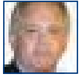
Who are my peers?

Company pay schemes continue to present a range of problematic questions



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The choice of peer companies for remuneration schemes should be as free from subjective judgements as possible to mirror the choices confronting investors.

How to turn salaried employees into capitalists is not as straightforward as it might seem at first blush. Having access to equity alone does not do the job.

As long as equity is granted without any capital contribution, undeserving executives get a free ride when external events drive share prices higher. Without any capital contribution there is no capital loss in the event of a share price downturn. Some executives even get another bite at the cherry at a lower price. Executives' risks differ materially from those of shareholders who have committed capital.

The concept of a peer group of supposedly equivalent companies against which to measure share price performance before any rewards are conferred is designed to help mitigate the potential for underserved outcomes. Apollo Minerals Ltd is one company going down this route.

Last November, Apollo shareholders approved an offer of three million ordinary shares to the company's executive chairman in the event that the Apollo share price beat those of its peers by at least 20%, as long as the company also attracted a strategic investment of more than A$2 million (US$1.9 million) and the chairman achieved the KPIs set by the board for the performance period.

Under the approved formula, rewards could be higher with a better relative share price outcome. Five million shares would be available if the Apollo share price outperformed the selected peer stocks by more than 60%, for example.

At face value, the Apollo formula neatly connects executive pay with the primary sources of investor wealth, although not all the features of the Apollo scheme are as commendable. Contrary to recommended governance practices, non-executive Apollo directors are given access to the same scheme as company executives, potentially hobbling board independence.

In choosing peers for its scheme, Apollo would have had to confront the choice faced by all ASX resources companies wanting to define a peer group for inclusion in an executive remuneration plan. There is no obvious independent benchmark for the 1,000 or so resources stocks making up nearly half the companies listed on the ASX.

On track… a peer group of supposedly equivalent companies against which to measure share-price performance before any rewards are conferred is meant to help mitigate the potential for underserved outcomes

The S&P/ASX 200 resources index corresponds most closely to the key S&P/ASX 200 equity benchmark tracked by investors in the Australian market. However, the index is dominated by BHP Billiton, which has a 40% weighting. Combined with Rio Tinto and Woodside Petroleum, the largest three account for 61%.

The vast bulk of Australia's listed miners would not see this group as peers in any operational or strategic sense, although an investor might see things differently. An investor should be able to expect a better return from an early stage mine developer than from the market leaders to compensate for risk.

There are times, however, when macro forces unconnected with company activities will produce prolonged and large disparities in returns between the market leaders and the rest of the sector, reducing the usefulness of the largest stocks as a performance benchmark.

The small-resources share price index is the most logical alternative candidate for a place in the remuneration schemes of the bulk of companies needing a benchmark measurement. In many ways, the index is the most representative of the available measures of resource-sector performance in the Australian market. Even this, however, comes with some warts.

The construction methodology of the small-resources index allows for constituent stocks to be deleted from the index if their performance falls short of non-resource, industrial-sector share price movements. As a result, the small resources share price index now comprises just 50 stocks compared to 99 at the end of 2010. Thirty-seven stocks discarded in the past year because industrial stocks were performing better had a median share price fall in the June quarter of 17%, compared to the headline index gain of 1.6%. The choice of only the most strongly performing stocks to make up the index biases the outcome and undermines its suitability as a peer indicator.

One reaction to the absence of an independently compiled market measure with sufficient credibility is the route followed by Apollo Minerals. It made up its own list of peers. Directors chose 10 iron-ore explorers and developers in a similar position to Apollo and facing the same challenges and needing to complete similar tasks.

The narrower the base, the more subjective the choice inevitably becomes and the greater the chance of outliers influencing outcomes. The Apollo choice also implies directors were rather selfishly looking at the benchmark choice from their own perspective rather than that of investors. Investors looking for the best returns irrespective of commodity exposure could reasonably expect executives to have a similarly broad perspective when judging the suitability of investment outcomes.

As it happens, the Apollo example itself illustrates why investors should not support schemes with such narrowly defined peer groups. Since last year, Apollo has given up on its iron-ore aspirations and wants to become a copper miner. This leaves the directors of the company with outcomes partly tagged to an irrelevant group of stocks and a shareholder approval based on an erroneous assumption about future activities.

The best solution for companies and for investors is to look at the sector as a whole, without picking and choosing to suit director or executive prejudices about how they should be judged.

Among the nearly 1,000 listed stocks making up the Australian resources sector, the median return over the 12 months to June has been minus 14%. The upper quartile cuts in at plus 25%. The top decile hits at 99%. Executives beating these latter two objective benchmarks could be confident they were adding value for investors looking for the best of what the sector had to offer. They could justifiably get something extra in their pay packets. ▼

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