

Newsletter May 2015

Pay for performance has been squarely on the international radar in the last month: the US' SEC recently released a proposal requiring increased disclosure of the link between company performance and executive remuneration and a UK report was released addressing the effectiveness of performance-based pay plans.

On the same theme, Egan Associates has looked at the payment levels for annual bonuses of Australia's top 100 companies in the 2014 year. We also conducted some analysis for the Australian Financial Review looking into the long-serving CEOs of top Australian companies that performed the best over the last five years.

The newsletter is rounded off by our budget overview.



Target STI Payments the Norm for Top CEOs

Analysis of the top 100 Australian companies by market capitalisation at 31 December 2014 has shown that over half of the CEOs received at least their target STI payment for the 2014 year.



Founders Dominate Top CEO Stakes

Founder CEOs and Executive Chairmen have outperformed in Egan Associates' most recent analysis of long serving CEOs over the last five years.



Abolish Long Term Incentive Plans? Or Just Fix Them?

A recent report published by UK think tank The High Pay Centre has recommended the abolition of long term incentive plans, claiming they have driven up executive pay to unwarranted levels without delivering a corresponding increase in company performance.



US to Standardise Pay for Performance Disclosure

The US Securities and Exchange Commission has released draft measures that would require companies to disclose the relationship between executive remuneration and total shareholder return over a five year period.



Federal Budget Snapshot

Egan Associates provides a snapshot of the Australian Federal Budget from a remuneration and governance perspective.

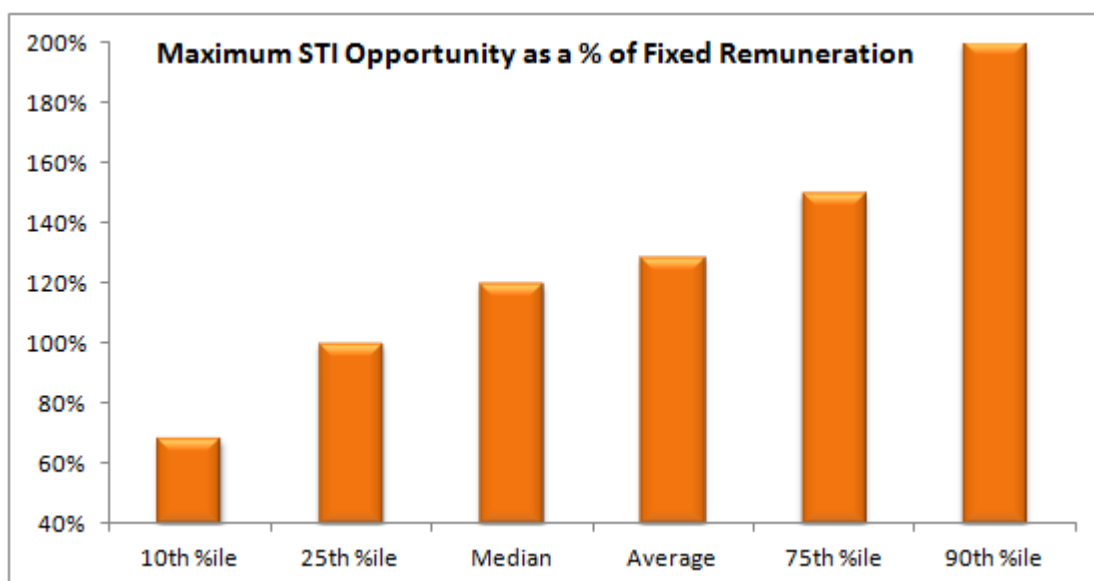
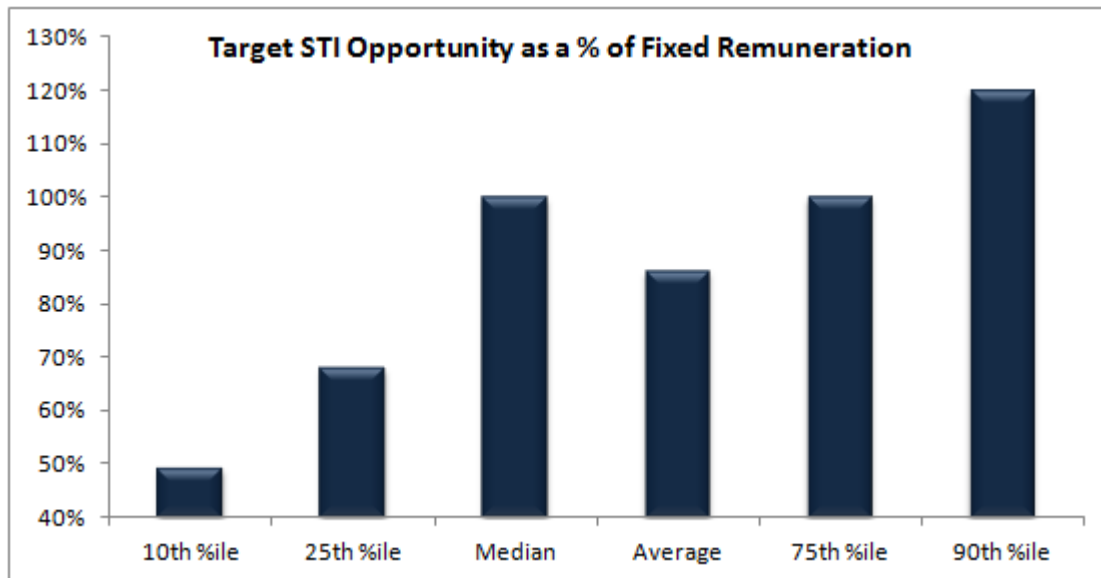
Target STI Payments the Norm for Top CEOs

Analysis of the top 100 Australian companies by market capitalisation at 31 December 2014 has shown that over half of the CEOs received at least their target STI payment for the 2014 year.

Not all companies disclose their target and maximum opportunity for short term incentives and some disclose target payments amount that are equal to the maximum award possible under their bonus arrangements.

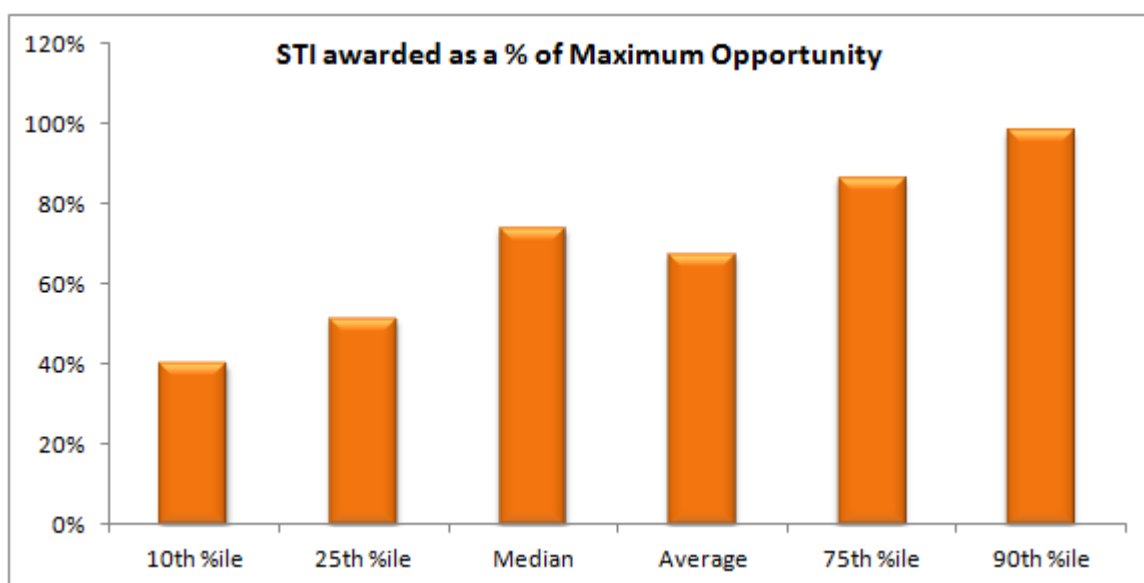
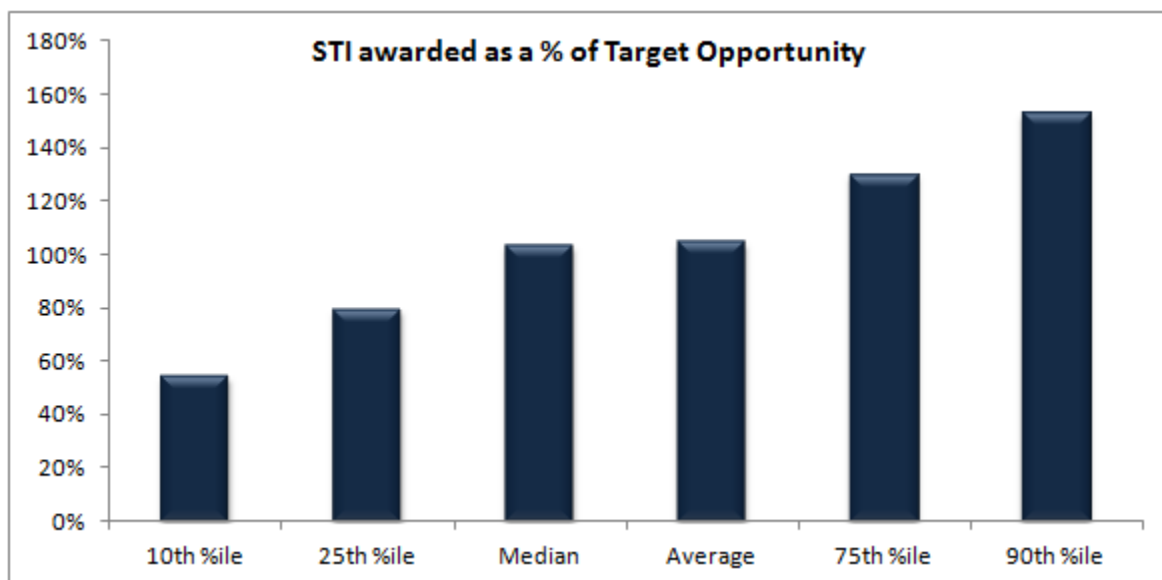
Of the 100 companies, 70 disclosed the target STI opportunity for the 2014 year as a percentage of total fixed remuneration and 86 disclosed the maximum STI opportunity.

The distributions of target and maximum opportunity for these samples were as follows:



For the median company, target STI opportunity was approximately equal to fixed remuneration.

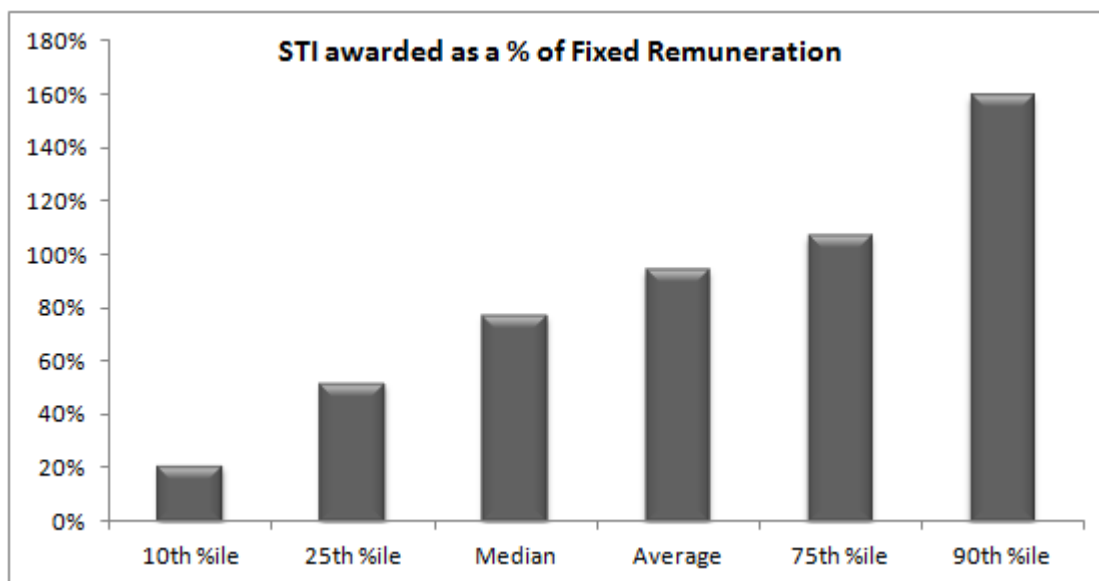
The percentage of the target and maximum actually awarded for the CEOs of these companies was as follows:



Of the companies that disclosed the target opportunity as a proportion of fixed remuneration, half paid their CEO at target level. Of those companies that disclosed maximum STI opportunity as a proportion of fixed remuneration, half paid almost 75% of the maximum payment.

A small number of companies were excluded from the above distributions because they were undergoing a structural transition and their remuneration was unable to be separated into portions related to the entity post and prior to restructure.

Disregarding whether the target and maximum opportunity was disclosed, the distribution of STI paid as a percentage of fixed remuneration was as follows (with a sample size of 96):



This appears to show that companies that do not disclose target or maximum STI opportunities as a proportion of fixed remuneration paid their CEOs lower bonuses during the 2014 year than those that did.

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Founders Dominate Top CEO Stakes

Egan Associates was requested by the Australian Financial Review for the third year in a row to identify the long-serving CEOs who have significantly outperformed their peers over the most recent five-year time frame.

Only the top 200 companies by market capitalisation at 31 March 2015 with CEOs who had been serving for five years or longer were considered in the analysis, which assessed companies based on their total shareholder return, return on equity and revenue growth over the last five years.

The top ten companies as assessed by these metrics were as follows:

1	AINSWORTH GAME TECHNOLOGY
2	MAGELLAN FINANCIAL GROUP
3	NORTHERN STAR
4	CORPORATE TRAVEL MANAGEMENT
5	DOMINO'S PIZZA ENTERPRISES
6	SLATER & GORDON
7	TECHNOLOGY ONE
8	VOCUS COMMUNICATIONS
9	SIRTEX MEDICAL
10	AMCOM TELECOM.

The Australian Financial Review's full feature can be found in May's BOSS Magazine, which was on sale 8 May 2015.

Of the top ten companies, five are led by CEOs or Executive Chairman who are founders – their performance is a testament to their ability.

"Entrepreneurs with the passion, knowledge and expertise who can engage staff can remain successful for a long period of time," Egan Associates Chairman and Founder John Egan said.

They are often rewarded well for their success, achieving rewards above non-founder CEOs, although this generally requires a level of commitment over many years often without significant reward.

"Their success often arises from many years of hard work pursuing a vision with a level of tenacity often not present among senior executives in established corporate roles," John Egan said.

"For every success there are a greater number of hard working, committed and inspiring individuals who fail to realise their dream due to either lack of capital or similar offerings entering the market which better capture contemporary and fast moving appetites."

Critical for a successful entrepreneur is developing the right marriage with an independent Board, according to John Egan.

“It’s important to have a Chairman who implements appropriate governance and offers enough direction to control the outrageous while not putting a noose around the fast moving, energetic entrepreneur who will always want to explore new horizons,” he said.

Some companies, such as Ainsworth Gaming Technology and Magellan Financial Group, with continued revenue growth and return on equity performance complementing their significant rise in share price over the five-year period, have outperformed other companies, being placed in our top 10 three years in a row.

Yet, past performance is as ever not a reliable indicator for future gains, with other companies presently absent who had been in the top ten in prior years. They made way for forceful newcomers, which included the telco Vocus and gold miner Northern Star.

Companies that just missed out on making the top ten, but performed well enough to reach the top 20, can be found below:

11	TPG TELECOM
12	NIB HOLDINGS
13	BT INVESTMENT MANAGEMENT
14	RAMSAY HEALTH CARE
15	BLACKMORES
16	SEEK
17	CARSALES.COM
18	INVOCARE
19	ARB
20	AP EAGERS

Methodology notes:

- The largest 200 companies by market value listed on the ASX as at 31 March 2015 were taken, excluding companies that are foreign registered, externally managed funds and investment trusts where KMPs are employed by the responsible entity for the trust. Companies excluded that were not listed for at least four years at 31 March 2015.
- CEO must have been in their role or in an equivalent leading role for at least five years at 31 March 2015.
- Companies were ranked based on revenue growth, total shareholder return and return on equity and then given a combined ranking. Total shareholder return was assigned double the value of the other metrics.
- Geometric mean for revenue growth, total shareholder return (TSR) and return on equity over five years were used. In the calculation of TSR, 20-day smoothing was used. Where data was unavailable, the mean was calculated for available years.
- S&P Capital IQ data, Annual Reports for 2009 to 2014 and ASX announcements.

Abolish Long Term Incentive Plans? Or Just Fix Them?

A recent report published by UK think tank The High Pay Centre has recommended the abolition of long term incentive plans, claiming they have driven up executive pay to unwarranted levels without delivering a corresponding increase in company performance.

The report was the result of a year-long enquiry conducted by a committee that included the UK Institute of Directors' Director General Simpson Walker as well as members of the media, academia and business organisations.

The report's concerns about long term incentive plans included:

- Their "long-term" nature is actually of a short enough duration that any investment in equipment or human resources expected to bear fruit in a longer time frame could impact negatively on incentive payout, thereby acting as a disincentive for executives to invest.
- Incentives focus executives on one goal rather than the complex pattern of behaviour required to drive the company's best interests and do not necessarily reward an individual for the right behaviour but rather for being in the right place at the right time.
- Research suggested that long term incentive plan (LTIP) payments to FTSE 350 Directors increased by over 250% between 2000 and 2013, approximately five times as fast as returns to shareholders. It also found the correlation was weak between LTIP payments to executives and shareholder returns.



The report's conclusion was that the concept rather than the design of long term incentive plans was flawed, as noted in the extract below:

Linking the largest component of executive pay to crude performance measures that imprecisely represent the complex role of leading a large company is clearly a mistake. Having committed their time, effort and career to obtaining and maintaining an executive position, executives are already invested in the long-term success of a company, so there is no grounds for concern that the abolition of LTIPs would cause the interests of a business and its managers to diverge.

Egan Associates would question the report's conclusion, though we believe that many Boards' management of long term incentive plans falls short of their stated objectives of rewarding superior performance and shareholder alignment.

In part our concerns have been due to the inflation in the value of long term incentive grants over time because of the increasing use of accounting standards to value equity for allocation purposes.

This practice, which has been going on for a number of years, is exacerbated by a lack of standard disclosure that leaves shareholders in the dark as to the value of grants executives are actually

receiving and what the maximum potential reward is likely to be if the executive meets all performance requirements.

This lack of transparency has also complicated benchmarking of long term incentives in a meaningful manner.

We acknowledge the High Pay Centre's concerns about incentive duration, noting that there is potentially scope for longer-term plans as long as they do not inflate the quantum of awards that have already been expanded due to the point noted above.

Finally, we have always endorsed long term incentives that are aligned with an organisation's long term strategy. An incentive structure and performance benchmarking that is appropriate for a company in the resources sector will not be appropriate for one in the retail sector.

The High Pay Centre report has been critical of relative total shareholder return (TSR) measures – it has not been the only report to do so. We support the initiative in recent times for companies' adoption of bespoke incentives that match their long-term strategy and aspirations. However, we would also note that relative TSR with an appropriate peer group can be powerful if supported by a targeted performance hurdle or gateway and the considered exercise of Board discretion.

We do not believe that the problems with long term incentives are so severe as to require their removal from the remuneration equation. Yet there are some points that could benefit from reform. We intend to complete a larger body of work addressing issues with long term incentive grants, their disclosure and their motivational value in bull and bear markets.

Other Recommendations from the High Pay Centre Report

Along with its recommendation regarding long term incentives, the High Pay Centre report also suggested that:

- Bonuses be paid in cash only due to executives undervaluing share awards.
- A broader range of company specific targets be utilised in short term incentives with a focus on productivity.
- Remuneration committees become more diverse.
- Golden hellos be abolished for unadvertised positions.

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US to Standardise Pay for Performance Disclosure

The US Securities and Exchange Commission released draft measures at the end of April that would require companies to disclose the relationship between executive remuneration and total shareholder return (TSR) over a five year period.

The proposed rules require companies to include a table in their disclosure with the following information:

1. Executive remuneration *actually paid* for:
 - The principal executive officer; and
 - An average of the remaining named executive officers who are covered by disclosure requirements.



Remuneration *actually paid* treats pension payments and equity awards differently than current disclosures:

- *Equity awards* – Under the proposal, equity awards would be considered actually paid on the date of vesting and at fair value on that date rather than recorded at the fair value on the grant date (as required in the summary compensation table included in current disclosures).
 - *Pension payments* – Pension payments are considered as the actuarially determined service cost for services rendered by the executive during the applicable year.
2. The total executive remuneration reported in the summary compensation table already included in current disclosures.
 3. The company's TSR on an annual basis.
 4. The TSR on an annual basis of the companies in a peer group.

Large companies have to provide this information for five years (with a phase in period where the first year of the rule's application only requires three years' information and the second year requires four), while smaller reporting companies only have to disclose the last three fiscal years (with a phase in period where the first year of the rule's application only requires two years' information). These smaller companies are also excluded from the requirement of disclosing TSR for a peer group of companies and the requirement to make the necessary pension adjustments for the remuneration actually paid.

Companies need to use an interactive data format for the disclosure, with this requirement being phased in for smaller companies.

Using the above information, companies are expected to explain the relationship between the remuneration actually paid and the company's TSR, as well as comment on the relationship between the TSR of the company and its peer group, either in text or graphical format.

The proposed rules would apply to all reporting companies except for foreign private issuers, registered investment companies and emerging growth companies, which are exempt from the statutory requirement.

The proposed rules are currently in consultation. There is no proposed effective date, however, it could be as early as the 2016 proxy season.

Reaction

Some comments that have been made by industry stakeholders have included:

- The new disclosure may lead to proxy advisors and institutional investors seeking to apply a pay for performance correlation across the board.
- Companies that are using a combination of measures or a measure other than TSR will run the risk of showing increased pay at a time where TSR has not increased proportionally. This may encourage them to adopt purely TSR measures for their incentive plans. Given the questions that are being raised in other jurisdictions about the wide use and efficacy of total shareholder return if not properly targeted, this could be controversial.
- The actual vesting of awards to the executive is often delayed from the end of the performance period and often occurs in the next financial year, which will affect the correlation between pay and TSR performance.
- Most long term incentive plans have longer timeframes than one year, so five annual values of TSR won't necessarily align with the vesting of awards from a longer term equity grant.
- It is unclear whether shares that are restricted post vesting will be considered to have "vested" for the purposes of the table.

It will be interesting to see what changes are proposed to this draft and the effects of the finalised rule post implementation on US incentive plans.

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Federal Budget Snapshot

It was hard to ignore the budget this week as the traditional storm of analysis broke over the nation.

Yet commentators have dubbed it a budget more ruled by politics than economics and there were not many new details to discuss: the \$41.1 billion forecast deficit was in line with expectations and most of the initiatives published in the budget had been telegraphed beforehand.

From a remuneration and governance perspective, the most important measures at the Board or HR executive level were:



- **Employee share scheme rule changes**

The budget reiterated the legislation changes to employee share schemes contained in draft legislation currently before the House of Representatives and scheduled to come into effect for equity grants from 1 July 2015. An announcement was made at the end of 2014 that a number of changes would be made to the taxation of share schemes including that options would be taxed at exercise rather than at vesting. After consultation, further alterations were made to the legislation before its introduction into parliament.

- **Fringe benefits tax (FBT) change for not-for-profits (NFPs)**

Currently, employees of public benevolent institutions and health promotion charities have a standard \$30,000 FBT exemption cap and employees of public and NFP hospitals and public ambulance services have a standard \$17,000 FBT exemption cap.

In addition to these FBT exemptions, these employees can salary sacrifice meal entertainment benefits with no FBT payable by the employer and without it being reported. Employees of rebatable not-for-profit organisations can also salary sacrifice meal entertainment benefits, but the employers only receive a partial FBT rebate, up to a standard \$30,000 cap.

In the budget, the government has announced a separate single grossed-up cap of \$5,000 for salary sacrificed meal entertainment and entertainment facility leasing expenses. Benefits exceeding the cap can also be counted in calculating whether an employee exceeds their existing FBT exemption or rebate cap. This change will apply from 1 April 2016.

Commentators believe this measure is likely to affect the ability of these organisations to attract employees on the levels of salary currently offered. Others have noted that caps have already been written into employment contracts, so the effect of the change will be quite small.

- **Parental leave**

Organisations may need to reconsider whether parental leave is the right benefit to grant female employees after the government announced that employees who are recipients of a

company parental leave scheme that equals or improves on the government scheme will not be eligible for the latter. This measure will apply from 1 July 2016.

Some commentators have noted that this decision could lead to backward steps in workplace diversity. However, there will be additional funds for childcare from 1 July 2017 for low and middle income earners, which could potentially enable more women to return to work.

Families meeting the activity test with annual incomes up to \$60,000 (2013-14 dollars) will be eligible for a subsidy of 85% of the actual fee paid, up to an hourly fee cap. The subsidy will taper to 50% for eligible families with annual incomes of \$165,000.

There will be no limit to the amount that can be claimed per year for families with annual incomes below \$180,000. For families with annual incomes of \$180,000 and above, the benefit will be capped at \$10,000 per child per year.

Low income families will receive further support under a childcare safety net.

- **Remote workers**

From 1 July 2015 FIFO (fly-in fly-out) workers will no longer be eligible to claim the Zone Tax Offset, which is intended to compensate workers living in remote areas. This may affect the attractiveness of certain roles for mining organisations.

Currently, to be eligible for the offset, a taxpayer must reside or work in a specified remote area for more than 183 days in an income year.

- **Work vehicles**

For the 2015-2016 income year, the government has reduced the number of calculation methods for work-related car expense deductions, removing the "12% of original value" and "one third of actual expenses" methods, leaving the logbook and cents per km method. For the latter, it has also introduced a flat rate of 66c per km rather than varying rates depending on engine size.

- **Hiring incentives**

From 1 November 2015, businesses will be eligible for a \$6,500 subsidy if they employ a young jobseeker for six months. This was previously 12 months. Payments to businesses for hiring workers over 50 will also be made available over 12 months instead of 2 years.

- **Defined benefit schemes**

Under current arrangements, some defined benefit superannuants (mainly employees in the public service) are able to have a large proportion of their superannuation income excluded from the pension income test.

From 1 July 2016, the proportion of income that can be excluded will be capped at 10% from 1 January 2016. Recipients of Veterans' Affairs pensions and/or defined benefit income streams paid by military superannuation funds are exempt from this measure.

On the day following the budget new figures were released by the Australian Bureau of Statistics (ABS) for the Wage Price Index that reported Australian wage growth at 2.3% – its slowest pace since the ABS began publishing the data in 1998.

Other measures include:

- **Crackdown on taxation avoidance** – The government intends to focus on tax avoidance through a number of measures: focusing on multinationals funnelling profits through low-tax jurisdictions; increasing GST compliance; and preventing financial and tax fraud. Country by country reporting and additional transfer pricing reporting will also be introduced from 1 January 2016 for large multinationals with global revenues of \$1 billion or more.

A consultation process has also been flagged in parallel with the budget for large companies to voluntarily increase the transparency of their taxation position as part of a code. The intention is that the **Board of Taxation** lead the development of a voluntary code to highlight companies that are “paying their fair share of tax”.

The announcements follow a general theme in recent months around ensuring companies are paying a “fair” level of taxation. Boards may want to review their taxation management practices consider the government and community’s taxation focus in their risk scenarios, especially around reputational risks.

The addition of **GST** to digital products and services imported by customers such as such as movies, music, apps, games and e-books as well as services including consultancy and professional services may affect certain organisations directly while indirectly affecting other businesses competing against overseas companies. This is due to begin on 1 July 2017.

- **Infrastructure organisations** and those operating in northern Australia will benefit from the establishment of a \$5bn Northern Australian concessional loan facility to make money available for the construction of ports, pipelines, electricity and water infrastructure across Northern Australia, comprising WA, NT and QLD. The facility will be open for applications from 1 July 2015.
- **Small businesses** (turnover less than \$2 million) are the recipients of significant measures. A tax reduction of 1.5% (from 1 July 2015) and an immediate tax write-off on assets of up to \$20,000 acquired from 12 May 2015 to 30 June 2017 have been announced. The 1.5% tax rate reduction also means the net benefit from the 45% R&D tax offset is greater for small businesses at 16.5%. These measures have been bolstered by cuts in red tape for starting a business, the abolition of fringe benefits tax on portable electronic devices and the ability for businesses to change their legal structure without attracting a capital gains tax liability at that point.
- **Pensioners** who have assets in excess of \$823,000 excluding the family home will now be excluded from the pension. This threshold has been reduced from \$1.15 million. The lower threshold for the assets test has also been increased from \$286,000 to \$375,000 and the taper rate has been changed, from \$1.50 to \$3 in pension lost per \$1000 over the lower threshold. For non-homeowners, the threshold will fall from \$922,000 to \$747,000 for singles and from \$1.3 million to \$1 million for couples. As a sweetener, the government has guaranteed eligibility for the Commonwealth Seniors Health Card.

For more detailed information on these changes, here are the links to the [budget papers](#) as well as summaries from [KPMG](#), [Deloitte](#), [PWC](#) and [EY](#).

About us

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 CEOs, executives, senior management and professional positions, including specialist roles
- **Annual incentive plan structures:** advice on performance criteria, target and maximum payment levels as well as deferral and clawback provisions
- **Long term incentive plan structures:** advice on participation, performance hurdles, equity instruments, valuation and allocation, as well as provision of performance monitoring services
- **Corporate transactions / IPOs:** assistance transitioning pre-IPO reward arrangements into the listed company environment (or any other corporate transformation) considering issues including escrow provisions
- **Government pay reviews:** assistance at federal, state and local level in administrative, policy and corporatised environments on reward for senior executives, professional and administrative staff, and governing Boards
- **Board fee reviews:** benchmarking Board fee levels, including Chairman and Director retainer fees, Committee Chairman and member fees and fees for adhoc engagements.
- **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.