10 minutes on...

Executive remuneration trends – serenity now

pwc

February 2015

Highlights

- In an ongoing period of pay restraint, executives are seeing modest increases slightly above the inflation rate. The median fixed pay increase for same incumbent CEOs and executives was 3%, with one third not receiving any increase
- Bonus payments are fairly consistent with the prior year, with almost half of executives (43%) receiving an actual short term incentive (STI) pay-out at or above target
- There was a further increase in STI deferral practices, with the vast majority of companies now having a deferral plan in place
- The prevalence of minimum shareholding guidelines jumped from 25% to 36% of the ASX100, indicating growing support for further focussing executives on shareholder interests.
- Unfavourable remuneration report voting remains rare for ASX 100 companies. There were a handful of significant 'no' votes amongst the broader market, some of which were driven by factors not directly related to remuneration (e.g. board composition, governance)
- Even so, companies are spending a significantly greater amount of time and effort on disclosures to explain the rationale for STI, particularly in articulating the link between pay and performance at both an individual and company level
- While the growth of executive fixed pay is likely to remain relatively subdued in FY15, we expect to see more companies review their structures in an effort to simplify. The new tax rules on Employee Share Schemes are likely to see the return of some equity reward structures that had fallen out of favour.

Summary

FY14 saw some further tinkering with reward structures, but continued efforts to exercise pay restraint and to maximise favourable Remuneration Report voting tended to result in a standardisation of pay practices across industries.

Core executive remuneration practices were stable in FY14. Companies appear to have reached a point of equilibrium with shareholders, with a high degree of support being demonstrated for remuneration reports through AGM voting outcomes and companies continuing to adopt predictable remuneration designs and pay increases.

For those companies making changes, most are triggered by internal drivers. These companies have made changes to enhance the impact of the remuneration structures by better aligning rewards with key value drivers. This is particularly evident for STI programs, for which disclosure of both financial and non-financial performance measures, and the links to past performance, is improving.

A push to allocate LTI using face value is causing much deliberation amongst Board members. While fair value allocations have some technical advantages (including alignment with accounting and disclosure requirements), concerns include the potential to over allocate and the general complexity of fair value. This complexity is a particular concern, as it causes many participants to disengage with their incentive, and can rankle third parties for whom valuation assumptions are unclear. Regardless, this debate has not yet translated into any significant changes in practice.

Broader and increasingly vocal concerns about the complexity of remuneration arrangements and remuneration disclosures are not leading to many other changes, as companies are currently prioritising transparency and market alignment.

Fixed pay and total pay movements

Following some "corrections" to pay levels in FY13, most executives saw modest pay increases in FY14

For the same incumbent executives in the ASX 100[1] (ie those executives who remained in their role from FY13 to FY14):

- Median fixed pay increased by 3% for CEOs and executives.
- Median total target pay [2] increased 7% for CEOs and executives, driven primarily by increases in LTI.
- 35% of CEOs and 30% of executives did not receive any pay increase. Although this is lower than FY13, it reflects the increasing tendency to abandon the practice of year-on-year increases for executives.

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

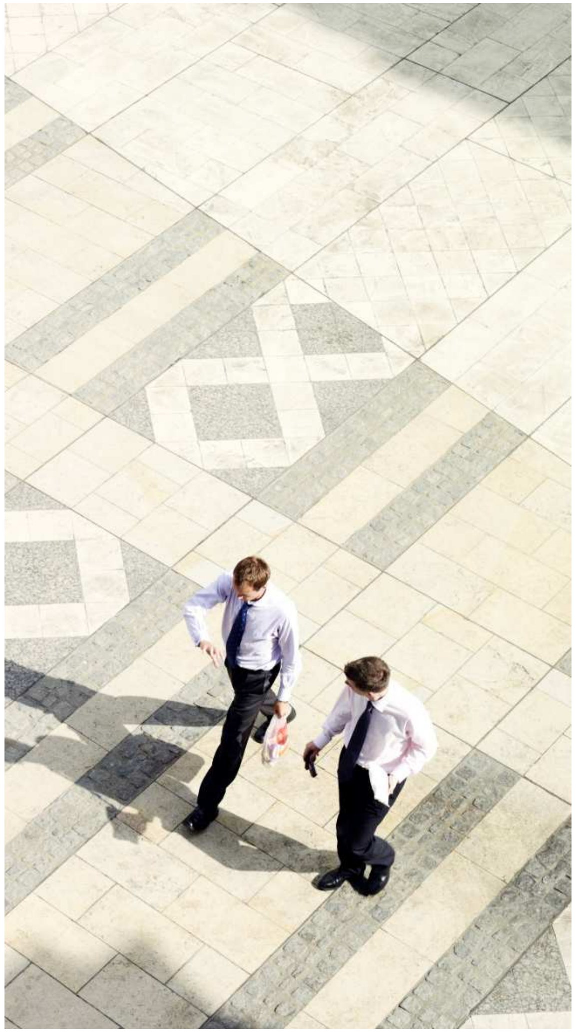
- Median fixed pay increased by 2% for CEOs and less than 1% for executives. For CEO roles, this reflects a return to normality following significant fixed pay decreases in FY13. For individual companies however, many are still comfortable appointing new CEOs at lower fixed pay than their predecessor.
- Median total target pay increased by 3-4% for CEOs and executives, driven primarily by an increase in LTI for executives and STI targets for CEOs.

1. Based on those executives whose remuneration is disclosed in annual reports
2. Based on LTI being calculated on a fair value basis

For CEOs and executives who did not change roles, median fixed pay increased by 3% and total target pay increased by 7%

Median fixed pay increased by 2% for CEOs and less than 1% for executives, while total target pay increased 3-4%

Approximately 1/3 of CEOs and executives did not receive a fixed pay increase



Short-term incentives

Companies continued to refine the performance and reward linkages in their STI plans, and have made them increasingly transparent

In FY14, 43% of executives received actual STI that was at or above their STI targets, matching FY13 outcomes (Figure 1). Not everyone got a piece of the pie, though, with 9% of executives receiving no STI in FY14.

Boards appeared to increase their efforts to articulate the link between STI pay and performance. In Remuneration Reports, explanations increasingly emphasised performance relative to peers, the impact on shareholder wealth, and how pay and performance outcomes compared to prior year results.

For STI plan design, the increased use of non-financial measures has continued a trend that started around the GFC. The average weighting for non-financial metrics has grown from 33% to 46% over this time, and has seen the incorporation of more behavioural, customer and sustainability measures.

Disclosure of clawback policies has also increased, which could be partly attributed to recent updates to ASX Corporate Governance guidelines, requiring companies to disclose any policy around the reduction, cancellation or clawback of performance based pay.

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

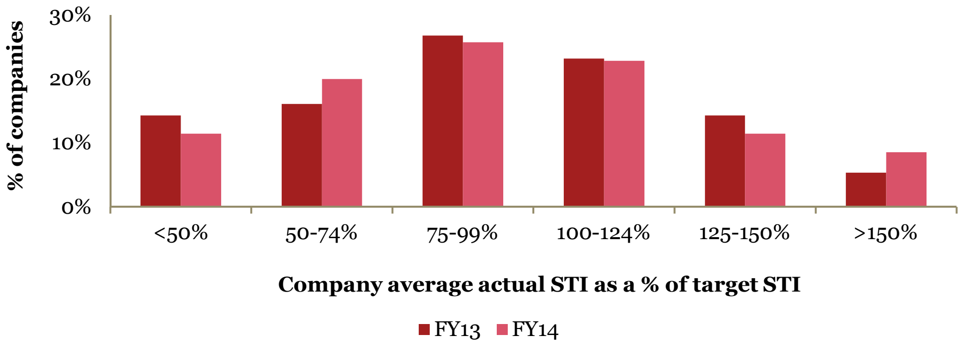


Figure 2: STI deferral period in the ASX100

% of companies		ASX 100 deferral period				
		1 year[2]	1-2 years[3]	2 years	3 years	Other period
Proportion deferred	20% - 30%	7%	7%	7%	2%	
	33%	7%	2%	13%	5%	
	34% - 49%		2%	4%		
	50%	9%	7%	16%	4%	
	Other[4]	4%				4%

1. Of those companies that had STI deferral in FY14.
2. This includes one company that has a deferral period of 1.3 years
3. This refers to 50% vesting after one year, 50% vesting after 2 years.
4. This refers to deferred amounts not disclosed or amounts other than 20-50% of the actual STI.

The prevalence of STI deferral in FY14 has increased by 15% to 70%, while structure of deferral has remained consistent: 50% deferral for 2 years continues to be the most common approach (Figure 2).

STI deferral continues to increase in prevalence, with 70% of executive STI programs requiring some level of deferral

The average weighting of non-financial metrics has grown from 33% to 46% since the GFC

Long-term incentives

Continued tinkering, but simplification remains elusive

Through FY14, we found significant enthusiasm amongst Boards and management to revisit LTI programs with a view to simplifying structures and improving strategic alignment. For the most part, though, changes were fairly cosmetic. The mix of performance measures used in the market has not changed considerably (refer to Figure 3) but there has been a gradual uplift in the adoption and consideration of return measures (such as ROE, which represents almost a third of the Other measures) and some less conventional financial and non-financial measures. This reflects a growing willingness by Boards and shareholders to better align LTI programs to strategy including measures such as customer satisfaction, free cash flow, sales revenue, reserves growth (resources), and comparative cost position.

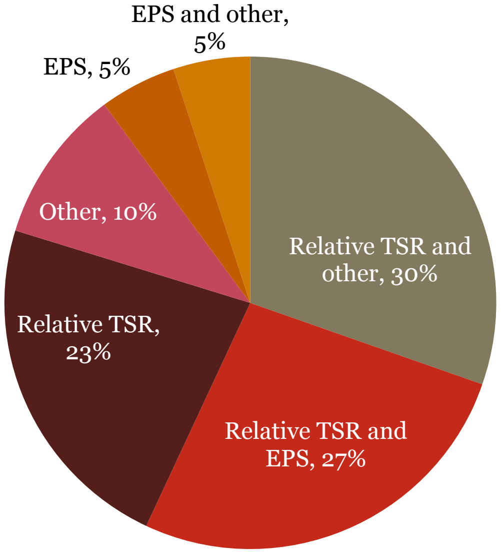
These arrangements often carry with them challenges around target-setting and commercial sensitivity. And depending upon structures, they can also add to complexity. So although there are many calling for simpler reward structures, the trend is currently the other way. Perhaps this will be reversed by the growing awareness of the performance-on-grant LTI models that are sometimes adopted in countries such as the UK in order to simplify executive remuneration structures, or more companies experimenting with blended STI/LTI structures.

In the meantime, there appears to be a slight drift in emphasis towards LTI in overall target pay mix, at the expense of fixed pay and STI. This is consistent with calls from proxy advisors for greater emphasis on long-term remuneration that aligns with shareholder outcomes.

The return of options?

Treasury has released exposure draft legislation on proposed amendments to the employee share scheme (ESS) tax rules. One of the key changes is likely to make the use of share options a more viable alternative in constructing LTI programs. But share options are not appropriate for many companies, so their resurgence is unlikely to be widespread. Refer to page 8 (Outlook) for further details.

Figure 3: ASX 100 LTI hurdles



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

Shareholding guidelines

The prevalence of minimum shareholding guidelines continues to grow, up from 25% last year to 36% of the ASX100 in 2014. The median guideline is for executives to hold 100% of their fixed pay in shares, acquired over a 5 year period. For CEOs, it is 150% of fixed pay over 5 years.

Although rarely enforced, minimum shareholding guidelines are increasingly being favoured by companies as a way of encouraging the alignment of executive and shareholder interests, in its simplest form. In some cases companies are reinforcing the guidelines with mechanisms aimed at driving the gradual accumulation of vested shares.

Long-term incentives (cont'd)

Fair value vs face value: the debate continues

A key topic of discussion in recent years has been the practices used by companies to determine LTI grants. In April 2014, ISS released a report suggesting the use of fair value for allocation purposes led to inflated LTI grants. ISS has been vocal about its scepticism regarding the use of fair value as an allocation approach. In June 2014, Credit Suisse released a report highlighting their disapproval with allocating equity using the fair value methodology. Their rationale was that the discount applied due to having performance hurdles results in an over-allocation of LTI grants, and a misrepresentation of the size of the LTI grant. They also argue that the fair value approach is less transparent, and makes pay comparisons more difficult as companies use different assumptions.

The discussion has caught the attention of Boards and other proxy advisors. Amongst the latter, Victorian Funds Management Corporation is updating its proxy voting policy guidelines, stressing that it would put greater scrutiny on companies' disclosures of how LTI allocations are determined.

In our view, fair value remains a useful means of undertaking relatively like for like benchmarking comparisons (assuming reasonable fair value assumptions for both market and non-market performance measures). We believe that fair value remains relevant because:

1. fair value is a valuation approach based on accepted methodologies and is consistent with the accounting standards
2. companies that use the face value approach inevitably adjust LTI values to account for the perceived (and in some cases real) lesser value
3. there are numerous examples of LTI awards that have been granted under the fair value methodology but have not vested

However, for disclosure purposes and internal executive communications, fair value is open to misunderstanding. Instead, describing LTI allocations in terms of face value (either instead of or in addition to fair value) is likely to prove simpler, and more meaningful, particularly with respect to clarifying the maximum possible vesting value. For many companies, though, fair value is an established and well-understood methodology – used appropriately and consistently it should not result in over-allocations, and a change in methodology may only add to confusion.

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Outcomes from AGM season and shareholder landscape

The FY14 AGM season saw a reduced number of strikes in the ASX 200: ASX100 remuneration reports had two strikes (matching FY13 results); and ASX 101-200 companies had four strikes (seven in FY13). Notably, strikes have not led to shareholders supporting a Board spill in any instance since the introduction of the "two-strikes" rule in 2011

While the attention on broader governance concerns has increased at AGMs over the past few years, reasons for strikes or large "no" votes against FY14 remuneration reports continued to centre around quantum of executive pay (illustrated far right). Pay quantum is not the only shareholder concern however. A handful of ASX200 companies narrowly missed a strike in FY14, with some of these voting pattern clearly being driven by factors not directly related to remuneration (e.g. Board composition or governance).

Companies receiving a strike in FY14 provided mixed responses. While most committed to addressing the underlying issues, some declared remuneration structures would remain unchanged despite significant criticisms.

There were no second strikes against FY14 remuneration reports in the ASX200. Several ASX200 companies that received a first strike in FY13 actively sought feedback from investors and proxy advisors, resulting in changes such as:

- exercising pay restraint by freezing executives' fixed pay and/or reducing incentive opportunities e.g. for new appointees
- adjustments to performance hurdles and associated targets
- improving the level and quality of remuneration disclosures
- reducing termination payments
- appointing additional independent directors to the remuneration committee.

Key reasons for strikes

The total pay package (including sign-on bonuses) paid to a new CEO viewed as excessive

Termination payments viewed as excessive

Large pay increases misaligned to market levels and viewed as unjustified on the basis of company underperformance

Pay mix lacking focus on long-term performance

Outlook for FY15

Fixed pay

The growth of executive fixed pay is likely to remain relatively subdued. Most of the market will probably return to more predictable year on year growth of around 2 - 3%, with pay freezes becoming more prevalent in those industries facing the greatest economic headwinds (mining, resources and property). New hires will probably claw back some of the bargaining power that they have lacked in recent years, as Boards grapple with the disclosure risks associated with “catch-up” increases (ie pay increases that are required to bring “underpaid” executives up to market levels of pay).

Incentive pay

There is still an appetite for simpler incentive structures, and we expect to see more companies experiment with blended STI/LTI structures below the CEO’s direct reports. Structures for disclosed executives will likely remain fairly stable for the immediate future, but there may be pockets where companies are willing to adopt bolder structures in line with countries like the UK e.g. performance on grant models. We also expect disclosures will continue to provide greater clarity around retrospective performance relative to targets.

Share based pay

New legislation, a draft of which was released on 14 January 2015, could trigger a number of changes to the share based remuneration landscape:

- The use of **Options** is likely to creep back into favour in some companies, namely those with relatively high growth prospects or those who have foreign parents with existing option-based schemes.
- For companies who would prefer to stick with **Performance Rights**, they may choose to introduce choice around the time that rights are converted to shares (much like a zero-priced option). This will enable employees to choose the timing of when tax is calculated.
- More generally, we may see the re-emergence of **salary and bonus sacrifice into shares**. The draft legislation provides for the deferral of tax on vested but restricted rights, even where there is no risk of forfeiture. This would allow employees and directors to choose to receive non-forfeitable rights in lieu of salary or bonus, which could provide a valuable means of building up shareholdings and alignment to shareholders. Many companies had such arrangements in place under earlier laws, and are likely to embrace the opportunity to revive the practice.

Refer to separate 10 minutes publication for more details, released 21 January 2015

How can PwC help?

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

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