Human Resource Services

The state of pay

Hospitality and leisure executive remuneration
October 2009

Introduction

This document aims to give you insights into the state of executive pay in the hospitality and leisure sector, looking at the period from January 2008 to September 2009.

The UK hospitality and leisure sector is currently operating within some of the worst trading conditions seen for many years. The recession has had a major impact on consumer spending which is being cut at the fastest rate in three decades.

British hotels are struggling with the worst trading conditions for 30 years. Average room rates are falling fast as hoteliers attempt to attract customers; there are warnings that weaker hotel groups could fail as corporate hospitality budgets continue to be reined back.

Also, that great institution, the public house is suffering. Public houses are being sold off at a rate of 50 a week, often being closed down and turned into a variety of other uses. There has been financial pressure on big pub companies to cut their borrowings and without a potential buyer for a large group of pubs they are forced to sell them off one by one in a bid to cut their debts.

A popular reaction in a recession is to start trading down and those restaurants with a lower price point are bucking the economic trend by managing to keep earnings fairly solid.

There are a number of business models in this sector which should impact on the design of companies' executive reward programmes:

- asset-backed companies, many of which often have substantial debt funding and securitisations;
- non asset-backed companies where the 'brand' is the main value;
- combination businesses where there are elements of the two models cited above.

These business models, coupled with different strategies, would suggest a wide variety of executive reward programmes particularly when companies are selecting the appropriate performance conditions for annual and long-term incentives. Has this historically been the case? If not, does the changing economic environment make a more company bespoke approach essential? During this period of instability, are there downward pressures on executive pay? Or do remuneration committees acknowledge that incentivising key individuals is essential and arguably more important during the current crisis?

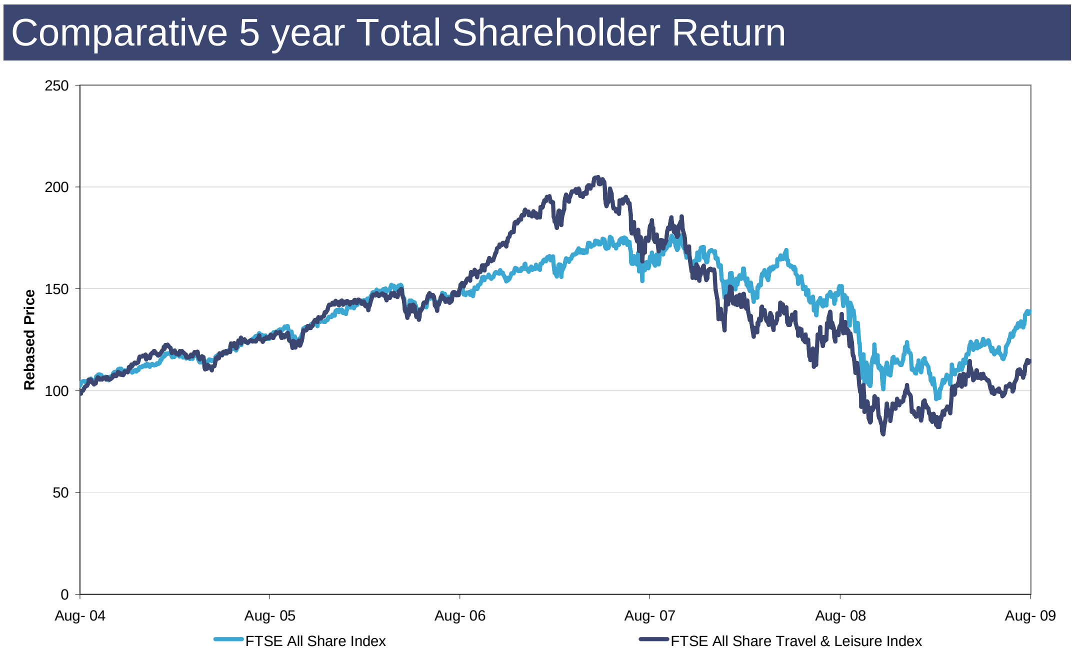
The chart on the following page shows that economic uncertainty has flowed through to falls in share price. Can remuneration committees justify bonus payments when there has been a severe reduction in company values but where executives have to date successfully mitigated the worst effects of the recession on their businesses? Remuneration committees still have a primary duty to motivate and retain management teams who they believe are necessary to execute existing or new business strategies through an appropriate balance of fixed and variable pay structures.

Over the past few years, executives have been well rewarded through annual bonuses linked to the delivery of large profits and share awards, driven by strong levels of share price growth in a booming economy. Such a reward profile is no longer sustainable in the current economic climate, nor does it fit with the general outlook for the UK economy.

Given this unprecedented level of economic uncertainty, we expect that there will be a radical re-think of executive remuneration structures within the sector. This report examines all these issues in more detail.

The chart below shows that the sector outperformed the FTSE All-Share Index at the height of its peak, but has since fallen below the Index.

Comparative returns to investors – five years to August 2009



Source: DataStream

Key issues faced by remuneration committees:

There are a number of issues facing remuneration committees:

- There is a general expectation from investors that fixed costs such as salary (including pensions and benefits) should not increase at a time when a company's profits are falling or where there has been a material reduction in share price. It is equally challenging to justify both externally and internally salary increases for executives in a company where redundancies are occurring or where pay freezes or reductions in salary levels are taking place.

- Companies are failing to achieve the financial performance required to pay annual bonuses. The challenges faced by remuneration committees in these circumstances may arise where there are conflicting positions around the performance actually delivered, because:
    - executives believe that the level of performance, given the economic background, while in absolute financial terms less than in previous years, was in practice far more challenging to deliver; and
    - investors feel that bonuses should be lower or not paid where absolute levels of profit and value delivered are less, irrespective of the economic background.

  In practice, remuneration committees do not often find such clear cut divisions of views! One of last season's contentious reporting issues was where companies have paid bonuses in circumstances where shareholders do not feel that they are justified, giving rise to sometimes heated and public debate.

- The challenge of setting appropriate annual bonus targets for 2009 against a background of:
    - shareholder bodies stating that if bonus targets are lower so should be the maximum bonus potential.

- The view of executives that achieving these lower absolute targets is at least as difficult as any historic targets set;
    - the fact that earnings per share (EPS) growth measures and profit may no longer be appropriate with cashflow, debt and covenants, asset values and return measures being of more immediate relevance to the company.

- There are similar issues with setting the performance targets for long-term equity-based plans with the added challenge of:
    - the lack of visibility over a three-year performance period when trying to establish financial targets;
    - the view gaining traction that traditional measures such as earnings per share (EPS) growth and total shareholder return (TSR) may have encouraged short-term decisions to enhance the probability of a payout to the detriment of long-term sustained value creation;
    - the effective removal of any long-term lock-in and retention of executives from their subsisting awards under their equity programmes due to falling share prices and lower levels of corporate performance. This gives the remuneration committee a double challenge of providing new incentives against a background of widespread investor cynicism;

- The pressures to provide the appropriate package in the current climate are exacerbated by the change in income tax rates and pension tax relief which will automatically result in a material reduction in the overall value of an executive's package.

Salary

The tables below show current and historic salary levels for chief executives and finance directors in the sector.

Current Salary Percentiles (£000's)			Sector CEO Salary Median Against FSTE Index (£000's)			Sector FD Salary Median Against FTSE Index (£000's)		
	CEO	FD		Sector	FTSE		Sector	FTSE
Upper Quartile	£612	£379	FTSE 100	£802	£757	FTSE 100	£494	£450
Median	£500	£279	FTSE 350	£548	£487	FTSE 350	£344	£314
Lower Quartile	£364	£235	FTSE 250	£525	£424	FTSE 250	£288	£278
			FTSE Smallcap	£304	£303	FTSE Smallcap	£205	£277

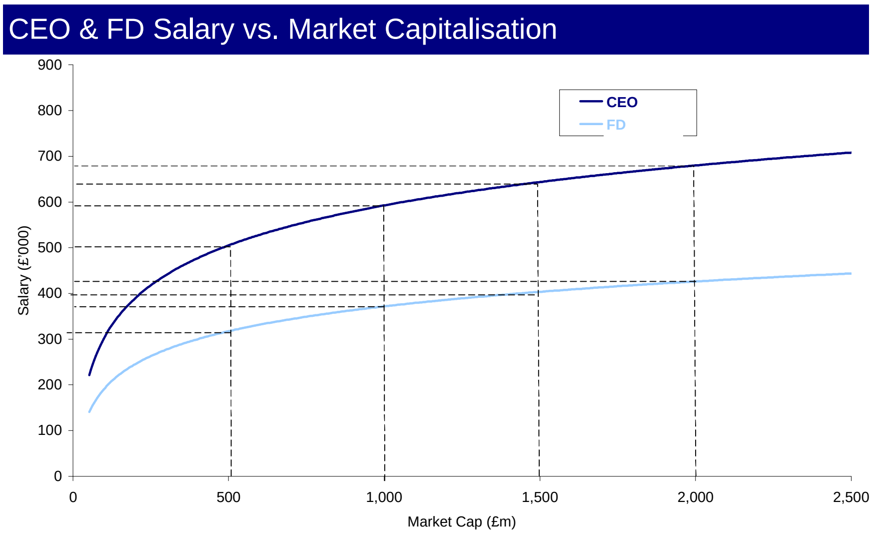
Historic Sector Salary Median (£000's)			Historic Median Increases in Salary		
	CEO	FD		CEO	FD
2008/2009	£500	£279	2008/2009	1.3%	0.6%
2007/2008	£525	£283	2007/2008	7.4%	8.5%
2006/2007	£459	£257	2006/2007	11.5%	9.5%
2005/2006	£333	£210	2005/2006	8.9%	8.6%
2004/2005	£290	£164	2004/2005	9.3%	10.0%

The data above reveals that the sector's median salary level is £500,000 and £279,000 for chief executives and finance directors respectively, which compares to the figures for the entire FTSE All Share Index of £411,000 and £275,000. Individual year on year salary increases have dropped below 1.5% for the first time in recent years (historically pay increases have always exceeded 7%). Indeed, as time has passed over the period reviewed, the percentage of companies freezing their levels of salaries has increased as the full impact of the recession, coupled with restructuring of their businesses, has made boards decide that increases to executive pay would be inappropriate. However, while salary freezes may offer a short-term fix they can lead to problems when the market improves.

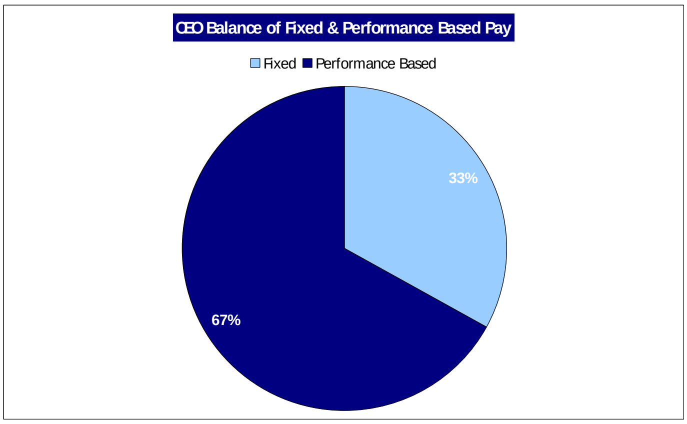
It is often debated whether or not there is a direct relationship between the size of a company and the salaries paid to the executive directors. Clearly, FTSE 100 companies pay their directors more than those in the FTSE Small Cap, but whether or not there is a strong relationship between salary levels and an individual company's size is harder to clarify.

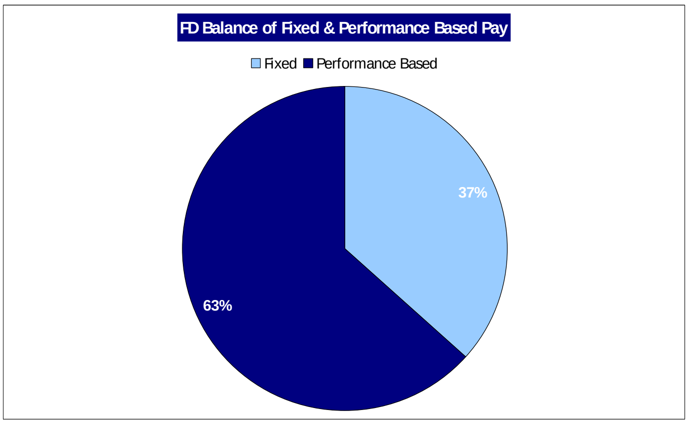
This is increasingly relevant in the current economic climate as the share price values of companies have dropped significantly. It is therefore important for companies to consider a wide range of corporate attributes when comparing remuneration and not just the market capitalisation at a given point in time. It should be noted that this is not just a company problem, investors also comment negatively on the level of salaries where market capitalisations have fallen.

The following chart illustrates the correlation between salary and market capitalisation within the sector:



Although salary remains the building block of an executive's total remuneration package, with all other elements typically driven off salary level, the balance between fixed (salary, pension and benefits) and variable incentive components (bonus and share incentives) is now largely weighted towards performance related incentives, as the tables show below.





This approach has now arisen as a result of the change in the balance of packages towards performance-based incentives, driven by the market and investors over the past five years and due to the leveraging which is now inherent in remuneration packages. While performance conditions have been met and incentives paid there have been no problems; however, now that incentives are not paying out, the value of executives packages have in real terms reduced potentially by up to two thirds compared to previous years. This is of course the purpose of incentive based pay to reflect the actual performance of the company. However, it is the historic expectation by executives of a level of remuneration paid, coupled with the subjective nature of the challenge of achieving absolute levels of performance given a different economic climate which is fuelling some of the emotion behind the current debate between executives, remuneration committees and investors.

The table shows the salary levels at the executive committee level below the main board positions for companies in the sector:

	Base salary £'000	Total cash £'000	Total direct compensation £'000
Upper Quartile	243	350	505
Median	173	221	304
Lower Quartile	133	168	207

Bonus

Maximum bonus potential continues to rise, with the majority of companies in the sector and increasingly in the wider market, operating a policy of a bonus maximum of 100% of salary. Maximum bonus potentials of 100% are becoming the norm in the quoted environment. It should be noted however, that institutional shareholders' bodies are wary of companies increasing bonus potential without a corresponding toughening of the performance conditions which must be achieved for maximum bonus payout. We expect the median level of maximum bonus potential to remain at 100% of salary in line with the vast majority of companies in the sector and the trend in other industries.

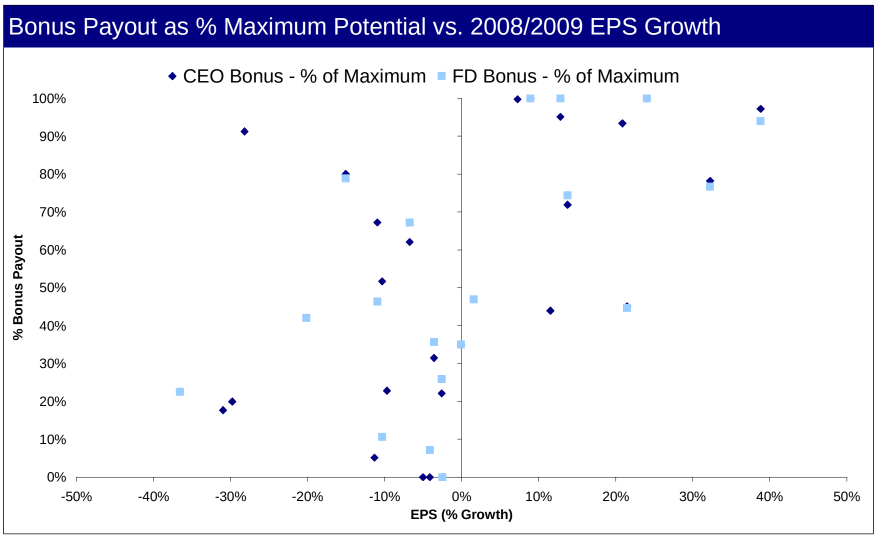
It is this increase in maximum bonus potentials over recent years that has maintained actual bonus payments as a percentage of salary while the payout as a percentage of the maximum bonus has started to fall. Given that the full impact on this sector of the current economic climate has not yet completely flowed through to bonus levels reported, we would expect next year's bonus payments to decrease in absolute terms.

Maximum bonus as % of salary			**Most recent bonus paid (£000s)**		
	CEO	FD		CEO	FD
Upper Quartile	146%	120%	Upper Quartile	£489	£301
Median	100%	100%	Median	£254	£200
Lower Quartile	100%	100%	Lower Quartile	£51	£51
Median payout as % of salary			**Median payout as % of maximum**		
	CEO	FD		CEO	FD
2008/2009	67%	71%	2008/2009	52%	47%
2007/2008	88%	66%	2007/2008	95%	81%
2006/2007	69%	65%	2006/2007	78%	50%
2005/2006	44%	45%	2005/2006	53%	55%
2004/2005	56%	54%	2004/2005	61%	54%

The table shows the maximum bonus potential and median bonus payout as a percentage of salary at the executive committee level positions below the main board:

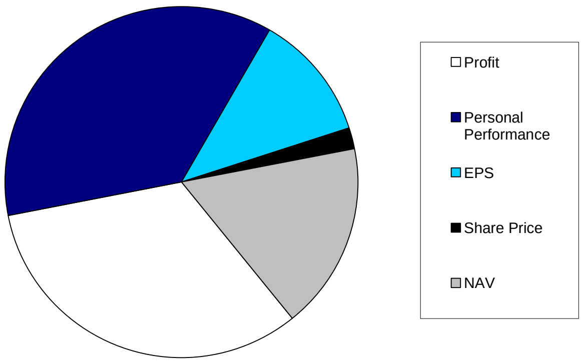
	Maximum bonus as % of salary	Median payout as % of salary
Upper Quartile	100%	68%
Median	60%	43%
Lower Quartile	50%	21%

Performance-related pay is designed to ensure that executives are remunerated in line with a company's success over the short-term and long-term, with annual bonus rewarding annual performance. However, whether it is actually the case that bonus payments do reflect a company's performance over the relevant year is difficult to gauge given the range of measures used and the nature of the targets set. Nevertheless, the following chart demonstrates that some companies have paid lower bonuses where they have experienced a greater fall in earnings per share (EPS) over the period. Overall, there is little correlation between bonus payments and actual short-term performance.



Group profit and EPS continued to be the most popular corporate measure of annual performance used in relation to annual bonus schemes with an element of personal performance prevalent in many schemes. The following chart shows the bonus performance measures used in the sector.

Annual Bonus Scheme Performance Measures



The outlook for many companies in the sector is that there is a high degree of probability that they are not going to make profits for the next couple of financial years (or severely reduced levels of profit). This makes the use of profit as a performance target either irrelevant or challenging to justify to shareholders, particularly where there is a lower profit target but the same level of bonus opportunity. There is a view, which has some justification that the cost of executive bonuses should remain at a constant percentage of profit, thereby automatically reducing the maximum bonus pot where profits fall over the financial year.

The key challenge for 2009 and 2010 will be setting both the appropriate type of bonus performance target and level of that target. Given the nature of the different business models we would expect to see a greater delineation in the types of targets used. For example, asset based companies, particularly those that are debt funded or have securitisations, may use free cashflow, debt levels / renegotiations and manage the reduction of / or maintaining net asset values. 'Brand' owners may struggle to justify the current levels of bonus payments on falling profits and instead look at the use of value maintaining measures such as return on capital employed (ROCE) where cost control and restructuring will impact on their satisfaction as well as revenue. In addition, we expect to see greater use of business restructuring and strategy based criteria which may not be directly financial in nature.

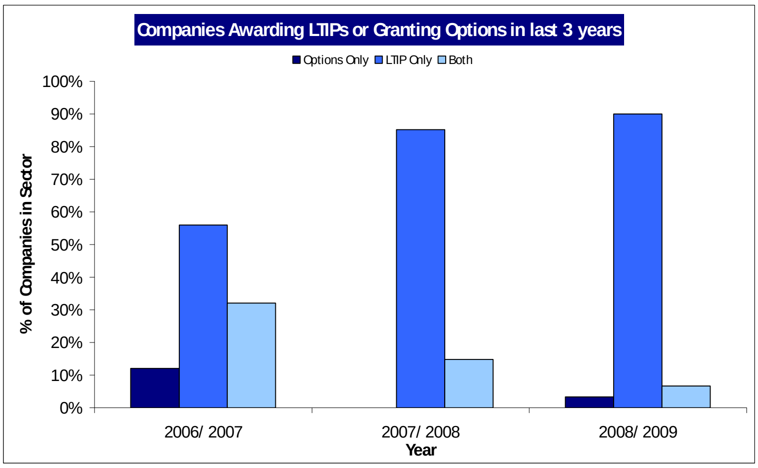
Given the challenge of setting long-term financial measures (please see the section following on long-term equity incentives), a number of companies are considering whether to increase the amount of incentive compensation driven off annual performance (reducing the levels of long-term incentive grant) with a deferral in shares of a significant amount of the bonus earned to ensure a longer term impact on the actual level of payment received due to the exposure to the share price of the company.

Where companies are not considering this route, although there is a corporate governance preference for bonus payments to be paid partly in cash and partly in shares, all cash bonus plans continue to be more popular than deferred share arrangements. We do not expect to see an increase in the number of standard bonus deferral arrangements going forward as cash continues to be the preferred delivery mechanism of annual bonuses and the fact that executives are reluctant to expose more of their remuneration to long-term share price volatility.

Long-term equity incentives

Conditional share awards (LTIPs) are the preferred delivery mechanism for equity incentives in the wider market, with 80% to 90% of companies in the FTSE All-Share Index operating LTIP schemes as their sole long-term incentive. The sector is in line with this and the popularity of LTIPs has grown over the past couple of years with options now only used in the minority of companies. This has been brought about by the change in accounting treatment levelling the playing field for LTIPs, the issues of underwater options and the increasing challenge of vesting conditions on options which may be satisfied but due to share price performance, provide no material benefit to participants.

The chart below shows that options are becoming less popular and are being used more to top up executive director pay as opposed to an alternative equity incentive scheme to an LTIP.



The tables following show the levels of long-term share award for CEOs and FDs in the sector. It should be noted that although reporting the face value of equity incentives is the norm, this may have little bearing on the potential value to a participant.

Shareholders of companies in this sector are currently expressing concern that depressed share prices, in conjunction with fixed grant polices based on a percentage of salary, may result in inappropriate windfall benefits for executives when share prices in the sector recover. Companies may also need to be more aware of the potential dilution impact of retaining the same historic value of shares granted but which will now be over a greater number of shares. This concern is exacerbated due to the sector's comparatively high salary levels and levels of grant as a percentage of these salaries.

Face Value 2008/2009 LTIP Award as % of Salary			Face Value 2008/2009 Option Grant % of Salary		
	CEO	FD		CEO	FD
Upper Quartile	217%	199%	Upper Quartile	176%	253%
Median	164%	127%	Median	121%	176%
Lower Quartile	99%	93%	Lower Quartile	66%	98%

Finding the most appropriate performance conditions for long-term incentives is increasingly one of the most difficult tasks facing companies. This is particularly true with an active corporate governance community strongly supporting the use of total shareholder return despite continuing reservations about the number of external factors impacting on share price besides management performance.

This is an area where companies should move away from a market driven approach to one which is much more bespoke to the company. When determining the appropriate targets for long-term incentives (and annual bonus targets) companies should be considering factors such as:

- the business model operated by the company;

- the strategy over the next two to three years;

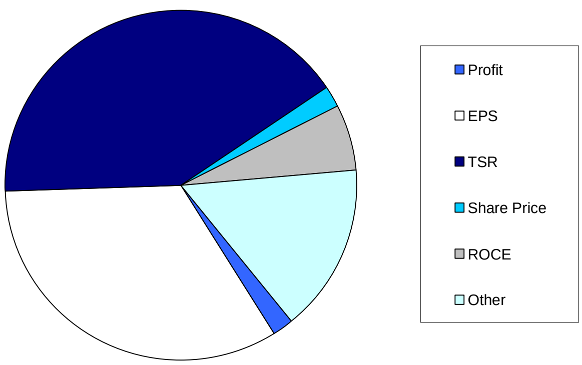
- objective measures of the successful implementation of this strategy; and

- the company's ability to measure and communicate the performance criteria used, to both internal and external stakeholders.

However, this approach gives rise to greater challenges in getting shareholder buy-in and requires more effort from companies. The benefits are criteria actually relevant to the business being run by the executives who are participating in the long-term incentives.

Companies have started to operate a policy of combined performance measures, with a proportion of the award linked to TSR to comply with corporate governance best practice, and the balance linked to a corporate performance measure directly aligned to the company's specific business strategy. The following chart shows the LTIP performance measures used by companies in the sector.

LTIP Performance Measures



Summary

We believe that in the near future the key reward issues for the hospitality and leisure sector will be:

- designing short and long-term incentive arrangements which strike an appropriate balance between the expectations of executives, the company and its particular strategy, and the prescriptive requirements of institutional shareholders and their representative bodies all in light of the challenging market conditions; and

- ensuring that performance conditions support company strategy rather than follow market practice – this will be a positive development from the one size fits all approach which has prevailed.

We do not expect to see any material increases in salaries over the next period with actual salary freezes occurring in an increasing number of cases.

In our opinion, maximum bonus potentials will continue to reflect a level of around 100% in the next reporting season. In the current economic climate shareholders will not envisage being able to justify any increases. Likewise, we do not believe that the quantum of annual LTIP awards will increase in the near future.

The main focus for remuneration committees will be:

- balancing annual bonus and long-term incentives, given the challenge of setting long-term financial targets with the current economic uncertainty. We may see companies shifting the incentive balance in favour of annual bonus where target setting is comparatively easier with large amounts of the bonus being deferred in shares to balance the short-term focus this may give;

- the performance targets used for annual bonus and long-term incentives. This is the time for companies to move away from a market driven approach, despite the greater challenge and effort in achieving investor buy-in, to one much more closely based on the business model operated by the company and the company's strategy over the next period (see previous page);

- the challenge of adjusting the reward package to reflect the effect of new tax legislation on pensions and the pressure by executives to mitigate the impact of the increase in income tax rates on their overall remuneration. These tax changes are encouraging companies to explore ways of remunerating executives under the CGT regime. This challenge will have to be faced at a time of tight corporate budgets and a general negative sentiment towards executive compensation.

Companies surveyed

The companies identified by the London Stock Exchange as the FTSE Travel and Hospitality Sector. Information has been obtained from the report and accounts of these companies and databases.

If you would like to discuss any of the issues raised in this document, or any other reward related queries, please speak to your usual PwC contact or one of the following advisers:

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