DOES SIZE MATTER?

CEO Compensation in Canada: 2015 Update

September, 2015
EXECUTIVE SUMMARY

Gallagher McDowall Associates is pleased to provide an overview of our latest research into the compensation of the Chief Executive Officers (CEOs) of two groups of Canadian publicly traded companies.

The first CEO group includes the 60 companies in the S&P/TSX 60 Index, while the second CEO group consists of the 60 next largest companies listed on the Toronto Stock Exchange (TSX) based on their market capitalization.

Comparing 2014 with 2013, we found no significant changes in the compensation of the CEOs in the first group. Meanwhile, the total direct compensation of the CEOs in the second group increased by 5%.

Company size continues to be important. Compared to the CEOs of the smaller group in 2014, the CEOs of the larger group had:

- 1.5 times the base salaries and 1.7 times the total cash compensation
- 1.5 times the stock option grant values
- 2.3 times the share-based award grant values, and
- 2.0 times the total direct compensation

The 2014 Pay Ratios of the two CEO Groups were 157 times and 78 times the 2014 Average Industrial Wage (AIW) respectively.

Their corresponding Tax Ratios were 435 and 205 times the AIW Tax Ratio, or almost three times their Pay Ratios.

High income earners, such as CEOs, pay a lot of tax—in fact about three times as much for every dollar of their pre-tax income as typical wage earners pay on their income.
Gallagher McDowall Associates is pleased to provide an overview of our latest research into the compensation of the Chief Executive Officers (CEOs) of two groups of Canadian publicly traded companies.

The first CEO group includes 59 of the 60 companies in the S&P/TSX 60 Index, while the second CEO group consists of 59 of the 60 next largest companies listed on the Toronto Stock Exchange (TSX) based on their market capitalization as of June 1, 2014. [Note: BlackBerry has been excluded from the first CEO group and Onex from the second CEO group due to special one time long term incentive LTI awards in 2013 that would otherwise significantly distort our market analysis.]

KEY CEO COMPENSATION FINDINGS

S&P/TSX 60 CEOs (Group 1)

- Average base salaries, total cash compensation and total direct compensation\(^1\) for the senior group remained stable year over year, while average long term incentive (LTI) grant values declined slightly.

- These results were influenced by:
  1. Lower new CEO compensation packages at four of the major banks\(^2\),
  2. The impact of the rising US dollar during 2014 on the compensation in CDN dollars of the 17 Group 1 CEOs paid in US dollars, and
  3. Three changes in the companies included in the S&P/TSX 60 Index.

TSX 61-120 CEOs (Group 2)

- Average salaries and total cash compensation for the second group of CEOs increased slightly from 2013, while average total direct compensation increased by 5%.

- These results were influenced by:
  1. The impact of the rising US dollar during 2014 on the compensation of 9 Group 2 CEOs, paid in US dollars,
  2. A 9% increase in the number of Group 2 CEOs receiving LTI awards in 2014, and
  3. Sixteen changes in the companies included in Group 2 in 2014 from 2013.

Table 1: Groups 1 and 2 CEO Compensation Summary

<table>
<thead>
<tr>
<th></th>
<th>Group 1 Averages (millions)</th>
<th>Group 2 Averages (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2013</td>
<td>2014</td>
</tr>
<tr>
<td>Base Salaries</td>
<td>$1.13</td>
<td>$1.17</td>
</tr>
<tr>
<td>Total Cash</td>
<td>$2.94</td>
<td>$3.01</td>
</tr>
<tr>
<td>LTI</td>
<td>$4.88</td>
<td>$4.80</td>
</tr>
<tr>
<td>Total Direct</td>
<td>$7.50</td>
<td>$7.64</td>
</tr>
</tbody>
</table>

\(^1\) “Total direct compensation” includes annual base salary, annual incentive awards and the present value of long-term incentives awarded in the year, such as restricted stock units, performance stock units and stock options, as reported to shareholders in the Summary Compensation Table of the management proxy circular.

Compared to the CEOs of the Group 2 companies, the CEOs of the Group 1 companies earn:

- 1.5 times the base salaries and 1.7 times the total cash compensation,
- 2.3 times the share-based award values,
- 1.5 times the stock option grant date fair values, and
- 2.0 times the total direct compensation

Interestingly, there was little difference between the average and the median total direct compensation results for the Group 1 CEOs. From this we surmise that the Group 1 compensation committees continue to be more focused on targeting the median CEO compensation of their peer groups.

Meanwhile, the average total direct compensation was 7% higher than the median for the Group 2 CEOs.

In Group 1, the prevalence of option based awards decreased by 4% from 2014, and share-based awards decreased by 2%. However in Group 2, the prevalence of both option-based and share-based awards increased by 9% and 6% respectively, as shown in Table 2 below.

**Table 2: LTI Grant Prevalence**

<table>
<thead>
<tr>
<th>LTI Grant Prevalence (% of Companies)</th>
<th>Group 1</th>
<th>2013</th>
<th>2014</th>
<th>Group 2</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share-Based Awards</td>
<td>90%</td>
<td>88%</td>
<td>71%</td>
<td>80%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Option-Based Awards</td>
<td>75%</td>
<td>71%</td>
<td>69%</td>
<td>75%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**2014 CEO PAY MIX**

The mix of total direct compensation for the Group 1 CEOs places a much heavier emphasis on share-based and option-based compensation than the Group 2 CEOs, as can be seen in the charts below:

**Chart 1: Group 1 CEOs**

**Chart 2: Group 2 CEOs**

Pension benefit values were reported for 66% of Group 1 CEOs, as compared to only 51% for Group 2.
CEO TAX RATIO ANALYSIS

While much public focus is placed on the magnitude of CEO compensation, little recognition is given to their significant contribution as individual taxpayers to our economy. Gallagher McDowall Associates has developed the “CEO Tax Ratio” to help fill this void.

For this purpose, we look at the income tax payable by a CEO on his or her compensation and compare that to the income tax payable by a typical employee as represented by the Average Industrial Wage (AIW) published by Statistics Canada. The results for 2014 are summarized in Table 3 below.

Table 3: CEO Pay Ratios and CEO Tax Ratios for 2014

<table>
<thead>
<tr>
<th></th>
<th>Group 1 2014 Averages</th>
<th>Group 2 2014 Averages</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO Pay</td>
<td>$7.64 million</td>
<td>$3.77 million</td>
</tr>
<tr>
<td>Average Industrial Wage</td>
<td>$48,636</td>
<td>$48,636</td>
</tr>
<tr>
<td>CEO to AIW Pay Ratio</td>
<td>157:1</td>
<td>78:1</td>
</tr>
<tr>
<td>CEO Income Taxes²</td>
<td>$3.44 million (45%)</td>
<td>$1.62 million (43%)</td>
</tr>
<tr>
<td>AIW Income Taxes²</td>
<td>$7,918 (17%)</td>
<td>$7,918 (17%)</td>
</tr>
<tr>
<td>CEO to AIW Tax Ratio</td>
<td>435:1</td>
<td>205:1</td>
</tr>
<tr>
<td>CEO Tax Ratio vs CEO Pay Ratio</td>
<td>2.8 times</td>
<td>2.6 times</td>
</tr>
</tbody>
</table>

While both the CEO Pay Ratios and the CEO Tax Ratios are much lower for the Group 2 CEOs than for Group 1, the relationship between the two ratios (i.e. 2.6 and 2.8 respectively in the table above) is similar.

At a macro level, we estimate that the total taxes payable by the 59 Group 1 CEOs equal the taxes payable by over 43,000 AIW level employees; furthermore, the taxes payable by the 59 Group 2 CEOs equal the taxes payable by over 20,000 AIW level employees. We believe the CEO Tax Ratio analysis is important to consider given the tax rate increases being imposed on high income earners. In addition there is the possibility that disclosure of CEO Pay Ratios will be mandated in Canada, as will be required from January 1, 2017 for US companies.

¹ Assumptions:
  a. The AIW earner’s compensation is all paid in current cash.
  b. The CEO’s long-term incentive awards for the year will actually pay out at the values reported to the shareholders in the Summary Compensation Table.

² Income tax estimates are based on the 2014 Federal and Ontario rates for a single taxpayer with no offsetting tax deductions (such as registered pension plan contributions) and with refundable tax credits being limited to the basic exemption, the Canada Pension Plan and Employment Insurance contribution credits and the federal employment credit. The estimates also assume that 50% of the grant date value of CEO stock options will be taxable on exercise.
CEO vs INTERNAL EQUITY ANALYSIS

While most of the focus of institutional investors, proxy advisors and business press is on the CEO, questions have also been raised about whether or not the compensation of the CEO is appropriate in relation to that of the CEO’s direct reports.

To provide context for discussion in this year’s study, we have compared the average compensation of the CEOs to the average compensation of the other year-end Named Executive Officers (NEOs). For example, suppose a CEO’s base salary is $1,000,000 and the average salary of the four NEOs is $500,000. The CEO/Average NEO base salary ratio in this case would be 2.0. Similar calculations can be made for total cash compensation and total direct compensation.

The results of our analysis are shown in Table 4 below.

<table>
<thead>
<tr>
<th>Table 4: CEO/Average NEO Compensation Ratios</th>
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<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Group 1</td>
</tr>
<tr>
<td>2014</td>
</tr>
<tr>
<td>CEO/NEO Base Salary Ratio</td>
</tr>
<tr>
<td>CEO/NEO Total Cash Compensation Ratio</td>
</tr>
<tr>
<td>CEO/NEO Total Direct Compensation Ratio</td>
</tr>
</tbody>
</table>

These findings are lower than we would expect in the U.S., where the CEO typically has much higher annual and long term incentive compensation than a typical Canadian CEO.

From this analysis we conclude that the Group 2 boards tend to award their CEOs significantly higher incentives than to their other NEOs in percentage of salary terms, while the Group 1 boards overall tend to be somewhat more consistent in their relative emphasis on executive incentives.

WHAT MIGHT WE EXPECT FOR 2015?

CEO compensation for 2015 will continue to be in a state of flux. On the one hand, the impact of the significant strengthening of the U.S. dollar in 2015 on those CEOs paid in U.S. dollars could increase CEO compensation in Canadian dollars by as much as 6 to 7%. On the other hand, there will be much lower bonus payouts in the energy and mining sectors than in 2014. The overall result could potentially be a wash.

Meanwhile, the outcome of the upcoming Federal election could have negative consequences for the longevity of the 50% stock option deduction. We estimate, for example, that the CEO Tax Ratios shown on page 5 would increase from 435 to 473 times for Group 1 and from 205 times to 231 times for Group 2 if the stock option deduction were to be eliminated.
CONCLUSION

CEO compensation levels continue to be heavily scrutinized and increasingly criticized.

One should not assume, however, that the compensation of CEOs of publicly traded companies is “money in the bank”. In fact, more than half of their reported compensation is deferred and heavily dependent on future performance.

While this article focuses on CEO compensation trends of publicly traded companies, Gallagher McDowall Associates has clients in many sectors, including privately held companies, industry associations, non-profits and various government organizations. We can conduct specific analyses identifying implications of pay trends for clients with reports that can be customized to their needs (e.g. sector, industry, pay for performance analysis).

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