GRG Remuneration Insight 86

ASX200 Incentive Plan Practices

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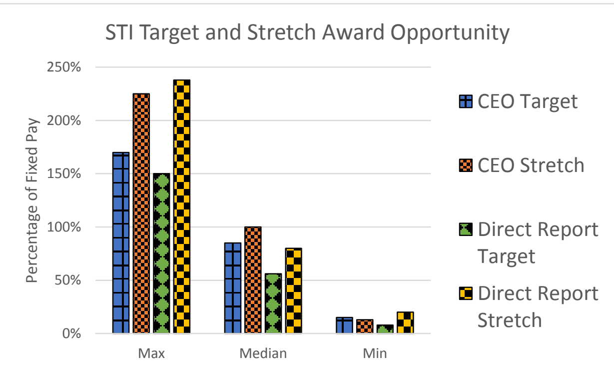
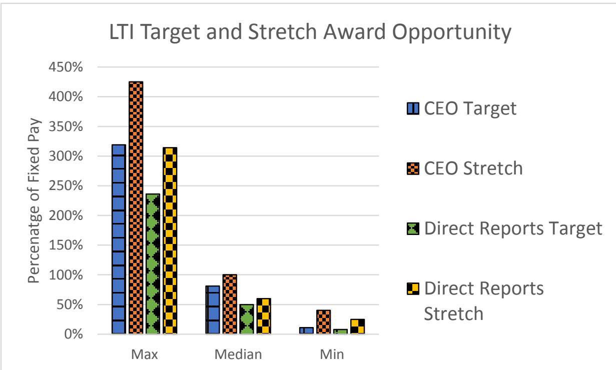
Introduction

This GRG Remuneration Insight provides a brief summary of our key findings from analysing the STI and LTI practices of ASX200 companies for the GRG 2016 Incentives Guide. Companies of all sizes should find this information of interest because the ASX200 represent sizeable companies employing large numbers of staff, and which in effect set the market for remuneration practice. They also tend to be leaders in terms of corporate governance and sometimes adopters of new practices.

Rising Importance of Incentives

We continue to see companies seeking a closer alignment between their remuneration strategies and practices with their business strategy. This is unsurprising given the strongly held view among shareholders, proxy advisors and other stakeholders that a large part of senior executive remuneration should be in the form of incentives, which stems from a belief that the remuneration of senior executives should be closely tied to the success of the company and thereby the interests of senior executives and shareholders will be closely aligned. The upside for the executives is that they can earn substantial rewards for performance that delivered value to shareholders (in some cases more than double an executive's Fixed Pay).





Summary of Key Findings from Analysis of STI Plan Practices

All ASX200 companies bar one use STI for their senior executives. Annual STI values increase as company size increases across all main industry sectors, and the value of STI spread is wide with P75 often being at least 50% higher than P50 values.

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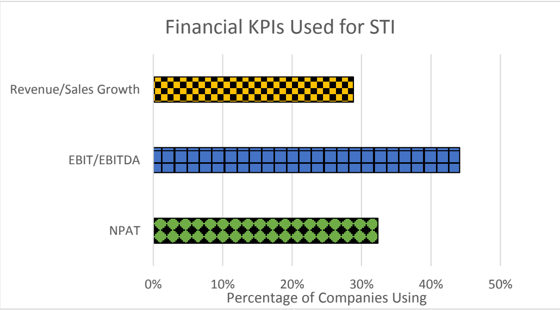
Analysis of policy and actual levels of STI together with GRG's consulting experience clearly shows that there is little, if any, consistency in the market's application of "Target" STI award opportunities (in many cases they are stretch/maximum levels, in some they are just above expected performance and in others they are true targets being set at challenging but achievable performance levels below stretch or maximum).

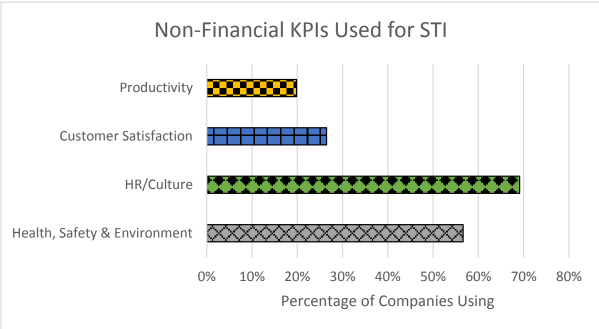
Key Performance Indicators (KPIs)

KPIs used to determine STI payouts vary depending on a company's circumstances and near-term strategies. As such, when selecting performance metrics it becomes critical that each company choose the metrics that will lead to increasing its shareholder value and not simply adopt metrics because they are popular or commonly used by competitors or others.



KPIs are generally set at the company and business unit levels (sometimes individual), and are split between financial metrics with a focus on various measures of profit and a range of diverse non-financial (or company operational) metrics. These graphs show the most common financial and non-financial KPIs used.

76% of ASX200 companies use non-financial metrics, which from time to time can be critical success factors, and should be used assuming that criticality has been assessed as a means for achieving an optimal financial outcome. For example, customer satisfaction or service/product quality are important performance metrics if it has been established that by improving them, there will be an improvement in NPAT and the rate of return it represents on shareholders' funds.

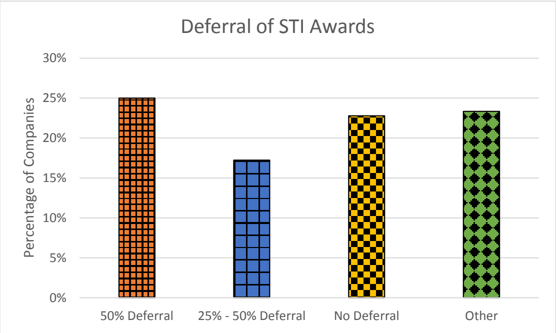


Having said that, and considering the constant coverage devoted to the 'importance of customers and customer experience', we find it surprising that only 26% of companies use Customer Satisfaction as a metric. Contrast this with a combined 69% of companies using HR/Culture as a metric (the highest used non-financial metric). Does this suggest that improving employee engagement will lead to better customer satisfaction; and hence, return outcomes?

As for the Productivity metric, it is only used by 20% of companies; perhaps it is because the majority of productivity improvements may have already been attained over the past few years.

While the usefulness of some non-financial metrics are debatable, it would not be a major issue if there is a meaningful STI Gate metric that represents the minimum level of financial performance that must be exceeded before the STI plan becomes operational. Unfortunately, 75% of the ASX200 are not clear or have not disclosed their Gate metric. GRG's experience indicates that many companies do not use gates/triggers; and thus, low disclosure on this aspect is most likely due to it not being an element of their STI plans. Its absence can lead to non-financial metrics driving poor alignment between company financial performance and remuneration outcomes.

STI Deferral



Lastly, STI deferral is now a common practice adopted most strongly by larger companies but to a lesser extent in small companies. 77% of ASX200 companies apply some form of STI deferral for a portion of STI earned.

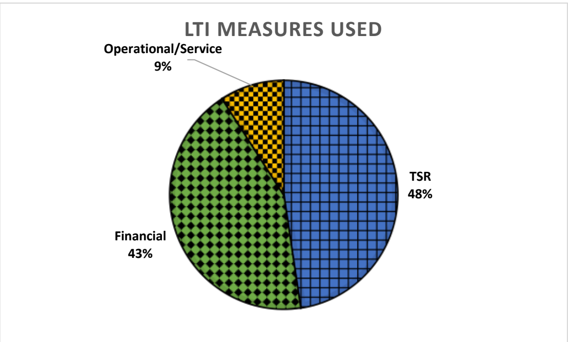
The deferral period tends to be mainly for 1 and/or 2 years with a small minority adopting longer periods. The STI portion deferred is mostly settled in equity by an 86% majority of companies (a bias driven by taxation implications and intention to increase the equity weighting), 8% settle in cash and 5% in other forms.

Summary of Key Findings from Analysis of LTI Plan Practices

Unsurprisingly, the majority of the ASX200 companies use LTI plans (only 7 companies do not utilise one).

- 78% of companies use Rights for LTI plan purposes consistently across company size ranges and industry sectors.
- Annual LTI values increase as company size increases across all main industry sectors, and the value of LTI spread is wide with P75 often being at least 50% higher than P50 values.
- Annual LTI grants remain the dominant practice and measurement periods are almost universally set at 3 years despite some pressure from some stakeholder groups for longer periods.

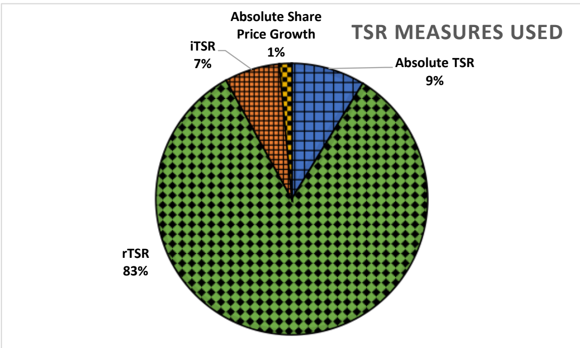
LTI Vesting Conditions



LTI vesting conditions mostly fall into the two main categories of; Total Shareholder Return (TSR) and financial. The other categories of operational and service are used in a small minority of cases.

Approximately a third of companies use a single vesting condition and two-thirds use multiple vesting conditions, usually two.

Of the TSR vesting conditions, ranked TSR (rTSR) remains dominant although declining due to replacement in whole or in part by other TSR metrics such as indexed TSR (iTSR) or financial metrics.



rTSR

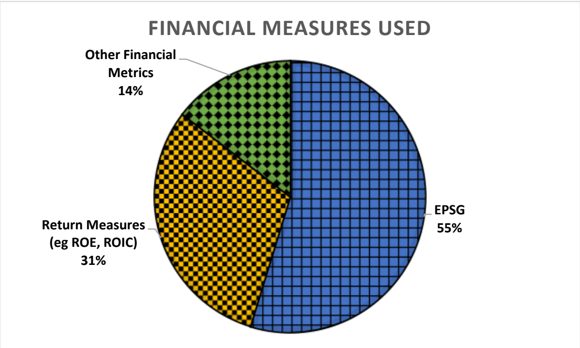
It is worthwhile noting the following regarding rTSR:

1. When rTSR is used, the dominant approach to selecting a peer group is not to be of industry peers but a diverse group of broadly classified companies such as those in an index. This appears to be an attempt to gauge the broad market.
2. Companies using rTSR tend to use a standard vesting scale of 50% vesting at P50, 100% vesting at or above P75 and pro-rata vesting between P50 and P75.

The combination of the preceding two points can result in rTSR producing inappropriate vesting outcomes which is a problem that the majority of boards seem reluctant to address.

TSR retesting remains a minority practice due to strong opposition from various stakeholders for some years. Although the resistance has diminished particularly when new style approaches to retesting are used, the entrenched position remains the dominant practice.

Lastly, using vesting scales for performance metrics other than rTSR reflects the fact that boards are giving greater consideration to setting targets that are relevant to the specific company circumstances.



Of the financial vesting conditions, EPS growth remains dominant being used by 55% of the ASX200 companies, but other financial metrics (such as ROE or ROIC) are emerging due to strong criticism of the inherent defects in EPS growth as a performance measure.

However, 9% of the ASX 200 companies do not use either internal or external financial metrics.

Remuneration Strategy/Structure

The introduction of the “two strikes” rule may have discouraged some organisations from doing something different with their remuneration strategies and structures out of concern that it may alienate shareholders/proxy advisers. However, remuneration report voting outcomes, despite an increase in “no votes”, do not appear to be related to changes in remuneration strategy/structure but rather as a protest vote due to shareholder dissatisfaction with a company’s performance or management (unrelated to remuneration), or perceived excessive pay for executives combined with poor organisational performance/results. The latter may be driven by poor incentive alignment that results from adopting standard/common practices.

Our recent discussions with proxy advisers indicate that they are open to the introduction of innovative remunerations strategies/structures as long as they clearly link the remuneration framework with the company’s strategy and its results.

Being aware of contemporary market practices in relation STI and LTI plans is a first step to identify deficiencies in current practices and recognise opportunities to improve current plans. Determining appropriate tailored incentive plans is an important next step. The GRG Incentives Guide is a valuable source of information that can assist in that regard. To obtain your copy of this Guide please contact Peter Godfrey on 02 8923 5700 or though info@godfreyremuneration.com.