CEO PAY:
What are CEOs worth?

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Executive remuneration is an investment of shareholder funds in the management team. As a shareholder, AMP Capital believes that remuneration should therefore be fair, reasonable and aligned with shareholder interests.
Executive pay can be one of the more controversial aspects of proxy voting season. While media attention is often paid to the absolute size of executive pay packets, as investors, we take a measured approach to remuneration structures and consider the size of pay in the context of each company, its industry and the economy as a whole.

Context is important because, at its most basic level, executive remuneration is an investment of shareholder funds in the management team. As a shareholder, AMP Capital believes that remuneration should therefore be fair, reasonable and aligned with shareholder interests.

For some time, we have considered the way in which boards are setting and reviewing executive pay. It appears that a significant factor when CEO pay is set and reviewed is the amount that peers are paying rather than the value that a particular individual provides.

We have suspected that this is the case because when we identify high levels of executive pay, company directors often explain that pay has been set at that level to ensure consistency with sector peers. We are often told that independent benchmarking studies have been conducted domestically and globally to ensure that pay packages are fair when compared with what CEOs would receive elsewhere.

Executive remuneration should be appropriate payment for the role for which the executive has been hired rather than a salary package that is based on what every other CEO is being paid.

Company directors often add that executive searches are now global, executives need to be paid at least as much as their peers to entice them to take the position or remain in the position, and there the discussion ends.

We have some sympathy with this position and acknowledge that in some circumstances it may be necessary to pay what others are paying to ensure that the best executive for the position is hired or retained. However, we believe that executive pay should be structured from a broader perspective — the value that a CEO provides — and that benchmarks and sector comparisons should be one part of the calculation rather than the entire equation.

Ultimately, executive remuneration should be appropriate payment for the role for which the executive has been hired rather than a salary package that is based on what every other CEO is being paid.

Some companies take this approach and demonstrate that they consider the value an individual CEO brings to the role within the context of the market. This can be done by setting a new CEO’s pay at a lower level than his or her predecessor and increasing pay to a similar level when or if they deliver the same value to the company.

However, in most instances the question of ‘CEO value’ is lost in discussions that link CEO pay with sector peers and/or market capitalisation. It is in this context that AMP Capital began to consider this issue by collecting pay data on CEOs and their executive team members (referred to as Key Management Personnel, or KMP, in the statutory accounts) for the 2013/14 and 2014/15 financial years.

Our aim was to assess the size of executive pay across the S&P/ASX 200 and detect trends, including how much CEOs are being paid compared with the second most highly paid executive, and how much CEOs are being paid compared with the average executive included in the key management personnel group (referred to as KMP hereafter).

The hope is that this study adds to the industry discussion on appropriate levels of executive pay by providing a slightly different perspective on the factors boards may consider when setting and reviewing CEO pay. Our intention is not to comment on whether executive pay levels are too high or too low. We are reflecting on whether current executive pay levels reflect a fair assessment of value.

### Key Results of Our Study

Some of the key results of our study include the following:

- The average CEO in the S&P/ASX 200 was paid a total of $3.8 million in 2014.
- Total pay among the CEOs in our sample in the S&P/ASX 200 ranged between $360,000 and $13.1 million. The lowest pay was in the consumer discretionary sector and was paid by a recent admittance to the S&P/ASX 200. The highest pay was in the financial services sector where pay is consistently high across the company and is closely tied to performance.
- Average total CEO pay was highest in the energy sector, with CEOs in that sector paid three times the amount paid to CEOs in the lowest paid sector (IT), on average.
- In the energy and industrials sectors, CEOs are paid three times more, on average, than the next highest paid executive in the company.
- The smallest premium is paid to CEOs in the financial sectors suggesting that executives in that sector may be highly paid across the board.
- While KMP pay across the S&P/ASX 200 seems markedly lower than CEO pay, KMP pay is 18 times the average Australian full-time wage.
- CEO fixed pay across sectors is much more consistent than total pay, which suggests that the size and value of equity incentives causes the large discrepancy across sectors. Most average fixed pay amounts range between $1 million and $2 million a year.
- There is a correlation between high levels of CEO pay and the size of the company.
HOW MUCH VALUE DO CEOS PROVIDE?

In order to assess the fairness of executive pay from the perspective of the value that CEOs provide, shareholders need to consider what that value is.

Most shareholders, including AMP Capital, would agree that CEOs deserve to be paid a premium for running a listed company in Australia.

The CEO is responsible for developing and implementing high-level strategies, making significant corporate decisions, managing short and long-term performance, overseeing the overall operations and resources of the company, optimising returns and capital levels, reporting to the board and being accountable to shareholders. CEOs are also the public face of the company and set its tone and culture. Every facet of the CEO’s role is crucial to investors but this doesn’t mean that boards have a blank cheque to set remuneration at whichever level they choose, particularly when CEOs are surrounded by executives who are paid to support the CEO in achieving all of these goals.

Ideally, boards and shareholders should consider how much value the CEO provides and how much his or her skills are worth when setting and reviewing pay.

CEO PAY DIFFERS ACROSS SECTORS

Our research showed that while the average key executive at major Australian companies is paid $1.4 million a year, more than half of all CEOs receive double the amount that the next highest paid executive at their company receives (see Figure 1 below).

This implies that, on average, CEOs are considered to be worth twice as much as the second most highly paid executive, who is often the CFO or manager of a significant business division.

Figure 1: Average total pay for CEOs in each sector relative to the next highest paid

In some sectors, CEOs are paid three times more than the next highest paid executive. This is the case in the energy sector, for example. This is an interesting result that warrants investigation. Why is the premium so much higher, on average, for energy CEOs relative to other sectors, and is this a fair representation of the value-add they are providing?

Having considered the data in detail, we cannot see a reason for this premium particularly when the second highest paid executive in the energy sector is paid $2 million. This is significantly more than the sample average of $1.44 million.

Figure 1 above also shows the varying sizes of average CEO pay across sectors. Total pay, which consists of fixed pay plus an accounting measure of short-term and long-term pay, differs widely across sectors. Energy, financials, consumer staples and materials sectors each pay their CEOs, on average, above the $4 million sample average per year.

CEOs in the energy sector, for example, received average total pay of $6 million in 2014, with five of the six CEOs being paid more than $5.7 million in 2014.

In the finance sector, CEOs received average total pay of $4.5 million in 2014. The use of an average, however, conceals the vast range of pay within that sector (total pay ranged between $467,000 and $13.1 million in 2014) as well as the high levels of pay for some CEOs. Eight of the 28 financial companies included in this study paid their CEOs more than $6 million and four companies paid their CEOs more than $10 million in 2014.

When it comes to the ten highest paid CEOs in the sample, the financials and materials sectors dominate, accounting for seven of the ten entries. The range of pay for the ten highest paid CEOs is $8.3 million to $13.1 million. The Figure 2 on the next page shows the sector split.
Figure 2: Ten highest paid CEOs in 2014, by sector

- Financials 40%
- Materials 30%
- Energy 10%
- Consumer staples 10%
- Healthcare 10%

Source: AMP Capital

Figure 3 also shows the sectors that pay CEOs the ten highest premiums relative to the second highest paid executive at each company. There is less sector concentration on this measure, with six of the eight sectors represented. The two sectors that don’t appear in the top ten are the consumer staples and healthcare sectors.

Figure 3: Ten companies that paid CEOs the largest premiums

- Financials 10%
- Materials 20%
- Energy 30%
- Industrials 20%
- Utilities 10%
- Consumer Discretionery 10%

Source: AMP Capital

A few observations should be made here. Firstly, high premiums are not necessarily sector specific nor are they always widespread across the sector. There are companies in each sector that pay CEOs three, four or five times more than the second most highly paid executive, and this is not correlated with size. None of the companies that pay the ten highest premiums are in the top ten companies by market capitalisation.

Secondly, considering the premiums paid to CEOs in isolation has the potential to mask persistently high pay across the entire executive team. This is because some companies pay all key executives, including the CEO, high amounts. Here, size is relevant. The largest companies by market capitalisation tend to pay their executives high amounts (see page 8 for details).

Why is the premium so much higher, on average, for energy CEOs relative to other sectors, and is this a fair representation of the value-add they are providing?
PAY AND PERFORMANCE

Given the desire to align pay with performance, AMP Capital plotted the performance of the four S&P/ASX200 sectors that paid CEOs above the sample average of $4 million in 2014 during the three years to 2015: energy, financials, consumer staples and materials. While an incredibly simplistic proxy for performance, it is interesting to note that of the four highest paying sectors in 2014, only the financial sector outperformed the broader S&P/ASX200 between 2013 and 2015.

Figure 4: How the highest paying sectors in 2014 performed relative to the S&P/ASX200 over 3 years (2013-2015)

However, caution should be exercised when interpreting this data as results can be heavily influenced by the number of companies in each sector that obscure extremely large variances in pay. Each company’s pay practices should also be considered in the context of industry, economic and company-specific challenges or benefits that may not be in the CEO’s control. It is appropriate for investors to acknowledge the performance of the company and sector when raising the issue of pay with companies.

THE NEXT HIGHEST PAID EXECUTIVES

The disparity across sectors when it comes to CEO total pay is not mirrored across the second most highly paid executives. These executives are paid within a narrower band, between about $1 million and $2 million, on average. (The financial sector was the only sector that paid above this range in 2014.) This is a much smaller band than we see among CEOs where sector average pay varies between about $2 million in the IT sector and $6 million in the energy sector.

Perhaps it is easier to assess the value of an executive just below the level of a CEO. Or perhaps executives just beneath the CEO level are less able to negotiate a higher level of pay on a case-by-case basis.

In the financial sector, the average pay for the second highest paid executive is $2.6 million. This is significantly more than their counterparts in the consumer discretionary and utilities sector, who receive an average of $1.2 million per year. Of the 28 financial companies included in this study, 15 pay their second highest paid executive more than $2 million and six companies pay these executives more than $4 million.
FIXED PAY: ARE THE RESULTS DIFFERENT?

It appears that short and long-term incentives account for much of the discrepancy in total CEO pay across sectors. However, it should be remembered that incentives, usually in the form of equity grants, generally vest subject to performance hurdles including earnings per share targets, safety targets and relative total shareholder return calculations. Compared with total pay, which includes an accounting value of these incentives, fixed pay is much more consistent across sectors.

The majority of sectors pay CEOs average salaries of just under $1.5 million, with the energy sector again paying a higher amount on average. Once more, this is due to the skew in the energy sector sample with five of the six CEOs receiving fixed pay of more than $2 million. The IT, utilities and consumer discretionary sectors each pay less than the sample average of $1.5 million.

As with ‘total pay’, CEOs generally receive double the ‘fixed pay’ received by the next highest paid executive. The average fixed pay across the S&P/ASX200 sample was $1.35 million for CEOs and $671,000 for the next highest paid executive.

In addition, there is also a much narrower pay band across sectors for the second most highly paid executive. The average fixed pay for this group was between $500,000 and $900,000.

HOW MUCH IS THE EXECUTIVE TEAM WORTH?

AMP Capital believes that the level of executive pay across the key management personnel group is just as important as the level of CEO pay. As CEO pay often dominates any discussion on the appropriateness of executive pay, we included the KMP group in our study and hope that future discussions on pay broadens to include the quantum paid to executive teams. All references to pay in this section are references to total pay, which is fixed pay plus the accounting value of all incentives, unless otherwise stated.

The amounts paid to the KMP group can be significant, even in the context of net profit in any given year. An industrial company based in the US paid its KMP group US$21 million, which represented 21 per cent of net profit in the same year.

Figure 5 below plots average fixed pay for CEOs relative to the next highest paid executive’s fixed pay across sectors. The line running across the chart represents the average fixed pay for CEOs in the S&P/ASX200.

Figure 5: Average fixed pay for CEOs in each sector relative to the next highest paid executive

<table>
<thead>
<tr>
<th>Sector</th>
<th>Avg. CEO total pay</th>
<th>Avg. next highest paid exec</th>
<th>Avg. total KMP pay excl CEO</th>
<th>Avg. CEO pay - S&amp;P/ASX200</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer discretionary</td>
<td>$1.5 million</td>
<td>$1.5 million</td>
<td>$1.5 million</td>
<td>$1.5 million</td>
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<tr>
<td>Consumer staples</td>
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<td>$1.5 million</td>
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</tr>
<tr>
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<tr>
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<tr>
<td>Industrials</td>
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<tr>
<td>Materials</td>
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<td>$1.5 million</td>
<td>$1.5 million</td>
<td>$1.5 million</td>
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<tr>
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</tr>
<tr>
<td>Utilities</td>
<td>$1.5 million</td>
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<td>$1.5 million</td>
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</tbody>
</table>

Source: AMP Capital

Of the four highest paying sectors in 2014, only the financial sector outperformed the broader S&P/ASX200 between 2013 and 2015.
The financials sector stands out when it comes to the size of pay for KMP executive teams as shown in Figure 6 above.

The average amount paid to the KMP group in the financials sector in 2014 was $16.6 million. This is significantly higher than the sample average of $9.9 million. This is partly explained by the size of the average KMP group in the financial sector. An average of 6.5 executives are included in the KMP group in the financials sector, which is the largest average executive group of any sector and above the sample average of 5.4.

However, we also found that the executives working in the financials sector received significantly higher amounts than the sample average. On average, if CEOs are excluded, executives in the KMP group at a bank, insurer or diversified financial received an average pay packet of $1.9 million in 2014, which is almost $500,000 more than the sample average of $1.44 million.

These are large pay packets and reflect the industry-wide observation that financial companies pay their executives well.

The sectors that pay executives in the KMP group the least are the IT, utilities and consumer discretionary sectors. They pay their executives (excluding the CEO) an average of $800,000, $880,000 and $930,000 respectively.

SHOULD COMPANY SIZE DETERMINE PAY?

Perhaps the least surprising result of this study was the correlation between company size and the size of CEO pay. Figure 7 below shows the relationship on a logarithmic scale. Companies with the largest market capitalisation typically receive the highest pay. The reverse is true for smaller sized companies.

For many years, we have observed the assumption and apparent acceptance that executives at the largest publicly listed companies in Australia are paid more than executives at the smaller end of the listed company spectrum. Why is this? Is there necessarily a relationship between the size of the company and the value a CEO provides particularly when CEOs at large companies are typically supported by large executive teams?
Of course some CEOs deserve to be paid a premium for running very large and often systemically important institutions to the Australian economy. Others deserve to be paid a premium for the level of complexity and difficulty in running the particular company in question. The issues facing a CEO are many and varied.

Indeed, for some companies it is likely that shareholders would support a level of pay that reflects the challenges at hand and the value provided by a particular CEO in managing those difficulties, especially if the board communicates these challenges to shareholders. However, in this scenario, it would not be the company’s size that would determine the level of pay to the CEO, but the value provided by the particular individual. We believe that this is an important distinction.

The chart above shows that there are several outliers when it comes to the relationship between company size and pay. Four companies in particular pay much more relative to their size: two financial companies, one healthcare company and one materials company.

Is there necessarily a relationship between the size of the company and the value a CEO provides particularly when CEOs at large companies are typically supported by large executive teams?

Of these four companies, the company with the highest total pay in the chart above persistently pays high amounts. These amounts tend to be aligned with performance and shareholder returns.

Another company was an anomaly in 2014 due to large parcels of equity incentives vesting at the same time following re-testing of the attached hurdles.

The other two companies pay persistently high amounts to their CEOs. One company pays a large package that it says is in line with US company peers. The other company repeatedly provides the CEO with a large number of zero exercise price options despite a significantly higher share price since that fixed number was originally calculated.

When we have the opportunity to meet with the boards of each of these companies, we raise the quantum of executive pay and discuss the company’s rationale for pay at those levels as well as AMP Capital’s position on remuneration.
AMP CAPITAL’S POSITION ON PAY

Australian investors have had a mechanism by which to review and comment on the approach to remuneration used by the companies in which they invest since 2005 when non-binding votes on remuneration reports were introduced. The impact of a shareholder’s ‘against’ vote on remuneration is now greater since the introduction of the two-strikes rule.

When reviewing the appropriateness of remuneration reports, AMP Capital generally considers a wide range of factors including the clarity of disclosure, satisfactory short and long-term incentive and termination arrangements and appropriate non-executive director remuneration.

In general, AMP Capital will vote against remuneration reports that exhibit one or more of the following criteria:

- Poor disclosure.
- Poor alignment with shareholder interests.
- Inclusion of non-executive directors in executive incentive plans.
- Excessive quantum.
- Incentive plans subject to poorly structured performance hurdles.

IN SUMMARY

AMP Capital is keen to see evidence that executive pay is truly fair, reasonable and aligned with shareholder interests. When we examine company remuneration reports ahead of annual general meetings, these are the factors we consider when deciding how to vote on pay.

For some time, we have felt the reliance upon global benchmarking studies and comparisons with peers and predecessors is perpetuating a cycle of persistently high levels of pay irrespective of each executive’s role and the value they generate. The globalisation of executive pools may be exacerbating this issue because of the higher levels of CEO pay in the US and some parts of Europe.

We recognise the challenge in setting pay when a new CEO begins, particularly in the context of a global search, historically highly-paid sectors, and the need to compensate executives for the loss of incentives that would otherwise have vested if they had stayed at their previous employer.

However, we encourage companies not to rely on past payments alone to determine the future. We would rather see boards set executive pay with reference to the value those executives provide. Some companies have taken this approach in the last year as new CEOs have commenced and reset executive pay at a lower level.

We encourage boards to be transparent about the factors they considered when setting pay so shareholders can assess it appropriately. Relying upon sector benchmarking studies, levels of pay paid by peers or accepting a precedent set by a previous CEO is not enough.

This analysis of CEO pay, despite some limitations of the data set, has provided AMP Capital considerable food for thought and we anticipate using the insights gained to inform our dialogue with companies with regard to this important issue. We welcome continued industry debate on pay in this context.
A FEW NOTES ON THE METHODOLOGY

A summary of this study was published in AMP Capital’s Corporate Governance Report in March 2016.

There are limitations to this data set. We collected statutory pay data on all companies that were members of the S&P/ASX 200 at 2014 calendar year end. Data on CEO pay and the next highest paid executive was collected when those executives were in place for the entire financial year for that company. This means that companies with changeovers in CEOs and second highest paid executives were excluded from this study.

The varying balance dates across companies meant that the full data set for each year is not available until the following calendar year. Actual pay (the cash value of pay collected, including the value of equity grants that vested during the year) was beyond the scope of this study but would be a useful addition.

AMP Capital is keen to see evidence that executive pay is truly fair, reasonable and aligned with shareholder interests.