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February 5, 2008

VIA E-MAIL to rule-comments@sec.gov

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

**Subject: Executive Compensation Disclosure (Release Nos. 33-8765; 34-55009)
Commission File No. S7-03-06 – Comments Regarding Disclosure of
Difficulty of Performance Goals**

Dear Ms. Morris:

We are writing to you to discuss a matter of concern from SEC registrants regarding a requirement of the new executive compensation proxy disclosure rules. As you likely have heard from registrants, many are puzzled on how to properly comply with the requirement that when a performance target is properly omitted based on the competitive harm standard, the company must discuss, in a meaningful way, how difficult it will be for the executive or how likely it will be for the company to achieve that target. Public comments from John White, Mr. John W. White, Director, Division of Corporation Finance, express disappointment at certain statements that were included by companies in their 2007 proxies:

“Without more, identifying a target simply as "challenging but achievable" or as "designed to promote excellence and motivate management" seems an empty disclosure that I would not think is useful to investors.”

Many of our clients have asked us how to provide "more" in their disclosures, and we have identified an approach we think helps them meet this standard. We are interested in discussing with the SEC Staff whether it believes our approach has merit, and would look forward to meeting with the Staff to demonstrate how it works. Our goal would be to provide the Staff a perspective on determining "degree of difficulty" so that it may offer to registrants some more specific parameters by which they may satisfy this requirement.

Our methodology was first developed, not in response to the SEC disclosure rules, but in our role as advisors to Compensation Committees, who asked us to help assess the "degree of difficulty" of performance goals being presented to them by management for their approval. We have used our approach with several clients in helping them prepare their 2007 proxy disclosures, and believe it is but one way to perform a more rigorous analysis of "degree of difficulty."



It works something like this, assuming for this example a company has established an annual sale growth target of 10 percent (More detail on this example are found in the 2006 Metrics and Goals attachment):

1. Review goal against historical company and peer median performance. Whatever the metric chosen (e.g., annual sales growth), determine the extent to which the company has performed versus its peers. To illustrate, assume the company has outperformed the peer group for many years, with a mean over 10-years that was 13 percent versus 10 percent for the peer group.
2. Review goal against historical probabilities based on a peer group performance. Calculate descriptive statistics on the data set (e.g., mean, median, mode, standard deviation) to show historically how likely hitting certain targets would be. For example, 20% of the time companies achieved a 0-5% annual growth in sales, while only 6.7% percent of the time did they achieve 20-25% annual growth, etc.
3. After observing the shape of distribution and various descriptive statistics, examine how a specific goal fits within the distribution. For a targeted sales growth goal of 10 percent, there would be an approximate 50 percent probability of achieving this based on historical peer performance.
4. Review analyst estimates. Markets are inherently forward-looking. However, many companies set goals based on prior performance only. We think historical data is helpful but can be enhanced significantly by incorporating forward-looking estimates into the process. By incorporating consensus analyst estimates, we provide an additional lens to view performance.
5. Consider stock price to understand long-term expectations. This balances with the use of short-term (2-3 year) analyst expectations compiled in Step 4 by taking a longer term view. We use a discounted cash flow model to gauge long-term expectations. For example, to gauge the stock market's expectation for sales growth, we use market-based assumptions (from Value Line or other sources) for all inputs except sales growth. We then modify the sales growth rate to determine the sales growth that generates the current stock price.

Once the above data is compiled, we would then combine the analyses to help a company set specific goals for incentive purposes and test the difficulty of achieving certain goals, depending on the purpose of the analysis. We have attached two attachments that provide additional details on how we undertake this analysis.

Mr. John W. White
February 5, 2008
Page 3



In sum, we believe the SEC might find it useful to review our approach and perhaps use it to set more specific guidelines for registrants who need to assign a "degree of difficulty." We would be very interested in sitting down with the Staff to provide more information on how we developed our approach and why we believe it works well. We look forward to meeting with you.

Best Regards,

A handwritten signature in black ink that reads "Ira T. Kay".

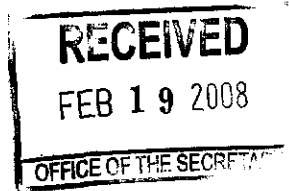
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Attachments:

1. *Linking Executive Pay to Optimal Performance Metrics and Goals: A Method for Increasing Shareholder Value*; watsonwyatt.com, 2006/2007, United States
2. *How Companies Should Balance Growth and Financial Returns in Executive Compensation Plans*; Michael Marino and Ira Kay, Watson Wyatt Worldwide, Workspan, The Magazine of WorldatWork, 6/07



How Companies Should Balance Growth & Financial Returns in

Executive Incentive Plans

Part One

By Michael Marino and Ira Kay, Watson Wyatt Worldwide

Increasing shareholder value is the primary objective of the corporation. However, creating continuous improvements in shareholder value is an elusive goal for many executive teams. Because companies typically get what they measure, it is important that they measure the right thing.

Many companies do a high-level, cursory review of executive-incentives metrics. However, few undergo a systematic exercise to evaluate the link between performance-incentive plan focus and increased firm value. As a result, some incentive plans are simply outdated and accidentally focus executives on past goals and objectives. In other cases, corporations unwittingly employ metrics that they believe are designed to create shareholder wealth, but which fail to achieve this goal. Therefore, companies can create enormous shareholder value by improving the line of sight regarding financial objectives in executive-compensation programs.

While there is no guarantee that excellent future financial performance will prompt stock prices to rise, a robust methodology for choosing the best metrics is essential to corporate success, positive shareholder relations and good governance. As the following example of a "typical industrial company" shows, it is possible to find a method that balances financial objectives in executive-incentive design.

Why is Financial Focus So Important? Why Now?

The current scrutiny of executive pay makes performance measurement essential to the proper determination of if "pay for performance" exists. Performance metrics are important at the executive level for

QUICK LOOK

- ⇒ The current scrutiny of executive pay makes performance measurement essential to the proper determination of whether "pay for performance" exists.
- ⇒ There are three cornerstones to building a robust framework: review corporate strategy, identify value drivers and review market expectations.
- ⇒ The more that boards and institutional investors require a clear pay-for-performance link, the more imperative it is that executive-incentive design supports shareholder value.

many reasons. First, they serve as a means for the board to signal the company's strategic imperatives to executives and shareholders. Second, metrics provide a direct link between corporate strategy and compensation. When the right metrics are incorporated in annual and long-term incentive plans they align executives with shareholders, focus executives on increasing shareholder value and provide a consistent framework for rewarding behavior.

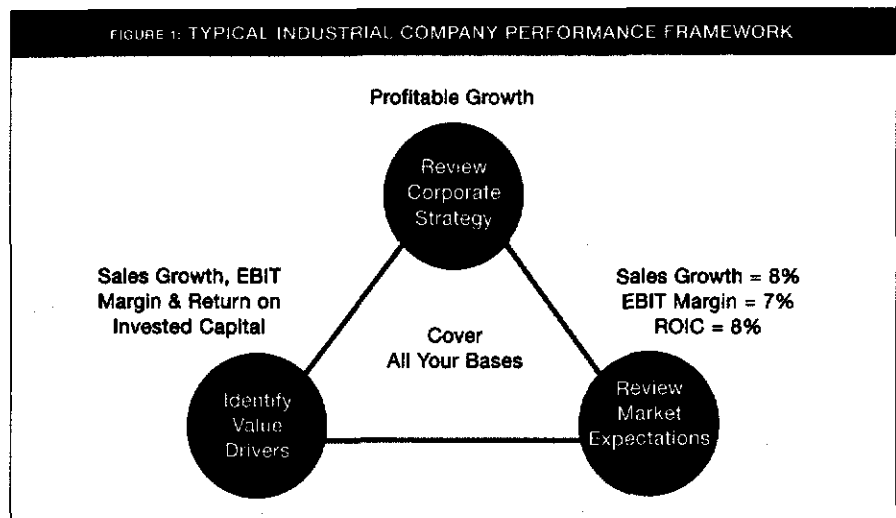
Satisfying these objectives is paramount because public concern about executive pay has never been greater. Recent Watson Wyatt research found that boards of directors and institutional investors have defined views about executive pay. Sixty percent of board members surveyed believe the executive-pay models at most companies have dramatically overpaid executives, while 90 percent of large pension funds expressed the same concern. However, when asked if the executive-pay model in the United States has improved corporate performance, the two groups are split. Sixty-five percent of boards believe the executive-pay model has improved corporate performance, while only 21 percent of pension funds share that view.

Therefore, the current scrutiny of executive pay makes performance measurement essential to the proper determination of whether "pay for performance" exists.

Step 1: Develop a Performance Framework

Companies that consider where to focus line of sight and that gauge market expectations make more well-informed decisions. The process for calibrating financial focus begins with establishing a performance framework that provides insight into key strategic themes, value drivers and market expectations for future performance.

FIGURE 1: TYPICAL INDUSTRIAL COMPANY PERFORMANCE FRAMEWORK



This framework is formed by reviewing readily available internal and external information sources. There are three cornerstones to building a robust framework.

1. Review corporate strategy.
2. Identify value drivers.
3. Review market expectations.

Figure 1 presents a completed performance framework for our hypothetical company.

The baseline includes the key strategic themes, value drivers and market expectations. At this company, the baseline shows that:

- Profitable growth requires a focus on growth and financial returns.
- Sales growth, operating profit and return on invested capital are key value drivers.
- The market is expecting an 8-percent annual sales growth, a 7-percent earnings before interest and taxes (EBIT) margin and an 8-percent return on invested capital (ROIC).

Step 2: Create a Growth and Returns Matrix

Companies increase value when they earn high returns on incremental invested capital. A simple two-by-two financial model helps illustrate how growth and returns support value

creation. Let's assume our "typical industrial company" has \$500 in sales, \$1,000 in capital and a 10-percent cost of capital. Furthermore, let's assume sales grow of either 5 percent or 15 percent next year (the vertical axis) and that capital grows in proportion to sales. Therefore, capital will grow from \$1,000 to \$1,050 or \$1,150, respectively. Assuming actual ROIC of either 5 percent or 15 percent (the horizontal axis), it is possible to calculate the nominal (gross) value improvement. Value improvement will range from \$2.50 to \$22.50. Under these conditions, all combinations of growth and returns generate nominal value improvement. However, this is not the complete story and may incorrectly suggest that growth is always good. This analysis does not address the cost of capital employed and whether gross returns exceed costs. Taking the nominal value and subtracting a charge for the cost of capital (for these purposes, 10 percent) creates a better picture of value creation because all capital has a cost—nothing is free. Figure 2 on page 29 presents a modified matrix that reflects nominal and economic value given different combinations of growth and returns.

For the "typical manufacturing company," growing sales under certain

conditions will increase value. Specifically, when the business generates returns in excess of costs, growth adds to the value of the enterprise. Growing sales without commensurate high levels of return will destroy value. In this case, the company that grew sales and capital by 15 percent but earned only a 5-percent return on capital (the upper left hand quadrant) actually destroyed value. In essence, the company earned \$7.50 gross at a cost of \$15 yielding (\$7.50).

Step 3: Read the Stock Market

The last step to understanding the relationship between growth in revenue and financial returns is to read the public market. To accomplish this, the same two-by-two growth and return matrix is utilized for a peer group. However, this requires calculating the median sales growth and median ROIC over a 10-year period and placing each company, based on above- or below-median performance, in one of four unique quadrants. Next, calculate the average total shareholder return (TSR) for the companies in each quadrant. Figure 3 shows the impact of growing sales and/or increasing returns.

Bringing it all Together

Applying this approach to our "typical industrial company" provides a fresh perspective. First, the company is pursuing a profitable growth strategy, and the market expects certain levels of performance. Second, the growth-and-returns matrix shows that, given this specific fact pattern, growth destroys economic value. Lastly, the market analysis shows that, on average, companies that provide low growth and low returns offer the least shareholder returns. Therefore, line of sight needs to be placed firmly on profitability until returns reach and/or exceed the cost of capital. The recipe calls for more returns and less growth.

FIGURE 2: TYPICAL INDUSTRIAL COMPANY NOMINAL/ECONOMIC VALUE IMPROVEMENT

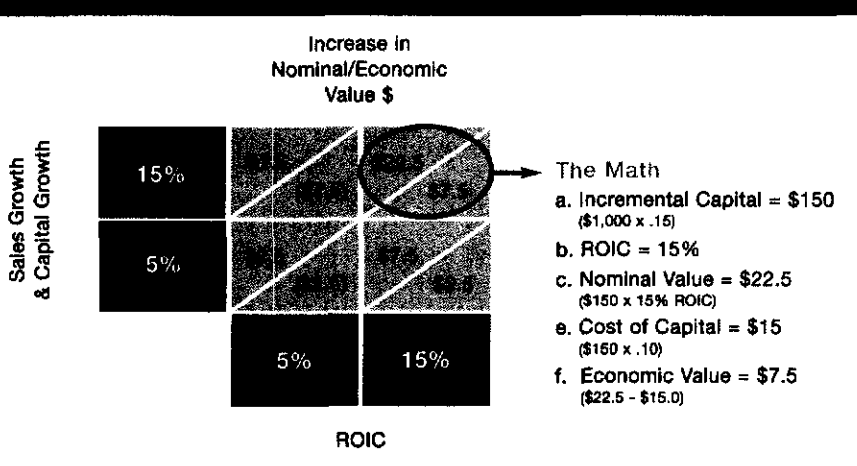
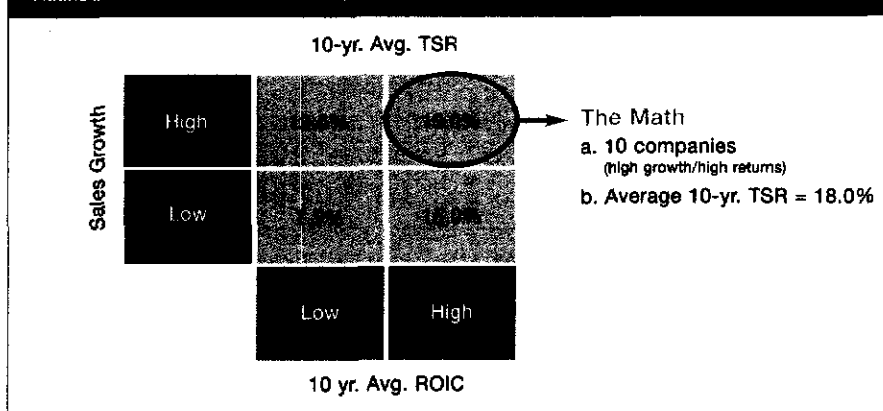


FIGURE 3: TYPICAL INDUSTRIAL COMPANY STOCK-MARKET VIEW—INDUSTRIAL SECTOR



Conclusion

Increasing shareholder value is the objective of the corporation. The more that boards and institutional investors require a clear pay-for-performance link, the more imperative it is that executive-incentive design supports shareholder value. Applying a systematic approach helps companies make informed decisions about financial focus in executive-incentive design. Correct line of sight through executive incentive design is key to establishing pay for performance. Part two of this series, "How Do Market Expectations Influence Shareholder Value and Executive Incentives?", in the July issue of *workspan*, will address the challenges inherent in measuring shareholder value for public corporations. □

ABOUT THE AUTHORS

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Part Two:
 Shareholder Expectations
 How Companies Should Balance
 Growth & Financial Returns in
**Executive
 Incentive Plans**

By Michael Marino and Ira Kay, Watson Wyatt Worldwide

The first article of this two-part series focused on the need to choose the right financial metrics and to balance the sometimes competing goals of growth and financial returns when setting executive incentives. While addressing these issues will certainly put employers on the right path to create effective pay-for-performance programs, it is important for employers to also go the next step. This involves considering the role that market expectations play in executive incentive design.

The majority of executive compensation and executive net worth is denominated in company common stock. Executives are typically rewarded with equity grants and in many cases are required to meet specific ownership levels during their executive tenures. Modern corporate finance theory explains that current stock prices reflect expectations of future financial performance. The value of common stock today is highly sensitive to investor expectations for the future. Therefore, the overall net worth of executives will grow or shrink dramatically based on future expectations for financial performance. The challenges inherent in measuring the effects of such expectations are a key part of implementing an effective executive incentive program.

QUICK LOOK

- ⇒ The overall net worth of executives will grow or shrink dramatically based on future expectations for financial performance.
- ⇒ Research has shown that stock prices react to new information in various ways at the time the information is introduced into the market.
- ⇒ The value of any common stock is highly sensitive to investor expectations.

**Understanding the Expectations Framework
 from a Short-Term Perspective**

Companies that use stock price or other market-based metrics must consider the role expectations play in influencing market prices. Research has shown that stock prices react to new information in various ways at the time the information is introduced into the market.

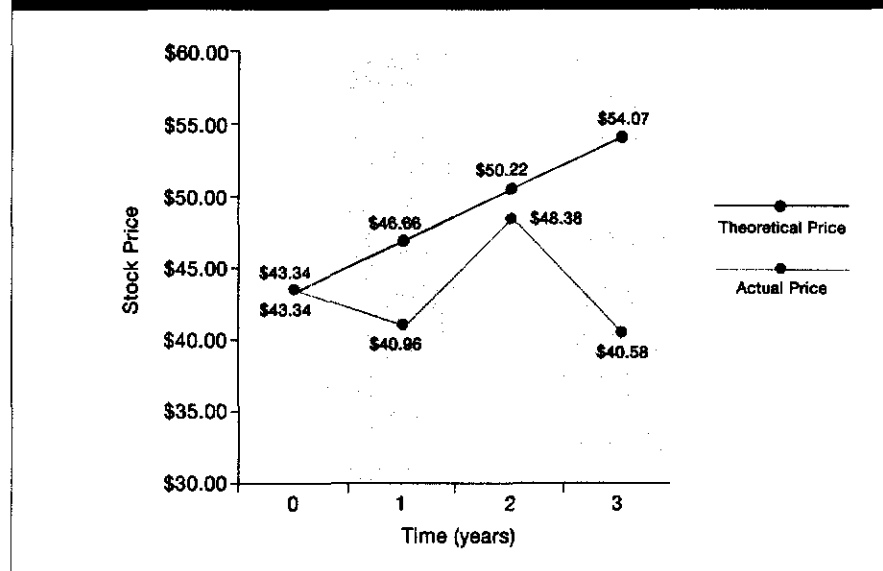
First, missing expectations due to the company's economic performance punishes the stock price to varying degrees based on the level of expectations. Second, exceeding expectations due to fundamental economic performance is rewarded in varying degrees based on the level of expectations. Finally, meeting expectations due to current performance, even if that performance is quite high, is not rewarded because the stock price already reflects those expectations for performance. This is called the "Patrick Ewing" effect. When the New York Knicks acquired Ewing, ticket sales skyrocketed in anticipation of his future performance. When he performed well, sales were sustained. When he performed poorly, sales declined. Therefore, using market-based metrics, such as total return to shareholders (TRS) or stock price, to measure executive performance is challenging because stock prices are highly sensitive to short-term investor expectations.

Understanding the Expectations Framework from the Long-Term Perspective

The price for any individual stock and its true economic value are not always in equilibrium, even in capital markets that function well. Price and value divergence is demonstrated dramatically when a major market correction occurs, but this dichotomy can also exist at the individual company level under normal market conditions. To test the role of expectations, we compared actual stock price performance to theoretical stock price performance during a three-year period. Theoretical stock price is the expected stock price assuming the stock price grows at the company's cost of equity. Figure 1 plots the results for a large consumer staples company with a cost of equity of 8 percent.

At the end of the performance period, the stock price should have been

FIGURE 1: STOCK PRICE AND VALUE DIVERGENCE. THEORETICAL PRICE VS. ACTUAL PRICE



approximately \$54 assuming the market price tracked with expected returns. The actual stock price was \$40.58. How can this be? The market value of a company's shares depends on how realistic the starting valuation was, and on how well the company performs relative to expectations. If the company had a realistic starting point and it met expectations continuously over the performance period, the two lines would overlap. The issue of individual stock prices and value not moving in equilibrium has serious implications for governing executive compensation programs.

Issues with Market-Based Metrics

Recent Watson Wyatt's "Finding the Right Balance" found that many institutional investors believe that TRS (defined as stock price appreciation plus dividend yield) is the best benchmark to evaluate executive performance. However, many academics and professionals have cautioned against using this metric when measuring executive performance for the following reasons:

- Stock prices reflect the expectations for future financial performance.
- Expectations are not directly under the control of the executives.

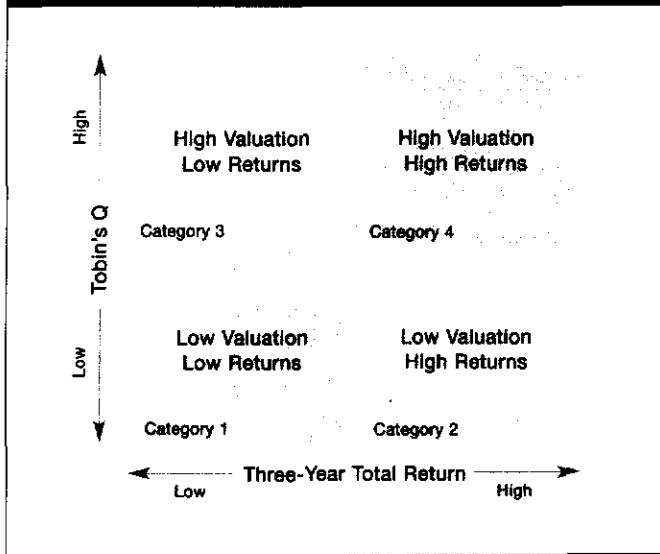
- Subsequent TRS does not account for embedded performance expectations at the start of the measurement period.

It follows that exaggerated expectations at the start of the performance period can influence the likelihood a company will outperform or underperform a peer group. This impacts executives, both positively and negatively, and, therefore, needs to be factored into the metric selection and target-setting process. Several recent CEO terminations manifested this issue. In two high-profile instances, revenues and profits doubled during the CEO's tenure, but stock price declined due to massive reductions in the business valuations. Unrealistic expectations appear to have played a large role in these situations.

Implications for Incentive Design

Applying a simple framework helps companies understand when market-based metrics are good metrics for executive incentive plans. Figure 2 presents a model that considers start-of-period valuation and stock returns over a typical three-year performance period. The model incorporates Tobin's Q as a gauge of enterprise value at the start of the performance period. Tobin's Q measures a company's

FIGURE 2: VALUATION AND RETURNS MODEL
THEORETICAL CONSTRUCT



value as a multiple of the replacement cost of its existing assets. It is an economic price-to-book valuation multiple that includes market expectations. Companies with a high Tobin's Q have relatively higher embedded expectations than those with a low Tobin's Q.

Categories 1 and 4 have consistent outcomes (low/low or high/high). Highly valued companies deliver superior shareholder returns, and lower-valued companies deliver lower shareholder returns. This is possible over the long term. However, this is less likely over shorter periods of time, for reasons cited earlier in this report. Essentially, economic theory would predict that, on the average, highly valued companies would underperform on TRS as investor capital migrates to companies with greater opportunity. Categories 2 and 3 are the mixed outcomes. Highly valued companies do not all deliver high returns, and lower-valued companies can deliver high returns. Figure 3 provides an ex post facto analysis for a specific industry to illustrate the relationship between valuation and returns.

For this industry, there is a negative correlation between start-of-period Tobin's Q and three-year TRS. This

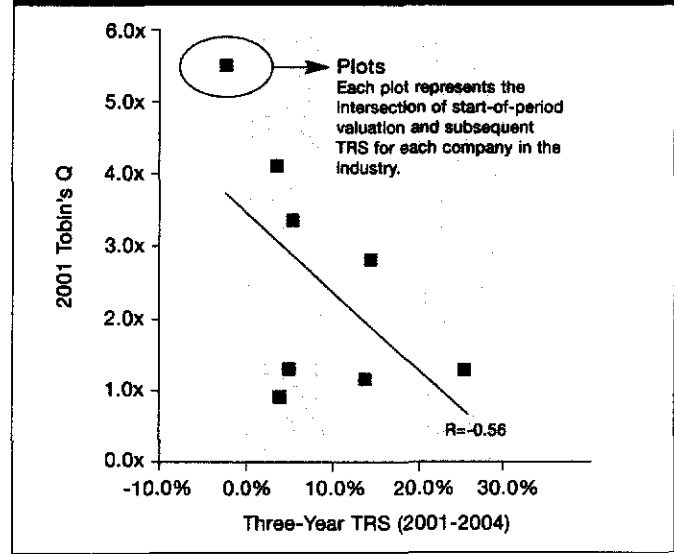
analysis shows that it would not be fair to hold executives responsible for delivering median TRS when they are valued above the median Tobin's Q at the start of the period. In addition, relative performance vesting may not properly compensate the executives at an already highly valued company because it would require companies to achieve two goals: (1) median TRS and (2) sustained valuation premium over the peers. Conversely, delivering median TRS at a low-Q company might be too easy. Research has shown that there is often a negative correlation between starting company valuation and TRS over a typical three-year performance period.

Conclusion

The value of any common stock is highly sensitive to investor expectations. Using market-based metrics to measure executive performance is challenging since stock prices are highly sensitive to investor expectations. Recognizing the challenges of using market-based metrics from both the short-term and long-term perspectives is the first step toward using market metrics most effectively in executive incentive design. Creating a valuation-

and-returns model helps companies decide if using a market-based metric makes sense for a given situation and helps companies set reasonable goals. □

FIGURE 3: VALUATION AND RETURNS MODEL
S&P 500 BEVERAGE INDUSTRY



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- T11: Fundamentals of Equity-based Rewards.



Linking Executive Pay to Optimal Performance Metrics and Goals

A Method for Increasing
Shareholder Value

2006/2007
United States

watsonwyatt.com

Introduction

In the ongoing executive compensation controversy, paying for performance is the most critical issue of all. While some critics argue that executive pay is simply too high, most shareholders are prepared to pay significant amounts for superior performance.

But what are the ideal performance metrics, and how challenging should the levels of performance be for those metrics? This study provides analysis that will help Boards and management answer these questions.

While it is our view that common stocks reflect long-term expectations for future financial performance and that long-term business objectives are primarily supported through long-term plans, we recognize that short-term plans and metrics also play a key role in supporting long-term objectives. In particular, shareholder value is supported when short-term incentive plans focus on fundamental value drivers. For this study, however, we focus exclusively on long-term incentive plans and metrics.

- What are ideal performance metrics for a given company or industry?
- Are total returns to shareholders (TRS) or earnings per share (EPS) growth always the best measures?
- How common are various metrics in incentive plans? Are these the same metrics that investors or Boards would use, given a clean slate?
- How do growth and returns metrics work together?
- What financial metrics have the greatest likelihood of increasing future TRS?
- How should market expectations influence goal setting for executive incentives?

- Once the metrics are chosen, how can the Board of Directors be sure that the actual goal/level of performance will be both value-enhancing and motivational to the executive team?

Creating Shareholder Value

Increasing shareholder value, typically defined as TRS – stock price appreciation plus dividend yield – is the objective of public companies. While there is wide agreement on this goal, creating continuous improvements in shareholder value is complex and very challenging. However, many companies can benefit from providing a clear line of sight between value improvement and executive incentives. As a result, most companies could benefit from increased alignment in this area.

How Can Companies Create More Shareholder Value?

Over the long term, companies increase shareholder value when they earn returns on capital greater than the cost of capital employed. Obviously, shareholder value is enhanced when stock price appreciates. However, many shareholders think that management often focuses too much on the latter, market price, without considering long-term value drivers. Boards need to be sure they are driving increases in long-term value.

The most common example of this is when companies link shareholder value and incentive plans primarily or solely to growth in EPS. The reality is that earnings per share is important to the extent that it represents true cash earnings. For this reason, companies must be thoughtful about implementing EPS as the primary or sole performance metric in executive plans.

Total Returns to Shareholders

Many investors consider TRS the best means for aligning executive incentives with shareholder value. Indeed, our recent Watson Wyatt survey of institutional investors found that investors prefer TRS to other metrics for aligning executive pay with performance (Figure 1). Boards of Directors, on the other hand, believe that revenue growth and cash flow measures are more important.

While TRS is a very shareholder-friendly metric in executive incentive plans, it too must be examined

carefully before being implemented. We will explore some common problems with TRS later in this report. Below is a short list of potential shortcomings.

- Stock price and value divergence -- stock price and value may diverge in efficient capital markets
- The role of expectations -- stock prices are set in a public market based on expectations of future financial performance
- Start date and end date dependence -- TRS is highly dependent on the starting point (and starting point valuation) and the end points (fiscal year-end)

Figure 1

Institutional Investors and Boards Disagree on Best Performance Metrics

| Performance Metric | Boards of Directors | | Institutional Investors | |
|--|-----------------------|-------------------------------------|-------------------------|-------------------------------------|
| | Single Most Important | One of the Top Three Most Important | Single Most Important | One of the Top Three Most Important |
| Sales growth | 25% | 44% | 4% | 8% |
| Return on equity (ROE) | 15% | 46% | 12% | 38% |
| Cash flow return on investment (CFROI) | 15% | 44% | 8% | 26% |
| Total returns to shareholders (TRS) | 10% | 25% | 38% | 62% |
| Return on assets (ROA) | 10% | 17% | 4% | 26% |
| Operating cash flow | 8% | 27% | 6% | 18% |
| Earnings (EBIT or EBITDA) | 8% | 23% | 2% | 16% |
| Return on invested capital (ROIC) | 4% | 6% | 6% | 30% |
| Earnings per share (EPS) | 2% | 19% | 6% | 32% |
| Economic value added | 2% | 10% | 4% | 24% |
| Others | | | 10% | 12% |

So, What's the Solution?

Unfortunately, there is no simple solution for linking executive performance with shareholder value.

The purpose of this report is to provide a context for selecting executive performance metrics and to offer some practical methods for setting goals. We begin by reviewing the common performance metric categories and the prevalence of different metrics in today's long-term incentive plans. Next, we review some common problems with implementing performance metrics. Last, we offer practical methods for setting goals.

Why Are Performance Metrics Important for Executives?

You can't reward value added unless you can measure it. Since you get what you reward, and reward what you measure, you get what you measure. Make sure you're measuring the right thing.

Brealey & Myers, Principles of Corporate Finance

With the current scrutiny of executive pay, Boards and shareholders need a common form of measurement to accurately evaluate whether pay for performance exists. Performance metrics are important at the executive level for many reasons. First, they serve as a means for the Board to signal the company's strategic imperatives to executives and shareholders. Metrics provide a direct linkage between corporate strategy and compensation. This requires the right metrics to be incorporated in annual and long-term incentive plans and goals to be set that are fair. When the right metrics are selected and goals are set appropriately, they:

- Align executives with shareholders
- Focus executives on increasing market value
- Provide a consistent framework for rewarding behavior

A three-step process to select performance metrics and set goals such as the following should meet the needs of most companies.

| | |
|--|--|
| Step 1: Understand performance framework | |
| Activity | Review existing corporate strategy |
| Activity | Understand value drivers in strategic plan |
| Activity | Examine market expectations |
| Outcome | Baseline performance summary |
| Step 2: Review potential metrics | |
| Activity | Review the relationship between various metrics and historical shareholder returns |
| Activity | Review value driver impact on shareholder value |
| Activity | Research industry and peer group metrics |
| Outcome | Most appropriate metrics for annual and long-term incentives |
| Step 3: Set appropriate performance goals | |
| Activity | Establish historical peer group performance norms |
| Activity | Review analyst expectations |
| Activity | Understand stock price implied expectations |
| Outcome | Reasonable performance goals |

What Are the Most Prevalent Performance Metrics in Executive Incentive Plans?

Corporations frequently and unwittingly employ incentives they believe are consistent with creating wealth but which fail the value creation test.

Michael Mauboussin, Expectations Investing

Watson Wyatt recently examined FORTUNE 250 companies in an attempt to better understand what types of performance metrics are prevalent in long-term incentive plans, such as performance share or performance unit (cash) plans. Figure 2 shows the prevalence of the most common metrics from a list of more than 20 disclosed metrics.

As expected, TRS and EPS are the most commonly used metrics in long-term plans. Measures considered more shareholder-friendly, such as return on invested

capital (ROIC), economic profit (EP) and cash flow return on investment (CFROI), are less commonly used. In discussions with Boards of Directors and management, we have found that they support the use of EPS as a well-understood measure that is looked at closely by the sell-side equity research analysts, and is correlated with other measures of economic profit.

How Should Companies Balance Between Growth and Returns?

The essence of "growth," in short, is not expansion, but the existence of opportunities to invest significant quantities of funds at higher than "normal" rates of returns.

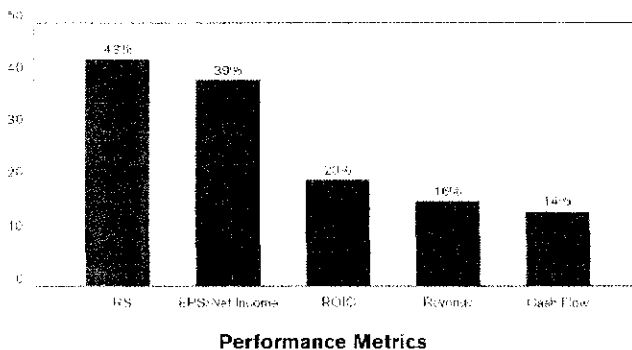
Miller & Modigliani, The Cost of Capital, Corporation Finance and the Theory of Investment (1958)

To answer this question, we grouped performance metrics (found in performance-based long-term incentive plans), as reported in recent proxy statements, into five categories:

- **Market value:** stock price appreciation, TRS and market value of equity
- **Growth:** revenue, net income, EPS, EBITDA, cash flow from operations (CFLO)
- **Financial returns:** return on assets, return on equity, ROIC

Figure 2

Prevalence of Specific Metrics



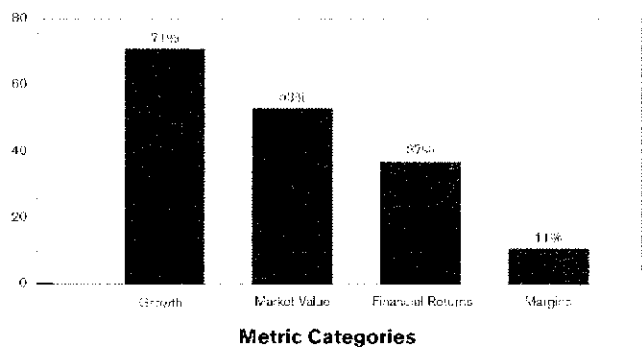
- **Margin:** gross profit margin, operating profit margin, sales margin
- **Economic profit:** financial returns minus the cost of capital employed.

We found that, in order, growth and market value metrics are the most prevalent, followed by financial returns (Figure 3). In particular, the findings show growth metrics to be nearly twice as common as financial returns in executive long-term incentive plans. The fifth category, economic profit, is extremely rare. However, we know that more companies explicitly or implicitly set their earnings or return metrics relative to their cost of capital in the budgeting process.

Companies are clearly focusing on growth, potentially at the expense of financial returns. As will be discussed later, Watson Wyatt research indicates that shareholder value requires both growth and returns.

Figure 3

Prevalence of Metric Categories



What Does the Stock Market Value: Growth or Returns?

The best business to own is one that over an extended period of time can employ large amounts of incremental capital at very high rates of return.
 Warren Buffet, *Chairman's Letter to Shareholders (1992)*

To illustrate what the market values, we begin by demonstrating how intrinsic value is created and how value is created in the public market.

The Intrinsic Value Perspective

A company's intrinsic value is the private market value of the enterprise. By showing various intersections of growth and returns, Figure 4 illustrates that intrinsic value requires growth and returns. The two-by-two table shows various intersections of growth and returns. More specifically, growth in sales requires incremental capital (working and fixed).

For example, let's assume XYZ Company has \$500 in sales and \$1,000 in capital and a 10 percent cost of capital. Furthermore, let's assume sales grow at 5 percent or 15 percent next year and that capital grows in proportion to sales. We can estimate that capital will grow to \$1,050 or \$1,150, respectively. Assuming actual ROIC of either 5 percent or 15 percent, we can calculate the value of the returns. Figure 4 shows the nominal (gross) value created.

Figure 4

Nominal Value Improvement

| | | | |
|--|------------|-------------------------------------|------------|
| | | Increase in Nominal Value \$ | |
| Sales Growth & Capital Growth | 15% | \$7.5 | \$22.5 |
| | 5% | \$2.5 | \$7.5 |
| | | 5% | 15% |
| | | ROIC | |

However, this does not address the cost of capital employed or whether gross returns exceeded costs. Figure 5 provides a revised economic impact by taking the nominal value and subtracting a charge for the cost of capital (for these purposes, 10 percent).

Figure 5

Economic Value Improvement

| | | | |
|--|------------|--------------------------------------|------------|
| | | Increase in Economic Value \$ | |
| Sales Growth & Capital Growth | 15% | (\$7.5) | \$7.5 |
| | 5% | (\$2.5) | \$2.5 |
| | | 5% | 15% |
| | | ROIC | |

Growing sales under certain conditions will increase value. Specifically, when the business generates returns in excess of costs, growth adds to the value of the enterprise. Growing sales without commensurate high levels of return will destroy value. In this case, the company that grew sales and capital by 15 percent, but earned only a 5 percent return on capital (the upper left-hand quadrant), actually destroyed value. In essence, the company earned \$7.5 gross, at a cost of \$15.0, yielding \$7.5 in economic value.

The Market Value Perspective

Translating theory into practice, we studied the S&P 500 to better understand the relationship between growth and financial returns in the public market. We calculated the median sales growth (6.8 percent) and median ROIC (10.9 percent) over a 10-year period and placed each company, based on above- or below-median performance, in one of four unique quadrants for each of the two measures. Next, we calculated the average TRS for the companies in each quadrant. Figure 6 shows the impact of growing sales and/or increasing returns on TRS.

Figure 6

Shareholder Value Delivered

| | | | |
|----------------------|------|-------------------|-------|
| | | 10-Year Avg. TRS | |
| | | High | Low |
| 10-Year Sales Growth | High | 13.3% | 19.4% |
| | Low | 9.4% | 15.6% |
| | | Low | High |
| | | 10-Year Avg. ROIC | |

Our research shows that superior shareholder returns require both growth and returns. More specifically, growth enhances shareholder value (TRS) when financial returns are high. Consistent with the intrinsic value approach described earlier, it is likely that TRS would be positive only if the company's expected returns exceeded its cost of capital.

This macro analysis is useful for showing the consistency between the intrinsic and market value approaches to shareholder value. In both cases, companies with higher sales growth and ROIC provided greater shareholder value.

What Financial Metrics Correlate Best with TRS?

TRS is a common metric in long-term incentive plans because it:

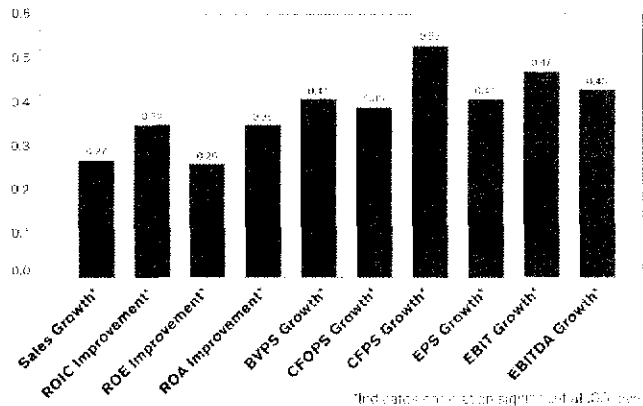
- Is preferred by institutional investors
- Avoids the vagaries of GAAP accounting
- Is considered prudent by compensation committees
- Is suitable for relative performance measurement
- Is easily understood by all constituencies
- Is defensible from a business judgment rule perspective
- Is most prevalent in long-term executive incentive plans

To determine what financial metrics correlate with TRS, we again examined the S&P 500 to better understand the historical correlations between a number of common financial metrics and TRS.

We found significant variation by sectors and industries and correlation coefficients that range from .26 (weak) to .53 (moderate), as shown in Figure 7. We did not find any highly correlated variables. This is likely because TRS (1) is a highly volatile metric based on constant revisions of expectations, (2) varies substantially by industry and (3) is based on many factors. We will discuss the role of expectations later in this report.

Figure 7

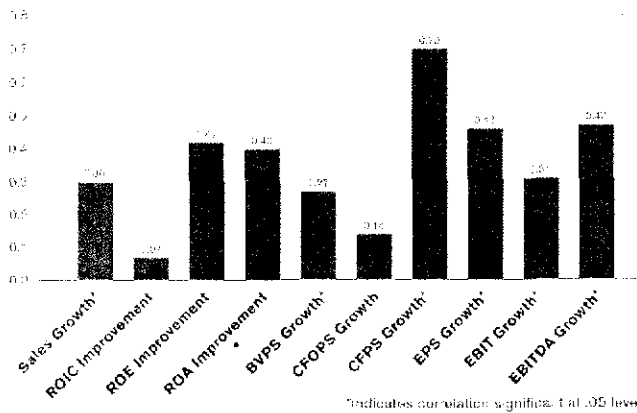
Correlations Between Metrics and 5-Year TRS All Sectors (1999 - 2004)



When we examined all sectors, we found that growth in cash flow per share had the highest historical correlation with TRS. In addition to our overall assessment, we examined individual economic sectors in an attempt to identify any industry-specific relationships. Figures 8 and 9 present the financial and industrial sectors, as examples to draw out some fundamental industry valuation differences.

Figure 8

Correlations Between Metrics and 5-Year TRS Financials (1999 - 2004)

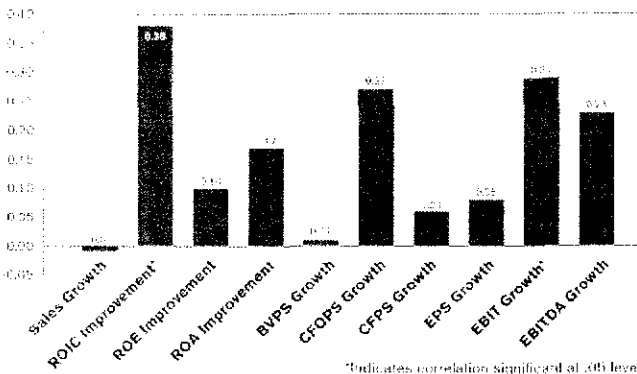


In the financial sector, we found that cash flow per share was the most highly correlated with TRS. In addition we found that ROE and ROA are both moderately correlated with TRS. We attribute this to the fact that financial firms (banks and insurance companies) are fundamentally different from other operating companies. Financial firms use debt as a raw material much the same way a manufacturer uses commodities or natural resources as raw materials in the manufacturing process.

In the industrials sector, we found ROIC growth, EBIT growth and cash flow from operations growth to be most highly correlated with TRS (Figure 9).

Figure 9

Correlations Between Metrics and 5-Year TRS Industrials (1999 - 2004)



How Do Market Expectations Influence Shareholder Value and Executive Incentives?

Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble...to give way to hope, fear and greed.

Benjamin Graham

Modern corporate finance theory explains that current stock prices reflect expectations of future financial performance. Executives are rewarded with equity grants and in many cases are required to meet specific ownership levels.

The majority of executive compensation and executive net worth is denominated in company common stock. Therefore, annual and long-term compensation in addition to long-term net worth could be dramatically affected by performance relative to expectations.

What this means is that the overall net worth of executives can grow or shrink dramatically based on future expectations of financial performance. This could create significant disconnect between current performance and current total pay/net worth changes.

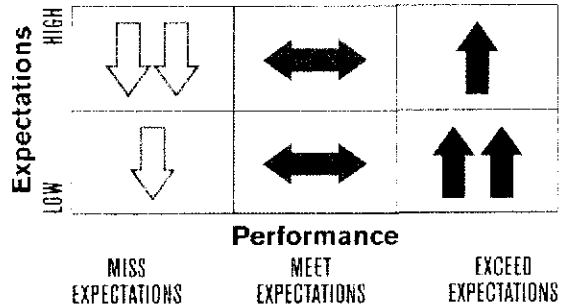
Understanding the Expectations Framework From a Short-Term Perspective

Figure 10 is a theoretical construct that links short-term stock price reactions to expectations of financial performance.

- Meeting expectations due to current performance, even if performance is quite high, is not rewarded, because the stock price already reflects those expectations for performance.
- Missing expectations due to economic performance is punished in varying degrees based on the level of expectations.
- Beating expectations due to fundamental economic performance is rewarded to varying degrees based on the level of expectations.

Figure 10

Theoretical Price Adjustments



For example, if the market has high performance expectations and the company meets those expectations, we would not expect to observe a significant improvement in the share price (the upper right-hand quadrant). Rather, the stock should appreciate at the investors' required rate of return (also known as the company's cost of equity). We call this the "Patrick Ewing" effect. When the New York Knicks acquired Patrick Ewing, ticket sales skyrocketed in anticipation of his future performance. When he performed well, sales were sustained. When he performed poorly, sales declined.

Understanding the Expectations Framework From a Long-Term Perspective

In theory, a company could set a stock price goal by assuming that its market value will grow at the cost of equity. However, the example below highlights the role expectations play in determining equity prices and how theoretical and actual prices may diverge.

To test the role of expectations, we compared actual stock price performance to theoretical stock price performance over a three-year period. Theoretical stock price is the expected stock price assuming the stock price grows at the company's cost of equity. This analysis shows that price and value **are not** always in equilibrium even in well-functioning capital markets.

Figure 11

Actual Stock Price Compared with Theoretical Stock Price

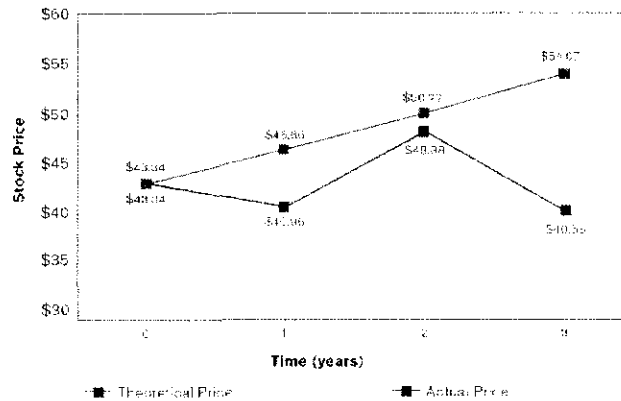


Figure 11 plots the results for a large consumer staples company with a cost of equity of 8.0 percent. At the end of the performance period the stock price should have been approximately \$54.00 (assuming the market price tracked with expected returns). The actual stock price ended up being \$40.58. How can this be?

The market value of a company's shares depends on how well the company performs relative to expectations. If the company met expectations continuously over the performance period, the two lines would overlap. One plausible explanation in this example is that the company missed expectations over the performance period. We should note, however, that shareholder returns tell us neither the reasonableness of the expectations nor the underlying health and long-term viability of the enterprise.

What Are the Shortcomings of TRS and the Implications for Incentive Plan Design?

Over short periods of time, TRS embodies changes in expectations about future performance more so than its actual underlying performance or health.

Dobbs and Koller, McKinsey Quarterly

Recent Watson Wyatt research found that many institutional investors believe that TRS is the best benchmark to evaluate executive performance. However, we recognize that many academics and professionals have cautioned against using this metric when measuring executive performance for the following reasons.

- Stock prices reflect the expectations for future financial performance, and expectations are not directly under the control of the executives.
- TRS does not account for embedded performance expectations at the start of the measurement period.

It follows that exaggerated expectations at the start of the performance period can influence the likelihood a company will outperform or underperform its peer group. This important issue undoubtedly has an impact on executives, both positive and negative, and needs to be factored into the Board of Director's decision-making process.

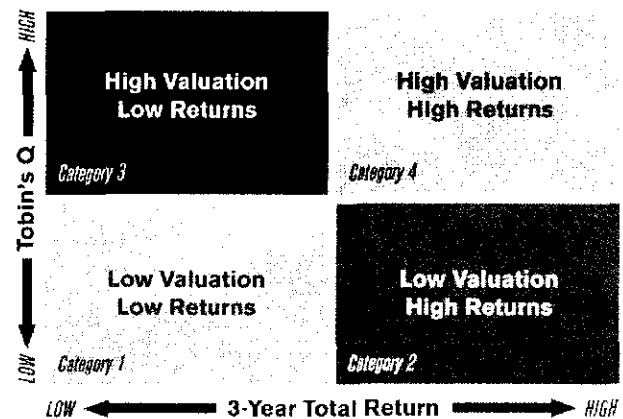
A Simple Framework

Recognizing the limitations and challenges of using TRS as a performance metric, to evaluate TRS, Figure 12 presents a framework that incorporates Tobin's Q as a gauge of enterprise value at the start of the performance period. Applying this framework can help companies decide if TRS is a good metric for their executive incentive plans. Tobin's Q measures a company's value as a multiple of the replacement cost of its existing assets. It is an economic price to book valuation multiple that includes expectations, as companies with a high Tobin's Q have relatively higher embedded expectations than those with a low Tobin's Q.

The two-by-two matrix below displays four possible outcomes or categories.

Figure 12

Valuation and Return Matrix



Category 1: Companies with low start-of-period relative valuation that delivered low relative TRS over the performance period

Category 2: Companies with low start-of-period relative valuation that delivered high relative TRS over the performance period

Category 3: Companies with high start-of-period relative valuation that delivered low relative TRS over the performance period

Category 4: Companies with high start-of-period relative valuation that delivered high relative TRS over the performance period

Interpreting the Framework

Categories 1 and 4 have consistent outcomes (high/high or low/low). That is, highly valued companies deliver superior shareholder returns, and lower-valued companies deliver lower shareholder returns. This may be true over the long term. However, it is unlikely that this is the best explanation over shorter periods of time, for reasons we cited earlier in this report.

Categories 2 and 3 are the mixed outcomes (high/low and low/high). Here, we observe that highly valued companies do not all deliver high returns and that some lower-valued companies deliver higher returns. These are the categories that are potentially the most perplexing. However, these quadrants best illustrate the role that expectations play in stock prices and returns.

Applying the Framework

By incorporating start-of-period "valuation" into the equation, we can examine historical valuation and returns. Over relatively short periods a company that starts with a high Tobin's Q should return lower TRS on average than those with a low Tobin's Q. Many believe that expectations often play a larger role in setting stock prices in the short term (three years) than does actual financial performance.

For example, incorporating TRS into performance share plans for high-Tobin's Q companies can lead to a moral hazard. After selecting TRS as the performance criterion, executives might take excessive risk to try to advance the stock price in the short term, since they need to beat high expectations.

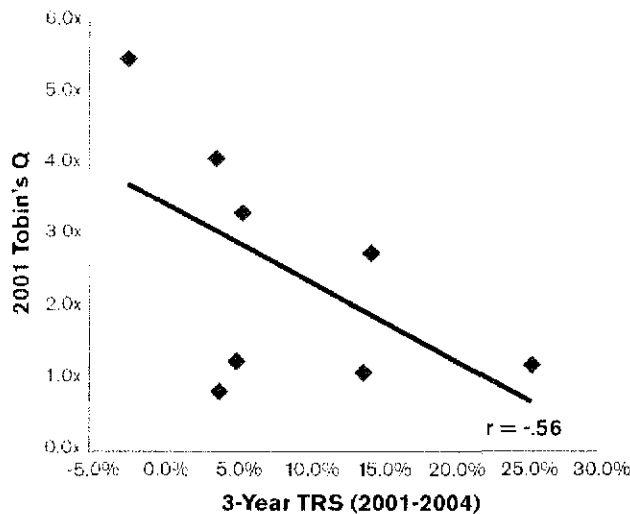
Figure 13 provides an example of an ex post facto analysis to better understand what the outcome would have been based on historical performance periods. The chart below focuses on the beverage industry and illustrates a key issue that must be considered before implementing TRS as a performance metric.

For this industry, as may be the case for many over a short period of time, there is a negative correlation between start-of-period Tobin's Q and three-year TRS. If the starting valuation is high relative to a peer group, expectations might be difficult to beat over the performance period given the lofty starting position.

In this example, we observe that companies with high start-of-period valuation delivered lower TRS than companies with low start-of-period valuation. **It would not be fair to hold executives responsible for delivering median TRS when they are positioned above the median at the start of the period.** In addition, relative performance vesting may not compensate the executives at an already highly valued company because it would require companies to achieve two goals: (1) median TRS and (2) sustained valuation premium over the peers. Conversely, delivering median TRS at a low-Q company might be too easy.

Figure 13

S&P 500 Beverage Industry: Negative Correlation Between Valuation and Return



How Do Companies Bring More Science to the Art of Goal Setting?

Paying people on the basis of how their performance relates to a budget or target causes people to game the system and in doing so destroy value.

Michael Jensen, Harvard Business School Professor

Once the best metrics have been chosen, it is then necessary to set the level or goal for that metric. Most companies use budget or plan as the goal for their incentive plans. Using budgets for this purpose creates problems in the goal-setting stages – especially setting the goals too low. To mitigate the “sand-bagging” problem inherent with setting budgets and targets, we advocate a process that considers both historical and

forward-looking approaches. In fact, the process can be used to select and test the reasonableness of goals against historical probabilities and future expectations. The process below describes how we would test the reasonableness of an 8 percent sales growth goal.

Step 1: Review goal against historical company and peer median performance. For example, Figure 14 shows that the company has outperformed the peer group for many years. The company's mean performance over the 10-year period was 13 percent versus 10 percent for the peer group.

Step 2: Review goal against historical probabilities based on a peer group performance. This begins by creating a simple data table. In this example, we created a data table of annual sales growth over 10 periods for 15 peer companies. This allows us to calculate descriptive statistics on our data set (e.g., mean, median, mode, standard deviation).

Step 3: Create a probability distribution (using the 150 data points above) to understand how the variable is distributed. To accomplish this, we create a number of bins that represent a range of possible

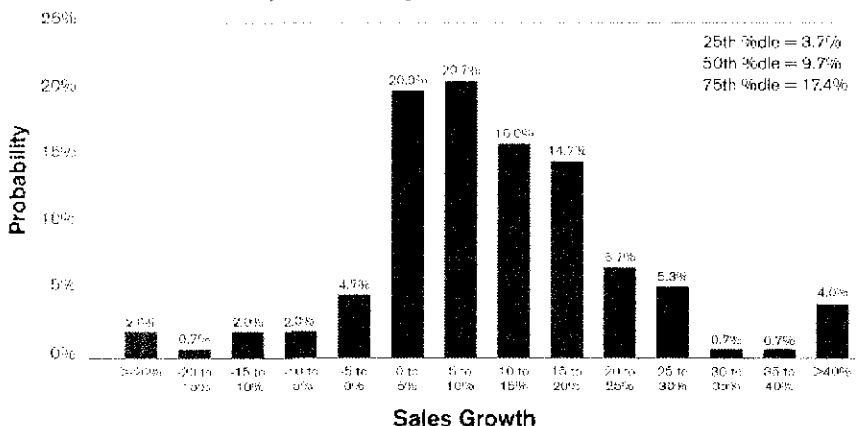
Figure 14

Historical Performance Data Table: XYZ Company and Performance Peers

| Annual Sales Growth | | | | | | | | | | | |
|---------------------|--------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Ticker Symbol | Company Name | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
| A | Company A | 5.8% | 9.5% | 6.6% | 9.0% | 134.2% | -1.9% | 3.2% | -6.1% | -0.5% | 12.6% |
| B | Company B | 42.1% | 7.7% | 7.6% | 20.4% | 24.1% | 22.7% | 27.9% | 6.0% | 17.2% | 11.8% |
| C | Company C | 10.7% | 7.2% | 11.8% | 11.0% | 13.1% | 17.1% | 8.2% | 11.4% | 9.8% | 13.1% |
| D | Company D | -14.1% | -42.9% | 130.4% | 19.9% | 18.5% | 11.0% | 10.7% | 8.7% | 10.0% | 15.1% |
| E | Company E | 78.9% | 1.3% | 2.6% | 0.7% | 12.4% | 3.2% | -14.6% | -1.4% | -1.1% | 0.1% |
| F | Company F | 18.1% | 20.2% | 23.2% | 39.1% | 28.5% | 17.5% | 1.3% | 4.4% | 9.7% | 2.6% |
| G | Company G | 24.0% | 25.3% | 23.7% | 25.1% | 27.2% | 19.0% | 17.1% | 8.8% | 11.3% | 12.8% |
| H | Company H | 4.3% | 5.2% | 5.5% | 6.2% | 60.8% | 8.0% | 2.2% | 3.3% | 3.9% | 4.9% |
| I | Company I | 15.8% | 21.6% | 17.9% | 20.8% | 29.9% | 18.1% | 17.7% | 15.8% | 16.4% | 18.2% |
| J | Company J | 1.6% | 13.2% | 28.5% | 0.5% | 3.6% | -2.0% | 0.5% | 1.1% | -45.0% | 3.6% |
| K | Company K | 20.1% | 28.0% | 63.2% | 11.9% | 4.6% | 8.8% | 4.5% | 4.2% | 5.1% | 1.3% |
| L | Company L | 4.9% | 5.3% | 30.2% | 8.9% | 17.9% | 10.8% | 7.3% | -5.5% | 9.7% | 0.9% |
| M | Company M | 1.0% | -9.3% | 2.4% | 4.6% | 6.7% | 3.1% | -2.4% | -14.9% | -24.4% | -15.3% |
| N | Company N | 10.3% | 7.9% | 9.4% | 11.5% | 8.9% | 9.5% | 8.1% | 10.1% | 9.7% | -2.7% |
| O | Company O | 12.6% | 13.3% | 13.5% | 14.5% | 18.5% | 18.9% | 16.1% | 16.5% | 13.3% | 15.4% |
| | 25th %ile | 4.6% | 5.2% | 7.1% | 7.5% | 10.6% | 5.6% | 1.8% | -0.2% | 1.7% | 1.0% |
| | 50th %ile | 10.7% | 7.9% | 13.5% | 11.5% | 17.9% | 10.8% | 7.3% | 4.4% | 9.7% | 4.9% |
| | 75th %ile | 19.1% | 16.8% | 26.1% | 20.2% | 27.8% | 17.8% | 13.4% | 9.4% | 10.6% | 12.9% |
| XYZ | XYZ Company | 13.5% | 12.0% | 12.5% | 16.7% | 20.3% | 15.9% | 13.8% | 12.3% | 4.8% | 11.3% |

Figure 15

Annual Sales Growth, Probability of Achievement (excl. XYZ)



values and assign companies to each bin based on their individual annual performance (Figure 15).

Step 4: After observing the shape of distribution and various descriptive statistics (in this case the median is 10 percent), we can examine how a specific goal fits within the distribution. To accomplish this, we display the distribution as a cumulative probability distribution and find the probability of achieving a goal (Figure 16). For example, if we set the goal for sales growth at 10 percent, there could be an approximate 50 percent probability of achieving this based on historical peer performance.

Step 5: Review analyst estimates. Markets are inherently forward-looking. However, many companies set goals based on prior performance only. We think historical data is helpful but can be enhanced significantly by incorporating forward-looking estimates into the process. By incorporating consensus analyst estimates, we provide an additional lens to view performance. In Figure 17 we see that the market expects sales to grow at more than 11 percent a year in the near term.

If past history was all there was to the game, the richest people would be librarians.
Warren Buffet

Figure 16

Annual Sales Growth, Cumulative Probability of Achievement

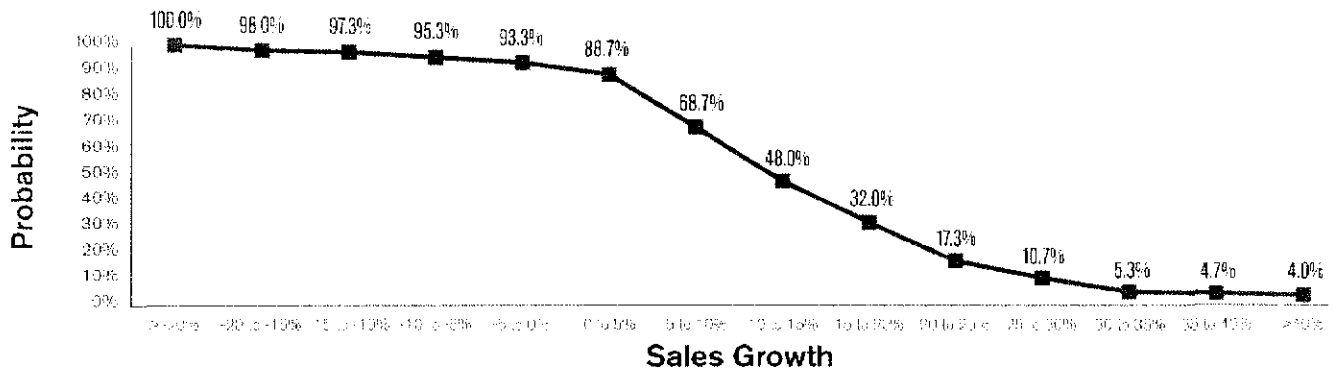


Figure 17

Compound Annual Growth Rate

XYZ Company
Forecast Multiples (\$ in millions)

| Metric | Actual | | Consensus Estimates | | | 3-Year CAGR |
|---------------|-----------|-----------|---------------------|-----------|-----------|-------------|
| | Jan. 2005 | Jan. 2006 | Jan. 2007 | Jan. 2008 | Jan. 2009 | |
| Revenue | \$288,189 | \$312,427 | \$348,554 | \$385,626 | \$431,197 | 11.3% |
| y-o-y growth: | | 8.4% | 11.6% | 10.6% | 11.8% | |
| EBITDA | \$21,721 | \$23,247 | \$25,410 | \$29,236 | \$31,989 | 11.2% |
| y-o-y growth: | | 7.0% | 9.3% | 15.1% | 9.4% | |
| EBIT | \$17,091 | \$18,530 | \$20,543 | \$23,057 | \$25,060 | 10.6% |
| y-o-y growth: | | 8.4% | 10.9% | 12.2% | 8.7% | |
| EPS | \$2.41 | \$2.64 | \$2.92 | \$3.33 | \$3.69 | 11.8% |
| y-o-y growth: | | 9.5% | 10.7% | 14.1% | 10.5% | |

Step 6: Since analyst estimates typically extend over a short period of time (two to three years), we often turn to the stock price to understand long-term expectations. To accomplish this, we use the discounted cash flow model to gauge long-term expectations. For example, to gauge the stock market's expectation for sales growth, we use market-based assumptions (from Value Line or other sources) for all inputs except sales growth. We then modify the sales growth rate to determine the sales growth that generates the current stock price. This analysis shows that long-term expectation for annual sales growth is approximately 11.5 percent (Figure 18).

Bringing It All Together

We suggest combining all of these analyses to help a company set specific goals for incentive purposes and test the difficulty of achieving certain goals.

In this example, we learned that the target company has historically performed at a level (12.7 percent) above the peer group (9.7 percent). Market expectations are for the target to grow sales at 11.3 percent in the short term and 11.5 percent over the long term.

Ideal Policies and Conclusions

Choosing performance metrics and setting appropriate goals are two of the most important tasks a Board of Directors can perform. Doing so connects shareholders with executives and sets the tone for the performance culture. It brings a third-party, objective view to help counterbalance internal assumptions and expectations. It also helps defuse shareholder and media concerns about accountability and pay for performance.

By applying additional rigor to the metric selection process, companies can control for some potential moral hazards that may develop after the Board of Directors selects metrics. And by applying more rigor to the goal-setting process, Boards of Directors can set goals that are fair to executives and shareholders and that ultimately benefit all constituents.

Figure 18

Basic Discounted Cash Flow Model

Assumptions

| | |
|-------------------------|--------|
| Sales growth | 11.50% |
| Operating profit margin | 6.00% |
| Tax rate | 34.0% |
| Working capital rate | 13.0% |
| Net fixed capital rate | 5.0% |
| Cost of capital | 7.9% |

| (\$ in millions) | Forecast Years | | | | | | |
|-------------------------------|----------------|-----------|-----------|-----------|-----------|------------------------|-----------|
| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
| Sales | \$288,429 | \$321,599 | \$358,583 | \$399,820 | \$445,799 | \$497,066 | \$554,228 |
| Operating profit | \$17,306 | \$19,296 | \$21,515 | \$23,989 | \$26,748 | \$29,824 | \$33,254 |
| Taxes | \$5,884 | \$6,561 | \$7,315 | \$8,156 | \$9,094 | \$10,140 | \$11,306 |
| NOPAT | \$11,422 | \$12,735 | \$14,200 | \$15,833 | \$17,654 | \$19,684 | \$21,947 |
| Incrn. fixed capital | \$3,667 | \$4,312 | \$4,808 | \$5,361 | \$5,977 | \$6,665 | \$7,431 |
| WC investment | \$1,487 | \$1,658 | \$1,849 | \$2,062 | \$2,299 | \$2,562 | \$2,858 |
| Total investment | \$5,355 | \$6,070 | \$6,657 | \$7,423 | \$8,276 | \$9,228 | \$10,289 |
| FCF | \$6,067 | \$6,765 | \$7,543 | \$8,410 | \$9,377 | \$10,456 | \$11,658 |
| PV FCF | \$5,622 | \$5,809 | \$6,062 | \$6,262 | \$6,468 | \$6,621 | \$6,841 |
| Current vs PV FCF | \$5,622 | \$11,432 | \$17,434 | \$23,636 | \$30,644 | \$36,665 | \$43,507 |
| PV residual value: perpetuity | | | | | | | \$162,788 |
| | | | | | | Enterprise value | \$206,295 |
| | | | | | | Plus: XS cash | \$0,000 |
| | | | | | | Less: debt | 24,700 |
| | | | | | | Equity value | \$187,595 |
| | | | | | | Shares out | 4,180 |
| | | | | | | Equity value per share | \$45 |



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