

Company Aligned New Incentives

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INTRODUCTION

In December 2012 Blackrock released a paper titled “Time to Rethink Executive Incentive Programs”. It was critical of many incentive plans being used for executives who are key management personnel (KMP). The criticism focussed on the similarity of plan types and vesting conditions particularly for long term incentive (LTI) plans. The similarity was seen as suggesting that companies were not designing incentive plans to suit their specific circumstances. Blackrock cited Macquarie Bank’s incentive plans as an example of incentive plans designed to align with the company’s specific circumstances – see later for more details. It also observed, not surprisingly, that many executives preferred fixed cash over incentive remuneration. In our view executive remuneration should not be about the preferences of executives but about what drives performance maximisation.

Since the Blackrock paper was released a small number of companies have indicated that they are trying different approaches or are looking for viable alternatives to current standard practice. The majority seem to remain committed to using plans and vesting conditions that are tried and tested and will meet with proxy advisor support and endorsement by shareholders, even if they are not specifically tailored to their company’s circumstances.

This paper discusses three examples of companies that have or are considering adopting different approaches to KMP incentive remuneration. It is important to realise that one size does not fit all. Thus, companies will need to consider critically what best suits their needs and can be explained to shareholders and proxy advisors. In this regard it should be noted that many superannuation funds are taking back voting on shares acquired with monies they have placed with funds’ managers.

Following are examples of companies that have adopted approaches that are not totally standard. It should be noted that any comments made on these plans are not made with regards to whether or not they are appropriate to the specific circumstances of the company, but are broad comments on the plan style.

MACQUARIE BANK LIMITED

Outline

The annual incentive plan is based on company, business unit and individual performance. It starts with a formula for determining an annual incentive pool (AIP). The AIP is calculated as a percentage of profits over and above the cost of capital for the year. While Macquarie refers to net profit after tax (NPAT) and return on equity (ROE) above the cost of capital it seems like they are referring to a variation of Economic Profit (EP). EP is broadly calculated as NPAT less a charge for shareholders’ funds as at the beginning of the financial year.

The AIP is then divided among divisions having regard to the performance of the divisions in terms of contribution to the company’s EP, risk management, and the Board’s view of the performance of the divisions including adherence to company culture and values.

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Each division then divides its share of the AIP among its executives having regard to contribution to EP, risk management and compliance, people leadership and adherence to company culture and values.

A large portion of each person's share of the AIP is deferred into shares and/or into funds operated by the Bank, if the person's performance affects the performance of the fund(s). The deferred part vests over a long period and is at risk of forfeiture if service and performance conditions are not satisfied.

Executives may also be granted performance share units (PSUs) as a long term incentive. The PSUs vest based on earnings per share growth (EPSG) (50%) and relative ROE (50%), over a measurement period of 3 to 4 years.

Comments

The foundation of this approach is that the Bank consistently produces returns that are in excess of the cost of equity capital i.e. it consistently produces EPs. Many ASX listed companies also consistently produce EPs although the levels of those EPs may be less than those produced by the Bank. For companies that produce EPs there would seem to be scope to adopt incentive plans that have similar characteristics to the Macquarie Bank incentive plans.

By deferring a large part of the incentive into shares it is ensured that executives have a strong interest in the long term health and prosperity of the Bank. Retention of key executives will be strong due to risk of forfeiture of the deferred component, if the executive resigns. That a large part of the incentive is deferred need not cause a retirement benefit limit problem for KMP provided that appropriate approaches to the type of securities and vesting conditions are applied.

The inclusion of an LTI to complement the STI provides balance and focus on delivering value to shareholders over the medium to long term. The EPSG metric is commonly used and ROE is rarely used but is a sound metric provided equity is also growing.

SEEK LIMITED

Outline

An article written by Colin Carter, a non-executive director of SEEK, published in the Australian Financial Review on the 11th of March 2013 outlined a new approach to executive remuneration to be adopted by SEEK.

Under the new approach the fixed remuneration of executives would be set by reference to market data for the total of fixed remuneration and short term incentives (STIs) actually paid. Two-thirds of the amount is to be paid in cash and one-third in shares with a 2 year lock. Executives will also be provided with an annual LTI grant of options with a value equal to one third of the fixed remuneration. The options will have a premium indexed exercise price set by reference to the share price at the time of grant and average market movements over the previous 10 years. The options will have a term of 3 years and shares acquired by exercising the options must be held for another year.

Comments

In effect SEEK will be converting the STI into an annual grant of shares with no regard to annual performance. The number to be granted makes no reference to performance and unless the share price falls to nil, some benefit is guaranteed.

Depending upon how the fixed remuneration is reported it has the potential to appear high and put pressure on market competitive levels of fixed remuneration.

It appears that the options will have no real risk of forfeiture and therefore will be taxed at grant. The taxable value of the options should be small as the exercise price premium should result in a small taxable value.

However, if the options are not exercised then the loss will need to be offset against capital gains as the taxed value cannot be reversed. If the taxable value for executive is nil then the company will be liable for fringe benefits tax on the market value of the grant.

By calculating market movement over a 10 year period the impact of the global financial crisis will constrain the amount of premium, possibly making it less challenging than it may otherwise appear.

TATTS GROUP LIMITED

Outline

The new approach involves discontinuation of a separate LTI plan and deferral of part of STI awards for KMP into Rights.

The STI has a target level determined by reference to the excess of a P50 total remuneration package (includes Base Package + STI + LTI) over a P50 Base Package for the role. For this amount of incentive to be available the current year's revenue must exceed the prior year's revenue by 7.5% or more. If lower revenue is achieved then the available STI award is reduced and if below 98% of the prior year's revenue no incentive is available.

The available STI is then factored up or down having regard to percentage changes in Group earnings before interest and tax (EBIT) margins and earnings per share (EPS). 40% of the resultant amount is automatically earned and the remaining 60% forms part of a pool that is distributed via Group SBUs and Divisions to individuals. Various factors including individual performance are taken into account in determining these levels of distributions.

For KMP the awards are paid partly in cash and partly in rights to shares which vest after 12 months of service and are then converted into restricted shares which may not be sold for another 2 years.

Comments

It would be rare for it to be reasonable to base an incentive plan on growth in revenue. In fact ASX Listing Rule 10.17.2 prohibits an executive director's salary from including a commission on, or a percentage of, operating revenue.

Both the EBIT margin and EPS metrics do not take account of the amount of capital employed in the business and growth in these metrics does not necessarily mean that shareholder value is being increased. They are directionally correct but incomplete metrics and therefore may lead to decisions that produce sub-optimal shareholder value.

As the main performance focus is on annual results the plan may lead to short-termism.

By deferring part of annual awards into rights and then shares there is some alignment of executive and shareholder interests. However, there is no incentive to strive for outstanding shareholder returns as vesting of rights is not subject to long term company performance. By delivering deferred STI awards in rights and shares which are not performance tested there is a risk that executives may be more motivated to minimise risk to avoid loss of share value than to pursue growth in share value but engaging in responsible risk taking.

CONCLUSIONS

Of the three examples the Macquarie Bank structure would appear to be most likely to be appropriate to a broad range of other companies. The following should be noted:

1. The basis for calculating the STI incentive amount is EP. This is a particularly useful metric because by achieving sustainable growth in it there will be an increase in the intrinsic value of the company. The intrinsic value of a company may be calculated as the total of the value of shareholders' funds and the

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capital value of future EPs. This may also be thought of as the value of a company being equal to the value of the shareholders' funds when the required rate of return is being achieved on those funds but less when the return is less and more when the return is more. Over time, shareholder value will be increased when the intrinsic value of the company is increased.

2. EP has the advantage that, unlike total shareholder return and earning per share growth, it can be calculated at divisional, business unit or customer segment levels.
3. Returns need to be considered in the light of the risk to which the company is exposed in producing those returns. Risk may take many forms. A common risk element is gearing and along with other risk elements, it needs to be taken into account when determining the amount of incentives to be paid. Excessive risk taking should not be rewarded.
4. Deferral of part of STI awards into rights/shares is desirable to create a performance tail whereby executives will suffer through reduced value if the performance that gave rise to the incentive has negative longer term implications and vice versa.
5. The STI is balanced with a LTI which vests over a measurement period of 3 to 4 years.
6. By having 50% of the vesting of the LTI based on relative ROE the LTI is correctly focussed provided that equity capital is not reducing.
7. One criticism of profit share type plans is that the motivational impact is diluted due to a lack of clarity around the benefit that will be available relative to different levels of performance. For this reason it is important to calculate expected threshold and target outcomes so that they may be communicated to incumbents and provide clarity around rewards for performance at the company, business unit and individual level. Often this step is not taken and the outcomes may appear somewhat random to participants which is not desirable for an incentive program.

While the Macquarie model may be adaptable for many companies there will also be many companies where it is not suitable. Thus, it should not be adopted without critical analysis and consideration.

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, meaning that we are truly independent.

To facilitate its advisory function GRG maintains Australia's largest KMP remuneration database with over 1,000 companies and over 6,000 incumbents. The analysis this allows keeps GRG up to date with current trends and developments and enables us to produce specialist benchmarking as well as broad remuneration guides.

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, and to communicate remuneration decisions clearly and effectively.

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. We can also assist in communication strategies, drafting of Remuneration Report disclosures, resolutions related to remuneration, incentive plan rules and engaging with stakeholders to manage strike risks. Please call Denis Godfrey, or James Bouchier on (02) 8923 5700 or Nicholas Jackson on (03) 9607 1318 for further information.