Evaluating Pay for Performance Alignment

Implementing a Pay for Performance Model for Australia

Authors:
Vasili Kolesnikoff
Sarah Gallard

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EXECUTIVE SUMMARY

In the 2017 annual meeting season, ISS is introducing a quantitative pay-for-performance (PFP) assessment covering the largest Australian companies. We have sought to leverage the common features of the ISS pay-for-performance models implemented in the U.S., Canada, and Europe where appropriate. In addition, the approach has been adapted as necessary to fit the Australian context, notably in relation to the construction of peer groups and the pay calculation methodology.

The ISS Australian PFP model uses a variation of the grant-day (or granted) definition of pay that is similar to the one currently used in the ISS PFP models for the US and Canada, adapted to the disclosure practices in Australia. And similar to other global pay-for-performance models, the measure of performance in the quantitative test is total shareholder return (TSR). An ISS Peer Group is constructed for each subject company to make a relative comparison of pay and performance between the subject company and the list of comparable peer companies. Additional details on each of these topics is provided later in this document.

For ISS benchmark voting policy, assessment of remuneration for Australian companies follows the ISS Global Principles on Executive and Director Remuneration which are detailed below. These take into account global corporate governance best practice principles.

The ISS Global Principles on Remuneration

Companies should:

1. Provide shareholders with clear, comprehensive remuneration disclosures;

2. Maintain appropriate pay-for-performance alignment with emphasis on long-term shareholder value;

3. Avoid arrangements that risk “pay for failure;”

4. Maintain an independent and effective remuneration committee;

5. Avoid inappropriate pay to non-executive directors.

The ISS Australian PFP model will provide quantitative elements, which consider both relative PFP alignment compared with peer groups and absolute PFP alignment. The methodology is described in this paper, and, like our PFP methodology for other markets, it incorporates models for RDA (Relative Degree of Alignment,) MoM (Multiple of Median) and PTA (Pay-TSR Alignment).

It is important to emphasise that the addition of the Australian pay-for-performance model to ISS benchmark research reports will be additive and is intended to provide additional data points for comparability. Therefore, while the PFP model reviews total pay versus TSR performance, the qualitative review by ISS research analysts will continue to take into account various pay elements, such as award opportunities, service contracts, performance measures and achievements, and actual award payouts, among other factors . The qualitative factors that ISS considers in its holistic analysis of pay are discussed in the separate ISS Australian benchmark policy.

The initial Australian PFP coverage universe will comprise companies in the S&P/ASX 300[1] that fall under ISS’ Australia policy coverage. For the 2017 introduction of the model, the universe of constituents was set in June 2017. Index constituents will be reviewed annually going forward. ISS research reports on companies covered by Australian PFP

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[1] https://us.spindices.com/indices/equity/sp-asx-300

assessment will include the pay-for-performance assessment for meetings on or after 1 October 2017.

Further information will be available from the ISS PFP helpdesk, which should be contacted in the first instance for any queries. The Helpdesk can be contacted using the following email address: AustralianP4PSupport@issgovernance.com.

INTRODUCTION

The current ISS pay-for-performance (PFP) model for the U.S. was launched in 2012, and similar models were implemented for Canada in 2013 and Europe in 2016. Feedback from institutional investors has identified significant interest in a quantitative pay-for-performance model for Australia as part of a common framework of measuring pay and performance alignment in global markets.

However, ISS recognises that remuneration disclosures within the Australian market differ from those of the U.S., Canada, and Europe; therefore, quantitative methodologies need to be adapted to be appropriate for the Australian context. The pay definition adopted for ISS' Australian PFP model therefore takes into account the various elements of pay common within the market and accounts for Australia-specific disclosure practices in order to use a standard definition that can be used in relative comparisons between Australian companies.

The purpose of ISS' pay-for-performance evaluation is to measure the alignment between pay and performance over a sustained period, and identify companies where there appears to be a misalignment.. The ISS PFP quantitative assessment is designed to identify such misalignments, based on both relative and absolute pay-performance evaluations, as well as to identify apparent good or satisfactory alignment that investors also appreciate being aware of.

The ISS PFP quantitative methodology delivers a common, global approach

The quantitative methodology utilises two components:

- **A relative evaluation** – rankings of CEO pay and performance relative to peer companies.
- **An absolute evaluation** – CEO pay relative to shareholder return for the subject company.

Both are considered from an investor's perspective in evaluating the efficacy of top executive pay packages over time. For the relative evaluation, ISS peer groups are designed not for pay benchmarking or stock-picking but rather to compare pay and company performance within a group of companies that are reasonably similar in terms of industry profile and size.

The evaluation focuses on the total pay for the lead executive, typically the CEO, for the period under consideration, although it is important to note that the three different models measure pay over three different time periods (typically one, three and five years for the MOM, RDA and PTA models respectively.) To keep things simple, for the rest of the document, we will refer to this as total CEO pay, as this is what will be analysed in the vast majority of cases.

What We Measure -- Pay

All figures in the Australian PFP model are based on a variation of grant-day (or granted) pay. The CEO's total remuneration includes base salary, benefits, actual cash incentives received (paid out), and the granted or grant-date value of any share rights (stock) or option awards.

During the development of the model, the ISS Australian Research team reviewed typical pay disclosures in the market and the outcome was that a model based on granted pay was determined to be the best fit and is most closely associated with the mandated disclosures in the market.

Calculating Australian Total Pay

The Australian PFP model calculates total pay based on the CEO's earned cash and granted equity for the years under review. Where company disclosure is considered too limited to permit this calculation, a company may be excluded from the model for insufficient pay information. If a company wishes to see how its total pay figure was calculated, it can request this information from the ISS PFP helpdesk via AustralianP4PSupport@issgovernance.com.

Below is a breakdown of the pay components covered by the Australian PFP model along with a description of each component:

Figure 1. Australian PFP Total Pay Components

Item			Description
Total Pay	Fixed Pay	Base salary	The annual base salary received for the fiscal year. This figure is annualised in cases of partial-year CEOs.
		Non-monetary benefits	Any non-cash benefits and miscellaneous amounts given to the individual. Examples are life insurance, fringe benefits tax, and commercial interest on employee loans.
		Superannuation	The statutory payment for retirement to the executive by the company (company contribution).
		Retirement Accrual	The non-statutory benefits for retirement paid to the executive by the company.
		Expat benefits	The non-cash benefits or miscellaneous amount in relation to relocation costs given to the executive.
		Other benefits	All other payments that do not fit into any other category, such as club membership fees, security payments, and housing allowances.
		Sign-on payment	The sign-on benefits amount that an individual received upon joining the company.
	Short-Term Incentives	Cash Bonus	The earned cash component of the short-term incentives (paid out and deferred).
		Deferred Share Bonus	The earned value of the equity component of the short-term incentives that an individual earned in relation to the fiscal year.
		One-Time STI	The value of the one-time STI award that the individual received during the fiscal year. This can either be cash or equity.
	Long-Term Incentives	Option Awards	The company disclosed option award fair value (company disclosed grant-date fair value) for each LTI option award granted within the fiscal year. Includes time-based, performance-based, and retention awards.
		Stock Awards	The grant date value of LTI stock awards granted within the fiscal year, as calculated by ISS. The stock awards values are calculated by ISS by taking the target number of shares granted and valuing them at the grant date share price. Includes time-based, performance-based, and retention awards.

What We Measure -- Performance

There are many ways to measure corporate performance, and key metrics may vary considerably from industry to industry and from company to company depending on their particular business strategy at any given time. Investors generally expect incentive plan metrics to stem from that strategy and be designed to motivate the behavior and executive decisions that will lead to its successful execution, but the one key common measure for investors in the context of a long-term pay-for-performance evaluation is total shareholder return (TSR).

We would note that this does not imply that ISS advocates for companies to use TSR as the single metric underlying their incentive programs; many companies and shareholders may prefer that incentive awards be tied to the company's business goals more broadly than TSR. However, if a company's business strategy is sound and well executed, the expectation is that it will create value for share owners over time, and this will generally be reflected in long-term total shareholder returns. TSR is therefore the primary measure used in ISS' quantitative pay-for-performance alignment models. Various other financial and operational metrics are also considered when company practices and remuneration decisions are analysed as part of the qualitative review undertaken for ISS proxy research reports.

The TSR data used in the Australian pay-for-performance model is provided by the same data vendor (S&P/Compustat XpressFeed) using the same TSR methodology (S&P's standard TSR methodology) as the TSR data already included in the ISS proxy research reports.

What We Measure -- Relative and Absolute Alignment Over Time

In 2011, a substantial majority of institutional investor respondents to ISS' global policy survey confirmed two factors as important in determining pay-for-performance alignment: pay relative to peers (considered very relevant by 62 percent of investor respondents), and pay increases that are disproportionate to the company's performance trend (considered very relevant by 88 percent of investor respondents). A majority of company (issuer) respondents also indicated these factors as at least somewhat relevant to a pay-for-performance evaluation.

In light of this and similar feedback from roundtables and other discussion forums over a number of years, ISS incorporated both perspectives into the quantitative component of its pay-for-performance analysis when developing the US pay-for-performance approach which was launched in 2012 followed by the PFP models for Canada in 2013 and Europe in in 2016. This ensures a balanced evaluation from both relative and absolute pay-for-performance perspectives.

ISS' QUANTITATIVE EVALUATION OF PAY-FOR-PERFORMANCE ALIGNMENT

Measures of Pay-for-Performance Alignment

At the core of the quantitative methodology are three measures of alignment between executive pay and company performance: two *relative* measures where a company's pay-for-performance alignment is evaluated in reference to a group of comparable companies, and one *absolute* measure, where alignment is evaluated independently of other companies' performance.

The three measures are:

- **Relative Degree of Alignment**. This relative measure compares the percentile ranks of a company's CEO pay and TSR performance, relative to an industry-and-size derived comparison group (i.e., ISS Peer Group), over a three-year period.
- **Multiple of Median**. This relative measure expresses the prior year's CEO pay as a multiple of the median pay of its comparison group for the same period.
- **Pay-TSR Alignment**. This absolute measure compares the trends of the CEO's annual pay and the value of an investment in the company over the prior five-year period.

Measures of Relative Alignment

Relative Degree of Alignment (RDA)

This measure addresses the question: Is the pay the CEO has received for the period under review commensurate with the performance achieved by the company in the same period, relative to a comparable group? The measure compares the percentile ranks of a company's CEO pay and TSR performance, relative to a comparison group of at least 11 companies selected by ISS on the basis of size and industry over a three-year period.

To determine this measure, the subject company's percentile ranks for pay and performance are calculated for the three-year period. Because of the sensitivity of TSR to overall market performance, annualised TSR performance for all companies will be measured for the same period.

Combined percentile ranks for pay and for performance are calculated, and the Relative Degree of Alignment is equal to the difference between the ranks: the combined performance rank minus the combined pay rank.

Figure 2. Example of calculating RDA score

	Performance	Pay	Difference
3-year percentile rank	32	59	-27

Values for the Relative Degree of Alignment measure range between -100 and +100, with -100 representing the high pay for low performance (i.e., 100th percentile pay combined with 0th percentile performance), zero representing a high degree of alignment (the pay rank is equal to the performance rank), and positive values representing a relative performance rank above the relative pay rank.

If a subject company does not have 3 years' worth of pay or TSR data, then RDA will be run using a 2-year scope. If a subject company does not have 2 years of pay or TSR data as of the measurement date, the RDA test will be excluded from the PFP assessment.

Multiple of Median (MoM)

This relative measure identifies instances where CEO pay magnitude is significantly higher than amounts typical for its comparison group, independent of company performance.

Calculating is straightforward: the company's one-year CEO total pay is divided by the median pay for the comparison ISS peer group.

Values can therefore range from zero (if the subject company paid its CEO nothing) to any positive value, with no upper limit. A MOM value of 1.00 indicates that CEO pay in the last fiscal year is equivalent to the ISS peer median.

Measure of Absolute Alignment

The absolute alignment test is intended to compare pay and TSR trends to determine whether shareholders' and executives' experiences are directionally aligned.

Pay-TSR Alignment (PTA)

PTA is a long-term measure of directional alignment. It is important to note that it is not designed to measure the sensitivity of CEO pay to performance – i.e. whether pay and performance go up and down together on a year-over-year basis.

The measure is calculated as the difference between the slopes of weighted linear regressions for pay and for shareholder returns over a five-year period. This difference indicates the degree to which CEO pay has changed more or less rapidly than shareholder returns over that period. For technical information on how the regressions are calculated, please see the US pay-for-performance white paper, Pay-for-Performance Mechanics, published in December 2016.

The trend lines calculated by these regressions are analogous to a 5-year "trend rate" for pay and performance, weighted to place a greater emphasis on more recent history. The final Pay-TSR Alignment measure is simply equal to the difference: performance slope minus the pay slope.

THE AUSTRALIAN APPROACH TO PEER GROUP CONSTRUCTION

The approach to peer groups in the Australian pay-for-performance model mirrors that of other markets by building peer groups based on a company's industry and size. Unlike other markets, the Australian ISS peer group construction process does not include a company's own self-disclosed peer group, and in any case, many companies in this market do not disclose their peers groups. Additionally, the Australian construction process includes a review of each subject company's ISS peer group by the ISS Research team to ensure an appropriate fit of peer companies, which is particularly important given the smaller size of the Australian market and the available pool of peer companies relative to other larger markets such as the US and Europe.

Number of Peers

The Australian model typically has a minimum of 11 peers. The relative PFP tests (RDA and MoM) require a minimum of 11 peers with sufficient data to run.

Remuneration Data and Industry Classification

ISS' remuneration data sample covers about 600 Australian companies' total remuneration for the past 3 to 5 years – roughly 300 subject companies in the ASX300 and roughly another 300 public companies in the Australian market for use as peers-only. All monetary amounts are converted to the disclosure currency of the subject company.

The industry classification used is the Global Industry Classification Standard (GICS)[2] code, which is a four-tiered, hierarchical industry classification system consisting of 11 sectors (GICS 2), 24 industry groups (GICS 4), 68 industries (GICS 6) and 157 sub-industries (GICS 8). Each company has an 8-digit GICS code based on its principal line of business activity.

ISS Peer Group Construction

ISS constructs a comparison group of a minimum of 11 Australian peer companies for each subject company covered by the PFP methodology. Peer groups for all subject companies analyzed under this methodology are constructed once per year, based on data provided by an independent source (S&P XpressFeed Quarterly Data Download [QDD]). The following criteria are used to determine peer companies:

- the GICS industry classification of the subject company
- Size constrains for for both revenue (or assets for certain financial companies) and market value, utilizing four market cap "buckets" (micro, small, mid, and large)

Subject to the size constraints, and while choosing companies that push the subject company's size closer to the median of the peer group, peers are selected from a potential peer universe in the following order:

1. from the subject's own 8-digit GICS group
2. from the subject's own 6-digit GICS group
3. from the subject's own 4-digit GICS group
4. from the subject's own 2-digit GICS group
5. from the subject's "Super GICS" group (described further below)

If 11 comparator group members are not selected from the companies in the universe that share the subject company's eight-digit GICS category, the process is repeated with companies in the comparison universe that share the company's six-digit GICS category, maintaining the company at the median position where possible, until 11 or more comparison

[2] https://www.msci.com/gics

companies are selected; if 11 comparison companies cannot be selected using the peers' six-digit GICS category, then the process is repeated using the next universe set listed above (i.e., the subject's four-digit GICS group), until 11 or more companies are selected; and so on.

In some cases where less than 11 peers have been identified using the standard methodology, the industry group to which the subject company belongs is expanded to include companies that are otherwise comparable to the subject company operationally. To do this, ISS creates a "Super GICS" group, which combines closely related two-digit GICS groups to create a larger peer universe for companies that have fewer than 11 peers. The Super GICS groups used by ISS are:

Super GICS Category	Two-Digit GICS Included	Names of Included Sectors
A	10, 15, 20, 55	Materials, Industrials, Energy and Utilities
B	25, 30, 35	Consumer Discretionary, Consumer Staples, and Health Care
C	45, 50	Technology and Telecom

Qualitative Peer Group Review

As part of peer group selection process, ISS also includes a a qualitative review of the company comparator groups by the ISS Australia Research team to ensure that the comparison companies are considered appropriate. ISS has and will continue to adjust comparator groups where the quantitatively-constructed comparator companies are deemed inappropriate.

If a company does not agree with the peers which have been allocated by the model, or considers they have been wrongly allocated, it can provide this feedback to the ISS PFP helpdesk via AustralianP4PSupport@issgovernance.com.

Company-Disclosed Peers

In the US and Canada, most companies include their chosen peers for pay benchmarking purposes in their disclosed meeting materials. In Australia, it is still very rare to see companies systematically include self-selected peers in the annual report or other materials, with the exception of some larger companies in certain markets.

As this is not a widespread practice in the Australian market, the decision was made for the 2017 season to only use ISS-selected peers in the Australian pay-for-performance model. However, if over time more Australian companies begin to disclose their company-selected peers, this decision may be reviewed again in future, in line with developments in market practice.

NOTES ON IMPLEMENTATION

It is important to emphasise the addition of the Australian pay-for-performance model to the ISS benchmark research reports will be additive and is intended to provide our clients with additional data points for comparability. Also, while the model is based on an analysis of CEO pay and TSR, the qualitative reviews by ISS research analysts will continue to take a holistic view of the entirety of the remuneration report, including numerous elements of the pay program for the CEO, named executive officers, and directors.

The rest of this section will discuss how the pay-for-performance charts will be presented in the ISS benchmark research reports, and how frequently the model will be updated.

Presentation Within the Research Reports

Beginning with ISS reports for meetings on or after 1 October 2017, the relevant ISS Australian proxy research reports for the companies included in the Australian PFP model will include pay-for-performance graphs similar to those seen in other markets.

Within the analysis for the agenda item pertaining to the remuneration report, a Components of Pay table will be presented to illustrate how the total pay number was reached (Figure 4); this is followed by the three models under the Pay for Performance assessment – the RDA, MoM and PTA charts (Figure 5). Along with the three tests and their scores, an overall level of concern is presented as Low, Medium, or High, indicating the strength of CEO pay for TSR performance alignment as determined by a triage assessment of three tests.

Figure 4. Remuneration Profile – Components of Pay

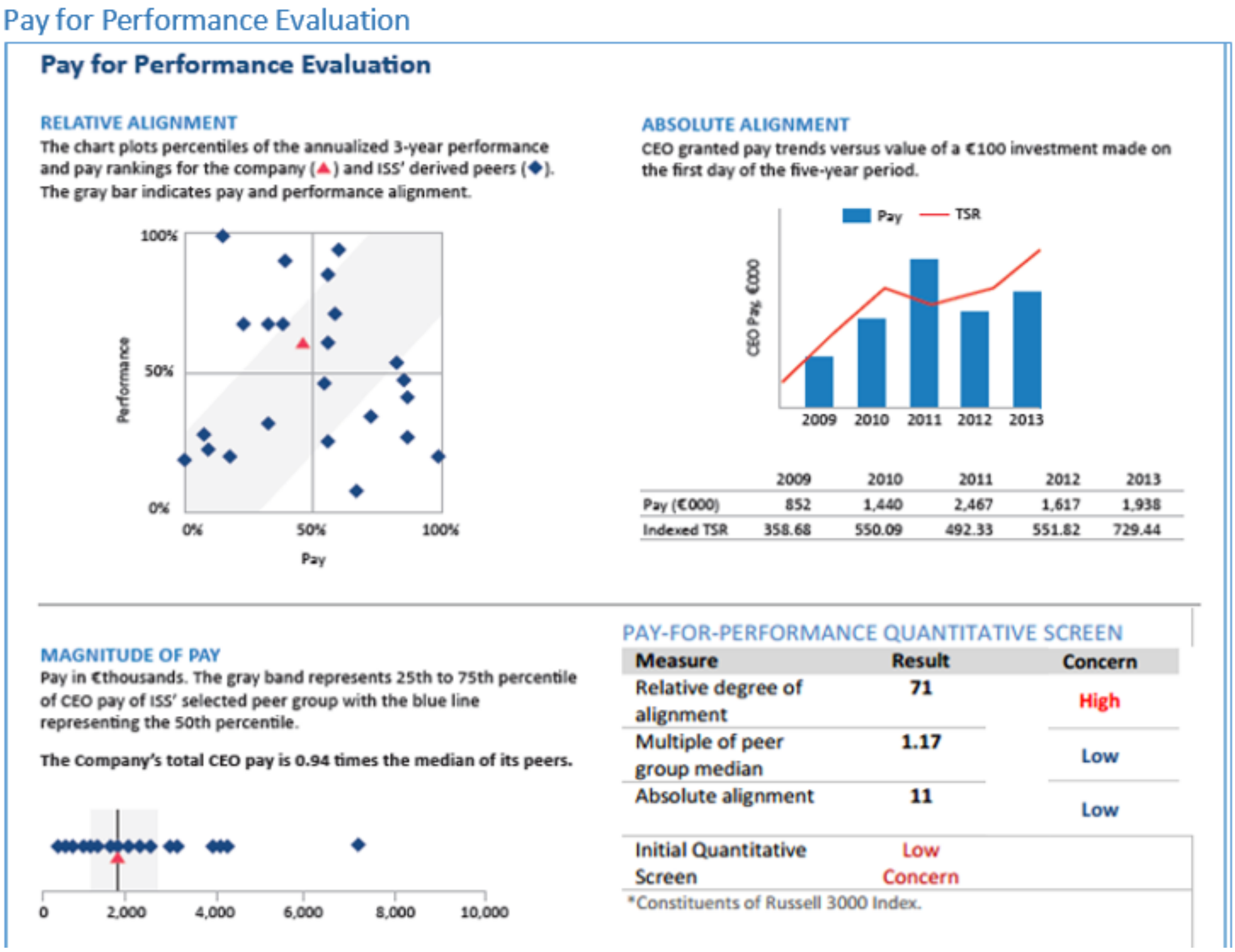
Components of Pay

Components of Pay					
AUD in thousands	Lead Executive				Lead Executive Peer Median
	CEO Name		CEO Name	CEO Name	
	2017	% Change	2016	2015	2017
Base Salary	**$1,000**	0.0%	**$1,000**	**$1,000**	**$1,000**
Non-monetary benefits	$1,000	0.0%	$1,000	$1,000	$1,000
Superannuation	$1,000	0.0%	$1,000	$1,000	$1,000
Retirement Accrual	$1,000	0.0%	$1,000	$1,000	$1,000
Expat benefits	$1,000	0.0%	$1,000	$1,000	$1,000
Other benefits	$1,000	0.0%	$1,000	$1,000	$1,000
Sign-on payment	$1,000	0.0%	$1,000	$1,000	$1,000
Total All Other Payments	**$6,000**	0.0%	**$6,000**	**$6,000**	**$6,000**
Total Fixed Pay	**$7,000**	0.0%	**$7,000**	**$7,000**	**$7,000**
Cash Bonus	$1,000	0.0%	$1,000	$1,000	$1,000
Deferred Cash Bonus	$1,000	0.0%	$1,000	$1,000	$1,000
Deferred Share Bonus	$1,000	0.0%	$1,000	$1,000	$1,000
One-Time STI	$1,000	0.0%	$1,000	$1,000	$1,000
Total Short-Term Incentives	**$4,000**	0.0%	**$4,000**	**$4,000**	**$4,000**
Stock Awards	$1,000	0.0%	$1,000	$1,000	$1,000
Option Awards	$1,000	0.0%	$1,000	$1,000	$1,000
Total Long-Term Incentives	**$2,000**	0.0%	**$2,000**	**$2,000**	**$2,000**
Total Pay	**$13,000**	0.0%	**$13,000**	**$13,000**	**$13,000**

Within the ISS research reports:

- **The Relative Alignment (RDA)** chart compares the performance and pay rankings of the subject company and its peers over (typically) three years.
- **The Magnitude of Pay (MoM**) chart shows the CEO pay for the most recent year compared with that of its peers.
- **The Absolute Alignment (PTA)** chart compares the subject company's CEO pay with indexed TSR over (typically) five years.
- **The Pay-For-Performance Quantitative Screen** summarises the overall level of concern.

Figure 5. Pay for Performance Evaluation



Immediately following the pay for performance tests, a summary for the ISS peers used in the relative assessments is displayed (Figure 6), with a list of the peers and chart displaying their size relative to the subject company. As previously discussed, there will be no company-selected peers in the Australian model so the elements of other markets' reports which display this ISS vs. disclosed peer comparison will not be present in the Australian reports.

Figure 6. Pay for Performance Peer Group

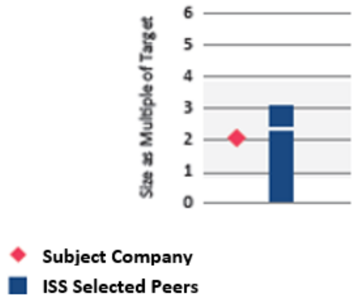
Peer Group

ISS SELECTED PEERS (16)

Peer Company A	Peer Company J
Peer Company B	Peer Company K
Peer Company C	Peer Company L
Peer Company D	Peer Company M
Peer Company E	Peer Company N
Peer Company F	Peer Company O
Peer Company G	Peer Company P
Peer Company H	Peer Company Q
Peer Company I	Peer Company R

PEER GROUP SIZE ANALYSIS

Size (by revenue) of the ISS selected peer group. Gray indicates 0.4-2.5 times the company's revenue". (Instead of "Size (by revenue) of the ISS, company and overlap peer groups. Gray indicates 0.4-2.5 times the company's revenue".)

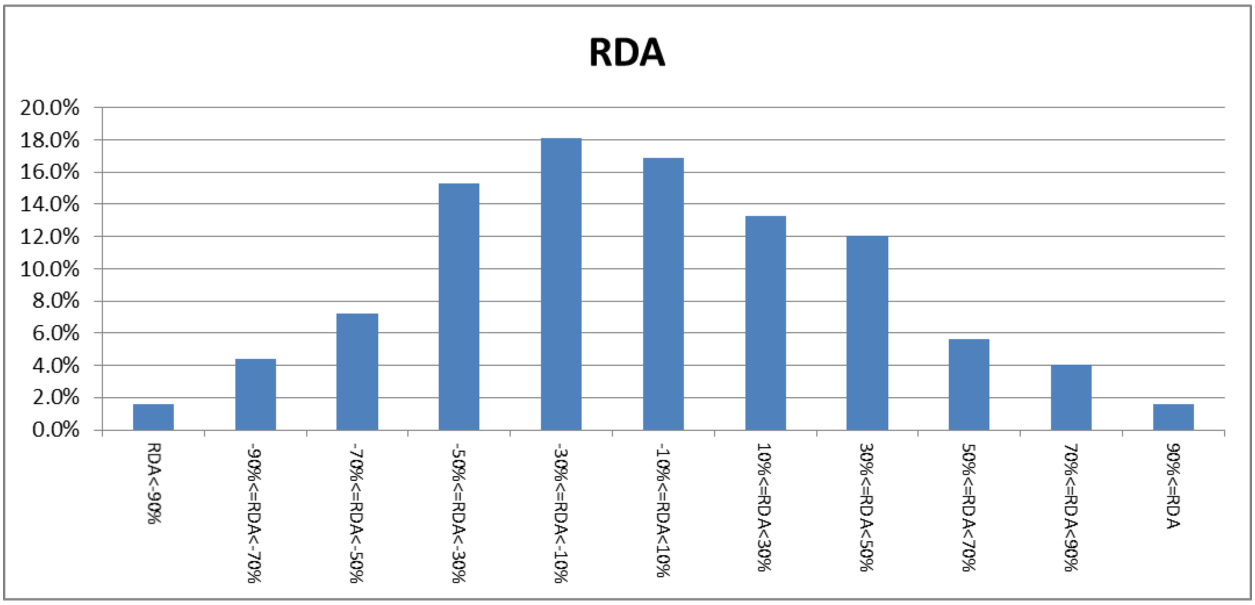


APPENDIX: BACK-TESTING THE MODEL

The distribution of scores has been tested for the three models, RDA, MOM and PTA, and was broadly in line with that seen for the North American and European models.

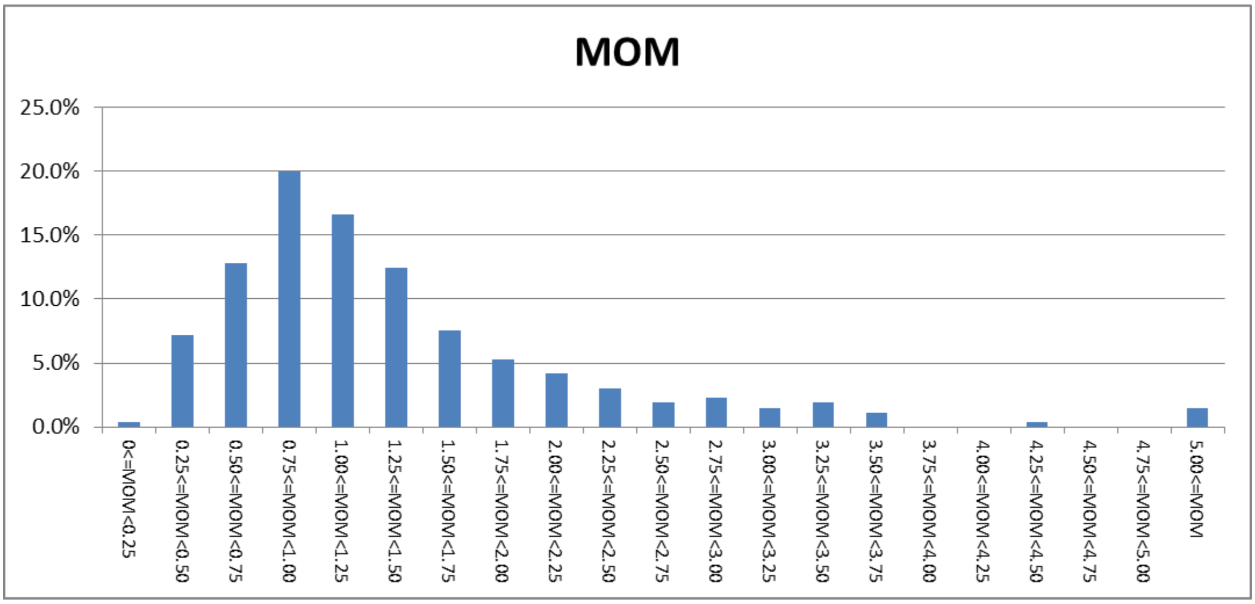
Relative Degree of Alignment

Figure 7. Distribution of RDA Scores



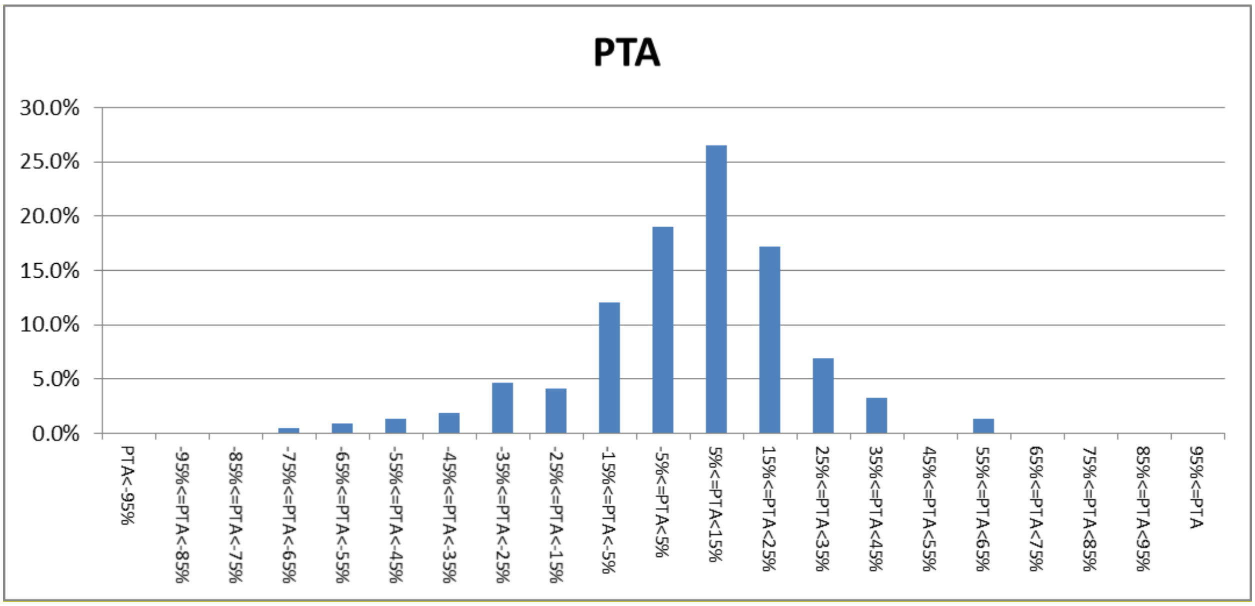
Multiple of Median

Figure 8. Distribution of MOM Scores



Pay-TSR Alignment

Figure 9. Distribution of PTA Scores



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