Mining Journal

FMG sets reporting standards

Pretty damn impressive. That's my take on the Fortescue Metals Group remuneration report.

John Robertson* | 07 Sep 2017 | 13:27 | Opinion

How FMG chief Nev Power and colleagues are paid and for what is crystal clear; something of an industry anomaly

Australian-listed companies must produce annual audited statements of their remuneration practices and outcomes. The Corporations Act describes in detail the information they must disclose.

Companies must also submit their remuneration reports to shareholders for approval. Under the law, insufficient support could result in a spill of board positions.

Over the upcoming annual-meeting season, hundreds of directors will be nervously awaiting their shareholders' approvals.

Report quality varies but tends most frequently toward the lower end of the feasible range. Mostly, remuneration reports are turgid recitations of standardised scripts.

Repeated references to 'shareholder value' and 'alignment with shareholder interests' – concepts mentioned nowhere in the Act – are usually rhetorical smokescreens as linkages with remuneration outcomes go largely unexplained.

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Remuneration reports, if well written, can offer important insights into executive effectiveness. If poorly written, insights are sometimes even more compelling.

The FMG remuneration report stands out as an example of high-quality statutory reporting. The company's explanation of its goals, the measures it has adopted to monitor performance and the related outcomes are clear.

The design of the report complements the overall quality of the content. The layout is a credit to the report's designers and those who must communicate to them the key ideas for inclusion.

In short, shareholders would be hard-put to ask for more.

"Shareholders are now being asked to endorse a redundant scheme in favour of one for which no details are being given"

In common with other companies in the sector, FMG's executive remuneration structure has three layers: a cash salary entitlement; short-term incentive payments based on measures of performance calculated over a single year; and equity-based performance rewards based on measures extending over multiple years.

Within this common structure, FMG places more emphasis than other companies on financial and operational outcomes and less on share-price performance in defining executive rewards.

Making share-price movements, either absolute or relative, the center-piece of remuneration packages attributes more power to executives than they actually possess.

At the margin, macro events well beyond the sway of executives can easily overwhelm company-specific influences on share prices.

Sound corporate management is a necessary condition for strong market returns in the longer term but not sufficient.

Production, costs, safety and capital management are factors executives are most able to influence. After that, whether a share price is five or 15 times earnings has more to do with decisions by Mario Draghi, Janet Yellen and, perhaps, Kim Jong-un.

Share-price-related rewards raise the proportion of remuneration attributable to executive luck and correspondingly reduce the proportion for executive skill.

Among the financial measures that distinguish FMG from the pack is an emphasis on return on capital, which figures in both its short term and long-term incentive components.

Return on capital employed remains the mother's milk of equity markets and, in the end, the only true source of corporate value.

Over the past year, long-term rewards for FMG executives have been tied to achieving returns on equity of 20-30%.

In an industry in which companies try justifying projects using discount rates as low as 5%, FMG's approach verges on the revolutionary.

Gold and base-metal miner Independence Group has decided to abandon entirely even its lowly 10% rate of return target, which had been part of its long-term incentive plan, in favour of a share-price related measure of performance.

Independence says it has adopted a 50:50 split between absolute share-price performance and relative performance giving executives a possible benefit if the share price rises by enough or, under some circumstances, even if the share price falls.

Rewards for relative price performance are commonplace but do not accurately replicate the interests of investors. Ordinary shareholders are never financially better off from a lower share price.

Like fund managers with performance-linked fees, directors should consider recouping prior losses before rewards start accruing or stop talking misleadingly about shareholder alignment.

If anything, the FMG rate-of-return target has probably been too ambitious and was likely to require unsustainably-high iron-ore prices for it to be achieved consistently.

To avoid demonstrably unrealistic goals being ignored, an incremental return may be a more effective remuneration tool.

Trying to add one or two percentage points to the existing return (possibly after adjusting for any changes in metal prices) rather than targeting an absolute outcome would be consistent with executives striving to push the value base higher each year.

FMG has pared back its minimum return target for forthcoming years to 15%. The lower return still beats the cost of capital and a 30% stretch was retained for the maximum benefit. Importantly, the reasons for the change were explained clearly.

Not all companies are as transparent. Pilbara Minerals, for example, has adopted what it describes as "a new remuneration policy and formulated a framework, which is more appropriate for the company's transition from development to a mining operation".

Unfortunately, Pilbara shareholders are now being asked to endorse a redundant scheme in favour of one for which no details are being given. Going through the motions is commonplace.

FMG stands out for its detailed description of management goals. The company has quantified production cost targets (eg. a C1 cost of US$12.16/wmt in fiscal year 2017) in its short-term pay scheme, for example, and disclosed actual outcomes.

In contrast, Independence Group directors have baulked at such forthright disclosure invoking a right to confidentiality "due to the sensitive nature of some corporate KPIs".

Orocobre, another ASX 200 company, has offered only the most general descriptions of its remuneration benchmarks without quantification of production, quality or cost targets.

Despite the apparently prescriptive nature of the remuneration reporting rules, the quality of the information on which investors must base their decisions varies greatly.

Using a proprietary remuneration report rating framework, PortfolioDirect has scored the quality of reports in 2017 as low as 11 to as high as 95 on its 100-point rating scale. FMG is at the top end of what is on offer so far.

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