HaRe Group newsletter: **19 October 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 reports in recent weeks.

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Roaring returns and smart salaries (The Age, 16 Oct.)
In this company reporting season, there has been far less excitement about executive pay levels. It seems that any objections to large increases in remuneration have been quashed by larger increases in company earnings; eg. a 23.9% increase in net profit within the S&P/ASX 300.

The Age reproduced data on CEO pay, net profit and share price from recent company reports from the top 50 (by market capitalisation). The average of CEO base pay from this group was $1.57 million. Average total remuneration (including bonuses & shares) was $5.69 million, compared to $4.32 million last year.

Further research within the top 100 companies by Hay Group has revealed that CEO remuneration rose by 18.2% in 2004. However, the base pay component increased by only 7%. Most CEOs receive over 60% of their total remuneration as incentive-based rewards, which often include profit targets. Nearly all share option plans include performance hurdles. Some companies have replaced their option plans with full share plans.

Better disclosure of executive remuneration is helping explain how and why executives receive as much as they do. Next year, shareholders will have even greater insights when a non-binding vote will be required on senior executive pay plans. The Australian Council of Super Investors is already telling its members that they should vote against the pay plans that will be put forward at 16 company AGMs.

This new environment tends to camouflage an increasing shortage of talented executives. Company boards are struggling to find the business leaders that are critical to guiding & directing a competitive organisation. Rather than offering great lumps of guaranteed salary, boards and their top executives are negotiating smarter deals that offer greater financial rewards *IF* performance hurdles are cleared. These hurdles are now based on multiple measures against industry benchmarks. Generally, the greatest rewards arise from superior equity performance and long-term tenure.

A silly excuse for a bonus plan (The Age, 18 Sep.)
Does a CEO need $25,000 a day to persuade him (or her) to come to work? Is an elaborate formula of incentives and performance targets needed to motivate a CEO? In one case, a board provided shareholders with a 20 page remuneration report that details a wide range of bonuses for various degrees of outperformance. Measures include Total Shareholder Return (TSR) relative to a "scientifically" selected group of peer companies, as well as a range of key performance indicators.

Alan Kohler argued that incentives don't produce different behaviour in top executives. They will not be tempted to walk away unless there is a bigger & better job being offered - it's not about the money, it's about opportunity and challenge. "Elaborate bonus schemes have been devised to justify the amounts to shareholders." In addition, executives are being rewarded for the wrong things: viz. for increasing profit, company size and the share price. What matters most to shareholders is whether executives have added value to the capital that has been entrusted to them. Measuring economic valued added (EVA) provides a fairer assessment of company performance because it deducts the cost of capital from profit.

Comment
In broad terms, the bigger the company, the bigger the CEO's pay cheque. Among the top 100 companies, there is a general (but diffused) trend suggesting that base pay correlates with company revenue and market capitalisation (not reported in The Age). Bonuses vaguely correlate with net profit, but the values of shares don't seem to correlate with any readily available data.

There is still more information required to explain why some executives receive their incentives. The use of value-based measures (like EVA) in transparent incentive plans, in plain English, will need to be seen more often in future.

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