# The outlook and issues for Australian director and executive pay in 2018

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This article dusts off our crystal ball and provides our outlook for director and executive pay for calendar year 2018.

**The economy and pay**

While the Australian economy continued to grow relatively well with its recession-free record intact, the economic cycle changed tack during 2017 with higher commodities prices, employment, and business investment. 2018 looks set to bring more of the same, with bets on higher effective interest rates and higher inflation in successive years prompting investors to shift more capital into growth stocks and away from yield stocks. While this will take some years to roll through, it has implications for executive pay adjustments that remain a matter of supply and demand, if you can see through the distortions of regulations and guidelines. This means that more investment into higher growth, commodities and other cyclical companies will result in higher executive demand, and higher rates of pay in those industries. Conversely, relatively less investment in, and returns from, real estate, telecoms, banking, and consumer staples will see reduced executive demand, and lower rates of increase in executive pay.

In all sectors, however, rates of pay increase in 2018 will continue to be ameliorated by low inflation expectations that dampen the appetite for increasing pay at all levels. This may change rapidly beyond 2018. Our US colleagues are currently observing the initial signs of ambit claims and hubris from a few “master of the universe” CEOs, emboldened by US tax cuts, deregulation, and high stock returns (despite recent corrections). US disclosures from 2019 may see the beginning of a global lift in executive pay rates that will inevitably find its way to Australia and New Zealand. In the meantime, executive pay increases in Australia and New Zealand will remain relatively modest, if uneven, across industries.

## “Forgive me, for I have sinned”, but blessed be your total shareholder returns

The 2017 AGM season saw relatively few “strikes” against the remuneration reports, particularly when compared to the torrid 2016 year.

There is no doubt that most 2016 “sinners” put in significant efforts to amend their ways of engaging and, in many cases, the way they pay executives, to achieve adequate shareholder support.

However, 2017 did not see the usual crop of first-time offenders. Much of this can be attributed to 2017 being an excellent year for delivering shareholder returns. The unweighted median TSR of the ASX 300 in FY2017 was a pretty nice 14.7%, and the third quartile a whopping 32.4%. It was only at the very big end of town that there was a high level of dissatisfaction, with 7 of the ASX 50 receiving “no” votes of 10% or higher. This is understandable, given the median market capitalisation weighted return was a mere 3.4%, and the 25$^{th}$ percentile a paltry 0.1%. Big companies are not growing, TSR is low, and shareholder support for their executive remuneration lukewarm.

The outlook for shareholder returns in 2018 remains good, if not quite up to 2017 standards. While Guerdon Associates would not suggest boards reduce their focus on engagement, some companies may take the opportunity to try remuneration frameworks that are a better fit for purpose. In other words, companies should best try new ways of paying executives while portfolio managers who invest in them are getting their performance fees.

### Alternative remuneration frameworks

The introduction of alternative ways to pay executives increased in 2017. About 20 of the ASX 200 now have non-traditional frameworks. Guerdon Associates expect the trend to continue into 2018.

To their credit, most proxy advisers and investors have been open to alternative remuneration frameworks, despite the fact that, for most, their guidelines have not yet been revised to permit their support. This, combined with the kinder predispositions of portfolio managers enjoying good returns, continues to provide a window for companies to consider alternative remuneration frameworks. Nevertheless, mistakes can be made:

1. Be level-headed, and clear-eyed. Do not opt for an alternative just because of dissatisfaction with the current way of paying executives. For some companies, to paraphrase Winston Churchill, it may be a matter of "current executive remuneration frameworks are the worst forms of payment, except for all the others".

2. Ensure pay is fit-for-purpose. What is the nature of the business that management are running? For example, is it capital intensive with long-lived assets and a multi-decade IRR, or is it a working capital business that can easily adapt to changes in demand? Is it a yield business or a growth business or, thank the gods, both? Is it cyclical, anticyclical, or stable? Are absolute returns poor relative to others, but risk-adjusted returns good? These, and many other considerations, should go into considering an executive remuneration framework that is fit for purpose.

3. Test the alternative frameworks before implementation. What would have been delivered in the past under the proposed alternative? Would this have been fair to investors and executives? What would it cost in terms of cash and dilution?

4. Explain it. Can it be understood? Does it focus executives on desirable outcomes? Which investors will love it and who will not?

To understand how boards and investors are likely to react to alternative remuneration frameworks, seek out an invitation to our March Forum (held in conjunction with CGI Glass Lewis) for directors and investors (see HERE).

**Performance measures**

The maturing of the market in understanding the application of relative TSR measures continues. That is, there is an acceptance among investors that relative TSR is good for some companies' long-term incentive plans, and not for others. In 2018, we should see more boards considering whether, or if, their form of relative TSR incentive remains an appropriate incentive and compare it to alternatives. More companies will reduce or replace incentives that are contingent on TSR.

Beyond TSR there has been much gnashing of teeth over the extent and method to measure, and pay for, an appropriate corporate culture and, associated with this, reputation. For the great majority of ASX 300 boards considering this in 2018, the first step will be to measure it. The issues of accountability, and paying for it, have not been worked through yet.

Reputation is easier, and to an extent Australian companies could do well to consider the practices of some US companies that have provisions to clawback the proceeds of equity grants where the company has suffered significant reputational damage (Wells Fargo comes to mind – see HERE). However, even this aspect of performance measurement and payment will be a trickle rather than a flood in 2018.

Closely related, and getting more attention, is the measurement of customer satisfaction. Technology enables most companies to acquire new customers, and retain current ones, if their net promotor score and other indices of satisfaction are better than competitors. Expect to see more of it in 2018 incentive plans.

The 2017 AGMs saw more scrutiny and many more questions related to ESG matters including whether ESG factors influenced executive pay. While ESG will be a continuing focus for investors, activists and boards, there is no evidence that they are being explicitly factored into performance measures.

Pressures from proxy advisers and investors for better disclosure of STI measures have not abated. On the whole, directors need to have a better response around their STI disclosures for engagement with proxy advisers and their investors in 2018 than they have in prior years.

**Face value versus fair value grants**

Investors and proxy advisers abhor equity grants made on the basis of fair value. We will not see any reduction in investor vigilance in 2018.

There may be good reason for this (see why HERE). However, at the same time, directors can rightly wonder why it seems investors cannot simply multiply the number being granted by the stock price to work out face value. They can then make their judgement whether the substance of the grant is too much, or, importantly, if dilution is appropriate. That is, a judgement not on how a grant is made, but its materiality.

Notwithstanding that face value assessments of equity grant value are less sound than fair value methods , investors and proxy advisers are not going to give in on this, at least for 2018. Directors can continue to expect grief when seeking shareholder approval for CEO grants on a fair value basis. Best to either roll over, or better still, change the payment vehicle whereby fair value and face value are the same.

**Vehicles of pay**

More market volatility, and higher interest rates, will make equity compensation more expensive than it has been in our recent lower growth, low interest rate and lower volatility past. That is, all else being equal, executives will receive fewer rights, options and share appreciation rights (SARs) for each dollar of remuneration.

Cyclical companies have missed their chance to provide share options as an optimal payment vehicle. All we can say is that productive resource companies, and others, had their chance (see HERE). This will be offset, to an extent, by resources companies being able to pay a bit more cash than they could have afforded in recent lean years.

Unless you are a private company, biotech, explorer, or early stage technology company, you may want to reconsider payment in options. Capital will be flowing into higher growth companies. P:E multiples will be high, with growth fully factored into share price under the continuous disclosure requirements applicable to ASX listed companies. In the tight talent market that is already a factor impinging on growth within these industries it may be wise to consider better vehicles of payment.

Lower growth companies focusing on capital efficiency and yield will need to consider payment vehicles that do not discourage dividends. Unfortunately, most use vehicles that ignore dividends, devaluing the face value of the underlying equity over the vesting period by 15% to 20%. It is hard to fathom why boards and external stakeholders ignore the irrationality of not fully aligning management with shareholder interests, or reduce the economic value of equity awards for attraction and retention. However, we have seen little evidence of boards, their advisers or their investors waking up to this, and do not expect much change in 2018.

**Engagement**

2017 saw significant changes in the quality and frequency of engagement between proxy advisers, boards and investors. Directors stepped up in 2017 after a horrid 2016 Say-On-Pay experience. Proxy advisers worked incredibly hard both on availability and process in response to ASIC investigations and business lobbying to have them regulated. Investors acquired more, and better, governance resourcing to exercise more independent and informed judgement.

Despite ASIC removing its foot from proxy advisers' necks (see HERE), we expect the standards achieved by proxy advisers will, at least, be maintained in 2018. That is, they should be available for engagement unless you are still outside of the ASX 200 and are subject to their coverage. In that case, expect uneven availability. Unfortunately, this is where many of the newer growth companies are placed, and it is these companies that are more likely to have alternative remuneration frameworks that require proxy adviser understanding. Such companies also tend to have directors with less engagement experience. If you are one of these, get in front of the proxy adviser queue and wave your arms. You may also be better advised to directly approach your most significant institutional investors.

**Board fee increases**

Higher workload impositions have settled down, with the exception of APRA-regulated entities (RSEs, banks, and insurers), which are striving to respond to cultural issues, technological challenges, cost pressures and (with the exception of some RSEs), little top-line growth.

Despite the ease, tax effectiveness and other advantages of providing director fees in the form of equity, few companies did this in 2017. There is no indication that this is about to change for 2018. Meanwhile, proxy advisers and investors will continue to focus on the extent of NED shareholdings while the means to more easily meet these requirements goes begging.

Overall rates of 2018 non-executive director (NED) remuneration increases will, in contrast to recent years, be less than that of executives (see below). Many boards do not yet adjust fees annually, preferring to “double up” every two years. Therefore, there will be a broader range of director fee rate increases than executive pay increases. That is, some increases will seem small, as these boards adjust annually, while others will be large, as these boards adjust every 2 or more years.

While we note that ISS’ US guidelines indicate the proxy adviser will not welcome high NED compensation in that country, this is in response to a host of factors not evident in Australia. For example, US boards are larger, and their directors are longer tenured, effectively appointed by an executive chairman, cannot be voted off by shareholders, and according to a host of activists, mostly somnolent. Alas, no such sinecure exists for an ASX 200 director. In fact, the prospect is further diminishing, given the growing tendency of investors, like those in the UK, to vote against in individual director elections.

The director supply bottleneck remains. However, across the ASX 300 we have observed younger NEDs being appointed as we go through a generation change. Apart from younger NEDs, reaching board diversity goals have stalled (see HERE). Discussions with various chairmen seem to indicate that while boards have sufficient women sourced with professional services backgrounds (e.g. law and accounting), there is a dearth of supply when it comes to finding women with line management experience. For those that exist, the money is still not enough. This issue will be reviewed at our annual director and investor Forum (see HERE).

On an annualised basis since the last increase, the average ASX 200 NED fee increase is expected to be 3%, and the median will be 2.4%. Because not all boards adjust fees annually, actual median ASX 300 rates of fee increase are more likely to be about 7.3%.

**Executive remuneration increases**

Overall levels of executive remuneration will continue to be dragged down by new internal appointments on pay rates lower than their predecessors. This will be offset by a higher level of same incumbent increases exceeding that of recent years. And while CEO pay growth will continue to be moderate, there will likely be a wide disparity in rates of increase for direct reports and other executives. This will reflect increased job scope for some direct reports as boards seek to ensure a greater supply of potential CEO successors. Some executives are in particularly short supply, such as executives with experience in technology, innovation and customer experience, so they will receive higher rates of increase.

Significant remuneration increases are expected at the lower end of the ASX 300 as it changes membership, with stock re-ratings having an oblique effect also on executive remuneration.

The rate of increase for 2018 is likely to be slightly higher relative to prior years, with an expected same incumbent median fixed pay increase of 2.5%. However, this masks what we expect to be significant variation by industry and company. The expected market median increase also excludes the relatively high proportion of executives who will receive zero increases (mainly in the industries out of favour). Some industries, such as resources and energy, that may have “held back” in recent years will now have their turn, and will see larger than usual increases. So, expect to see many more instances of pay increase outliers than in prior years. As ever, boards need to be pragmatic, pay what the market demands to accommodate the new growth opportunities within reach now. These outlier companies will merely be at the forefront of more widespread and higher 2019 executive pay rates.

**Concluding remarks**

2018 will be an interesting year for outliers. By this we mean those that are implementing new executive remuneration frameworks, and those, especially at the smaller end of the ASX 300, seizing growth opportunities and eager investor capital who need to increase executive pay to realise these opportunities.

While good shareholder returns should continue to override much that investors could object to in executive pay, this should not mean that directors be more indifferent to engagement or, indeed, getting executive pay right. With more growth opportunities and the need for capital to realise this, directors cannot be complacent on how their governance is perceived, but rather must continue to work hard to optimise investor confidence that executive pay is well governed and fit for purpose.