FEBRUARY 2013

Performance Metrics

AND THEIR Link to Value

SBA FLORIDA
STATE BOARD OF ADMINISTRATION

The State Board of Administration (SBA) sponsored an executive compensation research study by Farient Advisors LLC, covering 1,800 companies, 24 Industry groups, and fourteen years of data (from 1998-2011).

The research project identifies the primary metrics used in executive compensation plans, overall and by industry, company size, and valuation premiums, and then tests these metrics to determine whether the metrics being used have the highest impact on total stock returns.

It provides the most definitive answer to date on a critical question: Are companies choosing their long-term incentive metrics wisely for the most sustainable benefit to shareowners?

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THIS IS THE SBA:

The statutory mission of the State Board of Administration of Florida (SBA) is to invest, manage and safeguard assets of the Florida Retirement System (FRS) Trust Fund and a variety of other funds for state and local governments. FRS Trustees are dedicated to ensuring that the SBA invests assets and discharges its duties in accordance with Florida law, guided by strict policies and a code of ethics to ensure integrity, prudent risk management and top-tier performance. The SBA is an investment fiduciary under law and subject to the stringent fiduciary duties and standards of care defined by the Employee Retirement Income Security Act of 1974 (ERISA), as incorporated into Florida law. The SBA has three Trustees: the Governor, as Chairman, the Chief Financial Officer, and the Attorney General.

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Farient Advisors LLC (www.Farient.com) is an independent executive compensation and performance consultancy which helps clients make performance enhancing and defensible executive compensation decisions that are in the best interests of their shareowners. Farient provides a comprehensive array of executive compensation and performance advisory services, including compensation strategy and planning, program design, decision support, process support, and other services including board of director compensation, technical reviews, investor communications, and assistance in transactional situations. In addition, based on its extensive data base covering the Russell 3000, Farient offers a proprietary performance and pay Alignment Model to help assess, improve, and convey pay and performance alignment. Farient Advisors was founded in 2007 and has offices in Los Angeles and New York. Farient also is affiliated with Kepler Associates, a London-based firm.

The full executive compensation study by Farient Advisors can be found on their website at:

http://www.farient.com/blog/farient-study-performance-metrics-and-their-link-to-value/

Which metrics ARE THE BEST?

Executive Compensation

EACH YEAR the State Board of Administration (SBA) evaluates hundreds of executive compensation plans. The SBA critically examines corporate compensation structures for quality and efficacy of their design. As part of this effort, we have frequently addressed a critical question that has challenged most shareowners - how effective are the individual performance objectives embedded within virtually all compensation strutures, and how closely are they tied to the company's stock price?

Many compensation committees struggle with this central thesis when developing long-term incentive plans for the companies they serve as directors. The performance metrics selected, as determined by the company and its board of directors, are deemed by many observers to be the best measures of corporate success. Investors and other interested stakeholders wish to validate that these metrics are in fact linked to Total Shareowner Return (TSR).

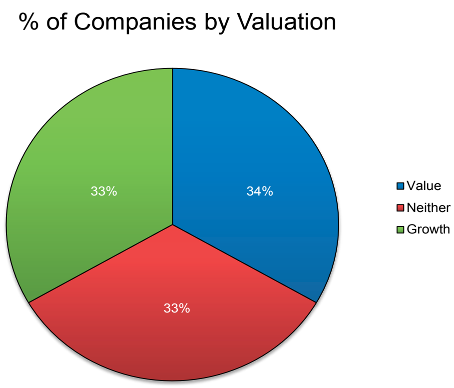
The SBA has adopted policies to evaluate the design features and individual components utilized within LTIPs, in order to understand what incentives are created and how performance against those measures impacts shareowner value.

STUDY FINDINGS

This study found that among companies using performance-based long-term incentives, most (53 percent) use a mix of TSR and financial measures in their long-term equity plans; others (28 percent) use financial measures only; and a smaller minority (15 percent) use TSR only. This allocation of performance measure usage underscores the need to identify the right metrics for a given firm.

The study found that, in aggregate, performance metrics are generally well-aligned with shareowner value. Earnings growth, followed by returns and revenue growth, has the greatest impact on stock

The study's researchers found that approximately half of all industry groups could use some improvement in their selection of performance measures. The companies in these industries either are not using the metrics that are most strongly correlated to value or, when the overall correlations of financial metrics to shareowner value are poor, they are not sufficiently using TSR as a direct measure of shareowner performance.



prices. This result matches the usage patterns for financial metrics in long-term incentives: earnings growth is the most popular financial measure, followed by returns and revenue growth. TSR (usually measured on a relative basis) is used as a direct measure of shareowner value in over 40% of companies with performance-based long-term incentives.

This review also found that many industries have a number of metrics to choose from, with half of the 24 industry groups studied having at least three metric categories with strong correlations to TSR. However, the optimal use of measures differs considerably by industry. Industry group classification, as an indicator of business model, has the strongest influence on the type of performance metrics in place over the study's time frame, with size and valuation premiums having little impact on metric selection.

RECOMMENDED ACTIONS

Based on the SBA's research with Farient Advisors, there are several key takeaways for shareowners and boards of directors to consider when they design and evaluate long-term incentive compensation plans.

1. Companies should undertake their own analysis to determine which measures of performance have the most influence on shareowner value.

Various measurement definitions (for example, approaches to depreciation, capital expenditures, asset definitions, and other items) could make a significant difference to shareowner value and should be given careful consideration.

2. Companies should identify two or three key metrics that appropriately balance growth and returns and demonstrate a proven link to value.

If overall correlations to value are poor for existing long-term incentive plans, a board should change the metrics.

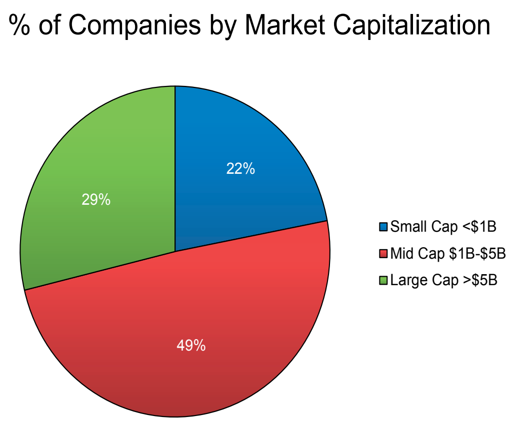
3. Investors are likely to increase engagement activities around executive compensation in general, and specifically on performance metrics.

In communicating with investors, companies should present compelling evidence as to how various measures of performance will lead to enhanced shareowner value.

Are companies choosing their long-term incentive metrics wisely for the most sustainable benefit to shareowners?

According to recent data, long-term equity incentives (stock options, restricted stock/units, and performance shares/units) now comprise over half of total compensation for the Chief Executive Officers at companies within the S&P 1500 stock index.

Investors and other interested stakeholders wish to validate that these metrics are, in fact, linked to TSR (defined as stock price appreciation plus dividends, as if those dividends had been reinvested in the company's stock).



COMPANY UNIVERSE AND METHODOLOGY

To conduct this research, Farient identified the primary metrics being used in executive compensation plans, overall and by industry, company size, and valuation premiums. Farient then tested the extent to which those metrics correspond to TSR to help answer the question, - are companies choosing the right performance metrics?

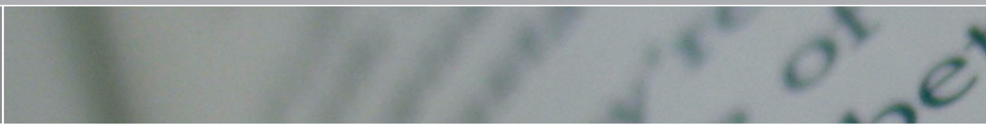
Data from 1998-2011 were used in the research, capturing the top 750 companies in market capitalization for each year covered, for what comprised a database of over 1,800 companies. Data on performance metrics were supplemented by additional data provided by Farient on executive pay trends. Farient conducted an in-depth analysis based on its experience analyzing and developing pay programs and performance measurement systems that link to shareowner value.

In conducting this research, Farient analyzed companies by industry (as indicated by their 2- and 4-digit global industrial classification standard codes (GICS)), size (as indicated by market capitalization), and valuation premiums (i.e., the premium of the market value over the book value of the company). All data collected pertain to that for the named executive officers (or NEO's), as disclosed in company proxy reports to shareowners.

The companies in the performance measurement data set span all industries, as well as a wide range of sizes (based on market capitalization) and valuation premiums (based on market-to-book ratio).

The valuation premiums split companies evenly into three equal groups – Growth (i.e., those with valuation premiums of 2.7 or higher), Value (i.e., those with valuation premiums of 1.5 or lower) and Neither (i.e., those with valuation premiums higher than 1.5 but lower than 2.7).

To determine which metrics are most correlated with TSR, Farient analyzed the correlations between financial measures of performance and TSR over 3- and 5-year rolling periods, using the 1998 to 2011 data set. To conduct the correlation analysis, Farient tested over 20 specific financial measures. Non-financial metrics, such as "Individual



PERFORMANCE MEASUREMENT

Performance" and "Other," were not included in the analysis. Farient also tested static as well as dynamic growth measures. For example, Farient tested both earnings as a percent of sales (a static measure) as well as earnings growth (a dynamic measure).

Farient notes an important caveat in its study - namely, that correlation does not infer causality. Since the study measured correlations between financial metrics and TSR over contemporaneous time periods, some of the correlations may be due to a large number of companies adopting the same metrics and executives increasing their focus to deliver better results on those metrics. In addition, Farient recognized that there is a bias in the correlation analysis, since growth measures, like earnings growth and revenue growth, are "dynamic" measures, just like TSR.

Dynamic measures gauge performance from period to period, while static measures gauge performance within a period. Correlating dynamic measures with TSR, which is itself a dynamic measure, vs. correlating static measures with TSR, favorably advantages the dynamic measures in the analysis.

To determine the extent to which companies are using metrics that most closely correlate to TSR, Farient compared the list of most frequently used performance metrics to the list of metrics that most closely correlate to TSR, by industry group.

METRICS MOST CORRELATED WITH STOCK PRICE PERFORMANCE

The increased use of performance-based long-term incentives makes it more important than ever for companies to select appropriate performance metrics, i.e., metrics that correlate to shareowner value and align executives with shareowner interests. To determine which financial measures have the greatest impact on shareowner value, Farient tested the correlation of various financial measures to value for each of the 24 Industry

"One clear outcome from Say-on- Pay voting on executive compensation has been a focus on pay for performance. To determine how well executives are aligned to the long-term performance of their companies, investors are evaluating to what extent executive compensation, particularly for the CEO, is linked to company performance, as opposed to being based on the passage of time – what is sometimes referred to as "pay for pulse." Robin Ferracone, CEO, Farient Advisors

groups. For ease of presentation, the measures were grouped into five measurement categories as follows:

EARNINGS GROWTH – 3-year compound annual growth rates (CAGR) for Net Income, various definitions of Operating Income, and Earnings Per Share (EPS)

REVENUE GROWTH – 3-year compound annual growth rate (CAGR) for Revenue

RETURNS – ROA, ROIC, ROE, and other measures (Operating and Net, but before Extraordinary Items) that were divided by Assets. Returns can be important in that they take the investment, i.e., the balance sheet, into account

CASH FLOW – Operating Cash Flow minus Capital Expenditures, measured either in terms of growth or in terms of return (i.e., divided by assets). Cash Flow is important because it takes investment, i.e., CapEx, into account

EARNINGS MARGINS – various Earnings measures (with combinations of Earnings before and after Depreciation, Amortization, Interest, and Taxes – e.g., EBITDA), divided by Sales

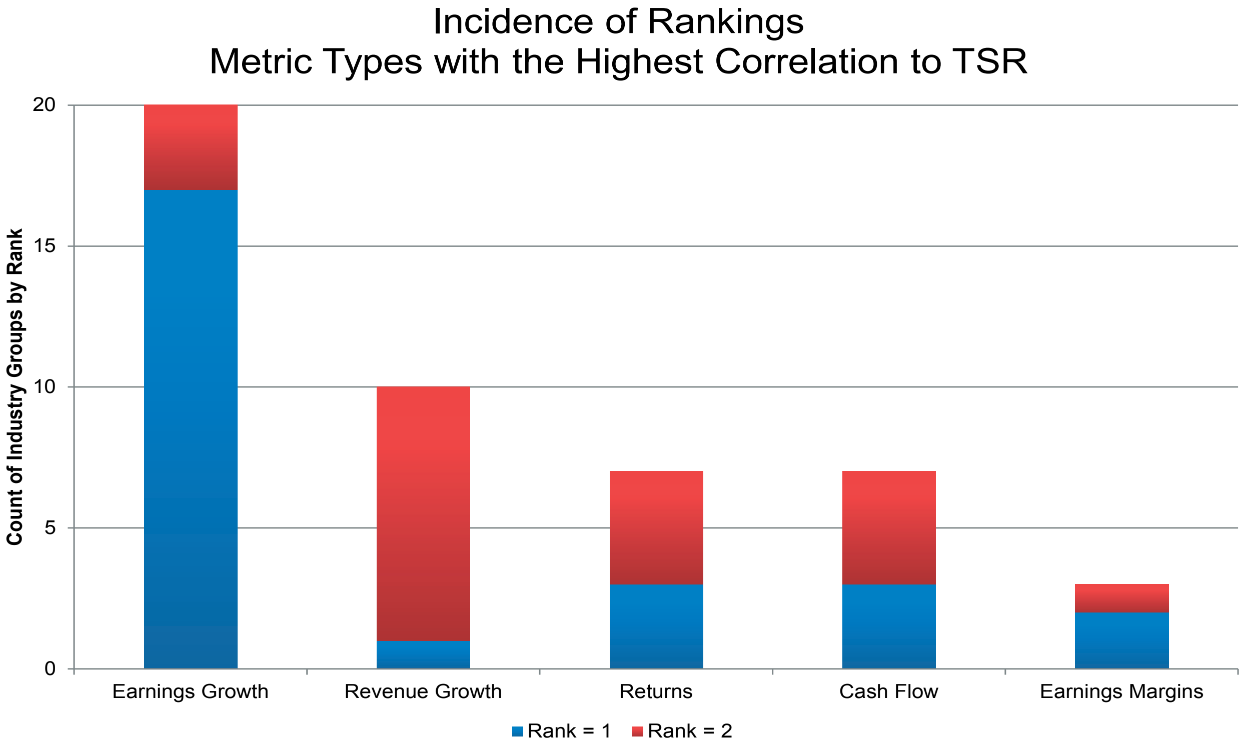
Farient ranked these measures into five categories from 1 to 5 for each industry group based upon which measures have the greatest influence on TSR, as indicated by their correlation to value. Correlation coefficients can range

METRICS MOST CORRELATED WITH TSR

from -1.00 to 1.00, with positive numbers indicating a positive correlation – the higher the number, the stronger the correlation. 1.00 is a perfect positive correlation; 0.00 is no correlation; and -1.00 is a perfect negative correlation. Farient counted measures with correlation coefficients of greater than 0.25 that also were statistically significant.

A more detailed summary of the Farient study provides the specific rank order of the correlations for each measurement category by industry group, as well as the correlation coefficient that corresponds to how well each measure is correlated with shareowner value in that industry group.

Farient research found that earnings growth measures have the strongest correlation to value (total stock price return). Earnings growth was ranked #1 in 17 of the 24 industry groups (with one tie). It was not unusual to see all three earnings growth metrics that were tested – EPS, Net Income and Operating Income – near or at the top of the correlation results. Revenue Growth was often the second most highly correlated metric.



How individual performance measures are defined is also important. For example, ROE (or Book Value growth) vs. ROA/ROIC has a high correlation to value in some industries, like Insurance, but not in others, such as Household and Personal Products. Farient noted that this suggests prudent leverage earns a premium to value in some industries (e.g., Insurance), but imposes a discount to value in others. This likely is due to the fact that leverage is critical to the business model in certain industries, like Banks, but is not critical to the business model in other industries. Researchers noted that in fact, if leverage is too high in those other industries, like Household and Personal Products, it only introduces greater risk.

Many industries have a number of metrics to choose from when looking to support shareowner value. Half of the 24 industries have at least three metric categories with strong correlations. Six industries (i.e., Materials, Capital Goods, Food & Staples Retailing, Household & Personal Products, Technology Hardware & Equipment, and Semiconductors and Semiconductor Equipment) have all five metric categories to choose from.

On the other hand, four industries (i.e., Media, Pharmaceuticals, Biotechnology & Life Sciences, Banks, and Real Estate) have only one or two metric categories to choose from. Industries with weak correlation results, or a limited set of metrics to choose from, could benefit from using TSR directly as a valid metric.

"Are companies using measures of performance that correlate to value?" While TSR (usually relative TSR) is measured directly in many long-term incentive compensation plans, companies have increasingly gravitated toward the use of absolute financial metrics in equity long-term incentive plans. The question is: "Have they chosen those metrics wisely?"

Some industries link at least 50 percent of their equity long-term incentives directly to TSR. These industries include: Utilities (89 percent); Real Estate (58 percent); Household & Personal Products (56 percent); Transportation (52 percent); Capital Goods (51 percent); Energy (50 percent); Consumer Durables and Apparel (50 percent); and Food, Beverage and Tobacco (50 percent).

As indicated in the table on the next page, some industries demonstrate a clear alignment between the metrics most frequently used in long-term incentive equity plans and shareowner value. Half of the 24 industry groups show solid to strong alignment; the metrics used most often also are those that best correlate to value. The other half could benefit from some improvement. It is important to note that these statements do not apply to individual companies. Rather, they point more generally to those industries in which improvement opportunities might exist.

In order to garner a "Weak" rating, companies in the industry group needed to most often use measures that were not the most highly correlated to value, and/or if the correlations were poor, did not make significant use of TSR as a direct measure of value. For example, Telecommunications Services uses Earnings Growth most often, but efficiency measures like Margins and Free Cash Flow are better indicators of value.

Only 26 percent of companies in the Telecommunications industry use TSR as a direct measure of value. Measures in Pharmaceuticals, Biotechnology & Life Sciences have an overall low correlation to value, and only 34 percent of these companies use TSR as a direct measure of value.

Among companies using performance-based long-term incentives, most (53 percent) use a mix of TSR and financial measures in their equity long-term incentive plans; others (28 percent) use financial measures only; and a smaller minority (15 percent) use TSR only.

Earnings Growth is the most popular financial measure, followed by Returns and Revenue Growth. TSR (usually measured on a relative basis) is used as a direct measure of shareowner value in over 40 percent of companies with performance-based long-term incentives.

Industry group, in general, as an indicator of business model, has the strongest influence on performance metrics used, with size and valuation premiums having little impact on metric selection. Half of the 24 industry groups use metrics that most highly correlate to value, and also use TSR as a direct measure of shareowner value.

Unfortunately for investors, the other half of industry groups could use some improvement. The companies in these industries either are not using the metrics that are most strongly correlated to value or, when the overall correlations of financial metrics to shareowner value are poor, they are not sufficiently using TSR as a direct measure of shareowner performance.

STRENGTH OF INDUSTRY ALIGNMENT
Performance Metrics versus Total Stock Return

"WEAK"	"MODERATE"	"GOOD"
1. Telecommunications	1. Transportation	1. Energy
2. Food & Staples Retailing	2. Consumer Services	2. Materials
3. Pharmaceutical, Biotech & Life Sciences	3. Media	3. Capital Goods
4. Semiconductors	4. Household & Personal Products	4. Commercial/Prof Svcs
	5. Banks	5. Automobiles & Comp.
	6. Insurance	6. Consumer Durables & Apparel
	7. Real Estate	7. Retailing
	8. Software & Services	8. Food, Beverage & Tobacco
		9. Health Care Equipment
		10. Diversified Financials
		11. Technology Hardware & Equipment
		12. Utilities

Metric Type	Metric
TSR	Total Shareowner Returns: Stock Price Appreciation, Including Dividends
Earnings Growth	Earnings: Income Before Extraordinary Items
	EBITDA: Earnings Before Interest, Taxes, Depreciation, and Amortization
	EBIT: Earnings Before Interest and Taxes
	EBT: Earnings Before Taxes
	EPS: Earnings Per Share
Earnings Margins	Various Earnings Measures (EBITDA, EBIT, etc) as a percent of Revenues
Returns	ROA: Return on Assets
	ROE: Return on Equity
	ROIC: Return on Invested Capital
EVA	Economic Value Added: Net Operating Profit After Tax - Capital Charge
Cash Flow	Cash Flow from Operations
	Funds from Operations
	Free Cash Flow Growth
Revenues (Sales)	Revenues (Sales)
	Sales Contracts
	Same Store Sales
Individual	Individual Performance
Other	Book Value
	Cost Reduction
	Customer Satisfaction
	Debt-related
	FDA Approval
	IPO of Subsidiary
	Operational
	Working Capital
	Others

Farient noted significant improvement opportunities in these industries, including a greater need to use TSR directly when correlations to value exhibited by existing metrics are poor and a greater need to take capital investments into account, not just the earnings from those investments.

Farient predicts that metrics will become increasingly important and more visible as investors and executives try to better align executive incentives with shareowner interests. Farient's study also suggest key steps that investors and companies can take in order to improve that alignment, including companies undertaking their own analysis to determine which measures of performance have the most influence on their shareowner value.

Companies may try to find two or three key metrics which appropriately balance growth and returns and demonstrate a proven link to value. If only one financial metric correlates to value, then companies should choose that single financial metric, perhaps supplemented by relevant non-financial metrics, and/or TSR.

Investors are likely to increase engagement activities around executive compensation in general, and specifically on performance metrics. In communicating with investors, companies should present (and investors should expect) compelling evidence as to how performance on various measures will lead to enhanced shareowner value.

CONCLUSION

In domestic equity markets, say-on-pay advisory votes have induced many investors to take a closer look at executive compensation and the relationship between pay structure and its link to shareowner value and stock price performance. Farient Advisors' CEO, Robin Ferracone stated, "As investors, executives, and boards try to better align executive incentives with shareowner interests, performance metrics (and the goal-setting processes that accompany those metrics) will come under greater scrutiny." This sponsored research sheds light on not only the correlation of specific performance metrics, but also on how industries can improve the alignment between performance metrics and shareowner value.

Executive compensation design has moved towards long-term incentive components in an attempt to align management interests with those of long-term shareowners; further, those long-term incentives are now largely performance-based.

The SBA hopes that this analysis is helpful to investors and companies alike, and that it contributes to the quality of the dialogue with increased focus on the fact that incentive programs, and the metrics that drive them, can enhance shareowner value and support the alignment between pay and performance.

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1801 Hermitage Boulevard, Suite 100
Tallahassee, Florida 32308
(850) 488-4406

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