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CEO pay continues to track performance—even in a down year.

Korn Ferry Hay Group 2015/2016 CEO compensation study.

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For the first time in the mandatory say-on-pay era, shareholders saw companies have a poor performance year while CEOs also had their pay impacted.

In determining CEO compensation at top public companies in 2015, economic uncertainty, slowing revenue and income growth, and negative shareholder returns drove CEO pay to the lowest increase in five years. Total shareholder return (TSR) was negative for the first time in five years. Overall, 2015 showed pay tracking performance in a down year.

During this same period, companies expanded their interactions with their largest shareholders, meeting with them periodically throughout the year to discuss any immediate concerns. These outreach meetings were responsible for many program changes, including pay mix changes, new or revised performance metrics, and increased emphasis on performance-based long-term incentives—particularly performance share programs. But now that companies have experienced a down year, and shareholders may realize little or no gains, support from shareholders and proxy advisory firms for continued pay program changes may be more difficult to obtain.

Overall, 2015 turned out to be not such a good year for the majority of the approximately 300 CEOs.

What's inside

CEO pay loses steam in light of overall company financial performance and investor caution.

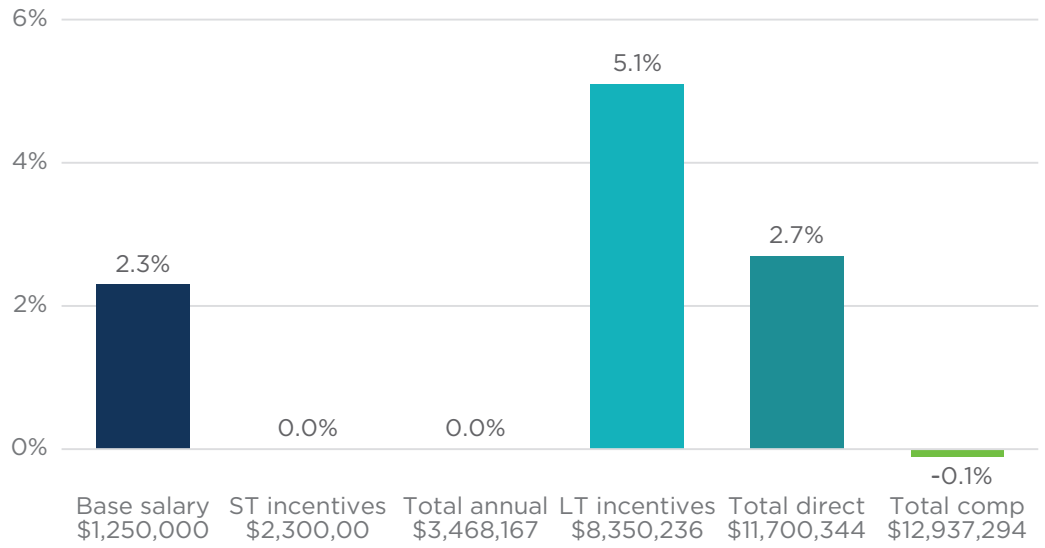
Shareholders suffer as financial results are down.

After a record year of financial performance in 2014, when shareholders earned a TSR of 17.5 percent, companies were expecting another banner year. Unfortunately, 2015 turned out to be the year that tested whether the pay-for-performance modifications put in place in response to shareholder outreach programs would work when performance was down. In 2015, TSR was a negative at -0.3 percent, revenue was down -0.4 percent, and net income was only up 1.8 percent.

As a result of this lackluster performance, CEOs saw their salaries post a modest increase of 2.3 percent to $1.2 million, while annual incentives were flat (0.0 percent change) at $2.3 million, yielding flat (0.0 percent change) median annual compensation of $3.5 million. Driving the positive increase in total direct compensation (TDC) was a 5.1 percent increase in long-term incentives to $8.4 million; this yielded a TDC increase for 2015 of 2.7 percent to $11.7 million which was the lowest increase in TDC in five years, as consistent with the lowest TSR in such 5-year period.

Last year, Korn Ferry Hay Group began reporting pay figures that are shown in the Summary Compensation Table of a company's annual meeting proxy statement (see Survey Methodology beginning on page 12). Korn Ferry Hay Group continues to report the total direct compensation of the CEO, but we are also reporting the total compensation of the CEO. After adding in the change in nonqualified deferred compensation earnings plus the change in pension value, as well as all other compensation, CEO total compensation was down -0.1 percent to $12.9 million.

2015 CEO compensation changes and values.



Consumer Goods and Health Care companies pay more in 2015.

The largest pay increases were seen in the Consumer Goods industry, where TDC increased 8.9 percent, with only a 3.6 percent change in net income but a substantial one-year TSR of 13.5 percent. Health Care companies (for the second straight year) saw TDC rise 8.2 percent, with a 6.7 percent improvement in net income and a one-year TSR of 7.1 percent.

On the other end of the spectrum, TDC for Basic Materials companies was down -5.4 percent, along with a net income decline of -12.5 percent and a -13.4 percent one-year TSR. For the second straight year, TDC for Technology companies remained flat (0.0 percent change), along with a net income increase of 7.8 percent and a one-year TSR of 7.0 percent.

The heavily-watched Financial industry had a mediocre year as salary plus bonus was down -1.1 percent, whereas net income was down -0.8 percent. TDC was up only 1.7 percent with a -2.4 percent one-year TSR.

Realized long-term incentive pay continues to jump significantly.

For the fifth year in a row, CEOs realized significant compensation gains in the form of "realized" or take-home equity-based pay. With a median 7.2 percent change in gains from the exercise of stock options and a median 22.1 percent change in the values of vested restricted stock and performance equity, the median percent change in realized long-term incentives rose 18.3 percent to $9.4 million. Realized pay levels continued to rise over the past five years, and it remains unlikely that we will see any leveling off of realized pay in the near future unless market conditions deteriorate.

Pay mix continues to evolve.

In response to shareholder concerns, companies have engaged with shareholders and their advisors, listening and responding to the issues raised. During these shareholder outreach meetings, companies encountered many issues that revolve around "pay-for-performance", including the adoption of a new long-term incentive vehicle (often performance-based equity), the redesign of short-term and long-term incentive programs, and pay mix changes. While companies have been making such changes over the past five-plus years, increased interactions with their largest shareholders since 2014 have accelerated the process.

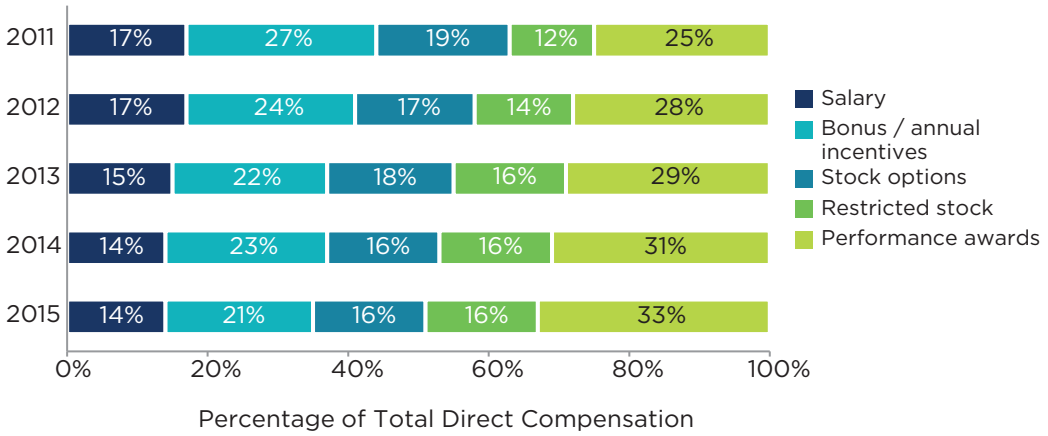
In a common situation, a company that granted an equal amount of restricted stock, stock options and performance awards was told by shareholders to place more emphasis on performance-based compensation. Companies often responded to these shareholder issues by adopting one of the following pay mix revisions:

- 25 percent restricted stock, 25 percent stock options and 50 percent performance equity
- 50 percent restricted stock and 50 percent performance equity
- 50 percent stock options and 50 percent performance equity, or
- 100 percent performance equity.

We are continuing to watch developments in the evolving pay mix, and expect that most companies will maintain certain time-based and performance-based long-term incentives. During 2015, we did see a few companies cancel their time-based long-term incentives and adopt a second performance-based program. There are now 30 companies among the 300-company sample that only made performance-based grants in 2015; we will continue to watch and report on this trend. But in comparison, there were 232 companies that made multiple grants of restricted stock, stock options and/or performance awards.

In the five-year chart that follows, emphasis on performance-based awards gradually increased, while the use of cash-based compensation declined.

The evolving TDC pay mix.



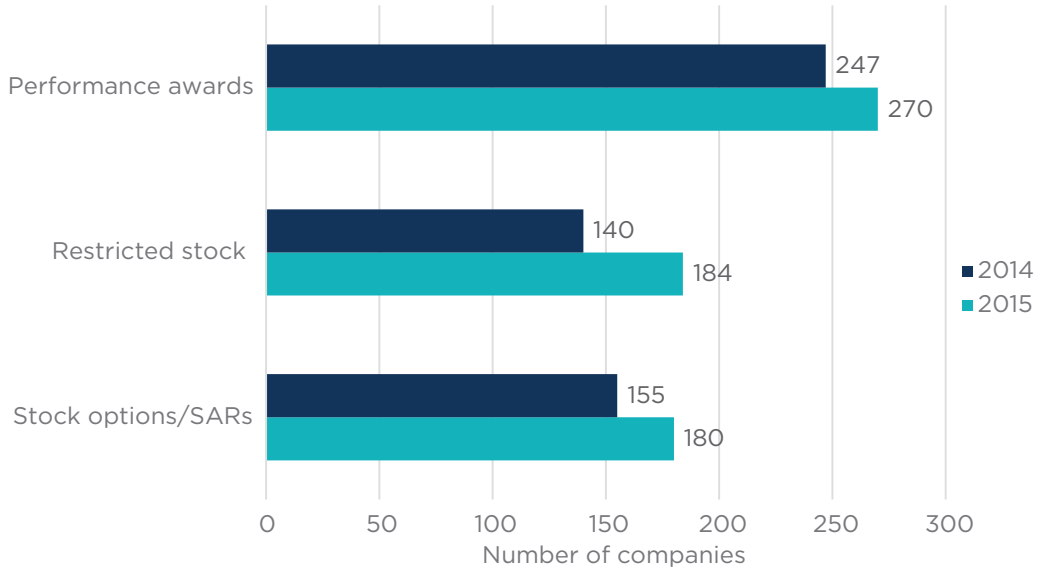
Long-term performance equity plans continue to be the largest piece of the long-term incentive pay mix.

Shareholder groups continue to articulate their support of performance-based programs as companies listen and react to this input. For the sixth straight year, long-term performance equity plans (e.g., performance shares or performance restricted stock units) were the largest component of the long-term incentive pay mix. The typical performance-based equity grant is a contingent grant that only vests upon meeting certain performance goals over a defined performance cycle, often three years. A standard time-vested grant of restricted stock or restricted stock units has no such performance targets and is simply earned by the passage of time. In the typical stock option grant, the optionee must pay an exercise price to obtain the option shares. As performance-based awards increased to their highest levels ever, stock options continue to slightly decline over time. Notably, the use of restricted stock/restricted stock units has had a modest increase over recent years.

In this year's sample, performance awards (sum of performance-based equity and performance-based cash) made up half (50 percent) of CEO long-term incentives, up from 49 percent last year and 46 percent in 2013. More companies made performance-based awards in 2015 as well; a record-breaking 90 percent of companies made performance-based grants in 2015, up from 82 percent in 2014.

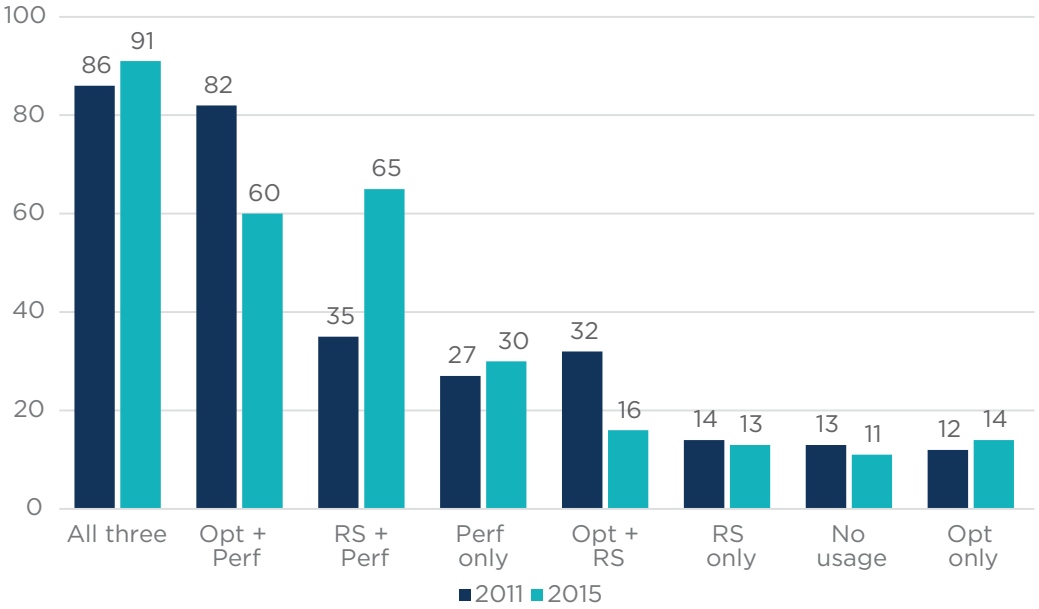
Restricted stock is now the second-most heavily used vehicle, with 61 percent of the survey group awarding them to their CEOs (up from 47 percent in 2014). It also made up 25 percent of the long-term incentive award value in 2015. Stock options were used in 60 percent of companies (up from 52 percent in 2014), also comprising 25 percent of the long-term incentive award value.

Change in CEO long-term incentive prevalence—all incumbents, 2014 to 2015.



Interestingly, over the past five years, companies making "portfolio" grants of more than one incentive vehicle remained essentially flat; 77 percent in 2015 versus 78 percent in 2011. The most commonly used combination included all three award types (i.e. stock options, restricted stock and performance awards) and was also relatively flat, only rising from 29 percent in 2011 to 30 percent in 2015. The next two most popular combinations showed much more dramatic changes, as pairing restricted stock and performance awards jumped from 12 percent in 2011 to 22 percent in 2015, while the combination of stock options and performance awards dropped from 27 percent in 2011 to 20 percent in 2015. Since 2011, the prevalence of granting only one such vehicle dropped from 24 percent to 20 percent, but grants of performance-based awards increased slightly from 9 percent to 10 percent.

Use of CEO long-term incentive portfolios, 2011 to 2015.

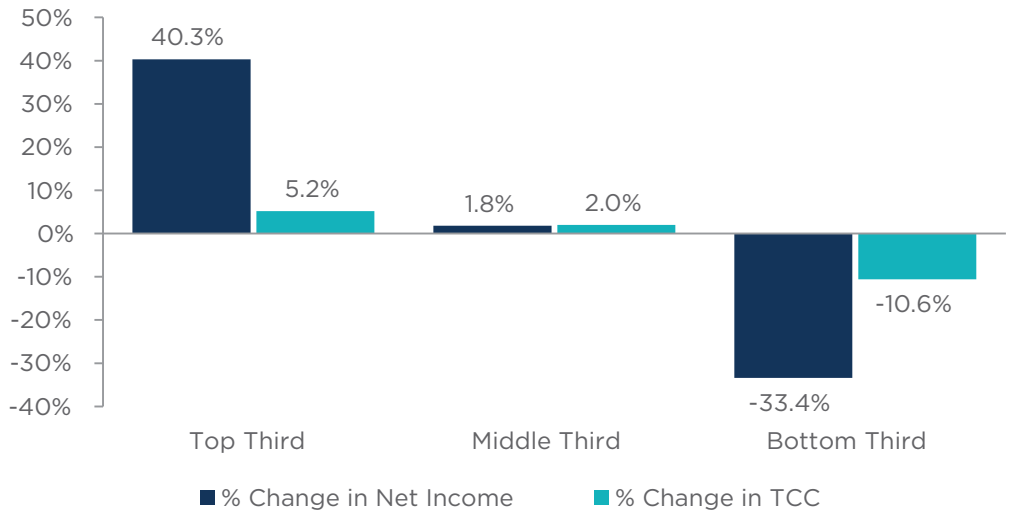


Even in a down year it pays to work for a top-performing company.

In 2015, it still paid to work for a company that had better financial performance. In proving this theory, we split the surveyed companies up into various groups.

First, we divided the sample into three separate groups by net income. The top third of net income performers had a median increase of 40.3 percent while their CEO's total annual pay (salary plus annual incentives) was up a median of 5.2 percent. The middle third had a net income increase of 1.8 percent and a 2.0 percent increase in CEO total annual pay. The lowest third saw their net income decline by 33.4 percent, coupled with a drop in annual pay or 10.6 percent.

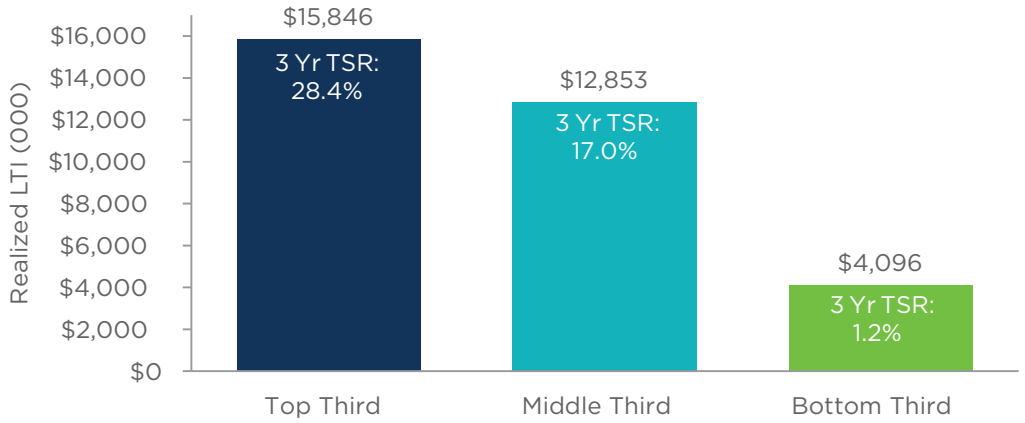
Change in CEO TCC vs. change in net income.



The sample was then split into three groups by 3-year TSR. The top third of companies had a median TSR of 28.4 percent, while their CEOs' realized LTI had a median of $15.8 million. The middle third had a TSR of 17 percent and a realized LTI of $12.9 million. The bottom third saw a TSR of 1.2 percent coupled with a realized LTI of $4.1 million.

These results show that even when the 300-company sample has a down year, it still pays for a CEO to work for a top-performing company.

Realized CEO long-term incentive income vs. 2013-2015 annualized total shareholder return.



How did companies respond to say-on-pay votes and shareholder outreach in 2015?

AFTER SIX YEARS OF SAY-ON-PAY VOTES, HOW HAVE COMPANIES EVOLVED?

Most companies continue to receive high levels of shareholder support. The typical goal is to receive at least a 90 percent approval rate from shareholders. To do so, most have established shareholder outreach programs to identify issues that are of concern to shareholders. Following those meetings, companies often adopt measures to address those issues before they become a significant source of dissatisfaction.

Companies have been working hard at enhancing the text in the Compensation Discussion & Analysis (CD&A) section of their annual proxy statements to provide more explanation and rationale regarding compensation design and decisions, such as pay-for-performance and pay metrics. An executive summary has become a best practice for highlighting key aspects of the executive pay program.

During the 2016 proxy season, we saw at least some companies do one or more of the following in response to shareholder interaction and feedback:

- Redesigned short-term and long-term incentive programs with new performance metrics, while eliminating any redundancy in metrics being used
- After years of resistance, gave into shareholder pressure and adopted a new long-term performance-based equity program
- Added a “total shareholder return” metric to a long-term performance-based equity program
- Continued enhancements of performance-based equity vehicles at the expense of time-vested equity vehicles
- Extended the long-term incentive performance period from one or two years to three years.

With each new proxy season, companies are evolving and working hard to extend their shareholder outreach activity. In previous years, there were low votes at some large companies that ranged between 40 percent and 70 percent approval. Rather than experience a similar shareholder vote, companies quickly learned that they should become more proactive.

The simple solution was to engage large shareholders throughout the year to identify issues of concern, and to develop solutions before the annual meeting. Companies have taken (and will continue to take) actions to change their pay programs before shareholders raise these issues in a say-on-pay vote.

Executive pay legislation and regulatory efforts began to pick up in 2015.

This past year was a very active period for the SEC as it finally proposed (and in one case finalized) rules on key pay-related provisions under the Dodd-Frank legislation. Actions included:

- In February 2015, the SEC proposed rules that would require companies to disclose whether any employee or director may hedge their company's shares
- In late April 2015, the SEC proposed rules to address the “pay-versus-performance” disclosure, which basically defines “performance” as relative TSR and “pay” as a version of realized pay
- In July 2015, the SEC proposed clawback rules that caused many companies to not only revisit their clawback policies for potential compliance for the 2017 proxy season, but also to reconsider the design of their incentive programs
- In August 2015, the SEC adopted final rules to implement the CEO pay ratio disclosure requirements of Dodd-Frank—we’ll see this disclosure beginning in the 2018 proxy season (related to 2017 fiscal year compensation).

What’s next? Staying ahead of say-on-pay.

Companies have listened to their shareholders over the past two to three years to make their pay programs more about a pay-for-performance orientation. Even in 2015, when performance was down, annual CEO pay tracked income performance. Also, while total direct pay rose in 2015 because of increases in long-term incentives, total compensation (which includes changes in nonqualified deferred compensation and pension value) closely tracked TSR performance. Companies will need to strengthen their relationships with shareholders in 2016 as the effectiveness of their shareholder outreach programs will likely be tested this year. Coming after two strong TSR years in 2013 and 2014, and a poor year in 2015, pay program support could be a harder sell as shareholders may realize little or no gains.

A review of CEO compensation by industry.

When it came to industry pay raises in 2015, most companies issued CEOs a standard base pay increase of 2-4 percent. One notable exception was the Telecom sector, which exhibited superior profitability performance during the year. Telecom's financial performance may have justified meaningful year-over-year increases to cash compensation (9.4 percent to 16.4 percent to base and bonus, respectively), but little increase was made to LTI.

A number of sectors displayed flat or decreasing year-over-year total direct compensation as companies were more cautious with pay amidst weakened market conditions. While more than half of the sectors experienced bonus declines, modest LTI increases helped CEOs gain in total direct compensation.

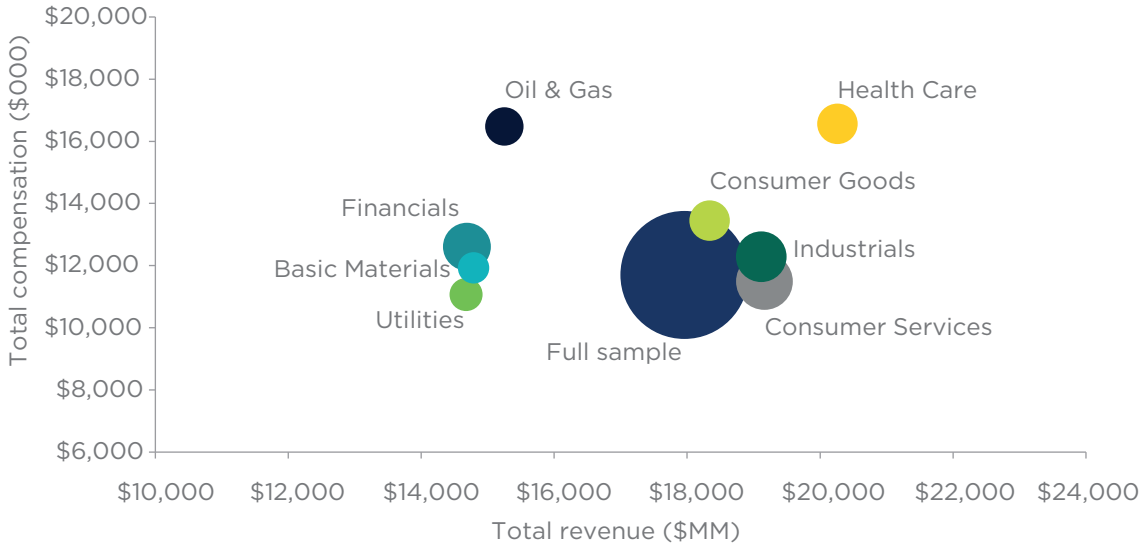
Year over year changes by industry, 2014–2015.

INDUSTRY	BASE	%	BONUS	%	TAC	%	LTI	%	TDC	%
Basic Materials	$1,250,000	3.4%	$1,496,250	-51.8%	$2,790,170	-35.4%	$8,173,392	-7.9%	$10,578,233	-5.4%
Consumer Goods	$1,333,333	2.4%	$3,062,500	8.5%	$4,268,000	6.6%	$8,140,289	6.2%	$12,585,446	8.9%
Consumer Services	$1,246,154	1.2%	$2,122,013	0.0%	$3,576,993	1.0%	$7,074,566	0.0%	$10,586,038	0.0%
Financials	$1,108,846	0.0%	$2,782,818	-2.6%	$4,118,510	-1.1%	$8,533,169	7.3%	$12,274,454	1.7%
Health Care	$1,339,692	3.9%	$2,807,550	5.2%	$4,123,896	7.4%	$10,272,485	10.8%	$14,579,693	8.2%
Industrials	$1,221,987	2.4%	$1,817,000	-2.6%	$3,076,877	0.0%	$8,453,874	11.1%	$11,144,454	3.5%
Oil & Gas	$1,524,582	2.9%	$2,425,000	-18.5%	$3,886,398	-11.7%	$10,812,760	0.2%	$14,233,615	2.9%
Technology	$1,100,000	2.1%	$1,875,000	-1.7%	$3,085,385	-1.0%	$9,543,349	0.0%	$10,266,457	0.0%
Telecom	$1,576,948	9.4%	$4,626,551	16.4%	$6,203,499	14.6%	$13,311,540	1.3%	$19,763,142	4.7%
Utilities	$1,241,170	3.1%	$1,890,406	6.8%	$3,094,610	5.7%	$6,509,616	5.1%	$9,510,087	4.3%

Total compensation by industry.

When looking at total compensation by industry, Telecom CEOs pulled ahead of the pack with a median total compensation of $21.4 million (nearly 30 percent more than the next highest paid sector and double the median) in light of its superior performance and revenue size. Additionally, Health Care and Oil & Gas CEOs are amongst the highest paid in terms of total compensation, but Technology CEOs are the lowest paid despite revenue size.

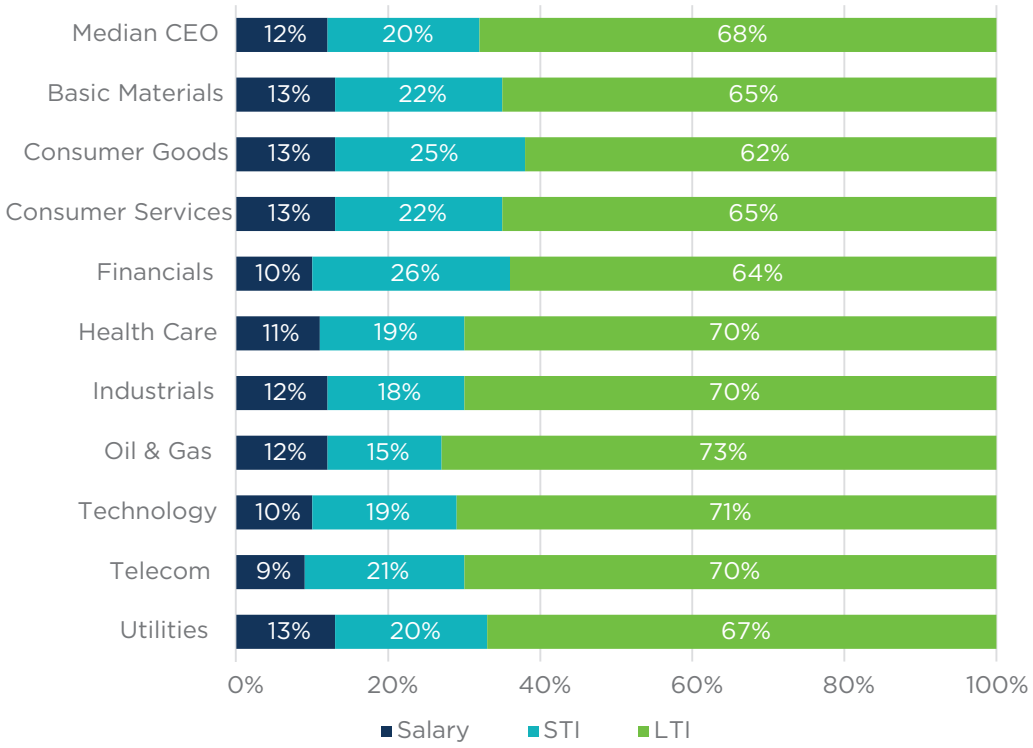
Total compensation by industry, 2015.



TDC mix by industry.

When it comes to TDC mix by industry, all sectors emphasized LTI, making up generally two-thirds or more of total direct compensation. More capital-intensive sectors such as Telecom, Technology, Oil & Gas and Industrial—that operate on longer-term business cycles—may tend to weight LTI more heavily than other sectors. Overall, modest differences in pay mix are observed as each pay element is generally differentiated within 5 percent across sectors.

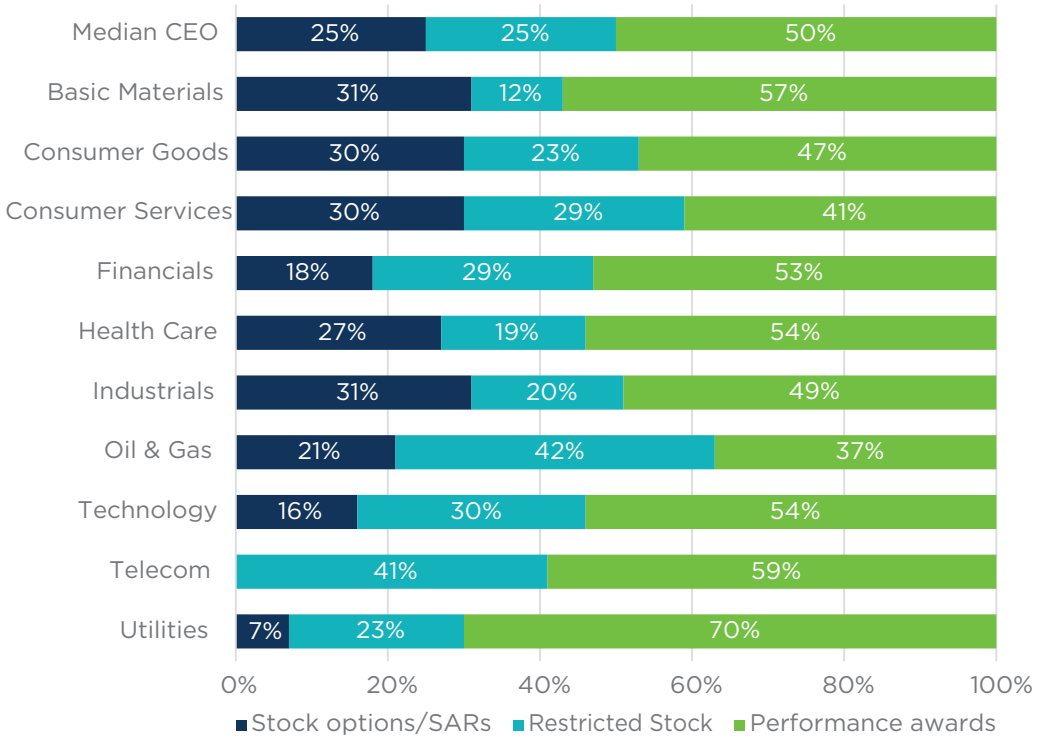
TDC mix by industry, 2015.



LTI mix by industry.

Almost every sector continues to emphasize performance plans over any other vehicle. Performance plans were highest in Utilities (70 percent) and lowest in Oil & Gas (37 percent), but at least 50 percent for most sectors. Retention remains an important element of LTI as most sectors maintained 20-30 percent in restricted shares/units. While stock options generally receive less emphasis than all other LTI vehicles, Consumer Goods, Consumer Services, Basic Materials, Health Care, and Industrials use stock options to maintain (where performance plans are less than 50 percent) or enhance (where performance plans are greater than 50 percent) leverage and shareholder alignment.

LTI mix by industry, 2015.



Survey methodology.

For the ninth straight year, Korn Ferry Hay Group, the preeminent global people and organizational advisory firm, has prepared its annual survey of CEO compensation. This year's study includes the 300 largest companies that filed their final definitive proxy statement between May 1, 2015 and April 30, 2016. The sample companies also include qualifying companies that are not incorporated or do not have their principal office location in the U.S. Throughout this study, we refer to the most recent fiscal year as 2015 and the prior fiscal year as 2014.

As in previous reports, this study provides readers with a snapshot of total compensation as disclosed in each company's proxy statement. This includes each CEO's Total Direct Compensation (TDC), which consists of salary, bonus or other annual incentives paid, and any long-term incentive awards (generally stock grants or stock options) granted. In addition, the study also provides information about each CEO's change in pension value and change in above market nonqualified deferred compensation earnings. A separate category, all other compensation, includes information on such items as perquisites, tax gross-ups and company payments to a defined-contribution plan. Taken together, these elements provide a picture of each CEO's total pay for 2015.

For the last two years, our approach to summarizing total compensation is now the same as the approach taken in the Summary Compensation Table of the proxy itself. What this means is that the study focuses on the value of what was granted in 2015, not necessarily what was earned in 2015. Companies have been reporting their CEO and Named Executive Officer pay in this manner for quite some time now, and until the Securities and Exchange Commission makes any changes to the reporting requirements, the survey will report the data as it appears in the Summary Compensation Table.

Please note that this year's population of 300 companies is different than last year's population. As a result, the summary statistics for 2014 differ from what was reported last year.

All company performance data (net income, TSR) is provided by S&P Capital IQ.

Definitions

2015 Salary is the base pay earned by the CEO in FY 2015.

Annual Incentives: 2015 Bonus is any discretionary bonus payments made in FY 2015.

Annual Incentives: 2015 Non-Equity Incentives are amounts classified as annual performance-based incentive pay in FY 2015, which typically results from the achievement of annual performance goals. The 2015 Non-Equity Incentives included here are the annual incentive portion of the amount disclosed in the Summary Compensation Table.

Total Annual Compensation: 2015 Salary + Annual Incentives is the sum of 2015 Salary, Annual Incentives: 2015 Bonus and Annual Incentives: 2015 Non-Equity Incentives.

Percent Change From 2014: Salary Plus Annual Incentives is the year-over-year change in Salary plus Annual Incentives from FY 2014 to FY 2015. This information is calculated only for those CEOs for which there is valid data in both 2014 and 2015, and thus excludes new CEOs.

Long-Term Incentives: 2015 Stock Awards is the company-disclosed grant value of stock awards, primarily in the form of performance-based equity, restricted stock and restricted stock units. These amounts are as disclosed in the Summary Compensation Table.

Long-Term Incentives: 2015 Option Awards is the company-disclosed grant value of stock option and stock appreciation rights (SARs). These amounts are as disclosed in the Summary Compensation Table.

Long-Term Incentives: 2015 Non-Equity Incentives is the company-disclosed payment value of cash-based long-term performance incentives. The Non- Equity Incentives included here are the long-term incentive portion of the amounts disclosed in the Summary Compensation Table.

Total Direct Compensation is the sum of 2015 Salary + Annual Incentives, Long-term Incentives: 2015 Stock Awards, Long-Term Incentives: 2015 Option Awards, and Long-Term Incentives: 2015 Non-Equity Incentives.

Percent Change From 2014: TDC is the year-over-year change in Total Direct Compensation from FY 2014 to FY 2015. This information is calculated only for those CEOs for which there is valid data in both 2014 and 2015, and thus excludes new CEOs.

Change in NQ Deferred Comp + Pension Value (Change in Nonqualified Deferred Compensation Earnings plus Change in Pension Value) is the aggregate change in the present value of accumulated defined-benefit and actuarial pension plans plus the above-market or preferential earnings on compensation that is deferred on a basis that is not tax-qualified.

All Other Compensation is the value of other compensation for FY 2015 that was not reported in any of the other columns of the Summary Compensation Table. Compensation in this column could include the value of: perquisites and personal benefits; tax gross-ups; discount stock purchases; company contributions to a defined-contribution plan; or company payment of insurance premiums.

Total Compensation is the sum of Total Direct Compensation, Change in Nonqualified Deferred Compensation Earnings plus Change in Pension Value, and All Other Compensation.

Percent Change From 2014: Total Compensation is the year-over-year change in Total Compensation from FY 2014 to FY 2015. This information is calculated only for those CEOs for which there is valid data in both 2014 and 2015, and thus excludes new CEOs.

Realized Long-Term Incentives: Stock Option Exercises is the value of stock option gains made from their exercise in FY 2015.

Realized Long-Term Incentives: Stock Awards Vesting is the value of stock awards, primarily in the form of performance-based equity, restricted stock and restricted stock units that vested or paid out in FY 2015.

Realized Long-Term Incentives: Total is the sum of Realized Long-Term Incentives: Stock Option Exercises and Realized Long-Term Incentives: Stock Awards Vesting.

Percent Change From 2014: Company Net Income is the year-over-year change in the company's net income from FY 2014 to FY 2015.

2015 Company TSR is a one-year total return for the company's stock during FY 2015, including stock-price appreciation plus reinvestment of any dividends declared in FY 2015.

Notes

Any compensation for CEOs with less than a full year of service is recorded as disclosed in the Summary Compensation Table. Signing, special-recognition and retention awards are included as disclosed in the Summary Compensation Table. Percent changes of 1,000 percent or greater are not meaningful and are designated as N.M. Percent changes for CEOs who are new in FY 2014 or FY 2015, as well as data that is otherwise unavailable or incalculable, are designated as N.A. Industry medians exclude new CEOs for 2015.

Please direct any questions or comments about the survey methodology to Irv Becker at irv.becker@kornferry.com.

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