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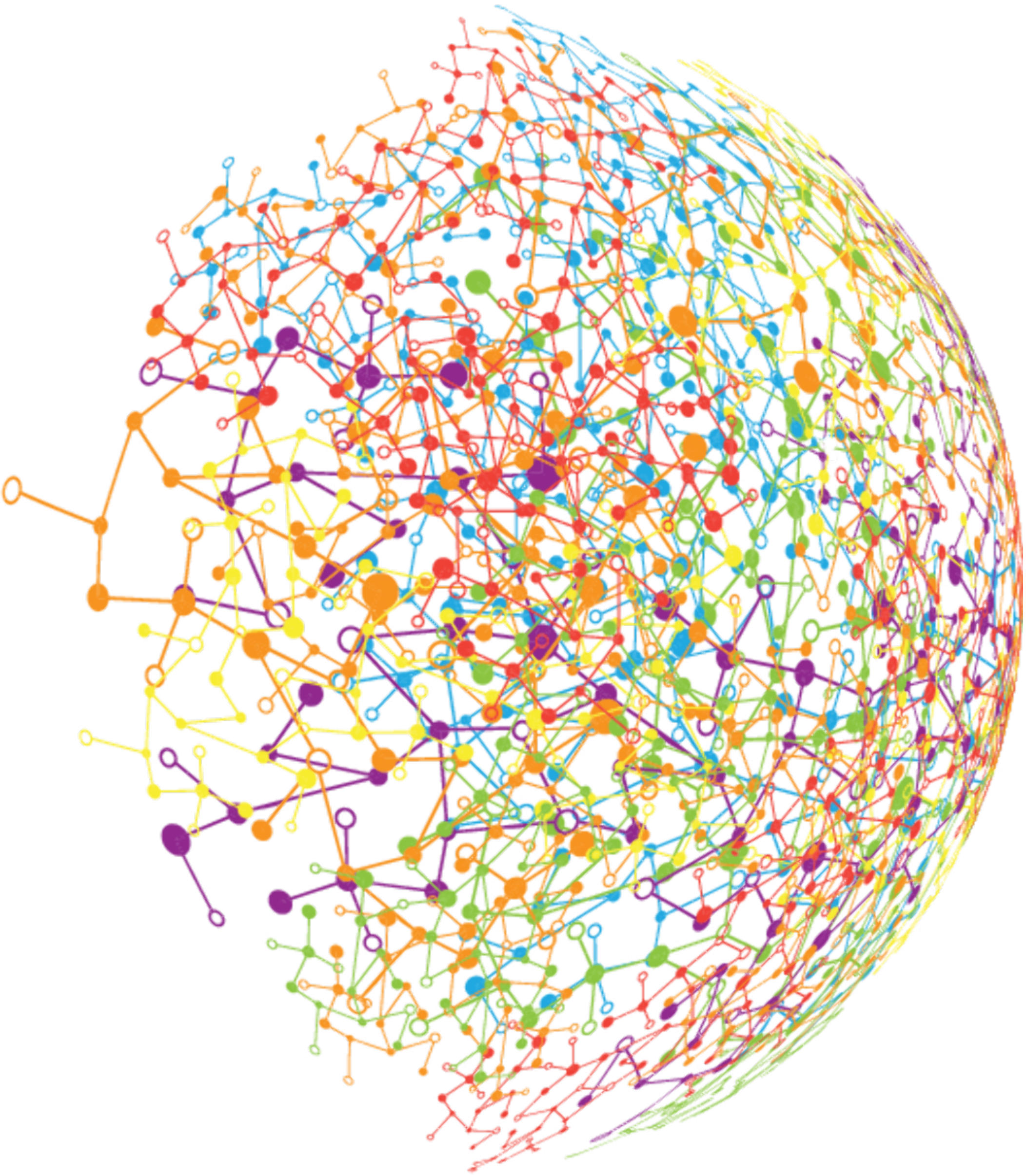


Trends in Long-Term Incentives
Analysis on ASX-Listed Companies

November 2020

MAKING AN IMPACT THAT MATTERS since 1845

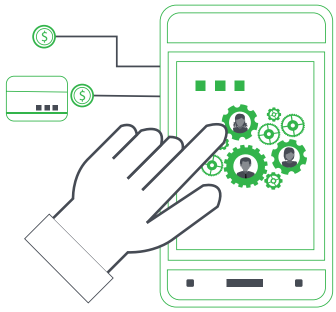
82%
of **LTI Plans** use **RTSR** as a hurdle

40% of **ASX Companies** have announced COVID-related adjustments to their remuneration schemes

95% of plans containing **RTSR** have it as the main vesting hurdle

There has been a shift away from generic market indices toward **industry-specific** comparator groups

The inclusion of **global peer entities** in RTSR comparator groups has become increasingly popular



Executive Summary

We have seen over 40% of companies announce COVID-19 related amendments to their executive remuneration schemes. We expect this proportion to grow as we move into the new year. In addition, COVID-19 has highlighted issues with comparator group selection, and companies are moving away from generalised indices to customised comparator groups

Deloitte has performed analysis on executive-level remuneration for ASX listed companies. Companies within the ASX 100 were selected for the purpose of providing market-based insights into trends in long term incentives for the period between 2015 and 2020.

Our analysis focused on the approaches to compensation structures, performance hurdle consideration, total shareholder return benchmarking and valuations.

Observations

01. Relative Total Shareholder Return (RTSR) remains the most commonly used performance metric for long-term incentives (LTIs); approximately 82% of companies we looked at in the ASX 100 used RTSR.

02. Market-based performance hurdles dominate as the most popular metric for determining LTI remuneration for ASX 100 executives. Typically, this is either a singular hurdle or paired with one or more non-market-based hurdles such EPS and ROIC.

03. As of 31 October 2020, approximately 40% of ASX 200 companies announced COVID-related remuneration adjustments. We expect more companies to apply adjustments to executive remuneration as we enter the new calendar year.

04. There has been an increased focus on the selection of RTSR comparator groups as a result of the impact of COVID-19 and its effects on recent LTI payouts. This has brought into question the appropriateness of using a general market index. Australian Boards have been shifting the comparator group from broader, market-based indices to sector-specific indices. Some companies in niche sectors or markets have overcome the issue of a limited number of local comparators by selecting international peers.

05. The proportion of target executive remuneration dictated by long-term incentive plans has increased from 2015 to 2019. This is likely in response to shareholder involvement and activism, as well as stricter regulation of executive pay.

06. Consumer discretionary[1], health care and real estate companies have relatively high proportions of LTI at over 40%.

07. RTSR remains the dominant performance hurdle, which aims to strengthen the alignment between executive remuneration and company performance. There are however design and calculation considerations which if overlooked can have unintended consequences and alter the payout received. Common pitfalls in designing RTSR plans include:

- The selection of an appropriate comparator group
- Treatment of corporate actions
- Managing international peers
- Treatment of dividends
- Determination of averaging periods

Manage your Share Based Payments with Deloitte
Deloitte has extensive experience in delivering share-based payment services to ASX listed companies, including:

- Valuation of employee share plans in accordance with AASB 2
- RTSR tracking and calculation of LTI payouts
- Share based payment management and accounting
- TSR calculation methodology, design, and governance

Deloitte has a suite of digital applications which could assist you with the valuation, accounting and reporting of LTI plans. Details about these tools are presented at the end of this report.

[1] The consumer discretionary sector is comprised of companies who obtain revenue by providing goods and services which are non-essential to consumers and are typically only purchased when consumers have excess spending capacity above their basic needs. Examples include electronics, luxury goods and leisure activities.

Our Analysis

Relative TSR remains a popular benchmark

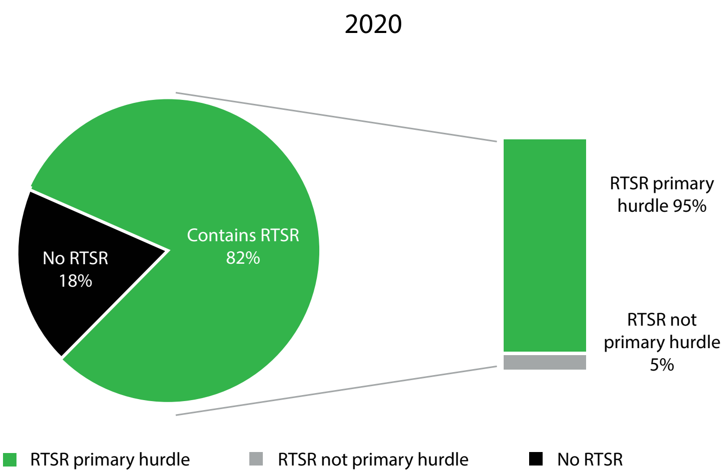
Relative Total Shareholder Return (RTSR) remains the most commonly used performance metric for determining LTI remuneration. RTSR compares investor returns for a company against a peer group of companies over a long-term performance period.

Performance hurdles are thresholds relating to the performance metrics that determine the level at which LTI plans vest. These hurdles are selected by companies' Boards which may include market-based performance hurdles and/or non-market-based performance hurdles. Many companies use both market and non-market-based hurdles in setting LTI plans.

Deloitte found that while market-based performance hurdles such as RTSR continue to dominate LTI schemes, there has been an increased focus on financial metrics such as ROIC and EPS.

- Approximately 82% of companies in our sample used Relative Total Shareholder Return (RTSR)
- This proportion represents a decrease over the past five years with a corresponding increase in non-market-based performance hurdles[2], notably return based metrics such as ROIC, ROE and ROCE
- In 2020, of the 82% of the sample that use RTSR, 95% use it as the primary performance hurdle

Figure 1: Use of RTSR across the ASX 100

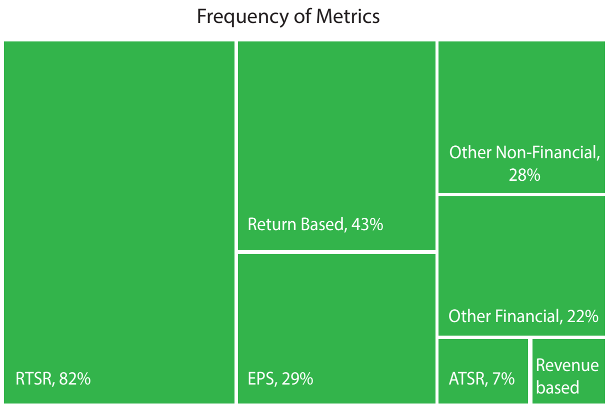


Deloitte analysis based on a selected sample of ASX 100 companies

These financial measures are often supplemented by 'non-financial' measures which, while not directly measured in short-term financial accounts or share price metrics, can be material drivers for long-term financial performance. Examples of non-financial measures include project-based targets, safety performance, customer satisfaction and employee turnover.

While these supplementary measures are often used, RTSR remains the most widely used metric relative to any other single metric and is the only metric which was observed in over 50% of the sampled ASX 100 companies.

Figure 2: Frequency of Performance Metrics



Deloitte analysis based on a sample of ASX 100 companies

[2] Long-term incentive offers generally hinge on one of two types of performance metrics; market, and non-market. Market hurdles are those concerned with the equity value or share price of a company while non-market-based hurdles are typically internal measures or financial reporting metrics like earnings per share (EPS) and revenue growth (i.e. revenue CAGR). Since the key objective of long-term incentives is to attract and retain leading talent, these metrics should be selected so as to facilitate accurate measurement of key performance indicators (KPI's).

Relative TSR: Selection of Comparator Groups

Selecting a comparator group to benchmark your company's TSR performance hurdle against can present a challenge for companies' boards. A critical decision in the plan design phase is whether or not to benchmark TSR against published indices (such as the ASX 100, the ASX 200, etc), or to define a customised comparator group representing direct competitors and other similar entities.

While there is often a desire to benchmark performance against specific and direct competitors, this presents a trade-off between selecting more relevant and targeted performance hurdles and ensuring that there are enough entities within the comparator group to produce representative vesting outcomes. A challenge with using a customised peer group is often how to deal with a small comparator group, which can often result in volatile payouts that are highly sensitive to small changes in the performance of a small number of the comparators and payout rankings which are not mathematically feasible. Our analysis indicates that Australian companies are increasingly adapting to this challenge by including global competitors in their comparator groups - a trend which we expect to continue as companies recover from COVID-19 downturns.

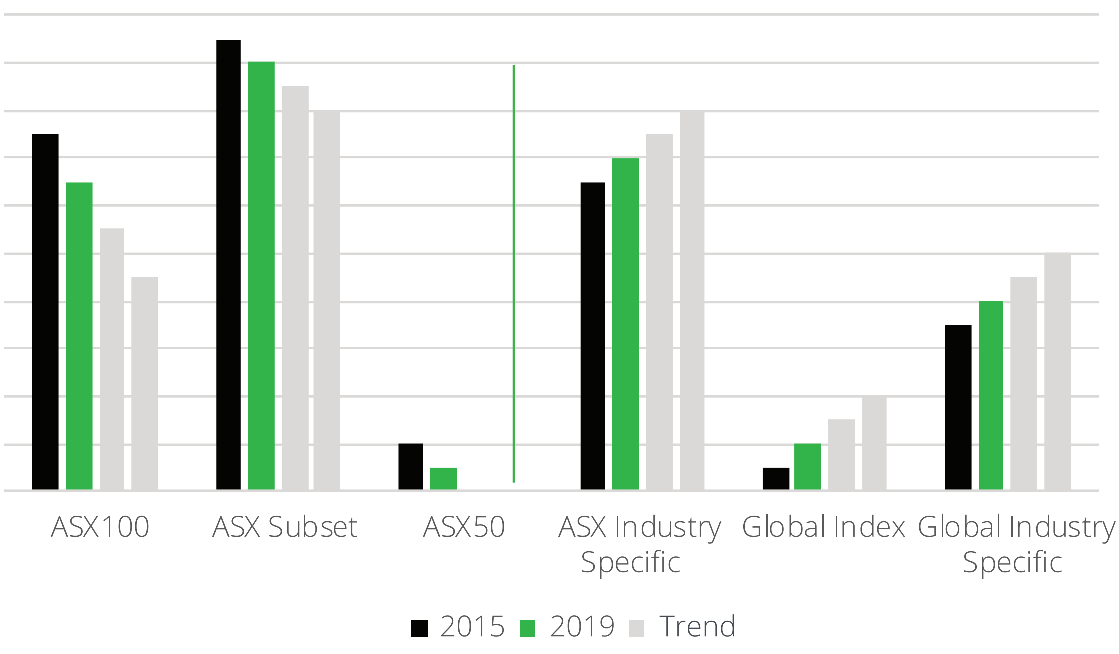
In analysing ASX 100 companies over the period 2015 to 2019, we found that:

- There has been a shift away from published indices, such as the ASX 100, towards industry specific subsets of the ASX 100 to better align the comparator group with the entity's industry and sector
- The inclusion of global entities within comparator groups of Australian companies has become more prominent

The economic impact of COVID-19 has varied significantly across industries. The impact that this has had on recent LTI payouts has brought into question the appropriateness of RTSR comparator groups. In response to COVID-19, we are seeing many companies reviewing the relevance of their RTSR comparator groups.

The analysis in Figure 3 indicates a shift in the market towards an industry/sector specific comparator group (which may include global entities). We expect the shift to continue as companies re-assess their comparator groups

Figure 3: Comparator groups used for RTSR[3]



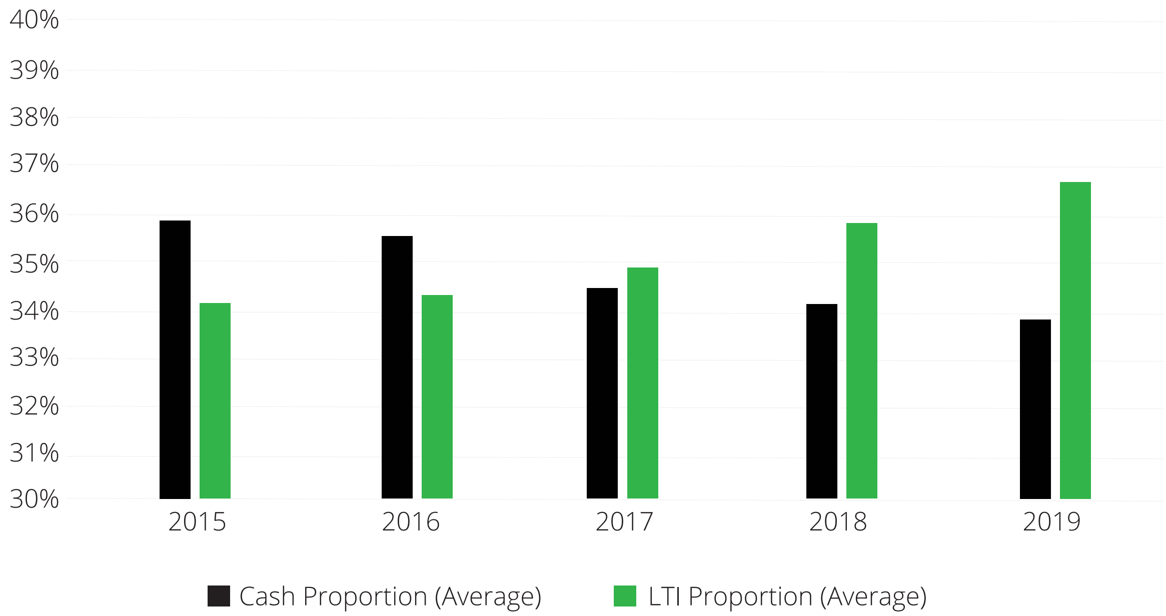
Deloitte analysis based on a sample of ASX 100 companies

[3] ASX subset refers to an index which is defined by taking a reported an index excluding companies from a specific industry or sector.

Proportion of LTI as a percentage of Executive remuneration

The proportion of target LTI as a percentage of total executive remuneration has increased over the last 5 years. Of the ASX 100 entities sampled, we have found LTI as a percentage of total executive remuneration has increased from 34% to 37%, with corresponding decline in fixed remuneration.

Figure 4: Average fixed remuneration vs LTI portion for ASX 100 Executive Remuneration:



Deloitte analysis based on a sample of ASX 100 companies

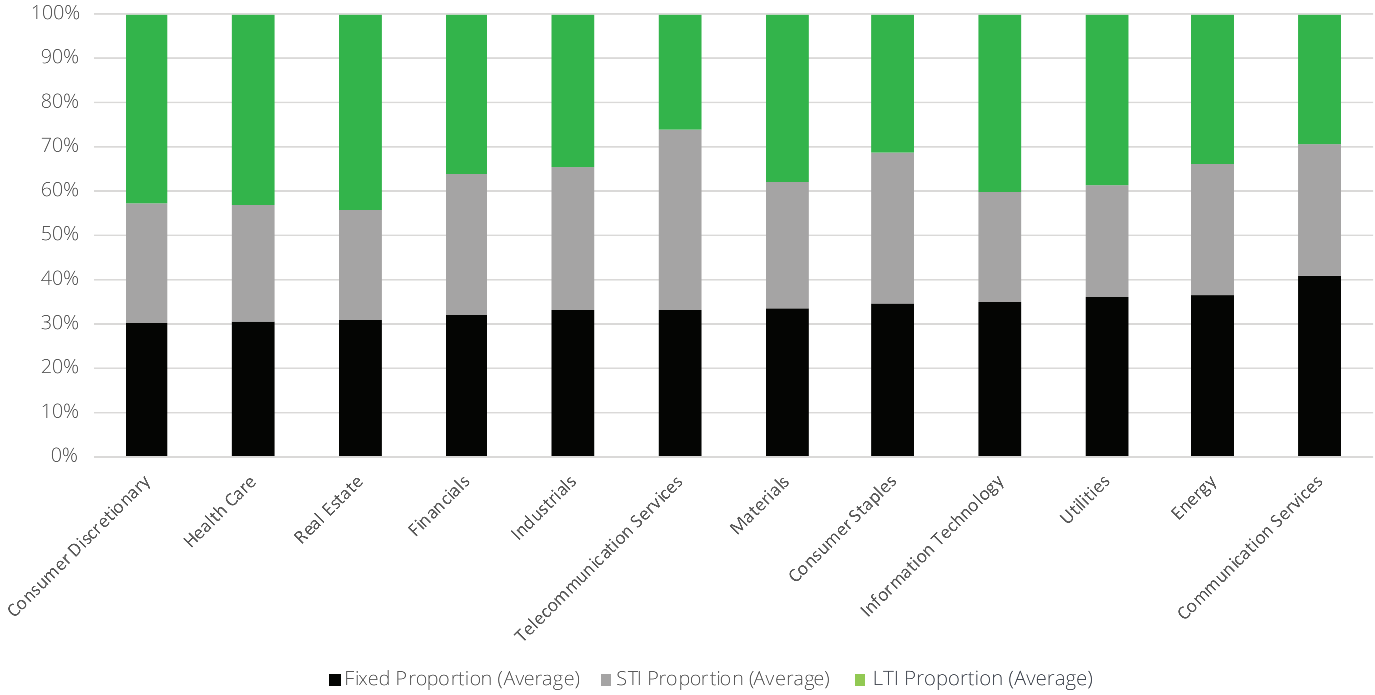
Our findings in this regard are broadly consistent with Australian Council of Superannuation Investors' (ASCI) findings that share-based bonuses as a proportion of total remuneration for the top 100 ASX CEO's has appreciated between 2015 and 2019, whereas cash-related compensation has decreased.[4]

A similar trend has been witnessed in other countries, as the proportion of stock-based compensation as a percentage of total pay across S&P500 companies continues to increase over the past 10 years. [5]

[4] ASCI's 2020 publication "CEO Pay in ASX200 Companies, highlighted trends of cash bonuses dropping from FY14 to FY19, accompanied by an offsetting rise in non-cash bonuses which are in turn comprised of LTIP awards.

[5] Harvard's "2019 U.S. Executive Compensation Trends", highlights executive compensation trends in the U.S. based executive pay disclosures.

Figure 5: LTI portion of executive remuneration by Sector



Deloitte analysis based on a sample of ASX 100 companies

Our analysis reveals that the proportion of LTI in terms of total executive remuneration varies across sector:

• The communication services sector had the lowest proportion of LTI, with the highest proportion of fixed remuneration.

• In contrast, consumer discretionary, health care and real estate had relatively high proportions of LTI, but relatively low fixed remuneration components. The proportion of LTI for these three sectors exceeds 40%.

Common pitfalls when using RTSR as a performance metric

Our analysis has found that RTSR is still the dominant performance metric.

Relative TSR LTIs aim to strengthen the alignment between executive remuneration and company performance. There are however design and calculation considerations which if overlooked can have unintended consequences and alter the payout received.

Selection of an appropriate Comparator Group

As outlined above, the selection of a comparator group against which performance is measured can have a pervasive impact on the final payout. Careful consideration should be given to the following:

- Whether TSR is measured against a market index, or a defined group of peers
- The inclusion of global peers
- The structure of the vesting function, particularly for a small group of peers
- The inclusion of additional hurdles (e.g. TSR must be positive)

Treatment of Corporate Actions

Over the course of the performance period, the entities within the comparator group may experience certain events that will impact the availability of share price data. The treatment of these events may impact the calculation of TSR or the composition of the comparator group and has the potential to alter remuneration outcomes.

Managing International Peers

Our analysis found that more and more LTI's linked to RTSR are including global peers. Measuring TSR across geographies can create challenges when dealing with different currencies and different trading windows.

Treatment of Dividends

The treatment of dividends should consider whether the TSR calculation assumes dividends are held in cash or re-invested into shares and the date at which are dividends re-invested. The treatment of cash, special dividends and other corporate events (which impact shareholder value) must also be determined.

Averaging periods

Using the share price on performance start and end dates creates significant payout uncertainty. The use of averaging period smooths out this volatility, resulting in a payout which is less exposed to any anomaly. Our analysis has found that 1-3 month averaging periods are the most common across the sample of clients surveyed. Volume-weighting these averages is another mechanism which has the potential to reduce the impact of anomalies around TSR measurement dates.

Our Services

TSR incentive design

Deloitte is able to leverage its experience in assessing, valuing and analysing long-term incentive plans to assist companies in devising relevant and feasible LTI's which use RTSR as a performance metric in the pursuit of attracting and retaining suitable talent. We can assist with RTSR hurdle design – including selecting meaningful comparator groups, developing an assessment methodology and assisting with RTSR plan governance and consistency.

We also provide incentive plan design and implementation solutions and assist in selecting appropriate comparator groups.

Valuation and hurdle assessment services for share-based payments

Deloitte provides end-to-end services to assist companies with their financial and internal reporting obligations for Employee Share Ownership Plans, Long Term Incentive Plans and other share-based payments.

Grant date valuations

We can assist with performing AASB 2[6] valuations for financial reporting purposes, and valuations for tax purposes. Valuations of share-based payment with market-based performance hurdles are typically based on Monte Carlo simulations, rather than the Black Scholes Model, to appropriately account for the valuation impact of vesting conditions.

When performing valuations, we consider plan-specific factors including volume-based weighted average prices ("VWAP"), performance term, special dividends, as well as the treatment of corporate actions and events.

[6] AASB 2 refers to Australian Accounting Standard Board 2 Share Based Payment

Ongoing hurdle tracking

We can aid in tracking the company's performance relative to the comparator group, throughout the vesting period, for internal reporting purposes.

Vesting date hurdle testing

We engage in external assessments of performance relative to vesting conditions at the end of the performance period, to determine the proportion of instruments that vest.

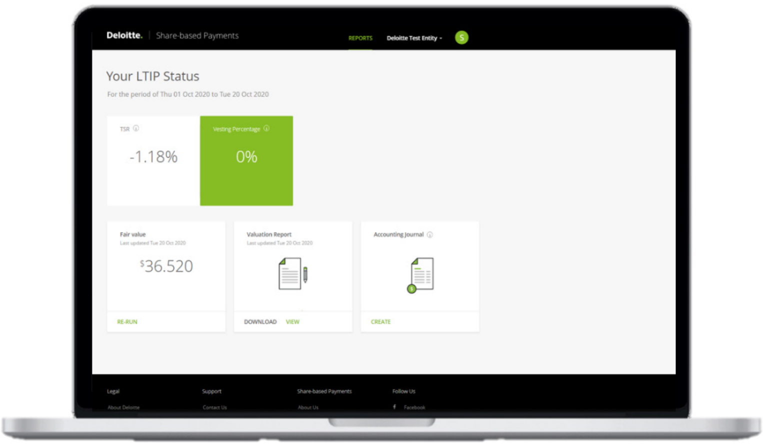
Share-based payments accounting services

We have developed an agile and adaptable accounting solution for share-based payments expenses. Users are able to implement this module to generate expenses, create accounting journal entries, produce expense forecasts and foster a granular understanding of how your company's share-based payments expenses affect your financial statements.

Our Solutions

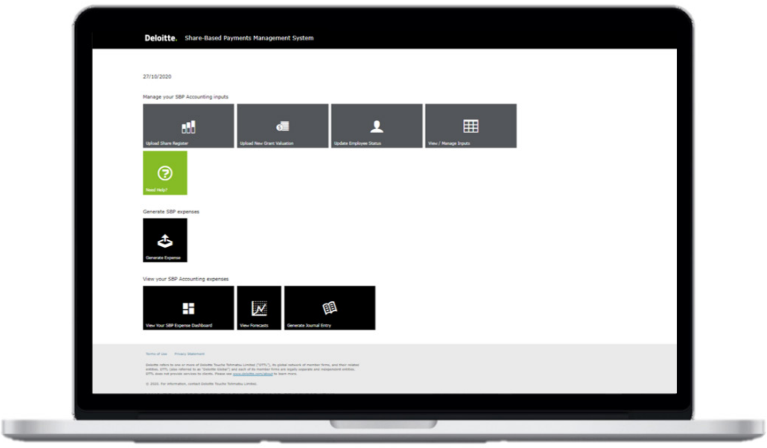
Share Based Payments

Our share-based payment tool helps our clients calculate AASB 2 grant date valuations within minutes. Our product also has the ability to track TSR performance against a defined peer group, with results automatically re-calculated on a daily basis.



My Incentive Plan

My Incentive Plan tool streamlines and de-risks the share based payment calculation process by creating a single source of truth. Share based payment expense calculations are performed within a secure modelling engine which enables our clients to mitigate the risk presented by performing and storing calculations of large data sets manually.
The calculation, input and output process is customisable to meet specific business needs.



Contacts

Hussein Hussein
Author - Partner
Asia Pacific Assurance Leader
huhussein@deloitte.com.au

Steven Cunico
Lead Partner
Treasury & Capital Markets
scunico@deloitte.com.au

Rob Basker
Partner
Australian Reward Leader
rbasker@deloitte.com.au

Lammert Vos
Author - Director
Treasury & Capital Markets
lamvos@deloitte.com.au

Jack Liu
Author - Senior Manager
Treasury & Capital Markets
jacliu@deloitte.com.au

Research Authors:

Timothy Hantzipavlis
Research Analyst
Treasury & Capital Markets
thantzipavlis@deloitte.com.au

Terence Lapsanas
Research Analyst
Treasury & Capital Markets
tlapsanas@deloitte.com.au