

CEO Remuneration and Performance

Stories about CEO performance and remuneration that hit the headlines tend to be either:

1. Scurrilous tales of excessive salaries and bonuses despite appalling company performance
2. Tantalising tales of huge salaries and bonuses because of strong company performance

This is a global phenomenon – as the UK-based Patterson Associates put it “Success is rewarded, failure is compensated”.

In a study of 59 FTSE companies, Patterson found CEO salaries and STIs averaged £4.5M in those providing a Total Shareholder Return (TSR) of less than 10%, and £3.2M in the better-performing organisations. Meanwhile, in the emerging giant of India, there was tut-tutting when 65 Boards set their CEO remuneration so high that it exceeded 5% of their net profit. And closer to home, in a scene reminiscent of The Emperor’s New Clothes, the CEO who steered Challenger in Australia to a \$44M loss (which he described as a ‘very credible result’) was rewarded with a 66% increase in total remuneration, to \$8.1M. One wonders at the performance criteria which allowed such a result to be rewarded.

At the more deserving end of the CEO spectrum, a proposed termination payment of \$10.7M was rejected, in a historic first, by Oxiana shareholders in Australia. Despite the CEO’s stellar performance, the prevailing view appeared to be that he had been adequately compensated along the way. Perhaps the introduction of non-binding shareholder votes on remuneration reports points the way to some cooler thinking on executive remuneration.

While the press clearly have a field day with CEO remuneration, Boards responsible for remunerating the CEO in a defensible manner have their work cut out for them. One thing is for sure, there is no one hard and fast rule for measuring CEO success.

Performance metrics very much come and go in terms of what’s ‘in vogue’. Fifty years ago, a great ‘company man’ was one who stayed with the business for the term of his natural born life (or close to it) and who steered the ship with stability and consistency, usually in the same direction, for the whole period. Now we are more likely to evaluate the most successful CEO as being one who comes and goes within a 3 – 4 year period, embarking on and delivering significant change and performance improvement in the business.

Regardless of which measure(s) you select, some argue that it’s impossible to comprehensively measure a CEO’s performance until long after they have left the business. However, at least attempting some reasonable measures is a good way to start.

Measures that have found favour in recent years include:

- Short-term stock price movements
- Quarterly earnings
- Total shareholder return
- Earnings per share
- Return on equity
- Return on assets
- Return on capital
- EBITDA
- Revenue growth.

Many believe the share market provides the most reliable indication of CEO performance. While this may remain the ultimate measure of long-term success, its day-to-day and even month-to-month movements volatility means it should be viewed with caution as a short-term measure. In a country the size of New Zealand, external influences can significantly affect our

sharemarket. Additionally, many of our large companies are not listed, which means company market value, the equivalent of listed share value, may be difficult to assess.

The evolution in the 1990's of the Balanced Scorecard by Kaplan and Norton saw strictly financial measures being supplemented by other measures, such as customer satisfaction and employee turnover. While this retains popularity, some have rejected the approach, preferring the good old fashioned financial metrics.

A key to remunerating your CEO successfully is to realise that it is not a science. A combination of some art with your science is likely to produce the best results. Metrics and packages tied to your organisation's specific short, medium and long term business objectives are likely to be the most effective. Factors that might drastically impact what those measures are include:

- Management style (do you need someone to lead behavioural change?)
- Industry evolution (do you need someone who is innovative and bold?)
- Aggressive growth versus maintenance (are you a start up or in decline, are you a traditional, stable and mature company?)

Tailoring the package and success measures to your specific objectives will be much more valuable than simply taking whatever financial or non-financial measures are most in vogue.

In the US, new government regulations require a new 'discussion' section, explaining how executive pay is determined (supplementing existing disclosure requirements from the Securities and Exchange Commission). Requiring companies to stipulate performance measures, why they have been chosen and how they have been performed against, minimises the amount left for shareholders and investors to wonder about.

Here are some other ideas for successfully structuring your CEO's performance-based remuneration:

- Link performance measures to your industry (peer group metrics and norms)
- Ensure the package design and measures are relevant to your current business state (stopping a decline, downsizing, aggressive revenue growth, maintaining stability, growing market share, etc)
- Make sure the measures are tied to your current business objectives
- Publish the measures
 - What is being used?
 - Why is it being used?
 - How is it being measured (the mechanism)?
 - What are the targets? (On-target versus stretch)
- Use quantitative measures focused on each of short, medium and long term success
- Preferably include no more than five measures (in order to focus performance and avoid unnecessary complexity).

A formal review, discussion and documentation of the CEO's performance at least annually are essential activities for a responsible Board. Similarly, Boards should hold true to incentive and performance measures rather than granting discretionary payments to the CEO where measures have not been met. After all, no one wants to be the next Director held up to the unforgiving glare of the media with the next scurrilous story off the block.....