Performance. Remuneration. Incentives

The Reward Practice

2017 Executive Remuneration Analysis

Should the mining sector rethink executive incentives?

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2017 EXECUTIVE REMUNERATION ANALYSIS:

Should the mining sector rethink executive incentives?

The corporate landscape

The mining boom created tremendous demand for critical talent, forcing companies to pay top dollar and offering lavish benefits to secure these individuals. This generous remuneration was also extended to the broader employee population, with employees earning much more in the mining sector than they would in other industries performing the same role. Now that the 'glory days' of the mining boom appear to be well and truly behind us, it is important for companies to optimise their reward strategies and adapt to the new business environment. Further, given the increased transparency requirements following the 2012 changes to the Corporations Act which introduced the 'two strikes' rule, public companies are continually reminded of the increased scrutiny and shareholder influence placed upon executive remuneration.

Key insights from the analysis suggests mining companies may consider:

- Strengthening the alignment of pay and performance
- Evaluating the length over which performance is measured
- Reviewing performance measures appropriate for the mining cycle
- Enhancing the disclosure of remuneration through greater transparency

Analysis approach

An internal analysis conducted by The Reward Practice compared ASX 300 remuneration reports by dividing companies into two groups. The first group covered all the companies which are part of the 'ASX 300 Metals and Mining' index. The second group consisted of the 'ASX 300' index companies, encompassing those from all industries (excluding 'Metals and Mining' index constituents). The companies within each of these two groups were then ranked by total shareholder return (TSR) for the financial year 1 July 2016 to 30 June 2017 (FY2017) to determine high and low performing companies.

Figure 1 – Average Total Shareholder Return

	Group 1 Metals & Mining	Group 2 Non-Metals & Mining
Top 10 companies	89%	105%
Bottom 10 companies	-40%	-21%

These two groups formed the basis for broader analysis to understand differences in executive remuneration and incentive practices.

SECTION 1: KEY FINDINGS

High and low performers adopt different reward strategies

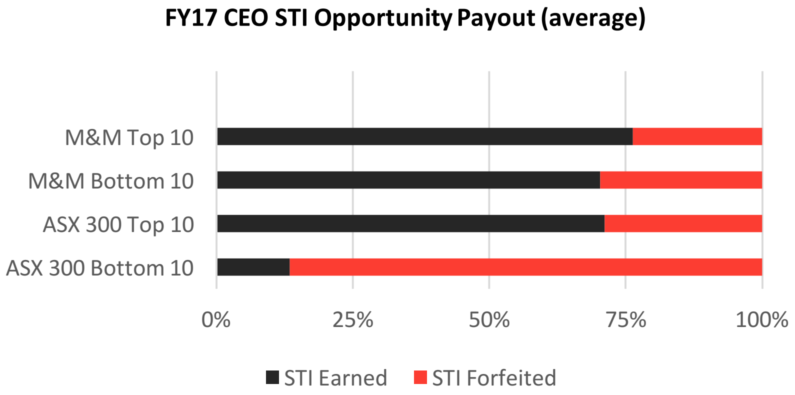
Although remuneration strategies are not the only factor influencing corporate success, they can have a significant effect on driving employee engagement and motivating executives to provide long-term value creation for shareholders.

Insights from the analysis found high-performing companies:

1. Show stronger alignment between pay and performance

Short and long-term incentives made up approximately 60% of ASX 300 CEO total remuneration opportunity in FY2017, providing a significant reward linked to their operational and strategic decisions.

Figure 2: Outcomes for CEO short-term incentives across the comparator groups.[1]



Whilst it is typical to observe CEO's of high performers receiving the majority of their STI opportunity, the high STI payout for low performing metals and mining companies is unusual.

Over the period, high performing companies across both groups rewarded their CEO's with short-term incentive (STI) pay-outs on average in excess of 70% of the maximum opportunity.

CEO STI payouts for bottom performing ASX 300 companies (non-metals and mining) averaged 13% of maximum opportunity. This was in stark contrast to CEO's of low performing metals and mining companies where on average more than 70% of STI was paid despite an average -41% TSR loss and profits falling in some of these companies.

Interestingly, STI gateways (e.g. profit) were more prevalent in non-metals and mining companies, providing a potential insight for how pay and performance alignment may be strengthened.

A deeper analysis into the bottom performing metals & mining companies also revealed a significant variation between CEO and other executive STI earned as a proportion of the maximum opportunity during FY2017.

Whilst CEO's received on average over 70% of their STI opportunity, in comparison, other Executives received on average 30% within their organisation. This finding suggests a variation in the types of performance measures used for CEO's and/or how effectively these companies align STI payments with performance.

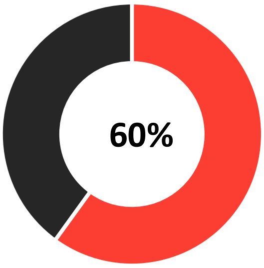
[1] ASX 300 excludes Metals and Mining index constituents. The actual number of companies may be less than 10 as some companies failed to report the STI opportunity for Executives, which reduced the size of the comparator group.

2. Use a longer-term horizon for delivering remuneration

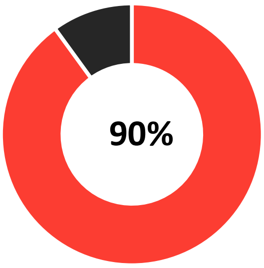
Companies that have a longer-term view in mind may provide incentives over a lengthier performance period to deter risky, short-term gains.

This point was supported by the top performing 'ASX 300' companies which showed a greater tendency to utilise mandatory STI deferrals and LTI performance periods of three to five years. As a result, Executives in this group will wait longer than bottom performing companies to realise their actual total remuneration.

Figure 3: Prevalence of mandatory STI deferral and LTI performance period 3 to 5 years



Mandatory deferral for a portion of STI for 1 to 2 years is applied in **60%** of the top performing non-mining & metals ASX300 companies.



90% of the top performing non-mining & metals ASX300 companies apply a 3 to 5-year performance period when assessing LTI outcomes.

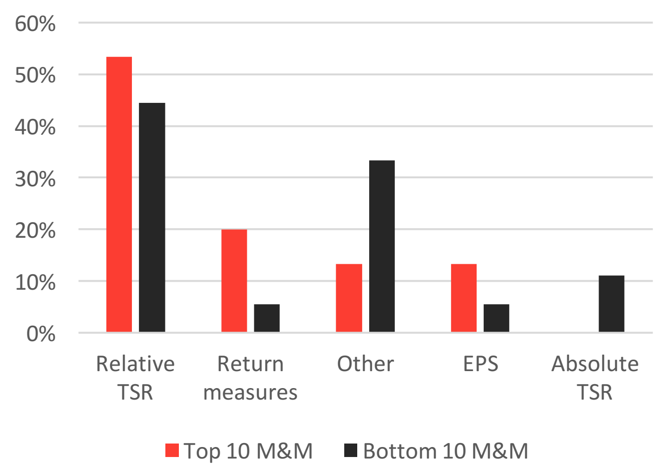
For bottom performing Metals and Mining companies, total executive remuneration (salary and incentives) was largely obtainable over a relatively short period of less than two years.

3. *Adopt a more nuanced approach to performance measures*

Setting appropriate short and long-term incentive targets is a challenging task. For resources companies, the 'peaks and troughs' of the commodity cycle provides particular complexity requiring a more dynamic approach to setting performance measures that encourage value creation throughout.

The analysis revealed top performing metals and mining companies have a greater propensity to set long-term aspirational targets with the goal of achieving high returns on capital through the cycle. This was indicated through a higher prevalence of LTI performance measures including return on invested capital and distribution of capital to shareholders (return measures) as well as relative total shareholder return.

Figure 4: LTI performance measures



Despite its potential challenges, TSR relative to peers continues to be the most prevalent LTI measure in the ASX 300 including mining companies. Effectiveness of this measure is largely dependent on identifying similar listed companies that can be benchmarked against. Company size (typically defined using market capitalisation), commodity type and quality, geographical location, and position on the cost curve will impact the comparability of companies.

To support long-term objectives, high performing mining companies endeavor to also focus on operational excellence over the shorter term. The analysis revealed a higher prevalence of STI metrics supporting cost reduction (profit and loss measures), sustainable growth through reserve replacement (operating targets) and engagement with stakeholders (safety).

Figure 5: STI performance measures

Metals and Mining Index	Most prevalent STI measures
Top 10 Performers	Safety (70%), Operating targets (40%), Profit and Loss metrics (40%)
Bottom 10 Performers	Safety (60%), Free cash flow (50%), Operating Targets (30%)

Changes to incentive hurdles can represent a shift in corporate and executive mind-set, potentially unlocking value for shareholders. A mining company that adopts a stronger focus toward return on capital as a long-term measure may result in reassessment of its asset base, divestment of underperforming assets, return of the released capital to shareholders and ultimately a stronger more focused business.

4. Provide greater transparency of remuneration for shareholders

Top performing companies in both the 'ASX 300' and 'ASX 300 Metals and Mining' generally disclosed a greater amount of detail concerning their reward framework and how it aligned with corporate performance in FY17.

This included more details on how remuneration quantum was determined, disclosure of maximum incentive opportunity, details of the measures used to assess performance and reasons why the measures had been chosen. This enhanced disclosure allows shareholders to better understand the remuneration outcomes, therefore reducing the risk of a strike being received at the AGM.

Figure 6: Additional voluntary remuneration report disclosures observed for top performers

	Top performers
Message from the board which may include highlighting: ▶ key aspects of the remuneration framework subject to review or change ▶ remuneration outcomes for the financial year	√
Remuneration strategy including: ▶ remuneration principles including external market comparisons and targeted positioning ▶ discussion of the objectives of strategy and links to corporate value drivers ▶ purpose and rationale for each component	√
Executive remuneration structure including: ▶ STI and LTI target and maximum opportunity ▶ target remuneration mix (proportion of fixed, short-term and long-term) ▶ discussion relating to the rationale for the selected performance measures (i.e., both financial and non-financial measures as appropriate)	√
Total remuneration earned for the period ▶ 'cash remuneration' table showing total remuneration realised with breakdown for each element ▶ used to provide clarity around what executives have received rather than the statutory remuneration table based on accounting values	√

Greater transparency for top performing companies was also typically supported with clear and simple messaging. Graphics, charts and tables are prevalent, thinning out 'heavy' narrative to effectively illustrate key remuneration concepts and outcomes.

SECTION 2: PLANNING FOR THE FUTURE

Good reward programs alone will not guarantee executive and corporate success, nor protect an ASX listed company from receiving a strike against their remuneration report. However, these differences in remuneration approaches are stark and therefore noteworthy.

We believe the research results suggest that top performing companies will continue to look for ways to optimise their rewards. They will do this with a focus on broadly defined "total rewards" and they will seek methods and approaches that allow them to pursue optimisation using data driven approaches that allow for ongoing measurement and continuous improvement.

With the AGM season wrapping up, it is too late to change the FY17 outcomes, but it is possible to be proactive and consider new remuneration frameworks aligned with the contemporary business environment.

How can we help?

The Reward Practice is an independent boutique remuneration consulting practice based in Perth. We specialise in board, executive and employee reward & recognition programs. Key to providing value to our clients are three fundamental characteristics of capability, comprehensiveness and commerciality that we bring to each and every opportunity that is presented.

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