

Pay on Performance 2014

*Third report on Directors' remuneration in Italian listed companies
The alignment of interests in the long term – Fiscal Years 2011-2013*

ABSTRACT



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Purpose and methodology

The study aims at identifying the main factors influencing the executive remuneration at Italian listed companies, as well as verifying the eventual alignment with the corporate strategies and the interests of shareholders in the long term.

The “say on pay” was introduced in Italy in 2012, therefore for the first time this year it is possible to analyze all remuneration components paid over a period of three years, which represents the usual vesting period of long-term incentive plans. Starting from the policies approved in 2014 and the remuneration paid in 2013, the analysis focuses on the long term, with the main purpose of verifying whether a positive correlation exists between the compensation paid from 2011 to 2013 and the results achieved by the company in the relevant performance periods.

In order to correctly compare the executive compensation with past performances, only the vested remuneration components have been taken into account:

- **cash amounts** paid during the fiscal year, including the base salary, the annual bonus, the vested portion of deferred bonus and long-term incentives;
- **shares granted**, valued at the closing market price on the vesting date; awarded components that did not vest are excluded, as often subject to future performance conditions;
- **vested stock options**, valued at the fair value on the vesting date, even if not yet exercisable (if the company’s reports and accounts do not disclosed the fair value, it has been calculated using the Black-Scholes formula).

The analysis covers 100 Italian listed companies, of an aggregate market capitalization of € 423.9 billion at the end of 2013 (representing 97% of total Italian stock market), including 37 FTSE MIB components (CNH Industrial, STMicroelectronics and Tenaris are excluded as not incorporated in Italy), 60 FTSE Italy Mid Cap components as of December 31st, 2013, and three small companies, which were included in main Italian indexes in the previous years.

Each remuneration component received by the CEOs in the 2011-2013 period has been analyzed in comparison with relevant key parameters:

- The **base salary**, not depending on any performance conditions, has been compared with size parameters (such as the market capitalization, total revenues and average workforce), average wages and share ownership structure;
- The **variable components** have been compared with sector specific performance indicators (EBITDA for non-financial companies, Tier 1 Capital Ratio for banks and Solvency Margin for insurance companies) and common criteria (EBIT and Total Shareholder Return), both in the short and in the long term (3 and 5 years).

Together with the remuneration of the CEOs, the study analyses at the same level of detail the compensations of all other members of the Board, differentiating between Chairpersons and other members, executives and non-executives.

Remuneration policies 2014

Level of disclosure: all Remuneration Reports clearly disclose the general structure of the CEO's remuneration, specifying whether it includes a variable component and how it is paid (cash, shares or stock options). However, it is not possible to estimate the pay-mix and the maximum amount reachable by the variable components in 32 companies out of 100. Less than a half (47%) of analyzed issuers fully disclose the annual bonus' performance criteria, but the level of transparency strongly increases with regards to long-term incentive plans (70% of full disclosure).

Claw-back mechanisms: although recommended by the Italian Corporate Governance Code, as updated on July 2014, only 29% of the analyzed remuneration policies included the possibility to reclaim variable components of remuneration that were paid on the basis of data which proved to be significantly misstated.

Discretionary variable: 43% of analyzed companies still allow the payment of discretionary bonuses, or variable components that are not clearly linked to performance conditions, including welcome bonuses and retention incentives.

Severance payments: the analysis of remuneration policies 2014 confirmed the trend towards a higher alignment with the market best practices in terms of severance payments, which are capped at the equivalent of 2 years of total remuneration (base salary plus the average annual bonus paid in the last 3 years) by 32% of Italian listed companies. Severances paid in 2013 did not significantly exceed the equivalent of two years of base salary, as recommended by the European Commission, with only few exceptions (including € 5,755,000 paid to the former executive Chairman of Telecom Italia and € 4,000,000 to the former CEO of Datalogic).

The remuneration of the CEOs

Total remuneration: the average compensation of Italian CEOs considerably decreased in 2013 (-13.1%) to € 1,746,747, after an increase of 5.8% in 2012. The fixed component represented the majority of the remuneration (56%), while the variable is more focused on the short term (average annual bonuses represented 23% of total compensation, versus 19% of long-term incentives) and benefits represented 2%.

The pay-mix notably changes according to the size of the company and the relevant stock market index. The remuneration structure of companies included in the FTSE MIB index tends to be more aligned with the international best practices, with a large majority represented by the variable component (56%) oriented to the long term (36% versus 20% of annual bonuses). On the contrary, the base salary in mid and small caps represented 67% of the average CEO's compensation in the three-year period 2011-2013, versus a quite marginal long-term variable component (11%).

The fixed component: despite still representing the main component of the remuneration, the average base salary of Italian CEOs decreased by 5.5% in the last two years, from € 1,039,885 in 2011 to € 982,276 in 2013. The amount of the fixed compensation seems to be almost totally independent from the size of the company, but it strongly depends on its share ownership structure: companies with a controlling shareholder (holding more than 50% of common shares) tend to pay 29% less the CEO.

The annual bonus is the only CEOs' remuneration component that increased in 2013, amounting at € 406,829 (+18.5% on 2012 and +9.4% on 2011). It is not possible to verify a direct correlation between the bonus and any performance criteria during the 2011-2013 period. Only in 10 companies the bonus amounts were in line with the annual changes in EBIT during the three years analyzed, while in 3 companies it has been possible to verify a clear alignment with main performance indicators disclosed in the Remuneration Report (Gtech, Interpump and Saipem), and only one company (Astaldi) paid a bonus constantly in line with the Total Shareholder Return (the bonus increased together with increased TSR in the previous year).

The general absence of correlation between annual bonuses and the most used performance criteria is mainly due to the still common practice to allow discretionary variable compensations, which in some cases are considered as a mere integration of the CEO's base salary.

Long-term incentives: the general absence of correlation between pay and performances has been confirmed through the analysis of the aggregate incentives vested in the three-year period 2011-2013, compared to results achieved in the performance period 2007-2012 (from 2007 to 2010 as reference for incentives vested in 2011, 2008-2011 for incentives vested in 2012 and 2009-2012 for incentives vested in 2013). However, the overall level correlation slightly improved taking into account the incentives vested only in 2013, which were more in line with the results achieved in the previous three years, at least in terms of EBIT, EBITDA and Tier 1 Capital Ratio. The correlation is still far from revealing a clear causal relationship between incentives and performances, but the general improvement observed in 2013 may be a result of the introduction of the "say on pay" and the closer dialogue between issuers and institutional investors.

Conversely, long-term incentives are completely independent from the Total Shareholder Return in the vesting period, confirming the noticeable misalignment between the interests of the Chief Executives and those of the shareholders. Taking into account the companies that allowed the payment of long-term incentives, from 2011 to 2013 the CEOs received average rewards equal to 43.2% of their base salaries, while shareholders of the same companies suffered an average loss of 16.9% from 2007 to 2012, which represented the vesting period of incentives.

Also in the case of long-term incentives, the misalignment of interests is mainly due to the fact that several incentive plans are just based on the continuing professional relationship between the CEO and the company (“retention plans”). Furthermore, the correlation coefficients increased taking into account average annual performances, highlighting that even the long-term incentive plans tend to reward more short-term results rather than the creation of sustainable value in the long term.

The impact of the remuneration structure on performances

The study also tries to verify whether different structures of the remuneration policy may affect the company’s performances and the sustainability of the results. The sample of 100 Italian listed companies has been divided in three groups, depending on the CEO’s remuneration structure: (a) including variable components both in the short and in the long term (annual bonuses and long-term incentive plans), (b) companies that reward the CEO in the short term only (no incentive plans) and (c) companies that do not pay any performance-related components to the CEO (only the base salary).

Through the analysis of long-term results, it has been possible to verify that the remuneration structure not only affects the amount of the compensation, which tends to strongly increase in companies providing for both annual and long-term incentives (on average € 6,732,470 in three years, versus € 2,715,095 in other companies), but also the quality and volatility of the performances:

- Companies with short-term and long-term incentives achieved higher and more stable results in terms of EBIT during the five-year performance period 2007-2012. In the same period, companies only rewarding the CEO in the short term, reported negative and much more volatile average performances.
- A similar result has been observed taking into account the TSR: companies with no performance-related remuneration components, reported average negative and more volatile shareholder return from 2007 to 2012, compared to better and more stable results achieved by companies that reward in some way the CEO.

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