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Phani Solomou, +44 (0)171 399 3644, psolomou@sternstewart.co.uk
Fredrik Gustavsson + 44 (0)171 399 3645, fgustavsson@sternstewart.co.uk

UK Remuneration Practices

Do UK Incentives Align Managers With Shareholders?

- Owner-like remuneration strategies should balance three main objectives: wealth gearing, retention and cost. We found little evidence of companies weighing tradeoffs and balancing objectives.

- UK short-term incentive plans have problems:
  - Incentives are based on too many measures with weak link to value creation.
  - Targets are based on negotiated budgets and reset each year.
  - Payout caps minimise opportunity.
  - Thresholds limit accountability.
  - Rewards are not at risk over multiple years.

- Long term incentive plans are not aggressive enough.

- We propose innovative structures that overcome many of the identified deficiencies.

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EVAluation is a series to be published monthly by Stern Stewart Europe Limited, drawing on the depth of our experience and internal research, to cover issues of valuation, organisational design, decision making, remuneration, and corporate governance. Our focus is to assist managers in understanding how their actions affect the value of their organisations. We believe that all stakeholders benefit from the creation of value through both innovation and efficiency.

"Executive remuneration should be structured to maximise NPV, not minimise expense. The media should stop its harassment of so-called fat cats. With incentives that better align the interests of managers and owners, corporate governance would be greatly reinforced. If managers are paid more like entrepreneurs, UK companies will be more aggressive, innovative and competitive, while also being more sensitive to risk management. This is vital for the success of the nation and its people."

Greg Milano, Managing Director, Stern Stewart Europe Limited.

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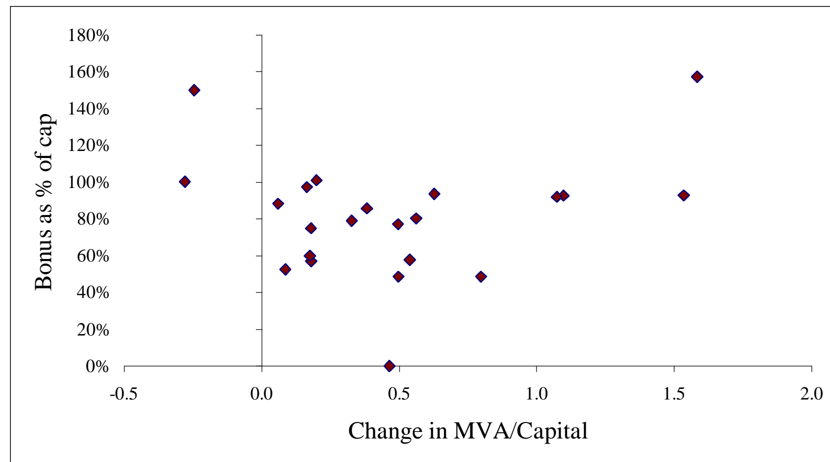
Executive Summary

Alignment of UK incentives with shareholders.

Most UK companies state a commitment to shareholder value in their annual reports. At a recent conference, we asked investors and security analysts how they distinguish the companies that take this seriously from those that have good investor relations. Unanimously, they said you could tell by the remuneration. "If management commits their pay to shareholder value, we know they are serious."

We reviewed the remuneration practices of the FT30 to see whether UK executive incentives really align with owners. Although our sample is small, only by combining the remuneration data with our Market Value Added database[1] we found effectively no correlation between performance and pay[2], as shown in Exhibit 1.

Exhibit 1. Performance does not seem to count!



Source: Stern Stewart Research

Design, policies and compliance.

We propose a framework for designing owner-like remuneration strategies, by balancing the three main objectives of gearing, retention and cost. We found no evidence of companies weighing the tradeoffs and balancing the remuneration objectives. Corporate governance committees and Stock Exchange Listing Rules have led to a "the same plan applies to all" situation.

Incentives are flawed.

We found many flaws in UK short-term incentive plans. Rewards are based on too many measures that do not directly link to value creation, targets are based on negotiated budgets that are reset each year, payout caps minimise opportunity, thresholds limit accountability, and rewards have no element of risk over multiple years. Long term incentives are often not aggressive enough.

Our proposition.

For short term plans we propose that multi-year targets are derived from investor expectations, caps and thresholds are removed and rewards are held at risk over multiple years. Long term plans should strengthen wealth gearing and alignment through the use of more aggressive equity structures and granting policies.

[1] Stern Stewart calculates annually the MVA (Market Value Added) of the top 500 UK companies. The FT200 MVA 1997 Ranking was published in the Sunday Times on 27 September 1998.
[2] We considered the relationship between actual bonuses declared and upper limits for highest paid director for 1997/8 as an indication of level of performance. If the maximum bonus had been declared then performance would have been considered exceptional.

Introduction

Shareholder value and management incentives go hand in hand.

Over 90% of the FT30 companies (Exhibit 2) state in their annual reports their commitment to maximising shareholder value. But how can we distinguish those that are committed to this paradigm from those that just talk about it as part of their investor relation strategy? The obvious place to look is in the remuneration reports. Managers with remuneration packages that poorly align with shareholders' interests can take actions that help themselves but hurt the value of the company. Or managers that have the success of the company at heart may be faced with a reduced personal remuneration to do what is right for the owners. Only when incentive systems fully align managers and shareholders' interests will such problems be overcome.

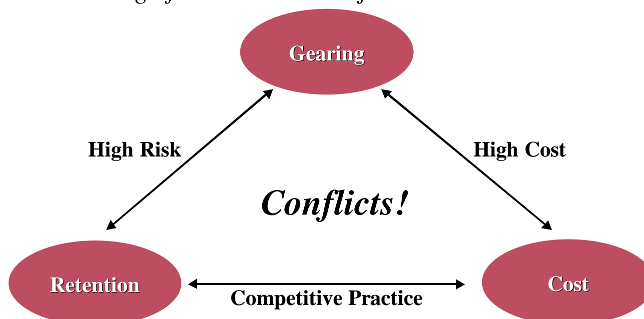
Exhibit 2. FT 30 companies for 1997/8(ranking based on market capitalisation).

Glaxo Welcome	Prudential	B Sky B
British Petroleum	GEC	Rio Tinto
British Telecommunications	Marks & Spencer	Bank of Scotland
Lloyds TSB	HSBC Holdings	Granada
Shell	CGU	Royal Bank of Scotland
Vodafone	Sainsbury	National Power
Barclays	Tesco	Orange
Nat West Bank	Boots Company PLC	Scottish Power
Cable & Wireless	Royal Sun Alliance	Standard Chartered
Abbey National PLC	Cadbury Schweppes	Pearson

Effective incentive plan design depends upon balancing three main objectives…

An incentive plan should achieve alignment by balancing three main objectives: gearing, retention and cost (Exhibit 3). Wealth gearing measures the strength of an incentive concept in aligning the reward to shareholders with that of managers (ie. wealth gearing measures the sensitivity of management's expected wealth from employment to changes in shareholder wealth). Alignment deals with what financial economists call agency costs. As agents, managers will often pursue their own interests which, if not aligned with shareholders', may lead to poor company performance. Full alignment is achieved when managers and shareholders fortunes are moving in the same direction.

Exhibit 3. Balancing of remuneration objectives.



Source: Stern Stewart Europe Research.

... an exercise which entails difficult tradeoffs.

Balancing these remuneration objectives entails difficult trade-offs. If we choose high gearing to provide strong motivation while keeping costs low, we create substantial management retention risk during business downturns. If we maintain higher gearing and protect against retention risk, the average expected cost of the incentive plan rises. If we instead choose to emphasise cost containment and retention risk, the gearing drops to levels that are not truly motivating. Each company must understand its own needs well enough to ensure that the desired outcome is achieved.

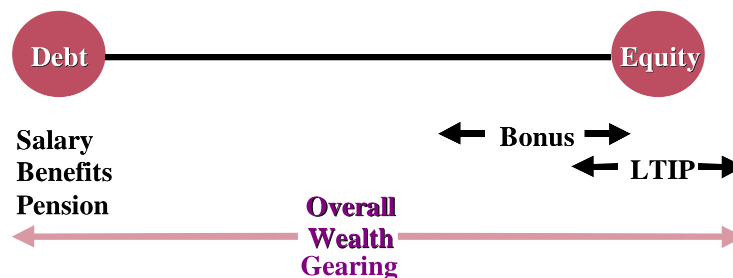
All components of remuneration package ...

Remuneration packages normally have three main components. Base salary (including benefits and pension), short-term bonuses and long-term incentives. From the employees perspective base salaries can be characterised as fixed income, resembling debt payments. As long as the company is a going concern and the executive remains employed, these payments are made. Short-term bonuses should be performance-based and should align with shareholders over the medium term. Long-term incentive plans further extend the time horizon and have the potential of shaping the overall wealth gearing of the remuneration package.

... should simulate ownership and encourage multi-year value creation.

The remuneration package should encourage managers to have a multi-year perspective and pursue strategies that create sustainable value. They should think and act as owners because they are faced with both the accountability and opportunity of owners. We evaluate the wealth gearing of remuneration packages by using a remuneration risk map as shown in Exhibit 4.

Exhibit 4. Remuneration risk map.

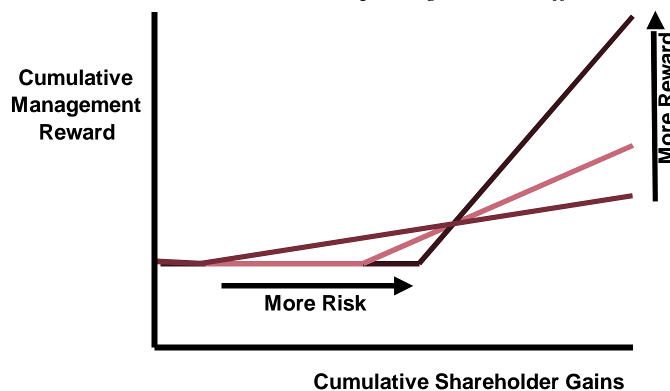


Source: Stern Stewart Europe Research.

Designing effective remuneration packages is a multi-step process.

Designing effective remuneration packages entails evaluating the company specific dynamics, defining the scope and boundaries of a desired remuneration strategy, understanding the relevant trade-offs of alternative structures, selecting the most appropriate package and communicating that both internally and externally. The "same value" of remuneration can be provided with vastly different levels of risk and reward, as illustrated in Exhibit 5.

Exhibit 5. Alternative same value packages entail different trade-offs.



Source: Stern Stewart Europe Research.

Individual elements should not be viewed in isolation or over a single period horizon.

The individual elements of remuneration should not be viewed in isolation nor be evaluated over a single period horizon. Management's expected wealth is comprised of current income (including existing stock and option holdings) as well as the present value of expected future compensation (including salary, benefits, pension, bonuses and long-term incentive gains). The desired reward profile of the remuneration package over the longer-term can be achieved by blending the individual elements of remuneration.

This report will analyse the current executive remuneration practices in the UK, focusing on the FT 30, with respect to policy, salary, short-term bonuses and long-term incentive plans. We also propose alternatives that overcome many of the identified deficiencies.

Corporate governance committees and Stock Exchange Listing Rules have influenced current practices.

Remuneration Policies & Compliance

Remuneration committees have been influenced by the publication of corporate governance reports[3] and the best practice provisions (Sections A & B) annexed to the London Stock Exchange Listing Rules. Despite the overwhelming "commitment" of FT30 companies to shareholder value creation, in more than half of the companies did not identify the link between value creation and incentive plans that align manager and shareholder interests[4] as shown in Exhibit 6.

Exhibit 6: Stated remuneration policies and objectives of FT30 companies.

Claiming alignment	47%
Mentioning gearing	0%
Focusing on retention	100%
Focusing on minimising shareholder cost	0%

Source: Stern Stewart Europe Research and 1997/8 Annual Reports

Public corporations have not been "eclipsed" as predicted by Michael Jensen …

… because remuneration practices have changed.

This is alarming as most investors and academics consider alignment with shareholders as one of the most effective corporate governance mechanisms. Michael Jensen of Harvard Business School publicised these issues in Harvard Business Review[5], where he argued that the incentive problems of large publicly traded corporations were so significant that they would become extinct. He claimed that they would be "eclipsed" by LBO type organisations. LBO's, that replace equity with debt, encourage management discipline through the need to service debt and through greater equity stakes by management[6]. However, LBO organisations have not replaced traditional corporations because remuneration structures and governance practices have changed. Ways of replicating the motivation inherent in LBO's, without the high risk and lack of flexibility caused by high debt equity ratios have been developed and proven.

Returning to the practices of FT30 companies, we find that there are little differences in the remuneration practices between companies that declare their commitment to alignment and those who do not. Exhibit 7 summarises the remuneration plans of companies that are claiming alignment and those that do not. In fact, by offering more equity-based incentives, the companies that are *not* claiming alignment are marginally better.

Exhibit 7. Summary of remuneration plans of FT30 companies.

	Short term incentive plan			**Long term incentive plan**		
	Cash	Shares	Bonus shares if cash invested in company's shares	Cash	Shares	Options
Companies claiming alignment of directors' and Shareholders' interests	89%	11%	20%	4%	54%	43%
Companies ***not*** claiming alignment of directors' and Shareholder's interests	81%	20%	20%	0%	50%	50%

Source: Stern Stewart Europe Research & FT30 1997/8 Annual Reports.

[3] "The financial aspects of corporate governance", December 1992. Committee was chaired by Adrian Cadbury. "Directors Remuneration, report of a Study Group chaired by Sir Richard Greenbury" July 1995. "Committee on corporate governance: Final report", January 1998. Committee was chaired by Ronnie Hampel.
[4] This was assumed to be the case given that only 47% of the companies included any mention of the fact in their remuneration reports.
[5] "Eclipse of the public corporation" Michael Jensen, Harvard Business Review Sep-Oct 1989.
[6] "Performance pay and top management incentives" Michael Jensen and Kevin Murphy, Journal of political economy, 1990.

No evidence of companies weighing tradeoffs and balancing objectives.

The remuneration policy statements should give investors clear insights on remuneration objectives. Unfortunately this is not the case. For example, all companies, whether clearly stated or implied, claim as one of their main objectives to "pay competitive salaries in order to attract, motivate and retain high calibre executives". This statement implies that attraction, retention and motivation are largely a function of base salary, which is not the case. From our experience, managers frequently accept jobs with lower salaries but more upside potential in an attempt to maximise their wealth.

There is evidence of "the same plan applies to all".

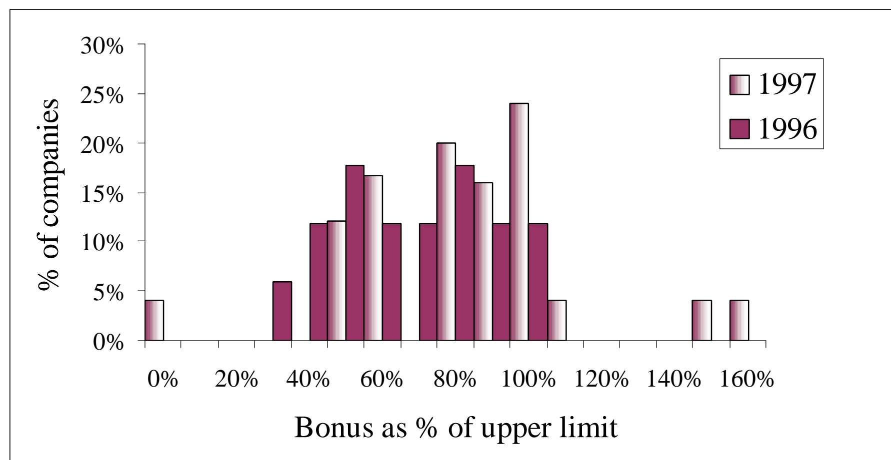
Policy statements are not customised to the specific circumstances of each company and the specific desired behaviours. There is also great similarity of incentives across companies in different industries. This might be because of compliance with listing rules and corporate governance guidelines. But it seems that companies with different dynamics, opportunities and management objectives should have different incentive policies. For example, one of the Stock Exchange Recommendations[7] states that "performance conditions should be relevant … and designed to enhance the business". For 70% of the companies this is translated as a generic statement such as "it is our policy to offer performance based rewards on the achievement of business objectives..."[8]. This does not provide investors with any useful information.

Guidelines require that performance conditions be stretching.

The listing rules recommend that performance conditions should be stretching and total potential rewards should not be excessive[9]. The objective of these clauses is aimed at giving a perception of ethical reasonableness and control of shareholder costs. We looked for evidence of these "stretch targets" and found none.

We tested the relationship between actual bonuses declared[10] and upper limits, or bonus payout ratios during the financial years 1996/7 and 1997/98. We considered the payout ratio as an indication of the evaluation of the CEO's performance. If the maximum bonus had been declared, then the CEO's performance would have been considered exceptional. Exhibit 8 shows the results of this analysis.

Exhibit 8. Evaluation of CEO performance - Distribution of actual bonus paid as a percentage of upper limits.



Source: Stern Stewart Europe Research & FT30 1996/7 and 1997/8 Annual Reports.

We looked for evidence of these "stretch targets" ….

We would expect the distribution to be bell shaped, (ie. normally distributed). This is not the case, especially for 1997. The clustering between 50% and 100% indicates that the cap is not deemed to be a "significant award for over-performance" but rather the high end of the target or expectation. Therefore, there is little evidence of the existence

[7] Stock Exchange Listing Rules, Schedule A: Provisions on the Design of Performance Related Remuneration, Point 1.
[8] The final report of the Committee on Corporate Governance, January 1998 reached the same conclusions. Section V 4.15. "A number of companies have met the letter of this requirement with anodyne references to the need to "recruit, retain and motivate" or to pay "market rates". We consider that a policy statement is potentially helpful, to set the context for the more detailed information; we hope that companies will provide more informative statements, drawing attention to factors specific to the company."
[9] Stock Exchange Listing Rules, Schedule A: Provisions on the Design of Performance Related Remuneration.
[10] Analysis is based on annual bonus of the CEO or highest paid executive (including executive chairmen).

of stretch targets. There also is a shift towards the right, year on year (ie. higher percentages of upper limits were paid in 1997/8 than in 1996/7 – 80% and 73% respectively). One reason for this is value creation in terms of MVA (Market Value Added) which increased more in 1997/8 than in 1996/7[11]. Another reason is that 18% of the remuneration committees in 1997/8 used their discretion to authorise bonus payments in excess of the stated maximums. Although rewarding exceptional performance for a "job well done" is not a practice we disagree with, the fact that rewarding for "over achievement or beating expectations" is left at the *discretion* of the remuneration committee (despite measured performance) is.

… and found none.

In the UK, there is a perception that base salary and benefits are an adequate reward for expected performance and bonuses are for exceeding expectations. We do not agree with this philosophy. Average performance should yield average bonuses with built in mechanisms that allow risk on the downside and opportunity on the upside. The bonus should be motivating across a wide range of performance possibilities. Unfortunately, given that bonuses are clustered between 50% and 100% of maximum, neither of these philosophies is evident in practice.

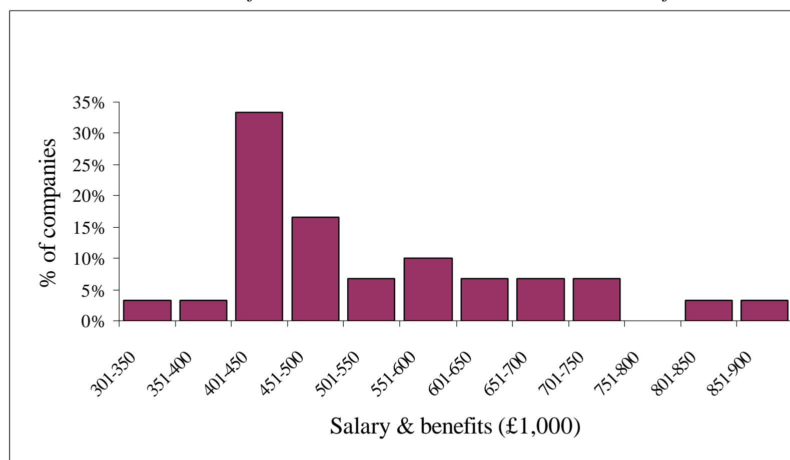
In summary, effective policy generation and incentive system design goes beyond compliance or a "following the leader" approach. It requires balancing remuneration objectives and making difficult tradeoffs taking the needs of each company into account.

Base Salaries

Levels of base salaries are based on surveys and director market value.

It is common practice to review base salaries annually by reference to external surveys of peer companies. Indeed, the base package of over 50% of the FT30 is within the £400,000-500,000 range (Exhibit 9). The final salary is adjusted at the discretion of the remuneration committee according to the individual's experience, performance and market value. There is no evidence that company size alone influences salary, which is good.

Exhibit 9. Distribution of FT30 CEO's base salaries and benefits.



Source: Stern Stewart Europe Research & FT30 1997/8 Annual Reports

Although we found no relationship between level of base pay and performance over a one or two-year horizon, one might argue that it is the aggregate performance or "market value" of the CEO over his/her career that counts. This is difficult to test.

Short-Term Incentive Plans

93% of the FT30 companies had short-term plans with a one-year horizon. Although long-term plans better encourage owner-like behaviour, short-term bonuses are important because as Professor Michael Jensen[12] of Harvard Business School puts it "if you pay people in terms of large equity positions… what will happen is because of imperfections

[11] The change in MVA between 1995/6 is £29bn and between 1996/7 is £108 bn. The FT200 MVA 1997 Ranking was published in the Sunday Times on 27 September 1998.

[12] Evangelist Magazine Volume II Issue III, 1998.

in the human brain, managers will actually lose focus on the day-to-day and year-to-year basis". Therefore, it is important that short-term plans incorporate owner-like characteristics as well.

Design of short-term incentives involves three steps.

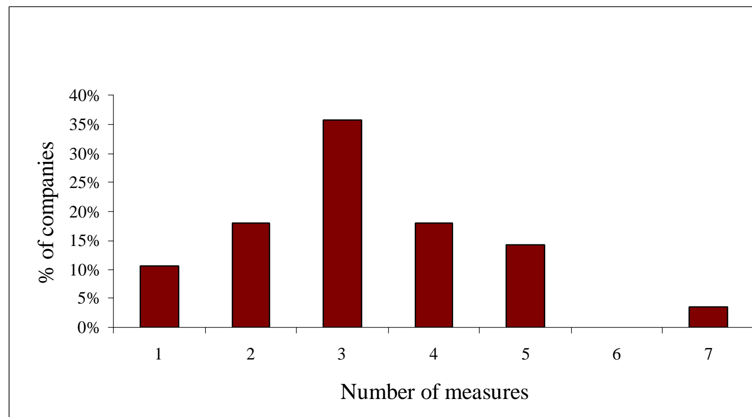
Designing effective short-term incentives is essentially a three-step process. The first step is selecting a performance measure that has a high correlation to value creation, that encourages owner-like behaviour and can be applied for decision-making at all levels of the organisation. The second is identifying a target setting mechanism that is robust and applicable over time. The third is designing a reward mechanism that encourages sustainable value creating behaviour and better aligns with shareholder interests over the medium term.

Performance Measure Selection

Multiple measures cause confusion and conflicts.

In general, companies use too many measures and often measures that encourage undesired behaviours. The actual number of measures mentioned by individual companies is shown in Exhibit 10. Using a variety of measures for day-to-day decision making, capital budgeting, planning, benchmarking and other important processes creates conflicts and confusion for managers. The system becomes fragmented with a loss of understandability and accountability.

Exhibit 10. Distribution of performance measures used by FT30 companies[13].



Source: Stern Stewart Europe Research & FT30 1997/8 Annual Reports.

Although companies tend to disclose only a sample of the measures used, Exhibit 11 gives a flavour of the wide range stated.

Exhibit 11. Performance measures used by FT30 companies.

- Achievement of individual performance objectives
- Achievement of strategic milestones/goals
- Achievement of financial plans/annual budgets
- Budgeted levels of operating expenses and income
- Return on capital employed
- Profit margins
- Growth in profit after tax, growth in trading profit
- Growth in sales
- Market share targets for key products
- Economic profit, Shareholder value added
- EPS growth, inflation adjusted EPS growth
- TSR
- Non-financial qualitative measures such as customer services, product quality, safety and environmental performance, millennium compliance etc.
- ETC…..

Source: Stern Stewart Europe Research & FT30 1997/8 Annual Reports.

[13] The actual observations of this table should be taken as guidance only as companies tend to disclose examples or more significant measures used rather than complete lists.

The performance measures used for reward can be summarised in five main categories.

1. *non-financial measures*.
2. some form *of accounting income-based* measure (eg. operating earnings[14].)
3. *growth-based measures (eg. EPS & revenue growth)*
4. rate of *return measures (eg. return on capital, TSR)*
5. *economic profit*

Non-financial measures

Non financial measures are too vague and the desired behaviour is not obvious.

Approximately 30% of the companies mention non-financial measures ranging from ethical guidelines to customer satisfaction. Non-financial measures could be useful for some businesses, especially if such measures capture information missed by financial measures (eg. compliance with ethical guidelines). This is particularly relevant when the non-financial measure is a leading indicator of future financial performance such as customer satisfaction where infrequent purchases occur.

Our experience is that such measures are often too vague, the desired behaviour is not obvious and there is no clear trade-off versus other factors. Consider an extreme example. Suppose Kodak wished to increase customer satisfaction, and decided to include a £20 note with each roll of film. The exceptional satisfaction of customers would not stop the company from going out of business. Managers should consider the trade-offs between the cost of improving customer satisfaction and the benefits in terms of volume or prices.

Accounting income-based measures

Accounting based measures are a poor measure of performance…

67% of the companies use operating earnings. Accounting based income (like operating earnings, net income or EPS) is a poor measure of performance for shareholders. These measures ignore the cost of capital, or at best only consider the cost of debt. If investors earn any return at all, even below investor expectations, earnings increase and bonuses benefit. As a consequence, managers are encouraged to over-invest and use more of the "free" resource - capital. Accounting profits are also distorted by accounting conventions such as expensing of research and development, despite the long term expected benefits[15]. Investment in the future is thus discouraged. Finally, accounting measures do not reflect the overall risk of the profit stream. As a result, accounting based profit measures do not correlate well with share prices[16] and may encourage undesirable behaviour.

Growth-based measures

…and so are growth based measures.

21% of the companies use EPS growth and 18% use revenue growth measures. Both EPS and revenue growth have negligible correlation to value creation[17]. Like accounting earnings measures, earnings growth measures also encourage over-investment.

Using growth measures can be systematically misleading. Any company that has experienced a "bad" year can easily show phenomenal EPS growth the following year while the actual results might well be below market expectations. In such a case, managers will receive rewards even if they destroyed value.

[14] Operating earnings are normally defined as earnings before extraordinary items, interest and tax.
[15] Stern Stewart research on 400 companies in 12 sectors concluded that in sectors like pharmaceuticals, chemicals and engineering share prices rise upon announcement of intention to increase R&D. This is because of investors' expectations of future rewards.
[16] Stern Stewart research of the 1997 FT500 companies has concluded that standardised EBIT has an explanatory power of standardised enterprise value of only 29% (ie. only 29% of the variations in enterprise value can be explained by operating earnings).
[17] Stern Stewart research of the 1997 FT500 companies has concluded that revenue growth had a 3% correlation between the firm's standardised MVA multiple and EPS had a 0% correlation. There is also negligible correlation between operating profits growth. Investment analysts at Credit Swiss First Boston have also reached the same conclusions.

Return measures

Return measures have an inadequate correlation to value creation.

10% of the companies use return measures such as return on capital employed, return on sales (profit margin) and total shareholder returns. Reward is normally tied to increasing the measure[18]. Although this is an improvement over EPS or revenue growth because capital investment is considered, return measures also have an inadequate correlation to value creation[19]. Basing reward and decision making on maximising such measures encourages over-investment in weak businesses and stifles growth in strong businesses as we will demonstrate below.

Return measures can be misleading for decision-making and reward the wrong behaviour.

The basic rule of modern corporate finance states that value is created if returns are in excess of the cost of capital and value is destroyed when returns are below the cost of capital. Maximising the rate of return does not support this. Consider a successful company that is evaluating a value creating investment, as shown in Exhibit 12. If rewards are based on maximising the return on capital, management would not be rewarded for this investment since the return on capital would drop from 25% to 23%.

Exhibit 12. Rewarding on maximising the return on capital encourages under-investment in successful businesses.

	Existing business	New investment	After investment
Income	250	100	350
Capital (Assets)	1,000	500	1,500
Return on Capital (R)	25%	20%	23%
Cost of Capital	10%	10%	10%

Alternatively, consider a business earning returns below the cost of capital, as in Exhibit 13. A new investment, which will also earn returns below the cost of capital and thus destroy value, will be rewarded because it improves the returns.

Exhibit 13. Rewarding on maximising the return on capital encourages over-investment in underperforming businesses.

	Existing business	New investment	After investment
Income	50	40	90
Capital (Assets)	1,000	500	1,500
Return on Capital (R)	5%	8%	6%
Cost of Capital	10%	10%	10%

Short-term TSR is a noisy measure of performance.

3% of the companies use Total Shareholder Return[20] (TSR) for annual bonuses. Over multi-year periods, TSR is an excellent measure of performance for shareholders. Given the share price volatility over a single year, this is problematic and it is questionable whether it would encourage any desired behaviour. TSR is a noisy measure and is influenced heavily by external factors. Managers might be more concerned with investor relations than managing the business itself.

Economic profit

7% of the companies listed economic profit as a performance measure. This is a shift in the right direction but unfortunately the lack of disclosure on how economic profit is calculated does not allow us to comment on either alignment with value creation or with respect to the behaviour it encourages.

[18] Return on asset measures were mentioned by 7% of the companies and profit margins by 3%.
[19] Stern Stewart research of the 1997 FT500 companies has concluded that return on equity had a 10% correlation with MVA.
[20] Total shareholder return is defined as the theoretical capital growth that would have been achieved by a shareholder over a pre-determined period assuming all dividends were reinvested and adjustments for rights issues and other changes to share capital are made.

Target Setting Mechanism

Annual targets are negotiated and reset each year…

All but one company set target performance levels based on annually negotiated targets[21]. These targets determine the level of reward at the end of the year. Such practice encourages the management of expectations rather than performance and the concealment of information about opportunities. The time horizon and focus becomes the next 12 months and how this is best justified since "we can negotiate next year later". By resetting targets every year the emphasis on continuous improvement is undermined.

… creating numerous problems…

This also reduces wealth gearing because actual cumulative results over time do not really matter. Exceptional performance could result in higher targets and less future opportunity, while poor performance could result in more future opportunity. In either case, managers are not encouraged to ensure that actual performance is enhanced over time.

…like focusing on the short term might limit long-term potential.

Focusing on the short-term might limit long-term potential. Good ideas that have negative short-term impact and benefits in the future are penalised now and merely built into future budgets, taking away the reward to the manager. This creates conflicts and dilemmas. Managers might make decisions that are beneficial for the company with a reduction in annual remuneration. We believe this has a big impact on the lower level of R&D spending by UK companies versus their foreign peers particularly in the U.S.

Reward Mechanism

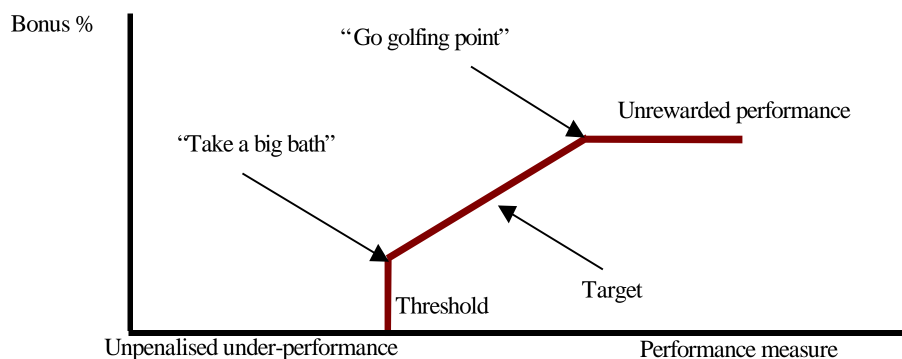
Caps and thresholds on performance

Caps and thresholds on performance are observed.

There are normally caps on annual bonuses set as percentages of base salaries[22]. The caps for the FT30 companies range from 25% - 150% of base salaries, with the average around 60%. We found no evidence that low salaries are reinforced by higher bonus potential or vice versa.

There is also normally an under-performance threshold, below which no bonus is earned. Disclosure is weak as companies imply the existence of a threshold but do not state the actual levels. A graphic representation of a typical short-term incentive plan is shown in Exhibit 14.

Exhibit 14. Typical short-term incentive plan.



Source: Stern Stewart Europe Research & 1997/8 Annual Reports.

Shareholders do not have caps and thresholds so why should managers.

One might expect such a plan to be attractive to shareholders as both a minimum level of performance and a maximum level of bonus (shareholder cost) is established. When viewed in terms of the behaviour it encourages, it is not attractive as it promotes a "take a big bath" or "go golfing" mentality! Once a manager expects performance to be below the threshold, the incentive would be to pull cost in from next year, and to "build reserves". This is often the time to restructure under-performing operations since it has no effect on the manager. Once the "deemed" maximum level of performance is reached

[21] The only exception is one FT30 Company, which distributes a fixed percentage of its earnings before tax to its board members at pre-agreed rates.

[22] 7% of the companies do not disclose the actual mechanism and 4% distribute a fixed percentage of annual earnings before tax to board members at pre-agreed rates.

the incentive is to “pull back” and again incur extra costs and “build reserves”. In either case, there is no incentive for the manager to turn a good year into an excellent year or to limit the negative effects of a bad year.

Of course, the above are mere guidelines as all actual bonus payments are at the discretion of the remuneration committees. We believe this in itself demonstrates a lack of confidence in the formal bonus structure.

Effects of not having rewards at risk over multiple years

Paying bonuses immediately encourages near-term actions without long-term accountability…

Paying declared bonuses immediately in cash and not holding part of the bonuses at risk discourages long-term accountability. Managers are encouraged to engage in value destroying actions without the risk of losing their bonuses in the future. For example, to boost the current year profits and bonuses, managers may reduce marketing or maintenance costs.

…since rewards are not at risk over multiple years…

No company in our sample offers rewards that are truly at risk subject to sustainability of the performance measure over multiple years. 75% of the companies pay the declared annual bonus awards in cash, 18% pay a blend of cash and shares (normally 50:50 split), 3.5% offer exclusively company shares and 3.5% give the option of cash or shares. Cash payments are either made upon declaration (93% of companies) or with a one-year delay (7%).

…although the encouragement of share ownership is a positive step.

Of the companies offering shares, such shares must be held for 2-3 years. 43% of such companies[23] offer bonus shares at the end of the cycle. In addition, 22% of the companies offering 100% cash payment of bonuses declared also offer bonus shares at the end of the cycle in order to encourage equity shareholdings. Although the practice of offering bonus shares might be deemed to increase shareholder costs this is not necessarily a bad investment. Bonus shares are compensation for non-diversifiable risk[24] (arising due to owning large holdings in one stock). Such practices encourage share ownership that adds another equity-based component, reduces retention risk and increases wealth gearing.

Can Short -Term Incentive Plans be Improved?

The current systems of performance measurement and reward have significant flaws that do not always encourage value-creating behaviour. In the following section we will propose a superior and proven design that overcomes the deficiencies discussed above.

Performance Measure Selection

Base rewards on Economic Value Added, EVAâ.

EVA has the highest correlation with value creation…

EVA® is the measure that best aligns manager interests with those of owners[25]. EVA[26] is simply the net operating profit after tax less a charge for the capital invested in the business.

A few simple adjustments to operating profit and capital are made to greatly improve the relationship between EVA and share price. An example is the capitalisation and amortisation of research & development to better match costs and benefits, improve the relation to share price and encourage a longer-term view.

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[23] In certain cases cash bonuses need to be additionally invested in company shares for the bonus shares to be vested.

[24] There have been a number of academic studies of the way that unique or diversifiable risk is reduced by diversification, including: M. Statman: “How many stocks make a diversified portfolio”. Journal of Financial and Quantitative Analysis, 22:353-364 (September 1987).

[25] Stern Stewart and other independent studies have indicated that EVA is a far superior measure of wealth creation. Our regressions of FT500 1997 data have indicated that standardised capitalised EVA has a 61% predictive power of market value. Inferior measures include return on equity, cash flow growth, EPS growth, dividend growth, sales growth. The results on an industry by industry basis are even more overwhelming. For example, a study of the global pharmaceutical industry by Credit Swiss First Boston has demonstrated a correlation of 87%. A Stern Stewart study of the UK retail sector indicated a correlation of 86%.

[26]

EVA	NOPAT – c * Capital
NOPAT	Operating profit (1-tax rate)
C	Weighted average cost of capital
Capital	Net investment of debt and equity holders
Tax rate	Cash tax rate before the tax benefit of interest expense

… and encourages the right behaviour all the time.

Reintroducing the earlier examples[27], EVA provides the right signals to management all the time. In Exhibit 15, despite the decline in return on capital, the new investment would be accepted as it adds to EVA. Since the investment beats the cost of capital, it adds value.

Exhibit 15. EVA always sends the right signal for successful companies.

	Existing business	New investment	After investment
Income	250	100	350
Capital (Assets)	1,000	500	1,500
Return on Capital (R)	25%	20%	23%
Cost of Capital	10%	10%	10%
Capital Charge	(100)	(50)	(150)
EVA	**150**	**50**	**200**

In Exhibit 16, the investment would be rejected as it has a negative EVA, even though both profits and return on capital increase. Since the investment falls short of the cost of capital, it destroys value. Only EVA shows both and quantity and quality of earnings, thus providing an unambiguous signal of value creation.

Exhibit 16. EVA always provides the right signal for under-performing companies.

	Existing business	New investment	After investment
Income	50	40	90
Capital (Assets)	1,000	500	1,500
Return on Capital (R)	5%	8%	6%
Cost of Capital	10%	10%	10%
Capital Charge	(100)	(50)	(150)
EVA	**(50)**	**(10)**	**(60)**

EVA encourages managers to do four things to create value.

EVA encourages managers to do four things that increase value.

1. Increase the returns from the assets already in the business
2. Invest additional capital and aggressively build the business as long as the returns on new investments exceed the cost of capital.
3. Release capital from existing operations where the returns are inadequate
4. Reduce the cost of capital.

Basing remuneration on a single measure that encourages the right behaviour and has a high correlation to value creation sends a strong signal to the market that the company is committed to value creation.

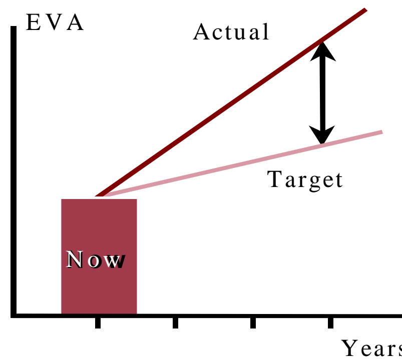
Target Setting Mechanism

Derive definitive multi-year performance targets from investor expectations.

Investor expectations of future EVA improvements are implicit in share prices. Share prices rise and value is created when managers exceed these expectations and vice versa. It is our practice to translate these market expectations into definitive multi-year performance targets, thus avoiding the need for annual negotiation. Exhibit 17 demonstrates how this provides rewards for cumulative success and penalties for shortfalls.

[27] Exhibits 12 and 13.

Exhibit 17. Multi-year definitive targets.



Source: Stern Stewart Europe Research

Our experience has been that this approach is applicable to all industries.

In some industries (eg. petrochemicals and mining) people might argue that external factors influence performance more heavily than management. It would be nice to separate the performance of managers from the influence of external factors. Unfortunately, as soon as we accept this, it creates a tremendous incentive to waste time explaining why the outside world caused all problems and managers created all opportunities. Superior value is created when executives better manage all business opportunities and risks, including external factors. If we want managers to behave as owners, they must be paid as owners.

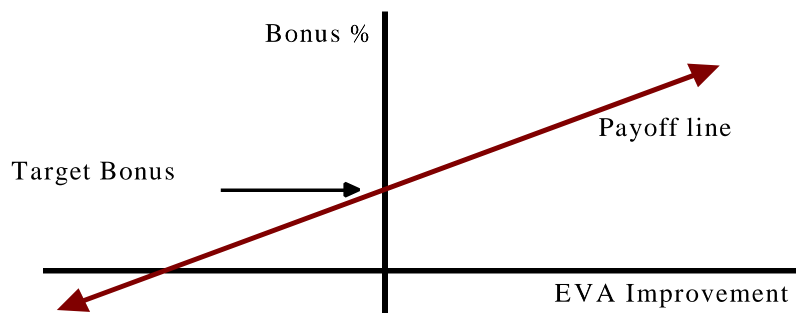
Reward Mechanism

Remove caps and thresholds.

Once caps and thresholds are removed, managers face more opportunity and accountability.

Managers face more opportunity and accountability, without gaming opportunities, once the caps and thresholds are removed (Exhibit 18). The unlimited upside promotes entrepreneurship and the unlimited downside, which allows for negative awards, discourages excessive risk taking. Whatever the performance is currently, there is always the same incentive to generate more EVA. This provides full alignment by simulating equity like payoffs.

Exhibit 18. EVA bonus plan.



Source: Stern Stewart Europe Research

The slope determines the gearing.

The slope of the payoff line determines the overall gearing of the plan. This is determined relative to the expected variability of business performance and the desire for a specific risk and reward profile among managers.

Place rewards at risk over multiple years.
An innovative way of ensuring that performance is sustainable before significant rewards are paid is through the use of a "bonus bank". Each year, a bonus is declared depending on the EVA improvement versus the target. The declared bonus is deposited in a bonus bank with only part of the total balance paid. Exhibit 19 illustrates how the bonus bank works. Year 5 is an outstanding year but a substantial portion of the award is held at risk. When performance declines, as in year 6, the bank allows negative payoffs and absorbs a portion. A bonus payment is made although the bonus bank balance is reduced substantially.

Exhibit 19. EVA Bonus Bank.

	Year 4	**Year 5**	**Year 6**	**Year 7**
Opening balance	120	120	180	100
Declared bonus	60	150	(30)	80
Available bonus	180	270	150	180
Cash payout (33%)	**60**	**90**	**50**	**60**
Carried forward	120	180	100	120

Source: Stern Stewart Europe Research

A "bonus banking" mechanism ensures that rewards are at risk over multiple years.

There are many different bonus bank structures providing varying degrees of risk, time horizons and dynamics. Overall the bonus bank discourages short-term gaming, smoothes through downturns, lengthens decision horizons for managers, and holds managers accountable for delivering expected returns year on year. This greatly enhances the simulation of ownership.

Due to the added risk and the possibility of negative declared bonuses, the average target bonus must be increased to compensate managers for the extra risk they bear. However, this is a worthwhile investment for shareholders as the behaviour that is motivated will be far superior to a conventional bonus plan.

Long-Term Incentive Plans

Long term incentive plans strengthen wealth gearing and alignment.

For remuneration in the UK, long-term is normally defined to be 3 years or more. There are many different types of long-term incentive plans. They differ with respect to the equity vehicle used (restricted share or share options[28]), the performance tests used to vest awards and the grant guidelines (level of grant, timing and management investment). The objective is to strengthen the wealth gearing and the alignment of interests between managers and shareholders.

Most companies state in their remuneration reports their aim to achieve alignment of directors' and shareholders' interests through the encouragement of share ownership. This approach is also supported by numerous academic studies[29]. Although long-term incentives are aligned with shareholders, the potential share ownership offered is often too small to encourage true entrepreneurial behaviour.

Disclosure

Disclosure is generally disappointing.

It is our opinion that the disclosure on long-term incentive plans is generally poor, especially with share option plans. Investors would like to know the rationale in selecting an equity instrument; the justification of the performance tests used; the goal of the granting mechanism and the details of such mechanism; the boundaries of the remuneration committee's discretion; the interaction created by the various plans in place; and the details of all restricted shares and share options. Disclosures on options should include the date granted, level of grant, time horizon, value, exercise prices, performance test targets, expiry date, extension periods if any, and the policy with

[28] Surprisingly 3% of the companies pay out long-term incentive plan rewards in cash.
[29] For example Bud Crystal has found that shareholder value increases in large capitalisation companies as the CEO's shareholdings increase. Professors Moon Song of San Diego State University and Ralph Walking of Ohio State University have concluded that significant managerial share ownership related to above market returns of 23.4% in successful takeovers. This is because managers only considered value creating acquisition activities due to the impact that had on their personal wealth.

respect to director departure or dismissal. The lack of consistent disclosure has limited our analysis and conclusions.

Equity Instruments

Restricted shares

Restricted share plans provide a strong retention incentive.

Companies with restricted share plans annually award shares that are held in trust for a period of 3-4 years. This provides a strong retention incentive. The shares are released at the end of the cycle subject to restrictions, such as continued employment and satisfaction of performance tests[30]. Currently, 53% of companies have restricted share plans with an additional 10% having a restricted share plan combined with an option plan. Normally, share option and restricted share plans are mutually exclusive rather than supplementary.

Short-term plan restricted shares enhance alignment and improve retention risk.

The practice of combining short-term bonuses with equity incentives enhances alignment and reduces retention risk. Over 25% of the companies combine their short-term incentive plans with time based restricted shares. In particular, 55% of such companies make it compulsory for all or part of the annual bonus to be paid in restricted shares that are held for a period of 2-3 years. The percentage of the annual bonus paid in shares varies from 30% to 100% with the average being around 50%. Almost 90% of the companies that have compulsory restricted shares offer extra rewards of bonus shares. Normally the only restriction with respect to the bonus shares is time, although 10% have a performance test restriction (eg. target EPS growth). The remaining 45% of the companies have a voluntary investment in restricted shares. Bonus shares are offered to encourage managers to take up the offer. Although disclosure is often vague, bonus shares are normally forfeited if the individual director leaves the company. The same applies to director dismissal.

Share options

Should plain "at the money options" common in the UK…

It is common in the UK to grant "at the money options"[31] which are exercisable three years after grant. Currently 36% of the FT30 companies have option plans in place. An additional 10% have option plans in combination with restricted share plans. To comply with the Greenbury report, companies have attached performance criteria to the options. This is desirable, as without a performance test, the option holders would benefit from any increase in the share price even if too small to provide an acceptable return.

There is a number of more aggressive option plans available, which are currently not in place at any of the companies reviewed. Options of such plans are not normally granted at the money. For example, the exercise price of *indexed options* tracks a specified index or peer group. *Premium options* are granted at a pre-set percentage out of the money. *Leveraged options* are granted at a discount and the exercise price grows at a predetermined rate (normally the cost of equity less the dividend yield with an adjustment for the inability of managers to diversify their risk). These leveraged options simulate the reward profile of an LBO without putting the company at risk with excessive debt. The fact that these are either out of the money or at a rising exercise price ensures that managers do not benefit unless shareholders get a desirable return first.

… be substituted with more aggressive plans?

Why would managers want to subscribe to these tougher standards? To deliver the same remuneration value, substantially more options are granted. But once performance exceeds the standard, the manager's participation in each additional increase in value is much more highly geared. Managers are less likely to get a reward, but if they do perform well, their rewards can grow much faster.

… we think so.

[30] 7% of the companies have a plan, which is not typical in the sense that shares are not awarded unless the performance criteria have been fulfilled. Once awarded, shares need to be held in trust for the required period of 3 years, subject to continued employment.

[31] Share options provide the owner with the right to purchase common shares at a pre-determined price over a fixed time period. Exercise prices can be "in the money" (ie. below current market price), "at the money" (ei. equal to current market price), or "out of the money" (ie. above current market price). The option holder receives a gain only if the market price during the term exceeds the exercise price and does not normally receive dividends on unexercised options.

Wealth Gearing

Wealth gearing is very difficult to calculate.

It is important to emphasise the difference between income and wealth. Managers, like shareholders, try to maximise their wealth, as opposed to current income. The true measure of the incentive strength is the sensitivity of management wealth from employment to changes in shareholder wealth. For example, assume that a manager holds 60% of his wealth in company shares and 40% as the present value of future base salary and benefits. As a 10% change in shareholders' wealth induces a 6% change in the managers wealth, the total wealth gearing would be 0.60. The total wealth gearing of a "pure entrepreneur" is 1.0.

Calculating the total wealth gearing of an executive can be a difficult process using the externally published information in the UK. However, we can examine the factors that influence wealth gearing. Exhibit 20 compares the wealth gearing of various equity instruments. Although restricted share plans provide strong retention incentives they are weaker than options in inducing wealth gearing. Since a substantial portion of remuneration is base salary and equivalents, which have a wealth gearing close to zero, options can be used to enhance the overall wealth gearing of the remuneration package.

Exhibit 20. Comparison of equity incentive securities.

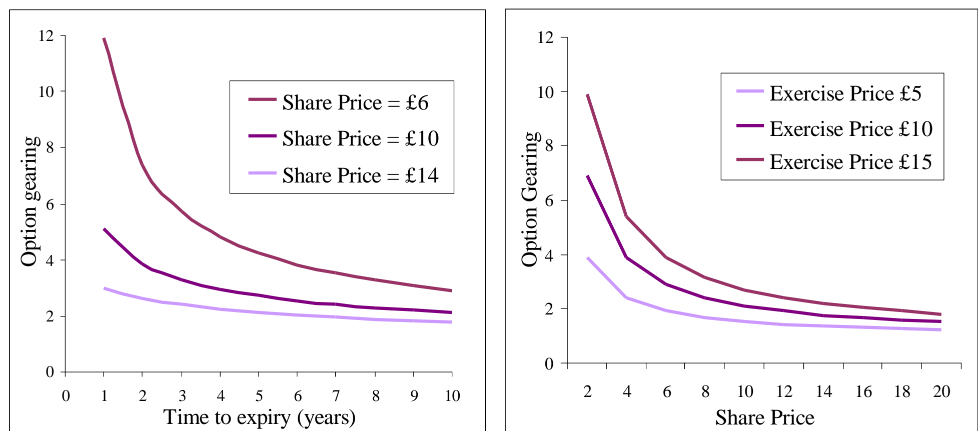
Increasing Wealth Gearing

Source: Stern Stewart Europe Research

Options have higher gearing than shares.

The gearing of an option is always greater than one while the gearing of a share is always one. In fact, the gearing of an option changes as the share price changes and as the option comes closer to expiration. To demonstrate, consider an executive who is granted a 10-year option at the current market price of £10. Using the Black-Scholes model with a volatility of 30%, a dividend yield of 3%, and risk free rate of 5%, the value of the option is £3.12. If the share price jumps by 50% from £10 to £15 the option value increases from £3.12 to £6.12 – an increase of 96%. If the share price drops by 50% from £10 to £5 the option price declines by 75% to £0.80. Exhibit 21 shows that the gearing of an option declines as the option comes into the money and increases as the option falls out of the money[32] as well as how gearing increases as the option approaches expiration.

Exhibit 21. Wealth gearing of an option with a £10 exercise price.



Source: Stern Stewart Europe Research

[32] Graphs are based on the assumption that a 10-year option with a £10 exercise price is granted at the money.

Academic research verifies that granting options is more efficient in aligning CEO incentives with shareholders.

The higher gearing of stock options versus shares is reinforced by a study carried out by Brian Hall, Associate Professor at the Harvard Business School and Jeffrey Liebman, Assistant professor at Harvard's Kennedy School of Government[33]. They found that shares and options provided a much stronger link to shareholder value than traditional base salary and annual bonus did. On average, a 10% increase in a company's value produced an increase in salary and bonus of only 2.4%. This shows how poor most bonus plans are at rewarding value creation. But when changes in the value of shares and options were considered, compensation went up by 50%. "If you look at the link between total pay and performance, you find that about 98% of that link is attributable to changes in the value of stock and option holdings, and only 2% comes from salary and bonus changes", says Hall. "And because options are much more sensitive to stock price swings – both positive and negative – than stock itself, the granting of options appears to be the most efficient means of bringing CEO incentives in line with the interests of company owners".

Hall[34] went further to review the link between pay and performance for different types of options. He analysed shares, *"at the money"* options, *"out of the money"* options and *"indexed"* options. He demonstrated that indexed options are more sensitive to share price than out of the money options, which are in turn more sensitive to share price than at the money options.

Are UK remuneration committees going a "step backwards"?

It is unclear whether remuneration committees consider the most appropriate vehicle of attaining the desired wealth gearing or even whether they consider wealth gearing at all. The current trend of replacing traditional stock option plans with performance based restricted share plans could be considered as a step "backwards". This is moving remuneration packages away from simulating ownership and will lead to less innovation, less accountability and poorer performance over time.

Although options provide a strong performance incentive for executive directors they are not an effective tool for lower level managers who have a modest impact on share price. The line-of-sight is just not adequate. However they are sometimes used at these levels because of the illusion that stock options are a "free form of compensation"[35]. We should not let accounting conventions mislead us on such important issues. It would be much better to design an EVA incentive system for these managers with a close line-of-sight and forget about shares and options altogether.

Performance Tests

The practice of using performance tests as a vesting vehicle is a big improvement.

The practice of using performance tests in the UK is a big improvement over the gifted equity vehicles used in the US. The most common performance test measures are TSR[36] and EPS[37]. TSR tests are predominately used for restricted shares while EPS tests are more common for share options (Exhibit 22).

Exhibit 22. Performance criteria of restricted share and option plans.

	TSR	EPS	Unspecified
Restricted shares	87%	13%	0%
Options	29%	57%	14%

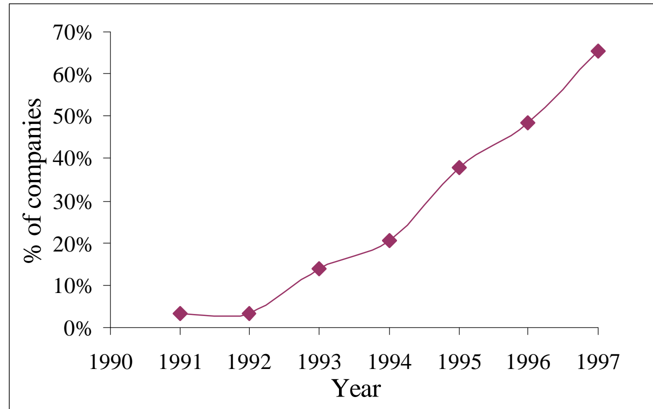
Source: Stern Stewart Europe Research & 1997/8 Annual Reports.

[33] "Compensation: Refining CEO stock options" Harvard Business Review; Boston; Sep/Oct 1998. Hall and Leibman used Black-Scholes method of option valuation to assess the correlation between CEO compensation and stock market valuations for 478 large US companies during the 1980's and early 1990's.
[34] "The pay to performance incentives of executive stock option plans" Working Paper Brian Hall. 1998
[35] Examples include the approved employee share ownership plans in the UK.
[36] TSR tests normally involve comparisons between the individual company's three-year TSR with those of either peers or the index.
[37] EPS tests normally refer to estimating whether the individual company's EPS growth exceeded the Retail Price Index (RPI) plus an additional pre-specified percentage (normally 2-3%).

Due to shortcomings of measures like EPS companies have begun to turn to TSR…

Due to the shortcomings of measures like EPS, companies have begun to turn to TSR tests. These tests effectively eliminate market movements and reward managers when they do well versus the market, not because of the market. Restricted share plans with TSR tests have become increasingly popular (Exhibit 23).

Exhibit 23. Increased popularity of restricted share plans with TSR performance tests.

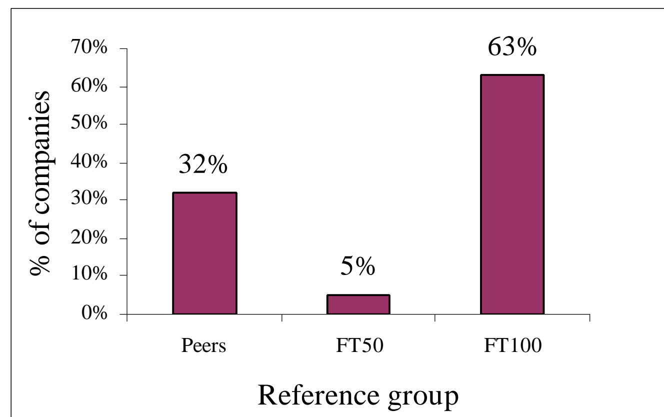


Source: Stern Stewart Europe Research & 1997/8 Annual Reports.

… which causes problems if you compare yourself to the wrong group.

At the end of the cycle, the restricted shares are released to the executive according to the performance test results. This increases gearing. What concerns investors is that many companies are comparing themselves to the FT100, as shown in Exhibit 24. Over 50% of TSRs are explained by external factors and there is evidence that TSRs are predominately sector driven (eg. IT and Pharmaceuticals). Ideally, a company would select a list of peer companies whose operations reasonably resemble its own.

Exhibit 24. TSR tests of restricted share plans.



Source: Stern Stewart Europe Research & 1997/8 Annual Reports.

It raises concerns that EPS is still used for options.

With respect to share options, it is concerning that EPS growth still remains the most common performance measure. The weak correlation between EPS and value creation as well as the behavioural issues discussed above, render this measure inappropriate.

Grant Guidelines

Equity incentives can be granted to executives through several processes, which have a hidden but significant impact on wealth gearing.

Although in general disclosure is poor for both restricted shares and…

UK practices
31% of the companies with restricted share plans do not disclose what determines the level of the award each year while 6% disclose that the award and level is at the discretion of the remuneration committee. The remaining companies disclose the fixed value of the award, which ranges between 25%-100% of base salary. This shows that the award of at least 63% of the companies is not tied to current performance.

… share options,

… current practices may diminish gearing.

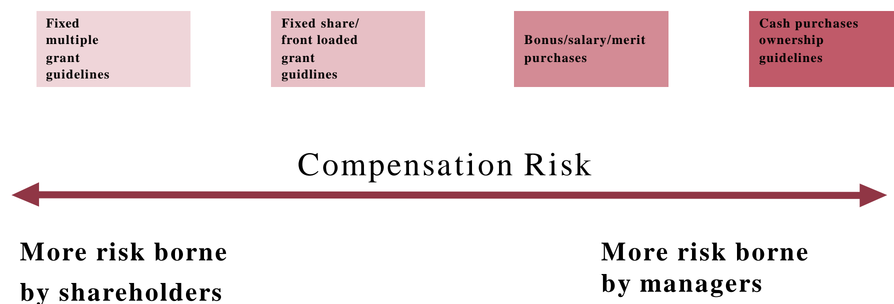
Disclosure of grant guidelines for share options is very poor. 61% of the FT30 companies either do not disclose the details or imply that the award is discretionary based on the evaluation of the remuneration committee. The remaining companies disclose a "fixed value" award whereby the value of shares underlying the options granted is determined by a fixed percentage of a director's annual base salary (ie. number of options is total value divided by exercise price). The most common value is an annual grant of 100% of base salary up to a maximum of 400% for all outstanding options. Ironically, if management is successful, they are penalised by receiving options on fewer shares in the future. The gearing is diminished the better a manager performs.

Althernative grant methods like purchasing equity incentives can shift risk from shareholders to managers.

Alternative grant methods
Alternative grant methods include fixed share grants where the number of shares or options to be granted each year is set in advance for multiple years (ie. the total value varies with the share price) as well as front loaded grants (ie. five years worth of grant at the begining of the period). Overall, fixed share grants have higher wealth gearing than fixed value grants, since the fixed number means executives are rewarded for good performance with a larger value of grants.

In addition to grants that are offered for "free", equity incentives can be purchased by executives through deferring a portion of their annual bonuses, through forfeiting a portion of salary or future salary increases, through purchasing equity incentives directly, or through a combination of recourse and non-recourse loans. As shown in Exhibit 25, grants shift risk to shareholders while purchases shift risk to managers.

Exhibit 25 . Compensation risk of alternative grant mechanisms.



Source: Stern Stewart Europe Research

There is no single structure that is applicable to all companies although current plans can be improved.

Briggs & Stratton demonstrate one way of creating an effective long-term incentive plan.

Can Long-Term Incentive Plans be Improved?

We cannot suggest a "*single structure*" that is superior to what we observe today. This is because the nature of long term incentives is to shape the alignment and gearing while balancing retention and cost objectives. We have suggested various mechanisms that would "improve" current practices. We discussed the selection of equity instrument, performance tests on vesting award and grant guidelines. Integrating the elements is unique for each company.

US based engine producer Briggs & Stratton has chosen leveraged share options (LSOs) and linked the long-term incentive plan to the company EVA bonus plan. The value of LSOs granted in a given year is directly related to the EVA bonus payout for that year. In addition to the cash bonus, each executive receives an out-of-the money option (with a five-year term) on shares with market value equal to 10 times the EVA bonus payout. These LSOs become exercisable at the end of three years. In effect, the executives receive double the EVA bonus payout with the requirement that half be invested in a 10-to1 leveraged stock investment. The principle is to reward only exceptional performance. The exercise price rises at the cost of capital return for the five year option period. With the EVA plan, performance determines the number of LSOs granted. Since the LSO programme is structured to require a cost of capital return before the options are in the money, the plan also rewards growth in EVA. Without developing a high value growth strategy, management can have little expectation for a payoff. The plan recognises that growth without capital discipline destroys value and it rewards only value creating growth. The LSO incentives are structured in such a way to reward the maximisation of both current and long-term performance. Linking EVA with LSOs is a very strong means of aligning managers and owners.

STERN STEWART EUROPE LIMITED

London
13 Saint George Street
London W1R 9DE
United Kingdom
T: [44-171] 399-3600
F: [44-171] 399-3601

Milan
21 Via Albani
20149 Milano
Italy
T: [39-02] 4675-31
F: [39-02] 4675-3333

Munich
Salvatorplatz 4
D-80333 München
Germany
T: [49-89] 2420 71-0
F: [49-89] 2420 71-11

Paris
264, rue du Faubourg
Saint Honoré, 75008 Paris
France
T: [331] 5633-1770
F: [331] 5633-1771

OTHER STERN STEWART LOCATIONS

NORTH AMERICA

New York (World Headquarters)
1345 Avenue of the Americas
New York, NY 10105
T: [212] 261-0600
F: [212] 581-6420

Chicago
20 South Clark Street
Chicago, IL 60603
T: [312] 372-5333
F: [312] 372-9770

AFRICA

South Africa
Suite 316, South Tower
Sandton Square
Sandton 2196
South Africa
T: [27-11] 883-5894
F: [27-11] 883-9320

ASIA

Tokyo
3F, Toranomon 45 Mori Bldg.
5-1-5, Toranomon, Minato-Ku,
Tokyo, Japan 105-0001
T: [813] 3431-3310
F: [813] 3431-3380

Singapore
80 Raffles Place
UOB Plaza 1, #28-02
Singapore, 048624
T: [65] 538-3532
F: [65] 538-7303

AUSTRALIA

Sydney
Grosvenor Place
225 George Street, Level 23
Sydney, NSW 2000
Australia
T: [61-2] 9251-3055
F: [61-2] 9251-3455