No pay-off for performance

Mining industry remuneration packages are more likely to reward good luck than skill or achievement.

John Robertson* | 27 Oct 2016 | 7:51 | Opinion

Pay packages that don't index performance against the market are rewarding luck

Australian-listed companies must produce audited annual statements of senior executive employment benefits for shareholder approval. The law aims to give shareholders enough information to decide whether they are getting value for money from their executives and directors.

Despite the intent, increasingly bulky and complex remuneration reports are often a sign of well-paid lawyers and accountants at work rather than evidence of strong linkages between pay and performance.

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The failure of the link between pay and performance is not new and by no means confined to the mining industry.

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Lucian A Bebchuk and Jesse M Fried ('Pay without Performance: Overview of the Issues, Journal of Corporation Law, 2005'), identified "compensation schemes that weaken managers' incentives to increase firm value and even create incentives to take actions that reduce long-term firm value" in a study of US publicly-traded companies.

A mining industry investor is especially vulnerable to being snowed by the adverse tendencies referred to by Bebchuk and Fried.

In an inherently cyclical industry, the market fortunes of a mining company are always going to come from varying combinations of organic effort and the consequences of the macro environment in which it operates.

The executives managing Australia's gold miners, for example, have had nothing to do with the rise in the gold price from A$600/oz (US$460/oz) to A$1,800/oz and the resulting transformation in the economics of the local industry.

"It is no surprise that a culture of noise creation has taken over from value creation as a strategic driver"

Former Federal Reserve chairmen Alan Greenspan and Ben Bernanke, Mario Draghi or Janet Yellen might have had a greater role in these outcomes than any of the benefiting executives.

Being in the right place at the right time is a vital ingredient in the income of a mining executive.

In one sense, mining executives are simply minding assets while awaiting a windfall from the actions of others.

A numerical example illustrates the dominant role of luck over skill in determining executive remuneration where the reward system is based around the typical option-based compensation.

Let's assume that company A is led by an astute executive with a strong sense of value, the epitome of the sort of executive an investor wants at the helm.

Company A is spending US$40 million on a new project. Let's also assume that, after one year, the project will either generate a positive cash flow of US$120 million or, depending on the confluence on uncontrollable circumstances, a negative cash flow of US$30 million. The two outcomes are assumed to be equally likely making the resulting net expected value US$5 million.

Now let's assume that the market price of the company goes up at the beginning of the period by the amount of the expected value increment, namely US$5 million, but that the market adjusts fully to the actual outcome at the end of the period when the evidence is in.

In this instance, the market price of the company will either rise by US$75 million or fall by US$75 million after taking account of the project value and the provisional price change at the beginning of the period.

If the same sequence is repeated year after year, the value of the company will either rise by US$80 million or fall by US$70 million in successive years.

Finally, let's also assume that the executive in charge is rewarded by being granted an option over a percentage, say 10%, of each year's value increment.

Under such an arrangement, the executive would be entitled to a payment of either nothing or $8 million each year.

There is a second less skilled executive confronting otherwise identical circumstances except that he spends US$60 million on the same project.

As a result, the expected net value is a negative US$15 million and the annual change in value of the company under his stewardship would be either an increase of US$60 million or a decline of US$90 million.

The options granted to this second executive at the beginning of the year would be worth either US$6 million or nothing.

Although the second less competent executive consistently opts for value destroying strategies, he ends up with a reward potential little different from the more highly skilled executive.

Luck gets a $6 million pay cheque.

Skill only gets an additional $2 million.

The modest premium for skill embodied in the reward potential of the first executive comes despite a 400% differential in the expected value of their projects.

Certainly, this is a simplified example but other combinations of numbers converge on much the same conclusions.

In businesses with a potentially large variability in the range of outcomes, a defining characteristic of the mining industry, rewards for competence are dwarfed by the size of the rewards for luck.

With so little reward for skill on offer, it is no surprise that a culture of noise creation has taken over from value creation as a strategic driver.

Presentation after presentation from industry executives is about news flow. Executives hop from one commodity exposure to another trying to grab a ride on the latest bandwagon despite such choices being irrelevant over nearly all realistic project development time horizons.

This cultural proclivity towards short-term outcomes also affects investors who tend to focus on near-term trading opportunities, too, as the industry conversation implicitly downgrades the importance of longer-term value.

If directors wanted to change this culture, which is by no means clear, they would have to recalibrate the executive-reward framework.

At-the-money options do not encourage skill. To avoid paying executives disproportionately for luck, directors need to set more appropriate strike prices, which are also indexed to industry outcomes.

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