The outlook and issues for Australian director and executive pay in 2019

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This time each year we dust off our crystal ball to provide our outlook for director and executive remuneration for the calendar year.

The economy and pay

The Australian economy appears to be firming into late-cycle characteristics. Resources and other commodities industries are going well, while the smart money is moving into defensive stocks. There are many global risks, and uncertainty abounds. It also seems that growth is subsiding across many global economies and industries as slowly as it grew following the GFC.

While these macroeconomic factors will take some years to roll through, they have implications for executive pay adjustments. This is because executive pay will continue to be a matter of supply and demand, providing you look through the distortions of political change, and more regulation impacting the financial services sand (as is likely) energy and aged care, and, following that, other dependent industries.

Investment in higher growth, commodities and other cyclical companies will continue to taper off, as will the recent higher executive demand in those industries. Technology disruption, and counter-technology investment in fintech, professional services and the public sector will see some job families benefit, and others wilt.

Fixed remuneration pay increases remained modest in 2018, while LTIs expensed were higher, although not as high as shareholder returns (see HERE) . FY 2019 rates of pay increase at all levels will be ameliorated by proxy advisers and investor scrutiny, more subdued growth across most industries, higher levels of uncertainty, and continuing low inflation expectations.

Notwithstanding this, as is common in a late-cycle economy, pockets of hubris will remain, undaunted by the negative sentiment of external stakeholders to executive pay. This will be limited, as in 2018, to those enjoying success, so executive pay will in effect continue to be mainly impacted by financial performance and sector supply and demand.

Engagement: "Forgive me, for I have sinned" is not quite enough

The 2018 AGM season saw many "strikes" and high negative votes against remuneration reports, particularly when compared to the mild 2017 season.

There were many reasons for this, including:

- Saying sorry, but still paying big incentives;
- Not saying sorry, not performing particularly well, and still paying incentives; and
- Increasing fixed pay significantly ahead of wage inflation and CPI without adequate justification.

In other words, the same reasons as in past years, but 2018 was particularly rife. And through all of this while the Hayne Royal Commission hearings and interim report were progressing.

While there were unusual exceptions, high "no" votes on remuneration matters tended to occur in companies with poor performance. The extent that this holds true across the years is the subject of an interesting research report we will publish on our web site over the next few weeks.

The outlook for shareholder returns in 2019 is likely to be mixed after the horror run during the last quarter of calendar 2018.

The rate of executive pay increases will be tempered by:

- the torrid 2018 year of strikes,
- more modest TSR,
- "fat cat" election rhetoric accompanied by a likely change in government,

- subsequent regulation by a likely Labor government for pay ratio disclosure,
- amendment to prudential standards for clawback,
- a prudential supervisor more prepared to both direct and enforce (see HERE) , and a more aggressive ASIC.

This will be despite the continuing need to recruit specialist executive talent from less-tempered and higher-paying offshore in areas such as risk management, technology, and infrastructure.

There is also no doubt that shareholder engagement was less effective in 2018 than previously. This had two causes:

- Boards relaxed, following a benign 2017, instead of keeping the pedal to the metal and working as hard to uncover and deal with shareholder concerns; and
- Less enthusiasm by some key external stakeholders to engage after the ASIC review of proxy advisers concluded (see HERE) .

Contrary to the views from some boards, we do not see an increase in proxy adviser intransigence. They have their views and, to a large extent, they have been entirely consistent with the prior season. What happened, it seems, is that some boards either did not listen, or weighted what they heard too much to those with vested interests.

Alternative remuneration frameworks

The introduction of alternative ways to pay executives died a death in 2018. Proxy advisers and investors reacted after witnessing outcomes not aligned with their interests.

Does this mean no more alternative ways to attract, retain and motivate executives?

No:

- Even Commissioner Hayne backed away from being prescriptive on banker executive pay (with the exception of clawback) after recognising that experimentation is necessary, and that there is no magic formula (see page 350 of Volume 1 of the report HERE).
- While prescribing the need for clawback policies to be adopted,

Commissioner Hayne opened the door for the adoption of non-financial measures. It is not likely that APRA will "prescribe" these in a prudential standard, but will have its supervisors insist on them (see HERE) . As a consequence, we may see several innovative measures, and frameworks being developed by some in financial services.

- New sectors subject to the BEAR (such as superannuation and insurance) will experience huge change. The non-listed organisations (like superannuation funds) can also be the most innovative (Guerdon Associates will publish articles on these matters as the dust settles, and government elections determined).
- Globally-exposed sectors, such as technology, have no choice but to innovate on pay frameworks to attract and retain suitably qualified people from a global talent pool.
- Perhaps, surprisingly, the stakeholders who reacted most to alternative frameworks in 2018, have been formulating views on what they think companies should consider, and these are certainly not traditional frameworks. Come to our Forum in March to find out (see HERE) .

Performance measures

TSR will not go away. APRA never wanted it, and Commissioner Hayne gave banks an excuse to BEAR down (forgive the pun) but it will never go away, even in financial services.

However, more companies are doing away with relative TSR, aware of its shortcomings (see HERE) . For those that have done away with it, or others (such as banks) making room for other measures, there is the question of its replacement.

Some will stick with pure financials. There is a place in many an investor heart for these companies.

In a back-to-the-future moment, some boards this year and next will be considering the introduction, or re-introduction of economic profit (aka EVA) measures. This may not be surprising, given ISS's acquisition of a firm to use EVA in its governance scorecard and "corporate consulting" (see this interesting piece by our sister GECN company in the US HERE) .

But the big trend will be the application of non-financial measures. While we bemoan the absence of measure integrity in the common forms being peddled by many advisers, “culture” measures are making headway.

Customer satisfaction and Net Promotor Scores are also making headway, despite the fact there has been no conclusive evidence of a causal relationship with revenue and profit growth.

Look to see these measures incorporated in LTIs for CEOs in financial services as they seek approval for equity grants in 2019, in anticipation of APRA being more directive. The trend will spread to other industries, as it already has in the UK and Europe.

In addition, and associated with changes in remuneration frameworks (see above), there will be interesting and innovative methods in the application of performance measures to deliver the “just” outcomes that external stakeholders are seeking.

Vehicles of pay

There remain many more types of equity payment vehicles than ASX-listed companies have tended to use. The majority of companies will continue to use share rights. And the share rights will not incorporate tax effective methods for including dividend entitlements. This is despite the fact that dividends generated over the performance period are a critical part of shareholder returns – in fact, for some defensive stocks, the main part.

Some external stakeholders are not so keen on dividend-entitled share rights, but have so far not quite understood that such payment vehicles are virtually the same as restricted shares which their UK equivalents applaud.

Outside of regular share rights are many other vehicles. These will continue to be apt for many companies in different industries, and in differing stages of their business cycles. In most cases they should find shareholder support, providing they are explained well, and related to the nature of company and business cycle. The challenge for most boards is to find an adviser able to think along these lines with the technical skills to develop and implement.

And remember, for those granting regular share rights (without dividends), use the face value share price rather than present value as the basis for allocation and grant. Otherwise you will face the ire of external stakeholders that mistakenly believe face value is valid.

Board fee increases

In FY 2018 the average NED fee increase was 2.04% (see HERE).

Despite this overall modest increase, calendar 2018 saw high 'no' votes for some director fee pool increases, and at least one strike on the remuneration report.

Against this is the continuing renewal of boards, and high demand for qualified directors. The supply has diminished in one regard – fewer ex- CEOs seem to be keen on becoming a public company non-executive director (NED). There is less hassle, and in some ways, it is more satisfying work, going into private equity. PE is alive and well, still with bucket loads of cash, and a very focused 4 to 7-year time horizon versus the one-year time horizon of public company investors.

Despite this, new generation NEDs are being found, and continue to feature women in particular. Interestingly though, it appears that diverse boards have to pay more to become diverse. Recent unpublished Guerdon Associates research indicates that boards with more female directors pay these female directors more.

On a rolling 2-year basis, the annual average ASX 300 NED fee increase is expected to be 2.0% to 2.5%.

Executive remuneration increases

Last year fixed pay increases were modest, at 2.3% (see HERE) .

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, plus pay necessary to attract executives from offshore in some key industries.

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 2019 is likely to be unchanged relative to prior years, with an expected same-incumbent median fixed pay increase of between 2.25% and 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 professional services and communications will see larger than usual increases.

As in past years, total remuneration including realised pay from vested incentives, will be aligned with financial performance on an overall basis.

Concluding remarks

2019 will be an interesting year!

Banks will be working hard in response to unhappy investors who voted against them last year, and the expectations of Commissioner Hayne and APRA.

All boards should be wary of a prospective new government keen to legislate.

ACSI may ramp up its call to impose a binding vote on remuneration matters.

Despite the 2018 strikes, new executive remuneration frameworks will be considered, and to an extent may be more evident in unlisted companies. Non-financial performance measures will be more prominent in LTIs being granted for the FY2020 year.

The torrid 2018 means there will be more shoe leather on the part of board remuneration committee chairs and their chairmen, as they engage with their shareholders. It will be worth the effort.