

Incentive Compensation Packages: A Survey

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“What gets measured gets managed”

“What gets measured gets managed” is a common but realistic consideration when designing an incentive compensation system. If the primary goal of a business is to create value then it follows that the incentive compensation system should have performance measures and targets that are consistent with this goal (see Valuation Matters, December 2010 Issue).

Another important design consideration arises from the need to make it easy to value the scheme and expense it AASB 2. We have found some challenges in this regard when doing so for clients.

We recently undertook a review of reported compensation packages of listed companies to refresh our understanding of them and the high level findings are summarised here. Value Adviser Associates compiled a database of information on 70 listed companies including 50 of the top ASX100. We sampled across industry sectors and also included 20 small to mid-size companies. Data was sourced from the executive remuneration reports disclosed in annual company accounts.

Overall spread of reported packages across components

On average, approximately 60% of executive compensation was base salary, 20% was in short-term incentives [“STI”] and 20% in long term incentives [“LTI”]. Interestingly the LTI component did not vary significantly across sectors (see Figure 1).

What did vary across sectors, and also to some extent within sectors, was how cash compensation was split between base salary and short-term incentives. Sectors in the financial sectors including Banking, Real Estate and Financial Services had the lowest component of base salaries (although our sample was small) and the highest in STI.

We note that in many instances, CEOs and senior executives had significant shareholdings or were required to have minimum shareholdings in the company. Changes in the value of this shareholding did not form part of the analysis so the overall LTI impact will be understated.

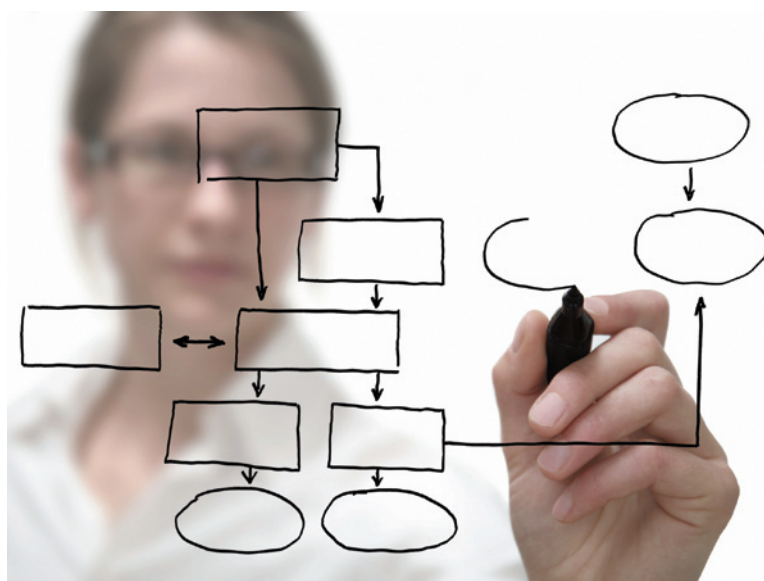
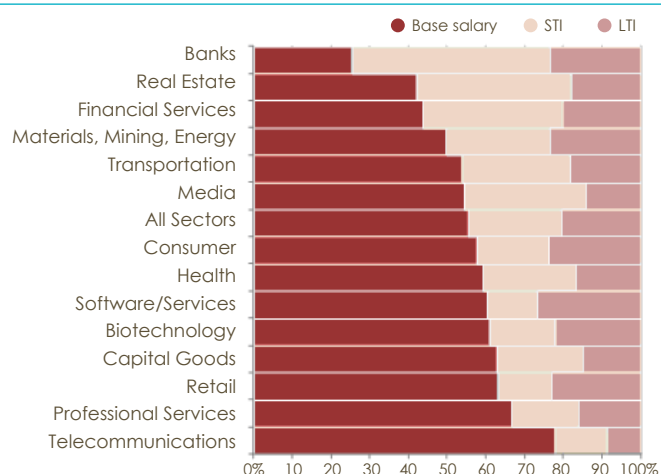


Figure 1: Split of Executive Salaries by Base, STI and LTI



Source: Company annual reports, VAA analysis

From our sample:

- On average 57% of compensation is in base salary, 23% in STI and 20% in LTI;
- Banks (retail and investment) had a significantly lower proportion of base salary versus other sectors;
- Real Estate and Financial Services (which includes Insurance) had the next lowest proportion;
- LTIs were rarely more than 20% of total compensation but were highest in software biotech, consumer and retail, banks and metals, mining and energy.

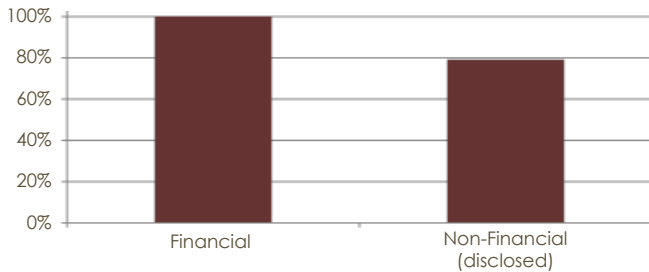
Measurement of Short Term performance – which measures were most used?

Short-term incentives were usually in the form of a cash bonus for meeting or exceeding certain performance criteria.

¹ Our thanks to Arun Chockalingam for a lot of data collection.

In general, STI performance measures included both financial and non-financial components (as outlined in Figure 2 below). Non-financial measures included measures specific to the individual as well as, for example, measures relating to customer or employee satisfaction, OHS days lost and other operational measures.

Figure 2: Financial versus Non-Financial Measures of STI

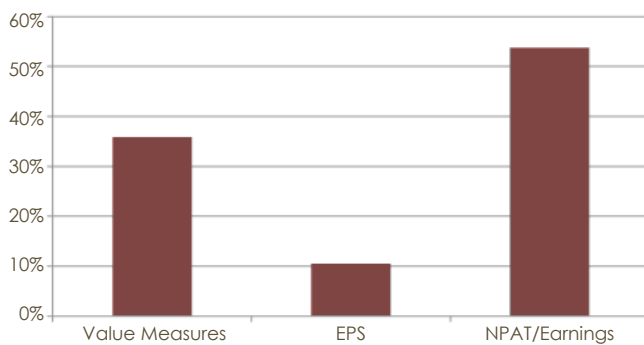


Source: Company annual reports, VAA analysis

Interestingly, specific mention of the Balanced Scorecard was relatively rare. However, it was clear that the concept was often present in terms of having measures that covered financial, internal business processes, customer and learning and growth.

Financial based measures based on traditional accounting concepts of profit were more prevalent than measures we classify as “value” measures.

Figure 3: Types of STI Measures Used



Source: Company annual reports, VAA analysis

Value measures usually incorporate a return on capital component, some examples include:

- Return on investment (“ROI”) or similar measures (e.g. ROIC, ROCE, ROE) where ‘profit’ is divided by ‘capital’;
- Cashflow-based measures, where changes in investment in working capital, PP&E and other assets are deducted from operating profit;
- Economic profit or similar measures such as EVA (Economic Value Added) and CVA (Cash Value Added) which directly incorporate a return on capital by subtracting a capital charge from the profit measure.

The specific use of these value measures varies across companies as illustrated in Figure 3.

Figure 4: Examples of Value Based Performance Measures for STI

Measure	Examples
Economic profit	Orica
Economic profit and cashflow	Westpac/ANZ
Return on Capital (BU level)	Wesfarmers, Leightons
ROCE / ROFE / ROIC	Woolworths, CSR, Reece, Bluescope
1 Year TSR	Woodside
ROE	QBE, AMP, Perpetual
Brambles value add, cashflow ops	Brambles
Free cash flow	Telstra
Free cash flow, ROAFE	Amcors
Budgeted cash flow	Boral
Cash flow ROA	Toll
Operating cash flow on capital	Origin

The specific use of non-financial measures also varied significantly across companies. Employee safety was often mentioned in particular industries (Mining, Oil & Gas, and Construction as examples), often alongside mentions of the environment. More broadly, employee satisfaction (or people management) was prominent, as was customer satisfaction. There were also mentions of strategic measures e.g. market share and growth and achievement of specific individual objectives such as specific project delivery.

Figure 5: Examples of Non-Financial Measures for STI

Measure	Examples
Balanced scorecard	ANZ
Health, safety, environment, community	BHP Billiton
Staff turnover, safety, food safety compliance	Woolworths
Safety	Woodside
Customer service, health, safety, environment	CSL
Project delivery, culture-engagement, safety	Origin
Service to customers and advisors	AXA
Market and competitive positioning	AMP
Growth, customer, talent management and safety	Brambles
Safety, health and environment, diversity	Orica
Customer satisfaction, risk management	Transurban
Customer, people management	AGL
Safety	Newcrest Mining
Customer, corporate responsibility, people	Mirvac
Sustainability (including safety, HR environment etc)	Boral

With such an array of non-financial measures employed by companies, it is critical that scheme designs consider the ultimate linkage of non-financial measures to longer-term shareholder value creation in a way that does not create conflicts in management priorities or over-complicate the priorities / initiatives of management.

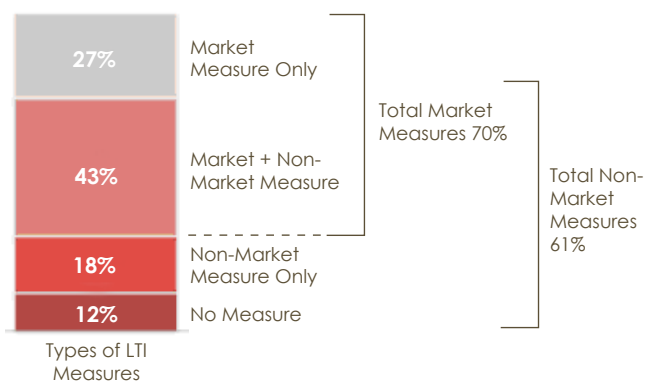
Measurement of Long Term performance – which measures were most used?

LTI measures were grouped as market based or non-market based measures.

Market based measures relate directly to shareholder return performance e.g. total shareholder return (“TSR”). Non-market based measures were internal measures performance such as NPAT or EPS.

A key observation was that the most prevalent approach to LTI performance targets (43% of measures) was a combination of market and a non-market based measures. Only 27% of our sample used a market based measure alone, while 18% used non-market based measures alone. The balance (12%) did not use a LTI measure.

Figure 6: Long Term Incentive Performance Measures



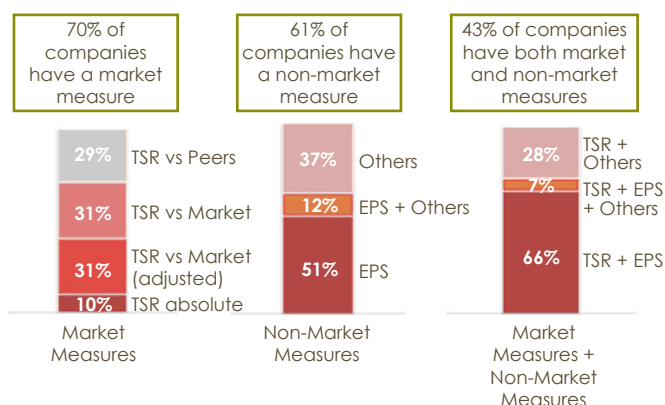
Source: Company annual reports, VAA analysis

Of the 70% of cases that used a market measure, 90% used a market based measure relative to an index of stocks. The balance used an absolute measure (usually because of a belief that there was no appropriate benchmark group).

The relative indexes were split evenly among:

- a general market index e.g. ASX100;
- an adjusted market index e.g. ASX100 excluding financial stocks or the ASX100 excluding resources;
- a select peer group e.g. an industry sector or more select group of peers.

Figure 7: LTI Performance Measures Breakdown



Source: Company annual reports, VAA analysis

Of the 61% of cases where a non-market based measure was used, EPS (or EPS growth) was the dominant measure being used. In most of these cases it was the only measure used.

When more than one measure was used the majority of plans (73%) included both TSR and EPS as the combined measures.

Ideally incentive targets should reference market expectations and long-term value creation targets

Perhaps of more importance than the measure employed is to ensure the measure is calibrated, at minimum, to current market expectations embedded in the current share price. There can be a tension between current market expectations and the internal view of value which often differ. Understanding the basis of any difference is important to establishing targets that will, if achieved, maximise the chance of value creation for the business. Both long and short term targets should be consistent with a long-term strategy that has been tested for its likelihood of creating and delivering shareholder value.

Market expectations can be derived from analysing:

- ‘banked’ performance compared with growth expectations – the former reflecting what has been achieved;
- consensus analyst forecasts and their dispersion around near-term profitability and growth. This can inform a minimum target;
- a valuation model of the business calibrated to current share price.

In the instance where calibrating non-market measures is too complicated, we recommend incentive plans focus on using market measures only.

The internal view of value can be established by converting plans into financial outcomes and valuing these. An essential part of this work is ensuring the financial projections and the view of market economics and relative competitive position is aligned. For example, if the valuation demonstrated considerable value creation then it must arise because there is some combination of an attractive market for the firm’s products or services and a strong relative competitive position thereby providing a source of sustainable competitive advantage.

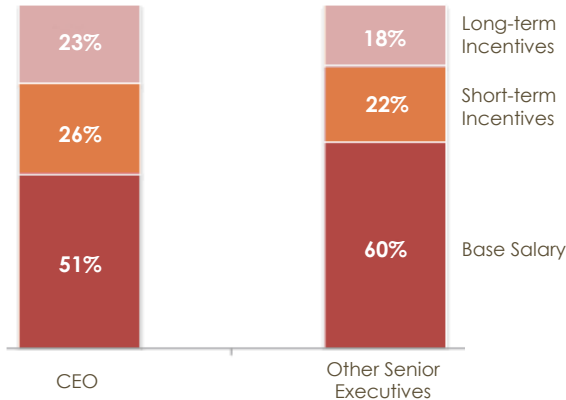
It is much easier to ensure consistency in the measures and targets used in the STI and LTI components of a plan and targets if there is a valuation model reflecting business strategy. The targets should fall out of such a model. Further there is a better chance of delivering and informing market expectations if an exercise of reconciling the external and internal view of value has been undertaken.

Unfortunately the remuneration reports were silent about the basis for the STI and LTI targets and also about any linkage to across the LTI and STI targets.

Remuneration of CEOs versus other Corporate Officers

Not surprisingly we found that on average CEO's had a lower proportion of their compensation in base salary versus other senior executives. The lower base was offset by proportionately higher STI and LTI amounts (split roughly evenly between the two).

Figure 8: Split of Remuneration, CEO versus Other Corporate Officers

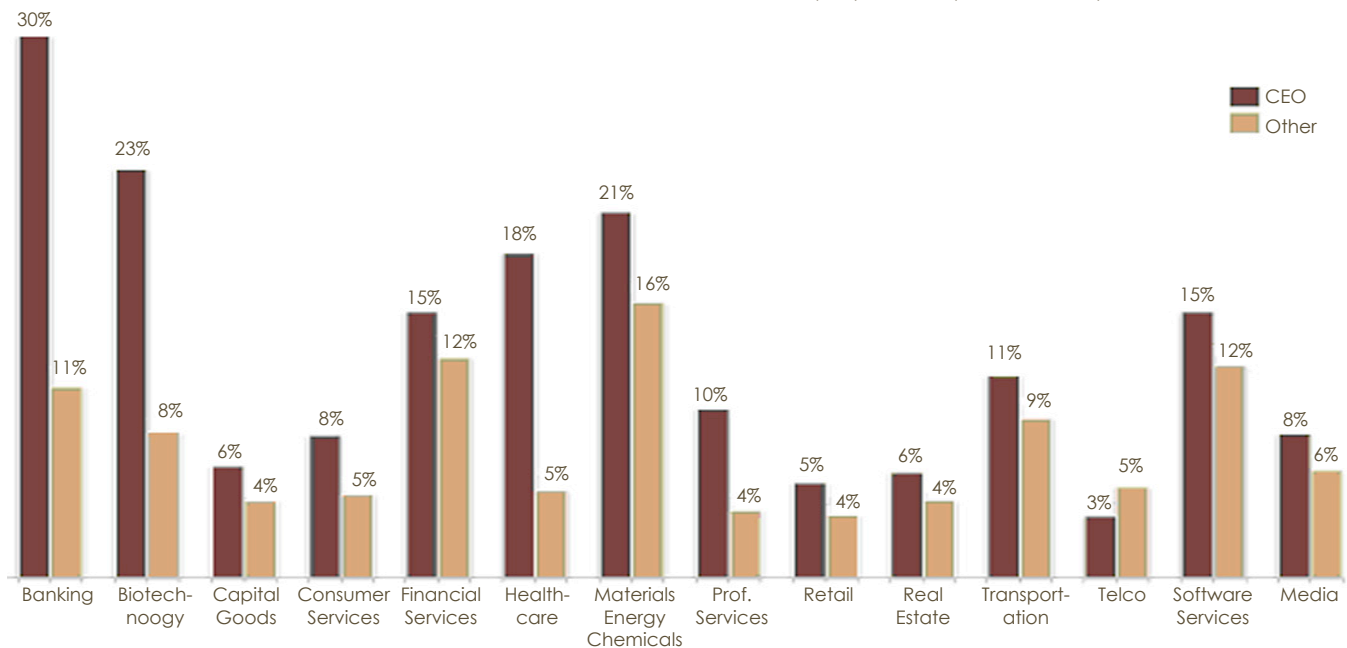


Source: Company annual reports, VAA analysis

Of interest was how sensitive CEO and other corporate officers were to TSR performance during the year. The measure we used was the percentage of LTI based remuneration multiplied by the proportion determined by TSR performance.

On average (noting small sample sizes however), CEOs in the Banking, Health, Biotechnology and Professional Services sectors had significantly higher exposure to TSR performance compared to other senior staff in the companies.

Figure 9: Sensitivity to TSR Performance



Source: Company annual reports, VAA analysis

In sectors such as Telecoms and Real Estate where TSR performance has been more sedate in recent years, the proportion of compensation determined by TSR performance was low for both CEOs and other executives.

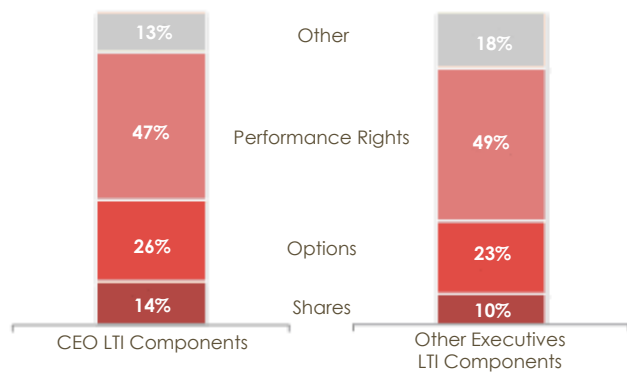
How did companies structure their incentive payout?

Following changes to the taxing of executive stock options in 2009 (options are now taxed on vesting at their fair value), performance rights (which are zero strike price options) have now become the predominant means of compensation for LTI plans representing nearly 50% of the total type of LTI incentives.

Perhaps not surprisingly, the proportion of performance rights, options and shares were not significantly different between CEOs and other senior corporate officers (they were largely dictated by the overall plan and not specific to an individual).

We do note that the structuring of options and performance rights can add to the compliance costs, if the schemes have added complexity. For example, options with reload features were popular forms of compensation through the 1990s. The reload features add considerable complexity to the valuation process.

Figure 10: LTI Remuneration by Type



Source: Company annual reports, VAA analysis

Additional observations from the research

Some additional observations from the research include:

- A number of companies (e.g. Mirvac and Bluescope) disclosed a termination Payment Cap (ASIC Regulation) as it is no longer possible for companies to make termination payments in excess of 12 months without receiving shareholder approval;
- Of the companies that still issued options, most issued the options at the money;
- Some companies also used medium-term incentives. For example, Leighton: awarded such a payment subject to a year-on-year increase in profit for the individual business unit and Group and Newcrest awarded payment based on performance measured based on the company's TSR measured against the TSR of a comparator group of companies over the previous financial year.
- Many companies had specific guidelines specifying minimum shareholding for executives. Most of the bigger market cap companies expect their executives to accumulate shares over a period time and maintain that shareholding while being an executive of that company e.g. ANZ, BHP Billiton and Rio Tinto;
- Many companies allowed for retesting of performance hurdles. When testing reveals that the relevant performance hurdles have not been met, then the particular tranche of rights or options can, within the limit of its retest opportunities, be carried over to the next anniversary and retested e.g. CSL and WorleyParsons.

To discuss Incentive Compensation Packages further, please contact Dr Steve Bishop or Justin O'Brien. 



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