

Executive Compensation In Asia - Best Practices In A Dynamic Environment

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Are publicly-listed companies throughout Asia paying their executives for the performance they help to achieve? Organizations in this part of the world have been mostly unscathed by the recent global economic woes, and are continuing to grow at a brisk pace. In fact, other than Japan and Taiwan, more than 50% of companies in several other Asian countries are expecting profits to increase in their next Fiscal Year (see Figure 1).

Figure 1: Country profit expectations for FY 2011 [Source: 2011/2012 Asia Executive Remuneration Snapshot Survey]

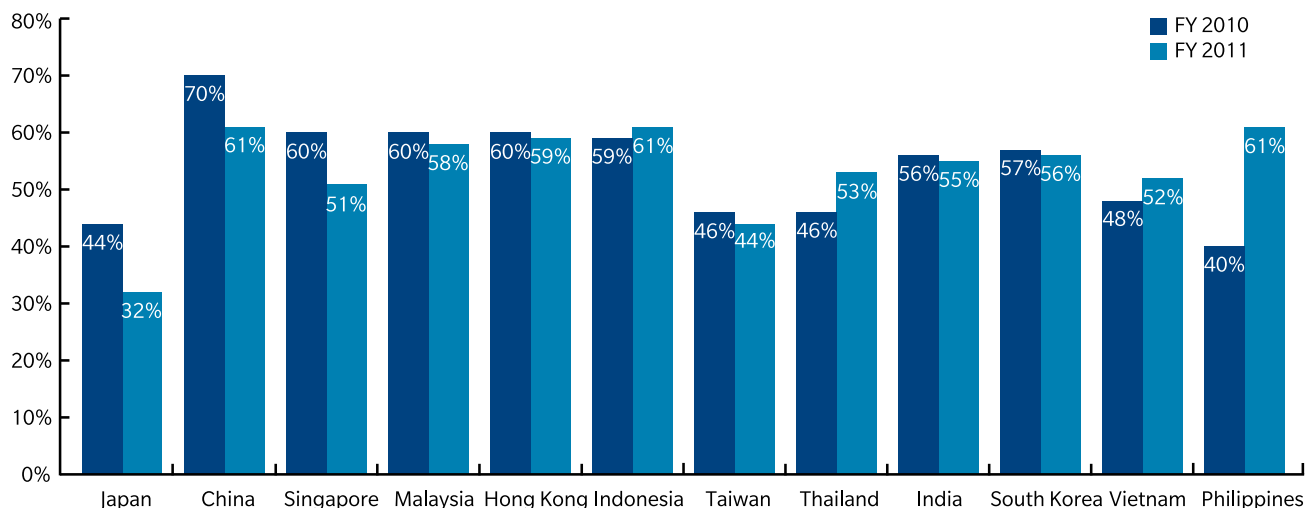
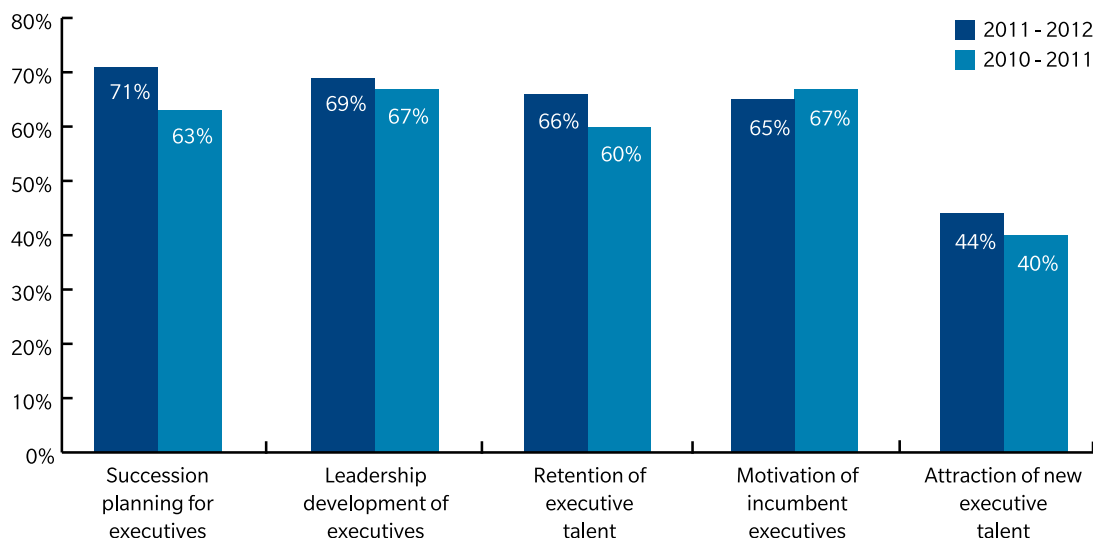


Figure 2: Main executive talent challenges [Source: 2011/2012 Asia Executive Remuneration Snapshot Survey]



Continued Growth

Even organizations in relatively “slow” economies, as Japan, are once again facing concerns related to talent retention. In the region’s rapidly evolving economies, there aren’t many certainties or even lasting trends. Yet one thing remains constant: An organization’s store of talent is vital to its continued growth. The illustration below (see Figure 2) shows that Executive Retention is one of the top three issues for most companies and this concern is increasing, reflecting the fierce competition for talented leaders among Asian organizations in “growth mode”

The resulting dilemma of paying for performance or paying for retention leads to some compelling questions about executive pay programs in general and the pay-for-performance philosophy in particular:

- Are executives paid too much, or is their pay aligned with shareholder value creation?
- What is the proper role of equity in a compensation program?
- What objectives should Remuneration Committees of Asian listed companies pursue: To attract and retain executives, or to deliver pay for results?

- How can companies differentiate between outstanding, average, and below-average performers and ensure that they still retain their key executives?
- And what should time horizons be for both individual and corporate performance assessments, as well as wealth creation over the course of an executive’s career?

Complications In Paying For Performance

These questions illustrate that “pay for performance” is far more complicated than the popular press suggests, and more so in Asia’s high-growth economic environment. Even though the “pay-for-performance” concept has become widely accepted, many companies have also discovered that the devil is in the

details. Simply doling out stock options at all levels of the organization is hardly an effective long-term approach, even if it does appear (even if only on the surface) to tie pay to performance and to foster retention.

Inability To Retain Talents Is A Key Business Risk

The notion of human capital as an investment to be cultivated, as opposed to a bottomless resource that can be tapped on demand, represents one of the most significant shifts in business thinking in recent years. In boardrooms around the region, it has become increasingly accepted that successfully competing for human capital is as important as competing for market share. The latter is not likely to occur without the former. In fact, it could

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In Asia, we find that companies provide a greater amount of variable pay than their Western counterparts in the region. In fact, the fact that the fixed pay element for Asian companies has fallen from 60% in 2009-2010 to 41% in 2011-2012 highlights the trend that Asian companies prefer more flexible pay structures which can be adjusted – up or down – based on business performance.

well be that retaining talent is harder than retaining clients. As a matter of fact, according to a recent (July 2011) Conference Board Inc. research in the U.S., human capital risk ranks fourth out of 11 risks in terms of potential business impact. This makes it more important than many other business risks that often get more attention, including IT, finance, supply chain, and reputation. When The Economist Intelligence Unit asked risk managers to rank 13 key risks, human capital topped the list! As a result of the above, effective human capital may become the single most important driver of long-term financial success and shareholder value creation.

In this article we provide an overview of how executive pay programs in Asia attempt to deal with this dichotomy. In our experience in the Region, there is no single “right” or even “best” way to blend all the elements of an effective pay-for-performance program. However, there are certain guiding principles that high-performing companies can follow, when designing and implementing their pay programs. These principles represent our understanding of “Asian current best practices” in this area and can help ensure that any reward program is properly aligned with a company’s overall business objectives, that it measures and rewards the appropriate performance factors, and that it delivers meaningful remuneration to support executive retention.

Common Practices In Executive Rewards In Asia

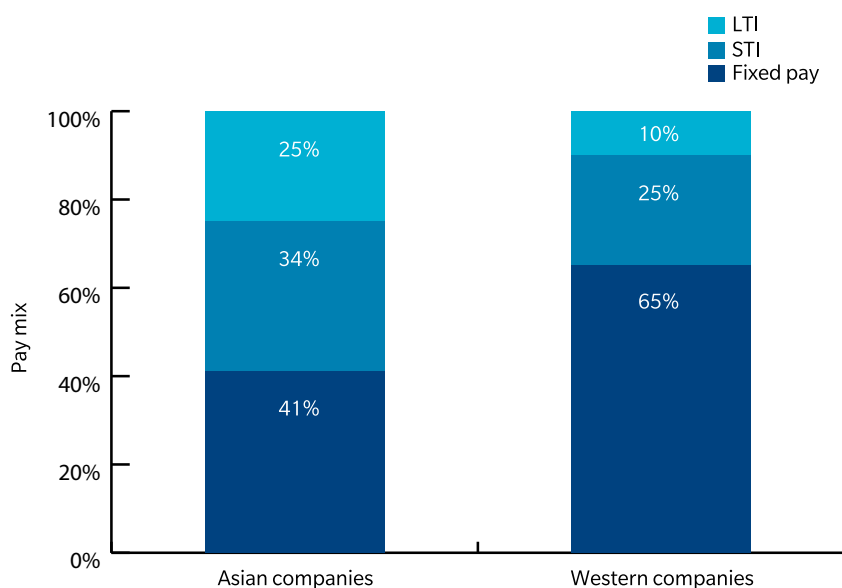
Common Practices of Asian companies must be understood in the context of several key themes that should form the foundation of any successful executive pay program. But their actual implementation can (and in fact often does) vary considerably from organization to organization. In the main, the majority of companies (and by extension the Remuneration Committees of their Board) generally follow these in the pursuit of designing and implementing an effective executive pay for performance system.

Market Competitiveness

Given the high priority placed on Talent as we saw in Figure 2 above, it is no surprise that there is a low supply of qualified, experienced, multi-cultural and capable CEOs in Asia. This top talent can demand a higher wage, and therefore companies and their Boards have to be willing to provide a higher level of pay to get the higher calibre of talent that can deliver the results shareholders expect. Otherwise, this talent is likely to go to the highest bidder.

Executive Pay in several countries in the region (e.g. Singapore and Hong Kong but also increasingly in Japan, China and India) is fairly transparent. This allows Boards to determine what competitive pay levels are for the talent they seek to attract and retain in terms of fixed salary, annual bonus, and LTI, along with other executive benefits. The most difficult decision a Remuneration Committee need to make in this respect is about the group of companies to choose for appropriate comparisons. This is not so straight forward in Asia as there are a limited number of large organizations in the same industry in each country (For instance, Singapore has only three locally

Figure 3: Compensation mixes at Asian & Western companies from head of organization to second level reports [Source: 2011/2012 Asia Executive Remuneration Snapshot Survey]



listed Banks) making comparisons more art than science. Many Remuneration Committees opt for choosing companies of a similar size, even if in different industries, under the premise that a CEO in one industry could be poached by a company in another industry.

Another area of concern regarding Market Competitiveness relates to pay mix. How much to provide in Fixed vs. Variable Pay? And how much for Short vs. Long-Term results? How much Cash vs. Equity to use? These are important questions to ponder as Remuneration Committees need to balance the need for retention of executives with the desire of value creation for the shareholders. An appropriately balanced pay program, including both short-term and long-term measures, should address the concerns that “Too much pay is given to Executives” by ensuring there is enough variable pay-at-risk and an adequate link so that non-performance of the executives results in low bonus / long-term payout and thus low overall levels of pay.

In Asia, we find that companies provide a greater amount of variable pay than their Western counterparts in the region. In fact, the fact that the fixed pay element for Asian companies has fallen from 60% in 2009-2010 to 41% in 2011-2012 highlights the trend that Asian companies prefer more flexible pay structures which can be adjusted – up or down – based on business performance (see Figure 3).

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And when they do, they are less likely to use shares than cash. There is perhaps less willingness to dilute the shares of the company in general in Asia. However, this is a trend that should wane as more Asian companies become global. For instance, AIA which is the world’s fifth largest insurance company, headquartered and listed in Hong Kong, has Long Term Programs which are aligned to global market practices.

Key Performance Indicators

For an organization to develop a successful pay-for-performance program, it must have a clear idea of the objectives it wants to achieve. While this may sound simplistic, without such clarity, it is difficult to identify the type of performance that should be rewarded, or to link performance to compensation. What does success look like next month, next year, and beyond? When such clarity in defining Key Performance Indicators

exists, the remaining elements of an effective pay-for-performance program can be put in place.

To align pay to performance requires proper calibration of compensation programs, to ensure that the levels of pay delivered are in line with levels of performance that are actually achieved. Consider a company that, as part of its pay-for-performance philosophy, provides highly leveraged annual incentive opportunities with maximum payouts equal to two to three times an executive’s “target” award. Theoretically, the company should only be paying out the maximum bonus amount when actual performance is outstanding. But what does “outstanding” mean? By comparing performance targets to both the recent and expected performance of relevant peer companies, we can determine if the plan’s definition of superior performance is, in fact, superior. Without such external validation, usually through annual reports and analyst’s reports, a company with a pay-for-performance philosophy risks overpaying for mediocre performance or even underpaying for exceptional performance

In Asia, companies use Profits and Total Shareholder Return as the two most used Key Performance Indicators in share plans (see Figure 5).

In this context, it is important to note that companies are often using a combination of hard internal financial metrics with external validation of performance against peers in implementing their pay programs. Such external calibration is often both retrospective, to assess how the company actually performed compared to its competitors, and prospective, to ensure

Figure 4: Asian and Western companies’ prevalence of LTI plans [Source: 2011/2012 Asia Executive Remuneration Snapshot Survey]

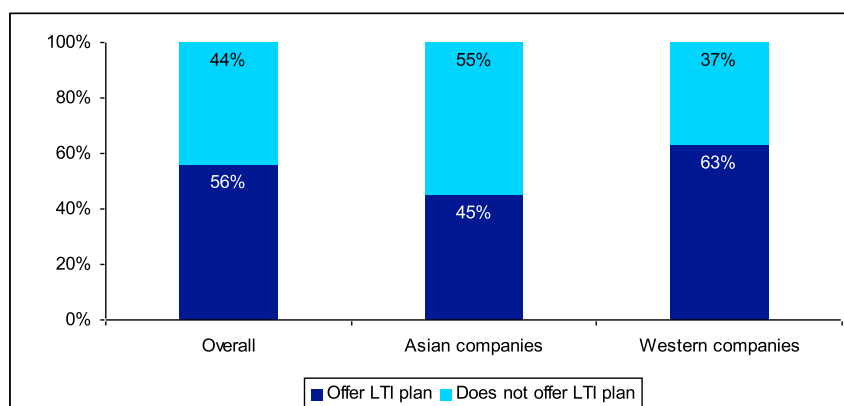
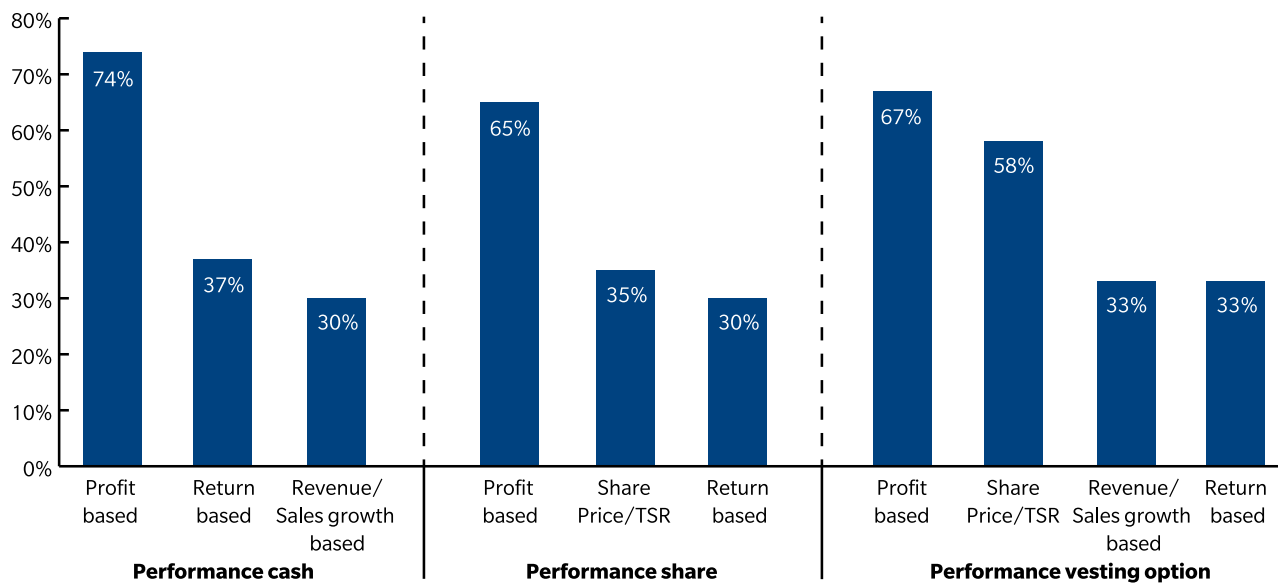


Figure 5: Prevalence of measures used in share plans [Source: 2011/2012 Asia Executive Remuneration Snapshot Survey]

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that performance targets include an appropriate degree of “stretch”.

Personal accountability is in many ways the hallmark of an effective pay-for-performance program. A well-aligned program with a rigorous performance evaluation process means little if, at the end of the year, individuals are not held accountable for meeting agreed-upon goals. Traditionally, a strong sense of accountability has meant that “the numbers tell the story.” While this notion of “black and white” results is common (numeric targets are either met or they are not), our research shows that 41% of Asian companies (Mercer 2011 ER in Asia) also use non-financial measures in their incentive plans. This can take the shape of a formal “balanced scorecard” in which performance is evaluated in specific areas such as people management, customer satisfaction or process improvements. The measures typically are quantitative, but they can give a more appropriate picture of overall

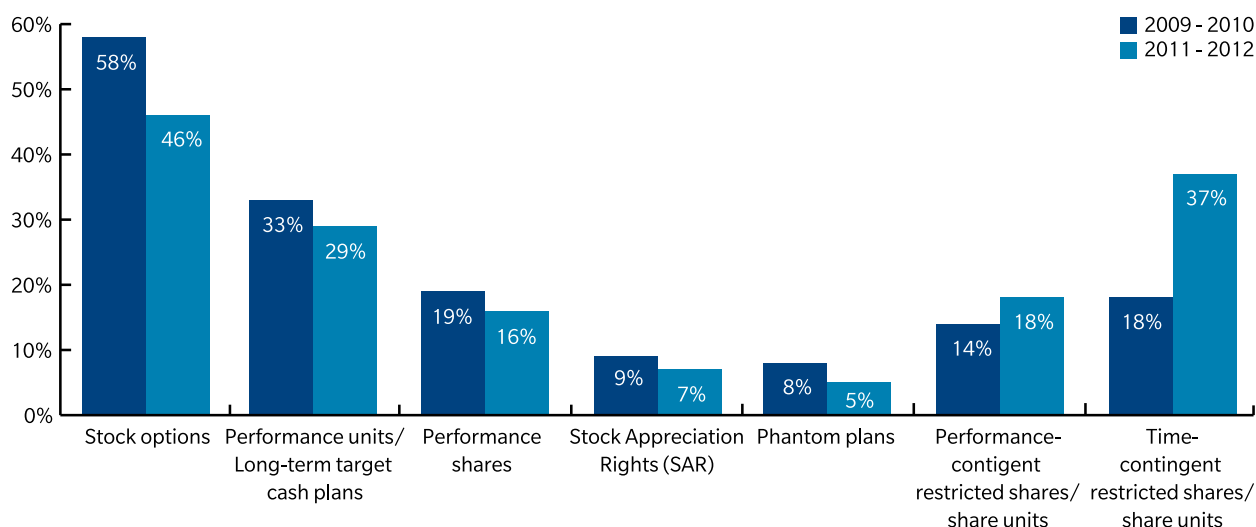
performance than rigidly adhering to a single financial metric such as Return on Equity. In fact, in an environment where, as we have indicated, retention is important and competition is intense, these non-financial metrics can be as strategic as the financial ones are. Take for instance the common criticism that CEOs get paid while employees are laid off. By adding people variables into the incentive plans, Remuneration Committees can address shareholders as well as stakeholders simultaneously. In either case, strong performance should be rewarded and poor performance should not.

Striking The Right Balance

One of the most challenging aspects of any executive pay program is striking the right balance among various compensation elements and performance measures. As Asian organizations grow and become increasingly complex, their multiple objectives are not always compatible. In the short term, many companies believe that meeting or exceeding the analyst’s expectations each quarter is critical. But how can they balance that short-term focus with a long-term need for sustainable growth, some of which may require investments that will actually reduce the short-term earnings? Over what time periods should performance be evaluated? In Asia, annual incentive plans are commonplace, but many companies also have multiyear plans to

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Figure 6: Prevalence of LTI plan types [Source: 2011/2012 Asia Executive Remuneration Snapshot Survey]



ensure that key executives do not lose sight of their longer-term objectives. And what about the balance between cash compensation and equity? It is no surprise that in Asia companies are moving away from Stock Options to other types of plans as the use of Stock Options can lead to retention difficulties in the current volatile market. Instead, Asia companies are using more restricted shares along with cash based plans to aid both in retention as well as linking pay more to performance (see Figure 6)

Good practice suggests that an executive's pay should have both fixed and variable components. The fixed component is designed to pay a

competitive wage for the accountability of the position, recognising that there is a competitive market for talent. The variable component should be linked to both short-term and long-term performance periods. The short term measures should furthermore be directly linked to the longer-term strategy of the business (e.g., the annual components of a 3-year strategy), and therefore the successful achievement of these goals should lead to long-term shareholder value creation. In Asia, all these are practiced but, in addition, there is a greater use of LTI plans for retention purposes; companies often have more than one plan to balance their need for

performance with their need to retain executives (see Figure 7)

Balancing Performance Against Retention

A frequent criticism in the popular press about executive compensation programs is that sometimes executives receive pay without an adequate performance to justify it. To be fair, this sometimes does happen. However, these types of articles seldom give examples of 'no pay for no performance', of which there are far more. Another delicate balancing act involves rewarding top individual performers when the company as a whole is not doing well. While it may be

Figure 7: Expected changes to LTIPs by Asian companies in 2012 [Source: 2011/2012 Asia Executive Remuneration Snapshot Survey]

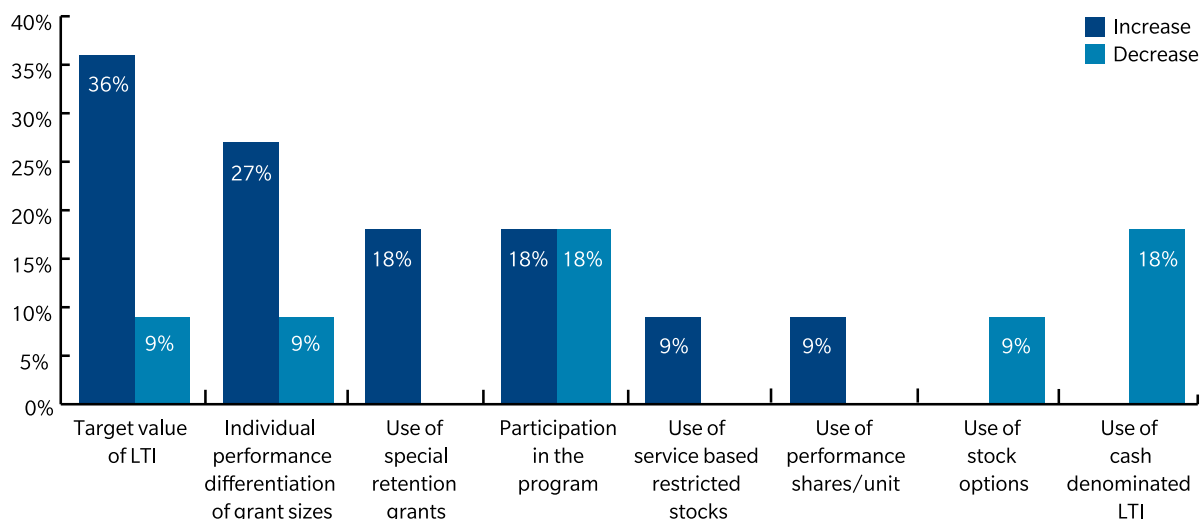
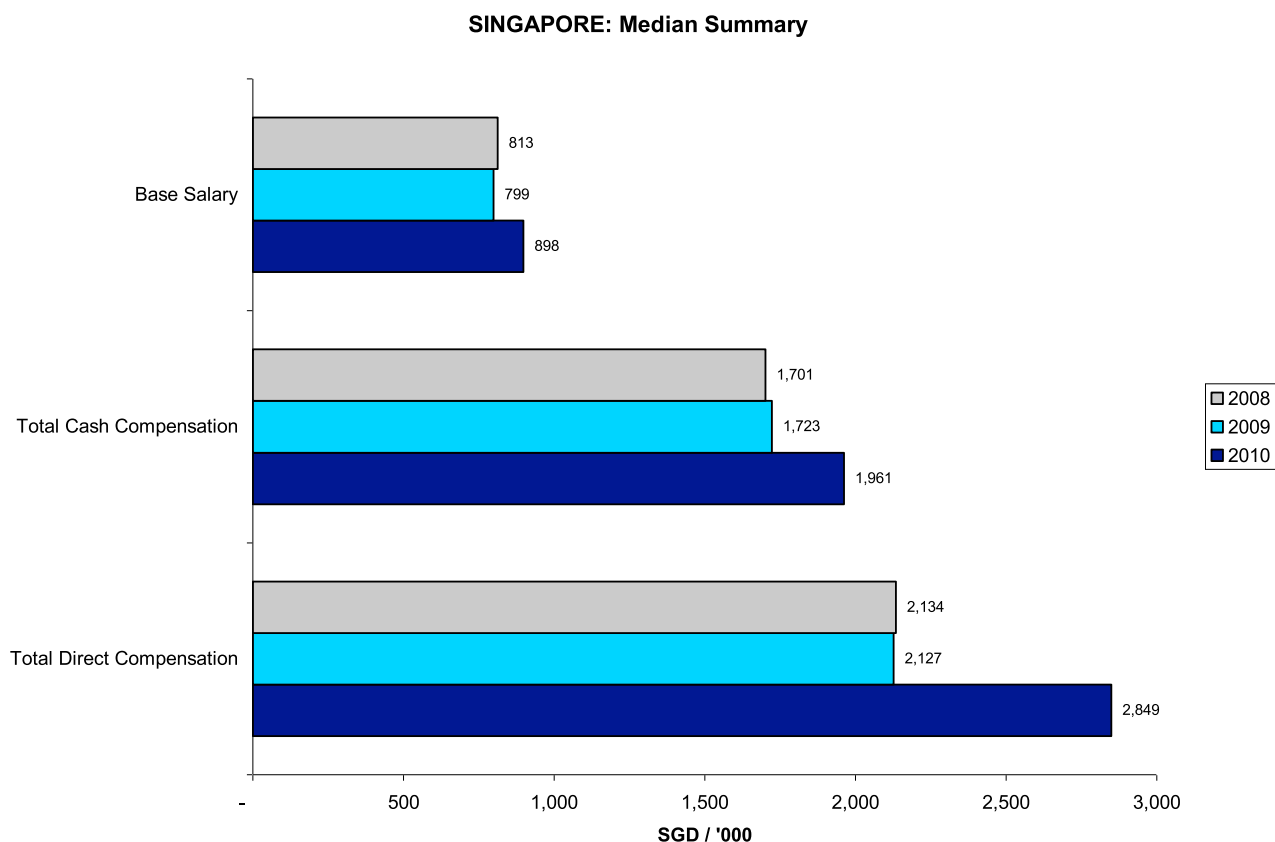


Figure 8: Median base salary, total cash compensation & total direct compensation in Singapore from 2008-2010

tempting to argue that no single person should receive a substantial reward if some baseline level of organization performance is not achieved, such an approach can be shortsighted at a time where good executives are hard to come by and harder still to retain. When an organization is not performing well, the top performers of today are the ones who will drive overall performance improvements in the future. Failure to deliver rewards to top performers in difficult times can result in retention problems that can exacerbate the poor company performance problem even further, because those top performers are most likely coveted by the company's competitors as well.

Corporate Governance

Shareholders have a right to know the financial decisions a company makes, and executive remuneration is effectively an expense that should be disclosed in more detail. Several countries in Asia

have made strides in the direction of greater transparency, partly spurred by the Financial Stability Board's guidelines for Financial Institutions. Variations of these good Corporate Governance practices have been adopted by Hong Kong, Singapore and other countries and they have had a spill-over effect on regulators and boards alike of organizations in other industries. To be sure, disclosure leads to

greater information which helps regulate and control pay but it has the side effect of potentially inflating pay, as Nomination Committees find they need to go beyond median levels of pay to attract external CEOs. With that said, shareholders should continue to request greater transparency in how executive pay was determined, what benchmarks were used and insist on a long-term element in determining

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pay. Disclosure should be supported by clear guidance and regulation, with the appropriate consultation period prior to implementation.

AN ILLUSTRATION: SINGAPORE

CEO's Compensation Stagnated During The Financial Crisis

Mercer analyzed CEO pay at 36 major Singapore listed companies whose median revenues over the 2008 – 2010 period ranged from approximately S\$1 billion to S\$1.7 billion. Figure

8 shows that during the years of the financial crisis total compensation did not increase. CEO pay increased in all three compensation elements (base pay, annual bonus and the annualized value of the long term incentive award) in 2010 when business performance and economic conditions in Singapore picked up substantially. Total cash compensation consists of base salary plus actual short-term incentives. Total direct compensation consists of total cash compensation plus the annualized value of the long-term incentive award.

Singapore provides a good case example for analyzing Asia's Executive

Compensation trends, as it has fairly transparent compensation disclosures in company annual reports, a dynamic stock exchange with large volumes of transactions of local companies' shares and a growing economy.

Do Companies In Singapore Pay For Performance?

Mercer conducted a further study to determine if pay for performance is the norm for these companies. We mined data from as many publicly-listed companies as possible, with the proviso that they had available data on levels of pay for their CEOs, separated by salary, annual bonus, and long-term plans. We ended up with 48 companies for our analysis

Total Direct Compensation Correlated To Market Capitalization

Figure 9 shows that the three-year average CEO's total direct compensation for the companies in the analysis is best correlated ($r^2 = 28.1\%$) with

Figure 9: Correlation of 3-year average total direct compensation (2008-2010) against market cap

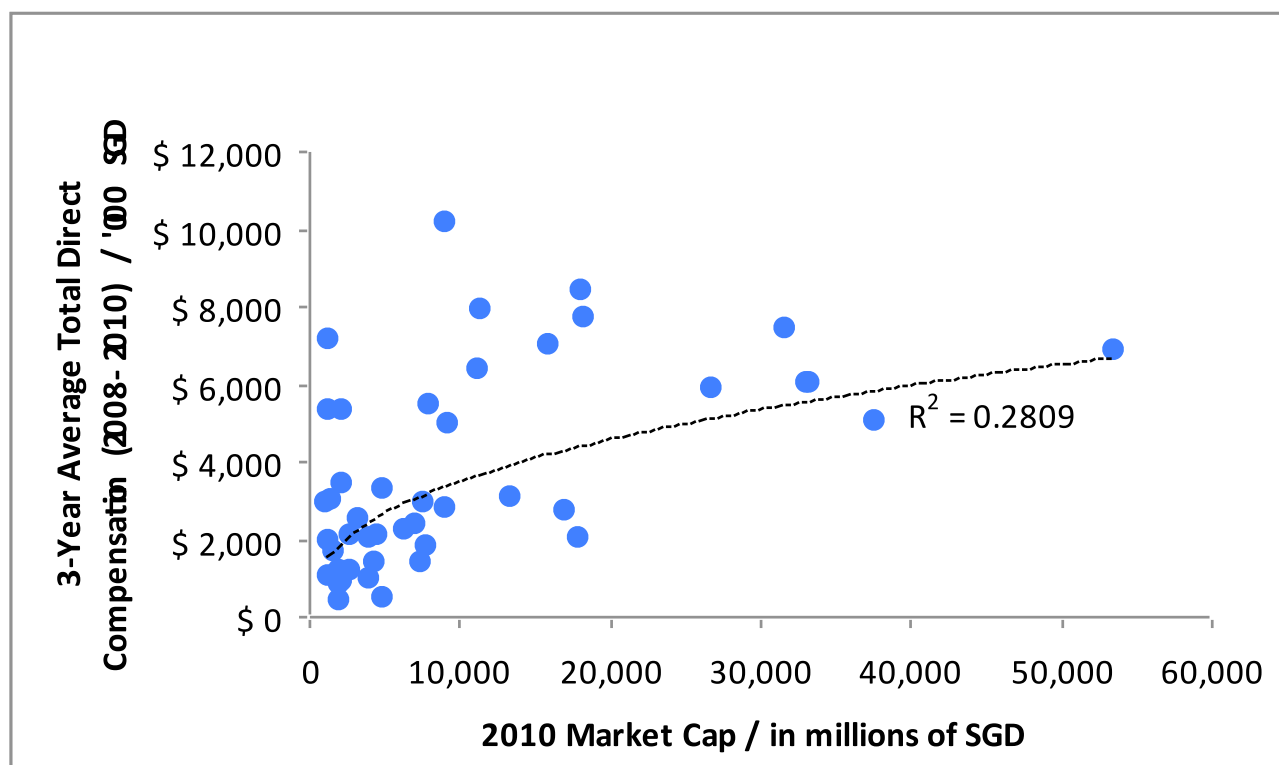
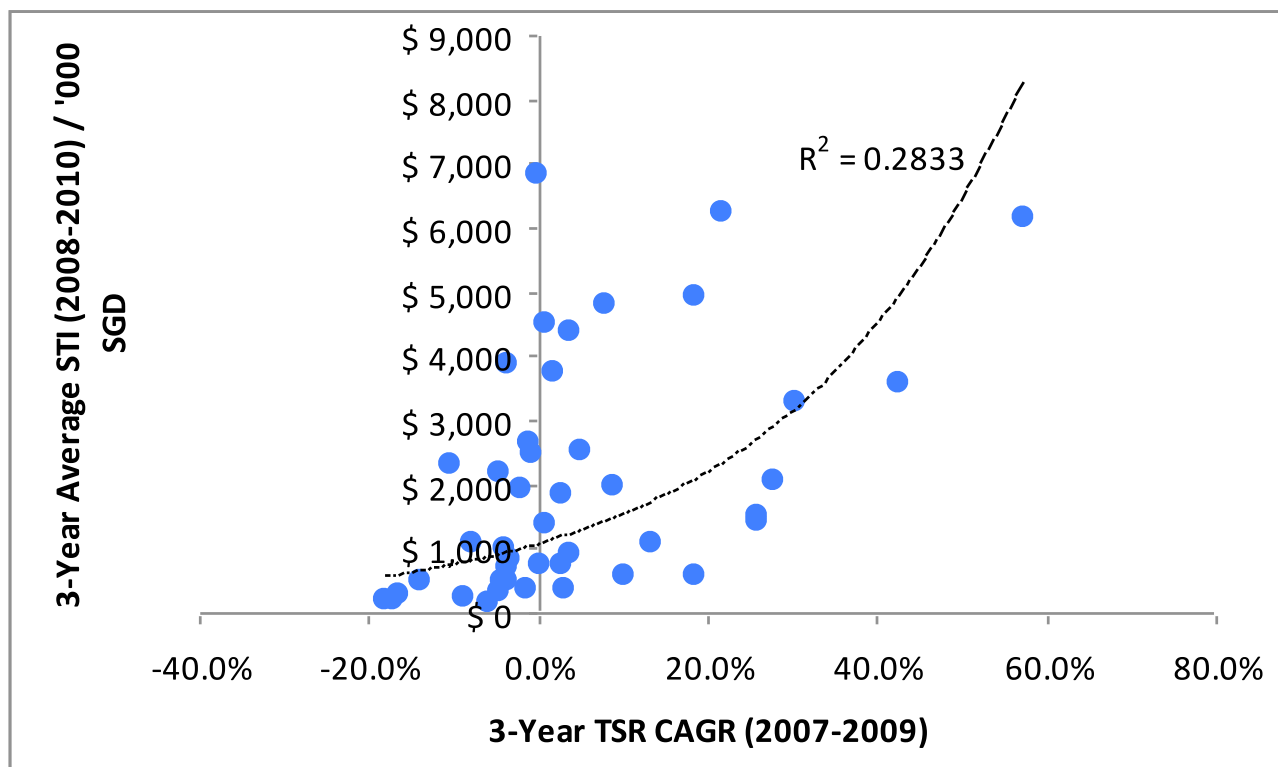


Figure 10: Correlation of 3-year average STI (2008-2010) against 3-year TSR CAGR (2007-2009)

market cap. For the group of companies in the sample, the total pay received by a CEO is best explained by the size of the company.

It is important to note that we also ran the analysis against several commonly used financial measures, including growths of Net Income, EBIT, EBITDA, Return on Assets (ROA) and Return on Equity (ROE). Of these, market cap has the highest correlation, suggesting that overall pay is linked to company size.

Short-Term Incentives (STI) Correlated To Total Shareholder Return (TSR)

When looking separately at each of the components of executive pay, 3-year average annual bonuses correlates best (r-squared = 28.3%) with the same three-year Total Shareholder Return

variable for these companies, with a one-year lag. (See Figure 10)

Long-Term Incentives (LTI) Correlated To Market Capitalization

Market cap is the dominant variable for both the base pay and Long-Term Incentives. Base Pay shows a slight correlation of 9.6% with Size of Company (Market cap). Long-Term Incentives show a significant correlation of 64.0% to market cap, as shown in Figure 11.

The Truth About The Compensation Mix

Does this mean that Long-Term Plans do not work in Singapore? No!

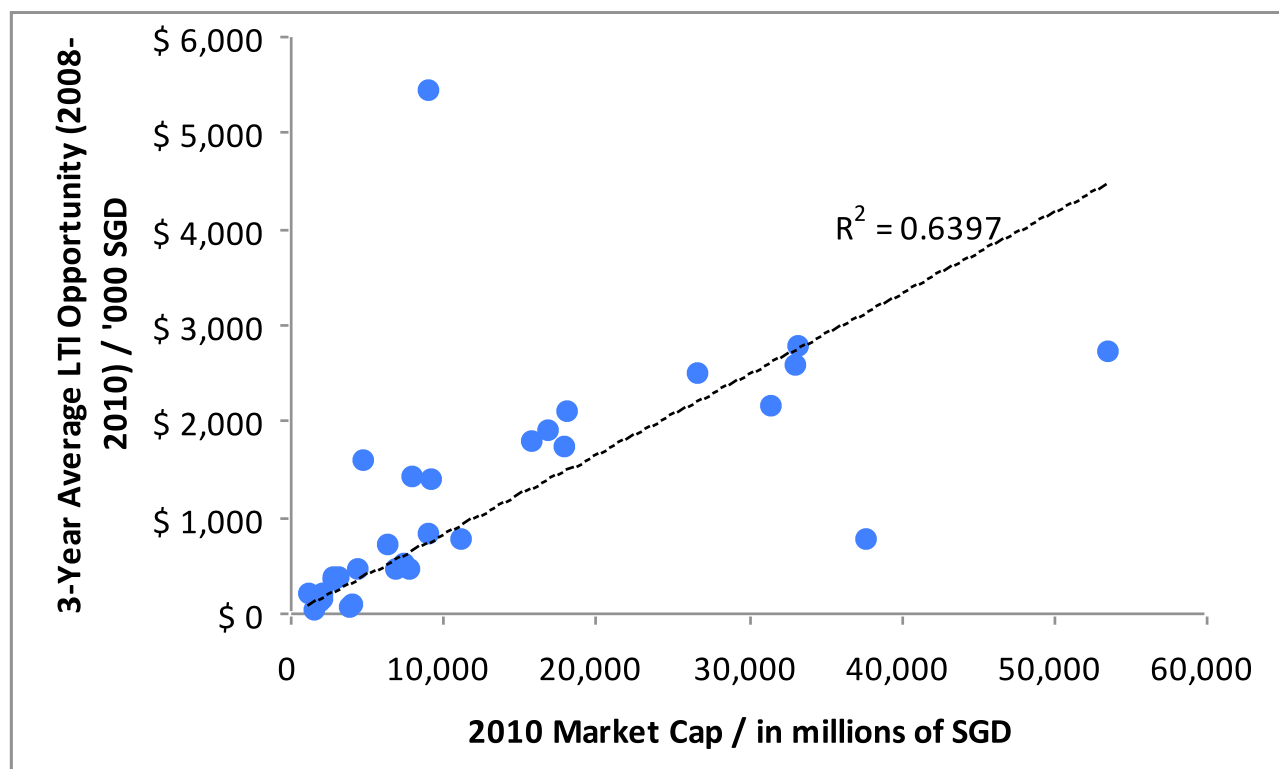
On the contrary, the data supports the notion that the market overall understands the need to both pay for performance and pay for retention of the CEOs.

The need to reward for performance is clear. Remuneration committees are seemingly setting the short term incentive plan amounts to pay for performance aligned to the shareholders, resulting in the correlation of the bonus amounts with the TSRs.

The need for retention is also clear. Remuneration Committees are seemingly setting Base Pay and Long Term Incentive plan amounts against a peer group of companies which are similar in size. This results in the correlation, especially of the LTI, with the market cap. In our experience, Remuneration Committees in Singapore typically compare against other companies in the industry as well as companies in the range of one-half to two-times their Company's market cap. This is done on the premise that they can hire their next CEO from a smaller

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Figure 11: Correlation of 3-year average LTI Opportunity (2008-2010) against 2010 market cap



company yet they can lose their current CEO to a company up to twice their own size.

Conclusion

Executive Pay has received a great deal of “bad press” lately. A frequent criticism is that executives do not earn the pay they receive; or that all related parties have a vested interest in increasing levels of executive pay. Sure, there are a few “bad” examples out there which fuel this fire, but comments of this sort really trivialize the role of Directors, and specifically of the Remuneration Committees. In the work that we have been doing in helping companies design and implement Executive Pay Programs

Singapore provides a good case example for analyzing Asia’s Executive Compensation trends, as it is has fairly transparent compensation disclosures in company annual reports, a dynamic stock exchange with large volumes of transactions of local companies’ shares and a growing economy.

for the last fifteen years or so in Asia, our clients (RemCo Chairs) take their role very seriously and objectively. In the main, publicly listed companies in the region understand the need for aligning pay to long term shareholder value creation, yet they temper it with the equally strong need in the region to

retain the good talent they have. And they also balance the shareholders’ view that quarterly earnings matter with a long term perspective. As Corporate Governance guidelines are honed around the region, we expect the trend towards more responsible Executive Compensation will continue to expand. ■