egan associates

THE KMP REPORT

Issue 10 – January 2015

Reward Trends 2015

Directors and Executives

Contents

We welcome your comments on the report and trust you will find it to be informative and thought provoking. For Board Advice, please call Egan Associates on 02 9225 3225 or **email us**.

Executive Summary

Egan Associates believes that fixed remuneration increases at all levels of staff in 2015 will be modest, with the majority of organisations making annual pay adjustments in the range of 2% to 3%, although we also expect greater variation by company and industry sector.

Board fees will be contained broadly in alignment with fixed remuneration adjustments, except where there have been minimal or no adjustments over the past three years to Board fee levels or where the demands on Directors have substantially increased due to organisation transformation or growth through acquisitive initiatives.

We believe there will continue to be churn at the level of CEO and senior management as Boards determine that their current leadership team, although suited to the last three to five years, does not have the relevant competencies to lead the organisation through the near-term challenges of the changing economic and technology environments. Board renewal will remain a constant focus, with some Boards reducing their number and others increasing their membership as demands on Directors change.

In our opinion, 2015 will be the beginning of more open discussion and debate around performance hurdles for long term incentive plans, particularly in the listed company environment. Bespoke performance criteria will gain acceptance in substitution of relative TSR and increasing pressure will be applied to shift timelines from the medium term three-year plan out to five years.

> “ **2015 will be the beginning of more open discussion and debate around performance hurdles for long term incentive plans.** ”

Where this occurs we believe there will be downwards pressure on the proportion and duration of short term incentive awards deferred. There will also be demands placed on Boards, particularly chairs of Remuneration Committees, to formulate policies and practice guidelines for exercising discretion relating to the vesting of equity to good leavers and the adjustment of performance hurdles for changing conditions.

In terms of IPOs and significant transactions, we believe the focus will remain on balancing reward arrangements to retain the leadership team that fostered the organisation pre-IPO, which will entail management maintaining a high level of skin in the game.

More detail on 2015 remuneration trends is provided in the following report, separated into relevant factors that will impact on pay adjustments for staff, management and CEOs:

- economic setting and workforce planning;
- the organisation’s business plans and challenges;
- the recent history of the organisation’s pay adjustments;
- criticality of retention, recruitment and succession planning; and
- legislative/government policy settings.

Economic Conditions: Australia

2015 will not be a year of certainty at a political, national economic or global socio political and economic level.

In the year to September 2014, Australia's GDP grew by 2.7%, according to the Australian Bureau of Statistics (ABS). The minutes for the Reserve Bank of Australia's last meeting stated that growth will continue to be below trend for 2014-2015.

While mining exports (including iron ore and natural gas) are ramping up, commodity prices have fallen and mining investment is tailing off. House price growth has moderated, although building approvals indicate that the housing industry will likely remain a source of growth.

Over the past twelve months labour market conditions have continued to decline as a number of major employers have announced their intention to reduce their workforce. The public sector has also implemented efforts to contain its labour costs.

The unemployment rate is currently at 6.1% in seasonally-adjusted terms and wage growth has slowed. The wage price index increased 2.5% over the year to September 2014. Full-time adult average weekly ordinary time earnings increased 2.4% over the year to May 2014. This is only just higher than the CPI increase to September 2014 of 2.3%. The Reserve Bank of Australia has forecast that employment growth would be moderate over the coming months, although the most recent data was positive, with the number of full time jobs rising by 41,600 in December.

In its 2014 annual wage review the Fair Work Commission determined that the increase in the modern award minimum wage should be set at 3% with effect from 1 July 2014, yet it is evident from the Australian economy outlook that the broad employer community expectation for salaried staff adjustments in the current Financial Year will be contained to a budgeted level of around 2.5%.

Executives and key staff

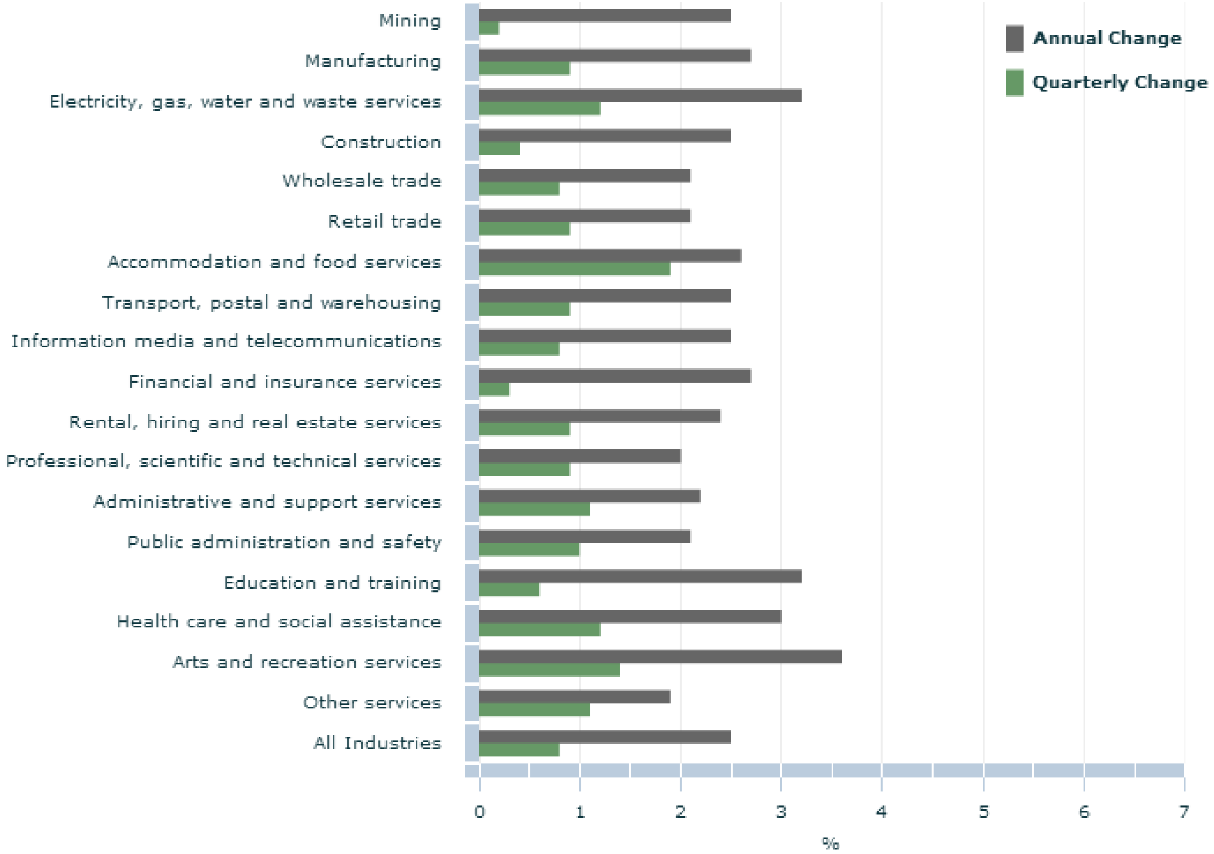
In contexting their own enterprise's alignment with a broad market perspective, organisations will need to have regard to the underlying movement in wage levels of award-covered employees and any significant pressure points, which may vary across different industry sectors and by location.

The Australian Financial Review conducted an analysis of government data revealing that the enterprise bargaining agreements for over 800,000 workers (including supermarkets, banks, insurers and telecommunications firms) are up for negotiation this year. The deals struck by companies will set benchmarks for the broader sector and need to be considered when planning executive pay reviews.

One recent example that sets the tone for the year is the deal that has just been reached by vegetable processor Simplot, where employees agreed to a 6% rise over three years, around half the increase unions had originally sought. New employees will receive less generous redundancy provisions. The deal also includes clauses which increase the ability of Simplot to hire external employees for certain types of work and allow it to operate the plant on days where there is no shift allowance or penalty rates.

Figure 1, sourced from the Australian Bureau of Statistics, provides data on the increase in total hourly rates of pay by industry to the September 2014 quarter.

Figure 1: Annual & Quarterly changes, Original, Total hourly rates of pay excluding bonuses, Industry



Depending on the sector, each organisation's performance and their prior and planned remuneration adjustments (which we discuss below), it would be our judgement that award exempt staff will receive indicative pay adjustments in the range of 2% to 3% in the 2015 calendar year.

This assessment by Egan Associates reflects a downturn from that of the previous twelve months, broadly in line with the relative decline in average weekly earnings, and reflects a fixed remuneration adjustment broadly aligned with forecast movement in the Consumer Price Index.

Until recently, the Australian dollar reflected parity or better with the US dollar. With our dollar's strength, the rewards of senior executives in Australian companies were highly competitive on a global scale.

Over the last twelve months this has changed. The Australian dollar will now only buy approximately 80 US cents, although this currency realignment has not been universal. Other economies, particularly those in Europe, have not enjoyed the same currency appreciation as the US.

The recent revaluation of the Swiss Franc may temporarily elevate the global weighting of the Australian dollar, but asset manager BlackRock believes it could still drop below US$0.70 in the first half of this year.

The impact of the Australian currency's 20% decline in value against the US dollar will affect the commitment to Australia of international investors. If companies do not achieve significant growth in share values and dividends, investors will take their money where they can get better returns.

However, in our view, although the depreciation of the Australian dollar will reduce the purchasing power of executives when travelling in some regions, it has not and will not impact directly on executive pay levels in Australia in 2015.

Recruiting US nationals could well be more difficult, although as we have previously noted, recruitment of talent from offshore always brings certain challenges, whether related to guaranteed income and retirement provisions or foregone at risk reward. We note Heidrick and Struggles' recent observations that companies are returning to global searches to meet talent gaps.

Boards

Boards appear to be generally significantly more conservative in seeking adjustment to their reward than executives. As we noted in our article for the Company Director magazine's December edition, the broad market adjustment in Directors fees will likely be in the range of 2% to 4%, with some Boards receiving no increase, while others pursuing acquisitive initiatives, demanding an increase in Directors' time commitment, or compensating for a long period since the last fee increase might receive 6% or more.

Other factors affecting Board fees include:

- The management of superannuation contributions – are fees inclusive or exclusive of super?
- The degree to which Director rewards are aligned with management's salary – in some organisations there is a link between Directors' fees and management salary adjustments.
- Board and committee accountabilities – is the increasing workload of the Directors handled by committees or the Board?
- The extent to which Directors are remunerated in equity – this can reduce pressure on fees and may become more popular as the government proposes changes to employee share scheme rules
- The primary domicile of Directors and the location of meetings – does attendance require travel or is it possible to attend meetings via video or teleconference?

A key question for an increasing number of major Australian-headquartered international companies is whether it is necessary to increase the membership of non-Australian resident Directors and compensate Directors required to attend a number of meetings around the world for travel time.

Government

Government recruitment will become more of a challenge as revenues come under pressure. In the latest State of the Service report, the Public Service Commissioner noted that the current pressure to retain costs was more like the years of austerity of the mid-eighties than the recent years of plenty. The service reduced its headcount by 7,925 in 2013-2014.

The Commissioner stated that the service had a number of human capital challenges, including hiring the right capabilities to manage risk, change and performance, lifting diversity and responding to a rising trend in unscheduled absence (12 days per employee in 2013-2014). Performance management was also an issue, not only in terms of managing underperformance, but also in terms of recognising superior performance.

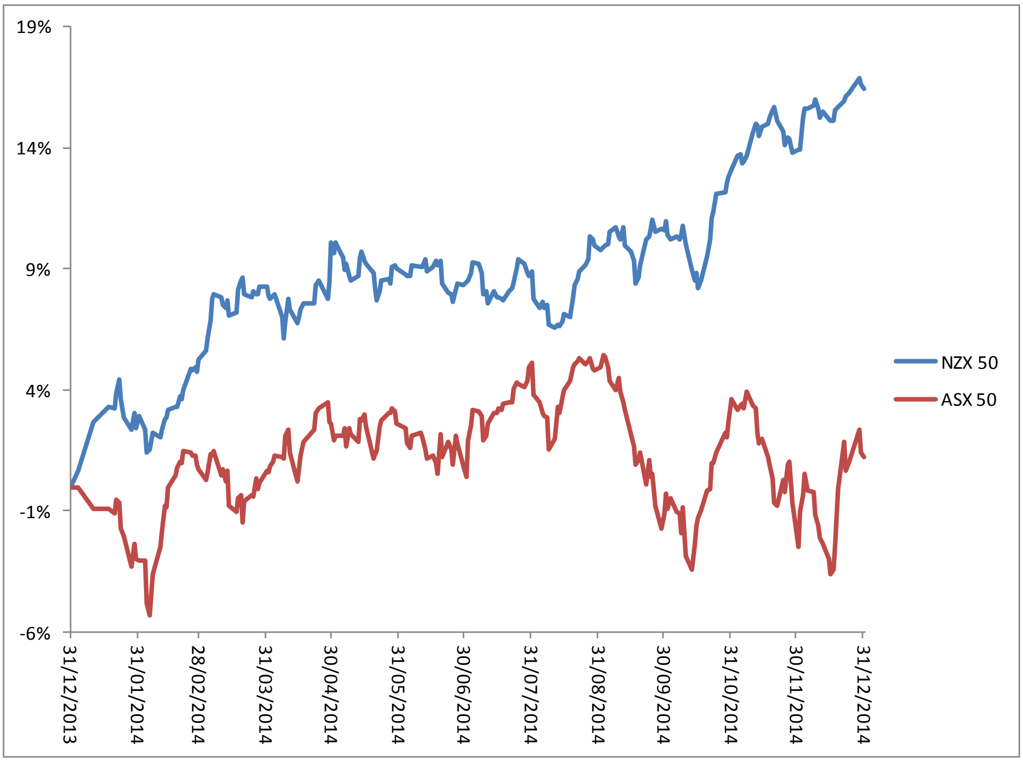
Given financial constraints and the need for a broader level of capabilities and diversity we believe the focus will shift further to the quality of hires rather than quantity. With most government organisations reluctant to pay incentives to senior staff, they may have to pay higher salaries to attract individuals of appropriate calibre to manage key policy and strategic initiatives.

This will not always be the case. We note that the Commonwealth Government has recruited a Head of Treasury and Secretary of the Department of Prime Minister and Cabinet from the private sector, both with an earlier career in government. This reflects current practice in a number of overseas governments. We might assume that these individuals have maximised their earnings in the private sector and have accepted the government challenge at remuneration significantly lower than their private sector roles offered.

Economic Conditions: New Zealand

New Zealand's share market outperformed Australia's in 2014, as can be seen in Figure 2 comparing the increase in the value of the NZX 50 index to that of the ASX 50 index over the 2014 year. The ASX 100, ASX 200 and ASX 300 indices followed the same pattern.

Figure 2: Growth in the NZX 50 index and ASX 50 Index over 2014



New Zealand's growth in GDP currently sits just above 3%. In the Reserve Bank of New Zealand's latest policy announcement it forecast that growth would remain at or above trend and unemployment would continue downwards to fall below 5% over the next two years. Inflation is low, reaching only 1% for the year to September. This is expected to increase to 2% over the same time period.

The low inflation rate provides the bank with the opportunity to delay expected increases to interest rates. The bank's concerns centred around dairy prices, which experienced sharp declines recently, and an exchange rate the bank considered overvalued and expects will deflate. New Zealand's terms of trade have been trending upwards, although they experienced a downward turn in September 2014 as prices for exported merchandise fell almost 5%.

While being mindful of the challenges of the Christchurch economy and reconstruction, the NZ economy appears to be benefiting from strong government leadership.

Management pay adjustments are likely to exceed CPI in New Zealand in 2015. While the NZ dollar has also fallen against the US dollar, it has appreciated in comparison to the Australian dollar, making the reward of New Zealand executives more competitive. Despite this circumstance and the relatively strong performance of the New Zealand share market, we believe the trans-Tasman movement of New Zealand executives towards Australia will continue. The primary attraction will be the higher fixed remuneration attached to increased company scale and higher levels of incentive reward.

Business Setting

After considering the broad economic framework, Boards and CEOs must also consider the company's own specific situation, including:

- The organisation's performance, including its near-term growth and profit expectations and relative performance compared to peers;
- geographic spread;
- product diversity;
- markets in which it competes for staff;
- variable performance of business units; and
- performance as measured by stakeholders: If a listed company their share price performance, if a subsidiary of an international group their relative standing within the global business, if a private company the view of shareholders, if a government enterprise the policy setting.

Consideration of the above elements will be crucial when determining growth in fixed remuneration relative to the general market. The factors will also be crucial for judging the appropriateness of annual incentive payments and benefits arising from long term incentives.

Fixed remuneration

While we believe the adjustments to executive fixed remuneration will remain modest, we anticipate greater variability in fixed remuneration adjustment, influenced by sector progress, innovation, productivity, development potential, import competition and the organisation's current alignment of fixed remuneration in the broader market.

Annual incentives

Over recent years executives in the listed market have benefited from an uplift in variable remuneration, both under annual incentive programs and equity-based long term incentive programs. We believe this will level out, with containment in many organisations of the annual incentive opportunity at current levels.

For organisations that achieve planned performance outcomes and in a number of instances exceed those plans, the proportion of the incentive opportunity awarded will lift. This will lead to staff receiving fixed remuneration of $200,000 per annum and above benefitting from an uplift in their total cash earnings.

In terms of performance measures, the focus will remain on the delivery of improved financial performance, sustainable outcomes, strategy and innovation. This will be apparent especially among listed companies where shareholders are carefully monitoring the alignment between incentive payments to senior management and profit improvement.

With various enquiries (such as the review of Australia's workplace relations framework) examining general conditions of employment – and by implication pay relativity – as well as Australia and New Zealand's global competitiveness, **Boards may experience pressure over the next two years to**

address management's effectiveness in improving labour productivity and in particular capital productivity. These elements, together with safety, could conceivably act as modifiers on performance-aligned rewards flowing through to management.

Long term incentives

Industries facing revenue, cost and productivity challenges may need to reconsider long term incentives over the next couple of years.

There have been a number of research papers released recently questioning the current dominance of total shareholder return measures. For example, the UK member society of the global CFA Institute, CFA UK, studied 30 companies over a ten-year timeframe and found that EPS, TSR and ROE display relatively low correlation with free cash flow to all capital providers and returns to all capital providers in excess of the cost of capital.

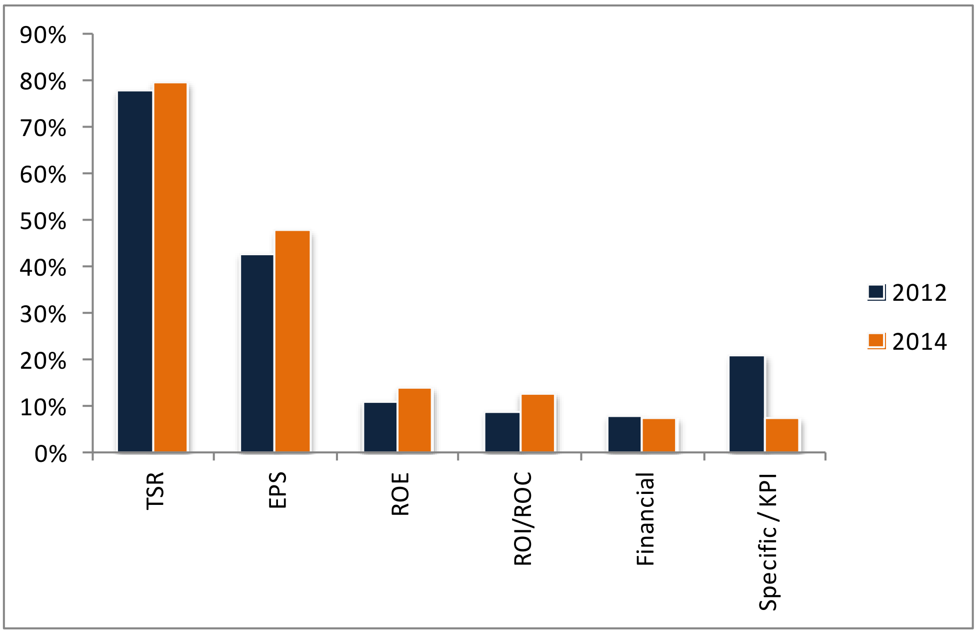
The Investor Responsibility Research Center Institute in the US studied the S&P 1500 over a five-year period and found that 17.3% of listed companies over five years had a positive relative TSR while they achieved a five-year return on invested capital (ROIC) which was less than their weighted average cost of capital (WACC). Meanwhile 17.9% of companies had a negative relative total shareholder return while achieving a positive five-year ROIC greater than WACC.

Factors which impact TSR such as fund flows, central bank policies, macroeconomic settings, geo-political risks and regulatory changes are all beyond the control of executive management, it stated.

The relative TSR measure become popular (including with proxy advisors and institutional investors) because it is simple to track, removes the need to set absolute goals annually, and is easy to explain to shareholders in terms of value accumulation. It also provides a yardstick with which to measure how well the company is performing for shareholders in comparison to other companies, taking the rise or fall of the market out of the equation.

The following graph examines the prevalence of performance measures among the top 100 Australian companies by market capitalisation that operate long term incentive schemes, comparing the current situation with that captured in an analysis conducted in 2012.

Figure 3: Prevalence of popular performance measures in Australia's top 100 companies



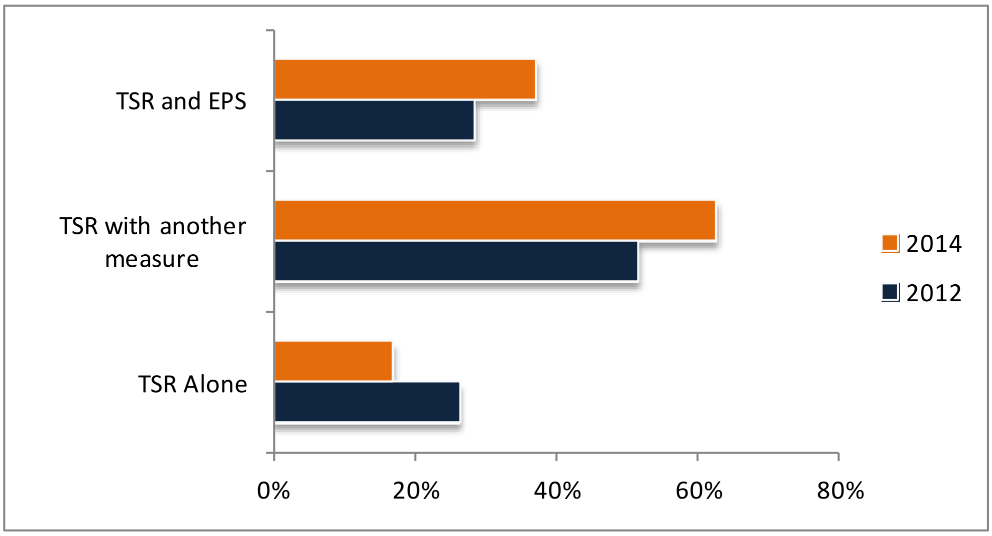
For the categories in Figure 3:

- TSR includes companies that use either absolute or relative total shareholder return (predominately the latter)
- EPS includes companies that use either absolute EPS growth or EPS growth relative to a peer group of companies (predominately the former)
- ROE includes companies that use either absolute ROE or ROE relative to a peer group of companies (predominantly the former).
- Financial denotes measures such as EBIT, EBITDA, profit before tax, NPAT and Revenue growth
- Specific/KPI indicates measures that could not be broadly categorised because they were milestone-based or represented an industry benchmark. This group also included those companies which did not disclose measures clearly.

The latter category has declined significantly between the two analyses. There are fewer companies now which have performance measures that are not broadly applicable or where lack of disclosure hinders categorisation.

Total shareholder return is used by a majority of companies, although its use as the sole long term incentive measure has declined as can be seen in Figure 4.

Figure 4: Prevalance of TSR with other metrics among the top 100 Australian companies



Yet, as the research mentioned on page 10 demonstrates, relative TSR is not ideal for every company or in every circumstance.

Companies experiencing particular market pressures and demanding certain transformative actions may need to turn away from relative TSR in 2015 and instead adopt performance measures that are tailored to the company's strategic direction and place emphasis on capital productivity, costs, innovation and meeting key performance milestones.

This may require detailed disclosure to ensure proxy advisors and institutional investors understand the change, however, we believe it will be worth it in the long run.

Time horizons may also need to extend to align management's mindset more closely to the long-term rather than medium term. This will require a commitment from key stakeholders: the Board, executive team, shareholders and customers.

A key issue will be maintaining the long term incentive plan's regional and global competitiveness: in our judgment a proportion of executives across many industries are placing insufficient value on their reward potential available from their participation in an LTI plan, despite the cost to the company of the plan.

Where the long term incentive program adopts an extended performance horizon (five or more years) the proportion of the annual incentive that is deferred may well need to be reduced.

Another factor that is likely to affect Board's consideration of long term incentives will be **disclosed IPO reward arrangements**. The executives of some companies in similar industries and of similar scale to organisations that have recently undergone an IPO have compared their own long term incentive arrangements unfavourably with the significant equity participation of executives in a newly listed competitor.

What is often lacking in the management's understanding is that executives operating in the pre-listing organisation will often have co-invested, taking on significant personal investment risk for a potentially large upside.

For crucial talent, one opportunity for Boards to respond to observations from management might come from deferred STI, which could be considered as a kind of co-investment (the executive is in effect investing a bonus they have earned into company shares). The company could potentially offer a matching option per share to increase their alignment with shareholder interests and achieve retention. Clawback would naturally apply to this award in the same manner it would to deferred STI.

Egan Associates is familiar with these demands and perspectives, having advised on the transition reward strategy and implementation for more than 20 transactions, IPOs and post-IPO reward frameworks in the immediate past. We expect our transaction consulting team to remain active in 2015.

Past pay adjustments

Management and Boards will need to both look back and forward when conducting remuneration reviews, setting adjustments with regard to the degree to which they believed they accommodated market pressures in 2014 or need to address such pressures in 2015.

This includes a retrospective and prospective examination of:

- adjustments in remuneration across the organisation;
- market adjustments in competitor companies;
- movements in internal relativity;
- internal/external pay anomalies including new hires and legacy deals;
- job/occupation specific strategies.

Criticality of retention and recruitment

In addition to the above-mentioned lenses must be laid one last critical consideration: supply and demand of crucial talent. How difficult is it to attract and retain staff? Is there a high level of staff turnover?

Organisations experiencing such concerns may need to adjust their remuneration policies to ensure the right talent is attracted and retained. Different market competitive policy settings may need to be developed at each layer of the organisation.

The considerations under the “business setting” heading provide pointers on where to place the emphasis in retaining and attracting talent for operations in the year ahead.

One area where retention will be crucial in 2015 will be significant transactions and IPOs: investors will want to retain the team that stewarded the company’s performance immediately prior to listing or sale.

Tailored remuneration advice will remain critical because reward structures which are geared to significant transformation will not be acceptable to institutional or retail shareholders in a listed environment. The challenge for the remuneration consultant will be to cater to the new Board’s requirement to retain and motivate management while also considering the expectations of the private investors, particularly where escrow provisions are modest.

In the volatile global capital markets expected in 2015, where organisations may experience unexpected share price gyrations, the more skin in the game retained by management, the better their alignment with new shareholders’ expectations.

Government policy

The government has proposed changes that will affect the taxation provisions of employee share schemes. This may make it more attractive for employers to offer share schemes to their employees and Directors, which could reduce pressure on fixed remuneration.

The 2015 year will see a review of the workplace relations framework and a examination of penalty rates within retail and hospitality awards in Australia. We do not expect these reviews to have a direct effect on executive pay, although we believe it will provide context, especially with regard to annual incentive plans, which will increasingly be influenced by leadership’s efficient management of capital and labour productivity.

A conflict of perspectives between the Coalition Government and the Senate may frustrate reform and not support long term national labour market transformation.

About us

Egan Associates

For more than 25 years, Egan Associates has advised leading organisations and emerging enterprises in Australia and New Zealand on the remuneration of Board Directors, executives and key staff members, as well as performance management, corporate governance and Board effectiveness.

Our Services include:

- **Remuneration reviews and benchmarking** for Boards, CEOs, executives, senior management and professional positions, including specialist roles
- **Corporate transactions / IPOs**: assistance transitioning pre-IPO reward arrangements into the listed company environment with considerations including escrow provisions
- Advice on **annual incentive plan structures**, performance criteria, target and maximum payment levels including deferral and clawback provisions
- Advice on **long term incentive plan structures**, participation, performance hurdles, equity instruments, valuation and allocation, as well as monitoring
- **Government pay reviews**: assistance at both Federal, State and local level in administrative, policy and corporatised environments on reward for senior executives, professional and administrative staff and governing Boards
- **Online human capital solutions:** online resources to assist organisations manage position documentation, work value, internal relativity, market competitiveness and performance.
- **Board effectiveness:** assistance with Board reviews, Board skills matrices, scenario planning and Board documentation.

John Egan

John's early career was with Cullen Egan Dell (now Mercer Human Capital), which he chaired from 1983 to 1989, when he formed Egan Associates. John has been an advisor to Boards and senior executives on organisation, governance and reward issues over many years. He has assisted a significant majority of Australia's top 200 companies as well as a myriad of entrepreneurial organisations and government entities across a wide range of industries.

John has been actively involved with Universities, chairing Sydney University's Board of Advice for its Faculty of Economics & Business (2001 – 2010). John is an Honorary Fellow of the University and an Adjunct Professor in the School of Business.

His personal interests are in cool climate gardens – www.thebraesgarden.com – and he served as a Trustee of the Sydney Royal Botanic Gardens & Domain Trust from May 2010 to June 2014.