

Executive Remuneration New Horizons, New Rules

by John Egan

Over the past decade the average level of market capitalisation of a top 100 company increased from less than \$4 billion to \$12 billion, with profits escalating from around \$350 million to an average in excess of \$1 billion.

In today's marketplace (early 2009) the average market capitalisation of a top 100 company had fallen below \$7.5 billion. Adjusting to these challenges will be a major focus of board Remuneration Committees and has become a key focus of the Rudd Government, resulting in its appointment of the Productivity Commission to review the framework of director and executive remuneration in Australia.

The bull market cycle had a fifteen year trajectory reflecting improving profits, growing revenues and more rapidly increasing enterprise value reflected in the stock markets around the world. Arising from this circumstance executive remuneration was progressively enhanced in every facet, that is the level of executive salaries increased at a pace well in excess of inflation.

In addition there were continuing refinements to annual incentive plans, with a reweighting of factors progressively away from financial elements to strategic, tactical, operational and leadership elements, in part sponsored by the adoption of balanced scorecard methodologies. These initiatives did not lack relevance or appropriateness as they focused the stewardship of enterprises on factors other than short term financial gain.

Annual incentives as an element also increased from conservative levels of 20% to 30% through to expected reward equivalent to one year's pay under annual incentive programs. Also emerging over this period was significant growth in the value of equity based incentives, with the initial foundation for allocation relating to a percentage of base salary, options being allocated for example with a face value of one times salary in anticipation of compound share price growth of 10% to 15%. Share rights or their equivalents were allocated in a similar vein, though to relatively modest levels.

With the introduction of accounting standards requiring the expensing of securities a new framework within which long term incentive plans were established emerged with the use of a Black-Scholes valuation or equivalent methodology being introduced. For reasons of minimising the impact on the P&L these valuation methodologies were further refined and discounted to take into account the probability of executive turnover, the probability of performance hurdles not being met, the probability of markets not being favourable.

Very quickly after the introduction of these performance tests new values were being used for the purpose of allocating equity which unintentionally, while introduced to enhance governance, transparency and benefit shareholders, had the reverse effect.

A Paradigm Shift

Notwithstanding this, until very recent times shareholders applauded management performance. Boards were required to deal with the reward outcomes arising from annual rates of growth in total shareholder return exceeding 20% year in and year out in the most recent five year period, when prior, rational and demanding expectations had identified superior performance was growing a business with sustainability at the rate of 15% return to shareholders. New paradigms and demands were emerging which led to management taking greater risk in order to meet the giddy relative performance hurdles demanded by institutions and shareholders alike.

What arose from this potpourri of parallel remuneration system development following the US sub prime initiated global financial crisis and squeeze on credit now forms a framework for the new executive remuneration play. Governments around the world are reacting and responding to a number of constituent perspectives and endeavouring to address these, in part through regulation and legislation.

In parallel executives are dealing with challenges they have not previously encountered and find themselves more challenged than in their entire executive careers, where meeting past performance levels in respect of profit and revenue growth seem improbable, particularly in a climate where shareholders' and boards' appetite for risk has diminished significantly.

In Australia there is every appearance that the performance of the regulators, notably ASIC and APRA, represent 'best in class' on a global footing. The ASX, partly guided by their corporate governance guidelines, have broadly contained the fallout experienced in other significant and highly traded markets.

The Government of Australia has not been forced to become a major shareholder in substantial companies, though have clearly taken initiatives to protect industry sectors and consumers where advice has guided their policy initiatives. In this economic and business environment top talent and top quality management teams will continue to shine, though the pay paradigm will change as shareholders' investments have declined in value and continuous profit improvement will be under pressure across most business sectors.

Growth in market value and profits sponsored the acceleration in executive pay over the prior decade, in many instances with the enthusiastic approval of shareholders whose paper wealth also grew significantly.

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The adjacent graphs reveal the relative decline on the Australian market among the global S&P1200 equity stocks, which represent 70% of the world's capital markets, incorporating the S&P/ASX50. It will clearly be observed in this context that while all markets have declined, the relative decline of Australia's leading companies is less than all other Exchanges over the period since mid-2007.

Of the other graphs, one portrays the financial attributes of the ASX100 over the past 10 years through to mid-2008. Since that time market values have declined significantly, though revenue continues to climb steadily and operating profit incorporating the most recent half year results reveals a modest decline foreshadowing a decline in the 2009 financial year profits likely to be reported by Australia's leading companies.

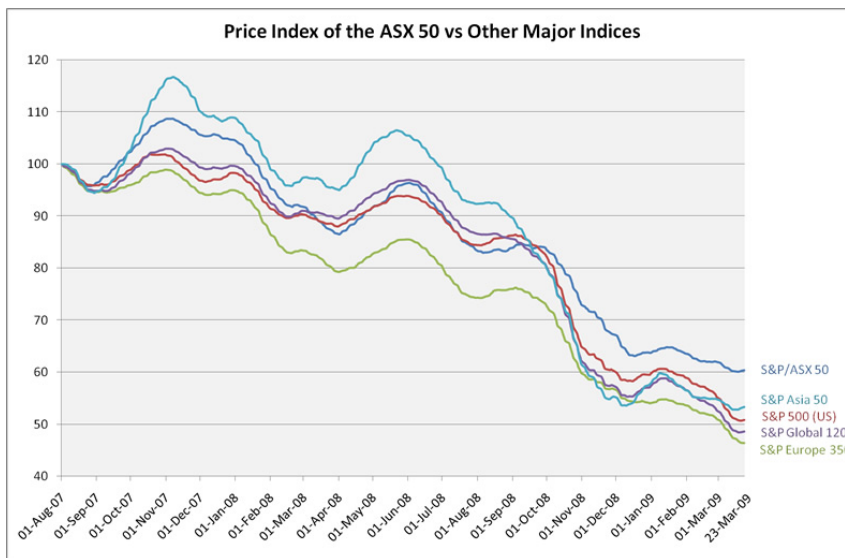
The last graph provides information on a calendar year basis of CEO and other senior executive remuneration excluding the value of executive participation in equity based long term incentives. It incorporates an analysis of fixed annual remuneration at the median plus annual incentives and reveals the first decline in CEO total cash compensation for a decade.

It needs to be acknowledged that in the most recent calendar year, one third of CEO positions have changed. Also over the decade the blend of industries in the ASX100 has changed with more recent shifts arising from an increased number of resources and energy companies with a decline in financial services.

We would anticipate on the current evidence with executive churn and profit growth under challenge, together with a significant decline in company market values, that the trend line for the senior executive population will not be one reflecting an increase.

The data provided covers Chief Executive Officers, the second highest paid executive among Australia's top 100 companies and the top 5 reported executives including the second highest paid, though excluding the CEO.

While the charts reflect a recent pause in growth and a significant decline in market value with a further decline of one third in the current calendar year, they also reveal the significant growth in value of the ASX top 100 companies over the past decade and the parallel growth in executive reward over the same period.



Source: Thomson Datastream

