10 minutes on...

Executive remuneration trends: making pay while the sun shines

February 2016

Highlights

- Fixed pay increases remain modest at 3%, whilst the proportion of CEOs and executives receiving an increase has increased from around two thirds in 2014 to 88% in 2015.
- Median short-term incentive payments were above target for the first time since the depths of the GFC (112% of target for CEOs and 116% for executives).
- The use of TSR as a sole measure continues to drop, with only 15% of ASX100 companies now using this approach. Conversely, the proportion of companies adopting 3 or more measures has increased to 13%.
- The prevalence of minimum shareholding guidelines continues to rise, and is now in place at 45% of companies in the ASX100.
- The number of strikes against remuneration reports remains stable, with seven companies in the ASX200 receiving "No" votes in excess of 25%.
- Disclosures are improving, but half the companies examined still only provide baseline disclosures of short-term incentive measures and weightings.
- The median length of remuneration reports has increased by more than a third over the past five years, mostly due to new graphics and summaries intended to aid understanding.

Summary

FY15 has provided a slight reprieve from the austerity of recent years, with fixed pay increases becoming more commonplace and payments made under short-term incentives (STI) bouncing back. If tough market conditions continue, however, executives shouldn't expect the same in FY16.

While more executives received fixed pay increases than in previous years, increases remained consistently low. A modest lift in STI payouts led to what will possibly be a high watermark for STI in the wake of the GFC, but overall pay levels were generally flat as organisations continue to exercise restraint.

Aligning pay to performance remains key. Evidence partly counters the scepticism that short-term incentives are truly at risk, with many companies seeing considerable variation in bonus quantum from year to year.

In a similar vein, the growing use of internal measures in long-term incentives (LTI) is not providing the free ride that some expected. Vesting levels are shown to be comparable for both external (e.g. TSR) and internal measures (e.g. EPS), suggesting Boards have done well to calibrate internal performance standards for the notoriously difficult 3 or more years over which these plans operate.

For the most part, remuneration structures continued in the traditional mould. Off the back of this, shareholders provided solid support when voting on Remuneration Reports, particularly where reward outcomes were well aligned to organisational performance.

Remuneration disclosures are mostly heading in the right direction, with many companies working hard to improve not just the depth of disclosure but the readability. But commercial sensitivity remains an issue, with a large number of companies choosing to disclose no more than the minimum requirement for their STI programs.

Fixed pay and total pay movements

Modest increases have replaced austerity

Organisations have exercised considerable restraint with executive pay in recent years, and for FY15 there appears to have been a slight relaxing of this prevailing austerity.

For same incumbent executives in the ASX100 (i.e. those who remained in the same role from FY14 to FY15):

- Median fixed pay increased by 2% for CEOs, with 24% of CEOs receiving no pay rise.
- Median fixed pay increased by 4% for executives other than the CEO, with 88% receiving a pay rise. This is a much higher proportion than recent years, when around two-thirds received increases.
- Median total target pay levels remained relatively flat.

Across the greater ASX, newly appointed CEOs tended to receive less fixed pay than predecessors, with 67% of new CEOs receiving fixed pay levels below their outgoing counterparts.

Non-Executive Director pay remains flat

The majority of NEDs received no or very little increase to base fees in 2015.

For those organisations who did make changes to base fees, the median increase was 3.5% for the Chair and 2.6% for other non-executive directors.

For a few companies, 2015 was an opportunity to significantly realign NED fees, with at least 4 organisations increasing their base fees by 10% or more. Notably, one organisation decreased base fees 'in light of the challenging external environment and the benchmarking data for peer companies'[1].

There was also little movement observed at the committee fee level, with median membership fees remaining constant for each of the standard committee structures across the ASX100.

1. BHP Billiton Annual Report 2015

Short-term incentives

More executives are receiving at or above target STI

The median actual STI payment as a percentage of target was 112% for CEOs and 116% for executives in FY15, which represents a greater percentage of target being paid out than in previous years (94% for CEOs and 87% for executives in FY14) and the highest levels since the depths of the GFC.

As shown in Figure 1, the vast majority of CEOs and other executives received close to or more than their FY15 target opportunity. Payments have improved steadily over the last couple of years, reflecting improved performance in the wider economy. For other executives specifically, the proportion who received at least target has increased to 58%, up from 43% in 2014 and 40% in 2013.

STI deferral practices remain steady

The adoption of STI deferral has been on the rise for a number of years, but in 2015 the trend appears to have plateaued, with 72% of companies requiring STI payments to be deferred (up from 70% in 2014). The median deferral period and portion of STI payments deferred remained at two years and 50% respectively, consistent with previous years.

2015 saw true variance in STI… to a point

Some observers have criticised STI programs as thinly veiled forms of guaranteed remuneration. Our analysis suggests the picture is more nuanced, at least for CEOs, whose STI payments showed significant like-for-like variation from those paid in 2014. Despite this, though, and as described in relation to Figure 1, very few FY15 bonuses dipped far below target.

As shown in Figure 2, 67% of CEOs received payments that varied at least 30 percentage points (greater or lesser) when compared to their previous year's payment (calculated as a percentage of each CEO's target amount)[2].

Figure 1: ASX 100 average actual STI as a percentage of target STI (CEO & Executives)

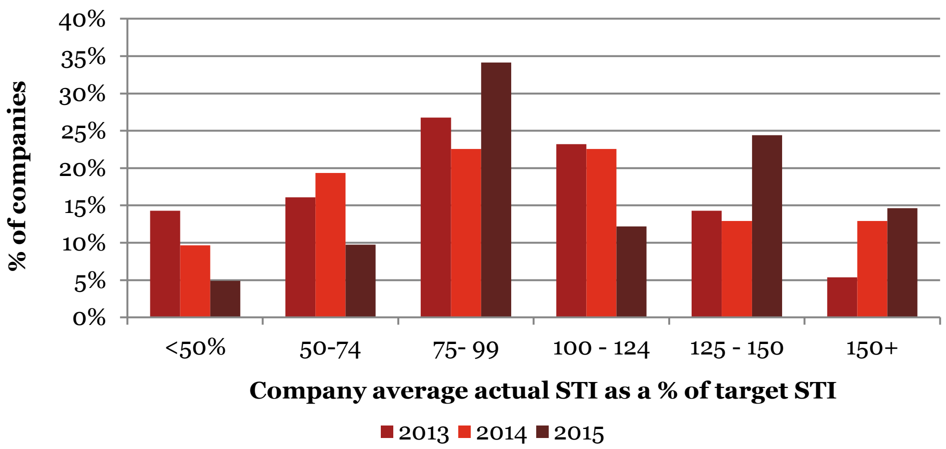
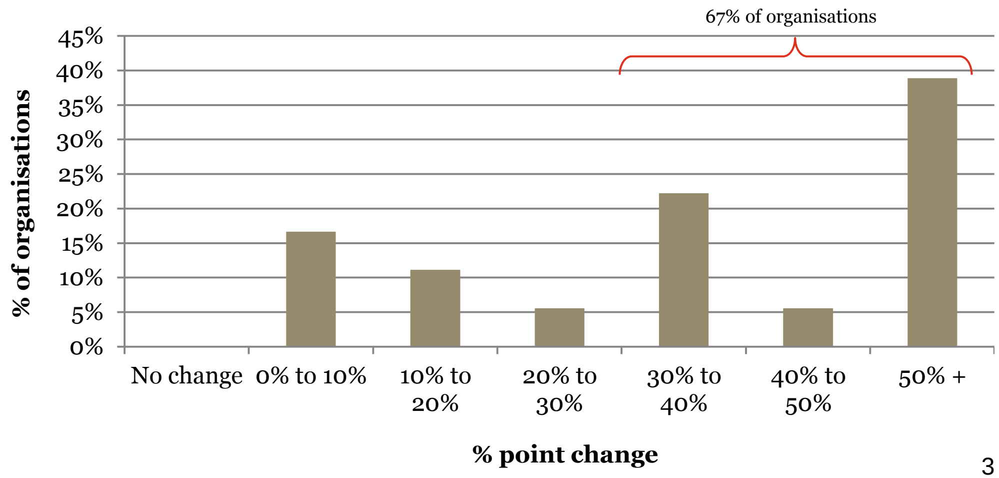


Figure 2: Year-on-year STI variation as % of target – ASX100 CEOs



2. In instances where both target and actual levels were disclosed in both 2014 and 2015, for ASX100 CEOs who were in the role both years.

Long-term incentives

LTI measures and performance period

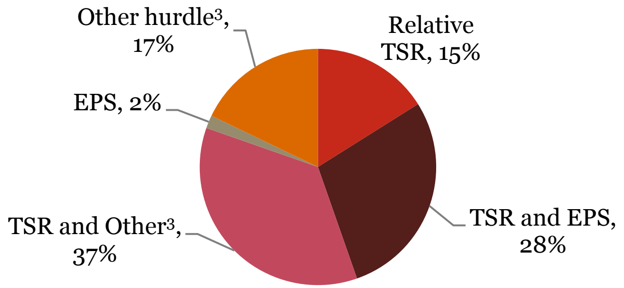
The LTI plans of companies in the ASX100 retain a high level of orthodoxy. The majority of companies continue to operate performance equity plans, which vest after three years. Vesting is typically based on the outcomes of two discrete performance measures, one of which is inevitably relative TSR.

Over the past 12 months we have seen a decline in the use of relative TSR as a sole hurdle, now representing only 15% of the ASX100 (refer Figure 3). This is down from 23% across this group last year. The number of ASX100 organisations with three or more measures is up to 13% from 6% in 2014. Given that just over half of FTSE 100 companies' LTI plans now use three or more measures, this may be a trend that continues.

The use of alternative LTI performance measures (i.e. other than TSR and EPS) continues to rise. Return-based measures account for more than half of 'Other' measures, with the balance made up of strategic measures such as customer satisfaction, free cash flow, sales revenue and comparative cost position.

Three years remains the most common performance period. In contrast, 26% of the ASX100 uses four or five year measures in their LTI plans. This has increased from 17% in FY14, perhaps in response to calls from governance bodies for longer performance periods.

Figure 3: LTI measures in the ASX100



3. Other refers to hurdles including return-based measures, customer satisfaction, free cash flow, sales revenue and comparative cost position.

Allocation methodology

The perceived issue of LTI allocations based on fair value continues to garner attention. The steady trickle of companies switching from a fair value to a face value approach has tipped the balance in favour of face value, with 59% of the ASX100 now using a face value approach. This is a significant swing from 2013 levels, when 75% of organisations were opting for a fair value approach. Given this trend and CGI Glass Lewis changing its policy to include a more explicit preference for face value, we expect to see more companies adopting the face value approach in 2016.

2015 also saw allocation methodologies grab the headlines for other reasons. Arrium, for example, received a significant 'No' vote after shareholders took exception to the allocation of performance rights on the basis of prevailing (weighted average) share price, as per their customary methodology. The sticking point was a rights issue 12 months earlier, in which shareholders invested at a much higher price. The resulting 'No' vote reflected shareholder concerns that management could benefit from a rebounding share price, even while shareholders remained out of pocket on their investment. This experience highlights that business as usual is not always appropriate when it comes to remuneration processes and structures.

Conversely, BHP Billiton took a proactive approach in managing shareholder expectations. The Samarco mine disaster resulted in a significant fall in BHP's share price, with the timing of the fall coinciding with the period that was to be used to determine equity grants. In order to ensure this didn't advantage executives, BHP Billiton calculated the allocation price by holding the share price constant from the day prior to the incident. This resulted in fewer shares being issued than would otherwise have been the case in both the STI deferral and LTI plans.

Long-term incentives (cont'd)

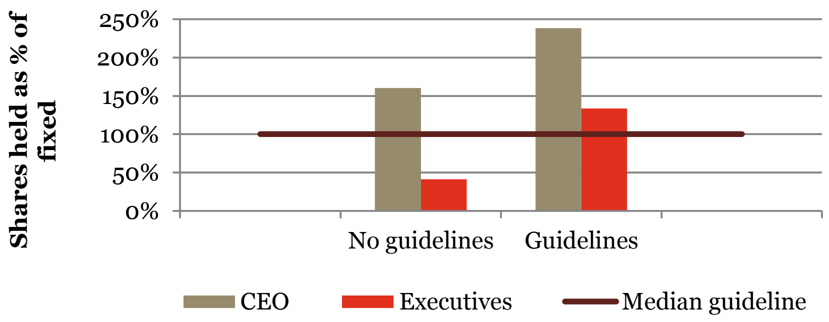
Shareholding guidelines

Consistent with the trend in previous years, the prevalence of minimum shareholding guidelines has continued to grow, with 45% of the ASX100 now requiring CEOs and executives to hold a minimum number of shares, up from 36% in 2014 and 25% in 2013. We anticipate this trend to continue next year.

The median guidelines across both the CEO and general executive populations are consistent, requiring an amount equal to at least 100% of their fixed pay in shares, acquired over a five year period. In practice, where companies operate guidelines for both the CEO and other executives, CEOs are typically held to a higher level of shareholding than their executive counterparts.

Whether or not the guidelines are driving greater shareholding is hard to say, as it tends to be easier for companies to implement such arrangements where shareholdings are already high. Nevertheless, there is a clear difference in the quantum of shares held for executives subject to guidelines, as Figure 4 illustrates. The difference in median shareholding values between ASX100 companies with guidelines and those without guidelines is the equivalent of around 1 year's fixed pay, for both CEOs and executives.

Figure 4: Comparison of current CEO and executive shareholdings median levels and median guideline levels[4]



4. Includes all executives, regardless of start date

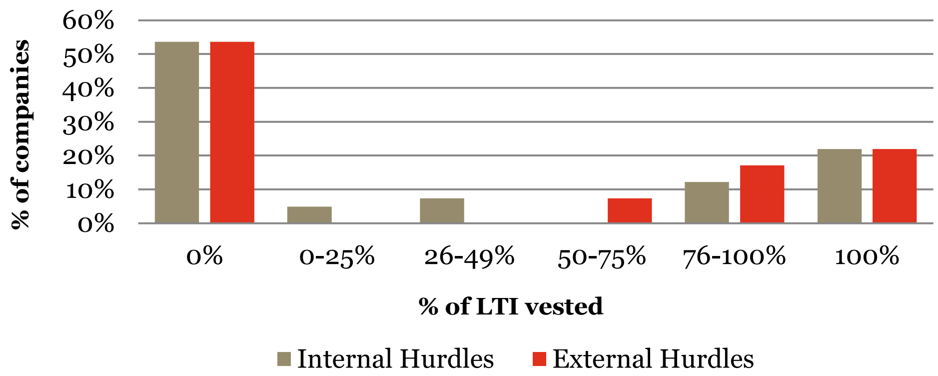
Vesting patterns

As LTIs have evolved in recent years, the use of internal measures (such as EPS) has become much more wide-spread. As a result, companies have been open to potential criticism over the reasonableness (specifically softness) of the performance standards relating to those internal measures. To help understand whether this has indeed been the case, Figure 5 (below) charts the distribution of vesting patterns for both internal and external LTI measures. The sample is drawn from 43 ASX100 companies with dual hurdles.

The findings seem to suggest that Boards have been tough and fair in setting internal hurdles, with vesting levels marginally lower than for the portion of the plan subject to an external measure.

It's a remarkably similar vesting profile that (notwithstanding the small sample size) calls into question the assumption that internal hurdles are a soft alternative to external measures such as relative TSR.

Figure 5: Distribution of Vesting Patterns for LTI Hurdles



Disclosure – Short-term incentives

Few ASX100 companies disclose quality information regarding STI targets and payments

As one of the most controllable, valuable and contentious elements of remuneration, much attention has been given to the disclosure of short-term incentives.

For companies in the ASX100, half disclose only the minimum required information in relation to STI targets and actual performance outcomes. Just one in ten detail how actual performance outcomes compared relative to the STI performance standards set at the start of the year.

The quality of disclosures is greater in the ASX30, where nearly two thirds of companies provide at least an indicative disclosure of performance outcomes relative to target objectives, though 30% still disclose only the minimum requirements.

This suggests that we still have some way to go on the quality of STI disclosures in Australia compared to other countries. In the U.K. specifically, companies are required to disclose the targets set by the remuneration committee at the start of the year, and the level of achievement (and bonus earned) against those targets. And although there is scope for withholding details where commercial sensitivity is a concern (a reason often cited by Australian companies, too), U.K. investors have become increasingly intolerant of such an excuse. The objective of the regulation is to encourage remuneration committees to link pay more tightly and transparently to performance. Whether this has been achieved is arguable, but the result is unquestionably a much greater level of STI transparency than currently exists in Australia.

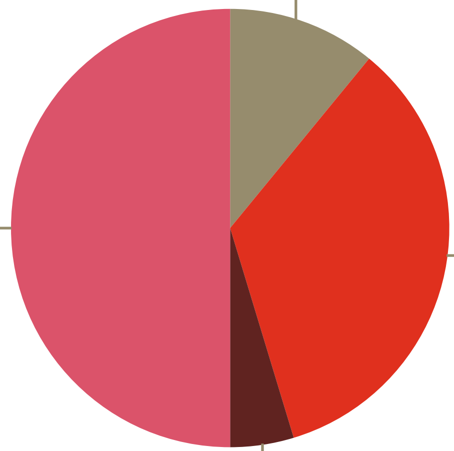
Figure 6: Disclosure of STI Targets in 2015

Minimum disclosure ★☆☆☆

50% disclosed the minimum requirements (ie plan overview and overall payout levels), but did not disclose targets or the actual performance outcomes of key metrics.

Full disclosure ★★★★

11% made a full disclosure of actual performance outcomes relative to short-term incentive performance standards (ie also disclosing target requirements and sometimes maximum and/or threshold).



Performance only ★★☆☆

5% provided a full disclosure of the performance outcomes for STI metrics, but did not disclose detail of how these compared to target requirements.

Indicative disclosure ★★★☆

34% disclosed performance outcomes for STI metrics and gave an indication of whether they were either above, equal to or below target, but did not disclose details of the actual targets.

Disclosure – Remuneration reports

Reports are getting longer, but clearer

Remuneration reports face the challenge of simultaneously satisfying the potentially conflicting needs of different readers: shareholders (retail and institutional), proxy advisors, regulators and the companies themselves. To increase the likelihood of meeting each of their needs, remuneration reports need to be easy to read, digest and comprehend. So how do reports in the ASX100 shape up and what has changed over time?

Compared to 2010, the length of reports has increased, likely due to companies providing more detail to satisfy stakeholders' demands. However, to compensate for this, we are seeing companies putting in the effort to make them more digestible by summarising the content and presenting arrangements visually. Further detail is shown on the right of this page.

Financial Services

In the financial services industry, where stakeholder pressure for greater detail tends to be higher, a similar trend is visible. Reports are longer (a median of 26 pages), but 95% of reports include both an Executive Summary and graphical or tabular depiction of the framework. This reflects the balancing act that companies face: how to provide the detail desired, whilst keeping the report comprehensible?

Increasing length

The median number of pages has increased from 15 to 20 per report. There is, of course, significant variation, but half the reports are between 15-25 pages.

The median number of words has increased 27%, from 6,200 to 7,900. Half the reports have between 5,500-10,000 words.

Reducing complexity

71% of reports included an Executive Summary to cater for readers who want an overview of reward and performance, an increase from 42% in 2010.

75% of reports provided a graphical or tabular depiction of the remuneration framework compared to only 50% in 2010, again in an effort to reduce the amount of time readers require to understand the framework.

The median number of visual representations has increased from 1 to 3 (ie graphs, descriptive tables, graphics, etc.) since 2010.

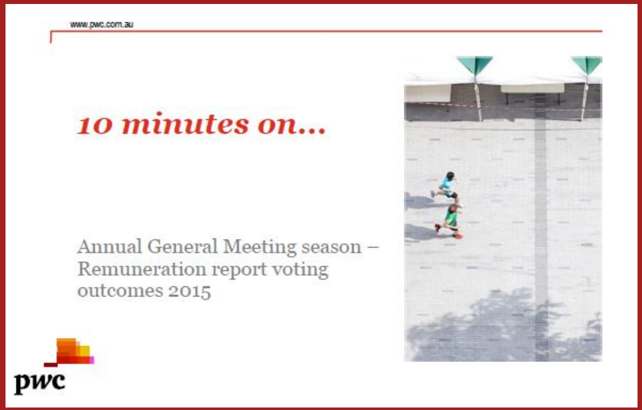
Outcomes from the AGM season

The FY15 AGM season generated a number of headlines, but the overall voting patterns were similar to recent years

Of the ASX200:

- Seven companies received first strikes against their remuneration report (i.e. "No" votes above 25%), compared to six in 2014. There were only two companies in the ASX100 who received a strike, which was unchanged from 2014.
- The median percentage of votes cast against the Remuneration Report was well below the 25% threshold for a strike, at 2.8% per company (up from 2.4% in 2014 on a like-for-like basis).
- One third of companies experienced an increase of at least 1% in their "No" votes relative to the previous year.
- To date, no ASX200 companies have received a second consecutive strike (i.e. the trigger for a vote on all directors' Board positions).

Refer to our most recent "10 minutes on the 2015 AGM season" for more details, available **here**.



Shareholders are looking for continuous improvement and have voted "Yes" where there is clarity and consistency in an organisation's approach to remuneration

Where there were significant "No" votes, the reasons were typically as follows:

- Limited disclosures around STI measures, weightings, performance standards and the use of discretion.
- Internal LTI measures (such as EPS) that were perceived as having inadequately stretching performance hurdles.
- Payments that were not linked to performance, in particular large fixed pay increases or retention payments.
- Adjustments/discretion applied that were perceived as favouring executives relative to the experience of shareholders.

Outlook for 2016

A falling market could make FY16 a particularly difficult year for companies as they try to strike the balance between executive engagement and shareholder alignment

History shows that when a company's performance falls, the scrutiny on remuneration outcomes increases. With the ASX200 down more than 10% in FY16 at the time of writing, shareholders may not be in a forgiving mood at year's end. Companies will therefore need to be careful to ensure reward outcomes are well explained and fully defensible.

Fixed pay

Pay freezes for CEOs have become less common in FY15. If current market conditions persist, though, we expect to see the proportion of CEOs and executives not receiving a salary increase to return to around a third, consistent with prior years. More bullish companies are likely to settle for the new norm of 2 – 3% increases. High-end exceptions will be a risky proposition and will probably become less common.

Incentive pay

Scrutiny on the true "variability" of incentives continues to grow, particularly amongst companies who show questionable consistency in KMP bonus levels from year to year. In this context, and especially if harrowing share market conditions continue, there will be high expectations that incentive outcomes will drop in accordance with the shareholder experience. Some Boards may choose to intervene to achieve this alignment, for example where TSR has been deeply negative but relative TSR would otherwise trigger vesting, or where STI has emphasised qualitative over financial measures. Companies should avoid surprising executives or shareholders with such adjustments if at all possible.

Share-based pay

As foreshadowed last year (here), new legislation relating to employee share plans came into effect on 1 July 2015. The legislation now allows for tax deferral on share rights without the need for a real risk of forfeiture. This approach is particularly useful for companies adopting minimum shareholding guidelines and we expect to see more companies take advantage of the new rules during 2016.

How can PwC help?

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

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