10 Minutes on…

2018 Annual General Meeting season - The big squeeze

December 2018

Last AGM season, the media predicted a 'shareholder revolt' in relation to remuneration report votes that never happened. In fact, last year we titled this publication *'..a fuss about nothing'*.[1] What a difference a year makes.

This AGM season we've seen some of the largest 'no' votes against remuneration reports in Australian corporate history, and an overall increase in the number of companies receiving a strike. Three times the number of companies received a strike this year as compared to last, and five companies received 'against' votes of more than 60% (having only being experience once by an ASX 200 company, being Telstra in 2007). To round out this perspective, it is worth noting that the vast majority (~92%) of ASX 200 remuneration reports were supported.

Company behaviour in relation to executive remuneration does not seem to have shifted substantially - in fact pay increases are more conservative and STI payments are not materially different - but the context within which these decisions are being made has changed. And context is everything. With a relatively soft economy (with GDP at 2.8%[2] and the ASX 200 index declining 8% ytd[3]) and significant regulatory and community pressure on matters such as governance, accountability and culture, the outcomes of this AGM season are unlikely to come as a surprise.

In particular, coming into this AGM season, there was high anti-bank sentiment and shareholder dissatisfaction with certain companies in relation to disappointing financial results, commercial decisions, and reputational issues. As always, it is difficult to ascertain to what degree such considerations (other than remuneration practices) have affected remuneration report votes. But there is not doubt there has been an impact.

Nevertheless, the extreme votes against reports this year have been driven by some clear themes: ***dissatisfaction with the high quantum*** of executive pay and a perception that ***remuneration outcomes have not been a fair reflection of accountability*** for Group and executive performance.

The 2018 AGM season will also be characterised as a time in which shareholders ***acceptability of bespoke / tailored plan designs was further tested.*** This somewhat contrasts with the UK 2018 AGM season that has seen the increased willingness of shareholders and proxy agencies to consider alternative pay designs to the traditional base-bonus-LTI model that has also come to dominate UK practice. Here in Australia, while the majority of bespoke / tailored plans were supported when first announced, support after their first year in operation appears to have wavered. The average vote against companies operating tailored / bespoke plans in 2018 was 30.35% (versus 4.78% in 2017).

	2018	2017
ASX 100[1]		
% receiving a strike	10.81% (8 out of 74)	2.70% (2 out of 74)
Average % vote 'Against' Rem report	11.42% (0.01% to 88.43%)	7.05% (0.01% to 42.09%)
ASX 200[2]		
% receiving a strike	8.05% (12 out of 149)	2.61% (4 out of 153)
Average % vote 'Against' Rem report	9.28%	6.28%

[1] Results of AGMs held in the calendar year. ASX positions based on 3-month average market capitalisation as at 30 September 2018.

[2] Analysis based on companies who have had AGMs as at 19 December 2018.

Note: 2017 figures have been updated since last year's analysis (published here) due to the exclusion of REITs, alongside the inclusion of Tatts Group who was acquired by Tabcorp Holdings.

[1] PwC, '10 minutes on… 2017 Annual General Meeting Season - A fuss about nothing?', December 2018 (link)

[2] Australian Bureau of Statistics, '5206.0 - Australian National Accounts: National Income, Expenditure and Product', September 2018 (link)

[3] PwC analysis of CapIQ data

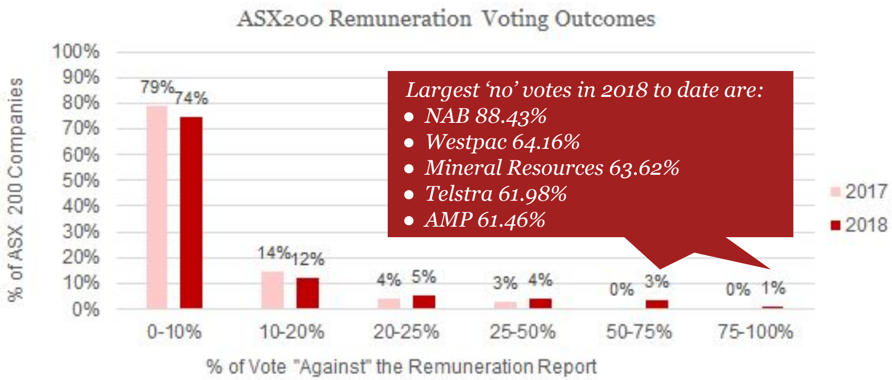
Summary of 2018 AGM season outcomes

With three times the number of companies receiving a strike this year (as compared to last year), and five companies receiving against votes of more than 50%, this AGM season is one to remember.

Shareholders and proxy advisers have been very active on executive pay this AGM season. We've seen both the number of companies receiving a strike increase markedly, and the degree of votes against rise sharply.

Two consecutive strikes triggers a vote on a board spill resolution, where all Board members may be replaced. There has only been one ***second strike*** in the ASX 200 this season (Mineral Resources), and the board spill resolution was not carried.

Adverse swings year-on-year in excess of 50% were seen even where there were minimal changes in remuneration policy or practice. The bar for proxy adviser or shareholders to vote 'for' appears to be higher this year, no doubt fueled by community sentiment that has become increasingly negative, particularly in relation to financial services remuneration.



Key issues for companies that did receive a strike this year were:

Perceived excessive quantum

- Increases to fixed remuneration seen as too significant, misaligned to the broader economy, and/or in excess of the industry / market.
- The provisions of high one-off and termination payments.

Insufficient remuneration consequence

- Some of the largest 'no' votes against companies have occurred where shareholders have expressed concern regarding the minimal consequences applied for poor performance, misconduct and other regulatory risks.
- Remuneration frameworks have not been seen by shareholders to be sensitive enough to appropriately vary remuneration outcomes for customer or other reputational matters, both in their design and in application.
- For example, the reductions made to STI outcomes by some of the major banks were not seen to have been sufficient / proportionate with impacts on other stakeholders, such as shareholders and customers.

Weak pay for performance link

- As in prior years, there are continuing themes of lack of alignment between reward outcomes and company performance.

Director judgement being questioned

- Remuneration decisions and the use of discretion has been challenged, for example why decisions were taken to adjust / not to adjust remuneration.
- There have been record high votes against individual director re-elections, where there was also a high vote against the remuneration report.
- While we have observed an uplift in disclosures explaining the use of board discretion, there continues to be cynicism regarding the use of such powers.

An imbalanced stakeholder view

- A desire for a more stakeholder oriented view of capitalism can be seen in how the appropriateness of reward outcomes have been challenged. This is particularly evident in financial services where customer detriment or reputational damage has occurred and yet bonuses have been justified on the basis of sound financial results / share price.
- This theme is also reflected in proposed changes to the ASX Corporate Governance Council's Principle 8 - remunerate fairly and responsibly.[1] The proposed changes included the entity not rewarding conduct contrary to its values or risk appetite, and considering pay quantum in the context of the its social licence to operate.

[1] *ASX Corporate Governance Council, 'Review of the ASX Corporate Governance Council's Principles and Recommendations (Public Consultation)', 2 May 2018 (link)*

Summary of 2018 AGM season outcomes (cont'd)

Key issues for companies that did receive a strike this year were (cont'd):

Bespoke plans: brave or mad?

- While the majority of companies who adopted bespoke plans received support for their remuneration report in the year the plan was announced, shareholder acceptability is again tested when the first awards are made at the completion of the first annual cycle.
- Support for remuneration reports for companies with bespoke plans has been much more varied at the 2018 AGM season, with favourable votes ranging from 11.57% to 99.40% (versus 89.54% to 98.34% in 2017). We note that some of the largest strikes were received by companies operating combined incentive plans, however there were additional concerns in most cases that arguably had little to do with the incentive structure.

Specific feedback and concerns raised on tailored / bespoke plans during the 2018 AGM season included:

- Lack of long-term performance conditions.
- Perceived lack of shareholder alignment.
- Discount not seen as proportionate with the reduced stretch in long-term performance conditions.
- Higher degree of discretion required (e.g. upon vesting) and some cynicism of appropriate assessment of performance.
- Substantive departure from historical shareholder expectations.

Relieving the big squeeze…

There is no doubt that the dissatisfaction expressed by shareholders this AGM season is not likely to dissipate anytime soon. But there are a number of actions boards may consider to address evolving expectations.

Clarify the purpose of variable pay

- Confirm the ***purpose of variable pay*** and better explain what outcomes can be expected as a result. For example, "The purpose is to reward executives for contributions to the long-term success of the company, and to attract and retain top talent. As such, the board may face situations where a bonus outcome is deemed appropriate notwithstanding a decline in share price" or "The sole purpose of executive reward is to reward executives for a share price appreciation which may mean that executives receive no bonus or LTI (only their fixed pay) in difficult performance years, even if they are responsible for critical contributions to minimise the downside for shareholder, or are being asked to make difficult in year decisions that could adversely impact share price in the short term".
- Only use ***one-off payments*** in rare circumstances, and clearly articulate the rationale and the linkage with shareholder outcomes.

Systematically consider a balanced stakeholder view

- Establish mechanisms to ***engage*** with a ***broader set of stakeholders*** on remuneration matters, beyond shareholders and proxy advisers.
- Monitor executive ***pay quantum*** relative to peers as well as average worker pay, as another test of reasonableness.
- Consider a broader performance context, include non-financial performance and outcomes for customers, suppliers and employees.

Relieving the big squeeze… (cont'd)

Reinforce executive accountability via remuneration outcomes

- Clearly ***articulate upfront*** how performance is defined, especially if this differs to statutory or shareholder expectations. Improvements in transparency should focus on the linkages to strategy, company performance, risk and governance.
- Actively reflect on whether a sufficiently ***broad range of STI outcomes*** has been achieved to reinforce both collective and individual executive accountabilities. Consideration of variability should be given to individual STI outcomes across the executive population, as well as variations year-on-year for individual executives. An appropriate range may include zero outcomes.
- Develop (and consider disclosing) a ***remuneration consequence policy*** that defines an approach to determining appropriate levels of risk, misconduct, health and safety related remuneration adjustments. This remuneration consequence or adjustment process should exist as an overlay to the reward outcome that is otherwise determined based on the performance criteria of the incentive plan alone (i.e. what circumstances might trigger the application of an adjustment or remuneration consequence).

Demonstrate board accountability for remuneration decisions made

- As a board, ***actively consider the appropriateness*** of outcomes, and utilise the discretions available.
- Better ***explain the context*** for decisions, including how they relate to stakeholder outcomes and what factors / trade-offs were considered. If a decision is taken to award variable pay to executives, notwithstanding shareholder dissatisfaction due to performance or other reputational issues, proactively and directly address why this decision was taken.
- Consider the need and timeframe to ***refresh directors*** involved in remuneration decision-making.

Proceed with caution if contemplating new, or continuing with, arrangements that deviate from the norm

- Consider the broader performance context and multiple stakeholder views prior to making any changes. 'Softer' performance outlooks will likely raise increased skepticism and distrust. ***Extensive consultation*** is critical.
- Have a ***compelling rationale*** for the alternative plan design, specific to the company's circumstances and operating environment.
- Apply a ***substantial face value discount*** to the traditional LTI grant in the case of restricted share awards with no additional hurdles (of ~50%).
- Apply a ***longer vesting/holding period*** than typically seen in the market (at least 5 years), subject to ***underpinning conditions*** that may mean no award is released in adverse or extreme circumstances i.e. there will be no ***'payment for failure'***.
- Provide transparent and clear disclosure of targets and underpins.
- Require executives to hold a significant amount of shares, such that a movement in share price of 5-10% has a significant impact to deferred equity.

Pay attention to emerging standards and expectations that are likely to continue to evolve

- *Hayne Royal Commission into misconduct in the Banking, Superannuation and Financial Services Industry* - Final report is expected 1 February 2019 which will include commentary and recommendations in relation to both executive and broader employee incentive arrangements. Whilst these recommendations will be specific to FS, as with a number of other remuneration developments that have had their origins in regulation applicable to FS organisations only, such practices have evolved to become an expectation more broadly (e.g. STI deferral).
- *ASIC Corporate Governance Taskforce, including a focus on Executive Remuneration* - Funding of $6.8m has been dedicated to support ASIC to bolster enforcement capabilities, enable it to undertake new regulatory activities and investigations, and to better deliver on its mandate of combatting misconduct. An ASIC Corporate Governance Taskforce has now been established, which is investigating executive remuneration practices at Australian listed companies. Again, any related findings and recommendations will have an impact on ASX remuneration practices.

How can PwC help?

To have a deeper discussion about these issues, please contact:

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