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Executive Remuneration trends – Safe Harbour or False Mirage?

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What you need to know about remuneration trends in FY13

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Safe Harbour or False Mirage?

FY13 was a relatively uneventful year in executive remuneration.

The steady homogenisation of Australian reward arrangements continued, driven partly by the significant scrutiny from shareholders, proxy advisors and the media.

Recent changes appear to be adding increased complexity to the operation of incentives, rather than improving strategic alignment.

Given this, we question whether the designs being adopted truly provide the safe harbour that appears to be intended. Incentive plans can be powerful tools to drive the right outcomes and behaviours but the increased complexity of these plans is meaning that executives are discounting their value more and more. As a result, incentive plans risk becoming a mirage for participants, whilst causing ongoing frustration for shareholders.

This alert provides a snapshot of remuneration trends in FY13, and our FY14 outlook, across ASX 100 companies.

Highlights

- *Fixed pay continues to be put under pressure through a combination of pay freezes and lower rates for new hires. More than a third of CEOs and other executives did not receive a fixed pay increase in FY13. Around two-thirds of new CEOs started on lower pay than their predecessor.*
- *Short-term incentive (STI) payments increased markedly, with over 40% of ASX 100 companies paying at or above target. STI plans also continued to increase in complexity with higher amounts deferred over longer periods with more robust clawback provisions. The use of discretion over actual STI awards is an emerging trend.*
- *Companies are continuing to operate mainstream LTI designs. 3 year performance rights assessed against a relative TSR hurdle, in conjunction with another hurdle (typically EPS) remains the most common LTI structure in ASX 100 companies. In contrast, we are seeing substantial customisation of LTI plans in the UK.*
- *Almost ¾ of ASX 100 companies received a "no" vote of less than 5% on their FY13 remuneration report, with only two ASX 100 companies receiving their first strike.*
- *We expect fixed pay levels to remain relatively stable over FY14 as companies continue to exercise pay restraint. We also anticipate:*
    - *small movements in remuneration mix as companies seek to deleverage STI*
    - *greater use of discretion in both STI and LTI plans*
    - *small shifts to more innovative and customised (and simplified) remuneration structures, in line with UK trends.*

Fixed pay and total pay movements

The historical model of annual fixed pay increases for well-paid executives continues to break down, with many disclosed executives not receiving any fixed pay increase in FY13.

For same incumbent executives in the ASX 100[1] (ie those executives who remained in their role from FY12 to FY13):

- The median fixed pay increase for CEOs and executives was around 3%
- 40% of CEOs and 33% of executives did not receive any pay increase. This is consistent with the widespread practice of announcing pay freezes and limiting increases to only those executives with fixed pay significantly below market norms.
- Total target pay[1] increased by 6% for CEOs and 2% for executives at the median.

Across the broader ASX 100 (ie not just same incumbents):

- Fixed pay has fallen by around 3% for CEOs and increased by around 2% for executives (at the median). Newly appointed CEOs are contributing to this trend, with two-thirds commencing on lower fixed pay levels than their predecessor.
- Total target pay has increased by 3-4% for CEOs and executives (at the median).

More than one-third of ASX 100 CEOs did not receive a fixed pay increase in FY13. Despite this, median total target pay increased by around 6% for CEOs who were not new to the role.

Approximately two-thirds of new CEOs started on lower fixed pay than their predecessor (the median reduction in fixed pay was $520,000 or 27%).

1. Based on those executives whose remuneration is disclosed in annual reports.

2. Based on LTI being calculated on a fair value basis.

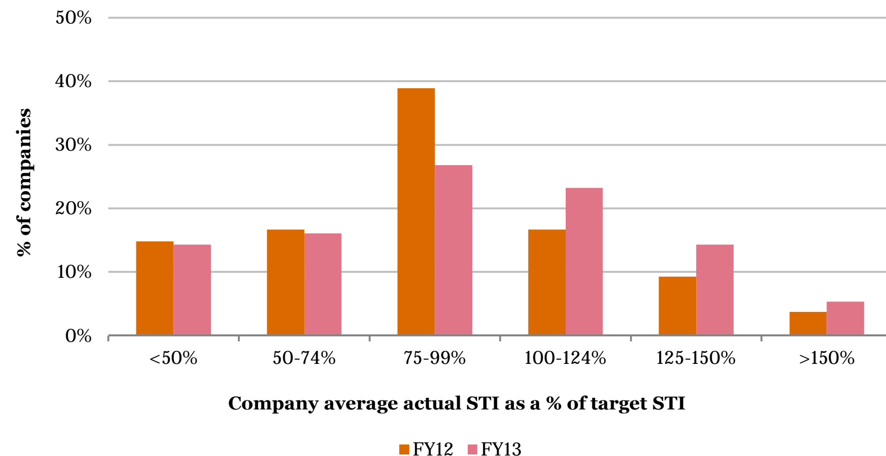
Short-term incentives

There was a marked increase in the quantum of STI payments in FY13. Over 40% of ASX 100 companies paid at or above target STI awards on average (compared to 30% in FY12).

The structure of STI plans has remained relatively stable, but we have seen an emerging trend throughout FY13 in relation to the increased use of board discretion when determining final STI payments. Despite media reports indicating that the use of discretion is a failure of incentive plan design, we believe this approach is critical when it acts as an overlay to a KPI-based plan. This is because good governance involves the board stepping back and making a decision at year-end as to whether STI awards are reasonable and appropriate in light of overall management and company performance.

Despite increased stakeholder scrutiny on the link between company financial performance and STI payments, there has not been any material increase in the use of financial gateways in STI plans. Only a handful of ASX 100 companies disclosed the use of a financial gateway in their STI plan. This reflects the general view in the market that sustainable longer term performance is more likely to be achieved through incentivising executives to focus on a combination of financial and non-financial (operational / strategic) goals.

Figure 1: ASX 100 average actual STI as a percentage of target STI



An emerging trend is the increased use of board discretion in determining actual STI awards

Short-term incentives (continued)

STI deferral and clawback / malus

FY13 saw a continued increase in compulsory STI deferral, with 55% of companies requiring a portion of STI payments to be deferred (up from 51%). The median deferral period is 2 years, and the most common amount deferred is 50% of the award. Figure 2 provides further information on STI deferral periods and quantum.

Despite the lack of regulation and legislation to date, clawback / malus provisions continued to increase in prevalence during FY13, with ~40% of ASX 100 companies now having such provisions in place. Typically, clawback is not structured in any type of formulaic way. Instead it is generally applied with board discretion, with indicative criteria often being disclosed. In the vast majority of cases, clawback only applies to unvested amounts (rather than cash amounts already paid).

The use and disclosure of clawback policies is expected to be incorporated into the next version of the ASX Corporate Governance Principles and Recommendations which will be effective 1 July 2014.

Figure 2: ASX 100 deferral periods and quantum[1]

% of companies		ASX 100 deferral period				
		1 or 1.3 years	1-2 years[2]	2 years	3 years	Other period
Proportion deferred	20% - 30%	7%	7.5%	5.5%	4%	
	33%	2%		15%	7.5%	
	34% - 49%		2%	4%		
	50%	7.5%	7.5%	13%	5.5%	
	Other[3]	2%	4%		2%	4%

Too much complexity?

With increased deferred amounts over increased time periods, which are then subject to clawback (but against conditions that are not known), we believe it is worth revisiting the purpose and structure of STI plans.

We suggest that companies consider getting back to basics, such as:

- Developing robust, strategically-aligned KPIs (which are an important mechanism for influencing executive behaviour through STI plans). Still too many STI plans are based purely on operational measures with no, or limited, focus on strategic priorities;
- Changing the reward mix to deleverage the STI – with less opportunity available, and more robust KPIs, the need for long deferral periods and robust clawback provisions are less important. Simple cash-based bonus plans have a lot of merit for many companies outside the financial services sector if these are structured appropriately within the overall reward framework.
- Increasing equity-based awards to compensate for the deleveraged STI. The purpose of these is to make the executives feel and act as owners of the business with long-term stewardship top of mind.

STI plans have become too complex – is it time to get back to basics?

1. *Of those companies that had STI deferral in FY13.*
2. *This refers to 50% vesting after one year, 50% vesting after 2 years.*
3. *This refers to deferred amounts not disclosed or amounts other than 20-50% of the actual STI.*

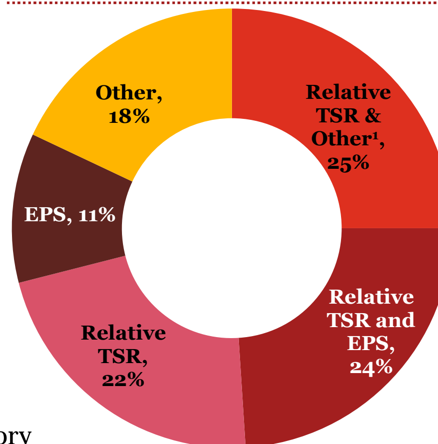
Long-term incentives & shareholding guidelines

Long-term incentive designs have remained consistent, with no meaningful shift in ASX 100 design practices.

3 year performance rights assessed against a forward looking relative TSR hurdle, in conjunction with another hurdle (typically EPS), remains the most common LTI structure across ASX 100 companies.

While we are aware of a limited number of companies introducing more customised LTI hurdles, it is clear that Australian boards are continuing to favour mainstream LTI designs. We have no doubt that our regulatory environment with the two strikes test is contributing towards this conservatism.

Figure 3: ASX 100 LTI hurdles



1. Other refers to hurdles including return-based hurdles, free cash flow, sales revenue growth and strategic hurdles.

UK trends - LTI

In contrast, in the UK, there has been a substantial increase in the number of customised hurdles used in LTI plans over time. In 2006, TSR and EPS accounted for the conditions on over 80% of LTI plans - this had decreased to around one-third in 2013.

New LTI plans put to the vote at AGMs in 2013 emphasise the trend that is occurring in the UK. Of the 20 FTSE 100 companies seeking approval for a new LTI plan, 75% involved hurdles either in addition to, or instead of, TSR and EPS. These hurdles are typically a financial hurdle with greater alignment to the company's strategy (eg relative margin improvement, organic revenue growth etc) or a strategic hurdle/s.

If Australia mirrors UK trends, there should be significantly more innovation in LTI plans over the next few years.

Another emerging trend in the UK is performance on-grant models. These involve an assessment of performance *prior* to the LTI award being made (eg over a 1-3 year period). Awards are then subject to time-based service conditions (typically at least 5 years) and clawback provisions.

Shareholding guidelines

The use of executive shareholding guidelines has increased over the past 12 months with approximately 25% of the ASX 100 companies now having such guidelines in place, and a further 5% introducing guidelines in FY2014. The median guideline is for CEOs and executives to hold 100% of their fixed pay in shares, acquired over a 5 year period. Shareholding guidelines are a simple mechanism for underpinning shareholder alignment.

UK trends – shareholding guidelines

As more simplified remuneration structures are being implemented in the UK, they are being supplemented by stringent holding periods. If Australia moves towards more simplified remuneration frameworks, the use of these guidelines / requirements is likely to continue to increase.

Outcomes from AGM season

It was another successful year at the AGMs of the top end of town, with only two ASX 100 companies receiving a strike against their remuneration report.

Smaller companies continue to be more prone to strikes, with a further 7 companies in the ASX 100 – 200 receiving a first strike in 2013 (ie a vote against the remuneration report of greater than 25%). There were no second strikes on FY13 remuneration reports in the ASX 200.

The three ASX 100 companies who received a strike in FY12 worked hard to avoid a second strike in FY13, with all three achieving a significantly reduced 'no' vote of 3% or less. In each case, companies have focused on engaging with, understanding and addressing shareholder concerns.

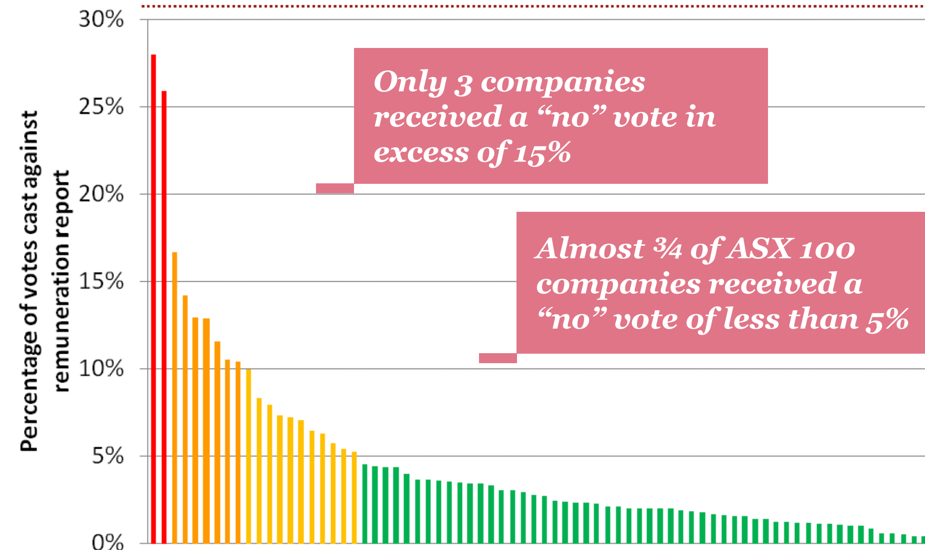
The reasons for "no" votes tend to be many and varied. They often relate exclusively to the CEO's remuneration, but sometimes the driving force might not even be remuneration. In FY13, the reasons for a first strike included:

- perception that executives were overpaid in the context of sustained poor company performance
- insufficient justification for pay increases
- misalignment of incentive outcomes and performance conditions
- weak LTI vesting conditions

Generally, we found an increasing tendency for companies to be challenged on quantum during consultation with proxy advisors. This was irrespective of the company's performance.

Concerns around pay quantum and incentive plan design and outcomes contributed towards first strikes in FY13

Figure 4: ASX 100 – Votes against FY13 remuneration reports



Outlook for FY14

Fixed pay: We expect fixed pay levels to remain relatively stable over FY14 as boards continue to exercise pay restraint. Particularly, we expect continued pressure to appoint new executives on equal or lesser pay than the predecessor.

Incentive pay: There appears to be no burning platform to change the structure of incentive pay. It is possible, though, that the spotlight will start to shift from fixed to variable pay, with some likely consequences:

- There may be small movements in remuneration mix as boards seek to deleverage the STI opportunity and place greater emphasis on long-term incentives or other equity based awards
- The use of discretion is likely to continue to increase in both STI and LTI plans, to ensure that pay outcomes are both defensible and reasonable
- Small shifts towards more innovative and customised (and simplified) remuneration structures in line with UK trends (notwithstanding that the transition to bespoke arrangements can often be challenging). A limited number of companies are considering, or have already incorporated, strategic hurdles into their LTI plan for FY14.

There may be small movements in remuneration mix as boards seek to deleverage the STI opportunity

We expect to see small shifts towards more innovative and customised remuneration structures in line with UK trends

Boards may take a step back to determine how their remuneration arrangements can be simplified to drive the desired outcomes and behaviours

How can PwC help?

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

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