QV UPDATE
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QV Investors Inc.

Say on Pay

It's proxy season – the period between April and early June when most public companies hold their annual shareholder meetings. It provides an important opportunity for shareholders to exercise their voting rights and participate in the corporate governance process. Routine voting items include the election of the company's directors, the appointment of auditors, and the receipt and approval of financial statements. Although not legally required in Canada, today's governance standards also encourage companies to seek shareholder approval on the compensation plans for top executives – a practice dubbed "*Say on Pay.*"

The majority of Canada's largest companies have adopted an annual advisory Say on Pay vote. Although they are non-binding, the Say on Pay results are important in facilitating discussion between directors and shareholders on the often contentious issue of executive compensation. A poor Say on Pay result (often considered anything less than a 90% approval rate) is expected to prompt increased engagement with shareholders and improved transparency by the board. The system seems to be working – shareholder pushback in the form of weak Say on Pay results have caused some companies to make drastic year over year modifications to their compensation structures.

Compensation is one of the most powerful tools that boards have to incentivise their management teams. The proper allocation of rewards is therefore important to the creation of long-term value. Most compensation plans today are highly complex, with long and short-term incentives comprised of various combinations of cash, stock options and other share-based awards. We focus on the following principles when casting our Say on Pay vote:

The overall level of pay should be enough to attract and retain executives with required skills, but should not be excessive or inequitable. Peer groups are often used to benchmark total compensation against companies of similar size. However, each plan should be considered within the context of the particular business and be primarily justified by corporate performance. A reasonable ratio of CEO pay versus other executives or the average employee may be used as an indication that compensation is equitable.

Alignment of interests – a company's annual disclosures should clearly outline how the compensation philosophy incentivises executives to act in the best interest of shareholders. Further, executives should be subject to share ownership requirements, often expressed as a multiple of base salary.

And, most importantly, pay for performance – a majority of executive compensation should be "at risk." The value of rewards, including annual bonuses and longer term incentives, should be directly proportional to performance. In the past, long-term incentives were dominated by traditional stock options. Many boards are shifting focus to other forms of equity incentives, including Performance Share Units (PSUs), which aim to improve the relationship between pay and performance. PSUs are linked to the full value of the company's shares, but the future payout is conditional on the achievement of specified financial, operational or strategic performance targets.

In 2015, Canadian National Railway (CNR), a holding in the Canadian equity strategy, placed greater emphasis on PSUs by shifting its long-term incentive mix to 55% PSUs/45% conventional stock options. 70% of the PSU value is subject to 3-year average return on invested capital targets and a minimum average share price. The remaining 30% hinges on CNR's total shareholder return versus other railroads and other S&P/TSX 60 companies.

In another example, Canadian Natural Resources (CNQ) recently introduced PSU vesting conditions based on relative reserve growth and total shareholder return versus industry peers. CNQ determines the size of its PSU grants using a scorecard of financial, strategic, operational and safety performance factors.

Evaluating the ins and outs of each complex compensation structure can be a daunting task, but it is a critical part of understanding the incentive structures in the businesses that we own. When giving our Say on Pay, we ultimately want to see that the compensation plan is reasonable as a whole and adequately designed to align the interests of all stakeholders.