Sustainable Remuneration

MM&K Remuneration Dinner 21 September 2015

MM&K regularly hosts dinners for Chairmen, Remuneration Committee Chairs and Chief Executives. For each dinner we select a topical subject for discussion. This time the subject was **"Remuneration should be linked to performance measures that reflect and encourage sustainable performance".**

Summary of discussion

Best practice for the choice of performance measures will depend on the circumstances of each organisation and the dynamics between the executives, non-executives ("NEDs") and shareholders.

Deep tensions exist in a number of areas when the issue of management remuneration is considered. These need to be successfully managed by executives and NEDs together in order to create a successful remuneration policy which will do more than just satisfy investors. We have included below commentary on some of the key tensions that emerged during the discussions.

The discussion also generated a number of interesting observations, summarised below, which both executives and NEDs may wish to consider when dealing with remuneration policy and strategy.

A remuneration policy that supports and galvanises sustainable performance is simple as an idea but difficult to execute properly. Done well, it has the potential to bring increased shareholder support to management and the company.

Introduction by Cliff Weight

- The key question in establishing the long term value of a company through sustainable performance is: "What are the drivers of future profits and, therefore, future value?"

- Profit is a lagging indicator as it measures what has happened in the past, whereas the balanced scorecard and a company's KPIs may be better leading indicators of sustainable performance.

- Strongly influenced by the interests of institutional shareholder groups, relative TSR and EPS are currently the dominant performance measures linked to long term incentives, at least among the largest companies.

- Outside the very longest incentive plans (10 years +) does relative TSR actually measure sustainable performance – or is it subject to too many external factors?

- Although important, the discussion for the evening was not solely linked to the green-agenda definition of sustainable. The focus was to be upon a wider consideration of sustainability – measures that could include, for example, sales growth, return on capital and profit margins, ethics and culture.

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Common tensions in creating remuneration which supports sustainable performance

Reward for success (shareholder return) v Reward for management performance

The most popular long term performance measure for investors is still relative TSR ("Total Shareholder Return"). However, there was almost unanimous agreement that TSR as a measure often did not adequately recognise the performance of management.

A number of examples were given of management teams who had performed strongly, but had not been rewarded due to factors outside their control which reduced TSR. This results in both specific demotivation and also a general increase in management dissatisfaction with and lack of confidence in TSR targets.

Similarly, poor management has been rewarded, simply because they were 'lucky' in terms of the market and other external factors.

The problems are not often solved by using a "peer based TSR", as it is difficult to identify true comparators and, again, the choice of comparators may unjustly punish or reward the performance of management.

MM&K Comment:

Given the popularity of TSR for shareholders, a Remuneration Committee that wishes to reward management for its actual performance will need to satisfy shareholders that any alternative structure to TSR has sufficient safeguards to reduce the possibility of unjust enrichment for management.

Discretion v Set rules

There are some well-known examples of successful management teams who did not have a predetermined reward structure. These teams were told the businesses' KPIs and were then told to deliver against them.

It was felt that the trust this created was a major factor in management feeling confident to make decisions which were directly linked to being able to grow profits and, crucially, react to changes in the market. It was noted that fixed incentive plans can become useless, or even reduce motivation, when market forces or unexpected events change the business landscape. NEDs supported having increased discretion in order to help improve and reward sustained company performance.

However, the majority view was that shareholders do not trust a company's non-executives to be able to exercise discretion in an even-handed manner. The consensus was that shareholders still think that discretion will only be used in favour of the executives.

MM&K Comment:

It would appear that there is still a huge gulf between shareholders and NEDs on the use of discretion and there appears little likelihood of any change in the short term. This is the way companies and shareholders have operated for decades. It is unlikely that institutional shareholders will see any benefit from changing and, indeed, they may consider being the first to budge on this position as a negative step.

As a result, the status quo looks likely to continue. Any Remuneration Committee looking to include an element of discretion will need to ensure that there are stringent safeguards (malus, clawback, etc.) that can be rigorously enforced to have any chance of gaining shareholder support.

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Investment managers v Governance officers

There was almost complete agreement about the emergence of an increasing disconnect among institutional shareholders between their investment and governance arms. There was frustration that the investment managers do not do more to provide positive feedback to the governance teams – particularly in cases where the investment manager has been unequivocal in his or her praise of management's efforts to generate value.

A strongly held view was that corporate governance teams had no accountability for making negative recommendations – although it was definitely possible to argue that a continued negative approach to remuneration policy inhibited the "natural risk taking" that management need to take in order to grow and generate sustained performance.

MM&K Comment:

Given that there is no perceived downside for a corporate governance team to be negative in its approach, managing the way remuneration policy is communicated to and received by key shareholders will become increasingly important to Remuneration Committees. The downside is that more and more shareholders are outsourcing their governance work to proxy agents, which inhibits the ability for companies to have high quality interaction with their investors.

Short-term measures v Long-term measures

One of the areas that generated lots of comment but little agreement was around how far in the future performance measures needed to be focused in order to keep profits growing and, therefore, sustain the business going forward.

The audience was divided as to appropriate lengths of time, with a number being very vocal that any long term plan should simply be a series of short term objectives renewed annually. Taking this approach would allow for adjustments, as needed, to changing market conditions. This approach was unsurprisingly thought to be of most interest to those shareholding institutions looking to make maximum cash returns on their investments.

Others were supportive of longer term objectives, in the range of 3–5 years, being set as a means of reinforcing long term strategy. In addition, given that in recent history there has been a fairly swift turnover in executives, a longer term plan helps prevent short term opportunism creeping in and also promotes retention of key executives.

Finally, there was also a number of individuals who considered that the notion of "long term" being 3-5 years was incorrect and that really sustainable businesses should be viewing the long term as plans that set goals and targets on a 10-year cycle. This cycle length was the most likely to create sustainable performance. One suggestion as to why the definition of "long term" had shrunk was that, for investors, the capital cycle was much quicker than in previous times and, therefore, there is an increased desire to set the long term agenda at the 3–5 year mark.

MM&K Comment:

Decisions about time frames may be easier to make if there is clarity about whether the incentive plan is designed to reward specific directors or the "executive office" they hold. The first, which may be valid where there is a need for a specific focus such as a corporate turnaround, is very much a reward for the person in role and would likely change if that person left. The second approach is consistent with a view of executives as stewards of the business.

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Shareholder bloc v Multiple shareholders

Differences occur when a listed company is in the majority control of a single individual or family. There was admiration for the ability of a single majority shareholder to provide a clear direction as to what they were expecting management to deliver.

This singular focus was considered to be a strong influencing factor in the success of management delivering above average market growth. The examples given included Sports Direct and Berkeley Homes, both of which had initially received strong investor disapproval of their remuneration policy from institutional shareholders and proxy agents.

In addition, where the majority shareholder is a family, some guests observed that sustainable performance was at the heart of all decision making, given the need to create a legacy business. In these circumstances, performance was less outwardly looking and more focused on internal behaviours and results. Cash flow was suggested as a good example of a performance metric that supported sustainable performance.

MM&K Comment:

It is undeniable that having a well-articulated and clear direction from shareholders will help management focus on achieving their goals. Where a business is held by multiple institutions, there can be real value in the Remuneration Committee (and possibly the key executives) meeting with the largest shareholders to understand what their expectations are. Although the business will be subject to the winds of change that can also affect institutional shareholders, it should be very helpful in discussions with corporate governance departments to show that these discussions have happened and that any proposed remuneration strategy has senior fund management buy-in.

Thought-provoking comments

The following are examples of thought-provoking comments that came up during the conversation over dinner and which both executives and NEDs might wish to consider when dealing with matters of remuneration:

"Setting targets which are just focused on producing a specific financial outcome are counterproductive. Your financial results should be the outcome or 'proof' that you are successfully focusing on the core elements of your business and the remuneration policy should reflect this."

"There is a school of thought that including a focus on the 'green' agenda has a direct and positive link to the overall sustainability of your company's performance."

"The quality of your earnings is the most important thing to know how sustainable your performance is. At my company, the Remuneration Committee undertakes a 'quality of earnings review' and any performance based payment to management is adjusted based on the findings of the review."

"At the end of the day, the Governance Code is only a guideline on remuneration policy. If you consider that you have strong support from key shareholders for your plan, then you should do what is right for your business."

"The simple truth is that shareholders will stay with you if you are continually returning money!"

To discuss anything you have read further please contact Cliff Weight on 02072 837 200.

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