GRG

Remuneration Review

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Preliminary Observations on "First Strikes"

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Remuneration Review No 35, January 2012

Introduction

The recent round of annual general meetings (AGMs) saw a number of companies receive their "first strikes" (25% or more negative votes) on their Remuneration Reports. Also many companies that did not receive a "strike", nevertheless received significant negative votes on their Remuneration Reports causing them concern about possible voting at next year's AGM.

GRG intends to undertake a detailed analysis of voting on Remuneration Reports once the AGMs for companies with December 2011 year ends have been completed. However, a number of observations have emerged from the limited analysis undertaken to date and these are discussed below.

Low Proportion of Total Votes Cast

In some companies the proportion of total votes that were cast was a small percentage of the total number of shares on issue. This was partly because key management personnel (KMP) and their closely related parties are prohibited from voting on Remuneration Reports. This prohibition extended to voting of undirected proxies by Board Chairs who, of course, are KMP. Going forward it is understood that the Federal Government is to change the legislation to allow Board Chairs to exercise proxies when shareholders provide express authorisation for the Board Chair to exercise the proxies. Boards will need to ensure that proxy forms for next year's AGM are structured so as to expressly authorise Board Chairs to exercise proxies related to the Remuneration Report.

When a low percentage of votes are cast a consequence can be that a small minority group of shareholders may be able to generate a "first strike". If this minority group's views are unrepresentative of the broader shareholder population then the "first strike" would be unwarranted and inappropriate. Further, if the small minority group were motivated by factors unrelated to the Remuneration Report then this would be an abuse of the Remuneration Report voting process and this has already been observed.

In the future the main reason for a small percentage of available votes being cast is likely to continue to be that shareholders have neglected or refrained from either voting their shares or providing proxies to another person such as the Board Chair. So as to avoid low percentages of total votes being cast on Remuneration Reports, boards may need to be more proactive in their communications and engagement with shareholders so as to ensure that they have a better understanding of the company's remuneration strategy, its market competitiveness, appropriateness to the company's circumstances and linkages to company performance. They should also understand the importance of casting their votes so as to avoid this aspect being hijacked by minority interests.

Remuneration Report Communication

One of the reasons contributing to "first strikes" seems to have been poor Remuneration Report communication with shareholders. In this regard two aspects are relevant being:

1. Lack of a clear explanation of the remuneration intended to be provided at target performance and the actual earnings realised by the executive from the performance achieved as opposed to the reported accounting values of equity grants which when market related vesting conditions are used do not reflect actual performance, and
2. Lack of clear explanation of the correlation of executive incentive values with company performance.

In relation to disclosure of executive remuneration the accounting valuation of equity grants which are the main form of long term incentive (LTI) gives rise to disclosed remuneration levels that are significantly different from those actually realised by executives. This is because the value of equity grants with market related vesting conditions is disclosed/amortised over the vesting period irrespective of whether all, some or none of the equity is likely to or actually vests. During recent years vesting has often been nil due to poor company performance yet disclosed remuneration values do not reflect this fact leading to shareholder dissatisfaction with the total remuneration reported for individual executives. While there were some first attempts e.g. Qantas, to overcome this problem there remains considerable improvement in communication that can be made. We can provide recommendations on improvements to those interested in this regard.

In relation to the second point, it should be noted that the metrics used to report company performance in the Remuneration Report are often not the same metrics used as key performance indicators (KPIs) in short term incentive (STI) plans or as vesting conditions in LTI plans. This leads to a disconnection between reporting on company performance and reporting on executive remuneration – this is exacerbated by the previous point on disclosed values of incentives. This may be overcome by going beyond the statutory requirements.

Remuneration Strategy

In some cases the "first strike" was warranted because the remuneration strategies of the companies concerned were inconsistent with best practice and good corporate governance and lacked strong connections with company performance. In these cases the "strike" was warranted and should be addressed via a comprehensive review of their KMP remuneration strategy including the types and design features of STI and LTI plans.

In this regard it should be noted that many companies have long been dissatisfied with total shareholder return (TSR) as a vesting condition for their LTI plans but have persevered with it in the absence of a better alternative. There is now light at the end of the tunnel as a new concept has been developed called TSR Alpha. It allows a company's performance to be measured retrospectively (always the case with LTI plans) in terms of TSR but relative to the company's risk profile and market movements over the measurement period. By using TSR Alpha and the levers that drive TSR Alpha as metrics in incentive plans there will be a strong correlation between company performance as experienced by shareholders and the incentives received by executives. Accordingly, companies that are reviewing their remuneration strategies should include TSR Alpha in their deliberations. See GRG Remuneration Review No 34 Righting Some Wrongs in the Executive Pay Debate in the Topical Articles section of www.godfreyremuneration.com for more information on TSR Alpha including examples of companies that received "first strikes" when they should not have done so according to the TSR Alpha analysis.