



10 minutes on...

Managing remuneration
during and post COVID-19:
discretion is key

October 2020



1 Overview

The varied impacts of COVID-19 on business has materially increased the complexity and uncertainty of the environment in which Boards and Remuneration Committees have had to make remuneration decisions for FY20, and for FY21. While such decisions have always had to balance multiple interests - management, shareholders, regulators, community - this year the question of “what is fair and reasonable” has been even more challenging to work through. As a result, many were expecting Boards to use their discretion in relation to remuneration matters more actively, and in some cases, more significantly, than ever before. And so PwC were keen to examine whether discretion did actually feature more prominently this year in remuneration decision making, and if so, how.

In the ASX 100¹ FY20 remuneration reports released to date (March and June year ends), compromised financial performance and ongoing economic uncertainty has impacted the remuneration decision-making process across 3 areas: (i) determination of FY20 short-term incentive (STI) and (to a lesser extent) long-term incentive (LTI) outcomes, (ii) FY21 target setting, and (iii) FY21 proposed remuneration framework.

One of the most significant developments in FY20 is the prevalence of a detailed rationale being disclosed for why discretion was or wasn't applied. Whilst most companies appear to have considered the need for discretion, the majority of companies did not apply any overarching discretion to the determination of FY20 outcomes with ~59%² of current disclosures indicating Remuneration Committees thought the “formulaic” outcome of their STI plan was appropriate. There was still variation in outcomes given the differing impacts of COVID-19 across sectors - only ~30% of March and June year end companies experienced TSR growth from 1 January to 30 June 2020, and 23% of companies had TSR reductions greater than 25%. Even so, ~40% of ASX 100 companies felt the need to apply discretion (to override the formulaic outcome) or pre-emptively cancel STI - a significant increase from prior years.

LTI outcomes were less materially impacted and the limited adjustments applied to LTI are not unexpected, given the impacted period only accounted for a small proportion of the typical 3 or 4 year performance period.

With regards to FY21 remuneration framework intentions, some companies have included prospective disclosure outlining the intent to alter target setting approaches, and in some cases to amend the remuneration framework.

Overall, it is clear that Boards have considered the use and disclosure of discretion to be more imperative this year than in the past. This change in practice is likely to have set the bar for good governance going forward, even after the economy recovers. Boards, external stakeholders, and executives will likely increasingly observe discretion being an inherent part of reward decisions.

¹ ASX 100 determined by 3 month average market capitalisation to 31 December 2019. Companies domiciled overseas or listed on foreign exchanges have been omitted from analysis due to differing pay structures and disclosure requirements.

² All figures in this update relate to only March and June year end remuneration report releases (63 companies in total).

In this 10 minutes on, we focus on how Remuneration Committees have responded to the economic impact of COVID-19 across three areas:



FY20 incentive: to adjust or not to adjust



FY21 target setting



FY21 remuneration framework changes

2 FY20 incentive decisions: To adjust or not adjust?

The majority of companies did not adjust the 'formulaic' outcome derived from existing STI framework outcomes. For companies who were materially impacted by COVID-19, these delivered lower (or no) reward outcomes anyway; and for some companies where payments weren't low it was considered appropriately aligned with performance (e.g. strong financial performance, no major workforce impacts). However, what was highly prevalent was explicit commentary about discretion being actively considered (to the reward outcome, performance outcome or the performance targets), regardless of whether it was applied - aligned with recent ASIC guidance indicating an expectation that active, timely and consistent exercise of discretion is a critical factor in effective board oversight of reward. LTI outcomes were less materially impacted, with only Qantas and Altium found to have applied discretion to the LTI vesting in FY20 - Qantas, with a decision on the vesting of the CEO's LTI deferred until August 2021¹ and Altium deferring the LTI testing subject to an employment test and a financial performance test to be set by the Board in future years.

~40% made discretionary adjustments to STI outcomes

Typical quantum of adjustment was 10 - 30% of target STI amounts

6 companies paid 100% of STI in equity (rather than cash or cash/equity)

2 companies have applied discretion to the LTI vesting in FY20

Higher prevalence



No discretion applied

Applied by the **majority of organisations (~59%)**, albeit includes a number of organisations that applied discretion not related to COVID-19 impacts, but as it related to the operations of their business.



Downward partial adjustment of a formulaic outcome - based on discretionary application

Where discretion was applied, most commonly it was in a downward fashion, anchored on the formulaic STI outcome with an overlay based on a holistic assessment of company performance. Where disclosed, the adjustment was typically between **10% - 30% (of target STI)**.



Pre-emptive cancellation of incentive awards

Six companies, anticipating they would be materially impacted by COVID-19, preemptively announced that the STI outcome for the FY21 year would be zero. These were primarily in those industries that were most materially impacted (e.g. airlines, travel, gaming).



Downward partial adjustment - based on a maximum cap on incentives

Some companies chose not to anchor on the formulaic STI outcome, but rather determined 'caps' above which the Board felt it wasn't appropriate to provide an award. This **varied as a percentage of target**: from 50% (Transurban CEO) to 100% of target - i.e. no award above target (Wisetech Global, Mercury NZ Limited). Woolworths also limited their STI to 70% of target (where an award was made).



Upward adjustment - discretionary assessment

A few companies **increased the outcome relative to scorecard** / STI plan outcomes (e.g. the Star Entertainment Group, Commonwealth Bank and REA Group) in recognition of a range of factors inclusive of the response to COVID-19 and measures put in place to optimise business recovery.



Downward full adjustment - zero STI awarded

Two companies (Ramsay Health Care, IAG) elected **not to award any STI** despite achievement against non-financial metrics which would have resulted in some incentive being awarded but for the exercise of discretion.



Downward adjustment - specific measures addressed, adjustment of targets (rather than outcome)

Other examples of **discretionary adjustments** included adjusting targets to take into account COVID-19 impact (Qube), and downward adjustment to specific measures (CSL applied a downward adjustment to its outcomes against NPAT and cash flow from operations).

Lower prevalence

3 FY21 STI targets: Forecasting in an uncertain market

In the continuing uncertain economic environment, RemCos and Boards will likely need to again give strong consideration to the application of discretion to STI reward outcomes for FY21, and should be regularly seeking updates from management on the impact of changing conditions. While few companies have communicated their intent for FY21, there are a number of emerging approaches. Whichever approach is used, shareholders will want to see clear rationale documented in the following year's remuneration report.

Align to corporate plan and current FY21 guidance

Likely to be the most common approach, with companies setting targets to the best of their abilities (in some cases reflecting no or minimal growth year-on-year), and in line with recent market trends relying on Board / RemCo discretion at the end of the year to adjust outcomes if necessary.

Telstra has disclosed that its Executive Variable Plan EBITDA hurdle incorporates a negative impact from COVID-19 and NBN headwinds.

Periodic review of annual targets after setting

Proactive and formalised review of targets during the performance year as the economic conditions change.

Dexus will set 12-month targets and will review these in February 2021 and adjust if required to avoid windfall gains or unachievable targets over the remaining six months.

IDP Education has implemented a process of quarterly budgeting and will apply a higher degree of discretion to the year-end assessment.

Shorter, discrete performance periods

Reducing the performance period to lower the uncertainty associated with a longer period.

BlueScope has disclosed distinct performance periods, comprising 2 x 6-month performance periods, with targets for the second half of the year to be set in February 2021. The overall outcome will be assessed at the end of the financial year.

Set wider performance targets and payout ranges

Setting broader performance ranges and associated incentive outcomes to help mitigate the risks associated with setting narrow performance bands where forecasting is challenging.

Domino's is implementing wider target and payout ranges for the FY21 STI plan and will also review targets at 6 months with adjustments if required (as well as extending STI deferral to all Executive KMP).

Set explicit expectations that discretion will be used at year end

The inclusion of a formalised discretionary mechanism has been increasing in recent years, and we expect this trend to continue, with companies setting expectations that discretion will be used at the end of the year.

Cochlear has stated that discretion will be required at the end of the year (up or down) within the bounds of the existing framework, given the uncertainty associated with COVID-19.

4 FY21 LTI targets: Avoiding windfalls or disadvantage

For many companies, setting LTI targets is a challenging exercise in normal business conditions. With so much additional uncertainty in the current environment there is understandably a lack of confidence in the ability to set multi-year LTI targets for FY21 grants. As such, different approaches have emerged including: deferring the setting of targets, allowing for adjustment of targets after they have been set, implementing wider/lower performance ranges or placing a cap on FY21 LTI outcomes to avoid windfall gains - all of which have received differing reactions from shareholders. This will continue to be a challenging exercise in balancing shareholder expectations and setting clear goals that do not undermine perceived value or motivational impact for executives.

Set wider performance ranges and/or lower thresholds

While we are not seeing nor expecting to see broader TSR vesting ranges, Boards are grappling with how to set performance targets for internal hurdles. While some plans have a natural mechanism to ameliorate the impact of COVID-19 (while a grant vesting in FY20 may not vest, the performance level may set a lower baseline for FY21 grants), there are some organisations proactively disclosing in their remuneration report that they are revisiting their performance ranges for LTI.

AGL (in addition to other LTI changes) has reduced targets due to COVID-19 for LTI metric Return on Equity (ROE). Threshold reduced from 8.5% to 5%, maximum reduced from 12.5% to 8%. Vesting schedule remains the same between threshold (50% vesting) and target. This appears to have been one of the contributing reasons for AGL's FY20 remuneration report strike.

The setting and confirmation of targeting has been delayed

A number of companies have chosen to delay the setting of LTI targets, anticipating that with the elapse of time there would be greater clarity on the potential impacts to performance and ability to forecast. However, significant delays may increase shareholder scrutiny and create some uncertainty for executives.

Dexus has disclosed in its Notice of AGM that the Board has deferred setting a hurdle range for LTI, and expects this to be confirmed and set at the end of H1, FY21.

The Star has disclosed that, in light of the uncertainty created by the pandemic, the target setting for the FY21 LTI awards will be delayed, albeit has not provided clarity on when targets will be confirmed.

Ability to review (and potentially adjust) targets after they are set

While more commonly RemCos and Board will reserve the right to adjust the outcomes, the unprecedented nature of COVID-19 has meant organisations are actively anticipating the need to review and/or adjust targets after these have been set.

Brambles has disclosed that due to the uncertainty associated with forecasting of the sales CAGR and ROCI LTI metrics for the FY21-FY23 matrix, they will consider adjusting the matrix metrics up or down to reflect more appropriate forecast economic assumptions once the impact of COVID-19 on global regional economies is better understood.

Alteration of the performance period

There is one disclosed example of an alteration of the performance period based on the assumption that economic volatility will lessen later in the year.

Mirvac's TSR performance period for the upcoming grant commences 1 October 2020 (post June year-end results announcements) and conclude 30 June 2023 so that the market is fully informed at the start of the performance period. This compares to the customary performance period commencing 1 July 2020.

Introduction of a LTI cap

While more commonly seen in the UK market, there is one example in the Australian market of an organisation placing a maximum 'cap' on realisable LTI value.

South32 has announced that the CEO FY21 LTI grant will be capped at two times grant face value at vesting to avoid any windfall gains. The vesting outcome applied to the CEO at the time will inform the Board's application of discretion with regard to the vesting value for the other executive KMP (i.e. there is no current formal cap for executive KMP).

5 Frameworks: A temporary or permanent change?

As in any year, a number of companies are proposing to revise either their entire remuneration framework or components of, typically to improve alignment to company strategy, or in response to shareholders or regulatory requirements. Disclosed FY21 frameworks however indicate that companies are also directly implementing temporary structural changes to address the complexity of COVID-19 impacts, ranging from tweaks to performance measures to wholesale suspension of STI plans.



Alter the metrics that warrant an incentive payment

When altering the metrics associated with incentive plans, there appear to be two fundamental drivers:

- That new / alternate metrics are *more* relevant in a COVID-19 impacted environment; and
- That the difficulty of forecasting means some metrics are *less* appropriate.

New metrics:

Qantas has disclosed changes to their STIP scorecard to align with the newly developed Qantas Recovery Plan which includes alignment to performance measures with key financial (cash preservation), operational and safety measures.

Removal of less relevant metrics

Transurban's FY21 LTI allocations will be based on rTSR only, and the Free Cash Flow (FCF) measure will be removed. This is in direct response to COVID-19, with the Board indicating a current preference for FY22 to revert to including FCF as the second measure for the Group's LTI plan.

Seven Group had committed to introducing an EPS measure as a second LTI measure (with the balance against TSR), following feedback from shareholders in FY19. However, due to the uncertainty around long-term financial targets, the Board determined to retain rTSR as the single measure for the FY20 and FY21 LTI grants.

Mirvac has removed the ROIC component of LTI, such that rTSR will now be the single performance measure. It is specific to the FY21 plan and the preference is to revert to inclusion of ROIC in the FY22 plan.



Amend how incentives are awarded (unhurdled instruments)

For some companies, more significant changes were required to the FY21 LTI plan which included changes to the type of instruments granted to executives, through the introduction of unhurdled instruments.

Computershare disclosed that the FY21 LTI grant would consist of a 50% performance rights tested against rTSR over a 3-year period and 50% as Share Appreciation Rights (will only have value if the share price increases). There will also be appropriate safeguards put in place to ensure windfall outcomes to executives are avoided.

Vicinity has disclosed, as a consequence of COVID-19, a one-off change to LTI for the CEO FY21 grant. The grant consists of performance rights subject to rTSR hurdle (no change), the total return hurdle however is replaced by restricted rights award (discounted at 50%) resulting in a CEO total LTI opportunity reduction from 135% of TFR to 101.5% of TFR.



Introduction of interim retention/ recovery award

Similarly rare, we have seen one company explicitly address the risk of poaching talent through the introduction of a retention share plan.

Northern Star Resources issued Restricted Shares in May 2020 as a retention tool, with employment conditions between 1 June 2020 and 30 June 2021. Within the KMP, only the Chief Operating Officer participated in the plan.

Computershare in addition to the above, disclosed that they will award a "Recovery Equity Grant" as SARs recognising the low likelihood of vesting of the EPS components of prior LTI grants, which are subject to a cap on value to avoid windfall gains.



Increase weighting of LTI relative to STI

Given the need to drive sustainable growth, and the likely volatility in the short-term, a number of companies have reweighted incentives to have a greater focus on LTI.

Qantas has increased the weighting on LTI by reducing STI by the same quantum therefore maintaining a neutral total remuneration).

Aurizon has increased the CEO's LTI opportunity from 120% of fixed remuneration to 150% of fixed remuneration, thereby increasing LTI as a proportion of total remuneration.



Suspend the existing incentive structure

We have seen two companies announce suspension of existing STI plans for executives, specifically:

Boral has suspended the existing STI plan, with short-term performance being managed through agreed objectives. The approach may be reassessed if conditions and performance improve through the year.

Flight Centre's executives have elected to receive 75% of their targeted salaries during the first quarter of FY21 (a reduction in fixed pay), and 90% for the remainder of the year (fixed pay reinstated, but no STI is earned). Note, for Flight Centre the STI component is built into targeted remuneration packages, not paid as annual bonuses.

How can PwC help?

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