Management incentives and strategy

Trends, business drivers and metrics across 20 sectors

- **Focus on incentives** – The alignment of incentive structures with company strategy is vital for long-term company performance, in our opinion. The choice of performance indicators is an important element, and what is right for one company is not necessarily right for another. These metrics are highly dependent on the sector and each individual company's situation.

- **20 sectors –** This report aims to provide a comprehensive overview by sector of key trends and business drivers, based on which our sector analysts discuss what they see as appropriate incentive metrics. While some common themes emerge, like the need for relative targets, many metrics are highly sector-specific: e.g. safety measures are important in the extractive sectors.

- **No measure is perfect –** We highlight in general the pitfalls of certain performance measures, and our analysts highlight how certain measures could be influenced specifically in their sector.

- **Strategic use** – We believe this overview could serve as a useful tool for strategic analysis and governance engagement.

Environmental Social Governance

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Table 1: Some common remuneration metrics

EPS	Earnings per share
EVA	Economic value added: measure of profit after meeting cost of capital
FCF	Free cash flow (operating cash flow less capex)
LFL growth	Like for like (or organic) growth: generally excludes impact of currency and acquisitions/disposals; in retail sector excludes impact of new store openings/closures
NAV	Net asset value (assets less liabilities)
Operating Margin	Operating profit/Sales
PBT	Profit before tax
RevPAR	Revenue per available room (in hotel sector)
ROCE (or ROACE)	Return on (average) capital employed
ROE	Return on equity
ROIC	Return on invested capital
TSR	Total shareholder return: increase in share price with dividends reinvested

Source: JPMorgan

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Executive Summary

Background

Recent years have seen an increasing focus by investors on the way companies are run, and governance is becoming an integral part of strategic company analysis, including remuneration strategies. Incentive structures can be an important driver in establishing a performance culture conducive to long-term value creation – or the opposite. An overtly short-term focus by management as well as the selection of performance indicators that do not appear to be aligned with company strategy and/or shareholder interests, are only some of the concerns. The appropriateness of the choice of metrics at any given company depends on its strategy, its stage of development and of course the sector that it is in.

This report

This report forms part of a growing body of JPMorgan research that considers the alignment of performance measures with corporate strategy (e.g. *Management Remuneration : Do EPS targets make sense? 11 December 2007*; *Feeding the Board : A review of food retailers' remuneration strategies, 28 November 2007*; *Siemens : CEO for a day - 10 Point Plan to lift stock to €130, 14 August 2007*).

We spell out key trends in each sector and business drivers of companies in the sector. On that basis, we discuss the key sector-specific performance measures that, in our view, would generally provide the best alignment between incentives and company strategy.

This discussion takes as its starting point the sector analysts' view of their sector and companies rather than a set of governance guidelines. We believe that an in-depth understanding of a company and its sector provides a highly valuable perspective on remuneration arrangements. We hope that this overview serves as a useful tool for strategic analysis and governance engagement.

The **summary table** on pages 6 and 7 provides an overview of the key metrics by sector, in the view of our analysts. They are discussed in more detail in the sector sections explaining their interconnectivity, potential flaws etc., and the relevance of some very specific sector metrics.

Absolute and relative: It is no great surprise that the use of both revenue and share price linked measures come up most frequently. Equally, the use of relative rather than just absolute metrics is considered important across all sectors.

How long is long-term? Different industries have different cycles and project terms that often exceed the default standard duration of 3 years for most long-term incentive schemes. As our Capital Goods team highlights, project terms would normally be 7-10 years, but structuring long-term incentives solely on such terms would inevitably be in conflict with staff recruitment and retention purposes.

Non-traditional financial measures: In particular in the extractive sector, health & safety should form a key element of an incentive scheme, as our oil & gas and metal & mining analysts discuss.

Likes & dislikes: The measures in this report reflect the views of the individual analysts, and views diverge as one would expect. For example, the Food/HPC team expresses a strong dislike of TSR, whereas other sectors consider it an important measure.

With regard to **performance measures**, we would generally encourage investors to ascertain in detail

- How companies define certain metrics such as EPS
- How those definitions compare to those used within strategy presentations
- How the structure of the incentive schemes correspond with corporate strategy and GAAP measures
- Which process the company has undergone to develop the strategy
- How changes to accounting standards are treated
- Why the company has chosen the metrics that it has and how these correspond to its strategy
- What kind of performance culture it seeks to create and how its incentive structure fits with it
- Whether it has considered non-traditional financial measures such as safety, customer satisfaction etc

Conducting such an extensive exercise across all sectors has brought out some **further common themes** that investors in our view should be aware of:

- remuneration targets and "perennial" restructuring in some sectors which ties in with concerns about "adjusted" metrics (see below)
- acquisitions which flatter EPS etc as various teams highlight the usefulness of return on capital metrics
- the need to link incentive metrics to targets articulated to market which commonly appears not to be happening
- management discretion over profit recognition in various sectors (long-term contract accounting, provisioning, etc)

Governance of executive remuneration

The choice of performance measures is only one – albeit an important – consideration when assessing the effectiveness and appropriateness of any incentive schemes and remuneration strategy.

Other important considerations include:

- Governance – Remuneration committee:
  - Is it composed of independent non-executive directors?
  - Is any director involved in setting his/ her own remuneration?
  - How often does the committee meet and what are directors' attendance levels?
  - Does the committee report on its activities?
  - Which factors are taken into consideration when setting remuneration strategy and determining target and award levels?
  - Does it have the budget authority to pay for external advice?
- Administration of incentives schemes:
  - Are they administered independently?
- Remuneration consultants:
  - Are these independent from the company or are there any potential conflicts of interest due to other business relationships?
  - Does the company disclose which consultants have given advice?
- Shareholder communication and approval:
  - Does the company consult with shareholders in advance of deciding on its final remuneration strategy?
  - Do shareholders have the ability to approve the remuneration strategy?
- Alignment with shareholder interests through shareholding guidelines
- Transparency & Disclosure: Remuneration reports are usually for the seasoned reader only, and often defy a comprehensive understanding or assessment of the overall strategy. Various initiatives aimed at improving corporate reporting on executive remuneration are currently under way, and are likely to grow in depth and in number as disclosure requirements increase. (PwC, Riskmetric, CFA).

There are huge differences in disclosure on remuneration policies which to a large degree reflect the difference in regulatory regimes governing such disclosure. In the UK, companies have to put a remuneration report to a non-binding shareholder vote, a requirement that has also been introduced in the Netherlands. Most other European companies have only limited or no remuneration-related disclosure requirements in place, which of course does not mean that companies should not opt for meaningful disclosure as a matter of best practice.

Trade bodies, such as the Association of British Insurers (ABI), have put out detailed remuneration guidelines, as have investors and groups of investors, e.g. the Performance Pay Group.

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Performance measures

The choice of performance measures is crucial, and as we discussed in our note *Management Remuneration : Do EPS targets make sense?, 11 December 2007*, no performance measure is perfect, but it is helpful to understand the limitations and pitfalls of each measure before deciding on its appropriateness for a given sector and company.

Performance measures typically fall into three types:

- Share price-based metrics, e.g. Total Shareholder Return (TSR)
- Accounting-based metrics, e.g. EPS, profit, cash flow or return on capital
- Other metrics, e.g. customer satisfaction, subscriber additions, etc

TSR measures the increase in share price on a total return basis (i.e. with dividends reinvested). It has the merits of being simple, aligned with shareholders, externally determined, and relatively easy to quantify. However, it may be less under the control of management in the short term, and may be affected by factors such as M&A speculation. Conversely, there may be a risk of management taking short-term actions to enhance the share price before the end of a measurement period. Usually minimum vesting occurs if TSR meets the median level of a group of comparable companies, up to maximum if a top quartile position (or similar target) is achieved. Shareholders should ensure that the group of comparable companies chosen is appropriate.

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Accounting-based metrics
All accounting-based metrics depend on accounting policies and judgments. Most commonly used measures other than reported EPS are not actually defined in IFRS accounting standards, such as free cash flow (FCF), return on equity or capital (ROE/ROCE), organic revenue growth, or even operating profit. For example, Sainsbury uses a cash flow per share measure which is adjusted to normalise the working capital figure and to exclude pension contributions. Many of these measures will therefore not be audited, and again investors should be aware of the risk of inconsistently or inappropriately defined targets. We also believe that acquisition accounting may flatter a variety of accounting measures, including FCF and return on capital. We encourage companies that use non-GAAP accounting-based metrics to derive these measures specifically and to report them within the financial statements. This will provide shareholders with some assurance that the auditors have checked that the definition is consistently applied and the measure is correctly calculated.

Non-accounting metrics
Non-accounting metrics, such as subscriber additions, commonly lack standardised definitions and are generally unaudited. We believe companies should work to develop standard industry definitions to improve comparability and reliability. Where companies use such metrics we would expect them to be assessed by an independent third party.

Incentive schemes should be structured around performance criteria relevant to a company's strategy and its stage of development. In order to incentivise management properly, targets should be challenging and structured progressively, so that rewards are linked to the achievement of superior performance.

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Summary of Key Metrics by sector, in the view of JPMorgan analysts

Table 2: Summary Key remuneration metrics by sector in the view of JPM analysts

Sector	Metrics
Aerospace & Defence	Medium-term organic revenue growth on a constant currency basis (5 year mean)
	Medium-term return on invested capital, including goodwill, and excluding write-downs and provisioning
	YoY change in cumulative cost at completion at constant currency, excluding customer change orders
	Medium-term free cash flow conversion
	Medium-term gross margin development on a constant currency basis, excl. hedging gains or losses
Biotechnology	Product development goals
	Financial performance (e.g revenues, revenue growth, margins, FCF)
	Strategic partnership milestones
	Share Price Performance (absolute and relative to peers)
Capital Goods	ROCE (incl acquisitions, cash conversion and organic growth)
	50%-66% based on personal, division (and group) targets
	Senior management based on group performance
	Long term stock vesting after 7-10 years
Chemicals	LFL sales growth (price and volume growth)
	Gross margin (though not manipulated through acquisitions)
	ROIC (also factoring in asset write offs)
	Cash flow
	Share Price Performance (absolute and relative to peers)
Food & Beverages	Volume/mix growth
	Operating profit growth
	FCF, ROCE, WC
Food Retail	Organic sales growth (LFL + space opening, differentiated by markets and ignoring acquisitions and FX effects)
	EBIT (target depending on amount of property ownership)
	EVA (across entire business and specific markets, achieved through specific ROIC targets depending on the market)
	EPS growth in long term (should follow sales growth rates)
General Retailing	LFL sales combined with achieved/cash gross margin
	EPS growth (specific to business maturity and dividend payouts)
	Returns (lease adjusted basis)
	Share Price Performance (absolute and relative to peers)
Insurance	Relative TSR
	Return on Embedded Value
Investment Banks	ROE relative to peers
	ROA relative to peers
	Cost/ income ratio of 70%
	Share Price Performance (absolute and relative to peers)
Leisure	Like for Like sales growth
	Gross margin development
	Free cash flow and dividend cover
Luxury Goods	Organic sales growth
	Gross margin and EBIT margin (margin CAGR over the LT)
	ROCE
	TSR vs index or peers on a 5 yr period

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Sector	Metrics
Media	ROIC
	Cash flow
	Key profit and loss metrics
	Share Price Performance/TSR (absolute and relative to peers)
	Non-financial metrics relevant to an individual's role
Metals and Mining	Volume tonnage growth at specific points in the cycle
	ROIC
	Share price performance vs peers (with care if production is mainly in one commodity)
Oil and Gas	ROACE
	Dividend yield
	E&P volume growth, reserve replacement and per-barrel costs (for E&P companies only)
	Revenue growth/order backlog growth (for oil service companies)
	EBITDA growth driven by revenue/margin growth (for oil service companies)
Pharmaceuticals	Sales growth (including effects of price, mix and volume)
	Pipeline progress measures
	Margin metrics (gross margin, SG&A as % of sales, R&D as % of sales)
	Sales per physician visit (marketing costs)
Property	LFL rental growth
	EVA (across entire business and specific markets, achieved through specific ROIC targets depending on the market)
	NAV growth
	Above metrics measured against peer group to see true outperformance
Semiconductors	Subjective factors are key, financial metrics unreliable
	Customer stickiness
	Market share gains
	Presence in key growth areas
	Strategic value of IP assets
Telecoms	Organic Cash flow growth driven by EBITDA growth
	EPS growth (excl restructuring costs
	Share Price Performance (absolute and relative to peers)
Transport & Logistics	TSR (but not solely)
Utilities	Operating / budget measures (operating and budgetary targets in simple utilities, composite efficiency in diversified)
	EBIT (near and long term targets)
	Net Income (near and long term targets)
	Share Price Performance (absolute and relative to peers)

Source: JPMorgan estimates

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Aerospace and Defense

Key Sector Trends

The quoted European aerospace and defence sector comprises a heterogeneous group of companies.

The sector is characterised by:

- **Numerous high value-added products or services** (many of which are highly customised, as with airborne surveillance aircraft);
- **Very long product life-cycles** (up to 60 years in the case of aero-engines);
- **Very high barriers to entry** (in terms of accumulated intellectual property, engineering capability and R&D and capital intensity); and
- Generally **low risk of product substitution**.

The companies have widely varying:

- **End-markets** (from governments with very long defence spending cycles to airlines with high economic sensitivity);
- **Cyclicality** (from those with long-term, relatively economically-insensitive revenues such as defence primes and service providers, to aircraft OEMs dependent on a very cyclical customer base); and
- **Rate sensitivity** (from highly dollar-transaction-exposed commercial aerospace OEMs to currency-matched defence contractors).

The major key trend is reducing US dollar exposure. Dollar exposure is the one virtually sector-wide issue, which varies from nearly purely translational exposure (e.g. BAE Systems or VT Group) to high transactional exposure (e.g. EADS). Consequently a key theme is offsetting dollar exposure by cost reduction, business relocation, or by increasing natural hedging by switching the currency of supplier invoicing.

Other key trends:

- **Preparing for a peak in the large commercial aerospace delivery cycle**. After a likely peak in orders for large commercial aircraft in 2007 and historically record backlogs (at >7x annual deliveries), one major issue for more aerospace-exposed stocks is the timing of a cyclical peak and duration and depth of the subsequent downturn, and to what degree aftermarket revenues cushion the impact.
- **Coping with potentially slowing or declining US Defense Budget growth.** Many UK defence names have broad exposure to areas of the US Defense Budget. A change of Administration, Federal Budget constraints and a potential withdrawal from Iraq are likely to cause a growth slowdown or contraction.
- **Budget pressures in the UK and France.** The two largest defence procurement budgets in Europe are facing acute pressures in coming years, due to limited real growth (~1%), over-ambitious programme plans and cost over-runs on existing programmes. New and existing programmes are at risk of delays, reductions in scope or outright cancellation.

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Key Business Drivers

The commercial aerospace delivery cycle. The large commercial aircraft market is likely to continue to see long-term secular growth of ~5%, albeit with marked cyclicality. The mean cycle post-1960 has seen a 219% delivery increase from trough to peak and a mean peak to trough fall of -46%. The peak in deliveries (upon which revenues and profit are recognised) is a mean 2 years after the peak in orders. Orders appear to have peaked in 2007 for this cycle, we estimate.

New commercial and defence programme wins and execution. While most companies are well-diversified, certain new programme opportunities can have significant per-share NPV and involve heavy development expense and risk, with the correlative benefit of long-term production revenues at low to mid double-digit operating margins.

Defence spending cycles. Defence spending is not acyclical, in our view, but is characterised by very long cyclical durations, which are driven primarily by perceived geopolitical threat and strategy, and by budget financing capacity. Periods of expansionary spending have historically tended to be longer than those of contraction.

Restructuring to adapt to a weak dollar. Given widespread transactional US dollar exposure amongst commercial aerospace-exposed stocks, nearly all companies have restructuring measures in place to increase dollar costs (via redenomination of purchasing, shifting production to low-cost countries or the US, headcount reduction or investment in low-cost facilities).

Key Metrics

Medium-term organic revenue growth on a constant currency basis (perhaps a 5-year mean would be appropriate) - given lags in phasing of programme milestones, cyclicality, acquisitions and currency fluctuations, revenue growth y-o-y can be erratic.

Medium-term gross margin development on a constant currency basis, exc. hedging gains or losses (over the same period as for revenue growth) - while not all sector companies disclose this, solid or improving pricing, effective cost reduction and good execution should be reflected in it.

Y-o-y change in cumulative cost at completion at constant currency, excluding customer change orders - given that many or most of the defence companies' contracts are over several years and accounted for using the percentage of completion method (with contingency creation and release over time), we believe that the y-o-y change in the cumulative cost at completion of its contract portfolio, at constant currency and excluding changes due to agreed customer contract change orders, is a good measure of execution across the portfolio.

Medium-term free cashflow conversion (over the same period as for revenue growth) - good programme execution, skilful negotiation of contract terms, and efficient capital investment should be clearly reflected here, with lower-quality profit movement due to provision creation and release being excluded.

Medium-term Return on Invested Capital, including goodwill, and excluding write-downs and provisioning (over the same period as for revenue growth) - skilful contract negotiation, good execution, effective cost reduction, productivity gains and efficient capital, M&A and R&D investment should result in superior ROIC.

Considerations in structuring remuneration:
Cyclicality (both of commercial aerospace and national defence budget cycles) that enables revenues and profits to grow irrespective of good management performance.

The long-term nature of programmes, contracts and R&D payback.

Distortions caused by currency fluctuations and gains or losses booked on hedging contracts that mature or are exercised during a given period.

Management discretion on profit recognition in any given period under the percentage of completion accounting method for long-term contracts.

Periodic cashflow can be highly volatile, due to variation in timing of contract milestones that trigger cash payments, receipt or unwinding of customer advances and the phasing of R&D and capital investment.

A ROIC measure is critical in assessing the efficiency of capital investment (and acquisitions) and pricing, execution and cost reduction.

It is reasonable to expect management over the medium-term to offset input and labour cost inflation via higher pricing (which is often automatically factored in by contract price escalation clauses), restructuring and other cost reduction and productivity gains.

Rough expectations of % base, % short and % long-term pay:
Base: 40%

Short-term: 10%

Long-term: 50%

EPS growth rates (ball park figures) that would be appropriate given general sector performance:
Appropriate medium-term EPS growth varies by company type: for defence prime contractors with OEM businesses, ~7-10%; for defence services companies, ~8-11%; for commercial aerospace OEMs, ~9-12%, for commercial aerospace suppliers, ~10-13% and for defence suppliers, ~9-12%.

Profit figures are the most easily manipulated, particularly the further towards net profit one gets. This is due to discretionary management choices as to hedging contract exercises, roll-forwards or lapses, contract milestone recognition, contract contingency creation, utilisation or release, company-funded R&D increases or decreases (particularly for projects that are more research than development), capitalisation and amortisation of intangible assets (especially R&D), restructuring charge size and scope, acquisition contribution and tax avoidance.

Balance Sheet figures can be manipulated to varying degrees, for example via accelerated or delayed depreciation, asset write-downs, deferred tax asset and liability recognition, defined benefit pension scheme assumptions.

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Banks

Key Sector Trends

Investment and wholesale banks in Europe primarily includes the French banks, the UK banks and the traditional investment Banks (eg Credit Suisse, Deutsche Bank).

The main focus at this point is on the balance sheet related risks arising from the credit crisis that originated in the US real estate sector. Hence at this point revenue growth potential is largely ignored by investors in our view.

Long term the key trends for the wholesale / Investment Banks include:

- **Financial innovation** – investment banking products continuously go through relatively short life-cycles. The winners will be the firms who recognize and capitalize on new market developments/products.
- **Risk Management/regulatory trends** – post credit crisis we believe regulatory pressures for risk management and capital management may increase. In addition these issues should remain in the spotlight for years to come.
- **Emerging Markets** – with Europe and US markets largely mature in terms of banking and capital markets products, the emerging markets (Asia, Latam, CEEMEA) represents an attractive opportunity for growth.
- **M&A** – like the rest of the European Banking sector, the investment and wholesale banks will be part of consolidation of the European and global banking space.
- **Capital markets developments** – however, management of investment banks is largely at the mercy of market trends, hence the outlook and performance of fixed income and equity markets will remain the key driver of revenues.

Key Business Drivers

Management should focus on creating value for shareholders. With revenue growth highly correlated to overall capital market performance, we believe management should focus on three areas:

the most efficient deployment of capital – this means both in terms of allocating risk capital across different businesses/trading desks, focusing both on ROE and ROA, as well as the most effective deployment for external growth via acquisitions and going into new business areas.

Cost management – the quality of IB management can be seen in their ability to manage cost, in increasing as well as decreasing revenue environment. Compared to retail banks, the cost base of IBs is more flexible, due to the relative ease of laying off IB staff, and the high proportion of incentive based compensation.

Stability and sustainability of earnings – balance between recurring client driven revenues and exploiting market trading opportunities. In our view, the market is more willing to pay for client driven revenues.

Key Metrics

As discussed above, we believe management's operational performance can be best measured in 3 areas:

Return on Equity and return on asset compared to peers, as well as compared to historical levels. Management should have incentive to consider returning capital to shareholders, rather than using it to increase risk limits or embark on acquisitions. ROA measures should complement the ROE to avoid inflation of balance sheets due to the difficulty of accurately reflecting risk in regulatory capital measurements.

Cost/Income ratio which should be managed on a consistent basis, with a set target (often ca 70%) to be maintained in every quarter of the year.

Stability (i.e. reducing volatility) of earnings, focusing on high ROE businesses and maintaining a 70% C/I will help achieve this.

Pure profit growth targets may not be appropriate as earnings and peer earnings tend to be volatile due to trading results, and the majority of EPS growth will reflect underlying capital market growth, or increased risk taking via higher equity allocations.

Lastly we believe a significant portion of compensation should be tied to share price performance (absolute and relative to peers).

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Biotechnology

Key Sector Trends

- This sector includes: Actelion, Élan, Lundbeck, UCB, Biovitrum, GPC Biotech, NeuroSearch, Renovo, Speedel. All companies are exclusively focused on the development of new drugs, but their financial and investment profiles differ.
- The prevailing theme is a need for genuine innovation and improvement over existing drugs. Since more drugs are available, new drugs have to work better than existing drugs, not just placebos.
- With increased healthcare spending a lot of payers (governments etc) are watching cost, and companies are under increased pressure to justify charges based on the effects of a drug.
- The regulatory environment has become tougher because of heightened concerns over side effects etc.
- M&A activity has been slowing down and is shifting from bigger to mid-size companies. While smaller companies remain interesting buy-out targets, larger companies employ higher due diligence standards than previously. However, competition has intensified for a company offering a compelling product.

Key Business Drivers

- Earnings for a relatively mature, diversified company
- Key product revenues (sustainability of earnings or long-term growth prospects)
- Cashflow management for cashflow negative companies.
- Newsflow for re-rating opportunities. News that changes the market's perceived chance of success for a drug candidate will move the stock, regardless of market conditions.
- Regulatory environment for drug approval
- Pricing environment for drugs

Key Metrics

- Share price performance
- Financial performance (e.g., revenue, revenue growth, operating margins, free cashflow)
- Product development goals (i.e. achieving milestones as stated by the company) with regard to moving drugs from stage to stage; sales-related milestones after the release of a drug. Drug development takes an average of 13 years.
- Strategic partnerships milestones (once established, valuation normally steps up)

We would expect 1/3 base, 1/3 short-term, 1/3 long-term (share-based compensation)

Cost is the most easily manipulable measure because there would be significant flexibility on expenses once the cost base exceeds a certain level. Costs are an important factor for the more mature companies: Actelion, Élan, Lundbeck, and UCB

Revenues are more difficult to manipulate, because there are independent sources of data to verify end user demand (e.g., third party prescription data). Revenues are an important factor for both the more mature companies as well as those with some revenues: Biovitrum and Speedel in addition to Actelion, Élan, Lundbeck, and UCB

Research milestones are also relatively difficult to manipulate, because the results would be expected to be published in independent, peer-reviewed journals.

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Capital Goods

Key Sector Trends

The main debate in the Capital Goods sector is on the cycle and where growth and margins could go to in the anticipated downturn.

Over the past 4 years, the sector has experienced unprecedented earnings upgrades driving strong out-performance. The rating of the sector in general has been below the long term average of around 10.5x EV/EBIT.

- **Emerging markets growth:** Capital Goods companies can grow quickly and in a capital efficient way in Emerging markets. Local competition in many areas is still limited. As most companies have assembly business models, increasing local capacity is quick and cheap, resulting in high returns and lower risks. Profitability in emerging markets businesses is general very good. Emerging markets account now for 25% of sector revenues with some companies in the 40-50% range. Many of these markets provided the sector with annual growth opportunities in the 20%+ range.
- **The big spenders are back:** The five big end-markets for the sector are Oil & Gas, Utilities, Mining and Metals, Construction and Automotive. During most of the nineties, spending in the first three of these was below trend, resulting in the Capital Goods sector organic growth of less than 2% p.a. during that period. While Construction and Automotive are weaker, Oil & Gas, Utilities and Mining and Metals are currently going through a capex build out. High Oil & Gas and commodity prices, on the back of strong emerging markets growth, are a key driver for this.
- **Many companies have carved out strong positions in niche markets:** The Capital Goods sector is characterized by many distinct sub-sectors. Due to low growth in the nineties and margin pressure, many sub-sectors consolidated and it’s common to now to find only 3-4 global credible competitors in many sub-sectors. This has resulted in a strong improvement in sector average EBIT margin from 5% in the early nineties to 13% now. ROCE post tax for sector has also more than doubled 17%.

Many products sold by the Electrical Engineers (Siemens, Schneider, ABB etc) can reduce energy consumption. This includes energy savings light sources, higher efficiency motor and drives, energy consumption monitoring and conditioning. Higher regulation and higher energy prices drive investment here.

Key Business Drivers

The key drivers for the sector are the economic activity level in developed countries and investment growth in emerging markets.

In **developed countries**, a key focus is the performance of leading indicators such as IFO in Germany and ISM in the US which indicate industrial activity levels over the coming six months.

Another key driver is **commodity prices**. Higher commodity prices are an indication of strong demand and limited supply of materials and hence should provide an incentive for producers to invest in more production equipment. They key commodity prices for the sector are the oil & gas prices, prices for carbon and stainless steel, prices for precious metals such as nickel and copper, and electricity costs.

Financing conditions play an important role in parts of the demand in the sector. This is mostly the case in Construction where tougher conditions could result in a decline in activity in the coming years. Project financing also plays a role for infrastructure spending in areas such as Power Generation, Pulp and Paper Mills, Mines and Steel Mills and many more.

The **business drivers** can be broken down into **demand driven** by a) Consumption of products: typical example would be use of consumables or components that go into consumer products; and b) **Investment into capacity**: The majority of the sector is driven by capital investment into production equipment (CAPEX), which tends to be more volatile, but also occurs later in the cycle.

Key Metrics

We would expect KPIs such as **ROCE including any acquisitions made, cash conversion and organic growth** to feature in the targets for management in the sector. For divisional management this should be based on its own division and for senior management it should be based on group performance.

Based on averages in the sector, we would argue that management should receive 50%-66% of total compensation as variable based on personal and group targets. The stock component of total compensation should be high (30% to 50%) and should incorporate longer term vesting requirements based on group financial performance.

Remuneration structures should reflect that Capital Goods is a **cyclical business** with lengths **of 7-10 years** and targets should ideally not allow management to underinvest in businesses for short-term gain or make the business more exposed to cyclicality in a downturn. Thus, longer-term 7-10 year vesting periods with portions of stock vesting throughout that period would be ideal, if likely impractical from the perspective of attracting suitable talent for such positions.

ROCE is impacted by acquisitions if only based on 'core business'. Growth can be enhanced by making expensive acquisitions. Cash conversion can be impacted by squeezing suppliers that might have negative long-term impacts. Capex and R&D may be reduced, boosting cash generation but to the long-term detriment of growth potential.

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Chemicals

Key Sector Trends

The European Chemicals sector is a fairly heterogeneous set of assets, ranging from fertilisers to pharmaceutical ingredients, and spanning such diverse areas such as upstream commodity chemicals and plastics, food ingredients and automotive catalysts.

The consequence of this wide range of activities is that no one theme has dominated share price performance.

Key themes that have remained prominent have been:

- **Portfolio Focus**. Strategically, companies have tended to try to narrow their focus, trimming down 'conglomerate' portfolios over the years. Most companies remain on the hunt for (high-growth, high-return) acquisitions, with significant balance sheet resources at their disposal.
- **Cyclicality**. The extent of portfolio change has meant that many companies have seen a significant change in the composition of their businesses. Consequently a key question is the extent to which these changes will allow the businesses to deliver improved margins and returns across a 'cycle'.
- **Pricing Power**. Against a background of significant input cost inflation. A key theme is the extent to which companies are able to offset this inflation with price increases, and the extent to which volumes have to be sacrificed in the pursuit of price increases.
- **Environmental concerns / drivers**. A number of companies are impacted by legislation / targets linked to climate change. The agrochemical and fertiliser companies are currently benefiting from rising grain prices and consequent improvement in farm incomes. Industrial Gases and Autocatalysts are other subsectors that should continue to experience growth supported by emissions legislation.

Key Business Drivers

End markets served are diverse, and consequently volume growth tends to be measured as a multiple of GDP, with that multiple varying depending on the markets served.

The majority of manufacturing technologies are relatively simple, and hence barriers to entry are low. In some cases (e.g Auto catalysts, Crop protection) barriers to entry have been created by a significant R&D legacy and consequent expertise.

A recurring trend has been the shortening of life cycles, and rapid commoditization of products and consequent price erosion. Intuitively, we would say that return on R&D has on the whole declined.

Restructuring programmes are widespread. Driven by portfolio re-alignment, as well as ongoing input cost inflation. Many companies have booked restructuring costs repeatedly in recent years, to the extent that these should perhaps be viewed as an ongoing operating expense.

Key Metrics

- Like for Like sales growth (combined price and organic volume growth)
- Gross margin development is also key as this illustrates whether the balance between price and volumes has been reflected in maintaining / improving margins.
- ROIC (incl. Goodwill). Given the level of balance sheet strength and the extent of portfolio moves that have been made recently (and potentially remain to be made), the level of investment required to deliver growth.
- Cash Flow. Although success in above measures will usually be reflected in improved cash flow, focus on cash flow metrics also overcomes the use of 'creative' provisioning.

The key focus when structuring remuneration should be:

- to somehow reflect the perennial restructuring costs in EPS-driven metrics
- to include balance-sheet metrics to reflect acquisition costs and capital efficiency
- Cash flow should also be included in remuneration.
- Also share price performance relative to peer group should be taken into consideration
- Appropriate pay scale would be :40% base, 20% short (i.e. cash bonus) and 40% long-term pay (i.e. Long-term share related scheme)
- EPS growth rates can vary widely from company to company and can be manipulated through the 'definition' of special items / restructuring costs.
- Sales growth / EBIT margin can be manipulated through acquisitions
- Return on Capital measures can be manipulated by asset write downs, so should factor in asset write offs.

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Communications Equipment

Key Sector Trends

Communications Equipment is really two major sectors in one, each with their own issues some of which are similar.

- **Mobile Devices** – For Nokia and others such as SonyEricsson the main issues are taking full advantage of the growth in mobile penetration of emerging markets while also effectively competing for replacement handset business in developed markets.
- **Telecoms Infrastructure Equipment** – The main issue for vendors such as Ericsson and NokiaSiemensNetworks (NSN) and others like them is industry repair. Mergers in 2006 and 2007 reduced the number of wireless competitors from 7 to 4 yet price competition has continued to hurt industry margins. Companies are currently doing a poor job of increasing short term industry margins.

Key Business Drivers

Key business drivers vary by sub-sector segments, and include:

Infrastructure: Ultimately the key driver for the infrastructure business is realizing solid margins during times of product upgrade and then reaping even higher margins as existing technology is maintained. Because technology cycles are accelerating it is becoming more important for companies to realize good margins on new product rollout.

Handsets: Handsets split into two main areas - emerging markets business and developed market business. For emerging markets the key driver is realization of increased returns from scale. Developed market performance is driven by maintenance or gain in market share as a result of meeting consumer demands.

Key Metrics

The sector splits between two key subsectors – handsets and infrastructure. Infrastructure splits again between fixed and wireless but, we believe, can be addressed roughly the same way from an incentive structure point of view.

For infrastructure:

Gross margins and cashflow. Top line growth also important but more a function of the industry achieving some pricing power which is more directly encouraged via gross margin targets.

For handsets:

Operating profits which are, in turn, driven by ASPs, unit volumes, gross margins and operating costs.

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Food and HPC

Key Sector Trends

Our universe of coverage within the Food & HPC sector provides insight on different parts of the value chain. It is made up of **packaged food and non-alcoholic beverage producers** (e.g. Nestle and Unilever, Danone, Cadbury, Premier Foods, ABF), **HPC producers** (L'Oréal, Reckitt Benckiser, Beiersdorf, Henkel), **Ingredients manufacturers** (e.g. Givaudan, Danisco, Kerry, Tate&Lyle) which supply the food producers with flavours, texturants, sweeteners etc, and **soft commodities players** (e.g. Sudzucker, Tate&Lyle) which produce sugar and ethanol. The packaged Food and HPC sectors are defensive, growing at an average 2-3% p.a. and 3-4% p.a. respectively.

Key trends in the sector include:

1. **Health and Nutrition**: The Food manufacturers are increasingly restructuring their product portfolios towards healthier and more nutritional products to respond to consumer demand. This leads to significant portfolio evolution driven by product reformulation (e.g. use of active ingredients in yogurts or margarines...), a step-up in R&D spend and M&A activity.
2. **Premiumisation / innovation**: Growth in mature markets like Western Europe and North America is driven by product innovation/mix and the development of premium products (e.g. growth in premium coffees, premium personal care products...).
3. **Emerging Markets**: Demographic growth and the development of western consumer trends (convenience, brand appeal...) constitute one of the major factors, if not the major growth driver for food and HPC players.
4. **Bottom of the Pyramid**: Food and HPC players are trying to capture new markets by developing products for the populations with the lowest incomes.
5. **Input cost inflation**: The rise in raw material and packaging costs (soft commodities, energy and packaging), which represent around 40-45% of large food producer sales and 15-25% of HPC companies sales, may have a significant impact on gross margins.
6. **Regulation / legislation** can have a meaningful impact on financial performance. E.g. sugar manufacturers (Suedzucker, Danisco, ABF, Tate & Lyle) operate in a regulated market. Nutritional and health claims are also heavily regulated in the EU.

Key Business Drivers	Key Metrics
The key driver for producers is to build strong brands and as they tend to grow at faster rates and enable companies to pass on price increases more easily, while scale gives the company operational leverage. Margins are essentially driven by operational leverage so it is important for companies to have sustainable and balanced LFL sales with solid volume growth.	Performance based remuneration is based upon executive management delivering pre-determined objectives. Most companies refer to underlying sales growth (some volume/mix growth) but not all of them, which we find surprising given it is the ultimate yardstick of value creation in the sector – we would encourage a stronger focus on vol/mix growth as opposed to pure LFL growth. Some companies refer to operating profit growth objectives but not all of them which we again find surprising given that most companies communicate some form of op margin expansion objectives to the market. And in general we would like to see a full alignment of management remuneration drivers with targets shared with the market. Some companies include ROCE as part of the drivers of management remuneration, which we think should be standard. A sort of alternative is to look at FCF but very few companies seem to include it. Working capital (WC) which we see as a key lever of value/FCF generation should probably be given more attention – that said, we know a number of companies do incentivize their employees on WC reduction objectives but do not necessarily mention it in their top management remuneration policy. Many long term share-based incentive plans are driven by EPS growth and TSR. Over a long-period of time EPS makes more sense than on a short-term basis but we think it is not sufficient on a standalone basis - ROCE should be included too. In general we don't like TSR/stock price driven incentive schemes (this represents the Food & HPC team view). We look at them as a tautology. In our view managers are paid to take care of the company, the market takes care of the stock price. Managers growing FCF, EPS, top line of their company above their peers group should see their stock outperforming - this is the principle of an efficient financial market over the long term. We dislike TSR as a driver of remuneration as stock performance can be affected by technical factors purely related to the financial markets (flows/sentiment) and noise (M&A/speculation). TSR can be subject to management manipulation - results are results.

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Food Retail

Key Sector Trends

- Interest in property and M&A angles has died down more recently and investors are becoming increasingly more focused on fundamentals – market share gains, food inflation, input cost rises etc.
- Europe wide, **food inflation** has become a theme. It tends to drive top line and, in the short term, can often be favourable to contribution. However, longer term, it should theoretically be competed away.
- European Retailers are increasingly venturing into **new markets** in Eastern-Europe, Asia or the US as growth is difficult to achieve in developed markets.
- The '**Battle for Space**' remains intense in the UK and other European markets where obtain planning permission is a key constraint.
- The relationship between **suppliers** and the larger retailers is often in focus, in particular in respect of the smaller suppliers. Suggestion has even been made of shortening supplier terms in some countries, for instance from 120 to 90 days, which could have a material impact on the generally positive working capital environment of the sector.
- Metro and Ahold have just undergone significant **management change**. The cycle of successive turn-around CEO and stabilizing CEOs is typical for this sector.
- Companies are increasingly trying to **simplify their portfolios** and focus on core assets and activities, e.g. Ahold sold its Food Services business. This means that valuations have moved away from sum-of-the-parts models to a straightforward analysis of multiples.
- Some companies like Carrefour have come under pressure from shareholders to improve their share price through e.g. spinning of property. Such activism is focused on both financial engineering and also substantive change to the companies.

Key Business Drivers

This is a sector with low barriers to entry (more or less anybody can open a food store) however scale is absolutely key to drive economies of scale. Companies in the sector are ultimately in the pursuit of sales and market share. Provided the market is allowed to operate relatively unrestricted, profit follows. Some barriers to entry do typically tend to exist, most commonly planning / land restrictions. As such, some excess returns can be earned.

Sales are a function of getting the pricing and quality of an offering correct. Consumers have relatively low loyalty to a particular retailer over a period of time so if too high a price is charged, they tend to vote with their feet. As such, margins are typically capped on the upside. The trick is to build sales densities (amount sold per sq ft) as costs are typically driven by square footage. Excess returns over the capped margin are then ideally invested back in price. As such, a market share leader tends to have a strong position in the market.

Key Metrics

LFL development differentiated by different market

Organic sales growth i.e. LFL + normal space opening (ignores the impacts of acquisitions and exchange effects): A reward which gives a bonus for flag planting rather than developing market share would be out of line with adding value.

EVA, preferably split between domestic and more risky overseas markets, is an important measure. Differentiation could be achieved through separate ROIC targets for the domestic and the international business, however, there is a degree of judgement involved in what is the true cost of capital for an overseas project versus a domestic one for instance.

For EVA targets across the entire business, a market share requirement for individual businesses would be a welcome hurdle rate to counter the risk of unbalanced contribution from individual businesses. In addition, EVA growth can be achieved relatively quickly whereas building market share takes longer. Through this combination long-term sustainable EVA could be better achieved. This is relevant especially for a company like Metro which has a number of diverse businesses, some with very high rates or return, and others without, yet still significant amounts of invested capital.

Margins can be important, but more on the upside from depressed levels. We consider high margins to be vulnerable long term. Gross margins are a useful metric but not easily comparable, as in the UK they include the costs of operating a store and for most continental European companies they don't. EBITDAR which excludes rental cost is perhaps the next best measure.

Metrics which can be manipulated can include sales (for instance, methods of consolidation, acquisitions) but as with most companies, the bottom line can also be manipulated through provisions etc. Companies in the sector often carry quite large property provisions (for empty properties in particular) and can also carry stock provisions. Through the release of provisions companies can more easily hit EBIT targets. The practice of building and releasing provisions is also referred to as 'Big Bath' accounting.

We would expect higher EBIT targets for companies who own a lot of property than for those who rent property.

EPS growth rates should tend to follow sales growth rates. Long term, food retail sales will grow more or less in line with GDP. Market share gains / dilution of traditional retailers tends to push EPS growth slightly higher, perhaps 4%.

Food retailing is a long term business, and as such incentive structures should biased towards long term elements with a focus on EVA.

In turn-around situations we would expect very specific metrics e.g. product availability metrics for Sainsbury.

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General Retailing

Key Sector Trends

The non-food retail sector is hugely fragmented:

- low growth and economically challenged – mainly UK – retailers (M&S, Next, Home Retail, Debenhams)
- a number of retailers which have developed significant non-UK operations (Kingfisher, Kesa, DSG Intnl, Signet)
- the pan- European or Global retailers such as H&M, Inditex, Benetton.

A very different situation country by country: While the UK is very much a mature market, other markets in Southern Europe such as Spain and Italy are still very fragmented, with independents representing c40% and more than 80% of clothing sales respectively. We believe that the most successful and larger retailers will continue growing in those markets not only through new space but also by gaining market shares.

UK retailers going international: Faced with a mature market, UK retailers tend to try and grow internationally in most cases. DIY being an ex-growth industry, retailers such as Kingfisher already have a significant international presence. Kesa for historical reasons has a broad presence in France but is also expanding into new markets (Italy, Turkey, Switzerland, Spain) while DSGI had an acquisitive growth strategy and has varied and significant international presence. HRG is still a 100% UK exposed retailer. Marks & Spencer has recently announced that it is buying 50% of its Greek franchisee's stake and that the JV planned to open up to 50 new stores in Greece and the Balkan markets over the next few years. Next has announced that it will buy-in an Eastern European franchisee as well.

The sector has been structurally impacted by different trends in the recent years:
The **shifting of sourcing to Asian countries**, particularly China, provoked deflation in high street prices. While textile retailers have been able to keep part of this benefit onto their gross margins, electrical and DIY retailers have given back most of these gains to consumers owing to fierce price competition.

Competition in the sector has been increasing with the introduction by food retailers of clothing and home improvement offers in their stores. These chose a volume-based strategy with very low prices, which also contributed to deflation in those sub-sectors.

More recently however, we believe that retailers' strategies have been focused on **two different parameters**: **fashion/quality and prices**, with food retailers clearly positioned on the latter while other retailers such as Next try to position themselves on quality.

Textile retailers have had to deal with faster fashion trends, increasing the stock rotation and introduction of new lines in stores. This move was led by best-in-class retailers such as Inditex which based its success on its reactivity.

Key Business Drivers

Retail sales are the key business driver. However performance, particularly in Apparel retailers, can vary significantly depending on collections and positioning. Other hard lines retailers will vary in performance depending on product trends in DIY, Electrical and Furniture segments.

Gross margin movements tend to be dominated by currency movements, raw materials inflation and the ability to pass on, or absorb sourcing gains or losses.

In terms of operating cost, the two main costs are store staff (which tends to move broadly in line with inflation) and property costs.

Key Metrics

LFL sales tend to be the most commonly watched KPI. These are useful as the best measure of underlying consumer satisfaction, but definitions vary considerably. LFL can also be driven regardless of the impact elsewhere in the P&L and driving returns. Therefore combining these with a measure of achieved/cash gross margin would be useful.

EPS growth achieved has to take into account the maturity of the business. There are stocks where consistently achieving high single digit growth would be excellent and others where less than 10% would be disastrous.

This should also account for dividend payout. Half the shareholder return of some businesses is now in cash payments.

Returns can vary considerably across the sector and asset-heavy, low return retailers need to be particularly careful of over-investing. Any returns calculation should be made on a lease-adjusted basis, to avoid boosting returns through off balance sheet leverage.

Share price performance relative to the peers should be given a high weighting.

As more general considerations:

Retail is volatile and cyclical. We would expect two thirds of a proper incentive scheme to be based on a 3Y basis.

Finally many retailers remain family controlled and a clear delineation needs to be made between the interests and the timeframe of the company and that of the external investors.

We believe there might be a trend towards more cash generation-based remuneration in the sector.

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Hotels and Leisure

Key Sector Trends

Pubs:

- Divergence between the managed estates which have greater operational gearing and the tenanted business models which have more secure income streams from rent and beer. Some of the medium sized operators have developed a mixed business model that includes the traditional brewing operations.
- Current trading has been negatively impacted by the smoking ban introduced in England in July 2007 but there is an increased focus on the food offering in many pubs to compensate for declining beer volumes.
- Potential to benefit from the increase in property valuations as the majority of pub companies own the freehold assets. Some tenanted pub companies may have the potential to convert into REIT with the consequent tax saving benefits and there has been discussion of further opco/propco splits in the sector.
- High leverage model may be under threat if credit remains tight in the medium term.

Hotels:

- The hotel business model is split into owned/leased or franchised business models. The owned/leased business model is more operationally geared to the RevPAR cycle as there is a higher fixed cost base. The franchised business model provides a more stable income stream and allows for quicker expansion.
- The hotel market appears to be seeing divergence between the upscale and economy brands with different drivers for each particular segment. The midscale business focused hotels may suffer from reduced corporate travel budgets.
- The global RevPAR cycle and corporate buy-out activity are likely to have peaked in 2007 and profitability is likely to be primarily driven by new room additions and cost management measures in 2008.

Tour operators:

- The consolidation of the major European tour operators from 4 to 2 should provide a sensible operating environment in the near term and earnings can be expected to be enhanced with the delivery of significant synergies.
- There has been historic overcapacity in the mainstream tour operating markets and we expect 5-10% capacity cuts for summer 2008 and a more active capacity management in the future.
- There is an increased transfer of capacity from lower margin short haul to higher margin, differentiated medium and long haul destinations.

Gaming:

- Gambling is a highly regulated activity in the UK following the introduction of the Gambling Act 2005 in September 2007 and this has created the framework for gaming companies to operate. Effectively the UK market is saturated for all types of gambling and the fastest growth areas remain internet gambling and gaming machines.
- Sports betting is deregulating across the European Union and this provides significant growth opportunities for the larger European operators.
- Global lotteries offer growth opportunities in countries where there is limited gambling at present or the government wants a significant share of the proceeds. There is potential to privatise the currently state run lottery operations.

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Key Business Drivers

Pubs:
Individual pubs are trying to increase spend per head on food to offset the declining spend on beer and pub chains are attempting to churn the portfolio to focus on the largest more profitable pubs. The pub industry has to compete against both a change in consumer preference towards wine and spirits and a preference to drink cheaper alcohol at home. The tenanted pub companies business model has been reliant on increasing property valuations to borrow against and purchase further properties.

Hotels:
The increase in global branded hotel chains and the growth in the European budget hotel market are the growth drivers. The upscale hotels are catering to the executive corporate traveler and rich individual who are not prepared to compromise on quality. The growth in branded budget accommodation is driven by the fragmented nature of the European hotel market and the ongoing attraction to branded products.

Tour Operators:
The number of holidays taken through tour operators has been stable for a number of years and the tour operators have been increasing the proportion of holidays that are medium/long haul and reducing the capacity in the short haul market. Capacity management is the key business driver in the short term for the tour operators as they strive to increase the profitability per passenger.

Gaming:
In the UK gaming companies are set to take advantage of the new freedoms offered by the Gambling Act 2005.
Global lottery growth is expected to continue as global spend per capita on gambling increases. Governments prefer softer lottery products as they are deemed as less harmful and raise more taxation.

Key Metrics

In order to fully assess the sector performance it is possible to assess a number of metrics that go beyond the purely financial ratios.

- Like for Like sales growth
- Gross margin development
- Free cash flow and dividend cover to reflect the geared financial structure in some of the companies

Considerations for structuring executive remuneration?

- EPS-driven metrics
- Balance-sheet efficiency metrics
- Share price performance relative to peer group should be taken into consideration
- Pay scale should reflect base, short term cash incentives and longer term share base incentives

Although the financial ratios give a greater measure of comparability each sub-sector has some important operational metrics.

Pubs:
Managed houses - Beer volumes, food sales as a % of total sales, cost increases per pub, average profit per employee
Tenanted pub companies – Number of pubs in the estate, average profit per pub, average tenant profitability, rent concessions as a % of the rent roll.

Hotels:
RevPAR, occupancy, room rate, number of hotels, management/franchise fee percentage, geographical exposure, head office costs as a percentage of sales, number of rooms booked through corporate website.

Tour Operators:
Aircraft capacity utilization, holiday sales cost as a % of holiday sales, synergy delivery against targets, percentage of holidays booked through owned distribution channels.

Gaming:
UK bookmakers – Profit per shop, gross win percentage, over the counter income as a % of shop income, number of visitors on website.
European operators – profitability of contracts, gambling spend per capita and new contract wins.

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Insurance

Key Sector Trends

- There are two key types of business within the sector: Life and Non-life. Many large groups are a mixture of these.
- The non-life market premium rates are falling due to competition, this is due to the cyclical feature of this market.
- The life market is impacted by the macro economic environment, in particular equity markets and attitude to saving.

Key Business Drivers	Key Metrics
Asset performance of equity and bond market influence the sector, as insurers take assets from policyholders to pay claims (non-life) or to back savings contracts (life). Weaker equity markets will typically depress earnings. The non-life business is short term and is driven by the difference between premiums and claims measured by the combined ratio. The claims are heavily influenced by the development of past provisions (reserve releases) in which significant subjectivity allows possible management control of the profit emergence. The life business is driven by sales and new business margins as well as profit emergence on existing business. For long term business, the measure of Embedded Value which is the present value of all the cash flows from business already written is commonly looked at. One issue with this metric is the assumptions used are not typically disclosed and the metric itself is not a cash measure as the profits emerge some time in the future (if the assumptions are correct). Recently assumptions used in Embedded Value have had to be adjusted as these proved to be too optimistic.	In many cases Life companies share prices are geared to the equity market, hence a TSR based on the FTSE100 index may be easy to achieve in bull equity market, very difficult in a bear market. Due to the subjectivity in the reporting assumptions for insurers (particularly for long term business), assessing performance is difficult. Particularly as the current market investors are more focus on cash earnings that increases in Embedded Value due to uncertain long term earnings. In many cases life companies will use a Return on Embedded Value target, although this will reward new business growth which may add little economic value in the current market where required returns are higher. Companies with RoEV targets may be unrealistic in putting through the full effect of assumption changes. In some cases the focus of companies on small acquisitions of growth business, seems to conflict with the objectives of investors who are keen to see improved cash flows and organic growth, rather than expensive inorganic growth.

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Luxury Goods

Key Sector Trends

The luxury goods sector encompasses companies with exposure to Watches, Jewellery, Leather Goods, Luxury Shoewear and RTW. The cut off between mass market and luxury mainly lies in pricing power, global appeal/scalability and concurring higher margin profile.

- **Currency risk:** Luxury goods companies produce in Euro and SF and sell in the main in $ and Yen terms. Forex moves hence have significant impact on company's profit (a 10% move in the $ typically impacts EBIT by 10%, identical for the Yen). Companies hedge through delaying the impact one year and 'buying the time' to increase prices to offset these forex moves. We have seen of late more price sensitivity from part of consumers to price increases notably in Japan and in the access price segment.

- **Wealth creation and polarization** are the key drivers of luxury goods spend. Self-purchasing women through their access and rise in the workforce has been particularly critical to leather goods and shoewear sales growth.

- **Relays of growth: Emerging markets and the US.** Over the past 5 years, luxury goods companies have seen significant growth with the Chinese consumer base (c6% of sales in Mainland China and to the Chinese traveller), Russia (c4%), Middle East (c4%) and the US (c18% of sales where the sector is still under-penetrated to date). A current big theme is whether their growth would be sufficient to compensate for a US/European slowdown: we argue not.

- **Cyclicality and operational leverage:** The ability of companies to withstand an economic deceleration is a key investor concern drawing on Richemont’s loss of 1000bp in margins in the last downturn. Companies with high operational leverage and timing of investments are particularly scrutinized at this point in time (e.g. Bulgari capex up 60% in 2007 and still running high in 2008). Typically high-end watches have tended to suffer most in downturns (owing to inventory overload at third party retailers, lower production and pricing flexibility, higher opex).

- **Professionalisation of the industry:** Over the past 5 years, we have seen a clear renewal in management and a new focus on cash flow generation (inventory turns have become of late only a key performance indicator).

- **Large family holdings:** All quoted luxury goods companies under our coverage (with the only exception of Burberry) have a significant family majority holding, typically long term in its views at times at the expense of shorter-term pressures. Egos involved can also run high (led to M&A price wars in 2000 albeit significantly more subdued since then). Family investors are likely to be focused on TSR over an extended period rather than shorter-term dividends/buybacks.

- **Typically little financial leverage:** Luxury goods companies do not tend to like to combine a high operational leverage with a high financial leverage. On top of this, they often wish to keep some cash for potential acquisitions.

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Key Business Drivers

Creating high barriers to entry through Ad spend and Stores: There are typically relatively high barriers to entry in the luxury goods sector through high advertising spend, capex spent on directly operated stores (in handbags) and production (most brands are fully vertically integrated) and high inventory (in watches and jewellery). Brands come and go but the ones that last (notably through downcycles) typically are those with the longest and strongest history.

Pricing power: Luxury goods companies tend to have significant pricing power and are thereby more able than other industries to pass on raw material prices and forex pressures. This being said, 5 years running of deteriorating forex and concurring price increases are starting to be felt by local consumer bases notably in Japan where the luxury market is lackluster.

Product innovation: The it-product can create significant appeal in a brand in one year (e.g. Chloe and its Paddington bag, Fendi and its Baguette) but to sustain momentum brands need to repeatedly hit the jackpot and manage to transform their it products into staples (the Hermes Kelly bag, the LV Murakami bag). Product innovation year-in year-out is also closely linked to pricing power.

Bigger is better: Large brands that have been successful in mature markets are what appeals most to emerging markets providing a second wind of sales growth to the largest brands in the sector.

Key Metrics

There is limited detail on targets with the exception of Burberry. In some cases no details of performance factors are available e.g. for Swatch.

We would expect a fixed and variable component for management to be rewarded on:

- Organic sales growth
- Gross Margin (best measure of pricing power) and EBIT margin (measure of opex control)
- Cash flow generation (incl working capital management)
- ROCE (although issue with ROCE in the sector lies in the fact that some brands have low ROCE penalized by acquisitions vs. home-grown brands - none of our companies appear to be retreating internal goodwill)
- Share-based long-term incentives based on TSR benchmarked against either an index or versus peers over a period of typically 5 years
- EBIT margin CAGR over an extended period adjusted for foreign exchange and structure vs its peers could prove to be a good basis to assess development of business and reward long term commitment. However, it could deter management from investing.
- We would not expect to see specific references to social and environmental targets as this is a still a low priority for the sector as a recent survey by WWF shows.

Earnings Expectations

On 08E and 09E estimates for Companies covered, we expect c.11-12% EPS growth, this is a normalized growth rate level.

A sharp deceleration in the US and Europe would put a squeeze to margins and on worst case scenario; in our view see a downgrade of 15-25% to earnings.

Which measures could be - in general - most easily manipulated?

Short-term under-investments to reach EBIT margin and cash flow targets

Push inventories in the trade (for wholesale businesses such as Watches, Wines & Spirits, Perfumes & Cosmetics) to drive reported Sales and lower in-house inventories.

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Media

Key Sector Trends

Media is a heterogeneous sector with a company's dependency on the economy varying according to the exposure to advertising.

The main subsectors are:

- **Broadcasting –** includes Free to Air TV (FTA TV), Pay TV and Radio companies. FTA TV and radio generates revenues mostly from advertising, whilst Pay TV is a subscription based business model. Being almost entirely dependent on advertising, FTA TV and radio are very cyclical companies. The main economic drivers are consumer spending and consumer sentiment. Incumbent FTA TV players are mature businesses in their domestic market and the increasing penetration of digital technology is increasing the number of competitors and deteriorating margins. Pay TV subscribers are taking advantage of the development of the digital technology by selling new products (Multiroom Pay TV access, High Definition TV, etc) and services (high speed internet accedes, telephone lines, etc)
- **Consumer publishers –** include magazines, newspapers and consumer books publishers. The main drivers are advertising and circulation. The sector is suffering from a decline in circulation figures. Internet advertising is taking market share.
- **Professional Publishers** (books, magazines and services sold to businesses). As a group, professional publishers are defensive businesses with a late-cycle and largely resilient cash flows. All are transitioning from print only to digital, from pure data provision to "value added" technology and services, and in doing do they are selling more products to customers.
- **Advertising Agencies and Outdoor** are almost entirely dependent on global advertising. Differently from FTA TV broadcasters, they have a global exposure to advertising and are therefore benefiting from the strong growth in Emerging Markets.

Key Business Drivers	Key Metrics
Multichannel TV penetration. In Western Europe the penetration of multichannel TV (households receiving more than 10 channels) is on average more than 50%. The switch off of the terrestrial analogue signal in favor of the digital technology is set to increase the penetration to 100% in the following 3 to 5 years. Broadband penetration. Faster internet connection across the world is a key catalyst for Internet advertising, e-commerce, video on demand, and IP TV. Management incentive is one of the key catalysts for professional publishers in our view. Total shareholders return plays a significant role in determining senior executives pay for all the professional publishers in our coverage universe. Advertising expenditure. Advertising trends are cyclical in the western world market and growing structurally in the emerging markets. The advertising investments stemming from the Olympics games in China this year are expected to partially offset the downturn in the global economy.	In our view a combination of financial targets (incorporating both key profit and loss, cashflow and ROIC) measures, performance versus peers, as well as a number of specific non-financial targets relevant to the role of the individual in question are key..

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Metals and Mining

Key Sector Trends

The Mining and Steel sectors are very different in that the one is **upstream** and the other is **downstream**. The raw material costs of the steel sector are linked to the prices of key commodities (e.g. iron ore and nickel) produced by the mining sector.

Both sectors have been through substantial **consolidation** and hence have seen improvements in pricing power in the past few years. More recent M&A is potentially consolidating the pricing power of iron ore and nickel so much that a key future issue in the two sectors is whether the steel groups can consistently pass these costs on.

The key strategic aim of management in the two sectors has been to gain the upper hand in this **pricing power**. The desperate need of the Chinese economy to source raw materials has, to date, allowed both mining and steel to cohabit profitably as Chinese demand has ensured rich margins. More recent G3 economic weakness may lead to more margin pressure and management will increasingly be evaluated on cost control and internal project management rather than on M&A.

Cyclicality of commodity prices in these two sectors means that any management remuneration linked only to the bottom line has typically in the past been a boom and bust remuneration cycle as well. It is difficult to avoid this cyclicality impacting incentive structures but these structures have increasingly moved towards more sophisticated measures in order to track the performance within these groups which is not commodity-related.

Key Business Drivers

The performance of the sector has been dominated by Chinese raw material demand and will continue to be dominated by this feature for at leas the next five years in our view. The time period from the point at which a group notes a potentially viable ore deposit through early-stage drilling to the point where metal can be produced from that project can range from three years to seven years, depending on the nature of the deposit.

The 'demand shock' (e.g. the rapid emergence of China) is typically quicker and so the success of these groups depends both on how efficient they are at maintaining the correct level of organic production growth and also how appropriately they judge M&A to be at the early stages of the cycle when their finances are typically stretched. At that point the 'build versus buy' decisions tend to separate management success from under-performance.

Past cycles have been punitive on groups who carried on with M&A too late in the cycle and had to carry the costs in the downturn. The world seems to have changed, with China potentially offering de-synchronised global growth and mining management having to decide if it's too late in the cycle for further M&A or if we have a 'new paradigm' which justifies ongoing M&A at almost any price. This feature splits the key mining groups at the moment, with some having been more hesitant than others.

Key Metrics

This is not a sector where management should be rewarded on revenue growth or cash flow because the commodity cycle dominates that trend. Rather, volume tonnage growth at the appropriate time of the cycle has to be a key metric, whether through organic growth or through well-times and appropriately priced M&A.

In a capital-intensive industry, volume growth can come at an unacceptable cost and so bottom line performance measures such as ROIC should carry a high weighting relative to other measures.

Share price performance relative to the peer group should be given a high weighting but with due care when the group's production is dominated by one commodity.

For example, the share performance of zinc producer Boliden has been poor relative to that of aluminum producer Norsk Hydro at a time when the zinc price has performed very poorly relative to the aluminum price. Management can hardly be blamed for the trends in the commodity prices and so performance measurement has to take this into account.

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Oil and Gas

Key Sector Trends

In the upstream, the key challenge for the majors has been to grow volumes and cash flows in the face of maturing asset bases and increasing competition for new opportunities.

- **Strong commodity prices**: Crude prices have risen dramatically in the past few years and have reached record highs in recent months, supported by strong demand from non-OECD countries and tightening spare capacity. However, the rise in crude prices has not necessarily translated into earnings growth for the integrated oils, as several negative factors have offset the strength in commodity prices.
- **Increasing competition for access to reserves:** The constant need to replenish reserves is coming against a context where non-OECD countries are increasingly dominating global oil production growth. Moreover, increased competition for access to resources has led to higher M&A activity as cash-rich companies find it increasingly difficult to access new reserves organically.
- **Rampant cost inflation and service sector tightness** are preventing the integrated oils from enjoying the full upside from high crude prices. The ability to control operating costs and capital expenditures in the current inflationary environment will become an increasingly important differentiating factor among the majors.
- **Worsening fiscal terms**: The rise in crude prices has led several producing countries (e.g. Venezuela, Russia) to tighten fiscal terms in order to increase their share of the economic rent. In addition, the share of production coming from non-OECD countries is set to rise, with negative implications for overall tax levels.
- **Indifferent reserve replacement and falling reserve lives:** Reserve lives for the majors has fallen in the past few years as new reserves bookings have failed to keep up with increased production levels.
- **The prospect of cyclical weakness in downstream businesses**: Recent evidence points to sustained pressure on refining and chemical margins. We think the refining industry is getting nearer to the end of an extended up-cycle.

Key Business Drivers

Commodity prices are a key driver of earnings and sentiment on the sector. The sector performance has historically been highly correlated to oil and gas prices and refining margins. Oil and gas price realisations can vary dramatically between different regions of the world due to differences in crude quality, price controls or logistical access.

Resource base growth: healthy reserve replacement is a key driver of long-term performance as it underpins a company' ability to grow production in the medium to long term. Resource base growth is essential due to the depleting nature of oil and gas reserves.

Production growth is regarded as one of the key metrics of success since it often correlates with E&P earnings growth, although this is not necessarily the case.

Net income/Cash flow per barrel: Upstream value creation is ultimately driven by the level of per barrel cash generation, which is determined by a number of variables e.g. oil and gas price realisations, tax, lifting costs and finding and development costs.

Key Metrics

While we think earnings growth is an important metric to measure operational and financial success, we think that this measure does not fully capture other factors that are also important in assessing performance.

EPS and CFPS growth do not tell the whole story as 1) they do not reflect long-term capital efficiency, 2) they are strongly dependent on commodity prices, which makes us reluctant to use it as a primary metric of success and 3) they do not take into account differences in timing of growth projects. In an industry with long lead times on projects, we think a focus on near-term EPS growth might be detrimental to investment decisions and thus to longer-term growth.

We think other relevant metrics on which management should be evaluated include:

ROACE: a useful metric of profitability and capital efficiency, although we would have the following reservations: 1) ROACE can be distorted by the accounting treatment of acquisitions - the calculation of capital employed should thus at least include goodwill - 2) it does not correct for the time lag between the initial capital investments and the returns on new projects, many of which have long lead times.

Dividend yield: becoming more important as a metric once more. Dividend increases are a strong signal of management's confidence in the long-term sustainability of cash flow generation.

For the integrated oils and E&P companies, we think the following metrics should be taken into account:

E&P volume growth: production growth can be acquired (sometimes expensively), so it is worth looking at the breakdown of organic vs external growth.

E&P reserve replacement

Per-barrel costs: lifting costs, finding and development costs.

For oil services companies, we think the following metrics are the most relevant:

Revenue growth/order backlog growth

EBITDA growth driven by revenue growth and/or margin improvement, which reflects changes in the operational performance and project management capabilities of the company

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Pharmaceuticals

Key Sector Trends

The European Pharmaceuticals sector has underperformed the market over the last 5 years as deteriorating fundamentals have eroded growth prospects. Companies that once offered strong double digit earnings growth are now struggling to produce high single digit growth, and often with help from financial effects, such as major share buyback initiatives. The key headwinds are:

- **Declining R&D productivity:** The industry saw, on average, 40 new drug approvals each year in the late 90s. This has fallen to less than 20 each year for the last 3 years. The worsening trend is a combination of fewer good phase III projects emerging from the industry pipeline, combined with regulators adopting a firmer stance on risks versus benefits.
- **Looming patent expiries:** One consequence of fewer drug approvals is an industry more reliant on their existing portfolio. Many of these drugs are maturing and will reach the end of their patent protected lifespan in the next 5 years. Copycat “generic” competition erodes these franchises very quickly, particularly in the US. As a result companies such as GSK and AZN will likely see their US businesses shrink dramatically over the next 5 years.
- **Pricing pressure:** The drugs bill can represent up to 10% of the total healthcare budget. The industry has long faced pricing pressures outside the US, but in the last few years managed care has started to put pressure on pricing in the US as well. We used to see high single digit, and even double digit, annual product price increases in the US but this is falling to low single digits and will probably fall further in coming years.

Key Business Drivers	Key Metrics
Market share, volume growth, price effects for Strategic Brands: The pharmaceuticals sector is predominantly driven by end product sales and each company has 2-10 key products that determine the health of the business. Typically these products account for the majority of our DCF valuations. Direct cost base: The industry typically has high gross margins (85%+) and spends somewhere between 30-35% of sales on SG&A. As a result pre-R&D margins are 50%+. However, ageing portfolios facing generic erosion means the industry is cutting costs to protect these margins. Pipeline progress: Drugs in late-stage development (phase III) are close to market and usually have publicly available information on signs of safety & efficacy. Progress with these projects, positive or negative, has implications for the mid-term business outlook. R&D reinvestment: R&D productivity has been declining (more spend on R&D, fewer product approvals) and there is increasing urgency to regenerate the top line. As a result the industry may have to increase reinvestment levels in R&D from around 18% of sales to 20%+.	• Sales growth, including effects of price, mix and volume. • Pipeline progress measures, e.g. number of approvals, number of phase III starts, number of phase II starts, number of clinical starts. • Margin metrics: gross margin, SG&A as % sales, R&D as % sales. • Specifically on marketing costs, sales per physician visit

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Property

Key Sector Trends

Slowing / negative capital growth in the underlying commercial property market: The trend has been continuing for the past 9 months with a detrimental impact on share prices. We believe the situation in the underlying market will get worse before it gets better, which means that companies will need to deleverage their balance sheets.

Rental growth is closely correlated with macro-economic indicators. We expect rents to fall driven by a weakening occupational market, which is in turn due to job cuts in a weak economic environment.

The **decline in margins on new developments** is set to continue, especially if job losses mean that rental growth buckles in core European city office markets. Construction cost inflation is high, again, eroding profits from developments

Increase in shopping centre consolidation: It has yet to be established whether property companies gain from retailer synergies, and whether economies of scale are material. Nevertheless, we expect the trend to continue.

Borrowing costs: Interest rates have come down but credit spreads have increased. Less well-funded companies are likely to find it difficult to raise sufficient capital to fund property transactions.

Focus on financing: Investors are increasingly focused on capital structure and how conservatively financed Property companies are. Upcoming refinancing is seen as a red flag, while company's that have sufficient credit facilities arranged to cover operating and development expenses for a number of years are more attractive.

Redemptions from property funds: Believed to have been caused some of the turmoil in 2H07, this has redirected capital flows into new types of asset classes. It is questionable whether open ended funds are appropriate for an illiquid asset class like property, and we may see further restructuring.

Corporate governance is still a concern for some companies. Externally managed companies face potential conflicts of interests - Where part of the management fee is based on asset size, management is incentivised to grow assets.

Increasing focus on **sustainability**, particularly in new developments, driven by customer demand.

Key Business Drivers

- Like-for-like rental growth and yield compression
- NAV growth, driven by rental growth: Share prices in Europe tend to trade around NAV.
- Developments: Timing (typical 2 year construction time, so companies need to time the market effectively); Pre-letting is important to avoid void periods
- Fund management: can be a way for companies to benefit from recurring profit without balance sheet risk of holding property
- Tenant management: managing the tenant mix, securing long leases with quality tenants with strong covenants
- Sector rotation: spotting trends in the underlying market and buying/selling assets accordingly
- Economies of scale less relevant than in other sectors because property management is a labour-intensive business, implying operating margins are little changed as the size of the portfolio increases.

Key Metrics

In general, we prefer a focus on KPIs that management has control over (e.g. Like-for-like rental growth, rather than capital growth which is partly market driven), management to have a stake in the company to align interests, and comparison to a peer group to ensure the management team are outperforming competition.

Like-for-like rental growth: how much more rent can the management obtain from the same portfolio. This should be a key metric as rents are the backbone of the business and drive both capital values and cash flow

NAV growth: This is linked to rental growth, but also takes into account yield shift (which is more market driven, although a good management team should be able to spot yield shift in advance) and financing (again, a good management team should gear up early in an upward trending market and de-gear in anticipation of a weak market)

Economic value added (EVA): how much shareholder value is management creating? Our valuations are based on an EVA model – we compare operating- and capital- return on invested capital, and compare this to the company's WACC. We argue that shareholder value is created if there is a positive spread between total return (operating + capital return) and WACC

Management stake in the company - for alignment with shareholder interests.

Above metrics could be measured against a set peer group to see which management team is truly outperforming, and which are merely benefiting from a strong market (also incentivises management in a weak market)

We would avoid measurement on Headline EPS or Asset growth. These measures have been used in the past, but shareholder's interests are not truly aligned with management. Headline EPS would incentivise management to acquire high yielding (e.g Secondary) property, whether or not it is a good investment. Asset growth would also incentivise management to build large portfolios, with less focus on shareholder value creating acquisitions.

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Semiconductors

Key Sector Trends

The sector consists of two segments – Software companies and IT Services companies.

A key trend in the Software sector is the growing popularity of the **Software as a Service** (SaaS) as a mode of delivery. SaaS basically means that the software is hosted/maintained by the vendor and is accessed by the customer remotely over a network.

Key Business Drivers	Key Metrics
For Software companies the key business objective has been to sell more software licenses. License sales have high incremental margins and typically generate recurring streams of maintenance revenue. However, the new SaaS model yields lower (and initially negative) margins till the model scales up to about a ~$1B business. Hence, the market may react negatively in the short term when an established software player invests in building a SaaS offering.	Total Revenues or Reported EPS do not effectively capture the operational health of a software business. The equity market tends to focus on license revenue growth as well as EPS exclusive of amortization of intangibles. We believe that incentivising management on the basis of any set of financial metrics will not align management interests with shareholders fully. Investors tend to value (and rightly so) a software company on the basis of a variety of subjective factors (customer stickiness, market share gains, presence in key growth areas, strategic value of IP assets).

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Telecoms

Key Sector Trends

The telecom sector is often seen as defensive, but in our opinion it is not entirely immune to a slowdown in economic growth. We note that the sector valuations appear full, earnings momentum is downwards, and hence remain cautious on the sector.

Excess returns: without doubt the large operators in the Telecoms sector make excess returns, and as the barriers to entry fall these returns will be eroded. The stocks' movement to some extent is dictated by the pace of the erosion.

Barriers to entry slowly falling: to an extent this has been driven by regulation but technology has played a bigger role. New technology has meant prices of equipment have come down substantially and networks can be rolled out more efficiently, combined it leads to lower costs for new entrants. It is increasingly difficult to see Telecoms products as anything but a commodity product in mature markets. Operators are forced to think of new ways of differentiating themselves, be it content, having the best handsets, well known brand etc.

Market share remains key: with competitors pricing more aggressively, large operators are continuously faced with the dilemma of whether to protect market share and reduce prices or stave off large immediate negative impacts by losing some market share. Inevitably large operators need to reprice and this tends to be the source of most profit warnings.

Globalisation: to some extent most of the large operators have recognized the risks above and have entered other markets to compensate for the competitive threat in their home markets, and effectively become the 'competition' in other European markets or enter fast growing/profitable emerging markets. We are now at the situation where only half of the typical incumbent's ebitda comes from its home markets, as a result there is some resilience in the cashflow generated by the incumbents.

Alternative technologies: whilst we don't expect disruptive wireless technologies such as WiMax, WiFi, mobile VoIP and SMS over-IP in themselves to become mainstream till the end of the decade, they will however continue to have a deflationary impact on the sector.

Balance Sheet: the telco operators largely enjoy a strong balance sheet and have generally been careful not to make value destructive acquisitions in the last 2-3 years. Large operators are also returning more cash to shareholders, as seen by a 2008 dividend yield of 5.2%.

Key Business Drivers

Price sensitivity: As was the case during fixed-mobile voice substitution, pricing remains key for mobile BB substitution, which is well poised to stimulate mobile revenue growth. To some extent this supports the view that telecoms is becoming a commodity product.

Scale: We believe that telecoms is a scale game: large subscriber base, coverage areas, ability to provide converged services (e.g. triple play) are all key for profitability

Operational efficiencies: High staff costs reduce operational efficiency for most of the incumbents. This is an ongoing project for most management teams hindered by the fact that many of the staff has civil servant status and so have a 'job for life'.

Mobile termination rate: We believe it is unlikely to disrupt in the near to mid-term as most European regulators had already committed to MTR schedules for a number of years out and have already been legally challenged and/or negotiated. However 3 years hence, regulators are considering alternatives that vary from large scale cuts to introducing Bill & Keep which is effectively the complete eradication of MTR.

Increased capex: We have seen guidance for higher capex given by several players who reported 4Q results. We believe this is one of the threats to the sector. In our opinion mobile broadband could lead to a capex uplift as mobile operators increase depth of their networks and fixed retaliate with fibre. We believe that capex requirements may not be as high if operators are allowed spectrum re-farming, use of home base stations and also via site sharing.

Key Metrics

From a valuation point of view, these are the key metrics:

FCF yield: This is by far the most important metric. As a low growth sector which tends to have several 'one-offs' in the P&L, the cashflow gives the best appraisal of the business. We tend to normalise for tax (adjusting for the NPV of the tax credit) but otherwise FCF yield tends to give the most reliable indicator of how the business is performing. The yield is important for many reasons, whether to determine if a stock is cheap relative to its peer group, ability to meet/increase shareholder returns and capacity to pay down debt. We would expect this to become a more important metric as focus on capex increases.

EV/EBITDA is the next most important metric in comparing various companies. Again its popularity stems from the amount of 'one-off' items that are booked below the EBITDA line. There are flaws such as different tax rates are not accounted for nor the growth of the EBITDA, which means this metric can't be taken in isolation.

P/E in effect should be the inverse of FCF yield, and is a useful metric in later years where there tends to be fewer 'one-off' items. Further this is a metric helpful in comparing the sector against the wider market.

Earnings momentum – this is a big driver of the share price. The best method of measuring this is to look at future growth assumptions imbedded in consensus forecasts, and if there is any sudden increase in future growth rates then it is likely that we will see earnings downgrade momentum, as fundamentals do not change that quickly in this sector.

ROCE: Though Telecom is a story about excess returns, this metric is good in determining where prices might stabilise as if the ROCE for new entrants is similar to the cost of capital then the new entrant will tend to avoid significant price cuts.

From this follows, that the key focus when structuring remuneration should be:

- cash flow generation balanced with good investments i.e. CF growth driven by EBITDA growth
- CF should be viewed in accordance with EPS, there should be some EPS growth coming in as well on a normalized tax basis and excluding any restructuring costs.
- cash flow growth should be organic rather than M&A driven
- share price performance relative to peer group

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Transport and Logistics

Key Sector Trends

The sector covers a wide variety of companies with generally high economic exposure (airlines, shipping) through to more defensive characteristics (UK local bus).

- asset light **freight forwarders** (with revenue growth driven by trade and share gains),
- **airlines** and **shipping** companies (generally asset intensive, operationally geared earnings),
- **public transport** companies (secular public transport shift beneficiaries - but with economically exposed rail operations) and
- **infrastructure** plays, such as ports and airports (e.g. HHLA, ADP).

Asset exposed companies operate typically 12-25 year life assets:

- Airlines, shipping lines and bus companies operate a high number of asset units, and thus can sell the individual assets (each one representing a small proportion of the total asset base)
- Infrastructure operators often face significant costs to create their assets, which are generally very large lumpy investments by nature and hence during construction (and in the immediate period thereafter) can result in dilution to free cash flow, earnings and capital returns.

Key Business Drivers

Key business drivers vary by sub-sector segments, and include:

Freight forwarders: As asset light providers, growth (market and gain share) gives some leverage on SG&A costs, in an earnings momentum, fee cash flow positive driven part of the sector.

Airlines: Yield, load factor and seat utilization, combined with cost control (or lack thereof) are key earnings drivers – with macro demand playing a strong role in the three core revenue factors. Within segment, a secular market shift to low cost airlines (which are growing faster) is occurring, we think.

Shipping: Shipping rate – itself normally a function of capacity buyers' ability to arbitrage perceived supply/demand imbalances is key to highly operating geared shipping lines

Public Transport: Political and demographic changes are key to bus volume growth (and thus potentially profitability). Internal drivers such as introducing new bus fleets and bus priority can be key to success, too. On the rail side, revenue growth is driven by employment levels, economic growth and regulated fare caps. In this segment, free cash flow potential and dividend yield are also important investor considerations.

Airports and Ports: Both are driven by typically long–term markets growing at c 2x GDP growth. Accommodating growth often requires large discrete capex projects which (near-in) can dampen earnings and cash generation (and increase debt) – as these projects are built with long term investment considerations.

Postal companies: e.g. TNT and Deutsche Post (DPWN) face secular decline and liberalization in their core (FCF generative) postal operations – which themselves are (unionized) labour and asset intensive networks. Parcel operations typically are driven by GDP growth and supply chain elongation/off-shoring – although as these too are network business, so insufficient volume in the network can see losses realized (e.g. DHL Express in the USA)

Key Metrics

While we think earnings and dividends may be an appropriate metric to measure financial success as part of Total Shareholder Return, we think theses measures in themselves do not capture other return metrics that we think are also important in assessing sector performance.

<u>These factors and issues include:</u>

As a sector, which overall has a significant macro economic context, we think company success needs to be benchmarked against peer group. Not taking this context into account penalises management for factors (such as the economy, or fuel prices) not within their control.

Infrastructure operators control and need to invest in long-term assets in order to secure the long-term competitive positive (and value of the company) for shareholders. In such companies we think a short term focus on EPS can result in long-term value destructive asset-sweating, not conducive to long-term value creation. In our view, the poor record of Railtrack in the UK was a good example of asset-sweating which proved unhelpful to equity value.

In RoCE regulated companies, we also think management performance and incentive structures need to recognise different regulatory constraints on the companies - e.g. the difference between dual till regulated airports (like Fraport)and single till regulated airports (e.g. ADP)

In an industry with a potentially significant carbon footprint and other environmental issues, such as nitrous oxide emissions and noise emissions, we think incentive structures should also pay heed to the net environmental impact of operations. For example, we think that a bus operator should not be penalised for its gross emissions, but rather the net emissions saved from car use could be considered too.

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Utilities

Key Sector Trends

The utilities sector is in reality two separate industries, entwined in a common value chain but with very different dynamics:

Competitive markets – Power generation, upstream gas, energy supply, water services

- **Energy security:** With much of EU-27 and US power generating capacity built during the economic growth of the 1960s, 70s and a lesser extent the 80s, a lot of generating capacity will reach the end of its natural life in the next 10 years. Power prices have risen, but don't yet cover full investment costs, and political pressure is forcing management to invest in new capacity. On the gas supply side clearly there is a push to diversify sources away from the Russian/Norwegian focus Europe currently has. Again, reinvestment is required here.
- **Environmental concerns:** As the single biggest GHG emitting sector, the power generation industry is under pressure to reduce emissions. The cap-and-trade carbon schemes in Europe and (eventually) elsewhere reduce the economic viability of “dirty” thermal generating capacity, and force management to look to invest in clean energy.
- **Reinvesting for growth**: Aside from the needs for investment from energy security and environmental reasons, utilities are a <5% organic growth business (ex rising commodity prices) and managements are challenged to further invest to find new growth opportunities – particularly via international diversification into emerging markets. Water services remains an area of growth, with ongoing needs for improved supplies in volume and quality terms and a limited number of experienced players continuing to drive lucrative project growth – many of these require capital investment, although there is a rotation to more management-only type contracts.
- **Pushback on pricing:** Price rises in power and gas for retail consumers is, needless to say, politically unpopular and utilities are facing pricing reviews across Europe. The German and UK governments have launched competition reviews; the French government has defended its regulated tariff; the Spanish government are clawing back windfalls via tariff adaptation. The general trend is towards liberalisation of prices (e.g. Greece), but the path is not smooth.

Regulated networks – Power & gas transmission and distribution, water networks

- **Cost control:** As natural monopolies the networks tend to be regulated. Given that this gives a regulator control over what costs are allowed for the network, there is clearly an incentive to reduce costs to beat the regulators’ assumptions whether on operating or capital costs. We are seeing a move away from pure cost focus in many countries though given the need for new investments.
- **Investment needs**: The move to introduce green energy, and the closing of older power stations can require significant investment to build new power interconnectors. A similar situation applies to gas, particularly with new LNG facilities. Ongoing EC moves to improve competition may also drive further investment in cross-border capacity.
- **Unbundling:** So far unbundling (i.e. separation of networks from generation/supply) has not been applied consistently across the EU – some countries (UK, Italy, Spain) have separated their grids on an ownership basis, others (Germany, France and most new EU states) have only followed legal / management separation. The EC is pushing for further ownership unbundling.
- **Capital structure:** The previous three drivers all require a focus on optimised capital structure. Over the past 5 years that has tended to mean increases in leverage (i.e. debt to regulated asset value) and also the entry of private equity into the space. However, the current credit market conditions would mitigate against further moves in this direction. It may be, therefore, that incremental capex has a much higher equity component – and hence need for higher returns – than that of the past few years.

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Key Business Drivers

In the competitive markets segment, we are generally dealing with commodity products where there is little brand differentiation, making operational factors the key drivers for success:

Effective capital investment: With the need for investment in new capacity, and given the length of operating life for power stations and LNG import facilities clearly construction on time and on budget, and a low cost is vital. Failure to do so can build in disadvantage for the company on a 40 year basis. This is especially vital in the current environment where demand for equipment is high, and inflation in capital equipment costs significant.

Efficient fuel sourcing: In a similar vein to capital investment, low-cost fuel sourcing can embed a strong capital advantage for a generator or gas supplier. However, it is important (we believe) to remain "hedged" – i.e. matching sourcing requirements to supply. Demand for fuel (especially equity gas and long term supply agreements) is particularly tough at the moment, giving advantages for larger-scale operators.

Efficient operations: Whilst true for any manufacturing industry, the high fixed-cost nature of power generation and gas sourcing makes high availability factors vital. This in turn is linked to efficient maintenance policies. There is clearly a trade-off against cost of course.

Customer service: Despite having said that energy is a commodity, in retail supply in particular there is a clear negative-brand image problem should customer service (particularly in billing and supplier-switching) fail to meet customer expectations. By counterpoint, good service does not necessarily attract new customers.

<u>The regulated networks need to be focussed on beating regulatory assumptions</u>:

Regulatory relations: Clearly, a destructive / hostile relationship with a regulator is likely to lead to harsh (and possibly unachievable) targets being set. A more constructive relationship - driven in large part by delivering previous targets on cost and investment - can embed an advantage for future negotiations. This is particularly vital when long term capex plans are under negotiation. A similar theme can be drawn in dealing with political stake holders.

Cost control: In countries where incentive regulation (i.e. revenue or price cap) has been established for several years (e.g. UK) there is likely to be little further that can be done to manage costs. However, many countries are far from being in this position, and indeed some (e.g. Germany) have to date run under actual cost-plus regimes that actually disincentivise cost controls. Key areas for management include headcount and equipment / supply purchases. Cutting these below regulatory assumptions allows generation of returns above WACC, and hence creation of SVA.

Capex spend: As is the case for the competitive markets, assets are long-lived (>40 years for power networks) and building at or below assumed regulatory cost can generate significant value.

Operating risk: Failure to deliver agreed service standards can often trigger malus payments, which act as a direct deduction from SVA that is often difficult to recover.

<u>On a more generic basis:</u>

M&A controls: The significant and ongoing M&A-based expansion / diversification drive makes controlled bidding (and defense) levels & strategies important. More vital, arguably, is the post-merger integration process where significant gains / losses of SVA can be made.

Capital structure management: With a high level of capital expenditure requirements in coming years, it is unlikely that significant value return opportunities will emerge. However, where they are we would look for detailed – and of course appropriate - capital structure targets to be provided & stuck too. It is possible to go too far – particularly in the competitive sector operations where the need to trade commodities can require minimum credit ratings.

Key Metrics

Given the mixture of long term investment and short term operating requirements in both the competitive and regulatory segments, we would see a blend of operating, financial and measures to be appropriate. As an aside, we see the use of independent remuneration committees as vital – aside from shareholder-oriented corporate governance issues the political element of the sector (energy & water supplies are often seen as a public good in the economics sense) means remuneration can be under broader public scrutiny:

Operating / budget measures: Given the importance we've mentioned of operating & capex costs we see detailed operating and budgetary targets as especially important at the level 2 and below management levels. In "simple" utilities - i.e. with a few business lines or geographies - it is also appropriate to apply these to top management. In diversified utilities, though, composite efficiency targets are less appropriate.

Ebit / Net income growth: The need for reinvestment and cost control make a balance of long and short term earnings targets desirable. We'd see recurrent EBIT as a key measure here – it avoids the incentive in EBITDA targets to over-invest. Net income measures can help ensure capital structure targets are met, although carry risks from overgearing / overpriced investments (which can be earnings accretive up to levels well in excess of those that are appropriate for required RoCE targets). A balance of near term (1 year guidance) and long term (3-5 years) are appropriate, we believe.

Sector relative stock performance: As a defensive sector much of utility stock price performance can be driven simply by movement in commodity price or in economic conditions (neither of which are in control of management). We have therefore seen the emergence of several "relative performance" stock schemes emerge, which we would see as appropriate providing they are linked to RSUs rather than option-based schemes.

Appendix I: Glossary

CAGR	Compound annual growth rate
Capital Employed	Equity plus net debt
Dividend Yield	Dividend per share/Share price
EBIT	Earnings before interest and taxes
EBIT Margin	EBIT/Sales
EBITDA	Earnings before interest, taxes, depreciation and amortization
EBITDA Margin	EBITDA/Sales
EBITDAR	Earnings before interest, taxes, depreciation, amortization and rental/lease expenses
Enterprise value	Various definitions; generally include market value of equity (including minorities) plus net debt plus pension deficit
EPS	Earnings per share
EV/EBITDA	Enterprise Value/ EBITDA
EVA	Economic Value Added: Measure of profit after meeting cost of capital
FCF	Free cash flow (operating cash flow less capex)
FCF Yield	Free cash flow per share/share price
Gross Margin	Gross Profit/Sales
Gross Profit	Revenues-Cost of Goods Sold (COGS)
Invested capital	Long-term assets plus net working capital
KPI	Key Performance Indicator
LFL growth	Like for like (or organic) growth: Generally excludes impact of currency and acquisitions/disposals; in retail sector excludes impact of new store openings/closures
NAV	Net asset value (assets less liabilities)
Operating Margin	Operating profit/Sales
P/E	Share price/Earnings per share
PBT	Profit before tax
RevPAR	Revenue per available room (in hotel sector)
ROCE (or ROACE)	Return on (average) capital employed
ROE	Return on equity
ROIC	Return on invested capital
TSR	Total Shareholder Return: Increase in share price with dividends reinvested

Note: Most of the terms above may be variously defined, we have highlighted basic or most common definition.

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Table 3: Sector-specific remuneration metrics per JPMorgan Sector analyst (12 out of 20 sectors covered in this report)

Sector	Metrics
Aerospace & Defence	Medium-term organic revenue growth on a constant currency basis (5 year mean) Medium-term return on invested capital, including goodwill, and excluding write-downs and provisioning YoY change in cumulative cost at completion at constant currency, excluding customer change orders Medium-term free cash flow conversion Medium-term gross margin development on a constant currency basis, excl. hedging gains or losses
Capital Goods	ROCE (incl acquisitions, cash conversion and organic growth) 50%-66% based on personal, division (and group) targets Senior management based on group performance Long term stock vesting after 7-10 years
Food & Beverages	Volume/mix growth Operating profit growth FCF, ROCE, WC
Food Retail	Organic sales growth (LFL + space opening, differentiated by markets and ignoring acquisitions and FX effects) EBIT (target depending on amount of property ownership) EVA (across entire business and specific markets, achieved through specific ROIC targets depending on the market) EPS growth in long term (should follow sales growth rates)
General Retailing	LFL sales combined with achieved/cash gross margin EPS growth (specific to business maturity and dividend payouts) Returns (lease adjusted basis) Share Price Performance (absolute and relative to peers)
Luxury Goods	Organic sales growth Gross margin and EBIT margin (margin CAGR over the LT) ROCE TSR vs index or peers on a 5 yr period
Metals and Mining	Volume tonnage growth at specific points in the cycle ROIC Share price performance vs peers (with care if production is mainly in one commodity)
Oil and Gas	ROACE Dividend yield E&P volume growth, reserve replacement and per-barrel costs (for E&P companies only) Revenue growth/order backlog growth (for oil service companies) EBITDA growth driven by revenue/margin growth (for oil service companies)
Pharmaceuticals	Sales growth (including effects of price, mix and volume) Pipeline progress measures Margin metrics (gross margin, SG&A as % of sales, R&D as % of sales) Sales per physician visit (marketing costs)
Property	LFL rental growth EVA (across entire business and specific markets, achieved through specific ROIC targets depending on the market) NAV growth Above metrics measured against peer group to see true outperformance
Telecoms	Organic Cash flow growth driven by EBITDA growth EPS growth (excl restructuring costs Share Price Performance (absolute and relative to peers)
Utilities	Operating / budget measures (operating and budgetary targets in simple utilities, composite efficiency in diversified) EBIT (near and long term targets) Net Income (near and long term targets) Share Price Performance (absolute and relative to peers)

Source: JPMorgan estimates.