DOES SIZE MATTER?

CEO Compensation in Canada: 2016 Update
EXECUTIVE SUMMARY

Overview

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 58 of the 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.

Our analysis is based on a database we have created since 2010 of the compensation of the top five most highly paid executive officers as reported to each company’s shareholders.

For this purpose, we track the following components of executive pay for each of the companies:

- Base salaries
- Annual bonuses
- Total cash compensation
- Share-based award grant values
- Option-based award grant values
- Total long term incentive values
- Total direct compensation

We also monitor pension and perquisite values.

Key Takeaways

Comparing 2015 with 2014, we found a slight decrease in the average compensation of the CEOs in the first group. Meanwhile, the total direct compensation of the CEOs in the second group increased on average by 4% (See page 3)

Company size continues to be an important factor in executive compensation. Compared to the CEOs of the smaller group in 2015, the CEOs of the larger group had 2.3 times the total direct compensation. (See page 4)

The 2015 Pay Ratios of the two CEO Groups were respectively 159 times and 83 times the 2015 Average Industrial Wage in Canada, much less than the levels typically reported in the US.

High income earners, such as CEOs, pay a lot of tax—in fact about three times as much for every dollar of their income as typical Canadian wage earners pay. (See page 5)

Our report also looks back six years to see how CEO compensation has changed in both Group 1 and Group 2 since we first began these studies.

We found that the total direct compensation of the Group 1 CEOs increased by 25% over the period, primarily due to higher share-based compensation awards. Meanwhile, the Group 2 CEOs’ total direct compensation increased by 35%, mainly due to higher share-based awards and higher salaries. (See page 7)
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 58 of 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 as of April 29, 2016. [Note: Constellation Software was excluded from the first group as their CEO receives no compensation at all, while the former US-Based CEO of Valeant Pharmaceuticals was excluded as he received a disproportionate $140 million U.S. equity award in 2015.]

### Key CEO Compensation Findings: 2015 vs. 2014

**S&P/TSX 60 CEOs (Group 1)**

- Average base salaries, total cash compensation, long term incentive (LTI) grant values, and total direct compensation\(^1\) for the senior group all declined slightly in 2015 compared to 2014.

- These results were influenced by:
  1. Somewhat lower incentive awards in the energy and mining sectors in 2015.
  2. The impact of the US dollar during 2015 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 significantly from 2014, while LTI grant values decreased slightly: Average total direct compensation increased by 4% in 2015 vs. 2014.

- These results were influenced by:
  1. An increased emphasis on cash compensation in 2015 in Group 2
  2. The impact of the rising US dollar during 2015 on the compensation of 9 Group 2 CEOs paid in US dollars, and
  3. Seventeen year over year changes in the companies included in Group 2.

### Table 1: Group 1 and Group 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>2014</td>
<td>2015</td>
</tr>
<tr>
<td>Base Salaries</td>
<td>$1.23</td>
<td>$1.22</td>
</tr>
<tr>
<td>Total Cash</td>
<td>$3.14</td>
<td>$3.08</td>
</tr>
<tr>
<td>LTI</td>
<td>$4.86</td>
<td>$4.81</td>
</tr>
<tr>
<td>Total Direct</td>
<td>$7.99</td>
<td>$7.89</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 on average earn:

- 1.4 times the base salaries and 1.6 times the total cash compensation,
- 2.3 times the share-based award values,
- 2.2 times the stock option grant date fair values, and
- 2.3 times the total direct compensation

Interestingly, there continues to be a small (2% in 2015) 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 are more focused on targeting the median CEO compensation of their peer groups.

Meanwhile, the average total direct compensation was 24% higher than the median for the Group 2 CEOs.

In Group 1, the prevalence of both share-based awards and option-based awards increased from 2014, while in Group 2 the prevalence of share-based awards increased, yet the number of option-based awards decreased, as shown in Table 2 below.

### Table 2: LTI Grant Prevalence

<table>
<thead>
<tr>
<th></th>
<th>LTI Grant Prevalence (% of Companies)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
</tr>
<tr>
<td>Share-Based Awards</td>
<td>88%</td>
</tr>
<tr>
<td>Option-Based Awards</td>
<td>71%</td>
</tr>
</tbody>
</table>

### 2015 CEO PAY MIX

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

#### Chart 1: Group 1 CEOs

- Salary, 15%
- Bonus, 24%
- Shares, 39%
- Options, 21%
- Other LTI, 0%

#### Chart 2: Group 2 CEOs

- Salary, 19%
- Bonus, 28%
- Shares, 32%
- Options, 21%
- Other LTI, 1%

Pension benefit values were reported for 71% of Group 1 CEOs, as compared to 50% 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 2015 are summarized in Table 3 below.

Table 3: CEO Pay Ratios and CEO Tax Ratios for 2015

<table>
<thead>
<tr>
<th></th>
<th>Group 1 2015 Averages</th>
<th>Group 2 2015 Averages</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO Pay</td>
<td>$7.89 million</td>
<td>$4.13 million</td>
</tr>
<tr>
<td>Average Industrial Wage</td>
<td>$49,510</td>
<td>$49,510</td>
</tr>
<tr>
<td>CEO to AIW Pay Ratio</td>
<td>159:1</td>
<td>83:1</td>
</tr>
<tr>
<td>CEO Income Taxes²</td>
<td>$3.47 million (44%)</td>
<td>$1.79 million (43%)</td>
</tr>
<tr>
<td>AIW Income Taxes²</td>
<td>$8,067 (16%)</td>
<td>$8,067 (16%)</td>
</tr>
<tr>
<td>CEO to AIW Tax Ratio</td>
<td>431:1</td>
<td>222:1</td>
</tr>
<tr>
<td>CEO Tax Ratio vs CEO Pay Ratio</td>
<td>2.7 times</td>
<td>2.7 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. 2.7 times and 2.7 times respectively in the table above) is similar.

At a macro level, we estimate that the total taxes payable by the 58 Group 1 CEOs equal the $200 million taxes payable by 25,000 AIW level employees; furthermore, the $107 million taxes payable by the 60 Group 2 CEOs equal the taxes payable by over 13,000 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. For example, we estimate that the CEO Tax Ratios shown above will increase as follows in 2016 due to the new top federal marginal tax rate:

Table 4: CEO Pay Ratios and CEO Tax Ratios for 2016

<table>
<thead>
<tr>
<th></th>
<th>Group 1</th>
<th>Group 2</th>
<th>Top Marginal Tax Rate (Ontario)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>431:1</td>
<td>222:1</td>
<td>49.53%</td>
</tr>
<tr>
<td>2016</td>
<td>473:1</td>
<td>240:1</td>
<td>53.53%</td>
</tr>
</tbody>
</table>

Assumptions:
1. 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 2015 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/NEO base salary ratio in this case would be $1,000,000 divided by $500,000, or 2.0. Similar calculations are made for total cash compensation and total direct compensation.

The results of our analysis are shown in Table 5 below.

<table>
<thead>
<tr>
<th>Group 1</th>
<th>Group 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>2015</td>
</tr>
<tr>
<td>CEO/NEO Base Salary Ratio</td>
<td>1.88</td>
</tr>
<tr>
<td>CEO/NEO Total Cash Compensation Ratio</td>
<td>2.21</td>
</tr>
<tr>
<td>CEO/NEO Total Direct Compensation Ratio</td>
<td>2.32</td>
</tr>
</tbody>
</table>

A pattern can be seen from the table, as the emphasis on incentive compensation increases relative to base salary for the CEOs in both groups.

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

## WHAT MIGHT WE EXPECT FOR 2016?

CEO compensation for 2016 will continue to be under heavy scrutiny by investors and the media. We expect little change in the market for Group 1 CEOs, however but still higher compensation for the Group 2 CEOs.

## LOOKING BACK SIX YEARS

At Gallagher McDowall Associates, we have been analyzing the compensation of TSX CEO’s each year since 2010. The changes over this six year period have been quite dramatic, as illustrated in the tables on the following pages.
GROUP 1 CEOs

While the compensation of the S&P/TSX 60 CEO’s has now appeared to have stabilized, their compensation has increased by around 25% over six years, primarily due to higher share-based compensation awards.

Gallagher Comments
- Total cash compensation increased by 7%, or 2% less than inflation over the same period.
- $3.0 million appears to be a typical Group 1 CEO total cash compensation package.

Table 6.1 Total Cash Compensation

<table>
<thead>
<tr>
<th></th>
<th>Salary</th>
<th>Annual Incentive</th>
<th>Total Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>$1.22</td>
<td>$1.86</td>
<td>$3.08</td>
</tr>
<tr>
<td>2010</td>
<td>$1.13</td>
<td>$1.75</td>
<td>$2.88</td>
</tr>
</tbody>
</table>

Table 6.2 Long Term Incentive Grant Values

<table>
<thead>
<tr>
<th></th>
<th>Share Based Awards</th>
<th>Option Awards</th>
<th>Total LTI</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>$3.05</td>
<td>$1.65</td>
<td>$4.81</td>
</tr>
<tr>
<td>2010</td>
<td>$1.90</td>
<td>$1.57</td>
<td>$3.51</td>
</tr>
</tbody>
</table>

Gallagher Comments
- Total LTI grant values increased by 37%, primarily due to 61% higher share-based awards (i.e. performance stock units and restricted stock units).
- Stock option awards continue to be common, but are neither increasing nor decreasing.

Table 6.3 Total Direct Compensation

<table>
<thead>
<tr>
<th></th>
<th>Total Cash</th>
<th>Total LTI</th>
<th>Total Direct</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>$3.08</td>
<td>$4.81</td>
<td>$7.89</td>
</tr>
<tr>
<td>2010</td>
<td>$2.88</td>
<td>$3.51</td>
<td>$6.39</td>
</tr>
</tbody>
</table>

Gallagher Comments
- Approximately 60% of a typical Group 1 CEO’s total direct compensation is made up of LTI awards.
- In the US, 70% of a large cap CEO’s compensation is typically made up of LTI awards.
GROUP 2 CEOs

As discussed in this report, the compensation of the Group 2 TSX CEOs continues to rise each year. Looking back over six years, we see that their cash compensation and LTI awards have both increased dramatically.

Table 7.1 Total Cash Compensation

<table>
<thead>
<tr>
<th></th>
<th>Group 2 - Averages ( Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Salary</td>
</tr>
<tr>
<td>2015</td>
<td>$0.85</td>
</tr>
<tr>
<td>2010</td>
<td>$0.59</td>
</tr>
</tbody>
</table>

Gallagher Comments

- Total cash compensation has increased by about 30% to $2.0 million (i.e. two thirds of Group 1).
- Base salaries have been increasing more rapidly than annual incentives (by 43% vs. 22% respectively).

Table 7.2 Long Term Incentive Grant Value

<table>
<thead>
<tr>
<th></th>
<th>Group 2 - Averages ( Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Share Based Awards</td>
</tr>
<tr>
<td>2015</td>
<td>$1.30</td>
</tr>
<tr>
<td>2010</td>
<td>$0.69</td>
</tr>
</tbody>
</table>

Gallagher Comments

- Total LTI grant values increased by 44% mainly due to 88% higher share-based awards, but also due to 11% higher stock option award values.
- Group 1 LTI award values continue to be more than double the Group 2 LTI awards ($4.8 million vs. $2.1 million).

Table 7.3 Total Direct Compensation

<table>
<thead>
<tr>
<th></th>
<th>Group 2 - Averages ( Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total Cash</td>
</tr>
<tr>
<td>2015</td>
<td>$1.97</td>
</tr>
<tr>
<td>2010</td>
<td>$1.51</td>
</tr>
</tbody>
</table>

Gallagher Comments

- Total direct compensation for the Group 2 CEOs has been increasing at an annual rate of around 5%.
- They are currently being paid about one-half of the TDC of their Group 1 counterparts ($4.1 million vs. $7.9 million).
CONCLUSION

CEO compensation levels continue to be heavily scrutinized and increasingly criticized, especially for companies in the S&P/TSX 60 Index. The result has been a noticeable dampening of large Canadian company CEO compensation in the past few years.

The ongoing upward market trend continues, however, amongst the next group of 60 companies. Their CEO compensation appears to be less constrained by the “good governance” radar screens.

It should be noted that CEO compensation levels required to be reported to shareholders are not “money in the bank.” In fact, much of their compensation is deferred, at risk, and dependent on future performance.

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While this article focuses on CEO compensation trends of publicly traded companies, Gallagher McDowall Associates consultants have executive compensation clients in many sectors, including privately held companies, industry associations, non-profits and various government organizations.

Our services include:

· Board of directors’ advice
· Executive compensation strategy
· Executive compensation audits and market reviews
· Short-term and long-term incentive plan design
· Executive compensation risk assessments
· Executive compensation disclosure
· Board of directors’ compensation
· Expert witness consulting

At Gallagher McDowall Associates, our goal is to

Make Executive Compensation Work.
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