APG Remuneration Guidelines to listed European and US companies

1 Introduction

As a large asset manager for pension schemes in the Netherlands, APG Asset Management is invested for its clients in many companies worldwide. Of our total assets under management of approximately 452 billion euros (April 2017) 80% are managed in-house and 60% of that is invested in equities across several investment strategies. The integration of governance and sustainability factors is a key feature of our investment approach. We believe that it contributes to risk-adjusted returns and we see it as an important part of our commitment to our clients to invest responsibly.

In September 2015 we introduced remuneration guidelines to apply to our European portfolio companies. The guidelines were based on discussions we previously had with companies and intended to reflect our investment mind-set and views on the issue of remuneration. The guidelines were well received and have fulfilled our objective that they serve as a framework for discussions around these issues. Recognizing that success, we now introduce updates to reflect some market developments that happened since and at the same to time expand the scope to include US listed companies.

Pay for us has an additional dimension beyond corporate governance: the social impact of pay. Irresponsible remuneration practices can cause reputational damage to companies and to their investors. In the long run, if this is not tackled effectively, our concern is that the legitimacy of business itself is eroded. The social impact seem to be concentrated around the two ends of the scale, the high pay awarded to senior executives and the pay levels awarded to the lowest paid employees of a company. Whilst still remaining focused on corporate governance, this updated version of the guidelines take a further step in the direction of recognising the social impact of pay. In the most basic terms, we believe that long-term value creation to shareholders is the added economic value over and above the cost of capital. We believe that pay policies should be set to reflect and support this.

To achieve optimal creation of value over time, we expect boards and their remuneration committees to incentivise management to balance between efficient operation of existing assets and efficient capital allocations and capital growth.

This guidance supplements APG's Corporate Governance Framework[1] and other corporate governance guidelines relevant to listed companies in each market. It should be read in conjunction with our general voting policy and will shape the considerations we apply when voting at general meetings.

1. https://www.apg.nl/en/asset-management/responsible-investing

2 Part A: Pay structure guidelines

2.1 The basics

Pay policies should support long-term value creation for shareholders. By value creation we mean the added economic value over and above the cost of capital.

As long-term owners, we expect boards and their remuneration committees to incentivise management to balance between optimal operation of existing assets and efficient capital allocations and capital growth.

For their long-term continuity and performance resilience, companies also need to manage effectively other forms of capital including natural resources and human capital. This is a growing concern to shareholders. Miscalculation of these considerations may pose material business risks. We expect companies to ensure that they build and maintain relationships with relevant stakeholders and consider their diverse set of perspectives.

We expect the board and their remuneration committee to assess whether it is appropriate to include environmental, social (e.g. human capital, customers) or governance (e.g. compliance breaches, ethics) metrics in pay policies and to explain why these have (not) been included. Such metrics should satisfy the general requirements for metrics.[2]

It is the responsibility of the board to set the right strategy to create and sustain value and to supervise the execution of that strategy. This entails translating the strategy into objectives for senior executives and setting out commensurate remuneration targets. In doing so, understandably the board should retain discretion so that significant remuneration outcomes are sense-checked with independent judgment applied by the board. We will strongly oppose cases of discretion exercised without satisfactory justification.

APG expects its portfolio companies to provide meaningful disclosure of pay policies and pay levels, particularly those applicable to senior executives. It should be clear and easy to conclude from public remuneration disclosures how pay structures and incentive targets relate to the business strategy and its implementation, what management is incentivised to do and how pay-outs correlate with performance.

2.2 Pay structure design principles

To achieve the above objectives, boards have several key design levers at their disposal:

1. Strategy, risk alignment, and sustainability
2. Shareholder and stakeholder alignment
3. Pay levels
4. Time alignment

2. APG participated in a project by the UN PRI and the UN Global Compact LEAD participants on ESG in executive pay: http://www.unglobalcompact.org/docs/issues_doc/lead/ESG_Executive_Pay.pdf

2.3 Principles application

1 Strategy and risk alignment

Pay policies should be designed to reflect and support the company's business strategy. Adherence to generic market practice should not be a primary concern.

- Performance metrics should be clear to recipients of incentive awards ('line of sight') and closely linked to the value drivers of the company (see Part B of this guidance).
- Since pay policies should correspond to the company's business strategy, we expect them to maintain a similar level of stability. Frequent changes to company pay policies, for example annual changes to any aspect of the performance conditions or pay levels, could raise concerns about the competence of the remuneration committee.
- Pay strategies that are ill-fitted to the risk profile of the business may undermine the sustainable delivery of shareholder value. In determining remuneration policies, boards should be mindful of the company's risk profile and risk appetite, as well as the risk dimension inherent in pay policies. Actual pay volatility, stretch of targets, and incentivizing to pursue riskier capital structures are examples of such considerations.

2. Shareholder and stakeholder alignment

Pay policies should be aligned with long-term shareholders' interests. Inevitably this also means consideration of a broader set of constituents of stakeholders and indeed societal considerations generally, to ensure continuity and sustainable creation of value.

- APG favours pay policies that encourage executives to accumulate shareholding to be held over time. This should include holding obligations post departure.
- APG encourages companies to consider the use of non-financial measures in a way that is relevant to long-term value creation. Examples of such measures include customer satisfaction, human capital, health and safety and environmental performance. We expect companies to explain the process for assessment and the conclusion they have reached regarding the inclusion of such non-traditional measures.
- Total Shareholder Return (TSR) on its own is not a value driver, it is a market indicator of value delivery to shareholders. We prefer remuneration policies to be linked as closely as possible to the fundamental value drivers of the companies. Our concern about the use of TSR extends to it becoming a means to an end. This could have unintended consequences for management behaviour, such as excessive focus on short term price movement or pursuing inappropriate levels of risk through balance sheet gearing.
- If used, TSR should be appropriately structured and calibrated. Preferably it should be complemented by other measures related to fundamental performance drivers. This is needed to ensure that actual pay is linked to overall performance. For example, if TSR is measured relatively, another dimension of absolute performance measurement should be added. We encourage companies not to overly rely on TSR. We are generally not supportive of it determining more than 25% of total incentive opportunity, long-term plus short-term.

- We consider carefully the appropriateness of payments on recruitment and on termination. We support payments that are justified by a robust business case. We are mindful of the detrimental impact recruitment and termination payments can have on the alignment of shareholders and executives' interests and in some cases on the reputation of the company.
- In the US, albeit there has been significant improvements in termination and change-in-control payment practice, some companies still provide excessive termination payments. Whilst we acknowledge the variation in practice from other, especially EU markets, this is still a cause for concern to us. In the US we regard agreements for catch payments at or over 2.99x base to be excessive. We have a strong policy against specific US market issues that in our view may result in misalignment of interest in cases of change in control. These include, single trigger change in control early vesting provisions, excise tax gross-ups and accelerated vesting of equity awards.

3. Pay levels

Pay is part of the operational costs and as such should be effectively managed. Regardless of whether pay represents a material cost, individual executive pay levels at our portfolio companies are also of concern to us, especially when doubts are raised about shareholder alignment, effective governance or corporate disregard to societal responsibilities.

- Companies should be mindful of the social impact of excessive pay levels, which over time may lead to erosion of public confidence in business and consequently the licence to operate. Responsible behaviour includes demonstration of leadership at all times and restraint under certain circumstances. Retention considerations are of course of real concern but damage to brand and reputation can have far more powerful long-term impact.
- Pay levels should not be higher than is necessary to achieve the business strategy of the company.
- We are concerned about overly complex incentives or incentives that seem vulnerable to manipulation of corporate activity to improve payouts.
- Peer groups should be selected against relevant criteria such as strategy and geography match. For example, other organisations where executives are likely to be recruited from or join to.
- Incentives should be used to provide moderate enhancement to the basic remuneration package in cases of notable performance. We are therefore concerned about very high payouts potential such as the use of exceptionally high level of awards, uncapped arrangements and high multiple share matching plans.
- When calculated under a uniform standardised methodology, pay ratio disclosure[3] can be a useful piece of information for investors, albeit like many other pieces of financial disclosure, it requires informed comparisons and judgment as to the meaning of the results. We expect boards to consider explicitly pay differentials within the company and disclose their approach and rationale.

3. The ratio between executive or CEO pay and the pay level throughout the company, whether by reference to an average median etc.

4. Time alignment
Pay policies, especially incentives, should be considered in the context of the strategic and capital cycles of the company.

- The timing of incentive awards grant, the length of the performance period, time to vesting and holding periods are all examples of pay design considerations that should be taken in light of the strategy of the company and its capital cycle.
- Whilst we acknowledge that in certain markets there are strong conventions around this area, such as the length of performance periods, we would nonetheless expect boards to seek ways to optimize time alignment, for example through award retention or making less frequent awards.
- Incentives structure is something for each company to decide, involving the balancing of several considerations. Restricted shares, held for a very long period of time, have the advantage of simplicity and transparency but lack in alignment versus well calibrated performance shares. The impact these arrangements have over pay levels in the market over time is less clear. Therefore when asked for our view about a particular case, we would focus on (1) the soundness of the business case and (2) the impact on pay levels. Generally speaking, replacing conditional awards with awards that have greater certainty attached to their vesting, in some cases a near 100% certainty, is something that requires meaningful trade off in terms of amount, in our view greater than 2:1.

3 Part B: Performance drivers

We believe that pay should be linked to a combination of actual current performance measures, as well as measures of financial and non-financial health of the company. Actual and current performance measures can be used to assess value creation, whereas measures of health of a company provide an indication of its ability to sustainably create value in the future.

A company's intrinsic value is based on its future cash flows and its cost of capital, which reflects the financial risk the company is exposed to. Cash flows are driven by both operational returns (on the invested capital) and growth of the business. Therefore, we encourage boards to link executive pay to both of these measures when assessing performance. Moreover, we stress the importance of finding the right balance between these drivers. Too much focus on one while neglecting the others can lead to suboptimal results. Growth in areas where returns are below the cost of capital destroys value, while too much focus on operational returns in isolation can lead to companies underinvesting and foregoing profitable future growth opportunities. Metrics such as Economic Profit (EP), though not without flaws, can indicate growth when looked at over time, operational returns and cost of capital in a single measure.

The ability of a company to continue creating value in the future is ideally assessed by looking at a combination of financial as well as non-financial indicators and indicators of risk that can pose a threat to its balance sheet and operations over time. Therefore we encourage boards to consider non-financial measures in order to incentivise executives to keep long-term value creation in mind and to prevent short-term interests from jeopardising the sustainability of the company over time.

Below we have listed a number of typical measures categorised into performance areas. Knowing that each company faces different business circumstances and that often there could be more than one way of achieving good performance linkage, we encourage companies to set out their own tailored views and emphasise the most appropriate measures for their situation.

	Peformance area	Typical measures
Current Performance	Operation return	• Return on capital measures • Return over cost-of-capital spread • EBIT(DA) margins • Cash from operations
	Growth	• Organic top line growth • Cash flow growth • Market share growth
	Value Creation	• Economic Profit • Economic Value Added
Company Health	Business and financial risk	• Leverage ratio • Net debt to EBIT(DA) • Net interest cover • Qualitative measures linking to risk mitigation *
	Other measures	• Sector-specific non-financial measures • Human capital, for example employee engagement and leadership • Customers, for example satisfaction, churn • EHS (Environment, Health and Safety), for example safety performance • Carbon reduction

* For example, protection of business positions such as brand.

Where companies adopt pay policies that do not accord with our expectations, we may seek explanations. For instance, in general we expect that companies in capital-light industries with high operational returns would put more emphasis on growth, while those operating capital-heavy low-returns businesses would focus more on return on capital improvement instead.

3,1 Robustness of definitions

Boards and remuneration committees should bear in mind that the basic objective of incentive plans is to provide an indicator of strategic direction and behavioural guidance to the senior leadership. This should ensure that they are incentivised to act in that direction and be rewarded when they do so successfully within the behavioural and risk parameters set by the board.

With that in mind, we would expect that any metrics used will be:

- based on a definition and calculation methodology that are stable over time
- use return measures on an unimpaired capital base
- derived from the financial accounts in a transparent way

Additionally, we expect that at least some metrics will capture non-traditional aspects of (long-term) value creation such as human capital, customers, ethics and environmental and social sustainability considerations that can affect the sustainability of financial performance.

4 List of Abbreviations

BV	Book Value
COC	Cost of Capital
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest, Tax and Amortization
EHS	Environment, Health and Safety
EPS	Earnings Per Share
EV	Embedded Value
EP	Economic Profit
EVA	Economic Value Added
FCF	Free Cash Flow
MCEV	Market Consistent Embedded Value
NOPLAT	Net Operating Profit Less Adjusted Taxes
ROA	Return on Assets
ROC	Return on Capital
ROCE	Return on Capital Employed
ROIC	Return on Invested Capital
RSU	Restricted Stock Unit
TSR	Total Shareholder Return
WACC	Weighted Average Cost of Capital

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