LF: Laura Finn
JL: John Lukomnik

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LF: Hello and welcome to this edition of This Week in the Boardroom. I'm Laura Finn, Editorial Director for Digital Media at NYSE Governance Services. And sitting to my right is John Lukomnik, Executive Director with the Investor Responsibility Research Center Institute. John, thank you for joining me today.

JL: Thanks very much Laura. I'm glad to have the opportunity.

LF: I think this will be an interesting web cast for all of our board viewers since the IRRC just recently completed some research about value creation, performance matrix, and executive compensation. So I'm happy to have you here to talk about it.

JL: My pleasure.

LF: Now you started the research project by asking the question what is the relationship between company economic performance, shareholder return, and executive compensation. Were you surprised by the answer to this question?

JL: You know I didn't go into it with any expectations. In fact the truth is, and this is where it is un_____ as we're about to discuss an exec. comp. research piece, I hate executive compensation research. I find most of it to be overwrought, boring, and quite honestly a bit voyeuristic in terms of just look at how much someone got paid. It's not actionable and not particularly enlightening. So I did have expectation I guess I should say, which is that this analysis would be different. It would be all about creating value and you'll note, for instance, there isn't a single figure in it about how much a CEO got paid. So this was all about are we aligned with economic principles and value creation, and from that regard I thought we might get some surprising answers. What I did find surprising was the level of the findings. Some 75% of the S&P 1500 have no capital efficiency matrix in their long-term incentive plan so they don't measure the cost of capital. Let me explain how important that is. I know we have a sophisticated audience so I'll make this the briefest finance 101 ever. You need to earn more than your cost of capital, period. Now that seems obvious. I mean the formula's return on investment capital should be more than your weighted average cost of capital, but it seems obvious you can't; if you were just borrowing money at 5% you can't earn 3%. That's not a good trade right. Now you can do it for some period of time, you can invest for the future, and senior management and the board at that point has to make a determination of will that investment pay off over time even if not during the exact same time period, but you certainly can't do it forever. That's the end of the finance 101. So the fact that 75% of companies have no

measure of the cost of that capital was a little surprising. The lack of alignment – you know if you don't measure it you can't align with it – so the lack the lack of measurement of one of the key inputs to real economic value creation was surprising. That has real world consequences. Perhaps as a result of that 47% of companies in the S&P 1500 over a five year period ending 2012 did not earn more than their _____ and average cost of capital. In other words, they destroyed economic value. That's a pretty stunning result to say nearly half of the largest companies in America destroyed economic value over a five-year period. And by the way we tested over rolling five-year periods, over a 10-year observation window. It is not linked to coming out of the financial crisis or anything like that. So yeah I was surprised by the level of the lack of alignment.

LF: And you looked at S&P 1500 companies and what was the methodology. How did IRRC cull this data?

JL: It was actually a huge project. It was not easy. We had to combine multiple databases and sources and experts with analytical capability. So I should tell you, as long as you're giving me the opportunity I'll take the opportunity to thank Organizational Capital Partners, which is the primary author and analyst of this report, and Mark Van Cleave and ____ ____, the core raw data feeds and quality assurance checking were from Compustat, Execucomp, Morningstar, Hoovers, Credit Suisse, ____, Tom Hillman was very helpful. As I said Mark and Organizational Capital pulled together the economic performance data but there were others involved as well. For instance, the long-term incentive design and pay for performance line measurement came from Shareholder Value Advisors headed by Steve O'Byrne and from Incentive Lab, when Jack Zwingli was in charge. Now Incentive Lab has since been bought by ISS, but I want to make it clear that they were independent at the time of this project. The other thing is that there is a second report, which will be out by the time this airs, on how investors vote on Say-on-Pay and how proxy advisors recommend on Say-on-Pay in light of the economic issues and that was pulled together from Fund Votes and Jackie Cook. So it was hurting a lot of very high power, high analytical teams into answering what should have been I think a simple question: is long-term incentive design aligned with the basics of economic profitability.

LF: Huge project; so many people helped on it and I do want to talk about alignment with you because one of the findings from the research is that more than 85% of the S&P 1500 have no disclosed line of sight process matrix aligned to future value such as innovation and growth drivers. I wanted to talk with you a little bit about what exactly that means for these companies.

JL: We all talk about enterprise value. I guess I wasn't quite done with finance 101 so let's call this finance 102. Enterprise value actually has two major components: current value, which is the sum total of all your economic project plus capital, but there's also a future value component. Future value is often ignored but it's really really important. It's the net present value of yet to be achieved cash flows from new products, new services, new markets, new business opportunities that may increase your margins. So you can think of it; the way I like to think of it is it's the net present value of potential, or better yet of

realizable potential. I use realizable for a reason and it's real. Depending on the company it ranges from 25 to 70% of enterprise value for the S&P 1500. So it's a material fact and it's related to the perceived quality of management and that's what I mean by realizable. You may have the same opportunity set for two different companies, investors will value the quality of management to achieve that in a different way and it affects your market multiple, or if you're private private valuations. So the question is, to get to your specific question now that the background is set, what drives future value? Innovation, new products, new markets.

LF: Research development.

JL: Research development. Think about it in terms of places like pharmaceuticals. I mean it took Apple six years to develop and iPad. You've got a need to measure what percentage of revenues come from products developed in the last year or services. Now some companies have those matrix and as you might imagine we would recognize them immediately as the most innovative major companies in America.

LF: What kind of companies are those?

JL: 3M, Abbott Labs, those are two of the best examples. They measure their product development through the pipeline, but 85% of companies don't. That also has real world implications. So, for instance, research and development and new capital expenditure, which would be the two inputs into that product or marketing stream, they've actually declined as a percentage of revenue from 2.9% of revenues in 1998 to 1.7% in 2012. On a revenue adjusted basis, that's a 41% decline.

LF: Very significant.

JL: Very significant. So when you say line of sight it's if they don't measure capital efficiency they don't have a lot of _____ value and if you don't measure innovation in some way specific to that specific company you're not measuring future value so you're not really driving enterprise value.

LF: And innovation I think is key. You mentioned 3M and Abbott, and those are companies that maybe you would expect to weigh innovation, but I think it's important for all of the companies across the S&P 1500 to measure innovation no matter what your industry area is.

JL: You know the most over-used word I think in the business press in the last year is disruptive.

LF: Yes.

JL: Well, so lets try to avoid it, but someone out there is attacking your business model. You'd better be innovating. It's a very rare, probably highly regulated company that can afford not to innovate their business model, their products, their markets, etc.

LF: John, we are out of time and we have so much to talk about with your research that I would love to have you back on the show next week so we can talk some more and talk a little bit more about the impact on executive compensation.

JL: My pleasure.

LF: So join us again next week when John and I discuss more on IRRCI's research on value creation, performance matrix, and executive compensation. Thanks so much for watching.

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