GRG

Remuneration Review

Godfrey Remuneration Group Pty Limited, ABN 38 096 171 247,
Level 9, 56 Berry Street, North Sydney NSW 2060 Phone (02) 8923 5700
Website: www.godfreyremuneration.com

Strike Back On LTI Vesting Conditions

Author: Denis Godfrey and James Bourchier

Remuneration Review No 36, February 2012

Introduction

Over the next few months boards will, in the context of the "two strikes" shadow, be reviewing many aspects of key management personnel (KMP) remuneration including:

- whether executive Base Packages and/or non-executive director fees need to be increased to maintain or improve market competitiveness,
- what key performance indicators (KPIs) should be used for the short term incentive (STI) plans and what weightings and standard of performance should be applied to those KPIs given the business plans and value drivers for the next year, and
- determining the numbers of shares, rights and/or options that will be granted as the long term incentive (LTI) for the next remuneration year and what vesting conditions will be attached to them.

Those companies that received significant adverse voting on their Remuneration Reports may need to undertake fundamental reviews of their remuneration strategies and incentive plans. Others will simply need to ensure that their remuneration strategies are appropriate to their circumstances, take account of external guidelines, adhere to good corporate governance standards and ensure clear communication of alignment between incentives and performance relative to business strategies.

Of the foregoing the one area with which most companies seem not to be satisfied is the metrics used for vesting of LTI grants. This paper seeks to go back to basics with a view to finding a better way forward.

What is the Role of LTI Plans

An LTI is a component of executive remuneration. It aims to link LTI rewards with good company performance over the longer term which is often regarded as three or more years. Thus, assessing "good company performance" is the critical issue to be taken into account for LTI purposes. Since the LTI is rewarding executives it follows that the reward should be for what they have done or contributed to and not for aspects over which they have no control or influence. Another aspect to be considered is from whose perspective should "good company performance" be judged. Since shareholders are the owners of the company and may vote on the Remuneration Report it seems logical that "good company performance" should be judged from their perspective.

Measuring Good Company Performance

Good company performance can be assessed with both internal and external measures.

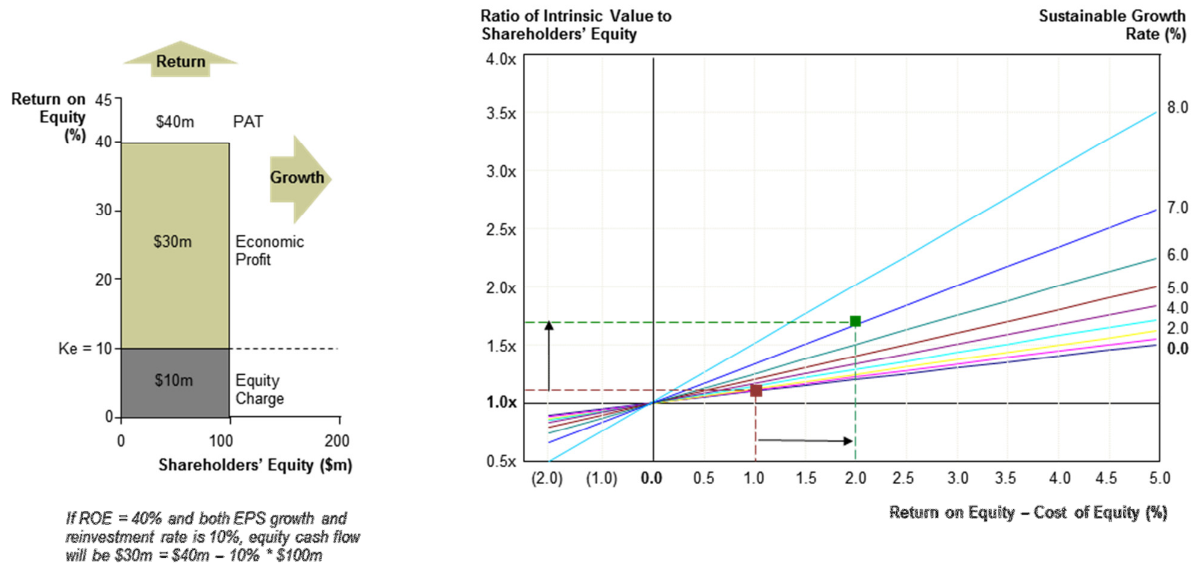
Internal Measures of Performance

The best internal measures are those that capture the drivers of the intrinsic value of the company. The fundamental driver of intrinsic value is expected free cash flow which is simply profit less reinvestment. Dividing profit and reinvestment by the capital employed gives us the two most easily understood drivers of intrinsic value, namely expected return on capital (or equity) and expected growth in the capital (or equity) base on which the return is earned.

Most managers relate easily to these two drivers, particularly when they realise that if returns are constant, growth in equity capital (reinvestment rate) and growth in earnings (EPS growth) are the same.

The graphs below illustrate how this works.

- The left hand side illustrates the impact of actual returns and growth on profit.
- The right hand side shows how different combinations of expected return (horizontal axis) and growth (coloured lines) give different value outcomes. It reveals (on the vertical axis) the extent to which management has added value to the funds entrusted to them by shareholders.



So the best way to measure company performance internally is with an appropriate combination of both return and growth measures, such as with ROE and EPS growth (EPS growth alone is an insufficient measure of performance and may lead to inappropriate behaviour). Some companies use these measures because:

- executives have more control over them,
- ongoing performance can be easily monitored, and
- they should lead to improved returns for shareholders by driving up the intrinsic value of the company.

External Measures of Performance

The most frequently used external measure is total shareholder return (TSR) measured either absolutely or relatively. TSR is the return that investors receive on the market value of their investment. Over a specific period, it is defined as:

$$TSR = (\text{Share Price}_{end} - \text{Share } Price_{begin} + Dividends\ Over\ Period) \,/\, \text{Share } Price_{begin}$$

The common feature of both internal and external measures of performance is that the ultimate objective is to encourage executives to focus on enhancing the value of the company.

Comment

When deciding on whether to use internal or external measures, consideration needs to be given as to whether it is more appropriate to reward success in relation to factors that "should" generate value for shareholders – or factors that reflect the shareholder value actually created. In terms of communication with shareholders and linkages to incentives, the latter will clearly be easier to explain and justify. Thus TSR does appear to be the obvious measure of company performance. However, both absolute and relative TSR measures have been found to be flawed measures of company performance.

Improving TSR - Adjusting TSR for Underlying Market Sentiment

TSR is influenced by three main factors being changes in:

- underlying market movement,
- company specific sentiment, and
- the intrinsic value of the company.

The underlying market movement is influenced by systemic factors which are often international and include interest rates and conflicts which are outside the influence of executives. Therefore, it would not be logical or fair to reward or penalise executives for the impact of these changes on TSR.

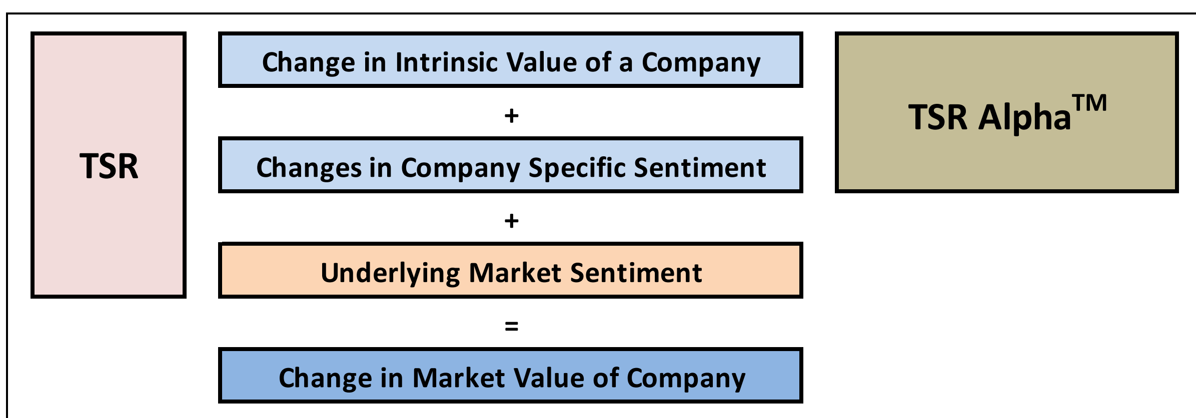
Company specific sentiment and intrinsic company value are interlinked in that the objective of boards and management should be to achieve an outcome where company specific sentiment recognises and supports the intrinsic value of the company. However, at any point in time companies will experience different biases in terms of company specific sentiment. Managing that sentiment should be recognised in assessing performance.

The factor over which executives have most influence is the intrinsic value of the company and it is for increases in this value that executives should be mainly rewarded.

Absolute TSR is generally not a good measure of company performance as it does not adjust for market movement over the measurement period. Thus, if an absolute TSR target were set with reference to the long term required rate of return of 12% then this may be too challenging or too easy to achieve depending upon the underlying market movements that prevailed over the measurement period.

Relative TSR is generally a better measure of company performance than absolute TSR because it broadly recognises underlying market movement. However, it does not recognise the company specific sentiment which will heighten or dampen the underlying market movement impact on the TSR of a specific company. It also does not adequately take account of the fact that, during a measurement period, companies will not be directly aligned in terms of the timing of the adoption and implementation of new value creation strategies.

A new TSR metric called TSR Alpha™ modifies the calculation of TSR so as to exclude the influence of underlying market sentiment. The relationship between TSR and TSR Alpha™ is illustrated in the following diagram.



Communicating With Shareholders

A clear advantage of using TSR Alpha™ as the metric for vesting of LTI grants is that the section of the Remuneration Report which covers company performance can be aligned with the section which deals with vesting of LTI grants (and the company performance part of STI awards). Ensuring that shareholders understand that the vesting of LTI grants is appropriate, given company performance over the vesting period, will be critical in the next round of "strikes".

Key Management Personnel Remuneration Advice

GRG is a specialist advisor on remuneration for key management personnel (KMP) i.e. non-executive directors, executive directors and other top executives. To facilitate its independent advisory function GRG maintains two remuneration databases with one concentrating on non-executive directors and the other on top executives. This data analysis allows GRG to remain up to date with current trends and developments and to be able to benchmark company practices against market practice. The increased focus being placed on KMP remuneration makes it more important than ever for Boards to be satisfied that they are adopting practices that are consistent with market practice and appropriate to their company's circumstances.

If you would like an independent review of the market competitiveness of your company's remuneration practices for KMP then GRG will be pleased to assist. Please call Denis Godfrey or James Bourchier on (02) 8923 5700 or Mike Carroll on 0416 226 131.