



# **Executive Reward**

## **Righting Some Wrongs in the Executive Pay Debate**

A Paper Prepared in Collaboration with  
the Godfrey Remuneration Group

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## Righting some Wrongs in the Executive Pay Debate

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It seems that no one is happy with the state of executive reward in Australia. Letters to editors are couched in outrage. Many speak of CEO villains, being richly rewarded when running organisations where profits and share prices are declining. Others defend hero CEOs they see as protecting shareholder wealth in a difficult and volatile business environment.

Despite the emotional yet in many ways understandable reactions to multi-million dollar CEO pay, what the debate has lacked is a practical and defensible response to the emotional question posed. Are CEOs heroes or villains? Are they creators of value or destroyers of value?

The new ‘two strikes’ legislation has brought this question into sharp focus. Behind all the emotion there are some rational changes that could be made to reward plan design, as well as an assessment that just might address many of the concerns being expressed.

To date more than 30 companies have scored a first strike, and while we hesitate to single out individual cases, the timing of its AGM meant GUD Holdings was a front-runner in attracting the ire of proxy advisors and shareholders alike. This was partly due to its CEO’s remuneration plan lacking equity-based payments, and instead being more fixed and cash-based in nature. But it was also about a divergence of views on the company and management performance.

We do not believe the issue at GUD was poor governance. Nor is that the case for most companies. The problem is twofold and it applies to many companies – a lack of agreement among stakeholders as to what really constitutes sustained and superior company performance, combined with shortcomings in current practice in setting executive reward hurdles. For GUD these two issues intersected in a way that delivered a first strike. So it provides a good litmus test. We believe the company has been wrongly pilloried, exposing flaws in how the new legislation is playing out in practice.

### *Some Underpinnings*

One point on which all stakeholders do agree is that the primary economic responsibility of a Board and its executive team is to create shareholder wealth.

But how is this achieved and what is the best way to measure it?

Wealth is created when an executive team either delivers financial performance in excess of market expectations, or it convinces the capital markets that it has the ability to do so. Usually this occurs when the company adopts a new strategy that is well received by the capital markets and leads to a sustainable increase in share price.

Embedded in every company's share price at any point in time is a series of expectations in relation to future financial performance. These expectations must be met in order to justify the current share price and conserve shareholder wealth. They must be exceeded in order to create shareholder wealth.

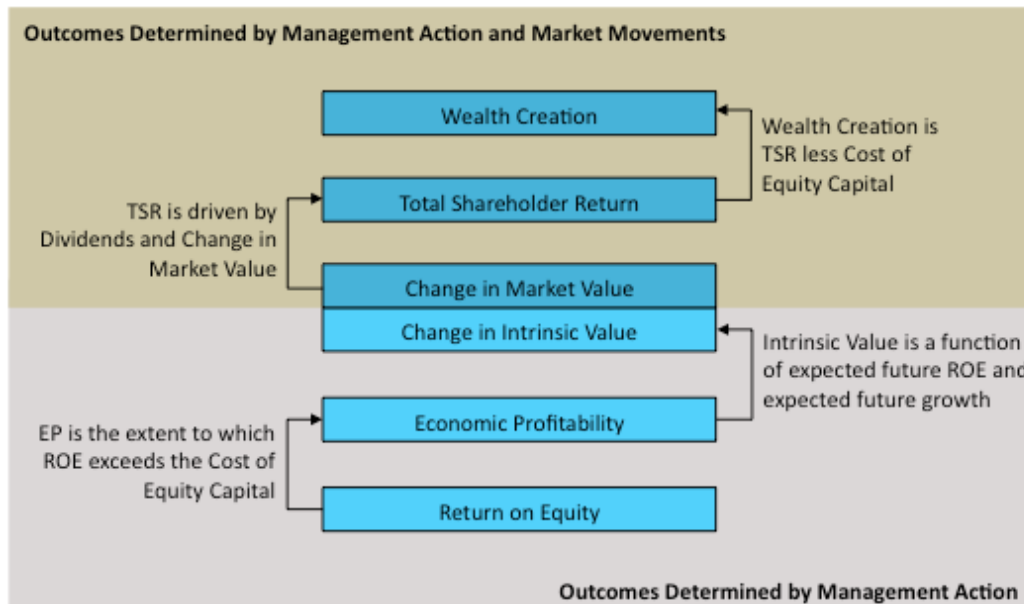
Meeting expectations and conserving shareholder wealth does not mean a static share price. It means shareholders get a return that matches their expectations. In fact share prices move up and down in order for investors to achieve their required rate of return. If shareholders require a return of 12%, then wealth is conserved if the total shareholder return (TSR) they receive from dividends and share price movement is also 12%. If the annual dividend yield was say 5%, this would mean a 7% annual increase in share price. The flip side of this is the realisation that a rising share price is not necessarily an indicator that wealth is being created.

Most incentive-based executive reward plans have a three-tiered structure comprising base salary, a short-term incentive (STI) and a long-term incentive (LTI). One way that many companies seek to align their incentive plans with the goal of shareholder wealth creation is to design the STI to encourage behaviour that is expected to lead to shareholder wealth creation, and to structure the LTI to reward shareholder wealth creation when it actually occurs. However it can sometimes be difficult to establish a link between the behaviours that Boards and senior executives believe drive value uplift, and actual changes in market value.

The primary reason for this difficulty is that there are two ways to think about value – management's internal view of intrinsic value and the externally observed market value. Each has its own set of metrics as shown in Figure 1. For simplicity all metrics shown are related to equity capital.

The bottom half of Figure 1 contains internal metrics for which the outcomes are determined largely by management action. The top half contains external market metrics like TSR and Wealth Creation, for which the outcomes are determined by a combination of management action, company-specific market sentiment, and movements affecting the market as a whole.

**Figure 1.** Hierarchy of Value-Based Performance Metrics



Equity markets move up and down. But over the long term, they have delivered a return to shareholders in the form of dividends and share price appreciation averaging roughly 12% per year. The capital asset pricing model tells us that higher risk, higher return companies like mineral explorers and biotechs have a cost of equity capital ( $K_e$ ) somewhat higher than this; and lower risk, lower return companies like utilities have a somewhat lower  $K_e$ . The actual  $K_e$  in each case depends on the risk-reward profile of the company in question.

Let us try to link the top and bottom halves of Figure 1. If management of a company with the same risk reward profile as the market as a whole (ie a  $K_e$  of 12%) adopts a new strategy that it is convinced will deliver improved financial performance (higher ROE, higher growth, or both), then intrinsic value will rise. If the market buys the new strategy, and accepts the new and higher financial performance expectations from management, then market value will also increase and so will the share price – but only until such time that the shareholders who are setting the new share price believe they will get a TSR of 12%.

If the company delivers the new and higher expectations, the new shareholders will conserve their wealth by earning a TSR of 12%. However wealth will be created for existing shareholders because they will have earned a TSR greater than 12%.

If the required rate of return were 12% every year, then this would be the benchmark for wealth creation both internally and externally (i.e. in both the bottom and the top

halves of Figure 1). Unfortunately life is not so simple. The market does not return 12% every year. Some years it moves up. Some years it falls. And in others it stays much the same. So aligning internal measures like ROE, for which the benchmark is 12% in this case, with external market measures like TSR, can be problematic.

The conventional way to deal with this in executive reward plans has been to employ Relative TSR as a basis for LTI awards, which typically deliver around a third of CEO pay. This involves comparing actual TSR over a given period to that achieved by a basket of comparator companies (or an index), in an attempt to adjust for share price movements that arise for market-related reasons rather than from company-specific ones. However there are a number of practical problems associated with Relative TSR, the most significant being that while comparator companies may have many similar characteristics, they don't have the same risk-reward profile. So they do not provide a benchmark consistent with true shareholder wealth creation, despite having become the almost unassailable 'tick-box' requirement of proxy advisors and fund managers.

#### *A Path Forward*

The good news is that the market itself provides a quite simple solution – for which we have coined the name **TSR Alpha**.

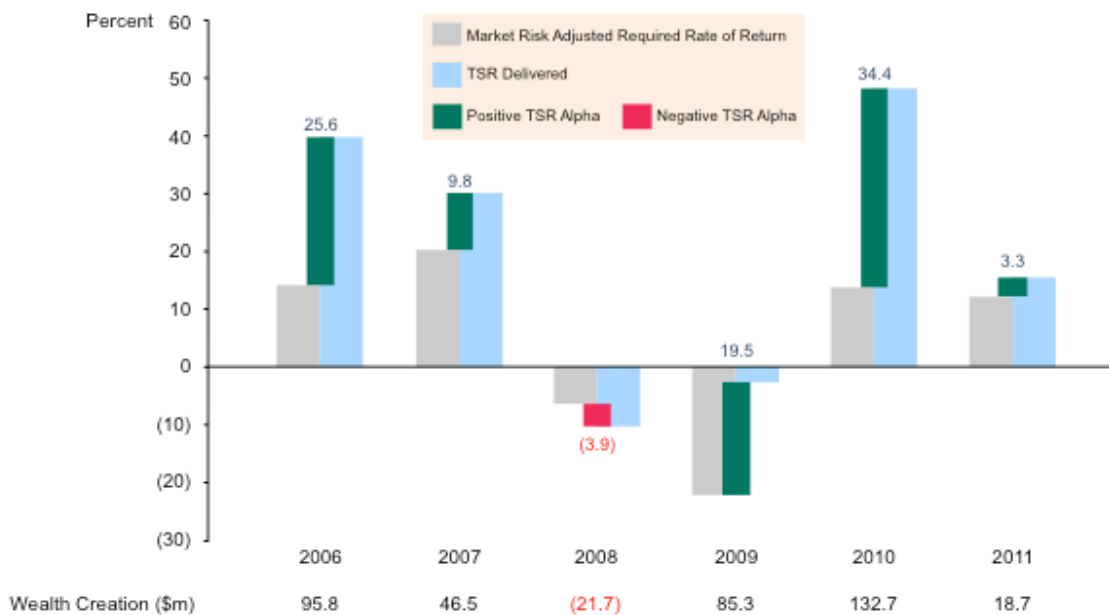
TSR Alpha is a measure of the extent to which a company's shares under-performed or out-performed the market over a given period, after adjusting for risk. It is the difference between the actual TSR achieved by the shareholders in a company over that period (in the form of dividends and share price movement) and the TSR investors would have expected to have achieved over the same period, given what the market did and the relative risk profile of the company in question.

In the same way that Relative TSR is applied, we can look back to measure TSR Alpha over the previous three to five years. If it is positive, then management has exceeded market expectations and wealth has been created. If TSR Alpha is zero, management has met market expectations and wealth has been conserved. If TSR Alpha is negative, management has failed to meet market expectations and shareholder wealth has been eroded.

If we think in terms of the typical LTI plan for which vesting rules are structured around Relative TSR, creating wealth by exceeding expectations does not mean delivering a TSR greater than the median TSR of a group of peer companies, or even an index. It means delivering a positive TSR Alpha. The case of GUD illustrates the power of this perspective.

Figure 2 shows the composition of TSR Alpha for GUD over the past 6 years. In 2006, the market was expecting GUD to achieve a TSR of 14.1%. It delivered 39.7%. This meant a TSR Alpha of 25.6% and market risk adjusted wealth creation of \$95.8m (the product of TSR Alpha and Market Capitalisation at the beginning of the year).

**Figure 2.** Market Risk Adjusted Performance for GUD Holdings



In 2007 the market was expecting 20.3% and GUD delivered 30.1% – a TSR Alpha of 9.8%. During the GFC in 2008 and 2009, the market was expecting negative returns. GUD’s returns were negative in both these years, but it beat expectations to a significant degree in 2009 when it delivered a TSR 19.5% higher than the negative 22.2% the market was expecting. This resulted in risk-adjusted wealth creation of \$85.3m. In 2010, GUD again outperformed market expectations to a significant degree, delivering risk-adjusted wealth creation of more than \$130m. In fact the company created wealth on a risk-adjusted basis in every one of the three years to June 2011 – the typical length of an LTI plan.

Shareholders and proxy advisors can criticise GUD as much as they like. Everyone has the right to express the truth as they see it. But if we strip away the emotion, and dig deep enough to overcome the confusion created by the use of incomplete and inconsistent measures of company performance, we find what some may see as an inconvenient truth. GUD has delivered sustained superior performance for its shareholders.

It is important to appreciate that TSR Alpha will move around from year to year. This is to be expected – not only because of movements in the market, but also because of the nature of TSR.

If a company develops and implements a higher value strategy, and the market buys that strategy, then the share price should rise. TSR Alpha could be quite high that year. However once the new and higher performance expectations are captured in the share price, it becomes difficult to exceed those new expectations and TSR will tend to fall back to the shareholders' required rate of return. When this occurs, good management performance will mean meeting expectations (TSR Alpha = 0) rather than exceeding them.

In general, investors cannot expect TSR Alpha to be positive and wealth to be created every year, or almost every year as has been the case with GUD. What they should expect, is for TSR Alpha to be positive on aggregate over the three to five years of a typical LTI plan – a period long enough to develop and implement a higher value strategy.

Regrettably, many shareholders seem averse to paying executives well for long-term wealth creation – seemingly wishing Boards to 'smooth' pay, so that in years when the share price is down they do not get much incentive pay, but opening the gates when the share price is up. For Boards and remuneration designers this is almost impossible to achieve – unless reward plans contain huge discretionary leaps that make incentives a lottery for executives.

GUD delivered a significant positive TSR Alpha in four of the last six years. It also managed to do better than just conserve shareholder wealth in a fifth year. Rather than a first strike, shareholders should have given GUD's Board and senior management a standing ovation. They probably would have if reward plans were designed and evaluated with the holistic understanding presented above.

While market commentators and pundits can paint the debate with emotion and a range of disparate metrics, a cold hard view of wealth creation will reveal the truth known to most CEOs and management teams: that beating real market expectations over a three to five year period is a tough and essentially creative challenge.

As a business community and society we should take care not to pillory those who take on the challenge and succeed. Nor should we richly reward those that hide behind 'easier' and often inappropriate performance metrics. Many companies avoided a strike and yet their management would not have cleared the TSR Alpha hurdle, casting a real shadow over the new legislated process of separating heroes and villains.