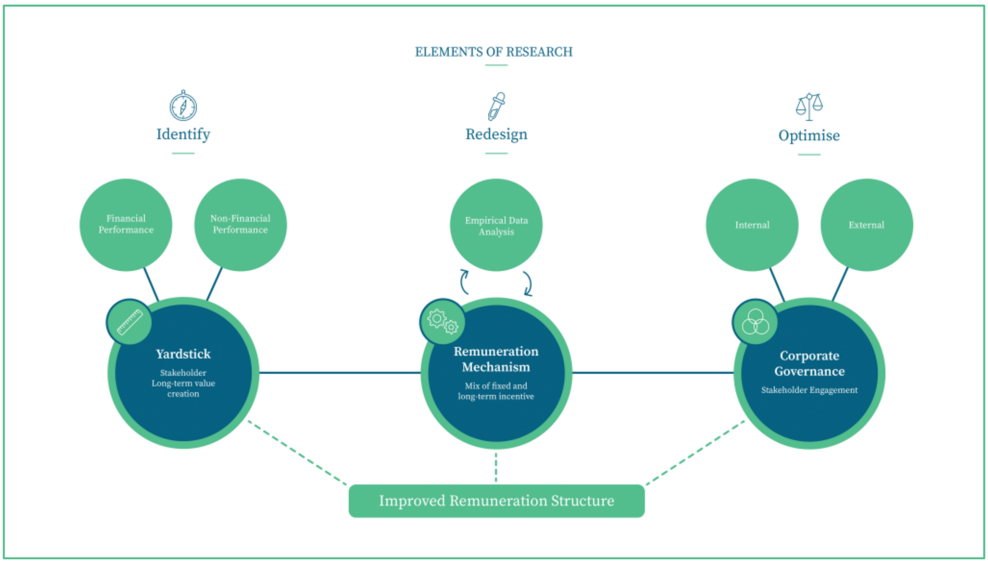
REWARD VALUE



EXECUTIVE PAY INSUFFICIENTLY ALIGNED WITH LONG-TERM VALUE CREATION

Executive remuneration today is driven by incentives that may no longer align with shareholder interests or reflect broader societal responsibilities.

Reward Value's mission is to support the development of remuneration policies that contribute to long-term sustainable and inclusive value creation. A preliminary scientific study commissioned to SEO Amsterdam Economics confirms an over-reliance on short-term financial measures in remuneration as a proxy for long-term value creation. Reward Value seeks to further the debate on executive remuneration with investors, business schools, and the business community at large to develop evidence-based, long-term, sustainable, and stakeholder-inclusive executive remuneration policies.

Reward Value is a not-for-profit research initiative. Reward Value can be reached by email (contact@rewardvalue.org).

BACKGROUND BEHIND THE INITIATIVE

Over the past decades, executive pay has seen tremendous growth, resulting in more and more public outcry as well as frequent discontent among the company's stakeholders (including shareholders). Not only is the level of pay leading to criticism, but the structure of pay, which impacts behavior, is also meeting considerable and growing resistance. Remuneration structures are often designed to stimulate short-term profit maximization instead of creating long-term sustainable value, disregarding environmental, social, and governance (ESG) considerations.

Executive remuneration is traditionally focused on an alignment with the interest of shareholders (principal-agency theory) but the mismatch in access to information, combined with a difference in time horizon between shareholders and management, makes it possible for managers to influence their pay beyond the contractual intent.

Corporate executives more and more are considered to have a role as stewards working toward long-term value creation for all stakeholders, integrating all assets (financial, social, and environmental) to generate sustainable contributions to its shareholders, employees, its customers, and society at large.

MISSION

What is needed is a thorough review of executive remuneration practice. Reward Value intends to contribute to the development of the required changes, and acts from an analytical, factual, and independent base. Reward Value is a not-for-profit organization and involves all relevant stakeholders in the development of its recommendations. Furthermore, Reward Value not only develops research, but it also can support the effective implementation of the required change.

Changing entrenched ideas on remuneration policy will require broad support from all stakeholders and a strong factual and scientific foundation. Reward Value has commissioned SEO Amsterdam Economics to support the initiative with extensive analytical research. Reward Value will continue to develop close cooperative working relationships with institutional investors, business schools, and the business community at large as partners in the development of recommendations for more effective performance-based pay reflecting long-term value creation and corporate contribution to society and nature.

FINDINGS INITIAL ANALYSIS

Reward Value and SEO Amsterdam Economics performed an extensive review of the relevant academic literature and in addition have built a database of 4,000 companies worldwide, going back up to 25 years, analyzing the relationship between executive incentive plans and short-term financial performance as well as long-term shareholder value creation. The full report is available upon request.

Incentives and behavior

The academic literature explains that incentives influence the behavior of executives, but the resulting behavior is not necessarily in the interest of shareholders or other stakeholders.

The literature offers three different views on the determining elements of executive remuneration:

- the shareholder perspective;
- the 'rent extraction' perspective; and
- the institutional perspective.

The shareholder perspective holds that shareholders broker an optimal contract with company executives, to align the executives' and shareholders' interests. In practice, however, this optimal contract does not exist. Executives may be in a position to influence their incentive packages, allowing them to extract undue remuneration from the company ('rent extraction'). Finally, institutional arrangements such as regulatory requirements or tax codes may affect executive remuneration.

Data analysis departing from these three vantage points shows that:

- short-term financial performance is a poor indicator of long-term value creation;
- market capitalization as a proxy for the value of the company is positively correlated to total executive pay, but executive share ownership is not correlated to long-term value creation;
- share price volatility can positively affect executive compensation but is negatively correlated to the long-term value creation of the company;
- cash bonuses and other non-equity incentives are more effective at driving better financial performance than equity incentives; and
- larger companies pay out disproportionally higher remuneration packages.

Corporate governance

Corporate governance is a critical factor in ensuring appropriate executive remuneration. Non-executives should provide a safeguard against undue value extraction from the company. In addition, good governance increasingly requires moving beyond the traditional shareholder value paradigm toward the sustainable performance of the company in relation to employees, customers, and society at large.

CATEGORIES OF RECOMMENDATION

Going forward, the focus on recommendations for improved executive remuneration revolves around three themes:

Identify

Identify performance metrics (Yardstick). Integrating financial, social, and environmental performance on long-term value creation for all stakeholders, assessing the company's sustainable performance compared with industry or market general performance.

Redesign

Redesign remuneration mechanism. Structuring executive compensation in support of long-term value creation, moving away from the current practice of short-termism, and incorporating the designed performance metrics as mentioned above.

Optimise

Optimise corporate governance. The effectiveness of pay for performance is highly influenced by the strength of corporate governance. This is dependent on the quality and independence of the Board of Directors supervising management, as well as external regulations (for instance, corporate governance codes, tax rules, and enforceability of clawbacks).

REWARD VALUE'S APPROACH

More effective executive remuneration policies lead to better outcomes for shareholders and other stakeholders (such as employees, customers, and society at large). The need for change is clear; the road to the required change, however, is to be developed.

Reward Value is building a foundation for new, stakeholder-aligned remuneration policies and has developed a research agenda around the three key themes for recommendation.

Following the initial academic research and building on historical data on remuneration and financial and non-financial performance, both short term and long term, the effectiveness of recommendations will be tested and validated research done in cooperation with SEO Amsterdam Economics and international business schools and universities.

Next to research, Reward Value will work closely with institutional investors and other key stakeholders to discuss and develop recommendations and agree upon vital next steps toward the implementation of the required change. Reward Value facilitates this process and acts as an intermediary between the different stakeholders.

PARTICIPATION

Across-the-board changes to executive remuneration should not be limited to one country or one company alone. Broad support from many stakeholders is required.

Two key networks are needed to create an evidence-based remuneration policy in collaboration with all relevant stakeholders:

1. A strong coalition of research professionals from universities, business schools, and leading strategy consultants, to establish credible analyses and support the design of new remuneration models ('evidence-based').
2. An active network of leading institutional investors and other key stakeholders (e.g. proxy advisors and accountants) influencing companies to modernize their remuneration policies ('collaborative approach').

Reward Value is looking to expand its above-mentioned networks. Your support can help us drive this important work forward. Reward Value is keen to discuss the opportunities for cooperation with you.