HaRe Group newsletter: **10 March 2004**

Subject: **Executive pay update**

From time to time, there are media reports that provide worthwhile information on executive remuneration. This email summarises and comments on selected reports in recent weeks.

CLERP 9 (AFR, 9 & 10 Mar.)
The Government's corporate law reform package is being debated over the next two weeks. Business groups and large companies are railing against proposals that include a "non-binding" vote that allows shareholders to express their views on executive pay. If introduced, a majority vote against a remuneration policy would not prevent a Board implementing the policy. ANZ submitted that directors are paid by shareholders to discharge certain duties, including executive pay – to vote on executive pay is not consistent with the delineation of the roles of the Board and shareholders.

On the first day of parliamentary hearings, Corporate Governance International (CGI) and the Australian Shareholders Association (ASA) both supported the non-binding vote. CGI director, Sandy Easterbrook, said: "the vote is simply an incentive for boards and remuneration consultants to do better – the only sanction of a shareholder vote is one of embarrassment."

New Foster's CEO (AFR & The Age, 4 Mar.)
The appointment of Foster's new CEO has given weight to a strengthening pay-for-performance trend amongst senior executives. Trevor O'Hoy will take the reins on 5 April with a fixed remuneration package (FRP) of $1.32 million for the next 17 months. This amount is somewhat below the trend for the top 50 Australian companies, based on either revenue or market capitalisation.

Another 75% of FRP ($990,000) will be paid in cash if certain performance targets are met. These targets include 10% growth in earnings per share (EPS). Following a common US & European trend, the 75% incentive payment could double to 150% ($1.98 million) if all performance targets are exceeded.

Foster's long-term incentive plan (LTIP) is still available to Mr O'Hoy. Under the LTIP, performance is measured using total shareholder return (TSR) relative to a peer company group. Shares will only be issued if Foster's performance exceeds the median TSR of the peer group. As a senior executive, Mr O'Hoy may receive shares to the value of up to 120% of his FRP.

IBM changes executive share option plan (NYT, 25 Feb.)
IBM has become the first large American company introduce a premium on the exercise price of share options. Over the next year, 5,000 IBM executives will be granted share options that will only have value if they exceed 110% of the market value at the grant date. The premium share options will vest over four years.

However, some market priced options may still be bought by an executive if s/he first buys a parcel of fully paid shares. These market priced options must be held for three years.

Other large US companies, like GE and Microsoft, have chosen to grant performance rights, which are fully paid share awards subject to a variety of well defined, peer company-based performance hurdles. Either method (premium priced options or performance rights) will increase the focus on reward for performance, but the IBM plan has only one performance hurdle that takes four years to clear and allows six more to exercise the options.

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Comment

During the next two weeks, the CLERP 9 parliamentary inquiry will hear submissions on the shareholders' right to vote on executive pay. Given that an opposing majority vote would only be non-binding, it would still deliver a strong message to a Board about perceptions of reward for performance. While there is so much complexity in operating a business, most shareholders want to see that company executives are paid in line with company performance, relative to other similar companies. Every Board's imperative should be communicating meaningful performance outcomes, relative to market performance, and explaining the alignment of executive pay to these performance outcomes.

Recent changes in market practice show that some companies are doing better at executive pay - in aligning reward and performance, and in shareholder communications. For example, Mr O'Hoy's new total reward package at Foster's is weighted heavily to incentive pay based on relative company performance. The performance measures include EPS growth, a simple measure well known by shareholders.

While equity-based incentives are more complex and their value less transparent, the market trend is clearly biased towards relative performance measures. Most common is total shareholder return (TSR) relative to a peer group of similar companies, usually within the same industry sector. Shareholders would benefit from improved communication by the Board on relative company performance and on the targeted value of long-term incentives available to executives.

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