RAILPEN Investments®

USS
UNIVERSITIES SUPERANNUATION SCHEME LIMITED

Company X: Thoughts on Best Practice Remuneration

INTRODUCTION

USS and RAILPEN Investments believe the primary responsibility of senior corporate executives is to deploy capital in the best interests of shareholders. This requires that they engineer strategies that optimise durable business performance, characterised by sound economics. Doing this underpins the stock market valuation of the business. Accordingly, we expect boards of directors to establish performance standards and executive remuneration arrangements that motivate management to deliver such performance.

USS and RAILPEN do not believe that any single performance metric can perfectly align managerial behaviour with the interests of shareholders. We therefore recommend that companies employ a blend of complementary performance metrics in remuneration arrangements.

Used with appropriate discretion, a mix of such metrics can compensate for the weaknesses of individual components and align recipient behaviour with the interests of shareholders concerned with long-term business performance and intrinsic value. To do this they should:

- factor in variables that are critical to business performance,
- be linked to strategy and strategy execution, and
- include a forward looking element of performance measurement.

USS and RAILPEN recognise that we are not experts in the detailed design of remuneration systems. We therefore propose that boards instruct specialists to advise on how its insights might be translated into practice.

Remuneration at Company X

With regard to the specifics of Company X's remuneration arrangements, we note from the Company's 2008 Annual Report the Company's commitment to its brand values of quality, value, service, innovation and trust. In addition, we recognise these are designed to set it apart from its competitors and offer its customers a compelling proposition. However, we feel that the Company's performance in respect of delivering its brand value, strategically expressed via a focus on five key growth areas, is difficult to capture with a single summary measure of performance: namely EPS growth (as used in the Performance Share Plan).

We agree EPS growth benefits from being easy to understand. We cannot agree with your assertion that it is a transparent measure of the Company's success and shareholder return. In fact, a body of opinion, including our own, suggests it is fundamentally flawed in this regard:[1]

1. It ignores the capital required to generate EPS growth and the cost of that capital. Since EPS growth produced at returns lower than a company's cost of capital are likely to generate negative TSR, this is a critical shortcoming.[2]
2. It is a backward looking measure of business performance, which does not necessarily encourage recipients to invest in sustainable growth. For example, EPS growth may be achieved through enhancing customer service – a practice which is likely to be aligned with sustainable growth and long-term shareholder interests. Or it may encourage under investment in, for example, staff training or the pace of store refurbishments. Considerations in this regard are key given that (in most cases) a significant proportion of a share's market value can only be explained by cash flow expectations beyond the next three years.[3]

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[1] See, for example, G. Bennett Stewart, *The Quest for Value*, HarperCollins, 1991

[2] Michael Mauboussin, Legg Mason Capital Management. *ROIC Patterns and Shareholder Returns: Sorting Fundamentals and Expectations*, Mauboussin on Strategy, January 18th, 2008

[3] Ian Davis: *How to escape the short-term trap*, The McKinsey Quarterly, Web exclusive, 2005.

3. It is easily manipulated and can favour questionable earnings retention or distribution. For example, earnings may be reinvested to hit EPS growth targets in spite of return on capital being lower than the cost of capital. Equally, EPS growth targets encourage share buybacks irrespective of whether the price(s) at which shares are bought back are higher than the intrinsic value of the company – in which case they will be value destroying.

Return on Invested Capital

USS and RAILPEN believe Company X should consider blending its use of EPS growth as a performance metric used in remuneration with carefully chosen complementary metrics. We recommend that in the first instance the Remuneration Committee considers using a return on invested capital (ROIC) measure in its remuneration arrangements (please refer to appendix for technical definitions). We favour ROIC – ideally measured over a 3 to 5 year time-frame - as a measure for three reasons:

1. Over the long-term, value is created by earning a return on your invested capital that is above the opportunity cost of that capital.
2. ROIC is less affected by changes in capital structure than measures like return on equity, and therefore reflects operational performance rather than financial structure (see appendix).
3. Research shows that companies that sustain either good or poor ROIC performance experience materially different total shareholder returns. Equally, the stock market rewards companies that improve their ROIC over time and punishes companies that suffer declining ROIC.[4]

Since we believe retail managers make daily decisions with an eye on return to working capital and fixed asset investment we expect ROIC to be easily understood.

Key Performance Indicators (KPIs)

Alongside ROIC, we also encourage Company X to consider using KPIs as a basis for determining remuneration.

[4] See, for example, Michael Mauboussin, op cit.

Company X identifies several KPIs that reflect the Company's focus on its brand values and five key areas of growth as outlined in its 2008 Annual Report. We believe there are a number of advantages to linking remuneration to these KPIs:

- they capture growth in a way that ROIC used in isolation does not,
- they introduce an otherwise absent forward looking component to reward, which encourages recipients to focus on durable growth (for example, in respect of focusing on customer service),
- they are closely linked to the Company's strategic plan and measure strategy execution at a level of detail that EPS cannot match,
- they reward performance that is in the remit of recipients to influence to a greater degree than EPS, and
- they extend to measurements of non-financial performance as well as financial performance.

We note from the Company's 2008 Remuneration Report that, in certain circumstances, the Remuneration Committee takes account of actual performance over the three-year performance period as well as EPS performance. To the extent that you already look at KPIs in doing this what we are suggesting here would not be a significant change.

Conclusion

We would encourage Company X to develop a stronger link between remuneration and capital allocation that creates enduring business performance and value. To that end we believe the Company should consider expanding the metrics it uses to incentivise management to include ROIC, preferably measured against the Company's cost of capital, and to include a forward looking element of performance measurement, which is also closely aligned to strategy and strategy execution by using KPIs.

We do not want to suggest that the measures we propose are flawless, or will ensure perfect alignment with shareholder interests, but we do believe they offer a better alternative to solely relying on EPS growth. Ultimately, however, the Remuneration Committee's role in guarding

against unintended consequences of any remuneration scheme will remain critical, and we would encourage the Committee to report back to shareholders how it will continue to ensure this oversight.

Appendix: ROIC Measures

1. ROIC

- Return on Invested Capital (ROIC) = NOPAT/IC
- Invested Capital(IC) = NA + Net Debt

2. Economic Value Added (EVA)

- Economic Value Added (EVA) = (ROIC – WACC) x IC
- Fair enterprise value (EV) = present value future EVA + IC
- Fair equity value = EV – Net Debt = present value future EVA + NA
- WACC (weighted average cost of capital) = (CoE x (Equity value/EV)) + (post tax cost debt x (Net Debt/EV))
- NOPAT = Net Operating Profit After Tax

Adjustments for the Retail Sector

Invested Capital: Capitalize the net present value of operating leases and include Goodwill in order to more accurately capture the amount of capital invested in the business.