GRG Remuneration Insight 108

Telstra – A Case Study in Misalignment

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Introduction

The 16th of October 2018 was a particularly interesting day in remuneration governance as Telstra received what looks to be a record strike against its Remuneration Report for an ASX 50 company; despite making significant changes and disclosures in a desperate attempt for damage control. How could a company so widely held by retail shareholders, self managed super funds and major institutional investors end up in such a position? This Insight is a fascinating case study that explores misalignment between stakeholders and the single/hybrid incentive plan (SIP) structure introduced by some companies. The band aid that was slapped on the problem may even have set a new standard for disclosure regarding short term performance, and SIP assessment, at least among top ASX companies.

The Setup

The events of the 16th October were at least 12 months in the making, but a few key things appear to have contributed to the spectacular outcome of the AGM. Telstra's share price has been volatile and falling from a peak in 2015, and the share price fell by nearly 40% over FY18.

Up until the end of FY17, Telstra's incentive structure was based on traditional short term incentives (STI, over 1 year) and long term incentives (LTI, over multiple years). These appear to have had relatively good support from shareholders with only minor votes against the CEO grant (3%) and Remuneration Report (4%) approval resolutions at the 2016 AGM, despite the falling share price. A brief summary of the previous Telstra plans are as follows (with some still on-foot, subject to future testing):

- Incentive opportunities at "Target" were 100% STI and 100% LTI (of Fixed Pay) for the CEO, with a maximum of up to double these amounts. Other senior executives had 100% of Fixed pay for STI and 80% for LTI at Target, with double these amounts for maximum. 75% of STI was payable in cash, and 25% in Restricted Shares in 1 and 2 year tranches, with the STI being based on a combination of financial measures, Net Promoter Score (NPS) measures and individual performance,
- 50% of the LTI based on the widely discredited ranked relative TSR (rTSR) measure, which is linked to a group of only 20 cherry picked companies, mostly international. This is statistically dubious as it will result in 5-6 companies between P49 and P75 outcomes, covering the range from 0% to 100% vesting, which is highly volatile and arguably does not really link to true executive or Company performance (i.e. a "lottery"), and
- 50% of the LTI based on Free Cash Flow Return on Investment (FCF ROI), a somewhat unusual but potentially interesting measure described by the Board as driving value for shareholders, which included a subjective assessment of delivery against the strategic investment program,

The FY17 Annual Report made it clear that the rTSR and FCF ROI tranches of LTI were not vesting since the last disclosed exercise of Rights in 2013. **Given the poor performance of the Company in recent times, it could be argued that the plan was working as intended** and aligning long term executive incentive outcomes with shareholder experience and interests (i.e. both shareholders and executives were losing value together).

In the same FY17 Annual Report, released in the first quarter of FY18, the Board announced and sought support for the SIP referred to as the executive variable remuneration plan or "EVP". The EVP is a version of a "complex SIP" i.e. subject to long term vesting conditions directly comparable to an LTI, rather than just service. The EVP was also detailed as part of the notice of meeting, with the first up-front grant to the CEO being subject to shareholder approval. This generated a warning shot from investors and governance advisors, summarised as follows:

- 10% vote against the Remuneration Report and 11% against the grant of equity to the CEO. These were notable negative levels for an ASX 50 company, and significantly up from the previous periods,
- At the time, the major proxy advisors released reports that included extensively qualified support for the Remuneration Report and grant of the EVP to the CEO, but all highlighted significant concerns and risks about the remuneration structure and lack of transparency.

This should have set off alarm bells for the Board, however, they stuck to their guns and appeared to see the new EVP as the answer to the following problems identified as part of a review in FY17:

- The LTI was too complex,
- The EVP would better reward the strategic pillars of "brilliant customer experiences", "driving value and growth from the core", and "building new growth businesses close to the core",
- Alignment with shareholders was poor under the old plan, and would be improved by extending the plan period from 4 years to 5 years, and testing a higher proportion of the reward against rTSR vs the ASX 100 excluding resource companies – certainly a more statistically robust group than the previous one used but arguably with limited relevance to the nature of Telstra's business to judge whether performance has been good or not (noting that outcomes must be ranked under rTSR).

The Plan

The following outlines the intended features of the EVP as announced (note: FY18 was a transition period):

- The Target incentive opportunity for the CEO would double to 200% of Fixed Pay (180% for direct reports) with 70% of Fixed Pay payable in cash, 52% of Fixed Pay payable in Restricted Shares, and 78% of Fixed Pay payable in Performance Rights.
- A maximum incentive opportunity of 400% of Fixed Pay for the CEO (360% for direct reports) payable in the same proportions for any EVP outcome as above,
- The **entire** award, including the initial grant of Rights, is based on an assessment over **one year**, which included:
  - Financial Measures (50%): 10% Income, 20% EBITDA, 20% free cash flow (FCF),
  - Customer Measures (40%): 20% strategic Net Promoter Score, 20% Episode NPS, and
  - An individual component at 10%,
- Restricted Shares are to be subject to disposal restrictions for 2 financial years following the year of performance assessment, and
- Performance Rights are to be held for 4 financial years following the year of initial performance assessment but tested over 5 years (i.e. including the initial year of performance). The Performance Rights are tested against rTSR only, with no apparent gate (i.e. would vest despite a negative TSR as long as a P50 performance rank or better is achieved).

While previously the CEO's Target incentive was 100% of Fixed Pay subject to short term performance, and 100% to long term performance, under the new EVP arrangement it became 122% based on short term outcomes with only 78% subject to long term outcomes. Thus, the focus on short term has in fact increased, noting that the Restricted Shares are not subject to any long term performance measure, only market fluctuations which will likely be drowned out by fluctuations in awards due to short term outcomes. Clearly, the EVP incentive *'message'* to executives became one of focusing on performance over the initial 12 month period by maximising short term financial performance, including getting NPS rating up, and then hoping that over the following 4 years the Company generates a return to shareholders that is at least as good as half of the ASX 100 (noting exclusions).

The use of NPS, particularly at such high levels is interesting as there is no direct link between NPS and value creation for shareholders or even financial performance (it is clear that a failure to keep customers happy will result in loss of value but the opposite does not necessarily hold true). Moreover, NPS, and customer service, cannot be increased ad infinitum and it can be argued that it is a minimal 'day-job' requirement of the executive team to ensure that customers are treated fairly and customer satisfaction is maintained at an appropriate level on an ongoing basis. NPS is really a hygiene factor that is better suited to the performance management framework than an executive incentive, or at best a gate to the incentive framework that turns off all opportunities if not maintained. After the events of 2018 it could be argued that they do have a strategic need for significant customer service improvement in the short term (though strategic NPS is apparently no longer an incentive priority, see below). However, it is difficult to see how an NPS score being maintained once an appropriate level is achieved can deserve a reward equal to 80% of Fixed Pay at Target and up to 160% at maximum, were the plan to continue as announced.

Together, the above issues produce an incentive plan that has very poor alignment with shareholders, value creation (not even a positive TSR gate on Performance Rights) or long term outcomes, and instead appears to reward short termism and hygiene.

Moreover, it is difficult to see how this plan is less complex than its predecessor, with the short and long term aspects being conflated making long term reward outcomes opaque being largely driven by short term outcomes four years prior. A P50 outcome over the long term could look like a stretch reward if the stretch outcome was achieved in the initial short term. Similarly, a P75 or stretch outcome over the long term could look like a target outcome if the initial short term outcome was below Target.

Lastly, we note that ASX Listing Rule 10.17B prohibits an executive director's remuneration including a commission on or percentage of operating revenue (because revenue is not profit and can be obtained at any cost). Some might say that this is a general governance principle that should be adhered to in order to avoid incentivising the wrong behaviour, and certainly to an MD/CEO.

The Crunch

By the end of FY18 the impact of the NBN was becoming painfully clear, with some estimates of EBITDA downgrades at $3 Billion (hard to see how that was a surprise to anyone), Telstra wrote down $500 Million investment in its Ooyala subsidiary to zero and the Ombudsman received about 85,500 customer complaints about Telstra in the last financial year (a 7.7% year-on-year increase).

June marked the start of a massive cost cutting strategy aimed at slashing $2.5 billion from the budget, including shedding 8,000 staff, with 1,200 to go before the AGM. Shareholders had lost significant value over the financial year. Following the end of FY18, Telstra released its Annual Report, and Remuneration Report, and the share price did recover a little in the lead-up to the AGM. The disclosures included that:

- FCF was subject to adjustments which resulted in a net increase, and an outstanding outcome between Target and Maximum,
- Strategic NPS fell below the threshold result, with no change, due to the impact of network outages and media performance (this measure suspiciously disappears for FY19),
- Episode NPS, however, increased significantly (this measure is perhaps unsurprisingly the one that is retained) producing a maximum award (i.e. double the target, wiping out the failure on the strategic NPS version above),
- Individual performance outcomes were on average, at Target,
- Once again, previous grants of LTI based on rTSR and FCF ROI failed to vest – arguably in perfect alignment with actual long term performance, and certainly the experience of shareholders.

Not much detail was given on other measures, but the comment was made that the Board had received feedback that there was too much focus on non-financial measures. More significantly, the Board had recognised that the outcome of the incentive assessment was likely to be seen as inappropriate in the circumstances of shareholder losses, dividend cuts, network outages and poor strategic NPS outcomes, and intervened to reduce incentive awards under the EVP from target, by 30%, which translates into 66% of the Target incentive. This did not quell the growing chorus of criticism from shareholders and proxy advisors were lining up against the Remuneration Report and associated resolutions at the AGM. The Board knew it was in trouble in the weeks following the release of the report.

The Band Aid

On October 11th the Board made a strategic move against the growing crowd of disgruntled stakeholders by releasing a carefully crafted letter to shareholders, which reiterated that the Board had intervened in the operation of the EVP to reduce the otherwise generous reward outcome by 30% in recognition of the pain that shareholders had experienced. The main problem that the letter identified and addressed was a lack of transparency and disclosure regarding how each short term objective was set, measured and translated into an award outcome. While this was certainly a contributing factor, it entirely missed the point that **the EVP has poor alignment with the shareholder experience by design**. The letter did not show how the EVP plan aligned with preserved shareholder value or incentive metrics that will support preserving wealth, let alone sustainably create it for shareholders. Under these circumstances, trying to justify any incentive outcomes; let alone near Target, would seem like a challenge.

The letter also attempted to assure shareholders that the plan would work better in FY19, while making the claim that the achievement of long term rewards would be harder under the EVP than in the past due to the double jeopardy of both short and long term assessment – a claim which was demonstrably dubious under the circumstances as only part of the equity grant is performance tested over the long term.

The FY19 opportunities would be based on short term assessments that would supposedly mitigate all other concerns:

- Financial (50% -no change): 12.5% Income (up), 12.5% EBITDA (down), 12.5% FCF (down), and a new 12.5% Net Operating Expenditure Reduction (unclear how the planned redundancies would impact this),
- Strategic, Customer & Transformation (50%): the removal of strategic NPS altogether (noting poor outcomes), 12.5% Episode NPS (down), 12.5% product portfolio simplification (new), 12.5% digital delivery (new) and 12.5% People Capability & Engagement (new).

Over the following pages the Board gave what appeared to be a detailed breakdown of the FY19 EVP measures/KPIs, each with a Threshold, Target and Stretch identified and accompanied by an extensive explanation, or perhaps more accurately, justification. This level of transparency was surprising and refreshing to see considering that external stakeholders and proxy advisors have been asking for these details from ASX 300 companies for many years. It is notable that the top 3 financial measures were linked to "Market Guidance"- something which management arguably has a high degree of control over. The new measures are arguably hygiene factors, also arguably under management control and do not have a direct link with value creation (more preservation); **these should be part of the baseline job of executives**, which is what their Fixed Pay is intended to cover. These types of issues are typically (and should be) addressed by a performance management framework, training and development - but not by incentives. Incentives are not performance management tools, they do not teach, develop or support executives, they do not problem solve - they only reward outcomes. Perhaps this indicates that a quality performance management framework is what is lacking at Telstra, which would enable them to better meet the value creation challenge, and reward for successful outcomes through incentives instead.

Having said that, GRG does applaud the use of Board discretion to avoid inappropriate outcomes despite it not going far enough, as well as this new level of engagement with external stakeholders, especially the extent of transparency and disclosure. Unfortunately, it was too little too late.

The Fallout

While the proxy recommendations were likely already locked-in by this point, it is impossible to say if any stakeholders would have been swayed by the letter. Unfortunately, it appears to have backfired in some key ways. Instead of the outrage being quelled by the attempted assurance that all was well, that alignment was there and that the Board could be trusted to ensure good governance and transparency, it became clear just how poor the EVP incentive design was and how misaligned it was with the shareholders experience. The Board appears to have admitted that the previous level of disclosure, a standard still held by many of its peers, was insufficient.

Conclusion

While Telstra's shareholders had been suffering losses for some time with a powder-keg of issues lining up, it appears that the introduction of the EVP was a turning point in sentiment on remuneration at Telstra, and that eventual disclosure of how the plan really operates during tough times finally lit the fuse. The result was an explosion of negativity towards remuneration governance and practices, and one which is not isolated. The fire appears to be spreading between companies that have introduced the single/hybrid incentive plan structure in the name of simplicity, due to poor alignment (it started with QBE 46% votes against and then AMP's 61% votes against). The Telstra case has clearly demonstrated the risks of misalignment between shareholders' experience and executive incentive outcomes, and to Company and Board reputation, of both simple and complex SIP approaches: the alignment with long term outcomes is weak, the elasticity simply is not there compared to traditional approaches. rTSR is the measure that has led many to criticise LTI as having poor alignment with either executives or shareholders, and it is this measure that should be replaced rather than the STI and LTI framework. When complex SIPs conflate short and long term outcomes, it is emerging that the simplicity objective is also not being met. As these issues are finally becoming painfully apparent to shareholders, there are significant consequences. In Telstra's case, shareholders have taken the view that it is not good enough that the incentive plan requires such intervention to avoid completely inappropriate outcomes, and that the intervention did not go far enough (GRG agrees). The silver lining in this process has been that Telstra appears to have set a new standard of a much higher level of transparency and disclosure regarding the setting of targets for companies operating SIPs. GRG always recommended such transparency and we stand ready to assist Boards to amend their incentive schemes for improved alignment and simplicity.