Radford Review:
2016 Say-on-Pay Results and Equity Share Plan Proposals in the US Life Sciences Sector

Prepared by Radford
Radford is part of Aon Hewitt, a business unit of Aon plc.

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Introduction

- This report highlights some of the biggest takeaways from the 2016 Say-on-Pay voting season

- It has been just six years since advisory votes on Say-on-Pay began showing up on annual meeting agendas, and in that time, investors have increasingly demanded pay levels that correspond to company performance

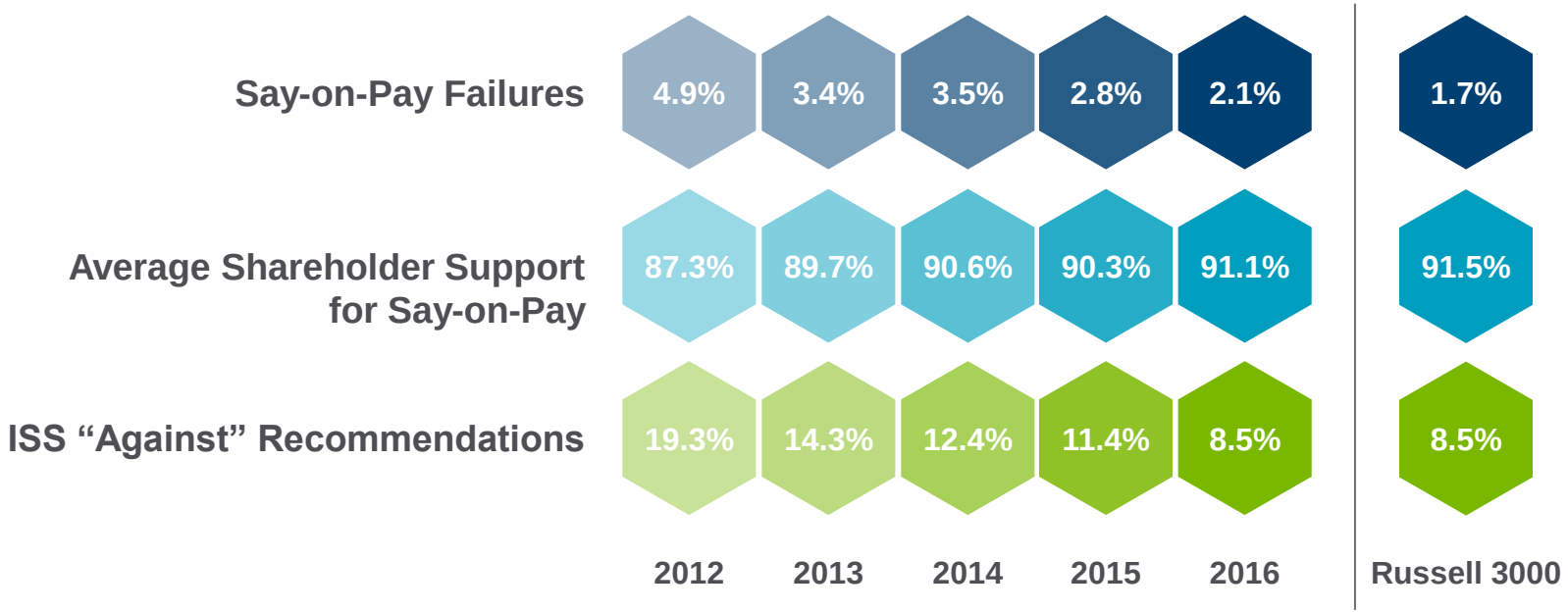
- This year in the life sciences sector, average support levels for Say-on-Pay are very stable, and ISS support is at a high since Say-on-Pay adoption

- Using ISS' analytics for Management Say-on-Pay, this report highlights:
  - Year-over-year trends for key Say-on-Pay metrics across the entire life sciences sector
  - Specific industry breakouts for GICS codes 3510 (Healthcare Equipment) and 3520 (Biopharmaceuticals)
  - We also take a closer look at outright Say-on-Pay failures and the problematic pay practices contributing to such votes
  - Finally, we share insights on equity incentive plan proposals gleaned from the 2016 voting season

An Overview of Say-on-Pay in its Sixth Year

- Average Say-on-Pay vote levels in life sciences have stabilized in the 90% to 91% range on an annual basis
  - The vast majority of companies receive support levels of well above 90%, with a minority receiving support levels in the 70% to 90% range
  - Only about 5% of life sciences companies receive support of 70% or less, which is the ISS prescribed standard below which companies should take remedial action
- ISS's support of Say-on-Pay votes in the life sciences sector is at its highest point ever
  - Last year, ISS voted "Against" Say-on-Pay at 15.2% of life sciences companies, while only voting "Against" Say-on-Pay at 10.6% of the broader Russell 3000
  - 2016 is the first year ISS support for the sector (94.3%) is in line with that of the broader Russell 3000 (94.4%)
- Outright failures remain very rare in the life sciences sector
  - Based on data year-to-date, ISS "Against" recommendations have led to outright Say-on-Pay vote failures at only three companies
  - This trend reflects the effectiveness of company strategies to engage directly with shareholders in contested situations to communicate their pay-for-performance story

A Five-Year Lookback at Say-on-Pay



- Say-on-Pay failures in the life sciences sector have trended consistently downward over the past five years and average support levels have gradually risen
- ISS too has consistently increased its level of support for life sciences Say-on-Pay proposals, with ISS's 2016 "Against" recommendations at a five-year low

Say-on-Pay in Life Sciences: 2016 By the Numbers

Average shareholder support levels in 2016

91.1%

Life Sciences vs. Russell 3000 Average Shareholder Support Levels – Support levels in 2016 are unchanged from 2015. Average support for life sciences companies is on par with the broader Russell 3000 (91.5%).

Life sciences companies receiving "Against" vote from ISS in 2016

8.5%

Pharma/Biotech vs. Russell 3000 ISS Support Rate – This year, the prevalence of ISS "Against" recommendations in the life sciences sector is down one third from 2015. ISS now recommends against life sciences Say-on-Pay at the same clip as for the broader Russell 3000, notwithstanding slower adoption of compensation and governance "best practices" in biotech than in general industry.

Say-on-Pay failure rate

2.1%

Say-on-Pay Failures – Outright failures on Say-on-Pay continue to be very rare. This reflects companies' effectiveness at engaging directly with investors to explain and rationalize their pay programs.

Difference in average support between ISS "For" and "Against"

36%

ISS Impact – ISS continues to exert considerable influence on the final vote when it recommends against Say-on-Pay, with average levels of support dropping 36% in instances where ISS recommends "Against".

Key 2016 Say-on-Pay Metrics

- While the stock market has been challenging, this does not appear to have affected shareholders' willingness to support Say-on-Pay in the sector
- Year to date in 2016, the average level of shareholder support for life sciences Say-on-Pay votes has closely tracked that of the broader Russell 3000
- Average Say-on-Pay support levels have ticked *up* slightly in 2016 for each life sciences industry group when compared to 2015

Industry Groupings	Median TSR Performance		% For			
			2016 Voting Results		2015 Voting Results	
	1-Year	3-Year	Average	Median	Average	Median
Biopharmaceuticals	-35.8%	-10.4%	90.6%	95.4%	89.4%	95.7%
Healthcare Equipment	-18.3%	0.7%	91.5%	96.1%	90.6%	95.7%
Life Sciences Sector	-29.8%	-4.3%	91.1%	95.6%	90.3%	95.7%
Russell 3000	-4.5%	8.4%	91.5%	95.8%	91.2%	96.1%

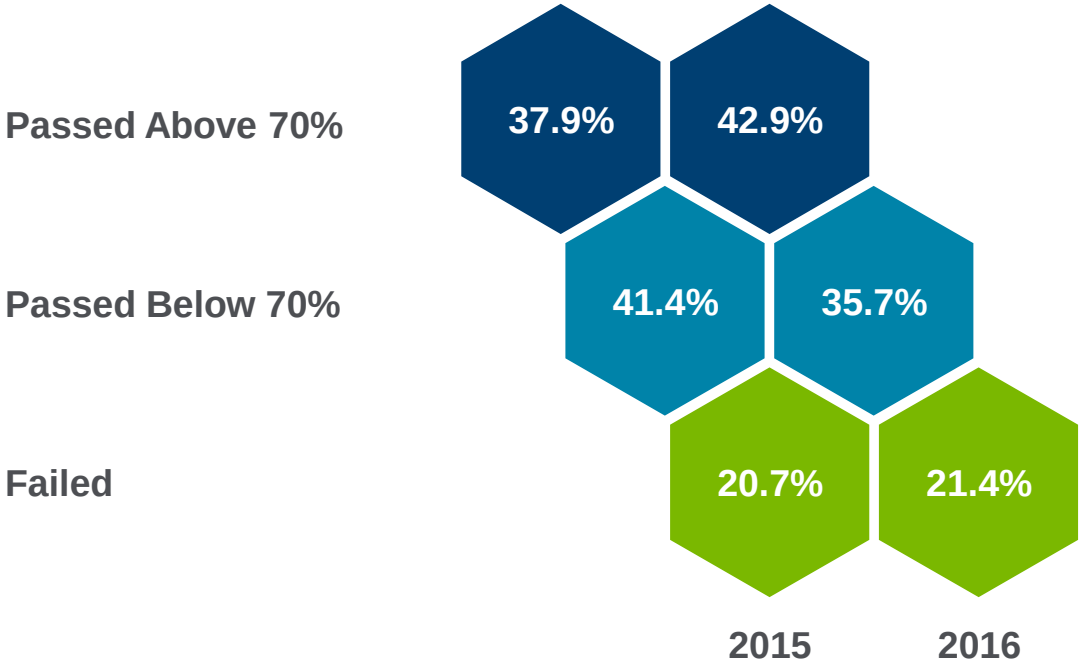
ISS and Say-on-Pay Voting Results

- Year to date in 2016, ISS has supported life sciences Say-on-Pay votes more often than it has in the past
- Both outright failures (votes below 50%) and “qualified passes” (votes between 50% and 70%) are down in life sciences and each of the biopharma and healthcare equipment sub-industries, likely attributable to more favorable vote recommendations from ISS and more sophisticated shareholder engagement efforts

Industry Groupings	2016 Prevalence of Poor Outcomes			2015 Prevalence of Poor Outcomes		
	ISS Against	50% to 70%	Below 50%	ISS Against	50% to 70%	Below 50%
Biopharmaceuticals	12.2%	7.9%	1.6%	14.4%	7.6%	3.4%
Healthcare Equipment	5.8%	2.4%	2.4%	9.6%	4.4%	2.2%
Life Sciences Sector	8.5%	4.8%	2.1%	11.4%	5.9%	2.8%
Russell 3000	10.0%	5.0%	1.7%	11.0%	5.2%	2.6%

The Impact of ISS: Say-on-Pay Results Following An “Against” Vote

- Only about one in five ISS recommendations “Against” Say-on-Pay lead to an outright failed vote (below 50% support)
  - Note: The 8.5% of life sciences companies receiving an Against vote on slide 7 includes companies where ISS made its recommendation but the vote had not yet occurred; the 21.4% failure rate statistic excludes companies that had not held their vote.
- However an adverse ISS recommendation is still usually sufficient to push the support level below 70%
  - Companies with Say-on-Pay votes < 70% should launch a shareholder outreach campaign and consider compensation and governance program reforms to avoid a second negative ISS vote recommendation the following year



Avoiding and Responding to Poor Say-on-Pay Results

Key Factors Contributing to Say-on-Pay Problems

- A review of ISS reports revealed four key factors accounted for a substantial majority of 2016's "below 70%" Say-on-Pay votes in the life sciences sector:

1. Disconnects between pay and performance
   - Where TSR performance fell below the peer group median and/or operating performance declined on an absolute basis vs. 2015 and executive pay increased, remained flat or didn't decrease enough
2. "Poor" incentive pay practices
   - Payout of incentives above target despite poor performance relative to prior year results
   - Over-reliance on non-performance-based compensation (particularly heavy use of time-based stock/option awards with no performance-based component)
   - "Sub-standard" design of performance-based LTI programs (frequently one-year performance periods, overlap of metrics with STI plan)
3. Poor disclosure
   - Lack of detailed discussion linking payouts under variable incentive programs to corporate and/or individual performance
4. Lack of responsiveness to 2015 Say-on-Pay concerns
   - Lack of detailed discussion linking payouts under variable incentive programs to corporate and/or individual performance

Best Practices to Turn Around a Say-on-Pay Challenge

- Companies receiving weak support (defined as below the ISS 70% threshold) for Say-on-Pay increasingly may need to consider substantive reforms to avoid a repeat the following year
- Based on a review of 2016 proxy filings in life sciences, the most typical remedial actions taken by companies that received weak 2015 votes have included:

1. Meetings and organized dialogue and engagement with shareholders, often representing up to 60% of total shareholder base
2. Changed equity mix to include greater emphasis on performance-vested vehicles
3. New performance metrics added to equity incentive plans, including relative TSR and return on invested capital
4. Extended performance periods for long-term incentives (moving from a one-year performance period to three years)
5. Enhanced disclosure of short-term incentive plan goal setting and payout determination

- These steps are effective: shareholder support in 2016 is up by 35% on average among life sciences companies that received less than 70% shareholder support in 2015

2016 Stock Incentive Plan Proposals – an Initial Snapshot

2016 Stock Incentive Plan Proposals

- The following table provides a snapshot of 2016 year-to-date ISS recommendations and vote outcomes for Stock Incentive Plan proposals for the following sectors:
  - Biopharmaceuticals;
  - Healthcare Equipment (medical device); and
  - Russell 3000
- ISS continues to recommend against equity plans in the biopharmaceuticals sector (which uses equity more heavily than any other industry except software) at a significantly higher rate than across the broader Russell 3000
  - But biotech investors largely understand the role of equity compensation in this industry and are persuaded to support company requests even in the context of an ISS "Against" recommendation

Industry Groupings	# of Proposals	# of ISS "Against" votes	ISS "Against" (as % of all proposals)	Avg. Support (all proposals)	Avg. Support (for ISS "Against" only)	# of Failed
Biopharmaceuticals	35	12	34%	83%	74%	0
Healthcare Equipment	37	7	19%	90%	73%	1
Russell 3000	477	99	21%	90%	79%	2

- Radford is separately evaluating the factors contributing to positive vs. negative proxy advisor recommendations on stock incentive plans, which we expect to publish later in the fall

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