Deloitte.

Motivating top management through well-structured pay
Key trends and issues

Mitul Shah / 11 April 2013

Introduction

About Deloitte

The Deloitte Executive Compensation Consulting practice covers all aspects of senior executive compensation and incentive design.

Our team includes deep expertise in areas ranging from reward strategy consulting, incentive plan design, valuation, accounting, legal and tax experts. Our practice has been consciously built around an integrated model, in which areas commonly separated in competitor practices are closely integrated.

Design ⟷ **Compensation advisors** ⟷ **Implementation**

Reward, corporate governance and research specialists	Employment and incentive plan practitioners & lawyers	Tax specialists and international network of tax advisor	Accounting, valuation, funding experts
• Reward strategy • Pay benchmarking • Performance measures • Market trends and corporate governance updates • Remuneration report • Shareholder relations • Employee communication	• Plan rules • Contracts • Share scheme participant documentation • All-employee share plans	• Global tax analysis • Tax efficient arrangements • Tax guides	• IFRS 2 and Share Plan accounting • Valuation experts • Cost effective funding

Mitul Shah, Partner, London

- Thirteen years' experience
- Significant experience advising Russian companies on all aspects of executive pay and incentive design

Today's agenda

Why is executive compensation important?

International market trends

Designing effective incentive plans

Corporate governance

Why is executive compensation important?

Why is executive compensation important?

Compensation in the news

"Fixing the fat cats – Switzerland votes to curb executive pay"
The Economist
March 2013

"Leaders must act fast to save the City – cap on bankers bonuses"
The Financial Times
March 2013

"Spain set to give shareholders say on pay"
The Financial Times
March 2013

"Germany weighs pay curbs, legislation would give shareholders more say over executive compensation"
The Wall Street Journal
March 2013

"Putin may cap golden parachutes after $100 million payout"
Bloomberg
March 2013

"In case you were worried, top Wall Street CEOs got nice raises last year"
The Huffington Post
May 2012

Why is executive compensation important?

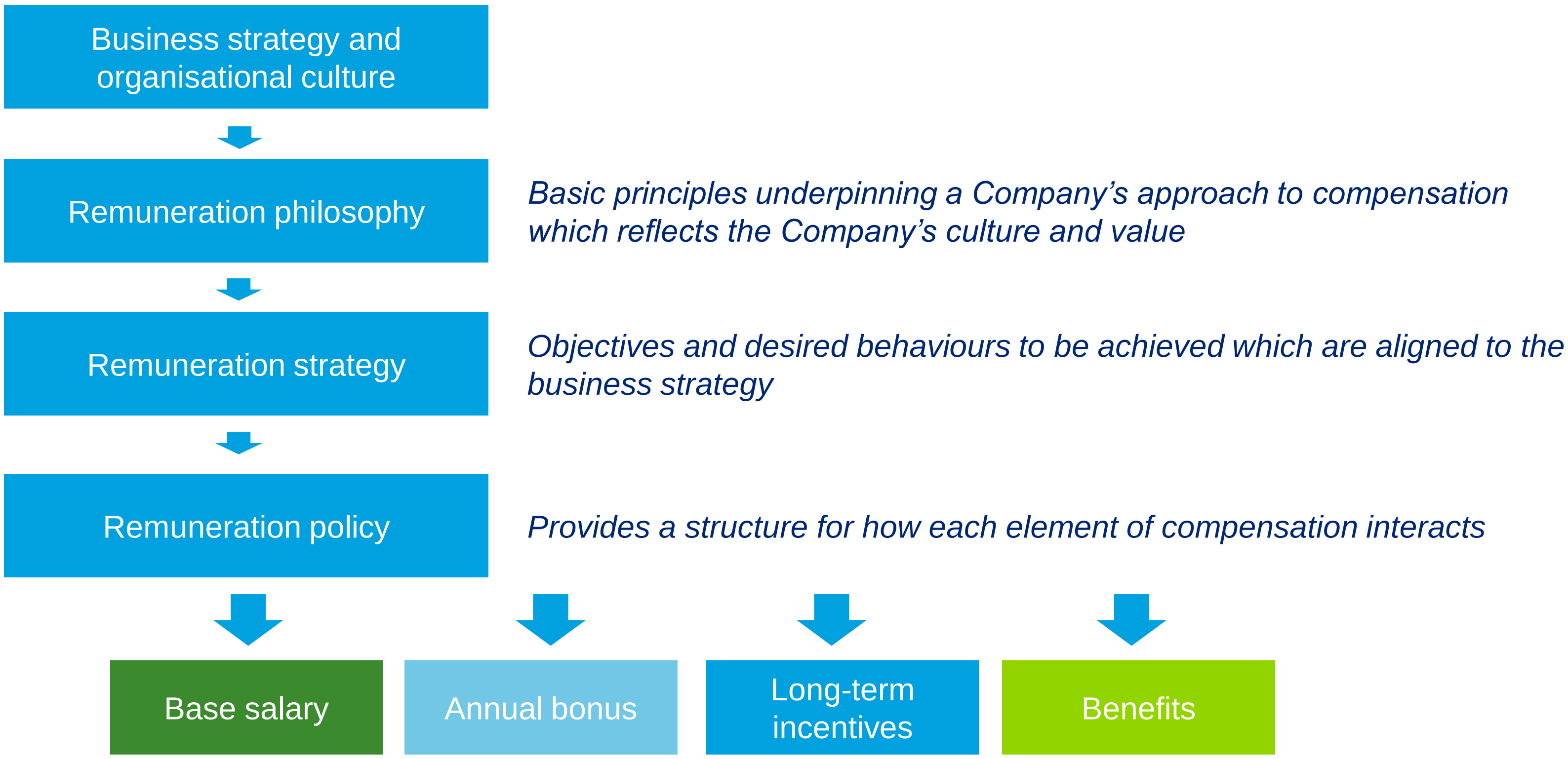
Driving the right behaviours

Recruitment, motivation and retention	The right compensation arrangements can be used to recruit, motivate and retain **high calibre** executives.
Alignment with strategy and owner interests	Successful compensation arrangements are ones that **align executives' interests** with **the long-term strategy** of the business and the interests of shareholders.
Good corporate governance	Well structured compensation arrangements send a positive message to shareholders and regulators about a company's attitude to **risk** and **governance**.
Avoid over or under spending	Compensation arrangements which are appropriately designed can ensure a company provides compensation that is **market competitive** without **over spending**.

Why is executive compensation important?

The compensation framework

- The most effective Remuneration / Compensation Committees will design remuneration arrangements which support the execution of the company’s business strategy and align the interests of executives with those of shareholders.
- The compensation arrangements should properly reflect, among other factors, the stage in the business lifecycle of the Company, type and location of operations and the market within which the company competes for talent.



Why is executive compensation important?

Overview of typical package in Europe and US

	Western Europe	U.S.
Base Salary	• Typically accounts for 30-40% of total package for top executives at target.	• Typically accounts for 15-25% of total package for top executives at target.
Annual Bonus	• Both financial (mainly earnings/profit) and non-financial performance measures. • Increased use of deferral of part of bonus into shares.	• Revenue growth and earnings-based measures are the most common financial measures. • Deferral less common than in Europe.
Long-Term Incentives	• Typically accounts for approximately one-third of total package for top executives at target. • KPIs tend to be linked to share value (e.g. total shareholder return and/or share price) and earnings (e.g. EPS). Use of strategic measures increasing. • Use of clawback continues to increase in popularity.	• Often accounts for at least two-thirds of total package value for top executives at target. • Continued use of a portfolio approach for LTI grants (e.g. granting two or more different kinds of equity vehicles). • Historically LTI grants had not been subject to performance conditions but there has recently been a marked increase in the use of performance shares.

Why is executive compensation important?

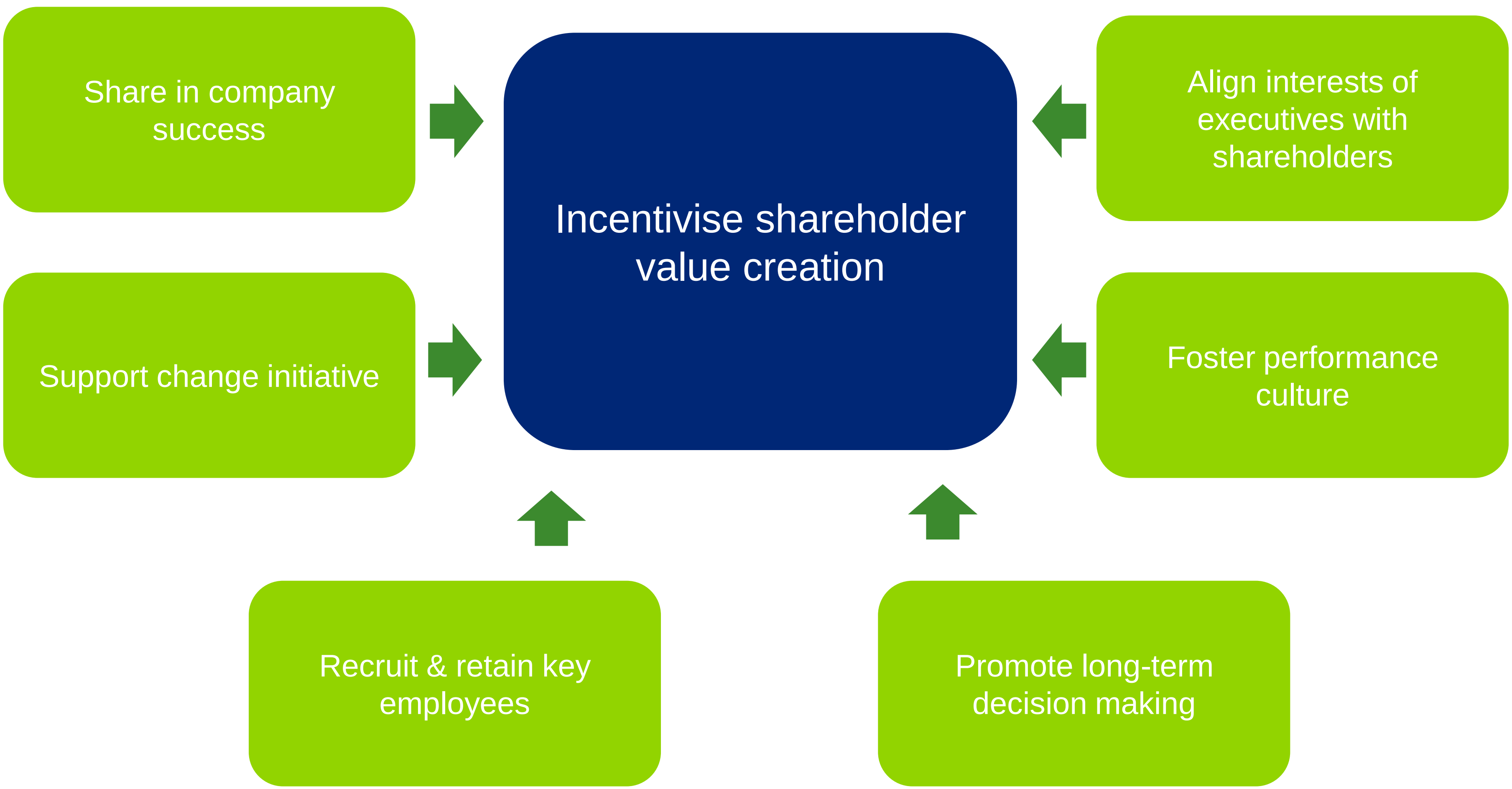
Overview of typical package - key objectives of each element

The illustration below shows how the various components of compensation can be used to achieve specific objectives and drive desired behaviours. However, in order to do this, the amount and balance of the overall package and the performance measures need to be appropriate.

	Elements of executive compensation		
Objectives	**Base salary**	**Bonus**	**Long-term incentives**
Can act as a lock-in / retention device	🗐 🗐	🗐 🗐	🗐 🗐 🗐
Can incentivise performance against specified objectives		🗐 🗐 🗐	🗐 🗐 🗐
Can incentivise value creation		🗐 🗐	🗐 🗐 🗐
Can align the interests of participants with those of shareholders		🗐	🗐 🗐 🗐

Why is executive compensation important?

The purpose of incentive plans



International market trends

Market highlights
Worldwide trends

UK – key themes

- New disclosure requirements for the Directors' Remuneration Report
- Introduction of binding vote on executive compensation policy
- Shareholder activism – the "shareholder spring"
- Focus on stronger link between pay and performance
- Longer-term horizons
- Frozen salaries / small pay increases

US – key themes

- Increased shareholder activism through say-on-pay proposals
- Alignment of pay and performance
- Concerns with benchmarking practice
- Questions about severance and change of control arrangements
- Remuneration Committee effectiveness and communication

Rest of Europe– key themes

- Measures aimed at taxing high earners introduced in *France, Greece, Portugal & Spain*
- *Switzerland* : vote on executive pay
- *Italy*: government intervention on disclosure for listed-companies, and pay of executives of state-owned enterprises
- *France* : increased shareholder activism
- *Across Europe*: cap on variable pay for bankers

Market highlights

Worldwide trends

Asia – key themes

- *Singapore:* Salary increases remain broadly flat. Although most Singaporean companies have an LTIP in place, few companies make annual LTIP grants.
- *China:* Above inflation salary increases. Weighting of annual bonus as a % of total pay is gradually increasing, although bonus amount remains relatively modest. Companies are focused on attraction and retention of talent with increased focus on performance related reward.

India & the Middle East– key themes

- *India:* Above inflation salary increases. Annual bonus amount remains relatively modest. Companies are concerned about retention and high expectations around salary increases.
- *Middle East:* Reliance on fixed pay. Annual bonus awards are typically lower than western markets. Long-term incentive plans are becoming more popular, but are only in place in 25% of companies in Saudi Arabia. Grants are also typically lower. Companies are concerned about retention and motivation of individuals given the high levels of variable pay elsewhere.

Australia – key themes

- Introduction of clawback provisions
- “Two strikes rule”
- Link between pay and performance
- Concerns about the amount of executive pay
- New guidance on remuneration governance in development

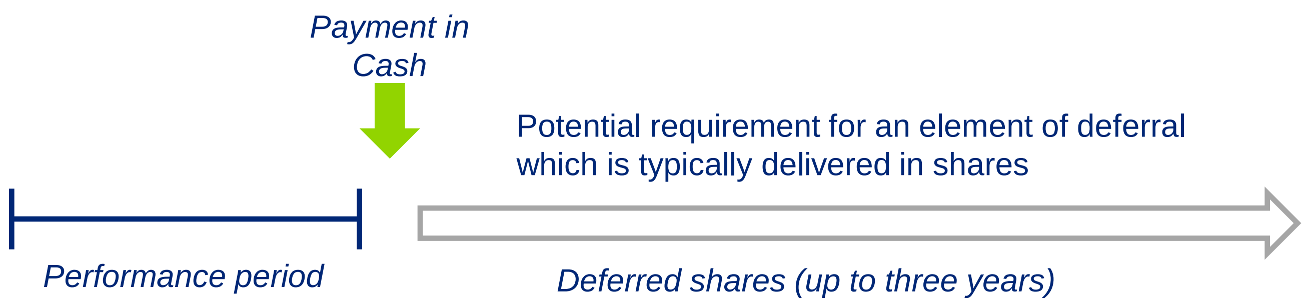
Bonus plans

Bonus plans

Purpose

- Incentivise performance against specific KPIs
- Performance measured against short-term goals
- Is a ‘one-off’ reward for this period’s performance
- Typically a cash payment which is payable on a monthly, quarterly and annual basis
- Developing international best practice - element of bonus deferral into shares

Illustration of bonus



Bonus plans

Key considerations when implementing a bonus plan

How?	• Bonus pool, sum of targets, multiplier approach
Who?	• Which individuals? • How far down the organisation? • Which business units / geographies?
What for?	• Financial and non-financial KPIs? • Corporate vs individual KPIs? Weightings? • Setting targets / measuring performance • How does the plan fit in with the overall compensation philosophy?
How much?	• Competitive pay vs good value • Funding model • Distribution model
When?	• Usually 1 year performance period • Deferral?

Bonus plans

Market practice in Russia

Typically between 3 – 6 KPIs
Revenue and profit are the most common

Only few companies incorporate an element of discretion in bonus assessment

Participation in bonus plan usually throughout the organisation

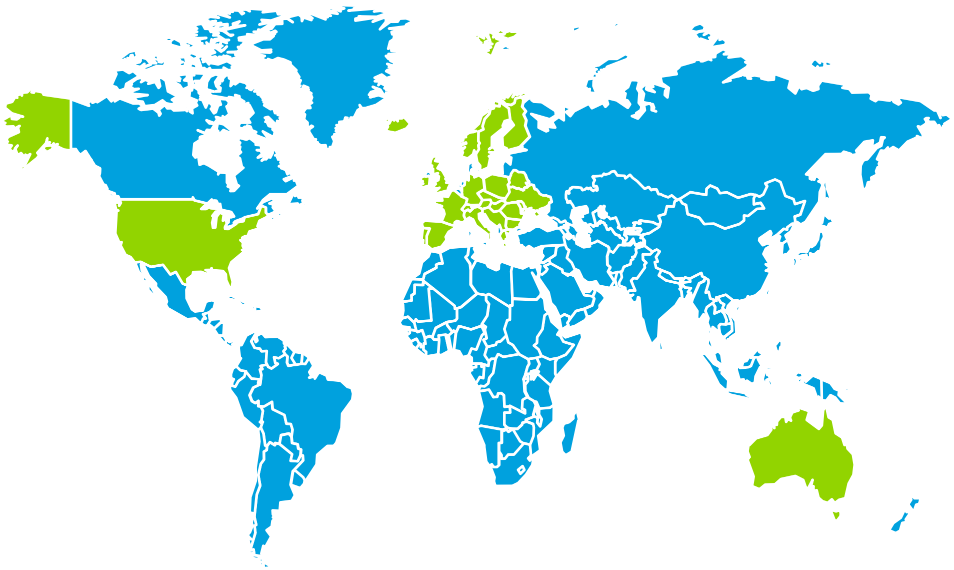
Amount may equate to up to 200% of salary, and could be substantially higher in larger companies or in Financial Services

Frequency of payment varies – monthly or quarterly for non-management employees, for more senior quarterly or annually

Deferral only used by a handful of companies with a premium listing in London, driven by UK best practice

Bonus plans

Market practice – Rest of world



UK

- Typically combination of a financial measure (profit) and non-financial KPIs
- Typical amount is between 1-2x salary
- Most companies operate deferral
- Clawback provisions increasingly common
- Shareholders increasingly demanding justification for bonus payments

US

- Typically use a combination of financial and non-financial KPIs
- Revenue and earnings are the most popular financial KPIs
- Deferral is less common than in the UK but still exists in some companies

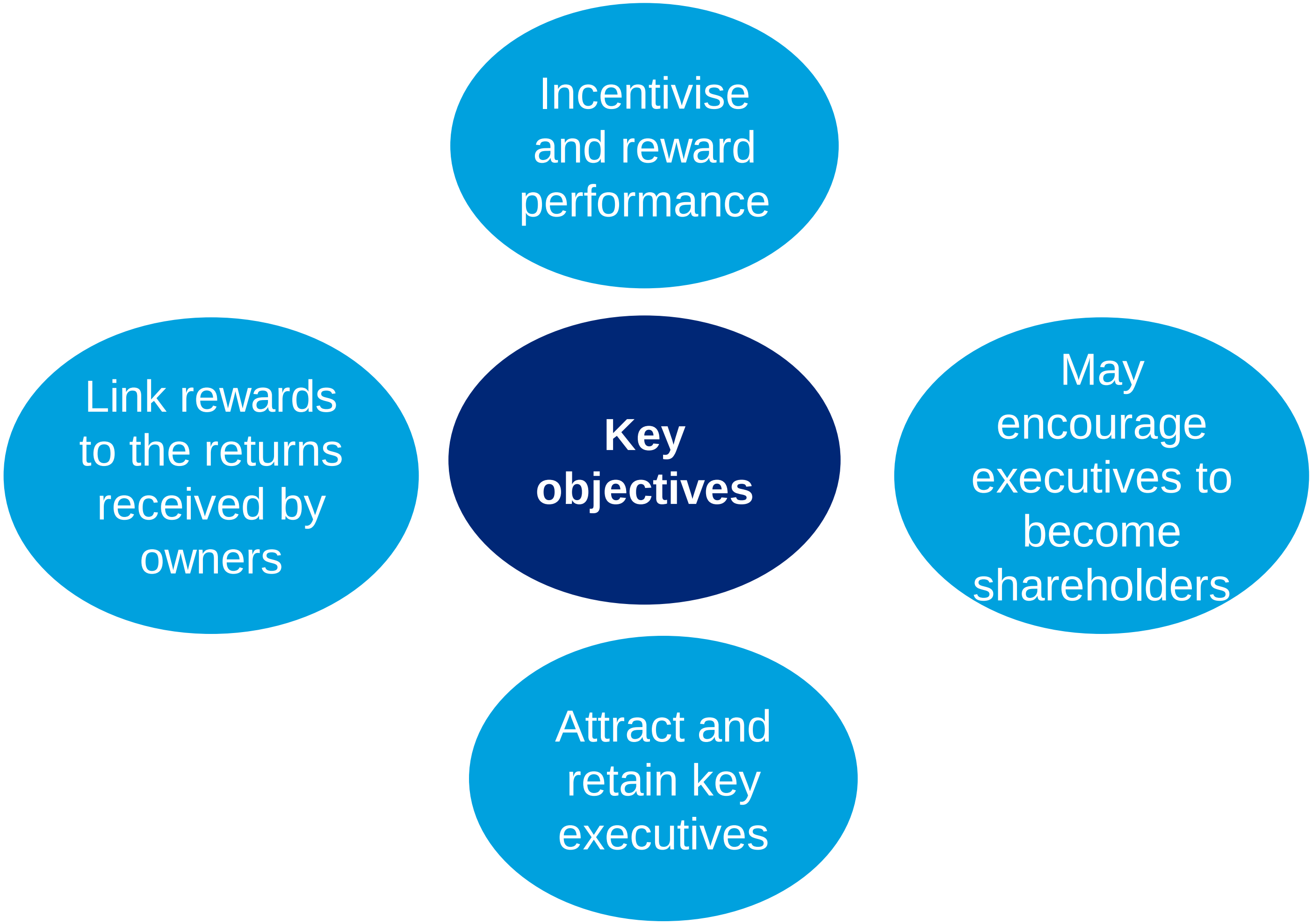
Australia

- Balanced scorecard of KPIs
- Deferral of part of bonus into shares becoming increasingly common
- Amount typically between 1-2x salary

Long-term incentive plans

Long-term incentive plans

Purpose



Long-term incentive plans

Key considerations when implementing a LTIP

How?	• Cash, shares, options
Who?	• Which individuals? • How far down the organisation? • Which business units / geographies?
What for?	• Incentivise, reward, lock-in, create shareholder value? • What is the link to the business strategy? • How does the plan fit in with the overall pay philosophy?
How much?	• Competitive pay vs good value • How much can the Company afford?
When?	• Timescales? • One-off or annual grants?

Long-term incentive plans

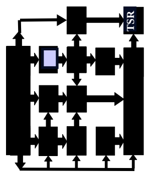
Different award types

Performance Shares	Market-value options	Cash
• Participants have a right to receive a certain number of shares subject to achievement of KPIs • Allow participants to receive value from the award even if the share price falls • Alignment to shareholder experience	• Participants only share in value if the share price increases. Therefore incentive to grow the share price • A larger number of options need to be granted to deliver the same value as performance shares • Already an inherent share price growth condition • Volatility of share price can significantly decrease value despite underlying good performance	• Participants receive a cash sum subject to achievement of KPIs or a share in the growth in value of the company • Not linked to share price • No dilutive effect • Simple

Long-term incentive plans

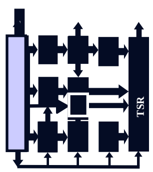
Performance measure selection

Includes measures focused on the 'top line', such as sales.



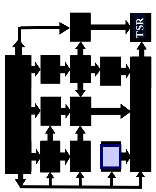
Revenue based measures

Includes measures based on achievement of strategic, commercial and/or personal objectives, e.g. linked to achievement of strategic milestones.

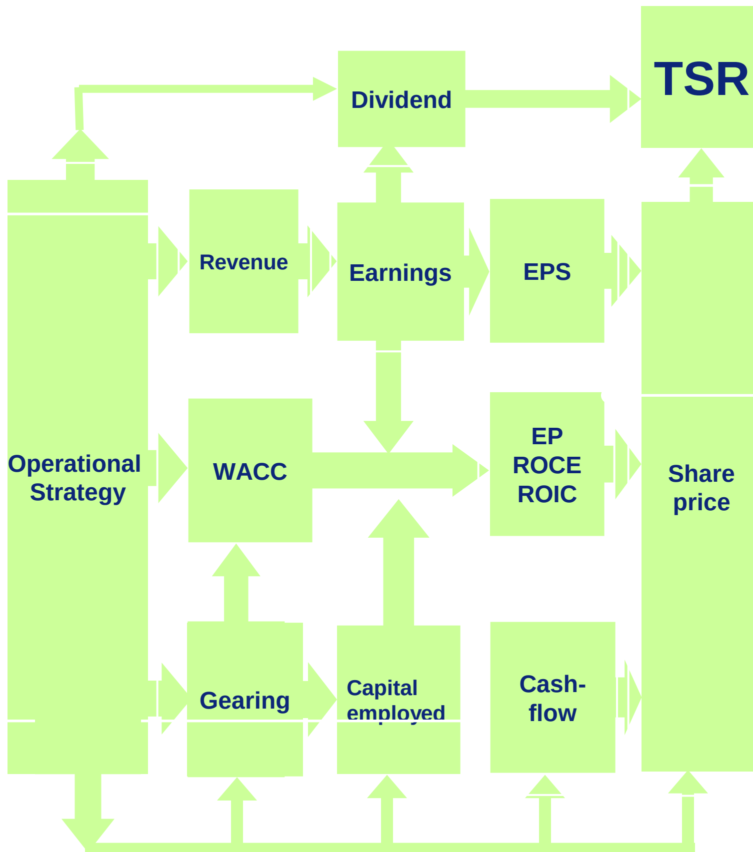


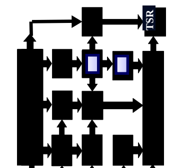
Strategic measures

Measures of cashflow.



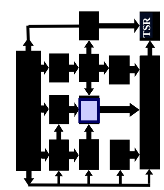
Cashflow based measures





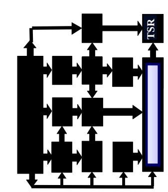
Profit based

Includes measures focused on profits/earnings, such as EBIT, EBITDA, EPS, etc.. The most commonly used senior executive measure in short term incentives



Capital focused measures

Includes measures linked to efficiency of capital use, e.g. economic profit and variants of return on capital employed.

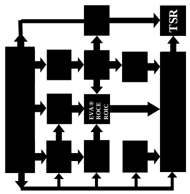
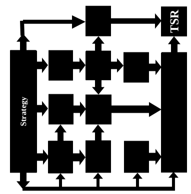
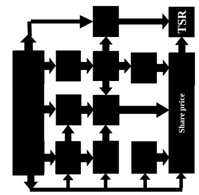
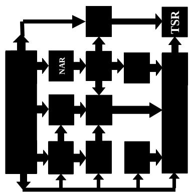
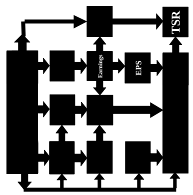
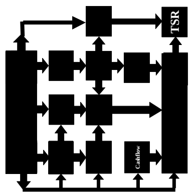


Share price based measures

Includes measures such as targeted share price and TSR.

Long-term incentive plans

Performance measure selection (cont.)

	Capital focused measures	Strategic measures	Share price based measures	Revenue based measures	Profit based measures	Cashflow based measures
						
Advantages	Provides a strong link to shareholder value creation Favoured by analysts	By linking to business plan and strategy, strategic milestone measures can be (internally) transparent indicator of individual performance	Strongest link to value creation and highly transparent	Relevant to business and recognised for sector as an important measure of performance (e.g. like-for-like sales and sales per square foot)	More directly under management control. Relatively well understood by investors and common as short term incentive measure and in longer term plans through EPS	Provides good indication of ability to cover financing costs and overall health of the business
Disadvantages	May be most suitable for capital driven companies, as opposed to those driven by revenues/earnings	Inherently subjective and so open to objections that they lack (external) transparency. This may also devalue the measure if decisions on whether they have been met are considered arbitrary by prospective participants	Share price performance already inherent in share-based plans. Share price reflects market perception of expected performance so may not be a good indicator of actual performance	Measurement questions and potentially too remote from ultimate delivery of value	Can be perceived as too narrow (e.g. relative to capital focused measures). Differences between accounting treatments can make inter-company comparisons problematic Adjustments can make some analysts distrustful of the measure	Adjustments can make some analysts distrustful of the measure

Ultimately, decisions on performance measures will depend on individual business economics and business maturity, how capital focussed is the business and how good is the line of sight to the different measures

Long-term incentive plans

An illustrative timeline for designing and implementing a long-term incentive plan

Design phase			Implementation phase
Understand company strategy and objectives	**Work with the company to develop potential solutions**	**Finalise proposals**	**Implement plan**
1 – 2 weeks	*2 – 3 weeks*	*Depends on scope and complexity of the plan*	
• Meet key stakeholders (e.g. Board directors, major shareholders, CEO, CFO, HR Director) to develop a better understanding of the Company's strategy, views on remuneration and objectives of the plan • Identify key metrics used to measure Company's performance • Identify current incentives used at the Company and undertake research on market practice	• Develop alternative designs for initial discussion including: – Form of award – Performance measures – Participation – Time horizons • Consider advantages and disadvantages of various approaches and technical considerations for each design • Consider high level overview of company valuation principles / costs (if appropriate)	• Refine and develop preferred approach • Consider more detailed design considerations • Develop detailed term sheet summarising key terms of the plan • Finalise and agree company valuation (if relevant) • Consider funding, accounting, legal and tax treatment • Agree award levels	• Draft legal documentation • Draft employee communications and award documentation (e.g. description of plan, legal and tax treatment etc)

Illustrative timeframe

Long-term incentive plans

Market practice in Russia

Around half of Russian companies which we have analysed as part of our research operate a long-term incentive plan

Typically operate phantom stock options

Share price growth is the most common KPI

Performance shares vest after three years, while option plans typically in tranches

Amount ranges from 1-3x salary, and up to 5-6x salary for some large companies

Many plans include industry-specific KPIs e.g. production targets for companies in the Resources sector

Long-term incentive plans

Examples of Russian market practice

RusPetro (Oil & Gas)	Uralkali (Chemicals)	Raven Russia (Property)
Performance share plan • Annual award • Award levels - 150% for CEO, 125% for other Executive Directors • 50% Relative TSR against a comparator group of Oil & Energy companies • 50% for improvement in the efficiency of capital expenditure required to increase production • 3 year performance period • Clawback applicable	**Performance share plan** • Long-term incentive • Total shareholder return relative to a comparator group • Adjusted to the volatility of the Russian stock market versus the US market • The absolute risk adjusted stock performance will also influence the amount of remuneration • No disclosure in the annual report on how these adjustments would be performed	**Combined bonus and long-term incentive scheme** • Award levels – max 300% p.a. of salary for Executive Directors • Annual awards based on performance during the year. No post-vesting performance conditions • Principally subject to operating cash income targets. If these are not met then assessment against TSR or NAV is performed • All awards must be retained until April 2016

Long-term incentive plans

Examples of Russian market practice

Polymetal (Mining)

Bonus pool linked to share price performance

- One-off award prior to IPO
- Bonus pool linked to share price increase above threshold
- 2.5 year vesting period
- Participants may extend this by one year, at their sole discretion
- Company has signalled its intention to adopt a more conventional LTIP going forward

X5 Retail Group (Food Retail)

Restricted Stock Unit Plan

- Award level – 200% of base salary
- Up to 1/3 for CEO, and ¼ for other participants subject only to continuous employment
- Performance criteria include performance against a group of competitors in achieving sustained growth and international presence, and EBITDA
- 2 year vesting period
- Additional holding period of 2 years

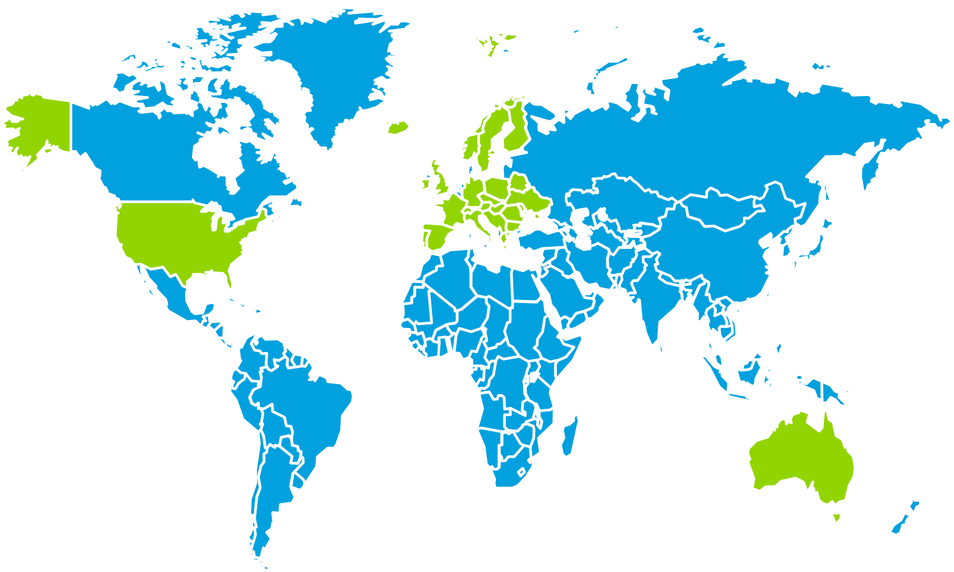
Russian resources company

Long-term cash and option plan

- Percentage of issued share capital for option element, cash as a % of salary
- Annual grants for cash
- Options granted every three years
- Strategic targets including production and cash flow
- 3 year performance period

Long-term incentive plans

Market practice – Rest of world



UK

- Most companies only operate a single share plan which is typically a performance share plan
- FTSE 100 median award is 200% of salary
- Performance share plans typically use two performance measures (e.g. EPS and TSR) though this is changing
- Some companies are beginning to think of unifying bonus and long-term incentive arrangements into a single plan
- Shareholding guidelines

Western Europe

- Many companies operate two long-term incentive plans, usually a combination of performance shares and options
- LTIs most prevalent in Switzerland, Germany and the UK
- LTIs typically account for one-third of total compensation
- Profit and TSR or other share price metrics are the most popular performance measures
- Most performance shares plans have a four-year vesting period (other than in the UK – see above)

US

- Most companies have two or more plans (performance share plan / restricted shares & options)
- Companies increasingly using performance share plans rather than option plans or restricted shares
- Typically only one or two performance measures are used, usually including a financial measure and/or TSR
- LTIs often account for at least two-thirds of total compensation

Australia

- Performance share plans most common
- Typically KPIs include a combination of EPS / TSR
- Performance periods are normally 3 years
- Amount is between 1-2x salary

Corporate governance

Corporate governance

Why it is important to get it right?

Compensation often seen as proxy for overall governance

Belief that better governance increases returns

Give investors confidence through transparency

Alignment of shareholders' and executive interests

External pressure

Improve company valuation

The role of the Compensation Committee

The key questions for a Compensation Committee:

- **How much** should we be paying?
- **What** are we paying for? And **how**?
- Does the compensation policy support our **business strategy**?
- Will the approach be acceptable to **shareholders**?

Corporate governance

Market practice in Russia

We analysed the annual reports of Russian companies with listing on the London Stock Exchange:

- **88%** have a Compensation and Nomination Committee
- **27%** have a separate remuneration report

75% of Compensation Committee Chairmen are independent

90% of Audit Committee Chairmen are independent

33% of directors on the board are classified as independent

2/3rds of directors on the typical Audit or Compensation Committee are independent

Corporate Governance

Financial Services Regulation

Following the financial crisis, a significant amount of regulation in relation to compensation has been released in Europe covering the financial services sector. The European-wide regulation will affect the European subsidiaries of Russian Financial Services companies and the subsidiaries of European companies in all countries (including Russia). The main regulations include:

	Regulation	Timeline	Scope
Europe	CRD III	Already effective	• Banks, Building Societies and limited licence firms • CRD IV will be implemented on 1 January 2014. It has been confirmed that this will include a 1:1 cap on fixed/variable pay ratio (2:1 with shareholder approval).
	AIFMD	July 2013 (subject to transitional provisions)	• Alternative investment fund managers (AIFMs). • ESMA issued final guidelines on remuneration rules in February 2013. • National regulators will now need to transpose into local regulation. In the UK, the FSA is due to publish a further consultation paper and then issue final rules in June 2013.
Russia	Central Bank Regulation N 2894-U “On Bank Economic Position Assessment”	1 July 2013	• Banks • Amount of incentive payouts should be based on the risk profile and profitability metrics of the bank • For executive management and risk-takers, variable compensation should be no less than 50% of total compensation • At least 40% of variable pay must be deferred for three years or more, and include clawback

Consistent themes: Risk alignment of pay | Payment in instruments | Increased deferral | Clawback

Questions for you

Making incentives work for you

Do the plans you have in place **effectively motivate** senior management?

Are they **competitive** in the right market?

How important are your incentive plans to **your employees**?

Does the package reflect your **strategy**?

Could incentives be **simplified** so that they are **easier to understand** and **administer?**

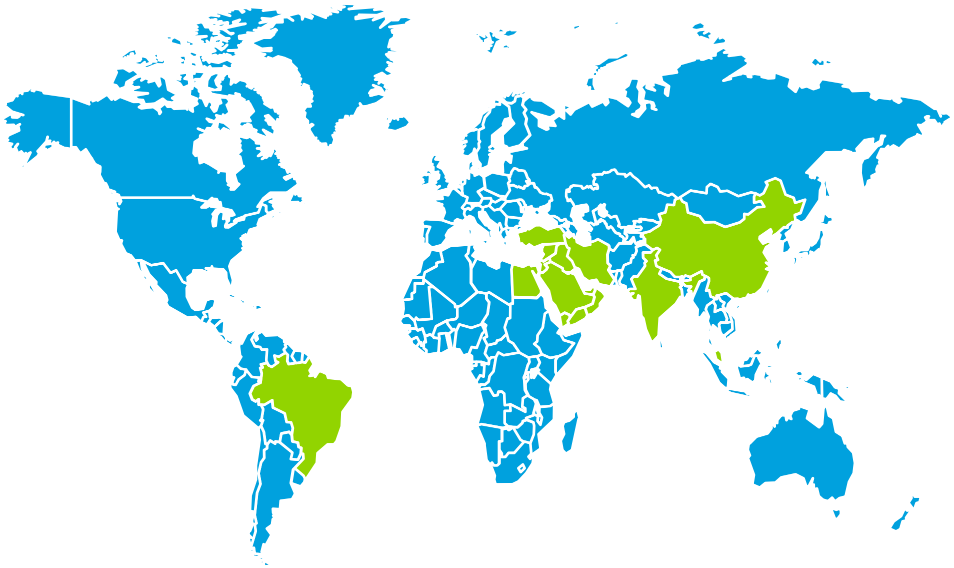
Are **the corporate governance structures** in place appropriate?

Questions?

Appendices

Appendix 1: Bonus plans

Market practice – Rest of the world (BRIC & Middle East)



China and Singapore

- Amount is between 1-1.5x salary
- Earnings growth and shareholder returns are two common KPIs, as well as ROIC, ROE and cash flow.

Middle East

- Amount is around 0.5 – 1x salary
- Mainly linked to individual or strategic performance, though most plans include Revenue or Net Income as a KPI
- Deferral and clawback provisions are popular in the financial services sector, but are not really seen outside of this sector

Brazil

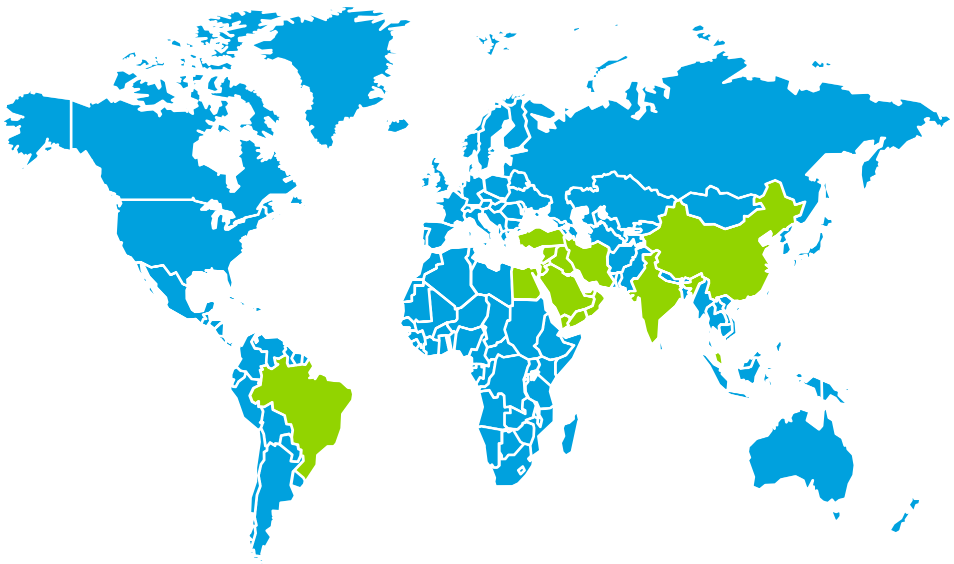
- Amount is around 1-2x salary
- Mainly linked to company results
- Deferred cash bonuses common
- Total pay is often significantly higher compared to top management in other developing countries

India

- Bonus remains modest as focus remains on large salary increases (c.10% a year)
- Amount is typically around 50% of salary

Appendix 2 Long-term incentive plans

Market practice – Rest of world (BRIC & Middle East)



China and Singapore

- Many different LTIP types including performance share plans, restricted share plans and share option plans
- Only 1/3 of Singaporean companies with LTIPs made LTIP awards in 2012, despite 78% of companies having one in place
- Amount is typically c. 30-50% of salary

Middle East

- Significant legal and cultural barriers to LTIPs
- 30% of companies operate an LTIP
- Plans vest over a three year period, most phased
- Award level of 1-2x salary
- Net income growth, return on equity, and dividend yield are popular KPIs

Brazil

- Difficult to operate long-term incentive plans in Brazil due to disputes about tax treatment
- Most companies operate profit sharing plans ,or stock options plans or share plans
- Phased vesting common

India

- Very few companies operate LTIPs
- As companies become more concerned about the unsustainable levels of salary increases and the resultant retention problems, LTIPs may become more popular