

Executive Remuneration – Should We Know More?

With the advent of a number of high profile corporate debacles, executive remuneration has again become a hotly debated issue. Investment managers have a role to play. In this newsletter we consider whether available data provide an adequate framework for assessing executive remuneration packages.

CHART 1 : Total Remuneration versus Prospective PE
 Median Remuneration = \$1.1 million, Top Quartile = \$2.2 million
 Median PE = 12.9, Top Quartile = 15.9

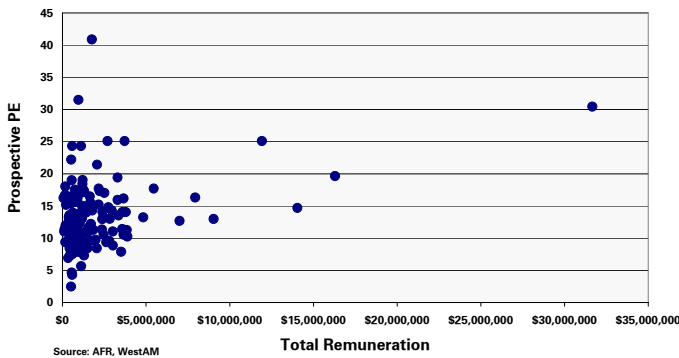


CHART 2 : Remuneration as % of Net Profit versus PE
 Median Proportion = 1.3%, Top Quartile = 1.9%
 Median PE = 12.9, Top Quartile = 15.9

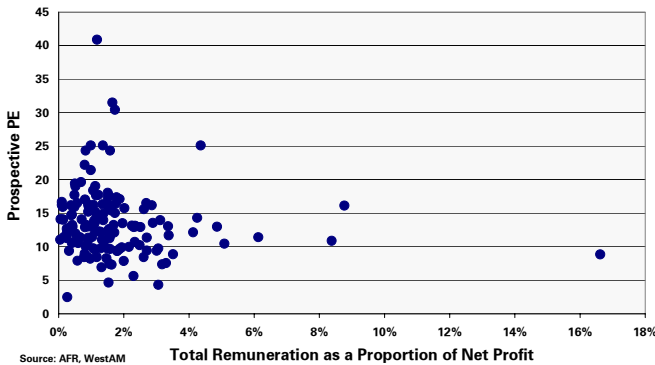
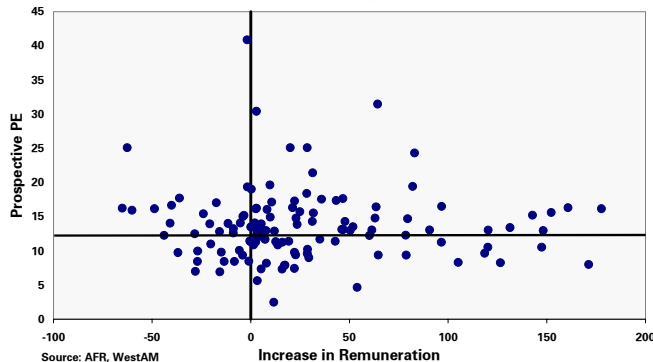


CHART 3 : Increase in Remuneration versus Prospective PE
 Median Increase = 17%, Top Quartile = 63%
 Median PE = 12.9, Top Quartile = 15.9



The data we have used in our research exclude termination payments and relate to approximately 140 of the largest companies listed on the Australian Stock Exchange (ASX) and have been supplied by the Australian Financial Review, who in turn extracted the information from company announcements to the ASX. The information may also be obtained from the Annual Directors' Report provided within a company's annual report

Chart 1 shows total CEO remuneration for 2002 against the prospective PE ratio for their company. One would expect that companies that pay their executives higher than average have prospective PE ratios greater than the industry median. The data do show that there is some tendency for high priced stocks to have highly paid CEO's but the relationship is very inexact. Some highly paid CEO's manage underperforming companies.

We conducted the above analysis using total remuneration as a proportion of net profit after tax against prospective PE (Chart 2). This chart also shows a slight positive relationship between highly priced stocks and highly paid CEO's but as with Chart 1 the relationship is weak. Again there were a number of outliers where some well paid CEO's manage underperforming companies.

We next looked at annual increases in CEO remuneration against prospective PE (Chart 3). Interestingly, a number of company CEO's achieved substantial increases in remuneration while managing companies that are not highly regarded by the market.

In isolation, any screen may not be the most appropriate method in analysing executive remuneration but with enough data, a collection of screens can provide a useful framework.

The screens used in the three charts can be used as a guide to identify those companies where the CEO's were paid above median in respect of each of our three measures of remuneration while the prospective PE's fell below median. We've listed these companies below. In practice, other measures of company performance should also be used such as eps growth over a suitably long time period. (Short term reported earnings, however, have the potential of being manipulated by managers to suit their own ends, as the authors of a recent paper show¹).

| Company | GICS Sector (Industry Group) |
|--------------------|---|
| Burns Philp | Consumer Staples (Food, Beverage & Tobacco) |
| Crane Group | Industrials (Capital Goods) |
| Downer EDI | Industrials (Capital Goods) |
| Henry Walker Eltin | Industrials (Capital Goods) |
| Iluka Resources | Materials (Metal & Mining) |
| One Steel | Materials (Metal & Mining) |
| Visions Systems | Information Technology (Hardware & Equipment) |

Over time, market forces should encourage companies to provide good disclosure of company earnings. The market rewards companies with transparent earnings and punishes those with uncertain accounts. However, while there is an incentive for companies to make their earnings transparent, the incentives can run the other way when it comes to disclosing executive remuneration. Those who make the decisions in this area, can feel that restricting disclosure is in their personal interest.

Unfortunately current rules do not provide sufficient disclosure for shareholders to adequately assess whether packages have been properly structured. Sections 300 and 300A of the Corporation Act that relate to disclosure rules for executive remuneration currently do not require a proper option valuation when shareholders vote on new option arrangements nor do shareholders necessarily know the nature of an executive's overall package when voting. Current disclosure rules also call for 'discussion' of the relationship between remuneration policy and company performance. This rule is vague in practice. Australian practice has in many cases focused on short-term share price performance, rather than long-term profit measures which are useful in removing CEO's incentives to select projects with short-term profits. In fact, research has shown that companies with long-term performance plans tend to have superior market returns¹.

¹Richardson and Waegelein. "The influence of Long-Term Performance Plans on Earnings Management and Firm Performance" *Review of Quantitative Finance and Accounting* vol. 18, no. 2 March 2002, pp161-183.

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