

Use of External Remuneration Consultants

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Introduction

GRG has over recent years been recording information disclosed in Remuneration Reports on the use made by ASX listed companies of external remuneration consultants (ERCs). This GRG Remuneration Insight presents some of the data analysed and provides commentary.

Legal Requirement to Disclose

Section 300A(h) of the Corporations Act requires certain information to be disclosed in Remuneration Reports of ASX listed companies. The disclosure is required when an ERC has made a remuneration recommendation in relation to any of the key management personnel (KMP) of the company for the financial year. The information required to be disclosed includes (but is not limited to):

- the name of the consultant,
- the amount and nature of the consideration payable for the KMP remuneration recommendation, and
- the amount and nature of the consideration payable for any other kind of advice.

Overall Use of ERCs

The following table relates to FY14 Remuneration Report disclosures. Preliminary analysis indicates that FY15 Remuneration Report disclosures will be consistent with FY14 disclosures.

The following table indicates that:

- the majority of companies with market capitalisations of \$1 billion or more use ERCs,
- a little under 50% of companies with market capitalisations of between \$250 million and \$1 billion use ERCs, and
- companies with market capitalisation of less than \$250 million generally do not use ERCs.

ERC Usage by Market Capitalisation FY14							
Market Capitalisation	Single ERC	Multiple ERC	% With ERC	No ERC	Unclear or Not Disclosed	% Without ERC	Total
> \$10 billion	16	5	81%	2	3	19%	26
\$5 - \$10 billion	14	5	68%	1	8	32%	28
\$2 - \$5 billion	25	3	61%	6	12	39%	46
\$1 - \$2 billion	31	3	58%	6	19	42%	59
\$500 - \$1 billion	21	4	43%	6	27	57%	58
\$250 - \$500 million	29	4	41%	6	42	59%	81
\$100 - \$250 million	26	6	21%	19	101	79%	152
\$50 - \$100 million	15	1	10%	23	123	90%	162
\$25 - \$50 million	8	1	6%	39	112	94%	160
Total	185	32	28%	108	447	72%	772

Note: Given the legal requirement to make ERC usage disclosures, it has been assumed that no ERC is used when Remuneration Reports are unclear or do not include any ERC disclosure.

It is interesting to observe that larger companies which typically have well-resourced human resources capabilities are the group of companies that mostly use ERCs. Equally, smaller companies that often have more limited internal capability tend to make less use of ERCs. Such an outcome is somewhat surprising in that less well-resourced companies, in terms of internal expertise, would have a greater need for professional independent advice. However, another factor that may be more relevant than internal human resources capability is the degree to which companies are on the radar of proxy advisors and institutional shareholders (e.g. superannuation funds). Companies that are in the ASX300 are on the radar of proxy advisors and therefore face greater scrutiny.

The companies in the ASX300 are those that are generally assumed to be on the radar of all three proxy advisors and most major superannuation funds (though scrutiny by proxy advisors does extend beyond the ASX300 as additional companies are covered at the request of the proxy advisor clients). If practices are seen as inappropriate or inconsistent with proxy advisor preferences or are not understood by them, it is likely for such companies to face negative voting recommendations from such groups. If 25% or more votes are against the Remuneration Report resolution then a “strike” will be received with consequent potential reputational damage. So as to minimise the possibility of a “strike”, companies in the ASX300 are more likely to engage an ERC than other companies. That said, it is interesting to note that ASX300 companies represent approximately 108 companies in the market capitalisation range \$250m and \$1bn and 28 in the market capitalisation range \$100m and \$250m.

The low use of ERCs among smaller companies may reflect an approach of using an ERC every 2 to 3 years to sense check practices relative to the market. Such an approach can work well for small companies that are relatively stable in size and have consistent business operations. However when such companies experience periods of rapid growth or are entered into the ASX 300, it can be challenging to make the required changes to remuneration structures to ensure appropriate retention and motivation of key executives in a timely manner, if advice has not been previously received. There have been a number of strikes against fast growing companies that found themselves counted amongst the ASX 300 before they have had the opportunity to get their remuneration practices in order.

It has also been observed that some consulting firms prefer not to provide and some companies prefer not to receive, KMP remuneration recommendations, as defined in the Corporations Act. In these cases there is no obligation to make the disclosures referred to earlier in relation to ERCs which provide KMP remuneration recommendations. When consulting firms are named in Remuneration Reports as providing information on KMP remuneration they have been treated as KMP ERCs in the foregoing data.

Advantages of Using an ERC

Irrespective of proxy advisor considerations there are many advantages for boards or remuneration committees when engaging ERCs, including:

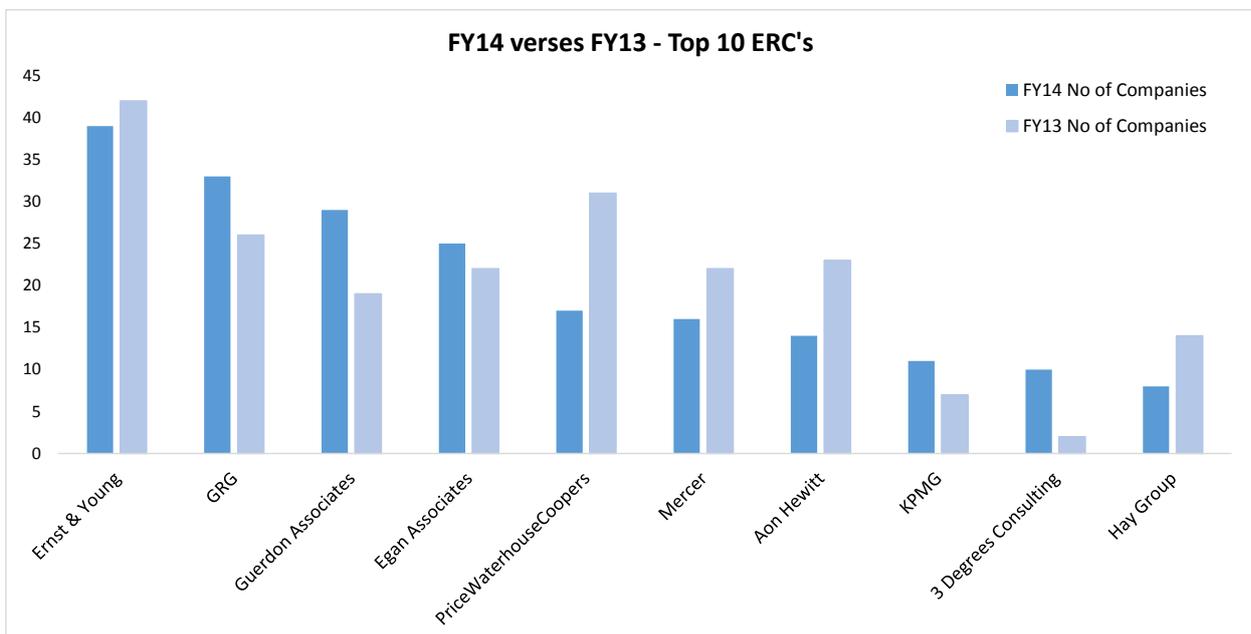
1. ERCs should have comprehensive databases covering all aspects of remuneration practices for senior executives and non-executive directors,
2. ERCs should be aware of emerging market trends and recent developments – such knowledge arises from exposure to a broad section of the market which non-executive directors (and executives) rarely have,
3. ERCs should be aware of the views of proxy advisors and should therefore be in a position to provide counsel to boards and remuneration committees,

4. ERCs should be not only aware of regulatory changes but should have developed strategies for responding to such changes,
5. ERCs should have deep experience in dealing with KMP remuneration matters and be able to draw on that experience in advising board and committee members,
6. ERCs should have detailed knowledge of all laws and regulations that may affect KMP remuneration and should be able to explain them in plain English to board and committee members, and
7. ERCs should have a sound understanding of business practices, principles, corporate governance and ethics so as to provide balanced and responsible advice.

Use of Specific ERCs

The use of specific ERC firms may also be of interest. The following bar chart shows the number of clients to whom KMP remuneration recommendations were provided in FY13 and FY14. Observations in relation to the chart include:

- a) The three independent boutique ERC consulting firms as a group dominate the market and continue to grow the number of clients they serve (i.e. a majority of listed companies seeking independent advice rely on independent specialist advisors),
- b) Ernst and Young has the largest number of clients but is showing a year on year decline. The decline is much less than experienced by PWC. That both Ernst & Young and PWC have experienced declines in the number of clients may be due to a number of factors such as potential conflict due to them servicing both management and the board, noting the need for boards to certify that they are satisfied as to the independence of KMP remuneration recommendations and why they are so satisfied,
- c) International human resources consulting firms (Mercer, Aon Hewitt & Hay Group) that previously dominated senior executive remuneration consulting in Australia appear to have surrendered their prominence but remain in the top 10, and
- d) There are a significant number of ERCs below the top 10 that dabble in the space, often as a sideline to other consulting activities such as recruitment, accounting, or search.



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