HaRe Group newsletter: **16 November 2004**

Subject: **Executive pay update**

From time to time, there are media reports that provide worthwhile information on executive pay. This email summarises and comments on selected articles in the AFR Salary Review, 9 November, BRW, 11 November, and BOSS, 12 November 2004.

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What the Top CEOs earn

That executive remuneration is still increasing is not news; that recent increases are so great has caused a media stir. Overall, these increases seem consistent with higher profits and rising share values.

Some of the greatest increases this year are due to new declarations of CEO remuneration; eg. Qantas CEO, Geoff Dixon, received a 164% increase because equity and other benefits have been reported for the first time. New disclosure rules now require all remuneration to be reported. (David Jones and Origin Energy are notable for their good, detailed disclosure).

In general, there is a growing correlation between company size and CEO remuneration. Recent HaRe Group research on overall 2004 trends indicates that a CEO's total remuneration (including incentives) tends to be:

- $1.0 - 1.6M in companies with $500M to $1B revenue
- $1.4 - 2.0M in companies with $1 - 2B revenue
- $1.8 - 2.6M in companies with $2 - 4B revenue
- $2.4 - 3.4M in companies with $4 - 8B revenue
- $3.2 - 4.4M in companies with $8 - 16B revenue

Of course, there are many CEOs paid outside the above ranges. In some industries, the total remuneration (TR) rates are far higher (or lower) than the general trend. In other industries, market capitalisation is a better predictor of CEO TR.

However, the variations in global and local benchmarking in Australia confine the use of broad comparisons. When setting CEO remuneration, the Boards of many companies align executive pay levels to specific types of organisations; eg. News Corp selects "major multinational corporations."

How the CEOs are paid

In the 2004 data, the alignment of company size and the CEOs fixed remuneration package is now weaker than TR. The largest companies (above $8 billion in revenue) tend to deliver 50-60% of TR as a fixed remuneration package (FRP). Smaller companies (under $1B revenue) usually deliver around 70% as FRP.

Typically, the incentive component of CEO TR will be highly variable and nearly always based on company performance measures including profit. A CEO who clears successive performance hurdles may expect to receive proportionally higher incentives - and as the above trends indicate, the larger the company, the larger the incentive proportion.

Additional analysis proves again that there is no clear relationship between the CEOs' incentive payments (as % of FRP) and profit margin (PAT as % of revenue). The statistical correlation between these two variables is almost zero. However, we can record the following percentiles on the data reported for a sample of over 100 of the top listed companies:

- 25th percentile: Profit margin = 3%; Incentive = 24% of FRP
- 50th percentile (Median): Profit margin = 7%; Incentive = 44% of FRP
- 75th percentile: Profit margin = 11%; Incentive = 75% of FRP

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Why the CEOs are paid so (much)

Most companies are reluctant to reveal much about internal performance measures. However, some have reported using the cost of capital to calculate a more objective incentive payment; eg. Macquarie Bank measures increases in after-tax profit and earnings above the cost of capital. Common among other measures are EPS growth and safety. Large annual payments are sometimes partly delivered as deferred shares; however, this practice may confuse the objectives of short and long term incentives.

Measures for long-term incentives (LTIs) usually include total shareholder return (TSR) performance against a peer group. Depending on business strategy, some companies (like Coles Myer) are replacing share option plans with performance share plans where an executive only receives fully paid shares when specified performance hurdles are cleared.

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