Aon Hewitt
Radford

September 2016

2016 Say-on-Pay Review

Technology Companies Receive Steady Support From Shareholders Despite Lower Performance

As executive compensation planning season kicks off, and another proxy season looms, we look back at this year's Say-on-Pay results and lessons learned.

Now that a sixth year of Say-on-Pay voting for technology companies has come and gone, and as many companies begin to assess their executive compensation programs for 2017, the consulting team at Radford decided to take a look back at the biggest takeaways from the 2016 Say-on-Pay voting season.

Download our full say-on-pay voting results for the technology sector **here**.

At technology sector companies, average support levels for Say-on-Pay proposals are at an all-time high, reaching 91.8% this year. This trend is fueled, in part, by higher levels of support from proxy advisory firms. For example, Institutional Shareholder Services (ISS) "Against" recommendations fell considerably from 14.1% in 2015 to 7.8% in the first half of 2016.

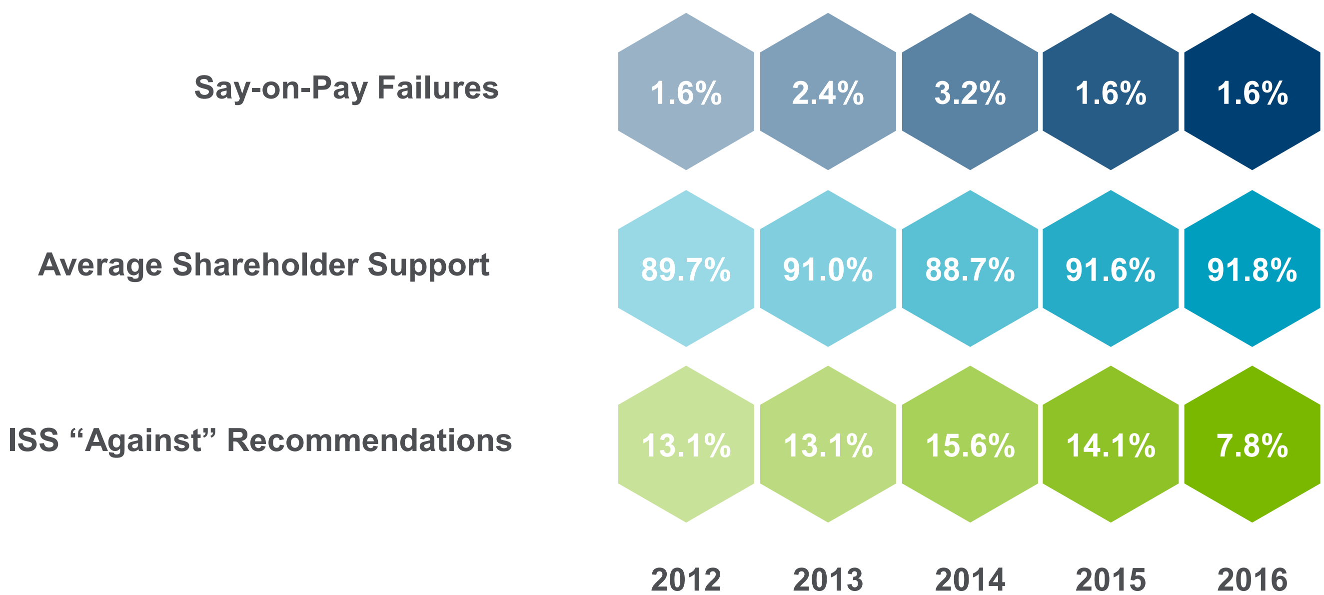
Furthermore, outright failures of Say-on-Pay proposals remain very low, with just 1.6% of companies failing to get majority support— this is unchanged from 2015 and down from 3.2% in 2014. At Russell 3000 companies, including technology and non-technology firms, Say-on-Pay failures stand at 1.7% to-date this year.

At first glance, solid shareholder support for executive pay practices at technology companies may be surprising given the sector-wide downturn in stock performance over the past year. On a 12-month trailing basis ending May 31, one year total shareholder return (TSR) in the technology sector is -14%, compared to -5% for the full Russell 3000 index over the same period. What's more, these declines follow an 8% increase in one-year TSR growth for technology stocks for the period ending May 31, 2015.

Yet, our work with technology sector clients reveals several explanations for the robust support of pay programs during a year of poor stock price returns. First, many companies in the software, hardware and semiconductor industries continue to take steps to enhance alignment between the design of their pay programs and ISS and investor "best practices," particularly in instances where doing so has a limited impact on the ability to effectively manage compensation programs to achieve short- and long-term strategic objectives. This dramatically reduces the likelihood that shareholders will raise alarm bells about pay or governance practices, even during periods of poor stock performance. We also continue to see strong adoption of enhanced compensation disclosures and proactive shareholder engagement on compensation and governance issues across the technology sector.

Our experience suggests this type of engagement works, and can often counteract the effect of a negative ISS Say-on-Pay vote recommendation. As boards and management teams become more responsive to investors' concerns and take greater pains to explain the rationale behind pay programs— especially those that aren't in line with so-called best practices— shareholders appear more and more willing to support their pay programs. This last point is particularly critical for technology companies where business practices and competitive concerns necessitate design choices like shorter performance cycles and heavier use of stock options that differ from what many proxy advisors and broad-based investors' voting policies might prescribe.

Five Years of Say-on-Pay in the Technology Sector



To get a better idea of what's driving these numbers, Radford conducted a detailed review of compensation practices among two subsets of technology companies: (1) Companies with below 70% support for their 2016 Say-on-Pay vote, and (2) Companies that improved their Say-on-Pay vote by 35% or more from 2015 to 2016.

Among the companies with shareholder support levels below the 70% threshold, we were interested in identifying the primary factors driving shareholder opposition to Say-on-Pay. Our research uncovered the following:

- A perceived disconnect between pay and performance: typically TSR performance below a peer group median or declines in absolute performance while compensation increased, stayed the same or didn't decrease enough
- "Poor" incentive pay practices, including above-target payouts despite perceived poor performance, short performance periods for long-term incentive awards, lack of predominantly performance-based programs
- Poor disclosure, including a lack of detailed discussion on linking payouts under variable incentive programs to corporate and/or individual performance

- Lack of responsiveness to prior year concerns

It should be noted that there may be valid reasons for companies in the technology space to make these design choices, and that detailed disclosure and proactive shareholder engagement can go a long way toward assuring shareholders that the program is aligned with their long-term interests and deserving of their support.

Our second subset of companies that improved their vote took substantive actions to align their programs with investor “best practices”. The most commonly observed initiatives include:

- Holding meetings and organized dialogue/ engagement with shareholders, often representing up to 60% of the total shareholder base

- Changing equity incentive mixes to include a greater emphasis on vehicles with performance-based vesting

- Adding new performance metrics to existing equity incentive plans, including relative total shareholder return (TSR) and return on invested capital (ROIC)

- Extending performance periods for cash and/or equity incentives (moving from one-year performance periods to two or three years)

- Developing enhanced disclosure of your process for setting short-term incentive goals and determining payout levels

Stock Incentive Plan Proposals

We also examined shareholder voting results for stock incentive plan proposals in 2016. Requests to approve or replenish stock incentive plans are a staple of annual meetings, particularly in the technology sector, which relies heavily on equity incentives to attract, motivate and retain talent in a competitive market.

While the vast majority of these proposals pass, they have received increased scrutiny in recent years amid shareholder concerns about burn rates and total dilution. ISS, which exerts considerable influence on these votes, overhauled the way it evaluates proposals during the 2015 proxy season and continues to make tweaks to its process. (You can read our client alert on initial ISS changes for 2015 **here**, followed by updates for 2016 **here**.)

The standout finding from our analysis of stock incentive proposal data is that plans in the software and hardware industries are now opposed by ISS at nearly twice the rate as in 2015. ISS now recommends against 30% of stock plans at hardware companies and 38% of plans at software companies. Our early analysis suggests this development is directly attributable to ISS’ new methodology, which penalizes technology companies heavily for qualitative compensation practices prevalent in the sector. These practices previously had little or no impact on ISS recommendations.

As a result of the higher levels of ISS opposition to stock incentive proposals, we now observe more companies engaging with shareholders preemptively when they have non-ISS compliant share pools. Fortunately, for most companies, they are able to ultimately obtain shareholder support for their requests when the launch a proactive solicitation campaign.

Industry Snapshot of Stock Incentive Plan Support

	Year	Number of Proposals	Average Support	Number of “Against”	Prevalence of “Against”	Average Support for “Against”
Software	2015	62	87%	11	18%	77%
	2016 (to-date)	40	84%	15	38%	76%
Hardware	2015	44	88%	6	14%	75%
	2016 (to-date)	20	89%	6	30%	81%
Semiconductor	2015	32	90%	1	3%	78%
	2016 (to-date)	12	80%	1	8%	61%
Russell 3000	2015	755	90%	147	19%	79%
	2016 (to-date)	477	90%	99	21%	79%

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