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Three Keys to Incentive Design

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Incentive design is critical to support strategy, retain and motivate the best talent, and align compensation with performance and shareholder experience.

Three keys to strong incentive design are:

1 Choose the Right Performance Metrics Metrics that reflect strategy, value creation and market context.	**2 Set Performance Goals with Reasonable Stretch** Targets triangulated from five distinct perspectives.	**3 Design for Resilience** Plans that hold up across a range of scenarios, not just one.

Choose the Right Performance Metrics

Choose the right metrics for your business by weighing:

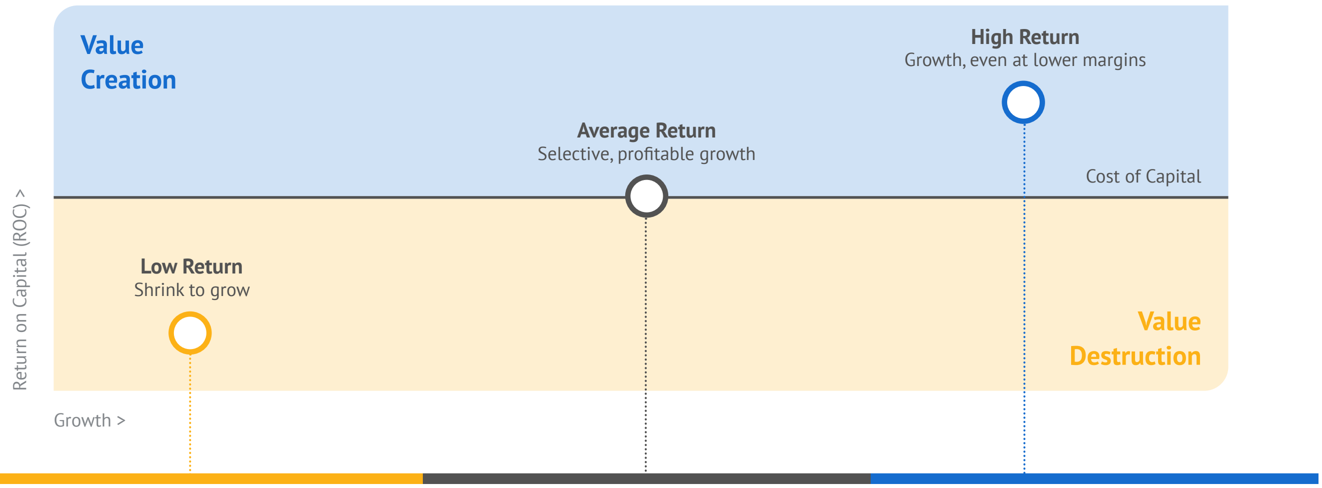
- Strategy & Investor Goals
  Near- and long-term business strategy, with a focus on investor-facing goals and targets.
- Value-Driving financials
  The financial metrics that most directly drive value creation for shareholders.
- Operating Plan
  Your critical annual operating plan metrics.
- Analyst & Investor Coverage
  Metrics covered by analysts and investors in your sector.
- Peer Practice
  Metrics used by your closest peers.
- Growth Stage
  Where your company is in its growth journey
  (pre-revenue, profitable growth, enhanced returns, "shrink to grow")

Creating value is a function of three primary activities:

1. Generating profitability/returns in excess of the cost of capital;
2. Adding business that has returns above cost of capital;
3. Eliminating business which has returns persistently below cost of capital.

Metrics need to have the right blend and degree of emphasis on advancing profitability/efficiency vs. growth. This depends on where a company is along the profitability continuum.

Exhibit: Return on Capital vs Growth



Low Return

Companies that do not sustainably generate returns above the cost of capital should focus on returning to profitability — from cost cutting to more fundamental change, including strategic alternatives and divestitures. **Relevant metrics:** cash flow, margin improvement, cost and debt reduction, and divestiture targets.

Average Return

Companies with returns close to the cost of capital generally focus on profitable growth — adding value by growing selectively, only at current or higher levels of profitability. **Relevant metrics:** operating profit, EBITDA, EPS and cash flow, with revenue weighted lightly.

High Return

High-profit companies should focus on growth which, even at lower margins than the current business, adds value. **Relevant metrics:** revenue, market share and/or investment growth, balanced with a profitability metric to keep returns above the cost of capital.

Set Performance Goals with Reasonable Stretch

Performance goals — whether for short- or long-term incentives — generally require both quantitative and qualitative assessments. Consider not just “target,” but the performance range around it (threshold and maximum). Five perspectives, in combination, drive reasonably stretched goals.

- Operating Plan / Budget
  The most common starting point — management’s assessment of what it expects to achieve next fiscal year, reflecting a realistic view of both risks and opportunities.
- Performance of a Relevant Peer Group
  How others in the same industry perform over time. Because this is backward-looking, it should be informed by where the company sits in its value-creation journey and realistic market and economic expectations.
- Strategic Aspirations
  Consistency with the company’s strategic aspirations — either matching or meaningfully progressing toward desired long-run results.
- Investor Expectations
  Consistency with what investors expect near- and long-term; at minimum, goals should not reward performance below market guidance.

- Sustainable Sharing
  Stress-tested to ensure the sharing of profit and value creation between employees and shareholders is both reasonable and sustainable.

Design for Resilience

Well-designed incentive plans work appropriately in most scenarios — not just a narrow band of expected outcomes. Resilience can be built in six ways:

- Balance market-sensitive metrics
  Include both market-sensitive and non-sensitive metrics — for example, a commodity-price-sensitive profit metric alongside a cost or production metric — and layer in sustainability measures such as safety, environmental impact, or customer and employee metrics.
- Vary metrics by time horizon
  Use different metrics for annual and long-term incentives so each aligns to its own duration and goals. Long-term metrics measured over three years can be designed to "ride through" shorter volatile periods.
- Consider an asymmetrical payout curve
  Where risks and opportunities aren't symmetrical, widen the range below target when downside risk dominates, or above target when tailwinds are significant — avoiding a maximum payout for tailwind enhanced performance.
- Use relative TSR to moderate macro noise
  Relative total shareholder return dampens the impact of commodity prices or macro conditions — and works best with a reasonable number of peers exposed to similar dynamics.
- Set adjustment principles in advance
  Agree on materiality and symmetry principles for external events outside management's control — FX rates, fuel prices, transactions — so targets can be set with more stretch from the outset.
- Balance long-term vehicles
  Combine restricted share units (retention in down markets), performance share units (leverage with controllable moderation), and stock options (long-term share-price alignment).

Meiridan Perspective

There is rarely a perfect incentive design. The goal is performance metrics that make sense for the business, targets set with reasonable stretch and downside protection, and a design that delivers reasonable outcomes across a range of scenarios.

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