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Justin Bown
Managing Director
Australia & New Zealand

29 May 2009

Executive Remuneration Inquiry
Productivity Commission
Locked Bag 2
Collins Street East
Melbourne VIC 8003

By email to exec_remuneration@pc.gov.au

Dear Sirs

Regulation of Director and Executive Remuneration in Australia

Further to your call for submissions to the Commission's current inquiry into Executive Remuneration, I submit the following paper, that seeks to address TOR 4, 'any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community'.

I have included in this document a brief background on our firm, a summary of some of the key issues faced by Boards in structuring executive pay and a submission for an alternative approach that we have developed and implemented in Australia over the past decade.

About Stern Stewart & Co.

Stern Stewart & Co. is a global consulting firm that advises on measuring the performance of companies and rewarding senior managers. We have been active in Australia for more than 15 years and during that time have advised listed, privately held and government owned businesses on how to measure their performance and reward their most senior executives.

The recommendations we make to clients on these issues and those that are included in this paper are based on more than 20 years research into company valuation and the key drivers of long term wealth creation.

Overarching assumptions made in this submission

For the purposes of this submission, I assume the predominant interest of shareholders is the sustained creation of wealth, ie that the value of their investment rises over time. The wider community benefits from this process through the allocation of scarce capital to its most useful application. I have also assumed that the interests of executives include the maximisation of their wealth.

Key issues faced by Boards in structuring executive pay

In order to justify an alternative mechanism for aligning the interests of executives to those of shareholders, it is perhaps helpful to outline some of the drawbacks of the incentive structure that currently dominants executive pay.

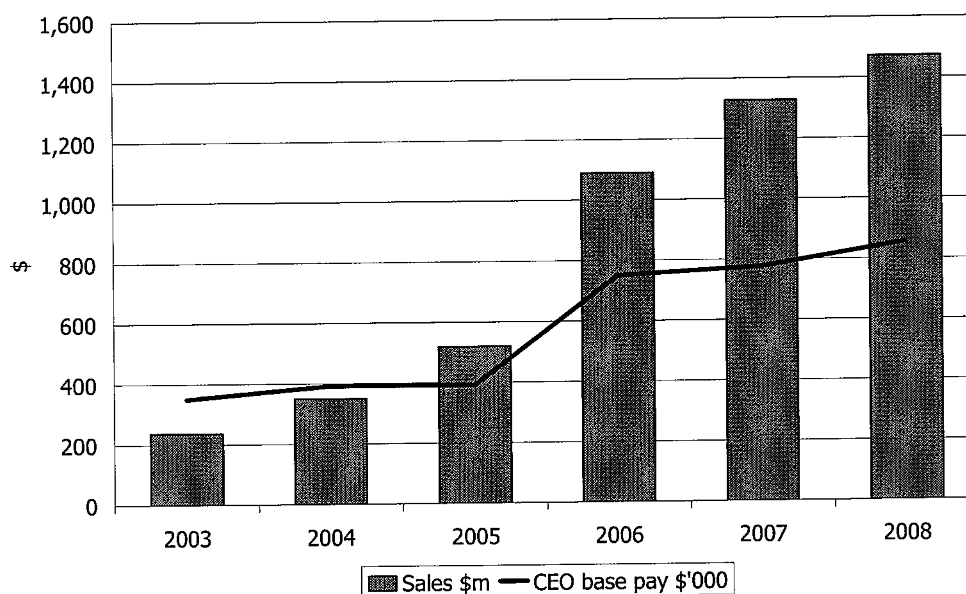
1) Size is the overriding determinant of base pay

As the Issues Paper notes, the remuneration of a senior executive in an Australian listed company in any one year usually comprises three parts: base pay, short term incentive and long term incentive.

Generally speaking, the base pay an executive receives is a function of the industry that he works in, geography and what is often called, 'job size'. Job size is a proxy for the complexity of the job and it is usually measured by reference to the size of the business (usually in terms of Total Assets, Sales and/or number of employees).

As a rule, the bigger the job size, the larger the remuneration of the executive. The remuneration of the CEO of the listed health care provider, HealthScope Ltd provides a typical example.

Figure 1: Base pay of the CEO of HealthScope Ltd compared to Sales



During the period 2003 to 2008, HealthScope enjoyed substantial growth in sales and assets and number of employees. The CEO's 'job size' grew as a result and so did his base pay.

Base pay, often labelled, 'fixed payed' is not fixed at all. As the HealthScope example illustrates, it is variable pay, driven predominantly by job size: grow the size of the business and you'll grow the size of your base pay. The problem here is that while growing the size of the company will almost always see an increase in the pay of its executives, it often sees a decline in the wealth of its owners.

So here is the first problem Boards face with executive pay: the size focus that is used to determine base pay puts managers' interests out of alignment with those of shareholders.

Most commentators calling for a limit on bonuses and other forms of 'at-risk' pay ignore the fact that the base pay of senior executives is in effect uncapped. It is limited only by

the size to which the executive can grow the business (not the wealth that they are creating for owners).

To counter the 'empire building' incentive inherent in base pay, Boards use incentive payments to focus the attention of managers on creating wealth for shareholders. Unfortunately, the structure of these incentive payments is often so poor that the vast majority can be said to be encouraging wealth destroying behaviour.

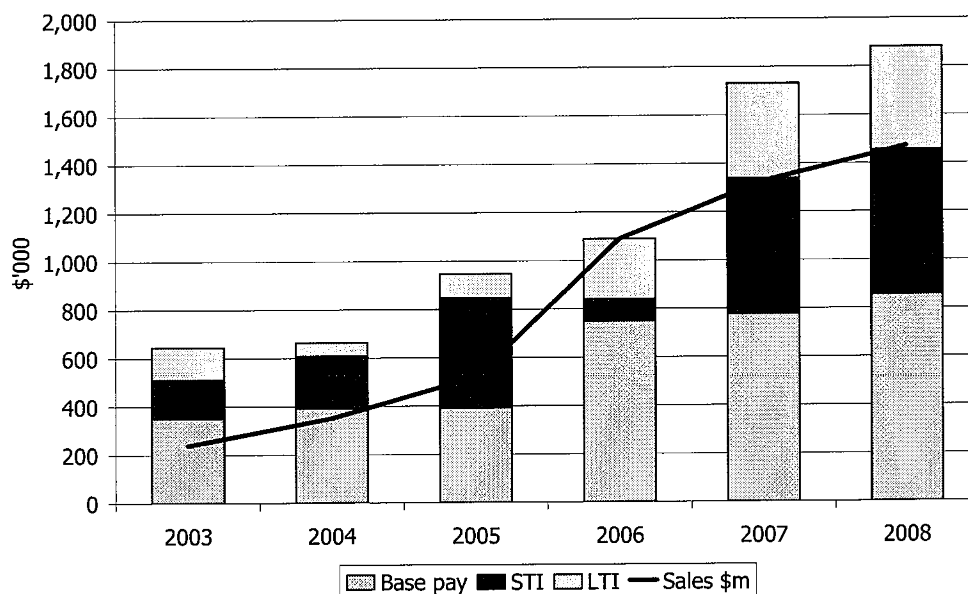
2) Incentive payments are a function of size

Incentive payments, be they short term incentives (STI) or long term incentives (LTI), need to be significant in relation to the base pay component of remuneration, so as to act as an effective balance to the empire building incentives inherent in base pay. In this respect, the STI and LTI opportunity (the amount that could be earned if targets are met) and maximums are usually set with reference to the executive's base pay.[1]

This has the effect of reinforcing the size incentives, as growth in the size of the company sees not only a rise in the executive's base pay, but also in the amount achievable in STI and LTI payments.

The composition of the remuneration of the CEO of HealthScope again provides an example of how incentive pay usually grows as the size of the business grows.

Figure 2: Total remuneration of the CEO of HealthScope Ltd compared to Sales



This has the effect of reinforcing the empire building incentives outlined above and further impeding alignment between the interests of executives and those of shareholders.

3) Boards don't really know how much they are paying managers

I'll move now to examine some of the key problems with long term incentive payments. This can include share grants, options or the most popular choice, 'performance rights', which are basically the right to shares in the company, if some conditions are met. A typical ASX 100 CEO might be granted performance rights worth equal to or more than his base pay each year.

[1] See for example, the BHP Billiton Ltd 2008 Remuneration Report, section 6.3.4 that discusses target STI for the Group's most senior executives set at 70% of base salary and maximum LTI award of 200% of base pay.

But the complex conditions added to equity grants over the last ten years have left us with a serious problem, that is rarely discussed: do Boards really know how much these rights are worth and therefore how much they are paying their executives?

Just to value a performance right with a relatively simple condition such as the shares will only pass to the executive after he has served three years and the price has risen by 20%, requires the application of the Black-Scholes Merton option pricing model which involves half a dozen assumptions. Even then, the theory assumes the rights will be held by a broadly diversified investor, very rarely the case with executives.

Today the 'gold standard' in performance rights includes conditions regarding the comparative Total Shareholder Return (TSR) performance of the shares against a peer group and partial vesting dependent on where the shares sit against this peer group after three or more years. These conditions are well beyond the capabilities that Black, Scholes and Merton set for their option valuation model in the 1970s.

Valuation professionals have developed models that require even more judgement in an attempt to value these instruments, but assumptions and valuation approaches vary so much that it wouldn't be surprising for five valuation professionals to give the same performance right five different valuations. And in my experience, the variation can often be material, meaning that while Boards may target to grant their CEO $1m of performance rights, if they asked for a second opinion, it could well turn out that they gave him $3m. Or $300,000.

As any valuation professional will tell you: the only certainty with performance rights is that their value is uncertain.

So here is our first fundamental problem with LTIs: neither the Board, the executive, nor the shareholders can say with any certainty, how much exactly has been paid to the CEO and his team.

4) Executives put little value on the equity granted to them

Perhaps the greatest irony of the equity pay debate is that few executives place any real value on the equity granted to them. This is especially true, the more onerous the conditions placed on the rights.

To paraphrase the typical perspective of executives with whom I've discussed equity compensation over the past 12 years: 'I'd rather have them [the equity] than not. And if he's getting them, then I should definitely be getting them. But truth be told, I put them in the bottom draw and forget about them until they vest. There's just too many factors outside my control that mean they may be worth nothing.'

The recent collapse in share values watched by executives who see only small declines in their operational performance will only serve to reinforce this feeling.

So our Boards go to inordinate length (and expense) to put together executive equity plans, only to have the majority of their executives put them in the bottom draw and forget about them like the long dated lottery tickets they really are. An ignored LTI plan will do little to align the behaviour of managers with the interests of shareholders and certainly is not good value for money for shareholders.

5) Managers don't agree on what really creates shareholder value

The assumption underlying the use of equity incentives is that they will give managers every incentive to grow the long term value of the business that they are charged with running.

But a disturbing exercise for any Remuneration Committee Chairman is to ask the executives to whom he has just granted equity what they think determines the value of the company.

My experience is that if you ask ten executives from within the one business that same question, you'll usually get eight or nine different answers, most with very little conviction. The truth is that most executives have very little idea about company valuation – far too little for LTI plans to be effective in shaping executive behaviour. And far too little to be paid a third of their remuneration in equity.

Even after more then a dozen years advising in this field, I am still surprised at the contradictory notions that managers in the one firm can have regarding what determines the value of their business. Again, this adds up to equity incentives representing very poor value for shareholders.

6) There is not enough real risk in how pay is structured

Pay consultants will submit that much of the increase in executive remuneration over the past decade has come in the form of 'at-risk' pay: bonuses and equity grants. But the truth is, there is very little risk that executives will miss out on their 'at-risk' pay.

I'll discuss bonuses in more detail below, but with respect to equity grants, like performance rights, what most people outside the Boardroom do not realise is that, there is *no* risk that the executive will receive these rights. Despite being labelled 'at-risk', they will be granted to the executive regardless of his or her performance or the performance of the company. Year-in, year-out.

This fact will be particularly jarring for shareholders this year as they read through the results of their publicly listed investments – likely to be the worst in more than a decade – then flick to the remuneration report to see that the 'at-risk' equity pay matches (or even exceeds) last year's.

The great trick that the pay consultants have pulled is to convince even the regulators that these payments are 'at-risk' because, some years down the track, they could be worth nothing.

Under this definition, the superannuation payments made to millions of Australians – that could ultimately be worthless – should be regarded as 'at-risk' pay.

This definition does not sit well with common sense. The test most people – and most investors – would put is whether the executive will be paid or not, not whether the asset will be worth anything some years down the track.

By that definition the vast majority of equity grants made in Australia are not 'at-risk'. They are made year-in, year-out, regardless of performance and they are no more at risk than the executive's salary. They should be classified that way.[2]

Of course, the real problem is that, if equity payments are really 'fixed' pay – made regardless of performance – then most of our top executives have at least 2/3rds of their pay fixed. At that level, executives are not prone enough to the cost of failure and are not rewarded enough for anything but spectacular success. This is a dangerous combination, as we have witnessed recently.

[2] Many executives would argue that the payment is at risk because it may not vest. This is confusing the value of the initial grant with the end value. The end value could be anything from $0 to millions of dollars. The probability of the equity not vesting has been taken into account by the valuation professional in determining the value of the initial grant of say $250,000. This $250,000 payment is not 'at-risk', it is made regardless of performance.

7) Variable pay is overtly short term

If equity pay is effectively fixed remuneration, granted regardless of performance and even then, misunderstood and its value discounted, the humble cash bonus must carry all of the weight of encouraging managers to grow the value of the business over the long term. Unfortunately, if managers were to follow the incentives of most cash bonus programs, they would destroy, rather than grow the value of the company.

For a start, most cash bonuses are determined based on the performance of the business over the past 12 months. The value of a company is driven by more than the past 12 months, generating a dangerous lack of alignment. But even more concerning is it sends a signal to managers that what the Board really cares about is just this year's performance.

There are often thousands of things that a manager can do in the short term to improve reported performance, but in the medium to long run, those actions can reduce the value of the company. Think of a banker writing poor quality loans, or a marketing executive cutting advertising spend or a mining company cutting exploration expenditure.

Paying for short term financial performance puts managers in the invidious position of having to choose between what's good for the business and what's good for them and their families. And this is the incentive pay that managers pay attention to.

8) The wrong measures

Changes over the past few years to the Corporations Law mean that remuneration reports are now required to detail the measures used by listed companies to determine bonus payments. We can see for the first time what Boards pay managers to deliver and the results are concerning.

Some of the most frequently cited financial metrics are EBITDA (Earning Before Interest, Tax, Depreciation and Amortisation), EBIT, Net Profit and Earnings Per Share (EPS). But these measures can encourage managers to invest funds entrusted to them at rates of return so low they destroy value for shareholders.

Rewarding managers for EBITDA, EBIT, Net Profit or EPS growth means that they are encouraged to invest in opportunities where returns are high and large profits can be made. So far so good. But at what rate of return does EBITDA, EBIT, Net Profit and EPS say managers should stop investing? In fact, an investment that returns as little as 1% will see these metrics grow. And grow the manager's bonus.

The popularity of these measures means that if you've got funds invested in Australian equities, chances are you are rewarding company managers for investing your savings at a rate as low as 1%.

And as if that wasn't bad enough, accounting measures of performance are also notoriously subjective. Be it rates of depreciation or amortisation, mark to market valuations, fair value adjustments - the list goes on - CFOs are able to swing the reported result in a way that can be material to their bonus, while staying within the definition of profit provided by the accounting standards.

Boards are well aware of the old maxim that 'Profit is opinion. Cash is fact', making it surprising that so many are prepared to put their CFOs in the position where they must choose between a large cash bonus and a conservative interpretation of the accounting rules.

Professional investors understand the weakness of accounting numbers. You'll often hear them talk about a 'poor quality' result, despite the fact the company hit its profit forecast. What they mean is the result was achieved not by the sweat and diligence of operating managers, but by the 'skill' of the CFO.

Worryingly, many companies have begun using these accounting measures as hurdles for their equity performance rights.

The use of EBITDA, EBIT, Net Profit and EPS in incentive systems leaves investors with a difficult question: are Boards aware of the limitations of these measures, but prepared to pay for behaviour that destroys wealth, or do they just not fully understand the measures by which they have chosen to tie a third of their managers' compensation?

9) Too many measures

As if to compensate for the weaknesses of one measure, Boards will often add others. I have seen as many as 25 measures on a public company incentive 'scorecard'.

I don't know how a manager can ever optimise twenty five different, often conflicting measures, let alone understand what the Board really expects of him. But I do know that a multitude of measures has some advantages for managers. Multiple measures take the risk out of a bonus plan in the same way a portfolio of investments can reduce risk: there is a good chance that some of those measures will pay in most years. And what's more, the more measures, the more difficult it is for the Board to set appropriate, informed targets for each one.

But multiple measures can be damaging for shareholders in other ways. I worked with a toll road business that had an incentive plan for senior managers that included one pool for revenue and one pool for expenses (but not a pool for profit). With a quarter of the year left to run, the revenue target was in the bag and no matter how much more revenue came in during the rest of the year, no more bonus could be earned from that pool. All focus moved to getting the expense result into bonus territory. After a small amount of deliberation, maintenance work for the roads was moved from a 9pm – 5am shift to a 9am – 5pm shift. This caused congestion, reduced traffic, revenue and profits, but it meant substantial cost savings and it meant the senior executive team could hit both their revenue and their cost numbers for the year.

As the Chief Operating Officer said to me at the time, 'Oh I know it makes no sense, but that's what we were paid to deliver.' You can imagine what it does to the morale of good people to know that their actions are damaging for customers, shareholders and the environment and beneficial only to the senior executive team's pocket.

10) It pays to lie

What the toll road manager pointed out to me later was that the lower revenue result caused by switching to day time maintenance not only increased his bonus for that year, it increased his bonus in the next year. You see, the lower revenue result allowed him to negotiate a more 'reasonable' target for the following year, boosting his bonus in that year too.

His experience is not unusual. The vast majority of bonus plans used in Australia are based on targets negotiated between layers of management, all the way up to the Board. In these businesses, the preparation of the annual budget is often a drawn out negotiation because millions of dollars of bonuses are at stake.

But linking bonus targets to the budget bizarrely means that the lower the goals that the business sets for itself, the higher the bonus will be. And conversely, the higher the goals that a business sets for itself, the lower the bonus will be.

It doesn't take too many years in middle management to work out that those who under-promise and over-deliver not only get a reputation for reliability, but they also take home bigger bonuses than managers who give their best estimate of the year ahead. In fact many

managers rise to the top precisely because they become adapt at playing the negotiation game.

The party paying for this game is the shareholder. Doubtless, a great deal of 'conservative' budgeting has been going on over the past few months as managers prepare their budgets for Board approval for the coming financial year. Just as certain, good sized bonuses will be paid for meeting those conservative numbers, despite the fact that they represent shamefully low returns on the funds shareholders have entrusted to the Board and management.

The shareholder pays in other ways too. Setting incentive targets based on the budget encourages managers to low-ball their forecasts, which can lead to under-resourcing, missed sales and missed profits. It encourages managers to hoard information (sharing it with their superiors will weaken their negotiating position), which reduces the quality of decision making at the top. And by negotiating targets, Boards take a lot of the risk of non-payment away from managers.

But perhaps even worse, negotiating incentive targets forces managers to choose between the best interest of their family and the best interest of their company, therefore generating a high degree of cynicism or a low degree of morale. It does not encourage managers to sustainably grow wealth for shareholders and it makes the vast majority of bonus payments made in Australia very poor value for money for investors.

11) Caps and floors are put on how much can be earned

The Australian Institute of Company Directors recently called for directors to put an 'upper bound' on incentive payments[3]. This is already common practice among our listed and unlisted companies. But it is also concerning.

Caps are a conscious choice in designing an incentive – it means directors have given some thought to the bonus plan and decided that the plan does not pay managers for sustained growth in shareholder wealth. If it did, then capping it would put managers' interests out of alignment with those of shareholders, who prefer more wealth to less. So why suggest capping bonus payments? Why say to managers that they should hold off above a certain level?

The AICD is merely acknowledging the flaws inherent in the design of most STI plans. And the wide spread use of caps on STI plans is an admission by most of our Board that they have not been able to devise a bonus program that they can say with confidence encourages sustained gains in shareholder wealth.

Rather than applauding caps, investors should be wary for what they imply: the Board acknowledges that they are paying for something other than the maximisation of shareholder wealth.

12) Too much subjectivity

Given all of the above, it is not surprising to learn that many Boards prefer to use their intuition about the performance of the business to determine the annual bonus, rather than be tied to short-term accounting definitions of performance versus budget. Expect more of this in the coming year as financial results become more difficult to predict and make bonus payments harder to justify.

But here again there are unintended consequences. Bonuses tied to the Board's intuitive assessment of performance encourages managers to share good news and discourages the

[3] 'Executive Remuneration: Guidelines for Listed Company Boards', AICD publication, February 2009

sharing of bad news – a grave concern to any director who is held liable for the financial health of the business. It encourages what can only be described as 'lobbying': the lengthy discussions about what a great year the company has had given the conditions and the retention issues that will arise if bonuses don't meet or exceed last year.

Subjectivity in incentive plans reduces their effectiveness and encourages managing of the perception of performance, over actual sustained gains in shareholder wealth. It too represents poor value for money for shareholders.

An alternative to the current remuneration orthodoxy

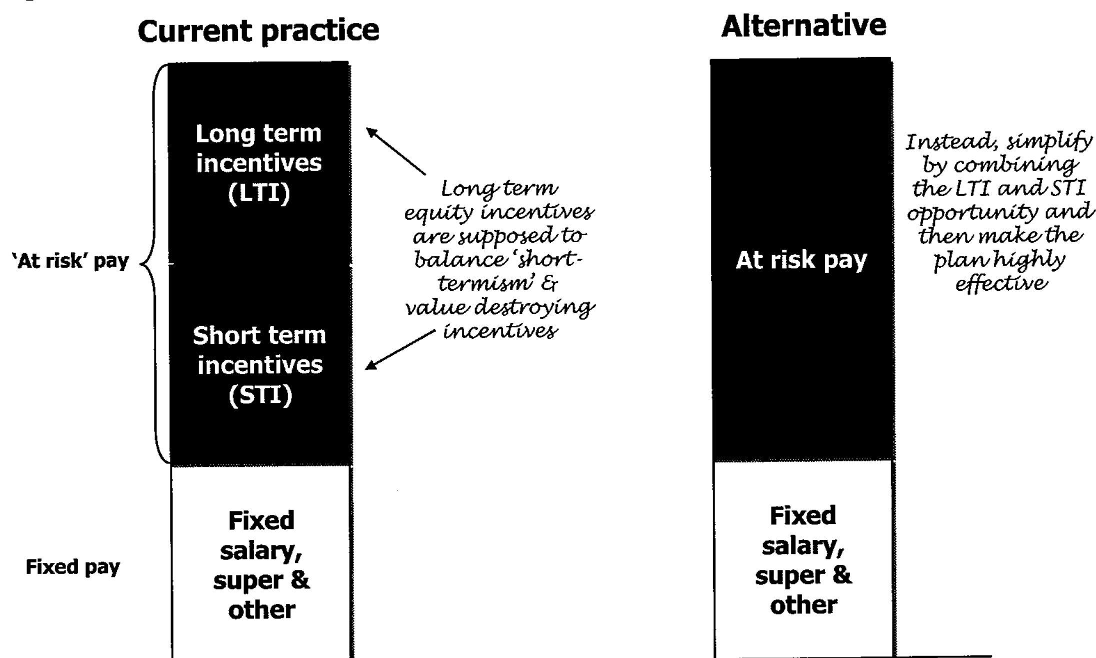
The Commission has called for submissions that address 'any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community'.

Having researched the questions of performance measurement and rewards for senior executives in Australia for more than 15 years, I have outlined below an alternative that is more effective in aligning the interests of executives with those of shareholders and hence the wider community than the dominant structures that are in use today.

1) Combine the short term and long term incentive opportunity into one

In my discussions with them, directors often acknowledge the value destroying incentives of short term incentive plans, but point to the long term incentive as a correcting balance. A more effective approach would be to combine the opportunity offered in the long and short term incentive plans into one and make that one plan highly effective, as illustrated I Figure 3.

Figure 3: Combine STI & LTI opportunity into one and make the one plan highly effective



This has the added advantage of simplifying the remuneration of senior executives which benefits managers, Boards and investors.

2) Measure performance based on EVA® growth

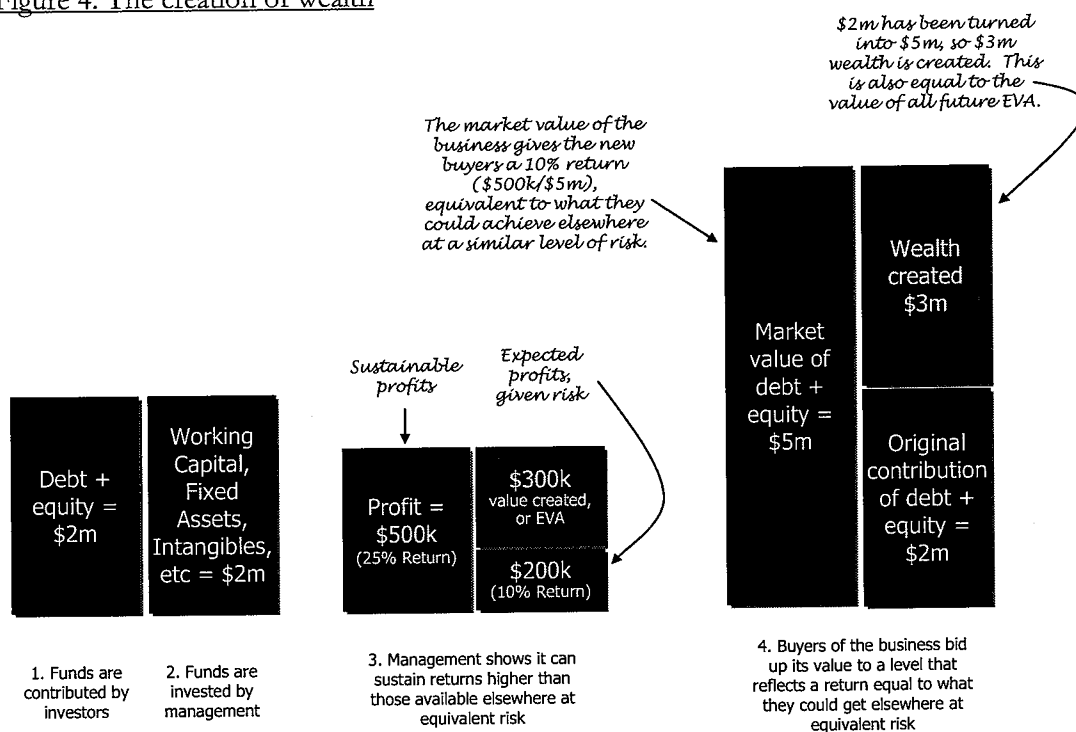
To align the interests of managers and shareholders, managers need to be paid for sustained gains in shareholder wealth. At it's simplest, wealth is created when investors put money into a business and some time later the business is worth more, so that if a company

can turn $100m of investors' money into an asset worth $500m, it has created $400m of wealth.

While there is ready agreement that the creation of sustained gains in shareholder wealth should be the over-arching objective of listed companies, there is some disagreement about how this is achieved. For the sake of clarity, I have outlined the findings of our research below, that forms the basis of our recommendations for how Boards measure the performance of executives.

As John Stuart Mill noted, the creation of wealth has its necessary conditions. Our research shows that wealth is created when a company invests the funds entrusted to it at high rates of return. If the high rates of return are sustainable, the business will be worth significantly more than the amounts contributed by investors and hence wealth is created, (see Figure 4).

Figure 4: The creation of wealth



For example, let's say you own a business that generates a 25% return on the $2m you have invested in it (or $500,000 in profits) and can do so well into the foreseeable future, despite the fact that investments of similar risk could only generate 10%. By generating 25% returns where other investments of equivalent risk offer only 10%, your business generates value at 15% for its owner for every dollar of capital invested. Value in this sense is no different from the way we all think about making buying decisions: am I getting more for my money that I could get elsewhere?

In dollar terms, your business generates $300,000 of value for its owner – that is, $300,000 more than what you could expect to earn elsewhere at equivalent risk ($500,000 profit less $200,000 that could be earned elsewhere at equivalent risk). Economists have long referred to this $300,000 amount as economic profit, or economic rent. We call it Economic Value Added or EVA.

Now you are looking to sell the business. Not surprisingly, there are several buyers interested in your high quality business. If they pay you $2m for it, they too will be able to

enjoy 25% returns, 15% more than they could receive elsewhere at similar risk. But in a competitive auction for the business, bids would rise quickly above $2m. Why? Because even at $4m, the business will generate a 12.5% return ($500,000/$4m) for the buyer, still 2.5% better than what could be achieved elsewhere. Logic suggests that bids would go to $5m – the level required to give the buyer a 10% return, or what she could earn elsewhere at a similar level of risk.

For you the owner, $3m of wealth has been created: you took $2m and turned it into $5m.

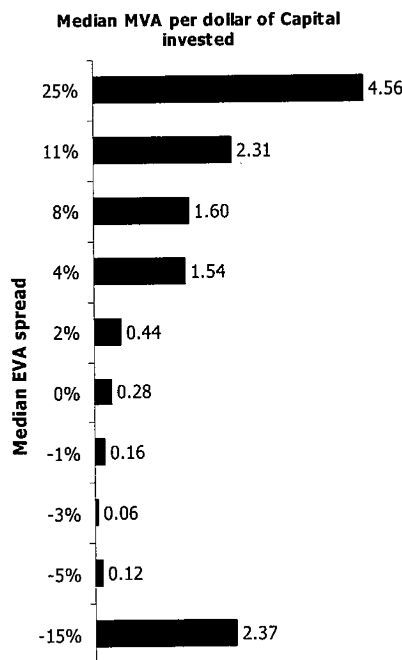
So businesses that create high levels of sustainable EVA attract high valuations as their value is bid up to a level that equals what buyers could get elsewhere at similar levels of risk. We call the difference between the enterprise value of the company and the amount of capital put in by investors, 'Market Value Added' or MVA and it is effectively the value placed by the buyer on all future EVA.

Now what if the business was expected to suffer consistently low rates of return? What would that do to your wealth? Well let's say the business was expected to only earn 7% or $140,000 well into the foreseeable future. Investors can get 10% on their money elsewhere at similar risk, so at auction, logic would suggest that the price would rise no higher than $1.4m. Any higher than that and investors would be accepting a rate lower than they could achieve elsewhere. In this instance, the business is destroying value and $600,000 of wealth has been destroyed. You started with $2m and ended with $1.4m.

So the EVA profit that your company is expected to create is a key determinant of the price that it will sell for and the wealth that will be created for investors. This is why EVA was called nearly 20 years ago, 'the real key to creating wealth'[4].

We can see how that plays out in practice by looking at Figure 5, which summaries the results of our 2008 Wealth Creators Report[5], a study of the EVA performance of 150 of Australia's largest companies.

Figure 5: Median MVA per dollar of Capital invested vs. median EVA spread



[4] Fortune magazine September 20, 1993
[5] Extract of the 2008 Stern Stewart Wealth Creators Report will be published by CFO magazine in June this year.

The figure summarises the EVA and MVA results for 150 companies into deciles. The top 10% of businesses enjoyed an average EVA spread of 25% – they are generating returns on investor funds 25% higher than what is available elsewhere at equivalent risk – and the highest level of MVA or wealth created per dollar invested, at $4.56. The trend continues, with businesses with lower levels of EVA in 2008 enjoying lower levels of MVA per dollar of capital invested.

The exception is the bottom 10% of companies, mostly made up of businesses in the early stage of their development like, Fortescue Metals. These businesses have very low levels of EVA in 2008, but some of the highest levels of MVA. Despite the lack of a track record, investors were confident enough to pay up today for a future full of value creation. It's not surprising therefore, that the share prices of these businesses are particularly volatile.

Sustained EVA growth is at the heart of the creation of sustained gains in shareholder wealth. It is an ideal measure to put at the heart of an alternative, more effective approach to aligning the interests of managers and shareholders.

As I have discussed in the critique of LTI plans above, if managers are unable to see a clear connection between their actions and their rewards, an incentive plan becomes less effective. This is the case for the majority of LTI plans in use today, where rewards are dependent on the share price movements of the company compared with a peer group.

EVA provides a measure of performance that is transparently linked to the creation of wealth and is a function of the key elements under the control of management: profits, capital invested and risk.

Finally, incentive plans should be based on EVA growth. Managers should be paid for improving the lot of investors, not just sustaining their current level of wealth.

3) Adjust the definitions of profit and capital employed to reflect long run shareholder returns

For an incentive plan based on EVA to align the interests of managers with those of shareholders, the definitions of profit and capital employed need to be adjusted from what is reported for statutory purposes.

Financial accounts today are prepared for a host of users and therefore do not provide at face value, a reliable report of the returns managers have earned on the funds entrusted to them by investors. For example, investment mistakes are written off, reducing the size of capital invested and inflating the returns achieved on capital employed. The use of non-cancellable operating leases provides 'off balance-sheet financing', understating the capital employed in a business and again, inflating returns.

We suggest making a small number of adjustments to statutory accounts to derive profit from a shareholder point of view. Add back the historical write-offs, put off balance-sheet financing back on balance-sheet and so forth[6]. Figure 6 illustrates a calculation of EVA for Coca-Cola Amatil.

[6] Further detail is provided in *'The Quest for Value'*, G. Bennett Stewart, Collins Business, 1991.

Figure 6: EVA calculation for Coca-Cola Amatil for the year ended 31 December 2007

	$m
Reported profit	311
Add back significant items	56
Add back cash tax differential	7
Add back finance costs	110
Add back implied interest on operating leases	13
Net Operating Profit After Tax (NOPAT)	496
Interest Bearing Debt	1,903
Shareholders Equity	1,441
Add PV of operating lease commitments	191
Add net deferred tax balances	152
Add cumulative significant items - loss (gain)	-856
Add accum goodwill amortization	27
Less capital work in progress	167
Total Capital	2,690
Total Capital prior year	3,353
Average Capital	3,022
Cost of capital	8.6%
Capital charge	261
EVA	235

1) Stern Stewart adjust reported profit numbers to get a better picture of the underlying economics of the business.

2) The balance sheet is also adjusted, to give a better picture of capital invested, for example by adding back off-balance sheet financing and the value of cumulative significant items

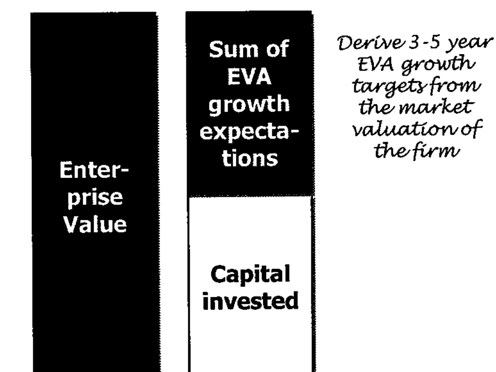
3) Finally, the weighted average cost of debt and equity capital is applied to the average capital balance to come up with a 'Capital charge'. This is deducted from NOPAT to give EVA.

4) Set targets based on shareholder expectations

Any incentive plan must answer the question, 'What is the relationship between performance and reward?' Boards need to set targets for managers and develop a formula that relates higher levels of bonus to higher levels of performance.

We suggest that the target for the incentive plan be based on shareholder expectations, as implied in the market value of the company. We have seen that when investors form the opinion that a business is capable of generating and sustaining high levels of return on the funds entrusted to it (ie EVA), the price they are prepared to pay for the business will rise and wealth is created. Using this logic in reverse, we suggest that Boards take the market valuation of the firm as a starting point and derive the EVA growth that is implied and use this as the target for incentive payments. Figure 7 illustrates this process.

Figure 7: Derive EVA growth targets from the market value of the business



Rather than set targets for managers annually, we suggest that a three to five year target be set, to better reflect the decision horizon expected of senior managers. This period of time allows managers the time necessary to develop strategies, prepare and gain approval for plans, implement them and see the fruits of their decisions show up in EVA growth.

Crucially, setting three to five year targets based on shareholder expectations decouples the budgeting process from the incentive program. It removes the incentive to sandbag budgets and makes that process more productive and a better use of shareholder funds and management time. It puts managers back in alignment with shareholders, meaning it no longer pays to lie and managers no longer have to choose between what's best for the company and what's best for them and their families.

Finally, by deriving targets from shareholder expectations, high levels of rewards are only paid when those expectations are exceeded and lower rewards flow from falling short of shareholder expectations: greater alignment is achieved.

5) Payout only a portion of rewards annually, to focus attention on sustainable gains

For gains in shareholder wealth to be sustained, gains in EVA need to be sustained. Ideally, rewards should be made to executives only when the Board is satisfied that the EVA gains achieved are sustainable. This could be achieved, for example, by measuring performance over five years and deferring any payment until the end of that period.

But executives asked to wait five years for any incentive payment, would rightly demand a higher level of payment, to justify the risk they might leave during that time without any payment and the time value of money.

A more practical alternative is to assess performance on an annual basis, calculate a reward and then place that reward into a reserve, paying out only a portion in the current year. The balance would be at risk, capable of loss if the EVA growth achieved proved unsustainable in future years.

We have developed a number of alternative reserve mechanisms such as this, but for the purpose of illustration, a simple version is included in Figure 8.

Figure 8: Incentive reserve mechanism

Year $'000	1	2	3	4
Opening balance	$0	$50	$125	-$75
Incentive declaration	$100	$200	-$200	$300
Available balance	$100	$250	-$75	$225
Pay out 50%	**$50**	**$125**	**$0**	**$113**
Closing balance	$50	$125	-$75	$113

In this illustration, the EVA growth of the business in year 1 is good and a $100,000 incentive is declared for the executive. This amount is put into his incentive reserve and 50% of the balance is paid out, or $50,000. The balance is carried forward as the opening balance of his reserve for the purposes of calculating the following year's payment.

In the second year, EVA growth is very strong and a $200,000 incentive is declared. The executive now has $250,000 available, of which 50% is paid out and 50% carried forward.

In year three, all of the EVA gains of the prior year are lost and the incentive declared is negative $200,000. This is offset against the $125,000 carried forward leaving a negative balance of $75,000. This amount must be earned out through improved performance before any payment is made in following years.

Year four sees a big leap in performance and a $300,000 incentive declared, which brings the incentive reserve balance back into positive territory allowing a payment to be made.

The incentive reserve mechanism allows annual payments to be made for multi-year performance. While the deferral of incentive payments is gaining popularity, many fail to hold deferred payments at risk, that is subject to loss if performance is not sustained. We believe this is a crucial component if managers' and shareholders' interests are to be aligned.

In addition to providing Boards and shareholders with the comfort that incentive payments reflect sustained gains in performance, the incentive reserve also acts to smooth payments through the economic cycle and can act as a mechanism to retain key staff, as the balance of the reserve is forfeited on the termination of the executive's employment.

6) Uncap the incentive plan in both directions

If we are paying for sustained gains in EVA with targets set by reference to shareholder expectations, then we have a plan that pays for sustained gains in shareholder wealth. Capping the amounts that executives can earn from such a plan would put them out of alignment with shareholders. If our goal is to align the interests of executives with those of shareholders, the plan would need to be uncapped.

But importantly, the plan should be uncapped in both directions. This means that if EVA falls significantly, incentive declarations should be negative, with no limit on the amount. As we have seen, a negative incentive would reduce the carried forward incentives from prior years and potentially generate negative balances that would need to be earned out before any payment is made in future.

7) Senior executives to establish a meaningful interest in the equity of the company

Finally, to provide further alignment of the interests of managers with those of shareholders, as a condition of participation in such a scheme, executives should be required to establish a meaningful proportion of their wealth in shares in the company that they run. This could be achieved by requiring a set proportion of incentive payments to be devoted to the purchase of shares in the company until the value of an executive's holding is two to three times their base pay.

This approach to equity ownership does not dilute the interest of existing shareholders and is funded by pay earned for performance.

We would also recommend that Boards provide appropriate corporate valuation education to participants in such a program.

Summary

The Commission has called for mechanisms that better align the interests of executives with those of shareholders and the wider community. An alternative incentive structure needs to encourage executives to sustainably grow the wealth of investors in a fashion that is more effective than current mechanisms.

The approach outlined in this submission pays for sustained gains in EVA, which is transparently linked to sustained gains in shareholder wealth as this submission has outlined. It provides a practical alternative to the base pay/STI/LTI structure that currently dominates executive remuneration.

Implementation of this approach

We have advised businesses from many sectors of the economy, of varying sizes and ownership structures on the application of the incentive approach outlined above. In the interest of a more comprehensive submission, I have included a brief discussion of some of the practical issues arising from the implementation of this approach.

1) Remuneration is relative

Unfortunately, the safe path for any Board to follow with respect to the remuneration of their executives is to do as their peers have done. By following their peers, they protect themselves from criticism should things go wrong, after all 'we have only done what every one else was doing'. But of course, that stifles innovation and prevents problems with the status quo being addressed.

Managers too, gain comfort from the familiar. When 'at-risk' remuneration is significant, executives often prefer an incentive plan that they have worked under before to one that they have not experienced.

2) The reserve mechanism still allows for overpayment

Where performance has been strong for a number of years, but proves unsustainable, it is possible for executives to be 'overpaid'. This would be the case in Figure 8, had the executive left at the end of year three. Nonetheless, the risk of overpayment is small compared to the dominant incentive approach and so this alternative represents an improvement on the status quo.

3) Executive power

The most difficult part of the alternative plan outlined above is where performance deteriorates to such an extent that no incentive or even a negative incentive is declared. It is my experience that the Board will come under pressure in this circumstance to over-ride the formulaic declaration to ensure some payment is made. This is especially the case where the Board fears losing a key executive.

While this is a weakness of the plan, it is also a weakness of traditional STI/LTI plans that in recent years have seen increases in base pay to offset falls in incentive pay, re-pricing of options, amending of hurdles and so forth to ensure payments are made to executives.

Further discussion

I would welcome the opportunity to discuss any aspect of this submission further with the Commission if that is of use.

Yours sincerely

Justin Bown
+ 61 3 9650 0472

Appendix: selected bibliography

Our firm has produced a number of books describing the recommendations made in this submission in more detail, together with detailed case studies of the impact on behaviour and company value. These include:

Stewart III, G. B. *The Quest for Value*, HarperCollins Publishers
Savarese, C. *Economic Value Added*, Business + Publishing
Ehrbar, A. *The Real Key to Creating Wealth*, John Wiley & Sons
Stern, J., Shiely, J. & Ross, I. *The EVA Challenge*, John Wiley & Sons