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Executive Compensation & Corporate Governance

Insights 2018 – Part 1

*A study examining
compensation in SMI,
SMIM and small-cap
companies as well as
trends in corporate
governance*

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Insights 2018

How much do the top management bodies – combining board members and executives – cost shareholders? How have pay levels of board members and executives developed over time? What are the main trends in pay structure? How are overall earnings distributed to top management, to personnel and to financial capital providers? How should companies communicate with shareholders, employees, the media and society at large? What are innovative, easy-to-understand reward systems that create incentives for sustainable firm value generation?

To help answer these questions, and to engage PwC clients in a dialogue, every year for over a decade PwC has presented one of the most detailed Swiss studies available on the level and structure of board and executive compensation.

We are delighted to present the twelfth edition of our study “Executive Compensation & Corporate Governance Insights.” This study comprises the years from 2007 to 2017 and investigates the largest 100 listed Swiss companies. Moreover, for more recent years, one part of our study also provides a comparison with the largest 130 listed German companies.

Like last year, we present the outcomes of the study in three short Insights releases. The notes are, however, closely related, and we hope that you will enjoy the breadth of perspective offered when considering them as a whole:

We look forward to engaging in dialogue with you.



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Partner, PwC



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1. *Insights 2018*, part 1, released in September 2018, studies the level and structure of compensation of CEOs, other executives, and chairpersons and other board members in Swiss listed companies, and thus provides valuable insights for board members and executives seeking the right quantum of compensation.
2. *Insights 2018*, part 2, released in October 2018, offers, for the first time, a comparison of the level and development of executive and board pay in Switzerland and Germany.
3. *Insights 2018*, part 3, released in November 2018, presents a new idea for linking equity-based (long-term) compensation with a focus on the achievement of strategic targets. This versatile method can be adjusted to the circumstances of each firm but is sufficiently general to allow straightforward communication to shareholders and other stakeholders

Our data facilitate a wealth of other analyses. Here we highlight only a few key points, but we are happy to engage with you in a dialogue about aspects of compensation which are of particular interest to you.

Introduction Insights 2018, part 1

PwC's *Insights 2018, part 1*, summarises the key highlights for the largest 100 Swiss listed companies regarding the level of compensation of CEOs and other executives, as well as chairpersons and other board members.

The key findings are:

1. Board and executive compensation are economically highly relevant quantities. The total sum of board and executive compensation (together referred to here as *top management bodies compensation*) in the largest 100 companies in 2017 was about CHF 1.6 billion – almost identical to the sum in 2009. There has, however, been a shift among companies. The total sum paid to the SMI top management bodies was CHF 811 million, a drop of 15.4% since 2009; the aggregate sums to the SMIM and small-cap top management bodies were CHF 416 million and CHF 354 million, respectively, reflecting increases by 16.7% and 19.1% relative to 2009.
2. In 2017, the median SMI firm spent CHF 31.8 million on executive compensation, the median SMIM firm CHF 13.2 million and the median small-cap firm CHF 5.2 million. As for board compensation, the totals were, at the median, CHF 4.5 million, CHF 2.0 million and CHF 1.0 million, respectively.
3. The median value of the executive-to-board compensation ratio – the ratio of total compensation of executives divided by total compensation of board members – can indicate the power of executives. In 2017, overall, that ratio was 4.9, the lowest value observed in 11 years, and the first time this ratio has dropped below 5. There is, however, wide variation across companies.
4. Median total CEO compensation in the SMI companies has fallen to its 2009 level, at CHF 5.5 million (–29.5% compared to 2016). Year-on-year, median CEO compensation in the SMIM companies has also fallen (by 7.6% to CHF 3.3 million) but is still 54.3% above its 2009 level. Median total CEO compensation has increased by 3.5% in small-cap firms; at CHF 1.4 million it is now 12.7% above 2009 levels.
5. In the spirit of Value Added Statements, we have introduced the concept of EBIPT – Earnings Before Interest, Personnel Expenses and Taxes. At the median firm, 1.3% of EBIPT goes to the top management bodies, 63.9% to other employees, 5.8% directly to society in the form of corporate income taxes and 29.0% to debt- and equity-holders. Talking about “the distribution of the pie” is an important element of value reporting of firms to sustain all stakeholders’ involvement in the long run.

Compensation levels in SMI, SMIM, and small-cap companies

The total sum of board and executive compensation (together referred to here as *aggregate top management bodies compensation*) in the largest 100 companies in 2017 was CHF 1.58 billion – almost identical to the sum in 2009.¹ As **Figure 1** shows, this consists of CHF 1.36 billion total compensation conveyed to executives and CHF 221 million conveyed to board members.² Throughout this report, board members refer to non-executive board members. Executive board members count as executives.

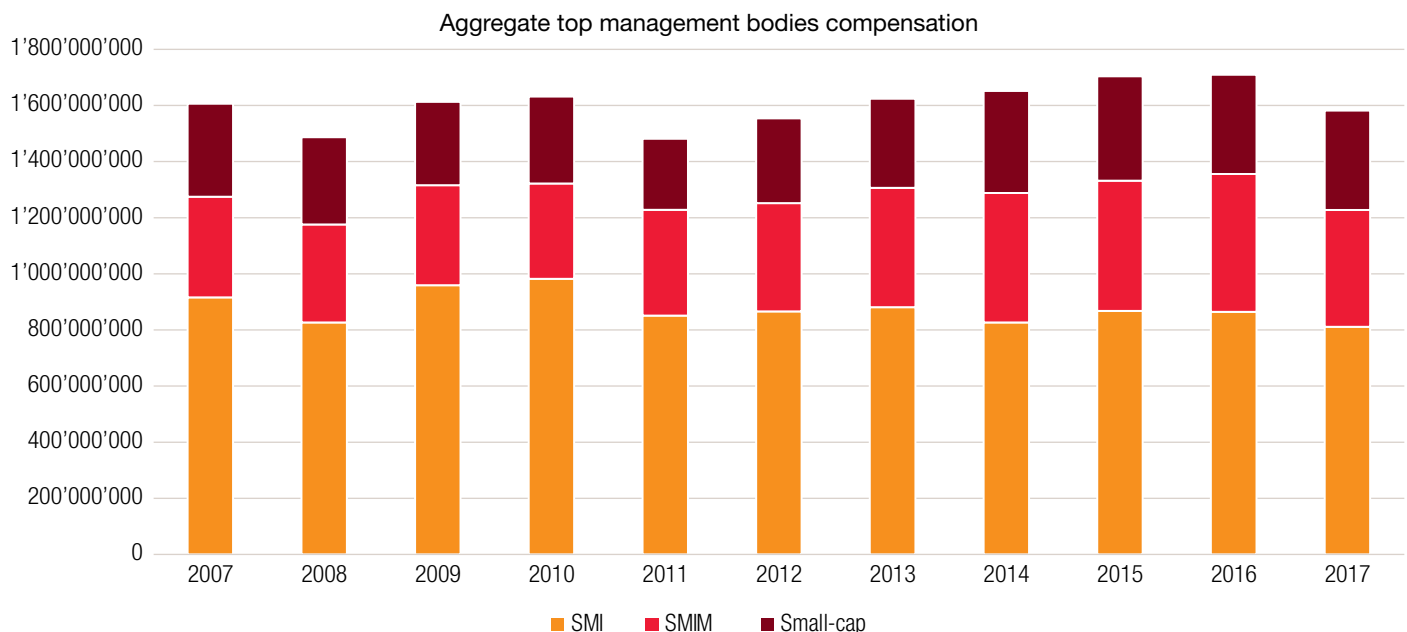
As can be seen, aggregate top management bodies compensation has remained fairly stable over the years, though it was somewhat higher in the years 2014 to 2016. From 2016 to 2017, the aggregate amount fell by 7.5%, mostly driven by a drop of 8.1% in aggregate executive pay. The fraction of aggregate top management bodies compensation going to executives is roughly 85%, with little change overall over time.

Consider next the three size groups that we have traditionally studied in this report: the SMI (essentially the largest 20 listed

companies), the SMIM (essentially the next largest 30) and the small-cap (essentially companies ranked 51-100 in size). There has been a notable shift in aggregate top management bodies compensation among these three groups of companies. The total sum paid to the SMI top management bodies has dropped by 15.4% since 2009 (from CHF 959 million to CHF 811 million), while it has increased by 16.7% and 19.1%, respectively, for the SMIM and small-cap top management bodies (from CHF 357 million to CHF 416 million, and from CHF 297 million to CHF 354 million, respectively).

Overall, these numbers suggest that top management bodies compensation is an economically important topic. The total cost of about CHF 1.6 billion is sizable compared, for example, to the total Earnings Before Interest and Taxes (EBIT) of roughly CHF 100 billion that these 100 companies accumulate in a given year (though that number fluctuates considerably over time). As such, it is understandable that shareholders and the public are strongly interested in an effective and well-governed board and executive compensation.

Figure 1: Aggregate top management bodies (board and executive) compensation has remained relatively stable over the last 11 years – but there have been substantial moves across companies



¹ We often refer to 2009 as the base year in this report, even though the figures also report data for the two years 2007 and 2008 for which data are also available. 2009 is the first year after the 2007/08 financial crisis.

² To provide a picture of the total cost to shareholders, these numbers include compensation to leaving executives (contrary to the analysis of pay for individual positions below, which focuses on executives and board members active at the end of the fiscal year, or active for the full year, as indicated).

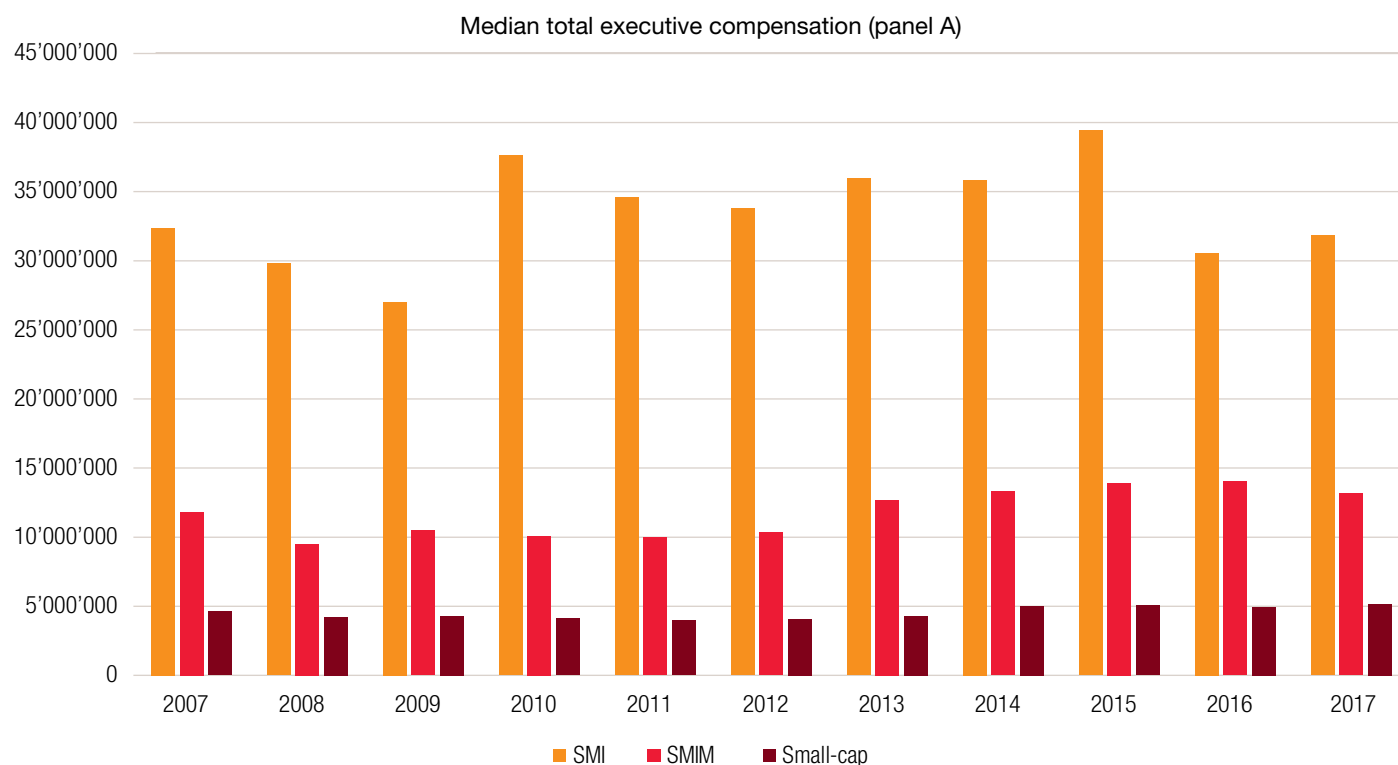
Differences across companies in aggregate top management bodies compensation

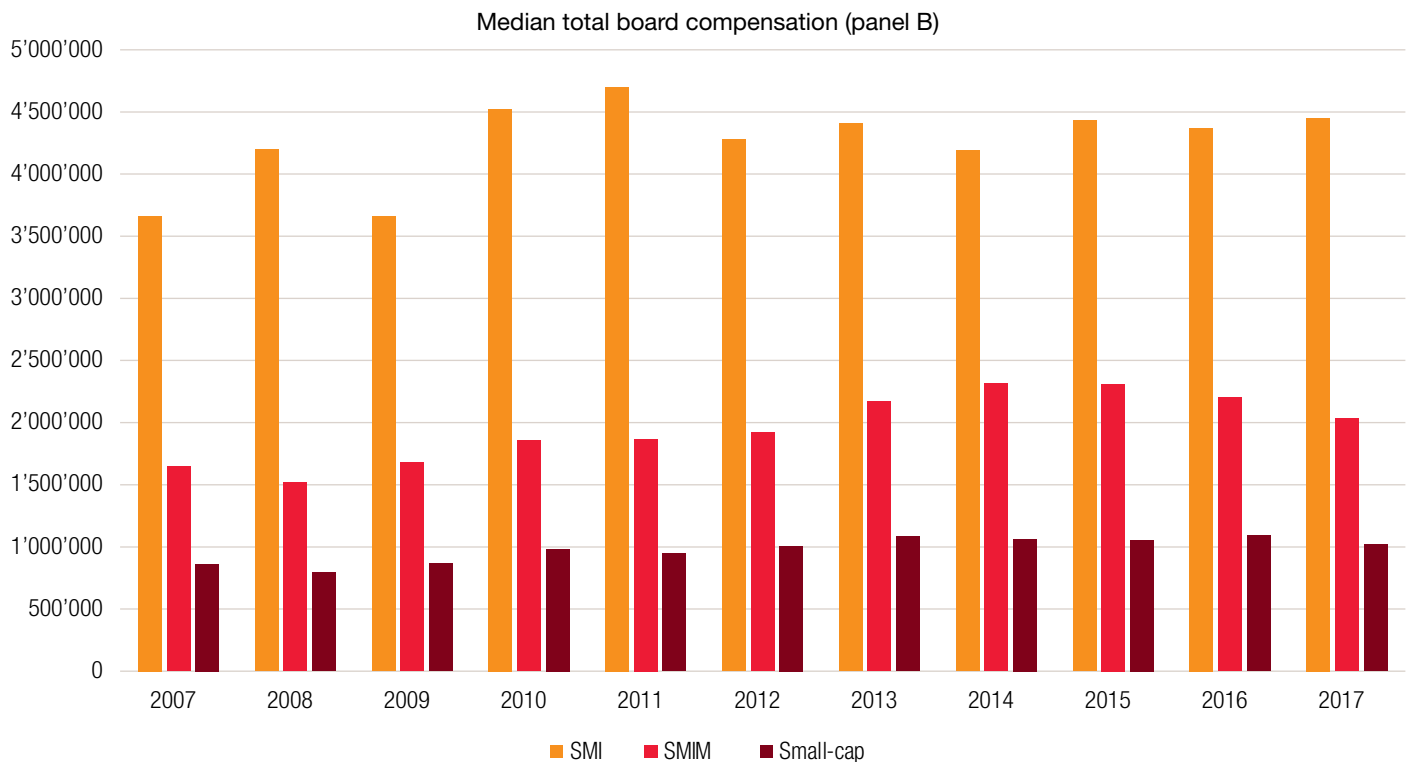
While the analysis in the prior section provided an aggregate view, decision-makers also need to know top management bodies compensation levels of a typical, representative firm. For this analysis, we refer to the median total compensation. Details on other quantiles (such as the 25th or 75th percentiles) are available upon request.

Figure 2 again considers the aggregate compensation conveyed to the two top management bodies, separately for executives (panel A) and for board members (panel B). Median total executive compensation increased from 2009 through

2017 by 17.8%, 25.6% and 20.8% for SMI, SMIM and small-cap companies, respectively. Notably, among SMI firms, the last two years have seen significantly smaller compensation than the years 2010 to 2015. In 2017, the median SMI firm spent CHF 31.8 million on executive compensation, the median SMIM firm CHF 13.2 million and the median small-cap firm CHF 5.2 million. Median total board compensation increased from 2009 to 2017 by 21.6%; 21.3% and 17.8% to CHF 4.5 million, CHF 2.0 million and CHF 1.0 million, respectively, in the three groups.

Figure 2: Median total executive and board compensation has increased since 2009





The figures suggest, not surprisingly, that executive compensation is substantially higher than board compensation at the median firm. (Remember that board compensation here contains non-executive board members only.³) To examine this issue in more detail, we compute, for each company, the sum of pay received by all executives and divide this by the sum of pay received by all board members. We label this the executive-to-board compensation ratio, or the E2B-ratio. Then, we compute the median and other quantiles of the distribution.⁴

Figure 3 shows the results. In 2017, overall, the median E2B-ratio was 4.9, the lowest value observed in 11 years, and the first time this ratio has dropped below 5. In 2009, the ratio was still at 5.3. This general trend is also evident within the three size groups, particularly within SMI and SMIM. For example, whereas in 2009 the median E2B-ratio was 6.6, 6.4 and 4.9 in SMI, SMIM and small-cap companies, in 2017 it was (only) 6.0, 5.0 and 4.7, respectively. It is worth noting that 2017 appears

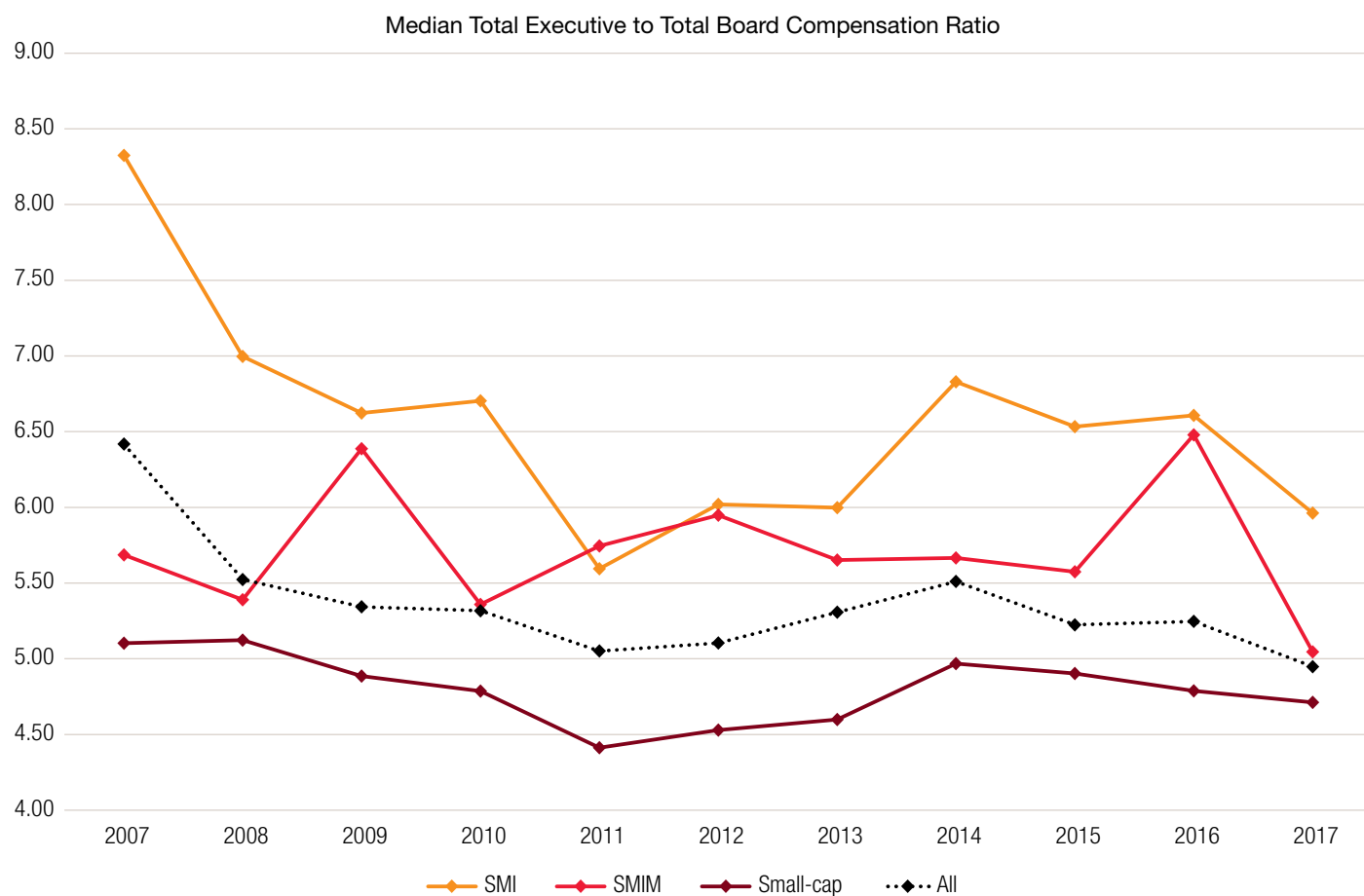
to be a bit of an unusual year (a theme that we will revisit in the analysis of CEO compensation below), so we do not predict these low levels will be the new equilibrium. We also note, however, that the outlier values (at the 75th percentile and higher) have decreased (with some fluctuations). In 2009, for example, the third quartile values were 9.6, 8.6 and 8.0 for SMI, SMIM and small-cap companies, respectively; in 2017 they were (only) 7.8, 7.6 and 6.0.

The E2B-ratio indicates the power that executives have relative to the board. While the ratio will be higher among successful firms (given that executive pay responds to performance more than board pay), an excessively high ratio can be problematic. There is no quantitative model or rule what an optimal ratio should be, but we recommend that firms be mindful of the practice they employ so they can explain it coherently to their stakeholders.

³ These results rely on disclosed values. For example, while most companies nowadays make a clear distinction between executive and non-executive roles of board members, they often do not disclose compensation separately. In such cases, we count all compensation towards the role as an executive. Thus, board pay can be understated relative to executive pay in such cases. This limitation notwithstanding, to the extent that this disclosure practice does not systematically vary across the three size groups, the analysis here can at least be considered indicative.

⁴ Note that this median of ratios is different than the result obtained when computing the ratio of the median values.

Figure 3: In recent years, executive compensation relative to board compensation has declined



Differences across companies: CEOs, executives, chairpersons, board members

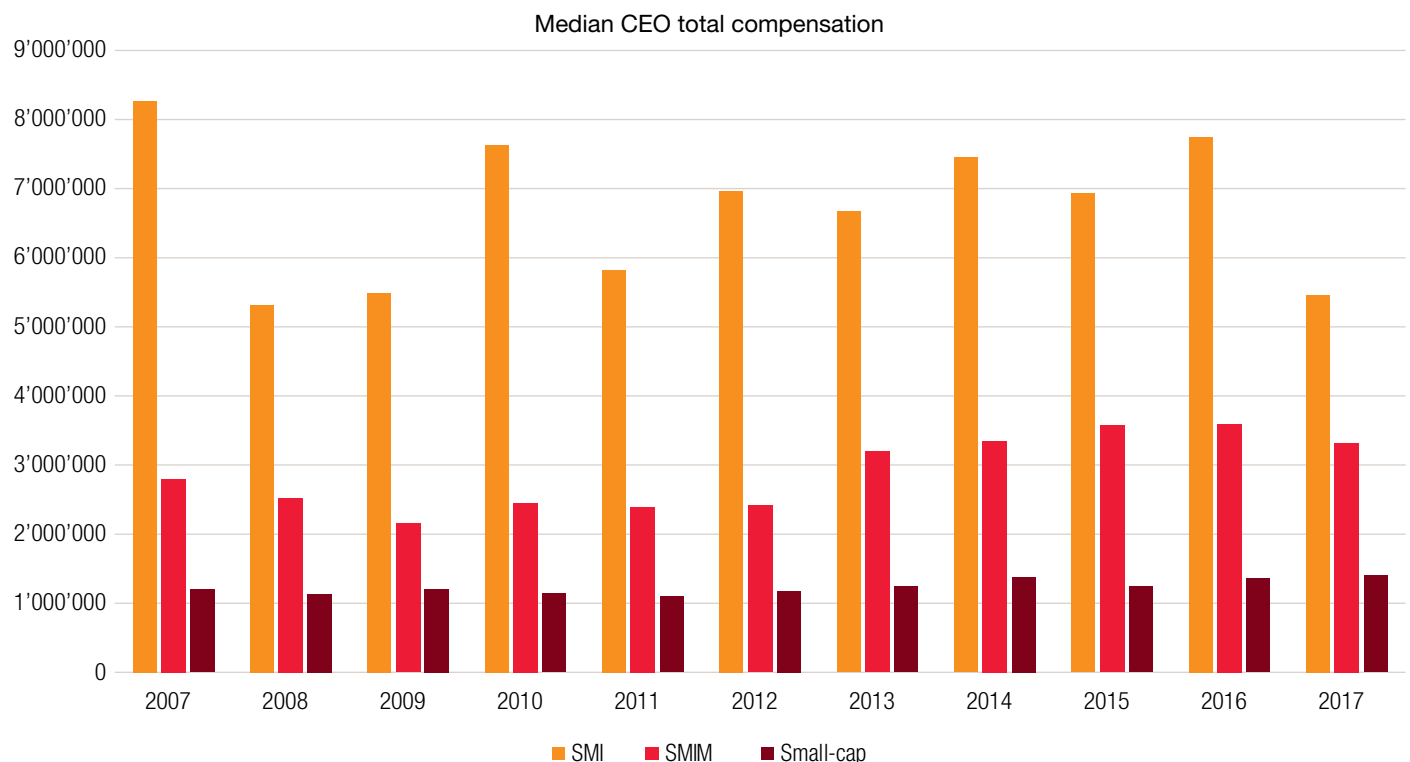
In this section, we drill down further to the compensation received by individuals in different functions. We primarily present results for individuals in office at the end of the year (excluding those who left during the year).⁵

Among SMI companies, median total CEO compensation returned in 2017 to its 2009 level. This striking finding is visible in **Figure 4**: SMI median total CEO compensation dropped by 29.5% year-on-year, from CHF 7.7 million to CHF 5.5 million. This change is due to a combination of factors. First, changes in compensation at the existing companies; second, CEO changes, all three of which resulted (somewhat unusually) in lower compensation for the incoming CEO; third, changes in the composition of the index (with two companies leaving and two entering); fourth, one company did not disclose a CEO this year. As such, part of the change is a technically driven one, and it will be important to keep a close eye on these developments in future. Interestingly, for other executives,

there has essentially been no change in median compensation among SMI firms since last year. In SMIM and small-cap companies, median CEO compensation is substantially higher than in 2009, at 54.3% and 12.7%, respectively. However, SMIM median CEO compensation has fallen as well on a year-on-year basis, by 7.6% to CHF 3.3 million. In small-cap companies, it has increased by 3.5% to CHF 1.4 million.

Extremely high CEO compensation levels (above CHF 20 million), prevalent in a few SMI companies in the years 2007-2009, have vanished in recent years. Therefore, average CEO compensation in SMI companies, at CHF 6.8 million, is substantially lower than in 2009, when it was CHF 7.7 million. In SMIM and small-cap companies, average compensation is now CHF 3.3 million and CHF 1.8 million, respectively, up 15.4% and 20.6% from 2009. (The detailed statistics are available on request.)

Figure 4: In 2017, median total CEO compensation in SMI companies returned to 2009 levels, but was still substantially higher than in 2009 among SMIM and small-cap companies.

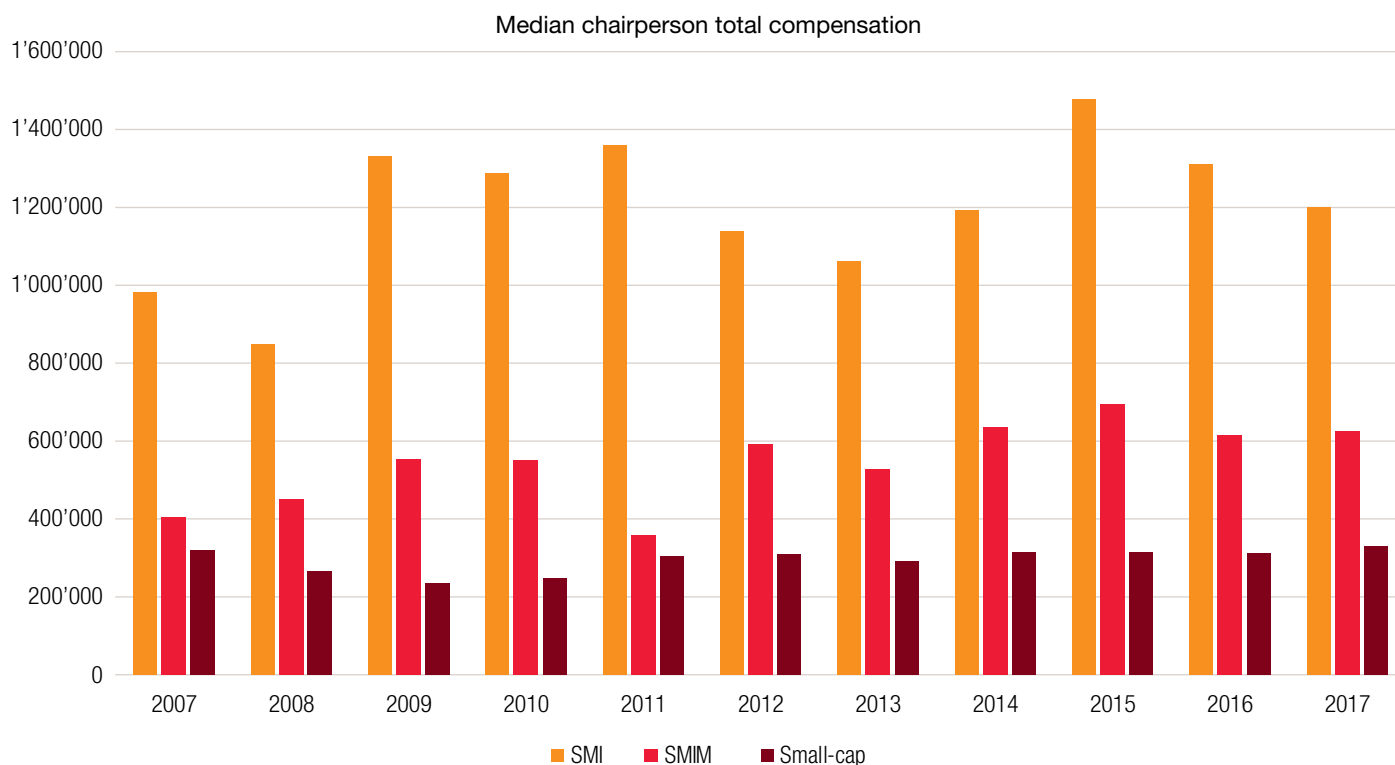


⁵ An alternative approach is to restrict attention to individuals in office for the full year. That approach has the advantage that potentially unrepresentative values (due to short service periods during a year or large initial replacement awards for prior compensation) are not included; it has the disadvantage that the sample is smaller. All results remain largely similar with the alternative approach (details are available on request).

Figure 4 shows that it is still the case that larger companies pay substantially higher total compensation. In prior years, a trend of convergence had seemed to materialise between SMI and SMIM firms, and of divergence between SMIM and small-cap firms. That trend has continued for CEO compensation as far as SMI and SMIM firms are concerned: specifically, in 2009 the median SMI CEO earned 2.55 times more than the median SMIM CEO. By 2017, that number had fallen to a multiple of 1.65. However, other convergence and divergence trends that had seemed clear in prior years now appear to have reversed, at least temporarily. For example, the ratio between the median SMI for other executives and the median SMIM for other executives is now 2.52, even higher than the 2.26 it was in 2009. Similarly, the (seeming, but not monotonic) divergence of SMIM and small-cap pay for CEOs and other executives has not continued for the time being. We still consider this analysis a useful diagnostic of the overall calibration of the quantum of pay.

We have also analysed data for chairpersons and other board members. Briefly, from 2009 to 2017, median **non-executive chairperson compensation** for SMI companies fluctuated slightly around CHF 1.2 million. In 2017 it was almost exactly CHF 1.2 million. In SMIM companies, chairperson compensation has increased by 13.0% from around CHF 554,000 in 2009 to around CHF 626,000 in 2017. A major increase had taken place before 2009: in 2007, median compensation had been only CHF 403,000. In small-cap firms (the next largest 50 companies), median chairperson compensation increased by 6% to around CHF 330,000 year-on-year, 40.4% above the 2009 level. **Figure 5** illustrates these findings.

Figure 5: In SMIM and small-cap firms, chairperson compensation has been increasing since 2009



The remuneration of **other members of boards of directors** who have no executive functions has remained more or less the same since 2007 (and 2009) among SMI companies, and increased for SMIM and small-cap firms. In 2017, a median board member of an SMI company received about CHF 309,000

(+4.3% since 2007, +0.5% since 2009), a median board member of an SMIM company about CHF 209,000 (+23.6% since 2007, +27.7% since 2009) and a median board member of a small-cap firm CHF 129,000 (+19.8% since 2007, +44.5% since 2009).

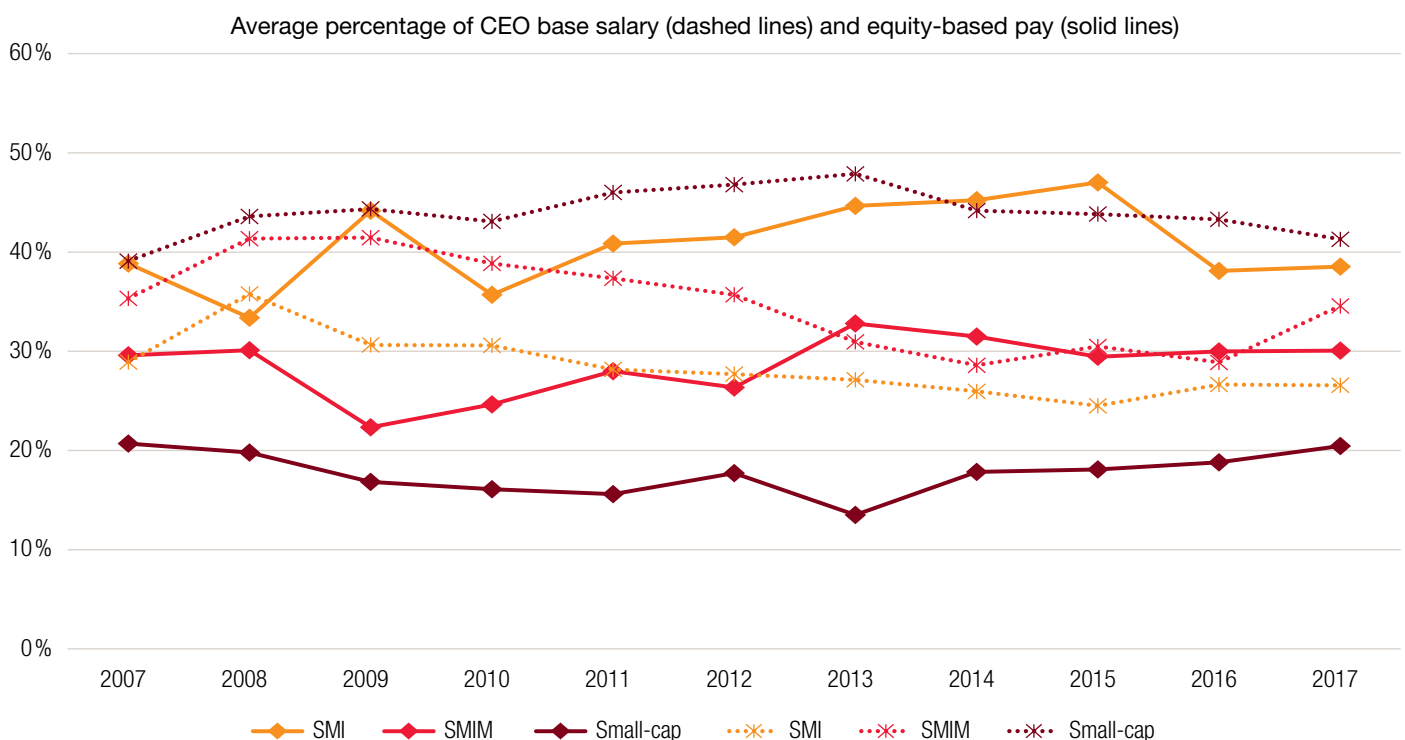
Structure of compensation

Of course, when assessing compensation, a key issue is not only the level of compensation, but also the structure of compensation.

Figure 6 shows the development of pay structure over time. In SMI companies, over the years base salary has rarely accounted for more than 30% of the total, and the equity-based element never less than 30% (and often close to, or more than, 40%). Indeed, the average percentage of equity-based compensation has been increasing steadily from around 36% in 2010 to 47% in 2015, although it fell to just below 40% in 2016 and 2017. As of now, it is not clear whether this is a temporary dip or the beginning of a permanent shift in pay structure.⁶ In SMIM companies, from 2008 to 2012 base salary (around 35–40%) was a much more important component of compensation than equity-based compensation (around 25%). However, these

companies, too, have trended towards increasingly using equity-based pay for their CEOs. As a consequence, in 2013 to 2017 equity-based pay and base salary both represented around 30% of total compensation. In small-cap companies, equity-based compensation is still at a low level, around 20%, and has not increased noticeably over the study period; however, the decline from 2007 to 2013 has by now completely reversed. Here, as a rule still more than 40% of total compensation derives from base salary, although this number has now declined for four years in a row. The fact that small-cap CEOs receive a smaller fraction of pay in equity compared to CEOs of SMI and SMIM companies is also because other CEOs have a higher overall level of compensation, and because a big part of this compensation differential reflects variable compensation.

Figure 6: Larger firms convey a higher fraction of CEO compensation in the form of equity than smaller firms



As for executive share ownership, shareholding guidelines are more frequent among large-cap companies than among smaller firms. For example, in 2017 14 out of 20 SMI companies (70%) had shareholding guidelines for their executives. 8 out of 24 SMIM companies (33%) had such guidelines – a two-

fold increase relative to 2015. A single small-cap company had guidelines for their executives. For board members, 4 out of the SMI companies and 4 out of the SMIM companies had guidelines in 2017.

⁶ When considering full-year SMI CEOs, the highest point for equity-based compensation, at 48%, was reached in 2013. Interestingly, a trend away from equity-based compensation has been observed since that time for this group of CEOs. Also, in that sample, 2008 actually saw a larger fraction of pay conveyed in cash than in equity on average. Small-sample effects may be at play here.

To assess the importance of wealth incentives, we compute, for each CEO, the ratio of wealth to base salary. **Figure 7** plots the median of the resulting ratios in the three size groups. In interpreting the results in this section, it is important to keep

in mind that the numbers reported here include all shares reported by the companies as shareholdings; they do not include options.

Figure 7: The wealth lever has increased substantially over time, indicating strong exposure of CEO wealth to shareholder wealth

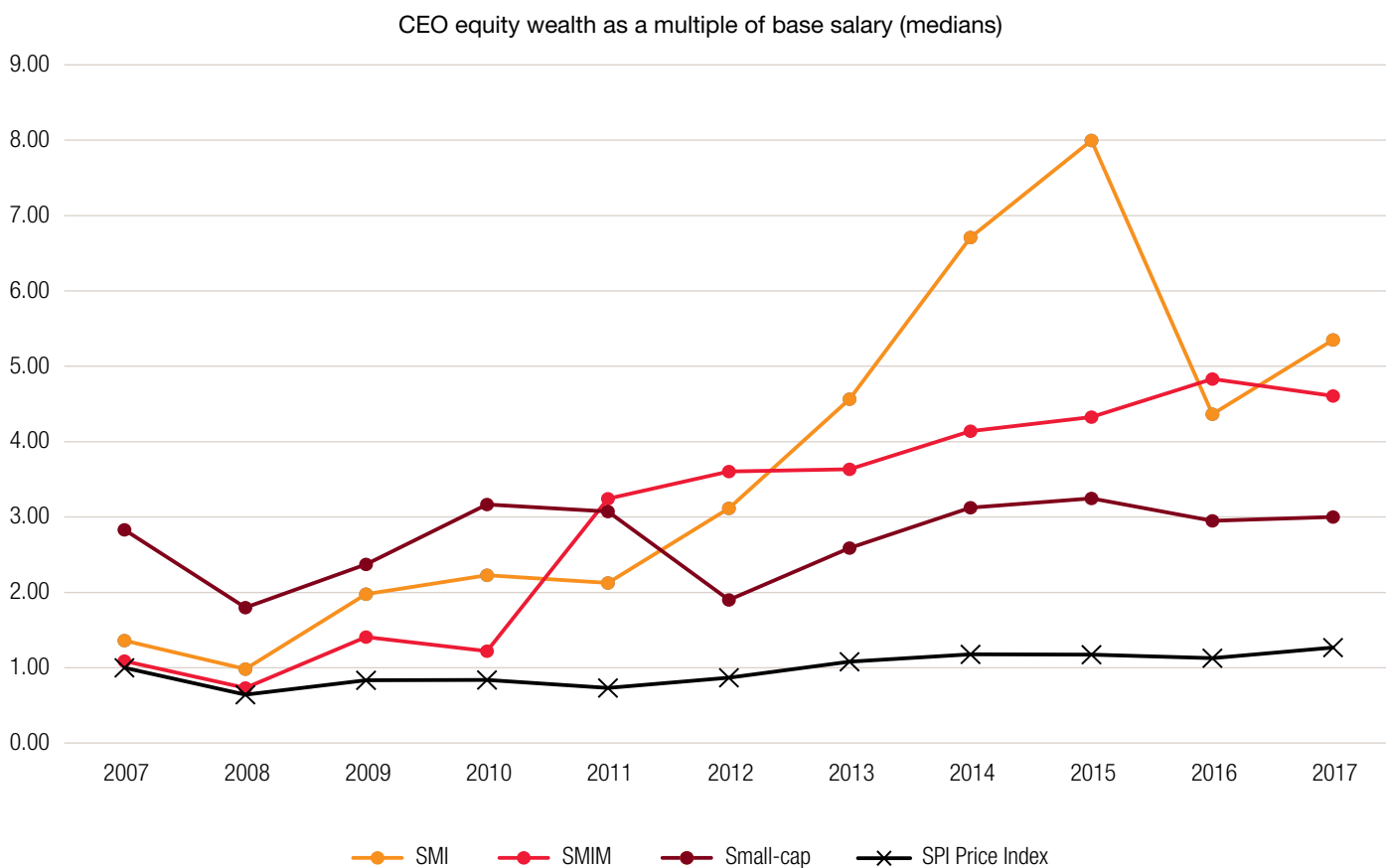


Figure 7 shows that, consistent with international trends, Swiss CEOs of large companies hold increasing multiples of base salary as equity. While in 2009 the median ratio of equity wealth to base salary was around 2 for both SMI and SMIM companies, respectively, this ratio increased to around 5 in 2017. (In 2015, the ratio had been at around 8 for SMI companies, but this result is partially due to the small number of observations, so it should not be overinterpreted.)

Interestingly, in small-cap companies, equity ownership has been relatively stable throughout the sample period. The graph also shows the development of the SPI price index, which is normalised to 1 for the year 2007.⁷ The graph suggests that the general development of the stock market explains relatively little of this overall development for SMI and SMIM companies.

⁷ An alternative approach is to restrict attention to individuals in office for the full year. That approach has the advantage that potentially unrepresentative values (due to short service periods during a year or large initial replacement awards for prior compensation) are not included; it has the disadvantage that the sample is smaller. All results remain largely similar with the alternative approach (details are available on request).

The big-picture view: How firms distribute the pie

In our opinion, when it comes to board and executive compensation, it is important to be detail-oriented and broad-thinking at the same time. Therefore, after having reviewed levels and structure issues of compensation in some detail, in this final section we return to a more aggregate, broad-brush view. We do this because for a corporation to be successful, all of its stakeholders need to be satisfied on a sustainable basis. Thus, not only the providers of capital (debt and equity) need to be able to secure a sufficient return, but also the providers of human capital (employees and managers) as well as society at large (government and citizens, who ultimately provide the company's license to operate). In this section, therefore, we provide an aggregate analysis of how the "pie" – the overall value that is generated by a company's activities in a given year – is distributed among its major stakeholders.

Specifically, we conduct an analysis in the spirit of Value Added Statement that a few Swiss companies provide as part of their extended discussion in the annual report. To measure the size of the "pie" we introduce a new concept, **Earnings Before Interest, Personnel expenses and Taxes, EBIPT**. Thus, EBIPT is EBIT *plus* personnel expenses. In other words, it is what remains after considering the direct costs of goods sold; sales, general and administrative expenses; and depreciation and amortisation.⁸ Sales themselves can proxy for the value that the company generates for another group of stakeholders, the customers. But here we are interested in how the value that comes from the customers' willingness to pay (minus the costs of production) flows to those who helped produce the goods and services in the first place. We consider four ratios as proxies for the four "slices of the pie":

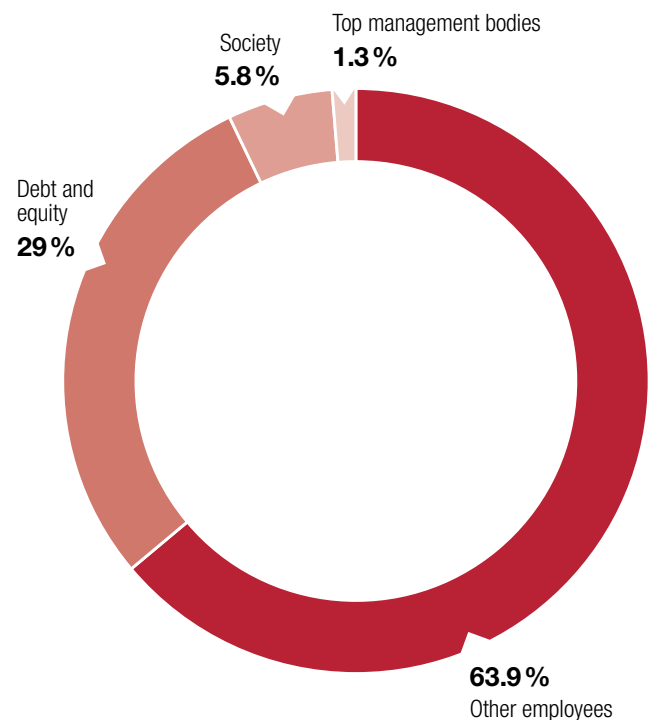
- 1) Society (direct tax revenues): Corporate tax expenses as a fraction of EBIPT show society's direct share of the overall value created.⁹
- 2) Employees: Personnel expenses, minus top management bodies compensation (board and executives), as a fraction of EBIPT, show the general employee share of the overall value created.
- 3) Top management bodies: Top management bodies compensation as a fraction of EBIPT shows the top management bodies' share of the overall value created.
- 4) Debt and equity: Interest payments plus the residual value (whether paid out as dividends or remaining inside the company as retained earnings) that remains after all other claims listed here as a fraction of EBIPT show the capital providers' share of the overall value.

In short, 1) is foundational capital ("society," in some sense "land"), 2) and 3) are human capital ("labor") and 4) is financial capital ("capital" in the narrow sense).

This analysis uses a somewhat smaller sample of around 75 companies per year over the 2007-2017 period. This is because several (even well-known) companies do not disclose total personnel expenses. Also, for some companies, such as real estate companies, the employee count is not meaningful, so we do not include these companies here. For each company included in this analysis, we compute the four above ratios, and we then consider the median values of the ratios.

Figure 8 shows that for the median firm in the last decade, very roughly speaking two-thirds of EBIPT goes to labour, slightly less than 30% goes to capital (debt and equity-holders) and slightly less than 6% goes to society in the form of corporate taxes.

Figure 8: At the median company, two-thirds of earnings before interest, personnel expenses, and taxes go to employees and the top management bodies (board and executives)



⁸ Management does have some discretion about these quantities.

⁹ This tax ratio is different than the corporate income tax rate that is usually used. The usual corporate income tax rate is calculated as a fraction of pre-tax income (that is, corporate earnings from which personnel expenses have already been deducted). The median corporate tax rate thus calculated is 20% in the sample of positive EBIT firms. That tax ratio does not necessarily go to the Swiss government; Swiss corporations also pay corporate taxes abroad, and the disclosed tax expenses cover the full amount. Conversely, the state also receives other monies, namely, the personal income tax that employees pay. Of course, not all employees of Swiss companies pay taxes in Switzerland, and the number of such employees is not disclosed. Therefore, we cannot estimate the tax revenue for Switzerland from employees.

Summary and outlook

In short, this analysis shows that executive compensation in Switzerland has, in the last 11 years, exhibited elements of both stability and change. The total aggregate amounts of compensation paid to boards and executives combined have hardly changed, but the distribution across firms of different size brackets and within firms (between executives and the board; between different roles) has shifted significantly. The structure of compensation has also undergone some change. It is critical for decision-makers to keep abreast of these developments.

In the next volume of this publication, we consider the international dimension. Although the legal and governance system of Germany differs markedly from that of Switzerland, the two markets are close enough to merit comparison. Are Swiss board members and executives paid more or less than their German counterparts? Are there structural differences? How has this changed over time? Find out in *PwC Insights 2018*, part 2, to be released in October.



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