GRG Remuneration Insight 128

How Have FY20 STVR Awards Gone So Wrong?

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Introduction

The current COVID-19 pandemic and economic crisis has brought FY20 short term variable remuneration (STVR) awards into sharp focus both in the media and for the current AGM season. We are witnessing two lines of inquiry, one private, and one public.

Privately, questions that have been raised by Boards most commonly include:

1. Should STVR awards be paid?
2. Should the quantum of STVR awards otherwise payable be moderated?

Publicly, governance commentators, journalists and the public more broadly, have been asking questions about how companies that received government funded "JobKeeper" payments, can still be paying executives bonuses. A number of boards have been called out publicly as paying executives "government funded bonuses", alongside statements that these practices are not passing the pub-test. Even the Business Council of Australia has weighed in to say that STVR awards should not be paid if the business received JobKeeper. But they may be missing the point.

In this remuneration insight we seek to address all of these questions by revising some fundamental principles that should drive all STVR awards regardless of external circumstances, which produce logical answers to the current salient issues.

Economic Profit as a Key Driver, or Just a Sense Check

Economic Profit is the profit remaining after a charge for shareholders equity is made against accounting profit; many people seem to think that equity capital has no cost, (while debt has an interest cost) but this is not true. Shareholders require an ongoing economic return on their capital, just like an interest rate, and this should be assessed on a book basis, as well as on a market basis.

Economic Profit = Accounting Profit Before Tax – Charge for Shareholders' Equity

A positive Economic Profit means that economic value is being created, a breakeven means that economic value is being maintained, and an economic loss means that economic value is in fact being destroyed, regardless of whether or not a positive NPAT is reported.

There can be complicated approaches to the Economic Profit calculation but for remuneration purposes it may be simplified. Thus, before calculating whether there is a profit from which STVR awards may be paid it is important to deduct the cost of equity capital. Of course, the cost of borrowed capital, being interest, will have already been deducted in calculating accounting profit.

The cost of equity capital may be expressed as an interest rate and for a company may be calculated as:

Cost of Equity Capital as a % = Risk Free Interest Rate + Market Premium x Company Beta

The Risk-Free Interest Rate in Australia is usually taken as the yield on 10 year Australian Government Bonds. Currently, this rate is just below 1% pa.

The Market Premium is the excess of the average long-term total return achieved on the stock market over the Risk-Free Rate. Over recent years the average long term ASX return has fallen from around 12% pa to around 9% pa. Thus, the Market Premium is currently around 8% pa.

Each company has its own Beta which is an indication of the risk associated with investment in that company's shares. If a company has a Beta of 1, then its share price tends to be synchronised with movements in the market. If a company's beta is greater than 1 its share price tends to go up faster than a rising market or go down faster than a falling market. The reverse is true of companies with Betas of less than 1. In the below example we use a Company Beta of 1.2.

Cost of Equity Capital as a %	=	Risk Free Interest Rate + Market Premium x Company Beta
e.g.	=	1% + 8% x 1.2
	=	1% + 9.6%
	=	10.6%

The Charge for Shareholders' Equity is then calculated by multiplying the opening value of shareholders' equity for the year by the Cost of Equity Capital %. If a company had opening shareholders' equity of $10 million then the charge for equity capital would be:

Charge for Shareholders' Equity	=	Shareholders' Equity Capital x Cost of Equity Capital %
e.g.	=	$10 million x 10.6%
	=	$1,060,000

If the Company had profit before tax of $6 million then the Economic Profit would be:

Economic Profit	=	Accounting Profit Before Tax – Charge for Shareholders' Equity
	=	$6,000,000 - $1,060,000
	=	$4,940,000

In this example the company is economically profitable and is adding economic value which will flow through to Total Shareholder Return. In this way, Economic Profit is an internal/financial indicator of the experience of shareholders over the period, while Total Shareholder Return will reflect the external shareholder value experience.

Can the Company Afford to Pay STVR Without Taking from Shareholders?

Few STVR schemes use Economic Profit as the primary driver of short term rewards for executives, despite its simplicity, logical foundation and demonstrated link to Total Shareholder Return over the long term. Those few companies that do use it, probably will not be facing the anxiety shared by Boards using EBITDA or even NPAT during the current economic crisis as the primary driver of short term rewards, because they will know whether or not they are destroying economic value for shareholders, or creating it.

In the example that has been developed in this Insight it would seem reasonable for the company to pay STVR awards. This is because it has made an Economic Profit which means that it has funds available, in excess of those needed to deliver a reasonable return to shareholders, to pay STVR. If the company had an accounting profit but no Economic Profit, then it may not be reasonable to pay STVR as such payments would reduce an already inadequate return for shareholders to an even less acceptable return or even an accounting loss.

Even if you haven't been using Economic Profit as a key management tool or performance metric, now may be the time to consider its use in determining whether or not the company can really afford to pay STVR awards.

Should the Quantum of STVR Awards Otherwise Payable be Moderated?

When considering the total quantum of STVR awards it is arguable that they should not exceed the amount of Economic Profit and preferably they should represent a percentage of the Economic Profit. As a guide, GRG recommends that the total of STVR awards should not exceed 50% of the Economic Profit. At 50% the sharing of Economic Profit between shareholders and employees would be on an equal basis. In some cases, this may be appropriate for example when the success of the busines is heavily reliant upon the intellectual capital provided by employees. In other cases where profitability is more heavily dependent on investment of financial capital than on employee intellectual capital then a percentage lower than 50% may be more appropriate.

Once the appropriate percentage sharing of Economic Profit between employees and shareholders has been determined then the employees' share can be used as a moderator to STVR awards that would otherwise be payable. If the employees' share of Economic Profit were lower than the total of STVR awards otherwise payable, then each STVR award could be scaled back to reduce their total cost to equal the employees' share of Economic Profit. Conversely, if the employees' share of Economic Profit were higher than the total of STVR awards otherwise payable then, each STVR award could be scaled up to increase their total cost to equal the employees' share of Economic Profit. If the employees' share of Economic Profit were to be used in this way, then it would be a modifier to STVR awards. For companies that have STVR plans that generate awards when company performance is below normal expectation the use of Economic Profit as a modifier can provide a sound foundation for adjusting STVR awards so that they are fair to both employees and shareholders. This would apply equally as well for companies that are performing above normal expectations.

COVID-19 is More Complex than Economic Profit – Should we Pay STVR?

Even if your business is economically profitable in FY20 and expected to be for FY21, there are other reasons that STVR awards might be considered inappropriate. Community expectations are now clear that STVR awards are likely to be poorly regarded when there have been substantial job cuts or reductions in hours due to the Company not being able to afford to fund the same number of hours of work, or as a cost saving measure. Some companies appear not to have learned that lesson yet and they can expect to be reminded of it this AGM season, even if they are economically profitable.

And then there is the elephant in the room.

The JobKeeper Elephant in the Room

Recently there has been considerable criticism in the press of Boards that have paid STVR awards to executives of companies that have received JobKeeper payments often in the 10's of thousands if not millions of dollars from the Australian Government. For such companies, the payment of the STVR awards has been causing reputational damage to the companies and the members of their Boards.

As a starting point, JobKeeper income should be excluded from all measures of financial performance, including Economic Profit. Several companies that have been identified in the Press appear to have failed to do this, indicating that they viewed these millions of dollars as immaterial. Regardless of the relative impact of JobKeeper on your financial performance, it is not a good look to include it on the same basis as other income generated by the business.

To qualify for JobKeeper companies needed to have suffered at least a 30% drop in revenue for the April to June quarter of 2020 compared to the same quarter in 2019. Such a drop in revenue is expected to be reflected in a larger drop in profitability for the quarter and a decline in profitability for FY20. Even if a company's profitability improved from FY19 to FY20 which may warrant payment of STVR awards there remains a public and investor relations issue that arises when a company is availing itself of Government support and paying executives STVR awards. In this regard it is important to note that government support via taxation and other concessions tends to be seen as being in a different category to JobKeeper which is seen almost as social security for employers.

The purpose of JobKeeper was to ensure that companies did not shed workers as a means to maintaining their books, and to keep those workers contributing to the national economy. If executives were told that accepting JobKeeper at any level automatically disqualified them from receiving an STVR award, then it would seem likely that more jobs would have been lost through redundancies, or reduced hours, undermining the purpose of the scheme. While it may be unpalatable to some, a company that received some level of JobKeeper during the process, but which, having backed-it out, still produced an Economic Profit, probably should still consider paying STVR awards to executives, at some level, if additional job losses are to be avoided as this crisis continues. The amount of JobKeeper received should probably also be considered however, as those companies receiving millions in support, and contemplating millions in STVR awards, will likely find themselves cornered.

Compromise

If you still find yourself in an uncomfortable position having considered all of the foregoing factors, then here are a few popular compromises that we are seeing being adopted by Boards that are still on the fence:

- Reducing awards, compared to the awards that would otherwise apply, by a substantial amount, to show that there is strong alignment, if not perfect alignment,
- Setting an award maximum at Target, and ignoring any outcomes in excess of Target, and/or
- Settling awards only in equity until further notice (it should be noted that at least one company that accepted substantial JobKeeper awards attempted this, and did not escape public criticism).

Taking strong action to reduce awards when you know you are headed for trouble will always be better regarded than stubbornly proceeding as if it is business as usual. Whether that will be enough to save reputation and negative voting patterns will only be known on a case-by-case basis.