

## Corporate Governance

# ESG

Sustainability Research

# Remuneration: pay ratios

## The good, the bad & the ugly



Sustainability Research

In cooperation with:

**HayGroup®**

### Remuneration has become a social issue

There is a growing consensus across geographies, socioeconomic brackets and the political spectrum that the pay gap between workers and executive management should be reduced. It is unclear whether the introduction of pay ratios in the US from 2015 will give investors new ammunition to help achieve this. Nevertheless, remuneration has become a social issue and one that is increasingly linked to income inequality.

### Pay ratios: value evolution rather than pay solutions

How value is distributed between management and workers when profits rise and fall (pay ratio evolution) may well become a key issue for investors. Pay ratios, however, may still not be the ultimate weapon for curbing executive pay inflation, due to peer benchmarking, and the limitations of these complex and cumbersome ratios for the management of human capital. We acknowledge the limited visibility on CEO pay to average workers' salaries and the potential bias that can distort a comparative analysis of pay ratio structures. For example, our research suggests that sectors with more exposure to emerging markets (particularly Africa) have greater pay disparities: we suspect companies operating in such sectors will continue to face upward pressure on wages.

### Investors' pay ratio headaches: we offer some relief

With our research partner the Hay Group, we highlight pay disparities across Europe. Based on 2013 data for a universe of 424 companies, we look for "the good, the bad and the ugly", as we wait for legislation to be introduced in the US and potentially later in Europe. We believe investors will come under increasing reputational pressure to explain their support for remuneration policies that show high disparities between executives and workers.

#### ESG team

##### Robert Walker (author)

rwalker@keplercheuvreux.com  
+44 20 7621 5186

##### Stéphane Voisin (coord.)

svoisin@keplercheuvreux.com  
+33 1 7081 5762

##### Mark Lewis

mlewis@keplercheuvreux.com  
+33 1 70 81 57 60

##### Sudip Hazra

shazra@keplercheuvreux.com  
+33 1 7081 5762

##### Samuel Mary

smary@keplercheuvreux.com  
+44 20 7621 5190

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# This report is the fourth in a series on remuneration

May 2013

Corporate Governance

## Remuneration: Publish why you pay!

**Remuneration: a proxy for strategy and risk**  
We see CEOs as risk-takers responsible for defining and executing strategy, but in some cases their remuneration packages can be considered to entail a degree of asymmetry between risk and reward, ensuring they are remunerated even if performance and shareholder value have declined.

**Linking management incentives to key sector drivers**  
In this report we have focused on 12 sectors. Our first step is to identify the key issues driving each sector and the second is to link these drivers to appropriate financial measures that we believe will ensure that management incentives are correctly aligned with corporate strategy and sector key performance indicators.

**Our top picks for aligning remuneration and corporate strategy**  
We highlight three companies: BMW, Munich RE and Techzip as examples of companies that in our view demonstrate a consistency between our investment recommendation and management remuneration that is tied to long term sustainable risk and reward.

**Sustainability Research team**

<p><b>Robert Walker (author)</b> walker@keplercheuvreux.com +44 20 7623 2168</p> <p><b>Stéphane Voisin (coord.)</b> voisin@keplercheuvreux.com +33 1 7081 2762</p>	<p><b>Erwan Créhalet</b> erwan@keplercheuvreux.com +33 1 7081 2760</p> <p><b>Sudip Hazra</b> shazra@keplercheuvreux.com +33 1 7081 2762</p> <p><b>Samuel Mary</b> smary@keplercheuvreux.com +44 20 7623 2168</p> <p><b>Catharina Saponar</b> csaponar@keplercheuvreux.com +44 20 7623 2168</p>
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Remuneration: Publish why you pay! [Document link](#)

31 November 2013

Corporate Governance

## Remuneration: Beyond short-termism

**Long-term focus for longer-term sectors**  
We expand on our view of remuneration as a proxy for strategy and risk, as outlined in our previous report, *Publish why you pay*, published in May 2013. In this report we focus on six sectors: Airlines & Airports, Construction & Building Materials, Food Retail, Media, Real Estate and Utilities. Excluding media, we find that the rationale for management awards to shift to medium-term performance is driven by two common characteristics: 1) all sector constituents have long-term physical assets; and 2) management/strategic decisions are generally taken on a 5-10 year view.

**Alignment between shareholder interests and investment case**  
For both investors and investment analysts, moving to a medium-term view for long-term-incentive awards would be a positive step. First, it would help deter management from making decisions that might destroy value in the short term (unnecessary acquisitions and capex); and second, it would highlight whether executive performance is both reasonable and sustainable and not just based on cyclical volatility.

**Bonus deferral another long-term anchor**  
The increasing push for deferred bonus awards outside the financial sector is an example of investor and regulatory pressure to encourage companies to rethink remuneration. We expect this momentum to continue, in order to ensure that wealth transfer to executive management is based on long-term sustainable performance.

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<p><b>Robert Walker (author)</b> walker@keplercheuvreux.com +44 20 7623 2168</p> <p><b>Stéphane Voisin (coord.)</b> voisin@keplercheuvreux.com +33 1 7081 2762</p>	<p><b>Erwan Créhalet</b> erwan@keplercheuvreux.com +33 1 7081 2760</p> <p><b>Sudip Hazra</b> shazra@keplercheuvreux.com +33 1 7081 2762</p> <p><b>Samuel Mary</b> smary@keplercheuvreux.com +44 20 7623 2168</p>
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11 April 2014

Corporate Governance

## Remuneration: Companies in the spotlight

**Pay-for-performance challenges**  
In an effort to better understand executives' performance incentives, we further refine our remuneration analysis. While say-on-pay has ensured that executive pay remains at the top of the governance agenda, issuers, investors and other stakeholders are dissatisfied with the unnecessary complexity of remuneration but fail to agree on the best solution.

**Striking the right balance between simplicity and transparency**  
Despite the widespread view that transparency and disclosure have overly complicated remuneration issues, we think that transparency is, in fact, necessary to simplify executive pay. It is increasingly important to ensure good long-term performance, especially in sectors with long capital investment cycles, through the correct deployment of pay strategies, while taking into account sector drivers and corporate strategy.

**Tracking remuneration: introducing the company view**  
By looking at 60 companies across six sectors, we establish a benchmark to enable investors to identify companies that are surpassing and failing to meet sector drivers and corporate performance standards, while including the financial metrics necessary to guarantee sustainable long-term performance.

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<p><b>Robert Walker (author)</b> walker@keplercheuvreux.com +44 20 7623 2168</p> <p><b>Stéphane Voisin (coord.)</b> voisin@keplercheuvreux.com +33 1 7081 2762</p>	<p><b>Mark Lewis</b> mlewis@keplercheuvreux.com +44 1 70 81 27 40</p> <p><b>Sudip Hazra</b> shazra@keplercheuvreux.com +33 1 7081 2762</p> <p><b>Samuel Mary</b> smary@keplercheuvreux.com +44 20 7623 2168</p>
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# Executive summary

## There is growing consensus for smaller pay gaps

We believe that there is growing consensus across geographies, socioeconomic brackets and the political spectrum that the pay gap between workers and executive management should be reduced. As such, understanding culture and how it relates to pay in a given country and within socioeconomic statuses is key. For example, research by Kiatponsgan and Norton suggests that on a country basis, there are wide discrepancies between what people consider to be appropriate gaps between CEOs' and unskilled workers' pay: for example, workers in Denmark were comfortable with a gap of 3.7:1, while those in South Korea were comfortable with a gap of 41.7:1.

We believe that investors will need to factor this into their thinking about what is reasonable and fair pay within an organisation, not only at the top but also at the bottom.

## Investors find it hard to understand the benefit of pay ratios

Various studies suggest that, on average, US CEO pay is approximately 200-300 times the level of median employee wages. Our research suggests that the gap in Europe is much lower, at around 66 times median wages. We believe that while pay escalation may be an issue in Europe, income inequality is not at the same level as in the US.

However, our research suggests that the real issue is that investors may not actually want pay ratios, nor do they see them as providing much ammunition in combating the risk of escalating executive pay. In our small survey of 40 large European investors we found that on average the introduction of pay ratios did not even make the top three issues on the investors' radar when thinking about remuneration. Furthermore, 79% of investors questioned did not believe that there should be a cap on the gap between CEO pay and that of the average worker.

While we acknowledge the rather small sample size, we believe that for the most part investors do not know what to do with pay ratios or more importantly whether they would actually be useful in ending CEO pay benchmarking, which is often considered to be the primary component driving the escalation of executive pay globally.

## CEO pay ratios: a new headache for investors?

Our investor survey of 40 large European investors suggests that CEO pay ratios are not high on the list of investor concerns; in fact, this issue didn't even make the top three of investor concerns, as the single most important issue was better alignment of awards with shareholder experience. What our research suggests is that a high CEO pay ratio may warn investors that there is a problem or indicate whether the level of pay is fair and in line with sector peers. More significantly, we believe these ratios will show investors how pay has evolved internally over time and therefore highlight significant jumps that may not be justified - for example where the company is restructuring its labour force.

## Potential benefits of pay ratios for investors

However, in our view, pay ratios by themselves may not help investors to curb the risk of remuneration appearing to be out of line with sector drivers and long-term performance.

As such, the introduction of CEO pay ratio requirements by the SEC and subsequent proposals by the European Commission are aimed at applying political downward pressure on executive pay by ensuring clear sunlight is provided on this issue.

Furthermore, one's perception of the benefits of CEO pay ratios depend on one's view of whether investors actually have the tools or means to reign in executive remuneration. Investors both in the US and Europe already have considerable power to hold management to account on executive remuneration, either by voting on annual remuneration reports by individual members of the remuneration committee, or by engaging with company non-executive directors on this issue. As such, it is hard to see how the introduction of pay ratios will really reign in executive pay on a general basis.

For investors the real issue may actually be the evolution of the ratio rather than the absolute ratio itself. In our view, investors will initially examine how value is distributed between management and workers when profits rise and fall.

## Are pay ratios a poor proxy for human capital management?

The ability of companies to properly manage their human capital is a key risk for investors. The introduction of pay ratios will certainly provide an additional filter for investors in terms of how pay operates vertically in an organisation. However, we would question whether the use of pay ratios will allow companies to practise better human capital management or investors to monitor it more effectively.

Indeed, one could argue that disclosure on pay disparity isn't a magic formula on remuneration for several reasons. First, both sides of the equation (CEO pay level and average/lowest paid pay level) are subject to a high number of variables, given individual businesses' operating models, business lines and places of operation, making it hard to conclude much that is meaningful.

Second, investors may well simply ask companies to explain why their ratio is different to those of others in their sector, but quite what they'll 'do' with this information is another matter. Third, pay ratios in our view are a very blunt and potentially ineffective instrument for assessing how the remuneration structure impacts the operating risk of individual companies. Furthermore, we believe it is unlikely that pay ratio disclosure would really allow investors to isolate enough variables to be able to say whether or not a high or low variable represents a particular risk to a particular company or sector.

## Investors' pay ratio headaches: we offer some relief

Investors may feel that they have been deluged with legislation and best practice on remuneration and – despite the (in our view) lack of European investor demand for the introduction of pay ratios – they look certain to be introduced in the US and potentially later in Europe if the European Commission gains enough support.

***For investors the real issue may be the evolution of the pay ratio rather than the ratio itself***

***In our view investors will as a first step examine how value is distributed between management and workers when profits climb and fall***

Clearly, the introduction of pay ratios in the US will give European investors who have exposure to US equities a preview of how European companies could potentially respond to this issue.

Nevertheless, while European investors face a longer wait for the implementation of CEO pay ratios (potentially in 2016), we suggest that investors concerned about the potential headache of trying to rationalise information on CEO pay ratios should follow our advice, which is specifically designed to relieve the potential pain of upcoming pay ratios.

### **First step to pain relief: link pay to key sector drivers and strategy**

In our view, the growing pressure to reign in CEO pay and the potential introduction of CEO pay ratios in Europe will mean that investors will come under increasing pressure from external stakeholders (trade unions, NGOs, etc.) to explain their support for remuneration policies, where the pay gap between key executives and median employees appears significant. We believe the best defence for investors is to be clear about the risk profile of remuneration, how it is linked to sector drivers and corporate strategy and finally long-term sustainable performance.

*We have written extensively on this issue in our three previous reports on remuneration: see links to our research on page 3 of this report.*

### **Second step: for instant relief, take a sector view – start with mining!**

In partnership with our research partner the Hay Group, we have analysed the pay disparity of 424 companies on which we were able to gather disclosure. We found that on average pay disparity across Europe was 22:1 based on CEO salary, increasing to 66.5:1 for total CEO pay.

However, it is on sector basis that we see the greatest divergence on this issue. Our research highlights the mining sector as having the largest gap both for CEO salary (70:1) and total CEO pay (260:1). This in fact tallies with the view of investors who participated in our survey on remuneration, a majority of whom suggested that this sector might have the largest gap between CEO pay and median wages. Looking in more detail at the mining sector, we identify Randgold as the main outlier not only in sector, but in our entire universe. In terms of total CEO pay, Randgold's CEO earns approximately 1317:1.

While this figure is startling, it needs to be seen in the context of the company's business model, which involves exposure to economically challenged African nations (we explore this theme further in step 3 below).

Unsurprisingly, the general retail sector follows mining in having the next largest gap on average in terms of CEO salary (48:1). We note that in the sector Inditex has the highest disparity on average for both salary and total compensation, at 155:1. This is also a sector that a majority of investors suggested would have the largest gap in terms of CEO pay disparity.

However, this does not extend to total CEO pay, where the beverages sector (a sector that did not resonate so loudly on the investor radar) takes second place behind mining, with a gap of 141:1.

***Investors facing a headache from the imminent introduction of pay ratios in the US (and potentially Europe) should follow our three steps to longer lasting pain relief!***

***Mining, beverages and general retail are three sectors that offer the greatest disparity on average***

***Our findings tally with the views of investors who participated in our survey on pay ratios***

***Within the general retail sector, Inditex has the highest disparity on average for total compensation of 155:1***

### Third step: secure long-term pain relief by focusing on country exposure

Our research suggests that the way in which companies incorporate geographical wages into their calculations for CEO pay disparity is key, particularly for companies that have significant exposure to emerging markets where wages are significantly lower.

Our analysis highlights a direct link between exposure to emerging markets, specifically Africa, and lower personnel expenses for companies like Randgold, Lonmin & Anglo American, which all tend to have the highest CEO disparity in terms of total CEO pay based on our sample universe.

**Table 1: Total CEO pay versus geographical exposure to Africa**

Company	Total CEO pay gap	Personnel expenses per employee (EUR 000's)	% of employee workforce based in Africa
Randgold Resources Ltd	1318	3,607	86.40%
Lonmin plc	138	19,360	84%
Anglo American plc	136	37,349	71%

Source: Kepler Cheuvreux

For investors, we believe the key issue to understand is how economic inequality in emerging markets will impact wage costs and therefore future profitability. For example, Anglo American and Lonmin as platinum producers have significant exposure to upward pressure on wages in South Africa, where 70% of the world's platinum is produced.

In June 2014 an agreement was signed between platinum producers (including Anglo American and Lonmin) and the Association of Mineworkers and Construction Union (AMCU).

The three-year wage agreement brought an end to a five-month strike, which cost platinum producers in South Africa, who are already exposed to softer commodity prices and rising cost inflation (via higher electricity prices and fuel costs), about USD2bn in lost revenue. Taking Anglo American as an example, the new wage agreement lifts wage costs by 8.4% per year on average over the three-year period.

Furthermore, this agreement will most likely raise pressure for new wage agreements elsewhere in the mining industry; and it provides no guarantee that platinum producers such as Anglo and Lonmin won't face new demands for wage increases before the end of the three years. In the longer term, there is clearly a risk that higher wages and poor labour relations will reduce the incentive for investment from mining companies in South Africa.

However, we believe the introduction of pay disparity data will also highlight more visibly the reputational risks for investors, who will need to consider the potential social pressure on companies that have exposure to emerging markets and may subsequently face increased wage costs in order to reduce economic inequality in these markets, which could potentially affect profitability.

**Our analysis highlights a direct link between exposure to emerging markets, specifically Africa, and lower personnel expenses in the mining sector**

**Companies like Randgold, Lonmin and Anglo American all tend to have greater CEO disparity in terms of total CEO pay, as they have a significant number of employees in Africa**

**We believe the key issue for investors to understand is how economic inequality in emerging markets can impact wage costs and therefore future profitability**

## Largest and smallest outliers

**Table 2: Top 20 co's with highest level of disparity between total CEO pay and median worker pay**

Name	Country	Sector	CEO salary gap	Total CEO pay gap
RANDGOLD RESOURCES LTD	JERSEY	MINING	329	1318
SABMILLER PLC	BRITAIN	BEVERAGES	65	695
WPP PLC	BRITAIN	MEDIA	22	562
TELEPERFORMANCE	FRANCE	SUPPORT SERVICES	306	419
COMPASS GROUP PLC	BRITAIN	TRAVEL & LEISURE	61	349
DIAGEO PLC	BRITAIN	BEVERAGES	25	310
DKSH HOLDING LTD	SWITZERLAND	SUPPORT SERVICES	90	304
VOLKSWAGEN AG-PREF	GERMANY	AUTOMOBILES & PARTS	34	271
WILLIAM HILL PLC	BRITAIN	TRAVEL & LEISURE	35	267
VODAFONE GROUP PLC	BRITAIN	MOBILE TELECOMS	27	266
RANDSTAD HOLDING NV	NETHERLANDS	SUPPORT SERVICES	47	266
LADBROKES PLC	BRITAIN	TRAVEL & LEISURE	31	256
BURBERRY GROUP PLC	BRITAIN	PERSONAL GOODS	23	249
BRITISH AMERICAN TOBACCO PLC	BRITAIN	TOBACCO	41	245
UNILEVER PLC	BRITAIN	PERSONAL GOODS	35	236
NEXT PLC	BRITAIN	GENERAL RETAILERS	36	233
G4S PLC	BRITAIN	SUPPORT SERVICES	109	228
CARNIVAL PLC	BRITAIN	TRAVEL & LEISURE	43	228
ACCOR SA	FRANCE	TRAVEL & LEISURE	24	225
WHITBREAD PLC	BRITAIN	TRAVEL & LEISURE	44	208

Source: Kepler Cheuvreux

**The UK features heavily, with 65% of companies having the highest total CEO pay ratio gap**

**Table 3: Top 20 co's with lowest level of disparity between total CEO pay and median worker pay**

Name	Country	Sector	CEO salary gap	Total CEO pay gap
TELEVISION FRANCAISE (TF1)	FRANCE	MEDIA	4	7
BANKIA SA	SPAIN	BANKS	6	6
BANCA MONTE DEI PASCHI SIENA	ITALY	BANKS	6	6
BANCA POPOLARE DI SONDRIO	ITALY	BANKS	2	6
RED ELECTRICA CORPORACION SA	SPAIN	ELECTRICITY	6	6
GENEL ENERGY PLC	BRITAIN	OIL & GAS PRODUCERS	2	6
ENAGAS SA	SPAIN	GAS, WATER & MULTIUTILITIES	4	6
BUREAU VERITAS SA	FRANCE	SUPPORT SERVICES	3	6
AIR FRANCE-KLM	FRANCE	TRAVEL & LEISURE	5	5
PREMIER OIL PLC	BRITAIN	OIL & GAS PRODUCERS	3	5
SCHIBSTED ASA	NORWAY	MEDIA	4	5
INDUSTRIVARDEN AB-A SHS	SWEDEN	FINANCIAL SERVICES	2	5
COFINIMMO	BELGIUM	REAL ESTATE INVESTMENT TRUSTS	3	4
ADP	FRANCE	INDUSTRIAL TRANSPORTATION	4	4
EUTELSAT COMMUNICATIONS	FRANCE	MEDIA	3	4
INVESTEC PLC	SOUTH AFRICA	FINANCIAL SERVICES	3	3
SHAFTESBURY PLC	BRITAIN	REAL ESTATE INVESTMENT TRUSTS	1	3
OPHIR ENERGY PLC	BRITAIN	OIL & GAS PRODUCERS	1	3
PORSCHE AUTOMOBIL HLDG-PRF	GERMANY	AUTOMOBILES & PARTS	2	2
BANCO DE SABADELL SA	SPAIN	BANKS	1	1

Source: Kepler Cheuvreux

## Pay ratios: a new headache for investors?

In recent years, corporates have faced increasing pressure on the remuneration front. While this pressure primarily started in the financial sector, the drive to continue the reforms and make remuneration more transparent has continued to gather pace in other sectors. In this endeavour, investors have used new tools such as having a binding say on pay votes, deferred variable compensation and longer holding periods post vesting of long-term awards, to ensure that management remuneration not only reflects actual performance but is sustainable over the long term.

However, the idea of shedding light on the gap between CEO pay and average wages has begun to gather momentum: first, in the US where under the Dodd Frank Act US companies will be required to disclose the ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer; second, in Switzerland the 1:12 initiative, which would have limited monthly CEO compensation to no more than the average worker can earn in a year; however, this proposal was rejected by Swiss voters in a referendum in November 2013; finally, in April 2014 the European Commission proposed a draft policy introducing pay disparity disclosure for European member states.

### Why is there momentum on this issue in Europe?

The EC's revised Shareholder Rights Directive announced in April 2014 includes for the first time a provision to introduce a binding provision on 'Say on Pay' in order to encourage companies to provide more meaningful disclosure on pay practices and how they relate to long-term performance. Unlike the financial sector, there is no explicit cap on executive remuneration although there is an explicit desire for corporates to outline the maximum level of remuneration payable to executives.

However, the EC's remuneration policy proposal also introduces a provision requiring an explanation of how the board determines the ratio between average wages and executive pay.

Pay for performance has always been the key focus for investors seeking to understand the pay practices of the companies in which they invest. It is clear from the EC's revised Shareholder Rights Directive that the Commission intends to provide more tools for investors to zero in on this issue and therefore engage more with companies to promote long-term sustainable performance and reduce short-termism.

### Corporates see investors as too short-termist?

Companies have certainly argued that traditional long-term shareholders have made up an ever decreasing proportion of most company's shareholder base and executive pay has therefore become one of the biggest red flags to investors, particularly where it not declining as quickly as short-term financial performance in any given year.

For companies, therefore, the conflict arises where pay is not declining versus a decline in short-term financial performance because the board want to reward directors for a contribution to the longer-term health and value of the business and in the view of corporates, it's difficult to exonerate investors from the 'short termism' criticism.

### **Human capital management**

In our view human, capital management is a key component of long-term value creation for corporates. As such, the clear risk for investors is the inability of companies to properly manage their human capital. Traditionally investors have not sought to understand this, instead preferring to focus on financial outcomes as a proxy for managerial competence. In as much as investors have to sought to understand this they have done so by looking only at how corporates managed their key employees at the top of the business.

However, given that corporate disclosure in relation to how human capital is managed is extremely limited, a clear movement towards requiring disclosure of the ratio between executive pay and average workers will certainly provide an additional filter for investors, enabling them to understand how pay drives incentives at both the upper and lower quartiles of a business and across the market in general.

### **Investors need to look at what is happening below board level**

We believe that it is not solely the CEO being poached that is the primary problem for investors seeking to understand escalating executive pay. It's also the executives below this level, e.g. Finance Director, and poaching across the market is not limited to the FTSE 100.

We believe a more fruitful and accurate story here is not about board/CEO level positions, but about what's happening for talent below this level – where competition is fierce. This is why we are seeing the increasing amount companies are paying both to pay executives as well as to assess them and improve their capability, together with the explosion of literature on 'leadership'. If supply were abundant, this would not be happening: companies would simply be poaching talent from one other.

As such, the reason this is relevant is that if there's pressure on pay below the board level it will come to bear at board level (unless we propose paying the very top executives a lower amount than those below them). This is part of where the pressure for companies to have proper succession plans comes from – a desire to not put the fortunes of the business in the hands of one or two executives and, in pay terms, to perhaps act as a brake on ever-increasing levels of executive pay.

***The inability of companies to manage their human capital represents a potential risk for investors***

## Executive pay escalation is increasing inequality in society

The continuation of pay escalation over the last few years despite the introduction of say-on-pay provisions, deferred pay components and even bonus caps in the financial sector, has raised questions over growing income inequality and whether actual executive performance justifies the continuing escalation of executive pay.

In fact, the International Monetary Fund has recognised that reducing inequality leads to “faster and more durable growth.” We believe it is important to put pressure on businesses and policymakers to develop measures to stop pay gaps opening up even further, and to share the rewards of success more fairly – for everyone’s benefit.

This theme is further exposed by Professor Thomas Picketty, In his book, ‘*Capitalism in the Twenty-First Century*’, he takes an aggressive stance against ‘super-managers’ which he describes as “*top executives of large firms who have managed to obtain extremely high and historically unprecedented compensation packages for their labour.*” Professor Picketty goes further by expressing doubts over whether the salaries of the new “super-managers” are actually based on merit or contributions to business profit.

However, one could of course argue that an increasing proportion of ‘profit’ going to management – even top management – or even to workers – is simply a reflection of the increasing realisation on the part of investors that the return they enjoy is essentially generated by human endeavour and that in an economy that is increasingly knowledge- and service-oriented people’s contribution is beginning to be properly recognised.

Therefore an alternative narrative for what’s happened to executive pay is one where for example in the past –before the 1980s – executive pay was low. As our economy, changed the role of people became more prominent and the people in the best position to demand a greater share of the profits they were responsible for generating with shareholder capital demanded a greater share of the gain – which investors duly gave them, subject to an ever-increasing list of caveats and rules. As demographic change, the increasing internationalisation and complexity of companies accelerated so too did executive pay levels – and, noted in the executive summary, so too did financial sector super profits and pay. The global financial crisis brought everyone back down to earth, resulting in regulation for banks and bankers pay, with companies coming under pressure from governments (which at least in theory represent the people) to recognise that company performance is as much about the performance of all employees/other employees (social pressure) as it is about top executives – hence the calls for a pay ratio to be adopted’.

### Switzerland's failed try at pay ratios

As mentioned previously, a Swiss proposal to limit executives’ annual pay to no more than the monthly salary of the lowest paid worker failed in November 2013, despite evidence that the pay gap between executives and the lowest paid workers is widening in Switzerland.

We highlight research by Travail Suisse, an umbrella group of trade unions, which suggests that Roche Holding AG, Novartis AG, UBS, Lindt & Spruengli AG stand out as companies with a significant wage gap between CEO and average workers. In fact for the aforementioned companies the pay gap is higher than 1:200, meaning that the top earner receives 200 times more than the lowest paid employee.

In addition, their research also found that UBS had the biggest increase in pay disparity (gap between those at the top and the lowest paid worker) where the pay gap widened to 1:229 in 2013 from 1:177 the previous year, while at Swatch Group AG the Chief Executive Officer Nick Hayek's ratio increased to 1:151 from 1:137.

In the UK, there has also been growing concern over the escalation of the gap between executive pay and average wages. The High Pay Centre has written a number of reports highlighting the problems of rising pay for top executives in the UK.

According to their latest research,<sup>1</sup> typical annual pay for a FTSE 100 CEO rose from around GBP100,000-200,000 in the early 1980s to over GBP1m in 2000 and finally to approximately GBP 4.3m in 2012.

### **The SEC is introducing a CEO-to-median-employee pay ratio**

In 2010 the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act) mandated the SEC to adopt a rule requiring issuer pay ratio disclosure. After four years of debate the SEC's proposed rule on pay ratios looks like finally being implemented. The SEC's rule on pay will require US public companies to disclose:

- The median of the annual total compensation of all employees of the issuer, except the issuer's CEO (or equivalent).
- The annual total compensation of the issuer's CEO (or equivalent).
- The ratio of those two amounts.

The proposed rule allows companies to select a methodology to calculate pay ratios that is appropriate based on the size and structure of their business and the way the company compensates employees, rather than stipulating a required calculation methodology. However, companies will be required to describe the methodology they have used and the material assumptions that were applied.

The final pay ratio rule is expected to be adopted in 2014. If this is indeed the case, companies will provide the pay ratio disclosure for the 2015 fiscal year in disclosure documents filed in 2016.

**At UBS, the pay gap between CEO and lowest paid worker widened to 1:229 in 2013 from 1:177 the previous year...**

**...while at Swatch Group AG the Chief Executive Officer Nick Hayek's ratio increased to 1:151 from 1:137**

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<sup>1</sup> High Pay Centre, Reform Agenda: How to make pay fairer 2014

# What is escalating executive pay?

## Is there a cultural consensus for lower pay?

We note the research by Sorapop Kiatpongsan and Michael Norton which looks at the preferences of people from different countries and backgrounds to pay differentials between the rich and poor.<sup>2</sup> Kiatpongsan and Norton's research reveals how important an understanding of culture may actually be when thinking about pay by exposing the cultural gap on this issue between skilled and unskilled workers.

Using survey data from 40 countries their research suggests that culture can highlight how comfortable certain groups or countries are when it comes to pay ratios between workers and executives. For example when looking at the estimated pay ratios of CEOs to unskilled workers Danish workers estimated the gap to be 3.7x while South Koreans estimated the gap to be 41.7x, this suggests that South Koreans are much more comfortable with a higher estimated pay gap between unskilled workers and CEOs.

However, what is significant is that the research highlights that there is a consensus across countries, socioeconomic status and political beliefs for ideal pay ratios of approximately 4.7:1 for CEOs to unskilled workers. What this suggests is that while people's estimations of pay gaps can vary based on their country or socioeconomic status there is clearly a consensus that current pay gaps are too large and that ideal pay gaps should be smaller.

## Political and not investor pressure behind pay ratio rules

What is significant about the SEC rules on pay is that they do not appear to be really motivated by shareholder pressure. For example, a bulletin published by Towers Watson in June 2011, highlights that the number of shareholder proposals on internal pay ratio disclosure in the US dropped from nine in 2010 to three in 2011. This doesn't suggest that there was significant investor pressure, although we would acknowledge that larger investors may have been pushing companies for this information in private.

The provision on CEO pay ratios in the Dodd-Frank Act was introduced by Robert Menendez, a Democratic Senator, who stated:

*"We have middle-class Americans who have gone years without seeing a pay raise, while CEO pay is soaring... What's too costly here are the big paydays for CEOs. And the burden is falling on workers with stagnant wages."*

As in the US, it does not appear to be the case that European institutional investors have been actively lobbying for the introduction of pay ratios for CEO pay. For example, Hendrik du Toit, chief executive officer of Investec Asset Management Limited, which manages USD110bn in assets, said it would "put Europe at a disadvantage."

Furthermore, while the UK, Germany and other member states have in the past (as part of their corporate governance reforms) looked at the introduction of a CEO-to-average-worker pay type ratio in the style of the one currently being proposed by the European Commission, they were ultimately not implemented.

**Culture can highlight how comfortable certain groups or countries are when it comes to pay ratios between workers and executives**

**There is a clear consensus across geographies, socioeconomic brackets and the political spectrum that the ideal pay ratios should be around 4.7:1 between CEOs' and unskilled workers' pay**

<sup>2</sup> How Much (More) Should CEOs Make? – A universal desire for more equal pay, Sorapop Kiatpongsan and Michael I. Norton<sup>3</sup>

## UK and Germany both looked at but did not adopt CEO pay ratios

During 2012, the UK, a market often viewed as a leader of governance reform, announced a package of measures aimed at addressing key executive pay issues. As part of the consultation process on the future of narrative reporting, the UK looked at whether disclosure by quoted companies of the ratio between CEO pay and the median earnings of the organisation's workforce would provide useful information to investors. Overall, the consensus from a broad range of respondents including investors, corporates, NGOs and investor representative organisations, was that requiring quoted companies to disclose the ratio of CEO pay to median employee earnings would not be useful. Furthermore, one of the main criticisms was that:

*“firm-specific factors, including workforce composition and main country of operation, could obscure meaningful comparison among companies”.*

As such the final package of measures presented by the UK government in 2012 did not include disclosure of CEO-to-employee-pay ratios despite several proposals to introduce such disclosure. However, the reforms did include a much more general provision that required companies to compare the percentage pay increase received by the CEO (not including LTIP awards) with that of the wider workforce.

Germany is an interesting case given that it pursued legislation over the disclosure of CEO pay ratio (they were one of the first, if not the first) but they ultimately determined that a pay ratio offered minimal value and instead they simply required the supervisory board to take responsibility for internal and external appropriateness of executive pay when determining executive compensation (with personal financial liability for supervisory board members to comply).

In fact, German shareholders may argue that the structure of co-determination whereby 50% of the board is comprised of employee representatives ensures a built-in pushback against excessive CEO pay. An example of this power came in 2012 when in a response to inequality post the financial crisis, employee board representatives forced through a 20% pay cut for the CEO of VW despite record company profits. The argument of the employee representatives was that the CEO's pay was too high, his bonus targets too easy and that ultimately work force wages had been held down.

***In 2012, the UK examined the usefulness of disclosure by quoted companies of the ratio between CEO pay and the median earnings of the organisation's workforce in information to investors***

***The consensus among a broad range of respondents was that requiring quoted companies to disclose the ratio of CEO pay to median employee earnings would not be meaningful***

***Germany pursued legislation over the disclosure of CEO pay ratio (they were one of the first, if not the first) but what they recognised was the minimal value of a ratio***

# Economics & strategy: the macro view

## Speculation and financial super profits

There cannot be investment without speculation about our future. However, excessive speculation is associated with instability and inequality. History reminds us why financial speculation has such a negative cultural resonance. Our objections to excessive speculation are not just moral in nature. History indicates that excessive financial speculation contains the seeds of its own destruction, which is why it can be so destabilising. A logic of return-to-mean applies to the financial industry as much as to any other industry.

The two great financial crashes of the last century were both preceded by periods characterised by rapid growth of the share of financial profits, financial activity and financial employment within the major western economies. Our most recent crash represented the culmination of a quarter century in which the financial industry grew stronger and richer, above all in America, as a consequence of disinflation, deregulation and globalisation. The antecedents of the crash of 1929-30 were similar. In the collective memory, the 1920s is remembered as a decade of wealth and excess, at least in America. Such periods of financial super-profits invariably produce a surge in the remuneration of those who work in the financial industry.

Those who doubt the strength of the link between financial profits and remuneration in the financial industry would do well to consult the NBER research paper written by Philippon & Reshef.<sup>3</sup> They found that compensation in American banking and finance, relative to the private sector as a whole, adjusted for age, skills and sex differences, rose to a premium of 30-50% through the boom years from the mid-1990s to 2007. Only one other period in recent history has seen such a differential emerge: the late 1920s.

A financial crash almost invariably signals a watershed between phases of financial de-regulation and re-regulation. In the 1930s the re-regulatory response was organised rapidly. The Pecora Commission of 1932 led to the Glass-Steagall Act of 1933. It might appear that the re-regulatory reaction since 2008 has been lenient. In particular, it does appear that America wishes to maintain the international dominance of its investment banks. However, the pendulum is swinging inexorably in favour of restriction regulations that will limit the profitability of financial activities.

The practice of non-orthodox monetary policy provides a source of support for the financial industry, but one whose effects should diminish with time.

## The end of financial super-profits in the US and Europe

The evidence since 2008 supports the interpretation that the profits of the trans-Atlantic financial industry will not return to the super-profits of the years from the mid-1990s anytime soon, in Europe in particular (see charts below on page 17).

**Christopher Potts**  
**Head of Economics & Strategy**

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<sup>3</sup> NBER Working Paper. December 2008: "Wages and Human Capital in the US Financial industry: 1909-2006". Thomas Philippon and Ariell Reshef.

The supposition is that the differential of compensation enjoyed by finance is on a return-to-mean trajectory. Ultimately it can return to virtually zero. Let us quote the Philippon & Reshef paper: "*Our main conclusion - - is that deregulation and corporate finance played dominant roles. We find that corporate finance activities linked to IPOs and credit risk increase the demand for skilled labour.*" At the present time it can be argued that the boom associated with cheap credit has been replaced by the boom of cheap capital. However, over the longer term" - *tighter regulation is likely to lead to an outflow of human capital out of the financial industry.*"

The end of financial super-profits is the single most effective mechanism that will resolve the question of excessive remuneration in the financial industry. Its effects are only just beginning to be apparent. In this respect the most interesting and most important question relates to the repercussions throughout our societies. It concerns the extent to which the financial industry is an authentic leading indicator.

The rise of financial profits and of remuneration in finance over the last twenty years has had a powerful demonstration effect upon compensation differentials in other industries. It is estimated by the Economic Policy Institute that the total compensation of chief executives in large US corporations in recent years is of the order of 250-300 times that of the salary of the average worker. 40 years ago the differential was about 35 times. The decline of super-compensation in the financial industry suggests that the tide may be turning.

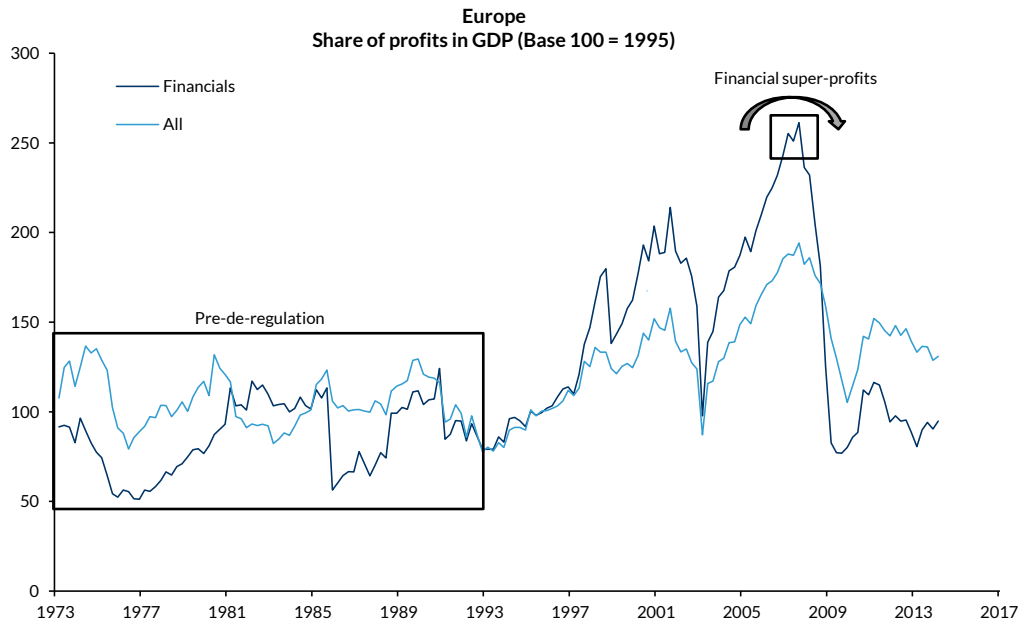
The end of financial super-profits in the great crash may be the leading indicator of the climax of the rise in the profit share in the national incomes of the developed economies that is such a characteristic feature of the last quarter century. The current investment cycle may mark the culmination of the fall in the share of labour in the national incomes of the developed world. After all, it is now widely recognised that sustained economic recovery requires an increase not just in labour participation but also in wage rates.

The decline of super-compensation in the financial industry may presage the narrowing of compensation differentials in the private sector in general. With a lag of perhaps a decade in relation to the financial industry it is becoming plausible to think that the degree of inequality of compensation within the private sector of the major developed economies is close to its highest point in recent history. Already we can note that there is greater emphasis upon income protection schemes for the disadvantaged, including extension of minimum wage legislation.

**Christopher Potts**  
Head of Economics & Strategy

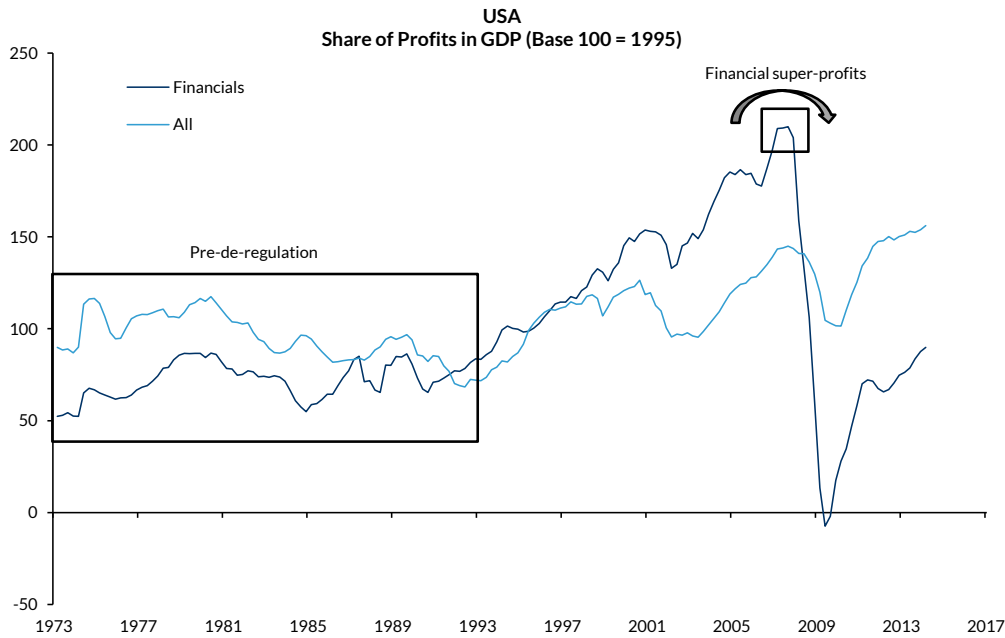
***The end of financial super-profits is the single most effective mechanism that could resolve the question of excessive remuneration in the financial industry***

**Chart 1: The end of financial super-profits in Europe**



Source: Bloomberg, Datastream

**Chart 2: The end of financial super-profits in the US**



Source: Bloomberg, Datastream

# US leading the way on pay escalation

Research by the Hay Group and the Wall Street Journal looking at pay rates at the largest 300 US companies by revenue suggests that companies were also more profitable in 2013, with a solid median net income growth of 8%. However, this greater profitability did not result from significant top-line growth. In fact according to Hay’s research GDP growth in both the US and globally was fairly stagnant and most measures of productivity were down and inflation was modest, yielding very little top-line growth for most companies.

Instead the path to greater profitability was achieved in large part through enhanced efficiency and low wage growth. For investors, it is the low wage growth particularly for average workers that will we believe become telling over the next few years as boards and compensation committees come under increasing pressure to justify the sharing of profits between the top and bottom levels of the business, particularly within the forthcoming glare of pay gap transparency.

## Increased disclosure to further highlight the CEO-to-worker gap

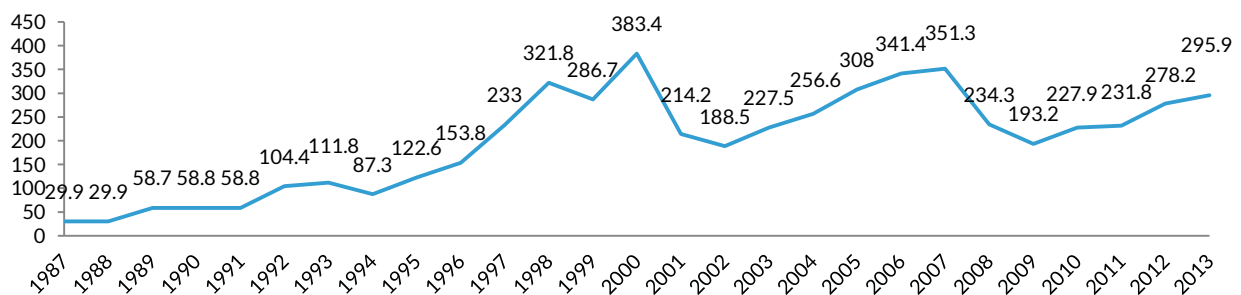
The US clearly has the highest gap between the pay of executives and average workers compared with other international markets. Various studies mainly by trade unions and academic think tanks support this even, if there is not always a consensus on the exact gap between CEO and average worker pay. In this report we have utilised data from the Economics Policy Institute and their research argues that between the 1930s and the 1970s, CEOs of the largest companies received approximately USD1m in total annual compensation (adjusted for inflation in year 2000 dollars).<sup>4</sup> However, by the 1990s CEO pay grew dramatically and research from the Economics Policy Institute suggests that from 1978 to 2013 CEO compensation (inflation-adjusted) increased 937%, potentially more than double the rate of stock market growth and significantly above the 10.2% growth in an average worker’s compensation over the same period.

**Companies were also more profitable in 2013, with a solid median net income growth of 8%...**

**... but this greater profitability did not result from significant top-line growth...**

**...rather the path to greater profitability was largely achieved through enhanced efficiency and low wage growth**

**Chart 3: CEO-to-worker compensation ratio, 1987-2013**



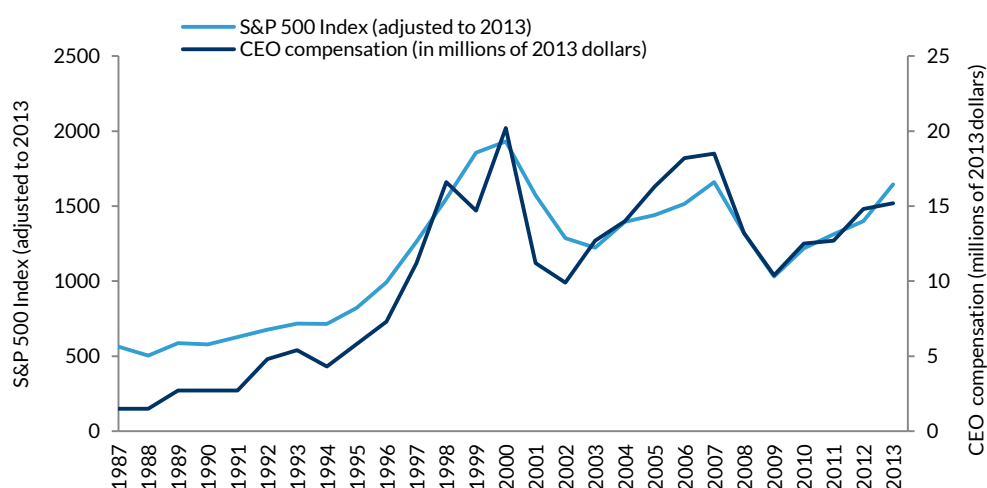
Source: Economics Policy institute based on analysis of Compustat’s ExecuComp database, Current Employment Statistics program and the Bureau of Economic Analysis NIPA tables.  
 Note CEO annual compensation is computed using the ‘options realized’ compensation series which includes salary, bonus, restricted stock grants, options exercised and long term payouts for CEO’s at the top 250 US firms ranked by sales.

<sup>4</sup> Carola Frydman and Raven E. Saks, Executive Compensation: A New View from a Long-Term Perspective, 1936-2005, July 6, 2007

## A rising tide lifts all ships... pay for real performance?

While the methodology used by the Economic Policy Institute may be open to scrutiny (particularly given the use of potentially unvested stock grants, the value of which has yet to be realised), the graph below certainly suggests that the alignment of CEO compensation to individual performance is perhaps not as strong as shareholders might like. In fact the graph suggests that since the 1990s CEO compensation has simply followed overall increases of the S&P 500.

**Chart 4: CEO US compensation & S&P 500 Index (in 2013 dollars) 1987-2013**



**The alignment of CEO compensation with individual performance is perhaps not as strong as shareholders might like**

**In fact the graph suggests that since the 1990s CEO compensation has simply followed overall increases of the S&P 500**

Source: Economics Policy institute based on analysis of Compustat's ExecuComp database, Current Employment Statistics program and the Bureau of Economic Analysis NIPA tables. Note CEO annual compensation is computed using the 'options realized' compensation series which includes salary, bonus, restricted stock grants, options exercised and long term payouts for CEO's at the top 250 US firms ranked by sales..

This assessment makes sense when one considers how most US executives are paid via share awards linked to share price appreciation and this is often not directly related to share price appreciation relative to peers. Therefore US CEOs would benefit from their share prices rising off the back of an overall increase in the value of the S&P 500 and not necessarily their own performance.

### CEO pay versus average worker: the disclosure problem

Numerous studies by trade union organisations, think tanks, and newspapers such as the Wall Street Journal and financial information providers such as Bloomberg have compared CEO pay with the average worker's salary.

However, the biggest obstacle to conducting analysis in this area is the absence of data on median employee pay within in US companies' financial reports. As such most studies looking at this issue are forced to use US government data on average worker pay by industry in order to derive an estimate of average compensation on a sector basis. This has led to a lack of consistency in reporting on CEO-to-average worker pay gaps, which ultimately will be solved by the introduction of the SEC's pay ratio proposal.

## US CEO-to-worker compensation ratio by sector

A report<sup>5</sup> by Demos, a public policy organisation, suggests that the gap between the highest and lowest earners is continuing to grow. New analysis looking at CEO pay disparity versus average worker salary on a sector basis highlighted a number of findings:

- Accommodation and Food Services had a CEO-to-worker pay ratio of 543-to-1 in 2012. Over the period 2000-12 the average ratio was 332-to-1, 44% higher than the sector with the next-highest compensation ratio.
- In 2012, the compensation of fast food CEOs was more than 1,200 times the earnings of the average fast food worker. Proxy disclosures recently released by fast food companies reveal that the ratio remained above 1,000-to-1 in 2013.

**Table 4: CEO to worker compensation ratio by sector**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Avg 2000-2012
Accommodation and food services	334	232	308	215	429	439	374	350	161	280	300	352	543	332
Retail	145	174	250	206	248	278	274	309	171	177	228	226	304	230
Information	540	111	110	129	231	206	196	219	110	92	132	140	513	210
Construction	102	203	309	234	325	490	184	164	189	158	107	92	93	204
Mining	176	75	87	102	135	346	330	199	282	106	134	175	121	174
Healthcare and social assistance	163	456	187	129	155	168	193	122	84	139	114	134	171	170
Finance and insurance	266	237	127	175	205	207	180	145	84	78	106	96	123	156
Arts, entertainment and recreation	51	191	59	309	63	59	299	147	170	95	146	145	241	152
Manufacturing	184	110	99	121	156	143	154	166	128	99	131	146	158	138
Administrative and support, and waste management	77	83	87	69	139	220	260	200	117	104	112	127	137	133
Real estate, rental, and leasing	63	144	79	65	116	124	149	134	114	76	146	172	151	118
Transportation and warehousing	102	91	64	83	88	134	112	107	102	84	130	106	96	100
Wholesale trade	45	46	80	72	82	112	155	140	98	82	145	106	95	97
Professional, scientific, and technical services	105	140	51	63	80	96	86	85	76	56	87	88	85	84
Other services	38	35	37	101	51	80	58	121	149	76	82	143	93	82
Utilities	44	38	35	44	57	78	74	73	71	58	59	61	66	58

Source: Demos analysis of ExecuComp, BLS and BEA data

*This table is taken from a report by Demos which looked at CEO pay disparity in the fast food sector*

*CEO pay is derived from the sum of six categories of payment: salary, bonus, restricted stock grants, long-term incentive plans, the value of exercised options, and other compensation*

*Calculations for total worker compensation used to calculate the pay gap between CEO pay and the average worker mirror those used by the Economics Policy Institute whose work we have referenced in this report*

## Fast food sector: an indicator of wider economic inequality

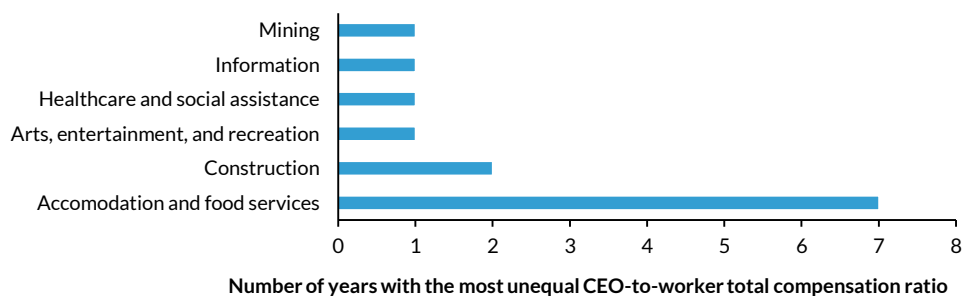
During 2014, pay inequality for front-line fast food workers has moved to the centre of public attention following a series of strikes by workers seeking higher pay and union representation. Despite our lack of coverage of the US equity market, we think the rising public attention on this issue in the US will have clear implications for Europe.

What is significant about the accommodation and fast food services industry is that the pay gap is not a recent phenomenon as a result of the financial crisis, for example. The research

<sup>5</sup> Fast food Failure, How CEO-to-Worker Pay Disparity Undermines the industry and the overall Economy. Catherine Ruetschlin

by Demos suggests that the accommodation and fast food industries have had the highest annual average CEO-to-worker ratio for 7 years (over the 13-year period) of all other sectors including retail, which is typically seen as a low-wage sector.

**Chart 5: Sectors with the largest number of years in terms of highest CEO to worker pay disparity**



Source: Demos analysis of ExecuComp, BLS, and BEA data

### Pay inequality is now becoming a business risk for fast food companies

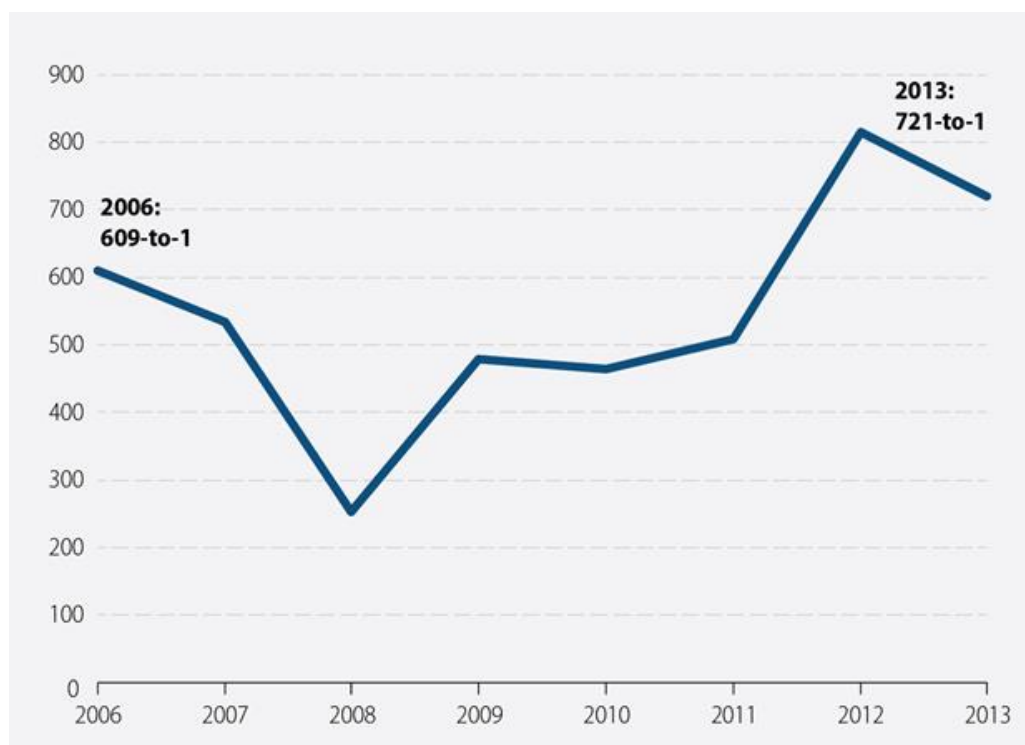
Extreme income inequality in the fast food industry clearly creates a problem for the economy and the performance of such companies, particularly as increasingly growth in the economy over the next decade is likely to some extent to come from this sector. McDonald's filing with the SEC in March 2014 reflects the growing potential impact of income inequality on corporate performance. Under "Risk Factors and Cautionary Statement Regarding Forward-Looking Financial Statements," the company highlighted a number of factors concerning pay inequality that it viewed as a risk to its business:

*The impact of campaigns by labor organizations and activists, including through the use of social media and other mobile communications and applications, to promote adverse perceptions of the quick-service category of the IEO segment or our brand, management, suppliers or franchisees, or to promote or threaten boycotts, strikes or other actions involving the industry, McDonald's or our suppliers and franchisees;*

*The impact on our margins of labor costs that we cannot offset through price increases, and the long-term trend toward higher wages and social expenses in both mature and developing markets, which may intensify with increasing public focus on matters of income inequality;*

*The increasing focus on workplace practices and conditions and costs and other effects of compliance with U.S. and overseas regulations affecting our workforce and labor practices, including those relating to wage and hour practices, healthcare, immigration, retirement and other employee benefits and unlawful workplace discrimination, and our exposure to reputational and other harm as a result of perceptions about our workplace practices or conditions or those of our franchisees.*

**Chart 6: Ratio of restaurant CEO pay to the minimum wage**



Note: restaurant CEO annual compensation is computed using salary, bonus, restricted stock grants, options exercised and long-term incentive payouts for CEOs at firms in the food services and drinking places industry. Minimum wage worker pay is the value of annual pay for a full time, full-year worker working at the national minimum wage.

Source: Economic policy institute

**Research by the economic Policy Institute highlights that...**

**... the pay ratio of CEOs of the US's top 25 restaurant corporations including...**

**...McDonalds, Burger King, the Cheesecake Factory, Chipotle, and Jack in the Box...**

**...earned an average of 721 times the minimum wage of their workers**

Research by the Economic Policy Institute highlights that in 2013 the CEOs of the US's top 25 restaurant corporations including McDonalds, Burger King, the Cheesecake Factory, Chipotle, and Jack in the Box earned an average of 721 times the minimum wage of their workers. This is significant because restaurants and food service companies typically employ nearly half of all American workers who earn the federal minimum wage of USD7.25 per hour.

**US investors starting to scrutinise human capital management**

During the 2014 proxy season, CtW, a group founded in 2006, unleashed a number of targeted say-nay-on-pay campaigns focused on companies in the fast food industry and beyond.

Although their results were mixed, CtW did win a significant victory at Chipotle where the non-binding advisory vote on pay and proposed executive pay plan drew the highest opposition level (77%) to date despite the company's strong performance and financial track record.

CtW noted in a release that the USD67.3m paid to Chipotle's top five executives in 2013 was 42% more than Coca-Cola's executive team was paid and nearly equal to that of General Electric, a company with 45 times the revenues of Chipotle.

Proxy advisers such as Glass Lewis and ISS, as well as institutional investors, including the California State Teachers Retirement System, Calpers, New York City Pension Funds and the Florida State Board of Administration voted against the proposed compensation plan for the co-CEOs of Chipotle.

Under the proposed stock plan both Steve Eells and Monty Moran would have received USD285m over three years. In addition, investors also voted against the say-on-pay report which awarded both CEOs USD50m in 2013.

In our view the rejection of Chipotle's pay plan by shareholders is a response to both shareholder concerns over excessive pay and the wider public debate over increasing income inequality.

## State-led corporate tax initiatives could be a solution

There is growing evidence in the US of states taking the initiative to reduce pay inequality through initiatives on minimum wage and now through the use of corporate tax rates to encourage companies to reduce their CEO-pay-to-average-worker gap. In California the largest state in the US, Senate Bill 1372 was introduced by State Senators Mark DeSaulnier and Loni Hancock. The bill would have allowed the state to raise the corporate tax rate from 8.84% to as high as 13% for companies where the highest paid executive earns more than 400 times what a typical employee earns. In addition companies where a CEO to typical worker pay ratio falls below 100:1 would get a tax cut below 8.84% to as low as 7%.

Furthermore Californian corporations that attempted to use outsourcing to reduce the CEO-to-worker gap could see their tax rate increase by 50% where there was clear evidence of a decrease in full time employees and an increase in contracted and foreign full time employees. While the bill narrowly failed to pass the State Senate in a 19-17 vote we believe this bill outlines a potential mechanism that could ultimately be deployed to reign in escalating pay inequality in the US.

However, elsewhere, particularly in Europe, we believe it is less likely that this particular use of corporate tax rates to either encourage companies to reduce pay disparity via lower taxes or punish those with too large a gap with higher taxes would be feasible. Furthermore, within the US only one state, California, has actually proposed this type of solution at senate level, where it failed to pass albeit narrowly.

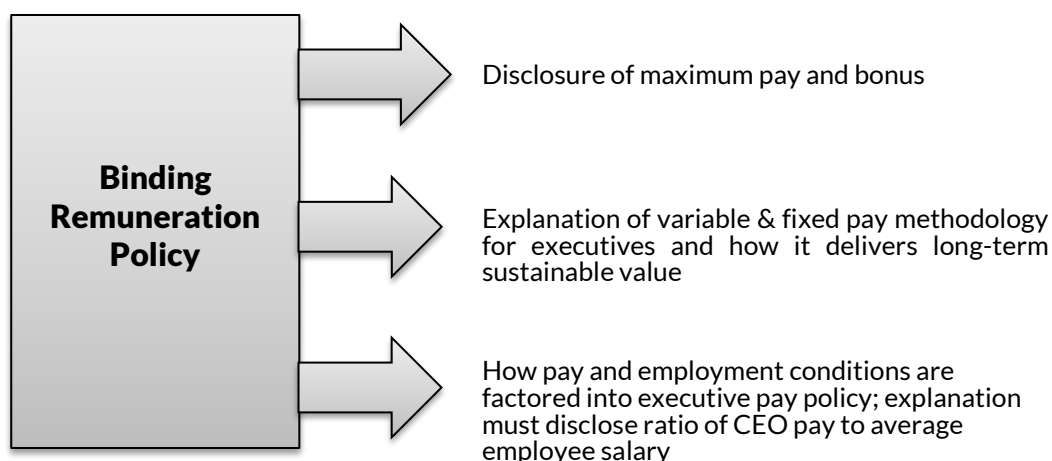
***In California, Senate Bill 1372 proposed raising the corporate tax rate for companies whose highest paid executive earns more than 100 times what a typical employee earns***

***In Europe it is less likely that corporate tax rates could be directly used to either encourage companies to reduce pay disparity via lower taxes or impose higher taxes on those with too large a gap***

## A framework for assessing pay disparity

The European Commission's proposal on pay disparity goes further than the SEC proposal by requiring a binding vote on a wide range of sensitive remuneration benchmarks, including CEO pay ratios.

**Chart 7: European Commission's plan for pay transparency**



Source: Kepler Cheuvreux

The European proposal will require over 10,000 listed companies to disclose clear, comparable and comprehensive information on their remuneration policies and how they were put into practice. Company pay policies will need to indicate the maximum executive compensation, and explanations will be required on how each company's executive team contributed to its long-term interests and sustainability. In addition, companies will need to explain how the pay and employment conditions of employees were taken into account when setting the executive pay policies, including disclosure of the ratio of CEO pay to the average employee' salary.

However, the European Commission is not seeing to impose a specific ratio for CEO pay to average employee salary, leaving investors to determine for themselves what is acceptable as corporates begin to disclose this information.

### How will the ratio be calculated and will it be granular enough?

The most significant issue in our view will be how companies determine average pay. The EC provides no explicit definition for this, which suggests that companies may be free to manipulate the way they calculate the pay gap by using mean pay, for example. In addition, it is unclear whether companies will be required to disclose the distribution of pay between the main countries in which they operate, contrasted against emerging markets.

This lack of clarity may raise concerns for investors, who would be looking for granularity from company reporting on this issue. For example, companies with greater emerging

**The main issue, in our view, will be how companies determine average pay...**

**...the EC sets no parameters for this**

market exposure would have a greater pay disparity between the CEO and average worker than companies more exposed to developed countries.

### Understanding the pay gap: where will investors draw the line?

Once companies begin to disclose pay disparity data on a consistent basis, we believe investors will inevitably face pressure from stakeholders not to support companies where the executive pay gap is too large. In addition, we believe there will initially be a significant reputational risk for investors who are perceived to be supporting pay gaps that are seen as far too wide, particularly where there has been significant restructuring.

The problem for investors is a simple one: how to determine where to draw the line on pay disparity. In our view, proxy voting agents, who tend to have a cross-market perspective, may step up to provide a view on what is an appropriate gap in terms of CEO pay versus average worker on a market basis. This may provide a useful baseline for investors who may opt to fall in line or adopt their own view on a case-by-case or sector basis.

### What should investors expect?

The policy will oblige companies to justify to shareholders why the ratio they have published makes sense for their business and possibly their sector. Companies that have a good story to tell will no doubt disclose more, while companies that don't are likely to provide less detail with more opaque disclosure.

In our view, investors will expect and receive in the first instance a variety of disclosure as companies vary eventually investors will have clarity on a best in class approach that they can use to encourage laggards to provide more effective disclosure.

### The regulator's view...

In writing this report our discussions with the European Commission's Corporate Governance Unit brought out several insightful comments that we believe may be of interest to investors.

- *The objective of this policy is not only to foster a long-term view in companies on this issue but also asset managers in terms of their investment horizon and engagement.*
- *The new requirement will introduce vertical transparency for shareholders in terms of pay disparity and long-term sustainability of companies.*
- *The requirement to disclose the ratio between CEO pay and average worker will help shareholders to have an opinion on how profit is distributed between shareholders (dividend), executives and workers.*
- *It will be in the interest of corporates to explain pay disparity based on different geographical areas because investors will have a vertical view of pay across the company and sector.*
- *While it may have been beneficial to impose a standard methodology for determining the ratio for CEO pay and average worker, it would have been impossible as it would not have been accepted by member states.*
- *The new pay ratio policy does not encourage companies to highlight the disparity between developed countries and emerging markets. As such, companies with greater revenue exposure to emerging markets may have greater transparency*

**Companies with a good story to tell on CEO pay disparity will inevitably disclose more**

## Using pay ratios: the investor survey

For the purposes of this report, we surveyed around forty institutional investors across Europe, asking a series of questions to gauge their views on what they considered to be the key issues for remuneration.

### Investors don't know what to expect on pay disparity

Despite the small sample, the results appear to suggest that, for most investors, disclosure of pay disparity is far down the list of five priorities that we proposed on remuneration.

**Table 5: Investor survey question - rate the following issues based on their importance:**

**(5=highest to 1=lowest)**

Binding say on pay vote
Advisory say on pay vote
Better transparency on variable awards
Disclosure of pay disparity between CEO and average worker
Deferred pay for variable awards
Bonus limits for key executives
Alignment of awards with shareholder experience (to avoid disconnects/payments for failure)

Source: Kepler Cheuvreux

Applying a weighted score to responses, our analysis highlights that in fact the three issues in order of importance to investors were:

1. Alignment of awards with shareholder experience
2. Better transparency on variable awards
3. Deferred pay for variable awards

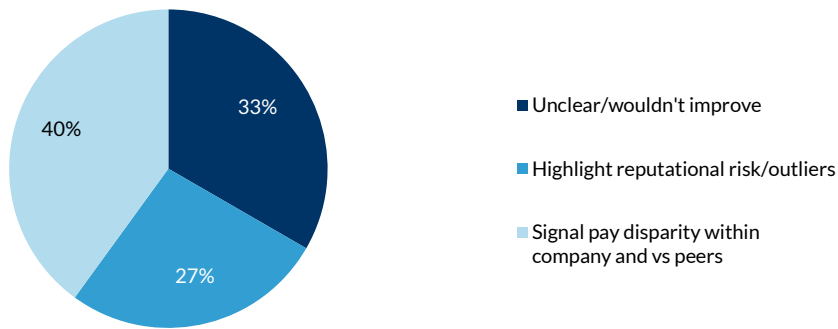
In addition, when investors were asked how introducing transparency on pay disparity would improve their analysis, a clear majority argued that it was unclear whether increased transparency would actually improve their understanding of remuneration policy. This is perhaps not surprising, given that most investors placed pay disparity towards the middle in terms of priorities. Transparency on pay disparity as a warning sign internally and versus peers was the next strongest view from investors.

However, we believe the usefulness for investors of disclosure on CEO and average worker pay will not become clear until companies begin to disclose on this issue and until then investors clearly have other priorities.

**Most investors participating in our survey argued that it was unclear whether increased transparency would actually improve their understanding of remuneration policy**

**Chart 8: Investor survey question**

How would introducing transparency on pay disparity improve your analysis of remuneration policy?



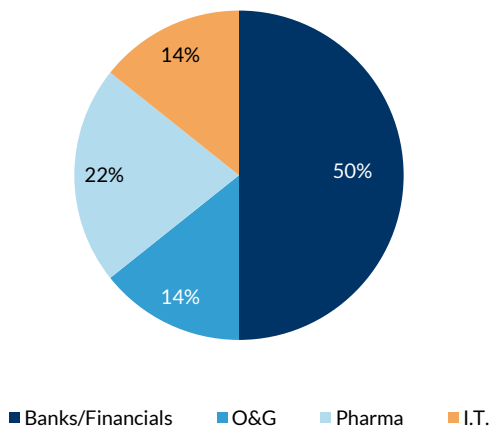
**Surprisingly, 33% of responses suggested that investors are unclear about how transparency on pay disparity would improve their analysis of remuneration**

Source: Kepler Cheuvreux

We were surprised to find that a third of investors appeared unclear on how transparency on the CEO/median worker pay ratio would improve their analysis of remuneration. We acknowledge that most investors believe that better transparency would signal pay disparity within peers and across sectors and highlight reputation risk by identifying outliers. However, the minority of investors who appear to disagree on the usefulness of CEO pay ratios suggests that the European Commission hasn't necessarily made the best case for introducing this provision.

**Chart 9: Investor survey question**

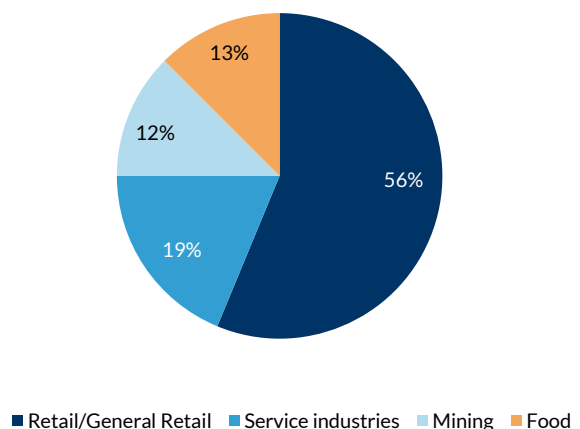
Which sector has the smallest gap in terms of pay disparity?



Source: Kepler Cheuvreux

**Chart 10: Investor survey question**

Which sector(s) have the greatest gap in terms of pay disparity?



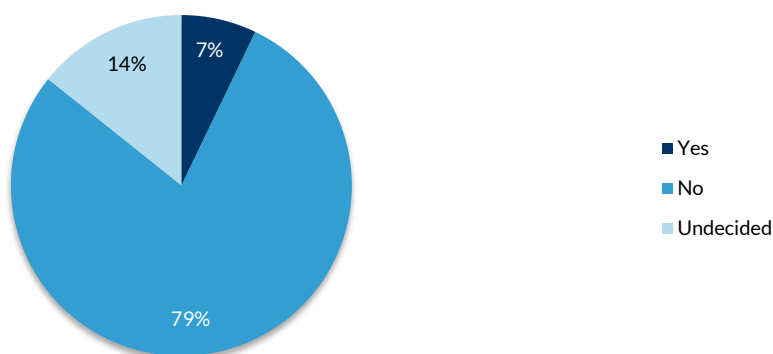
Source: Kepler Cheuvreux

For investors, the sector with the smallest gap in terms of pay disparity in their view was the banks & financials followed by pharmaceuticals. When turning to sectors with the greatest gap between CEO pay and average worker wages, four sectors emerge: retail, services industries, mining and food.

Overwhelmingly, investors participating in our survey did not support an arbitrary limit on the gap between CEO pay and average worker wages. Generally, investor comments on this issue were of a similar nature and expressed concerns over the arbitrary nature of such a limit, which they believed could lead to undesirable consequences (e.g. increased contract labour). In addition, investors felt that any pay ratio should be seen in the context of the particular business and the explanation provided by the remuneration committee.

**Chart 11: Investor survey question**

Should there be a limit on the gap between CEO pay and average worker



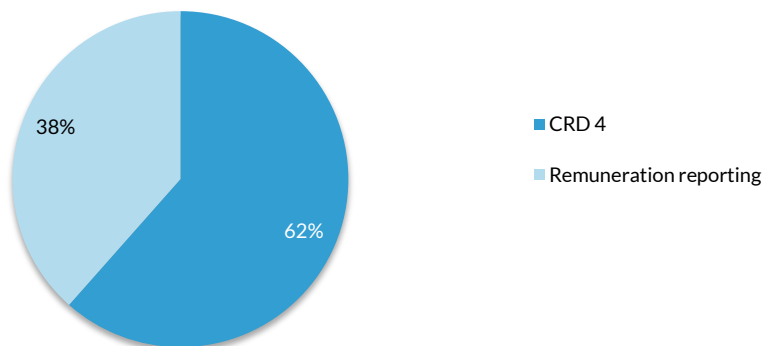
Source: Kepler Cheuvreux

**Investors participating in our survey do not support an arbitrary limit on the gap between CEO pay and average worker wages**

We believe that some recent initiatives implemented on the behalf of investors by regulators and governmental bodies may not necessarily have been wanted by investors. Unsurprisingly, CRD 4, which introduced bonus limits for executives working in the European financial industry, was the measure most commonly mentioned by investors as not especially desirable. The next most unwanted initiative was remuneration reporting, particularly the introduction of binding votes across markets and the length of remuneration reporting more generally.

**Chart 12: Investor survey question**

Which regulatory change(s) to remuneration were not especially wanted by investors



Source: Kepler Cheuvreux

*Perhaps unsurprisingly when investors were asked which regulatory changes to remuneration they felt were not really wanted...*

*...CRD 4 was the most commonly picked issue!*

## Promoting long-term sustainable remuneration

**Table 6: Investor survey question: in order of importance which of the following would best promote long term sustainable remuneration policies?**

(5=highest to 1=lowest)

Moving to a 5-year performance period for long-term awards
Disclosure of how variable performance criteria correlate to key sector drivers
Mandatory disclosure of salary, bonus, value of long-term awards past, present and future + other benefits paid to key executives over the last 5 years
Mandatory disclosure of the proportion of remuneration based on fixed, short term variable and long-term variable
Mandatory disclosure within the remuneration report outlining whether elements of the remuneration policy could have a materially adverse effect on future corporate performance

Source: Kepler Cheuvreux

*Disclosure of how variable performance correlates to key sector drivers is the key issue for investors looking at remuneration*

Our investor survey shows that data on pay disparity is not at the top of the agenda for investors. As such, we wanted to ascertain which remuneration issues are of most concern. Our survey of investors highlighted that the three key issues in order of importance were:

1. Disclosure of how variable performance correlates to key sector drivers
2. Moving to a 5-year performance period for long-term awards
3. Mandatory disclosure of salary, bonus, value of long-term awards past, present and future + other benefits paid to key executives over the last 5 years

The fact that a majority of investors surveyed selected disclosure of how performance metrics relate to key sector drivers appears to validate our previous research on remuneration, which identified key drivers alongside their appropriate financial metrics in order to highlight how remuneration could relate to corporate strategy and therefore long-term sustainable performance.

## Pay ratios: the good, the bad and the ugly!

### **The good: increased disclosure ensures a level playing field**

Clearly the introduction of pay ratios in Europe would lead to an increase in general disclosure around pay to include on a more general basis information on salary, bonus and variable compensation for key executives as well as more granularity on how the philosophy of pay at a company and how it is delivering long term sustainable performance. The recent requirements for Italian and Spanish companies to disclose separate remuneration report has in our view ensured much more detail on this issue which can only be a positive for investors seeking to understand whether management is being rewarded for the appropriate performance.

For example in a report looking at the controversy concerning CEO pay ratios as a result of the introduction of the Dodd Frank Act Cheng, Smith and Tanyi<sup>6</sup> argue that there is a potential link between CEO pay dispersion and managerial behaviour linked to financial reporting quality.

Cheng, Smith and Tanyi argue in their paper that CEOs with higher than expected pay ratios (i.e. “excess pay ratios”) tend to manage firms with lower financial quality. Furthermore they go further by arguing that CEOs who have larger pay ratios may be a signal that they are the driving force in influencing the quality of their companies financial reporting for their own benefit. They suggest that these results should be of interest to not only investors and regulators but also to directors who have responsibility for both determining and monitoring executive pay.

A such disclosure of CEO pay vs median worker pay would highlight outliers to investors of companies where there is not only a significant gap that does not appear to be justified by performance, it will also highlight pay that appears to be far in excess of peers or more importantly how the gap has changed or is changing over time.

In our view the expansion of this kind of disclosure through-out Europe would ensure a level playing field allowing global investors to have a better view on remuneration, thereby ensuring better voting outcomes and perhaps less allocation of resources and time to this issue.

### **The bad: will CEO pay actually fall and other unintended consequences**

One of the primary outcomes of introducing CEO pay ratios should be in our opinion a reduction in CEO pay or to put it another way will the introduction of CEO pay ratios act as a dampener on escalating CEO compensation.

It will be impossible to judge until we begin to see company disclosure on this issue and subsequent compensation levels. What our research suggests is that a high CEO pay ratio may warn investors that there is a problem or whether the level of pay is fair which may lead to some companies reducing CEO compensation out of embarrassment.

***Large pay ratios may indicate that the CEOs in question have an undue influence on the quality of their company's financial reporting, for their own benefit***

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<sup>6</sup> Cheng, Xiaoyan and Smith, David B. and Tanyi, Paul, CEO Pay Ratios and Financial Reporting Quality (June 8, 2014).

However, this new disclosure cannot provide investors with material information on the rationale behind the remuneration decision or whether pay is actually based on the most appropriate metrics for long-term shareholder performance.

Furthermore, neither the SEC nor the European Commission, in its proposed rules for CEO pay ratios, require investors to do anything with this information. As such, investors would be free to support remuneration plans with significant pay gaps between the CEO and the average worker.

We believe the introduction of CEO pay ratios may lead to unintended consequences such as companies outsourcing poorly paid jobs to increase the average worker wage. Furthermore, companies may be incentivised to reduce the workforce in their foreign subsidiaries, where labour costs are relatively low. However, this reduction would sacrifice the low labour cost advantage, which could lead to increased labour costs and therefore lower profitability (we presume this cost would come out of profits), which may ultimately not be in the interests of shareholders.

Finally, we believe that the introduction of CEO pay ratios may lead to companies adopting opaque remuneration practices in order to side-step the new rules. This is already evident in the banking sector, where the introduction of the European bonus cap for executives of Europe-based banks has resulted in the introduction of allowances (cash payments outside the variable compensation) to senior executives as a work-around for the new rules.

However, as mentioned in the previous chapter, the decision on where to draw the line and the justification for supporting a specific CEO-to-average-worker ratio will come down to investor views on a particular sector or company, which may differ from the expectations of unions and other external pressure groups. As such, this issue may actually force investors to spend even more time on an issue that is already claiming a significant proportion of time, and resources, from asset managers.

### **The ugly: pay ratios, the costly solution to the rising pay problem?**

There has been a lot of research into what has been driving higher CEO pay over the last few years. We argue that escalating pay may be tied to a number of factors including: increasing company size, complexity of pay schemes, weak remuneration committees and weak disclosure that fails to provide a proper European perspective on pay levels.

In our view the introduction of CEO pay ratio requirements by the SEC and the European Commission is clearly intended to force executive pay down, as light is shed on this issue. However, the benefit of CEO pay ratios is dependent upon your view of whether investors actually have the tools or means to reign in executive remuneration.

Investors in both the US and Europe already have considerable power to hold management to account on executive remuneration, either through voting on annual remuneration reports, representation on remuneration committees or engagement with company non-executive directors on this issue.

As such, it is hard to see how the introduction of pay ratios will really reign in executive pay across the board.

***How effective pay ratios will be as a method for increasing transparency on pay...***

***... depends on how investors will determine and justify the views they take...***

***...for example, is it positive that an investment bank CEO has a low ratio, and negative that a retail bank CEO has a high ratio, even if the latter is paid less for a job of equal complexity?***

In our view, even if we accept that weak governance has been a significant cause of escalating pay, the European Commission proposals excluding the CEO pay ratio already go some way to addressing this problem by forcing all European companies to publish what would amount to a remuneration report, setting out the rationale for executive pay. This alone in our view would assist investors in forming a sector or country view on pay levels in Europe.

In fact, the introduction of CEO pay transparency could require investors to run the gauntlet of supporting a remuneration policy that actually looks appropriate in terms of linking pay to sector drivers and long-term strategy, but that may include pay ratios that external stakeholders take issue with, leading to potential reputational risk.

In our view, the central ugliness of pay ratios as a method of increasing pay transparency is the uncertainty over how investors will determine and justify the views they take. For example, is it positive that an investment bank CEO has a low ratio and negative that a retail bank CEO has a high ratio, even if the latter is paid less for a job of equal complexity?

Clearly, geographical disparity and how companies determine what an average employee is will play a significant part. Nevertheless, while investors will use CEO pay ratios if they are introduced, and companies with good stories to tell on this issue will do so because of the reputational benefits, we believe it remains unclear whether such ratios will really help investors to understand remuneration and its link to long-term sustainable performance, or whether they will just become another initiative that adds even more complexity to an already crowded debate.

# CEO and average worker pay across Europe

## Sample group

We have analysed the CEO and average worker compensation data from 424 of the largest listed European companies across all major sectors. The companies included in this analysis are part of the DJ Stoxx 600 (the top 600 European listed companies by market cap) and can therefore be considered representative of practice in the largest European companies.

We note that the largest block of companies (36%) come from the UK, which is unsurprising given the high quality of disclosure on remuneration in this market.

## Methodology

We have looked at the pay ratio over a 1-year period, 2013, in order to maximise the sample group in terms of disclosure, as efforts by investors and regulators have boosted remuneration disclosure year on year. For example the introduction of remuneration reports in Spain and Italy has greatly increased disclosure of individual components of remuneration for key executives including the CEO over the last few years.

We would have liked to have looked at pay disparity over a larger time frame, e.g. from 2009 to 2013, but the varying degrees of disclosure across European markets in previous years means the sample size would have been smaller and therefore potentially more skewed towards larger outliers in some markets.

There are several different ways of comparing CEO pay to the average worker wage. We have chosen to provide two sets of ratios: one formed by using CEO salary as the CEO input; and the other formed by using CEO total cash (total salary plus any annual bonus) as the CEO input.

For the analysis, all raw data has been sourced from Bloomberg LLP. Neither Kepler Cheuvreux nor Hay Group accept liability for the accuracy of any data acquired from Bloomberg. Data collected from Bloomberg includes:

- CEO salary
- CEO total cash (salary plus annual bonus)
- Personnel expenses per employee (personnel expenses/number of employees)

Average worker wages have been calculated by dividing the total workforce wages & salaries by the number of employees, which Bloomberg has provided in a single figure expressed as personnel expenses per employee. Since a large amount of data is used for the analysis, we have broken the data down in various ways to show, for example, how different sectors or different countries compare with each other. The data in the tables and charts below are based on the *median* values, in order to minimise the effect of outliers in the sample group.

## Overall European ratio

First we looked at the overall pay ratio in Europe, applying no filters. The overall European pay ratio is approximately 21:1 when comparing just CEO salaries with average worker pay; however, it increases to 66.5:1 during the same period when using CEO total cash to compare with average worker pay.

**Table 7: Average CEO pay across sample universe for CEO salary and total CEO pay**

Region	2013 CEO salary	2013 CEO total pay	Sample size
Europe - All	21 :1	66.5 :1	424

Source: Kepler Cheuvreux

## Breakdown by sector

When looking across the sectors, just based on CEO salaries, the mining sector shows the greatest pay disparity, followed by general retailers and food & drug retailers. At the opposite end of the spectrum, the lowest amount of pay disparity occurs within the oil & gas, financial services and real estate sectors.

**Table 8: Average CEO pay ratios versus average worker – sector breakdown**

Sector	Average of CEO salary	Sample size	Rank
Mining	66	8	1
General Retailers	48	9	2
Food & Drug Retailers	39	14	3
Support Services	39	28	4
General Industrials	33	7	5
Personal Goods	29	12	6
Travel & Leisure	29	18	7
Tobacco	28	3	8
Automobiles & Parts	28	12	9
Beverages	26	11	10
Food Producers	24	11	11
Electronic & Electrical Equipment	23	7	12
Health Care Equipment & Services	21	9	13
Construction & Materials	20	15	14
Household Goods & Home Construction	20	9	15
Industrial Transportation	20	10	16
Media	18	23	17
Pharmaceuticals & Biotechnology	18	16	18
Forestry & Paper	17	3	19
Fixed Line Telecommunications	16	15	20
Banks	16	38	21
Electricity	16	10	22
Gas, Water & Multiutilities	16	12	23
Oil Equipment, Services & Distribution	15	7	24
Software & Computer Services	14	9	25
Technology Hardware & Equipment	14	7	26
Mobile Telecommunications	14	5	27
Industrial Engineering	13	22	28
Chemicals	13	19	29
Aerospace & Defence	13	9	30
Oil & Gas Producers	11	12	31
Financial Services	7	23	32
Real Estate Investment & Services	7	2	33
Real Estate Investment Trusts	4	9	34

Source: Kepler Cheuvreux

However, when looking at disparity based on total CEO cash, the picture changes dramatically. While mining retains the top spot, with the highest level of disparity, support services and general retailers fall down the rankings to be replaced by three sectors: beverages, travel & leisure and support services. At the opposite end of the scale, the situation remains unchanged apart from forestry dropping into the bottom three instead of retail estate investments and services.

**Table 9: Average total CEO pay ratios versus average worker – sector breakdown**

Sector	Avg of total CEO pay	Sample size	Rank
Mining	236	8	1
Beverages	141	11	2
Travel & Leisure	138	18	3
Support Services	112	28	4
Tobacco	109	3	5
General Retailers	99	9	6
General Industrials	94	7	7
Personal Goods	94	12	8
Automobiles & Parts	86	12	9
Household Goods & Home Construction	84	9	10
Food Producers	79	11	11
Food & Drug Retailers	78	14	12
Mobile Telecommunications	77	5	13
Electronic & Electrical Equipment	77	7	14
Media	70	23	15
Technology Hardware & Equipment	61	7	16
Pharmaceuticals & Biotechnology	55	16	17
Construction & Materials	54	15	18
Fixed Line Telecommunications	51	15	19
Aerospace & Defence	47	9	20
Gas, Water & Multiutilities	45	12	21
Software & Computer Services	43	9	22
Electricity	42	10	23
Health Care Equipment & Services	42	9	24
Industrial Transportation	42	10	25
Chemicals	41	19	26
Oil Equipment, Services & Distribution	38	7	27
Banks	36	38	28
Industrial Engineering	33	22	29
Oil & Gas Producers	32	12	30
Real Estate Investment & Services	28	2	31
Forestry & Paper	28	3	32
Financial Services	25	23	33
Real Estate Investment Trusts	14	9	34

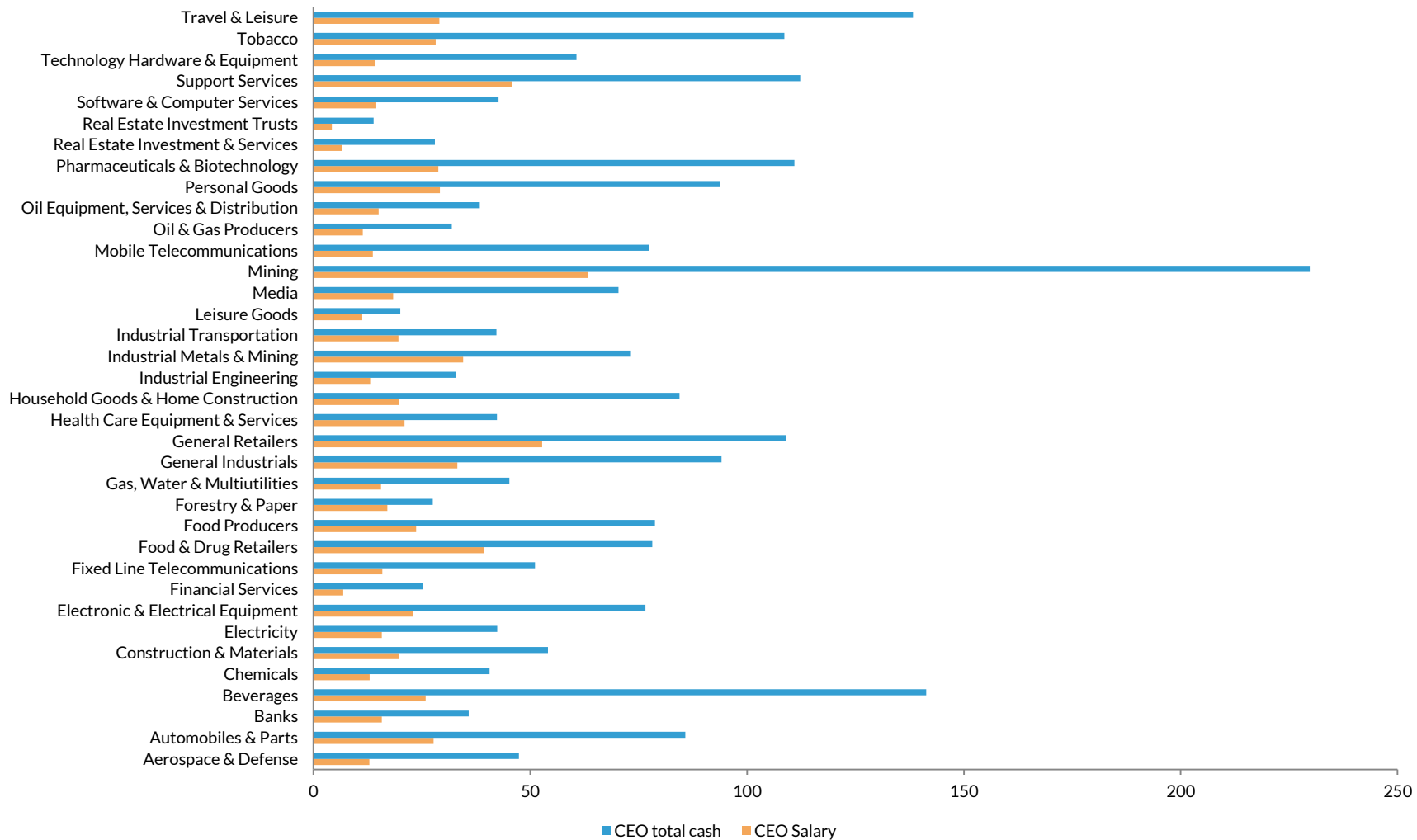
Source: Kepler Cheuvreux

**When looking at pay disparity based on total CEO cash, the picture changes dramatically**

**Mining keeps the top spot!**

**While three sectors join the top of the disparity league: beverages, travel & leisure and support services**

Chart 13: Sector breakdown – CEO salary & CEO total pay versus average worker wage



Source: Kepler Cheuvreux

## A closer look at the mining sector

### The geographical conundrum...

Randgold operates exclusively in African nations where wages are extremely low. For example, in its 2013 annual report the company reports that while wages depend on job level and site operation the company tends to pay 50% above the local minimum wage.

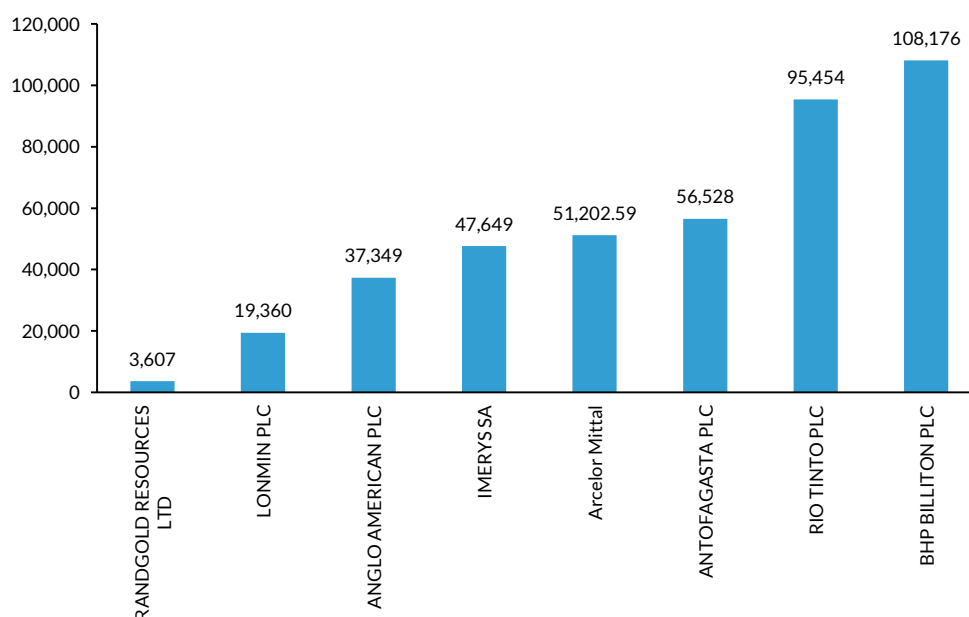
**Table 10: CEO pay disparity in the mining sector based on total CEO pay**

Company	Average CEO salary	Average of TOTAL CEO pay
RANDGOLD RESOURCES LTD	328.8578754	1317.764826
LONMIN PLC	43.31230101	137.8118669
ANGLO AMERICAN PLC	26.15349794	136.3934156
RIO TINTO PLC	14.99094802	75.74373736
BHP BILLITON PLC	15.28402154	73.60095861
ARCELORMITTAL	34.56856638	73.06271572
ANTOFAGASTA PLC	47.6302163	48.1631418
IMERYSA	16.78927101	30.88342331

Source: Kepler Cheuvreux

**For total CEO pay, Randgold's CEO earns approximately 1317:1**

**Chart 14: Personnel expenses per employee mining sector 2013 (EUR 000's)**



Source: Kepler Cheuvreux

**Randgold and Lonmin have the lowest personnel expense per employee, which is not surprising as their employees are almost exclusively based in African countries**

Most of the other mining companies in our sample universe (with the exception of Lonmin) have more exposure to Europe, North America, Australia and other markets in terms of employee diversity, where wages are inevitably higher on average, and this is evident in the graph above. In our view, this highlights the importance for investors to understand first where exactly companies do most of their business and second how geographical employee data can skew pay disparity outcomes.

We note that our sample sector group for mining the companies with the lowest personnel expenses per employee includes the three companies with the greatest employee exposure to Africa:

- Randgold 86%
- Lonmin 84%
- Anglo American Plc 71%

Furthermore, the two companies with the highest personnel expense per employee, Rio Tinto and BHP Billiton, have the greatest exposure to Australia, where employee costs are significantly higher.

**Table 11: Breakdown of mining sector coverage based on employee geographical dispersity (2013-14)**

Company	Employee geographical dispersity
Randgold	86.4% employees come from host countries Côte d'Ivoire, Democratic Republic of Congo, Mali and Senegal
Lonmin	84% employees come from Marikana operation in South Africa
Anglo American	Africa 71%, 23% South America, Australia 4%, Europe 1%, North America 1%
Imerys SA	Europe 47%, Central, Asia Pacific 22%, North America 18% and South America 9%
Arcelor Mittal	Europe 53%, North America 16%, South America 9%, Asia 17% Middle East & Africa 5%
Antofagasta	Chile 92% of mining business
Rio Tinto	Australasia 42%, North America 26%, Africa 12%, 11%
BHP Billiton	Australia 49%, South America 20%, Africa 19%, North America 9%, Asia 2%, Europe 1%

Source: Kepler Cheuvreux

## Exposure to South Africa equals upward pressure on wages

We believe the key issue for investors to understand is how economic inequality in emerging markets will impact wage costs and therefore future profitability. For example, Anglo American and Lonmin as platinum producers have significant exposure to upward pressure on wages in South Africa where 70% of the world's platinum is produced. In June 2014 an agreement was signed between platinum producers (including Anglo American and Lonmin) and the Association of Mineworkers and Construction Union (AMCU)

The three-year wage agreement brought to an end a five-month strike, which cost platinum producers about USD2bn in lost revenue. For Anglo American the new wage agreement lifts wage costs by 8.4% a year for three years and will therefore impact results. Furthermore, this agreement will most likely raise pressure for new wage agreements elsewhere in the mining industry; and it provides no guarantee that platinum producers such as Anglo and Lonmin won't face new demands for wage increases before the end of the three-year period.

In the longer term there is clearly a risk that higher wages and poor labour relations will reduce the incentive for investment from mining companies in South Africa. However, we believe the introduction of pay disparity data will also highlight more visibly the reputational risks for investors who will need to consider the potentially social pressure on these companies to increase wage costs to reduce economic inequality in such markets.

In our view it is this issue of geographical disparity or main countries vs emerging markets that companies will tend to focus on when determining median pay as lower wages will increase the gap. As such the lack of any discussion of this by the European Commission in their discussions of pay ratios is telling and suggests that companies may seek solutions such as outsourcing to avoid increasing the disparity gap via the inclusion of emerging market data.

***We believe the key issue for investors to understand is how economic inequality in emerging markets will impact wage costs and therefore future profitability***

## Pay disparity: the country view

When looking at the picture on a country-by-country basis, Jersey shows by far the highest level of pay disparity, at 328:1 on a pure salary basis and 1317:1 on total CEO pay. This should not be a surprise as the company involved is the largest outlier in our sample.

The company in question, Randgold, does most of its business in South Africa but has a UK listing, which means it is in fact a UK company despite the company being incorporated in Jersey. Based on our data the average worker salary per year is USD4,789, which is the lowest average wage in the mining sector, and which is the primary reason for Randgold having the highest pay disparity in our sample universe.

**Table 12: Country view – average CEO salary versus average worker wage**

Country	CEO salary	Sample size	Rank
Jersey	329	1	1
Luxembourg	35	1	2
Portugal	29	4	3
France	26	55	4
Austria	26	4	5
Spain	25	21	6
Germany	25	49	7
Denmark	24	11	8
Ireland	24	11	9
South Africa	23	2	10
Italy	23	17	11
Finland	20	14	12
Switzerland	20	31	13
Belgium	20	10	14
Britain	19	137	15
Netherlands	19	17	16
Sweden	19	31	17
Australia	15	1	18
Norway	14	8	19

Source: Kepler Cheuvreux

In addition to Jersey, Luxembourg, France, Austria and Spain form the highest band in terms of CEO salary disparity. When looking at the sample size, we can see that Luxembourg with only 1 company is a significant outlier primarily because Arcelor Mittal is incorporated there.

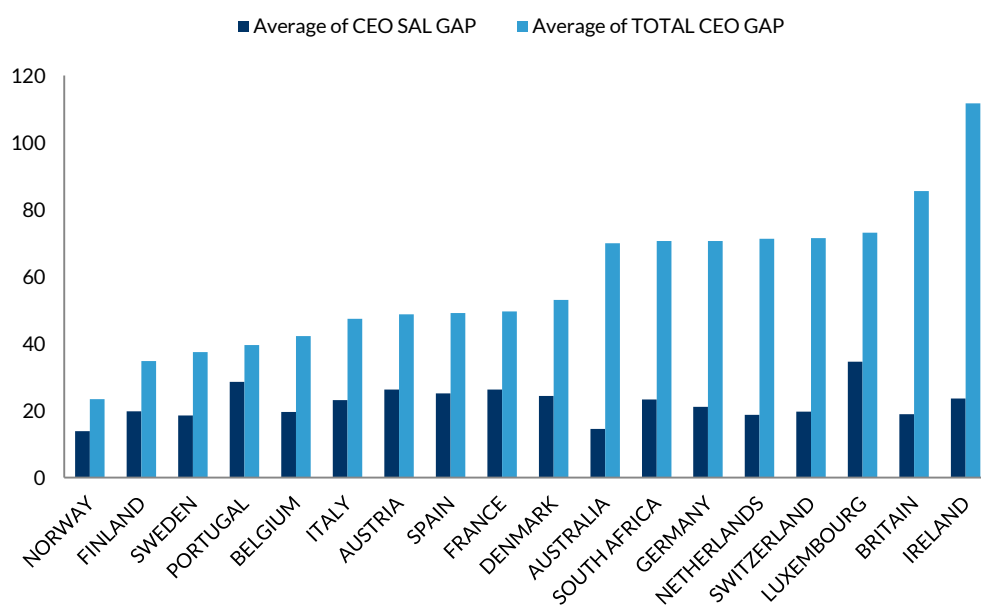
Our research also highlights that French companies in particular appear to be paying their respective CEOs more compared with the other larger European member states such as Germany, the UK, Italy and Sweden. In fact, in terms of CEO salary to average worker wage, British companies are significantly towards the bottom of the scale alongside the Netherlands, Sweden and Norway.

**Table 13: Country view – average total CEO pay versus average worker**

Country	Total CEO	Sample	Rank
Jersey	1,318	1	1
Ireland	112	11	2
Britain	86	137	3
Luxembourg	73	1	4
Switzerland	71	31	5
Netherlands	71	17	6
Germany	71	49	7
South Africa	71	2	8
Australia	70	1	9
Denmark	53	11	10
France	49	55	11
Spain	49	21	12
Austria	49	4	13
Italy	47	17	14
Belgium	42	10	15
Portugal	40	4	16
Sweden	37	31	17
Finland	35	14	18
Norway	23	8	19

Source: Kepler Cheuvreux

**Chart 15: CEO compensation country breakdown excluding Jersey**



Source: Kepler Cheuvreux

**When looking at total CEO cash ignoring Jersey (Randgold), which remains a clear outlier, we see Ireland and Britain move into the no.1 and no.2 position respectively followed by a cluster of countries: Luxembourg, Switzerland, the Netherlands and Germany**

**Interestingly, France which in terms of CEO salary was towards the top end of the gap, falls back to midway in terms of total CEO pay**

The country view picture excluding Jersey pushes Ireland and the UK to the top of the league based on total CEO pay versus average worker.

### Size matters when looking at pay disparity

We also looked at company size in terms of global number of employees and found a clear link between company size and pay disparity. Looking at the total number of employees for 2013, based on our sample size, we found that the greatest pay disparity occurs on average in the largest companies, while disparity reduces as size becomes smaller.

**Table 14: Breakdown of pay disparity based on global employees (2013) across sample universe**

No. of global employees	Average CEO salary	Average CEO total pay	Sample size
>100,000	39.2	105.6	60
50,000 to 100,000	27.39	62	62
25,000 to 50,000	24.2	77.9	64
10,000 to 25,000	21.8	69.3	85
5,000 to 10,000	16.4	61.7	55
< 5,000	10.8	28	98

Source: Kepler Cheuvreux, Bloomberg

## Research ratings and important disclosures

### Disclosure checklist - Potential conflict of interests

Stock	ISIN	Disclosure (See Below)	Currency	Price
Accor	FR0000120404	nothing to disclose	EUR	32.28
Aéroports de Paris	FR0010340141	nothing to disclose	EUR	90.21
Air France KLM	FR0000031122	nothing to disclose	EUR	6.94
Anglo American	GB00B1XZS820	nothing to disclose	GBP	1,374.50
Antofagasta	GB0000456144	nothing to disclose	GBP	639.00
ArcelorMittal	LU0323134006	nothing to disclose	EUR	10.10
Banco Popolare	IT0005002883	14, 16, 18	EUR	11.97
Banco Sabadell	ES0113860A34	nothing to disclose	EUR	2.26
Bankia	ES0113307021	nothing to disclose	EUR	1.38
BHP Billiton	GB0000566504	nothing to disclose	GBP	1,825.00
British American Tobacco	GB0002875804	nothing to disclose	GBP	
Burberry	GB0031743007	nothing to disclose	GBP	1,461.00
Bureau Veritas	FR0006174348	nothing to disclose	EUR	17.95
BURGER KING WORLDWIDE	US1212201073	nothing to disclose	USD	30.21
Carnival	GB0031215220	nothing to disclose	USD	38.00
CHEESECAKE FACTORY	US1630721017	nothing to disclose	USD	44.65
CHIPOTLE MEXN.GRILL	US1696561059	nothing to disclose	USD	607.5498
COFINIMMO	BE0003593044	nothing to disclose	EUR	89.27
Compass	GB00BLNN3L44	nothing to disclose	GBP	962.00
Diageo	GB0002374006	nothing to disclose	GBP	1,755.00
DKSH	CH0126673539	nothing to disclose	CHF	67.80
Enagas	ES0130960018	nothing to disclose	EUR	24.83
Eutelsat	FR0010221234	nothing to disclose	EUR	25.01
G4S	GB00B01FLG62	nothing to disclose	GBP	254.60
GENEL ENERGY	JE00B55Q3P39	nothing to disclose	GBP	720
Imerys	FR0000120859	nothing to disclose	EUR	54.70
Inditex	ES0148396007	nothing to disclose	EUR	21.04
Industrivarden	SE0000107203	nothing to disclose	SEK	119.20
INVESTECH	GB00B17BBQ50	nothing to disclose	GBP	528
JACK IN THE BOX	US4663671091	nothing to disclose	USD	69.09
Ladbrokes	GB00B0ZSH635	nothing to disclose	GBP	127.30
Lindt & Sprüngli	CH0010570759	nothing to disclose	CHF	54,580.00
LONMIN	GB0031192486	nothing to disclose	GBP	187.2
MCDONALDS	US5801351017	nothing to disclose	USD	91.01
Montepaschi Siena	IT0004984842	nothing to disclose	EUR	0.88
Next	GB0032089863	nothing to disclose	GBP	6,625.00
Novartis	CH0012005267	nothing to disclose	CHF	83.55
OPHIR ENERGY	GB00B24CT194	nothing to disclose	GBP	201
Porsche Holding SE	DE000PAH0038	nothing to disclose	EUR	61.61
PREMIER OIL	GB00B43G0577	nothing to disclose	GBP	263.2
RANDGOLD RESOURCES	GB00B01C3S32	nothing to disclose	GBP	4279
Randstad	NL0000379121	nothing to disclose	EUR	33.93
Red Eléctrica	ES0173093115	nothing to disclose	EUR	65.77
Rio Tinto	GB0007188757	nothing to disclose	GBP	2,337.05
Roche	CH0012032048	nothing to disclose	CHF	274.70
SABMiller	GB0004835483	nothing to disclose	GBP	3,392.50
Schibsted	NO0003028904	nothing to disclose	NOK	323.80
SHAFTESBURY	GB0007990962	nothing to disclose	GBP	678.5
Swatch Group	CH0012255151	nothing to disclose	CHF	449.00
Teleperformance	FR0000051807	nothing to disclose	EUR	46.66
Télévision Française 1	FR0000054900	nothing to disclose	EUR	10.74
UBS	CH0024899483	nothing to disclose	CHF	15.43
Unilever	NL0000009355	nothing to disclose	EUR	30.22
Vodafone	GB00BH4HKS39	nothing to disclose	GBP	193.75
Volkswagen	DE0007664039	nothing to disclose	EUR	159.30
Whitbread	GB00B1KJJ408	nothing to disclose	GBP	4,200.00
William Hill	GB0031698896	nothing to disclose	GBP	363.30
WPP	JE00B8KF9B49	nothing to disclose	GBP	1,171.00

Source: Factset closing prices of 21/10/2014

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Total	100.0%	0.0%

Source: Kepler Cheuvreux

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**Amsterdam**

Kepler Cheuvreux Benelux  
Johannes Vermeerstraat 9  
1071 DK Amsterdam  
+31 20 573 06 66

**Frankfurt**

Kepler Cheuvreux Germany  
Taunusanlage 18  
60325 Frankfurt  
+49 69 756960

**Geneva**

Kepler Cheuvreux SA  
Route de Crassier 11  
1262 - Eysins  
Switzerland  
+41 22361 5151

**London**

Kepler Cheuvreux UK  
12th Floor, Moorhouse  
120 London Wall  
London EC2Y 5ET  
+44 20 7621 5100

**Madrid**

Kepler Cheuvreux Espana  
Alcala 95  
28009 Madrid  
+3491 4365100

**Milan**

Kepler Cheuvreux Italia  
Via C. Cornaggia 10  
20123 Milano  
+39 02 855 07 1

**Paris**

Kepler Cheuvreux France  
112 Avenue Kleber  
75016 Paris  
+33 1 53653500

**Stockholm**

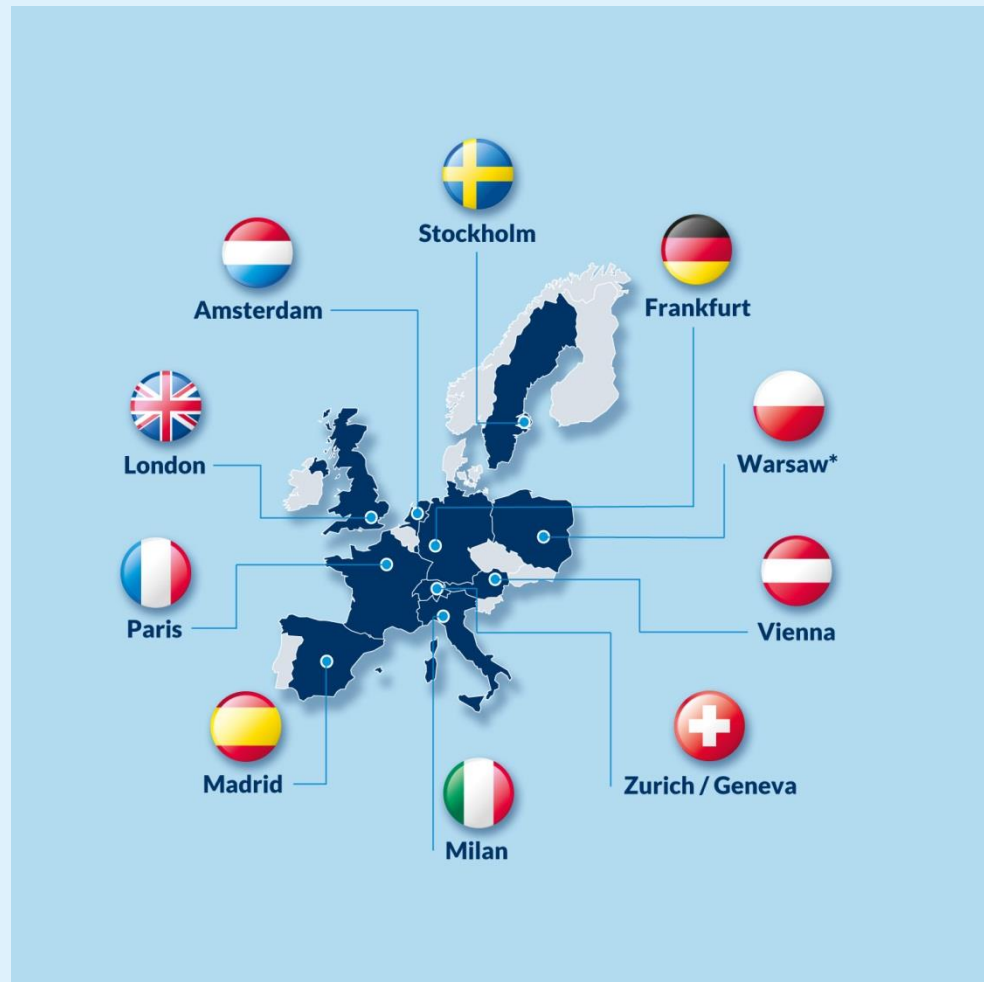
Kepler Cheuvreux Nordic  
Regeringsgatan 38  
10393 Stockholm  
+468 723 5100

**Vienna**

Kepler Cheuvreux Vienna  
Schottenring 16/2  
Vienna 1010  
+43 1 537 124 147

**Zurich**

Kepler Cheuvreux Switzerland  
Stadelhoferstrasse 22  
Postfach  
8024 Zurich  
+41 433336666



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## North America

**Boston**

Kepler Capital Markets, Inc  
225 Franklin Street, Floor 26  
Boston, MA 02110  
+1 617-217-2615

**New York**

Kepler Capital Markets, Inc.  
600 Lexington Avenue, Floor 28  
10022 New York, NY USA  
+1 212-710-7600

**San Francisco**

Kepler Capital Markets, Inc  
50 California Street, Suite 1500  
San Francisco, CA 94111  
+1 415-439-5253