CEO pay: A new way to judge the numbers

A dive into three companies' pay and performance data provides a compelling guide for compensation committees trying to determine what level of pay is 'just right.'

By Seymour Burchman, Judy Canavan, and Blair Jones

How much pay is "just right" for a CEO? Compensation committees struggle to answer this question, particularly at this time of year, when proxy statements open to the world the committee's decisions about executive pay. Although no single "right answer" exists, there are analytical approaches and contextual considerations that can offer greater comfort to committees.

CEO pay, particularly long-term incentives (LTI), has been rising at extraordinary rates since the early 1990s. LTI opportunities alone have increased by 350 percent. CEO total direct compensation (TDC) has moderated in recent years, perhaps in response to increased disclosure, shareholder activism, and the expensing of options. Yet levels remain high — so high that many boards, and even many CEOs, question whether payouts are reasonable.

While some perquisites and retirement benefits have been shaved back, causing subtle dips in total compensation, a significant across-the-board rollback of CEO pay is unlikely. A compensation committee taking such a step could put the company at a competitive disadvantage. But there are actions that compensation committees can take to ensure that the size of the opportunity and the program design are structured properly to align with performance and share value fairly among executives and shareholders. The price for success can — and, perhaps, should — be high. One could argue that those who create value deserve a significant payback. Lackluster results and, even more so, failure to perform should not produce a hefty payday, particularly when shareholders and other employees come up short.

How does a compensation committee avoid such discrepancy? And further, what factors should they consider in order to determine what level of pay is the right amount?

Seeking answers to four questions

We decided to look at the amount of pay a CEO earns and work backward to first assess how a CEO's paycheck measures up against performance delivered, and then to discover what aspects of plan design drive those outcomes. We focused on phar-

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maceutical and biotechnology companies because they typically represent some of the highest-paying industries for executive talent. From this group, we selected companies that spanned a broad spectrum from high to poor performance. Then, to keep things simple, we chose three representative companies across the performance spectrum for more in-depth analysis: Company A, a high performer; Company B, an average performer; and Company C, which has experienced several years of sub-par performance. (All three are Fortune 500 NYSE-traded companies.) For each of the companies, we examined five years (2001-2005) of publicly available total compensation data alongside the companies' performance levels to assess whether the amount of pay balanced with results achieved. (See sidebar on page 37 on our methodology.)

The price for success can — and, perhaps, should — be high.

In practice, a more robust analysis would include a far larger number of companies (15 to 20), preferably in the same industry and of similar size. We also acknowledge that looking at the numbers alone tells only part of the story. Other factors, such as pipeline strength, patent expirations on blockbuster drugs, and competitor's product offerings, have an impact on performance. But the focus of this analysis is on the numbers that are "out there" for public consumption and that contribute to public dismay. Even from this simple review, interesting insights emerge.

Our analysis sought answers to four important questions that compensation committees should be asking when evaluating CEO pay:

1. Does CEO pay align with company performance?
2. Is the value delivered to the CEO commensurate with the level of value delivered to shareholders?
3. What are the potential prospective payouts under a range of performance scenarios?
4. Does the payout fit the company's business and talent characteristics?

Our findings

Company A is the smallest of the three companies, with revenues only one-third of the other two. Yet its CEO's total direct compensation (TDC) — base salary, annual incentives, and long-term incentives, including both actual payouts and paper gains — was seven to 10 times higher than that paid to the CEOs of Company B and Company C for the five-year period. *(See Exhibit 1.)* Was this a case of egregious executive pay?

Does CEO pay align with company performance?

The answer, in part, must be considered in the context of the relative performance delivered:

• Company A's EPS growth far exceeded that of the other two companies. Its annual EPS growth over the period was 67 percent, three times Company B's and 15 times Company C's EPS growth. *(See Exhibit 2.)*

• Company A's stock performance was also above that of the other two companies by a wide margin, with an 18 percent total return to shareholders (TRS) — stock price appreciation plus dividends — over the past five years. This compares with negative returns for Company B (-1%) and Company C (-17%).

So although Company A's CEO was paid well in excess of Company B's and Company C's, the company's performance far outstripped that of the other two companies as well.

EXHIBIT 1: 2001-2005 CEO Total compensation summary* ($000)

Company	Base Salary	Annual Incentive	Total Cash Compensation	End of Year '05 Gain Value of LTI	Total Direct Compensation
Company B	$7,665	$10,450	$18,115	$17,045	$35,160
Company C	5,740	7,790	13,530	8,870	22,400
Company A	4,320	6,785	11,105	194,290	205,395

**Source: Equilar Inc.*

EXHIBIT 2: 2001-2005 Financial summary

Company	2005 Revenues ($ Millions)[1]	Four-Year Annual Earnings Per Share Growth (EPS)[1]	Five-Year Total Shareholder Return[2]
Company B	$22,338	21.5%	-1%
Company C	19,207	4.2%	-17%
Company A	6,633	67.5%	18%

[1] Source: Equilar Inc., [2] Source: Compustat/Research Insight

Is the value delivered to the CEO commensurate with that delivered to shareholders?

Relative pay and performance is one way of assessing how well a pay program is working, but it cannot provide a complete answer. While the assessment tells us Company A paid the most and performed the best, the analysis provides no gauge of how much more pay might

be appropriate versus the other two companies. This can be answered in part by determining how the CEO was paid relative to the value delivered to shareholders (i.e., how much of the value created did the CEO receive versus the amount realized by shareholders via stock appreciation and dividends). *(See Exhibit 3.)*

Using this lens, we find:

• Company A's CEO received $205 million in salary, annual incentives, and gains on his equity incentives over the five years. At the same time, the company created $67.5 billion for shareholders. Thus the CEO's actual pay and paper gains represented approximately 0.3% of the value created for shareholders.

• In contrast, the CEOs of Company C and Company B were paid $22 million and $35 million, respectively, but both of these companies actually destroyed value for their shareholders. So even though these CEOs earned less, their shareholders realized nothing in return.

From the above perspective, whose shareholders got the better deal?

What are the prospective payouts under a range of performance scenarios?

So far we have considered actual outcomes for each company. Yet, to better understand how well the pay/performance relationships will hold up, it is important to "stress test" pay programs under a broad range of performance scenarios.

Long-Term Incentive Composition. To begin, it is important to note that the designs of the companies' LTI plans differ. Company A delivered all of its LTI through stock options. Both Company C and Company B provided stock options too, but to a lesser extent. Company B's LTI consisted of approximately 80 percent options and 20 percent time-vested restricted stock. Approximately two-thirds of Company C's LTI consisted of options, while approximately 20 percent was delivered as a long-term performance plan, and the remaining 15 percent was time-vested restricted stock.

Pay/Performance Dynamics. The pay-performance dynamics of these designs differ considerably. *(See Exhibit 4.)* For example, if Company A's performance would have mirrored Company C's,

Methodology

The five-year analysis of the three companies was based on the following:

- Total cash compensation (TCC) equals the sum of salary and annual incentives received over the five-year period (December 31, 2000 to December 31, 2005).
- Total direct compensation (TDC) equals the sum of salary, annual incentives, and the "paper" value of long-term incentives realized over the five-year period.
- Stock options are valued by multiplying the spread between exercise price and price at the end of the period by the number of shares.
- Restricted stock is included at face value based on stock price at the end of the period.
- Other long-term awards are included at payout value.
- Under alternative performance scenarios, performance shares are based on the stock price at the end of the period and assumed the maximum number of shares for the two highest performance scenarios (25 percent growth and mirror of Company A's performance).
- Total return to shareholders (TRS) equals the sum of stock price appreciation (increase/decrease in market value) and total dividends paid over the five-year period.

EXHIBIT 3: 2001-2005 Value sharing actual

Company	Total direct compensation (TDC, $000)	TRS ($ millions)	TDC as a % of TRS
Company B	$35,160	$(6,200)	NMF*
Company C	22,400	(88,780)	NMF
Company A	205,395	54,766	0.38%

** Non-meaningful figure*

EXHIBIT 4: 2001-2005 Pay/performance scenarios ($000)

		Scenario 1: What if all companies experienced the same TRS as Company C?			**Scenario 2:** What if all companies provided stock options only?		
Company	Actual total direct compensation (TDC)	TDC	Dollar difference from actual	% increase/ decrease	TDC	Dollar difference from actual	% increase/ decrease
Company B	$35,160	$29,040	(6,120)	-17%	$20,700	(14,460)	-41%
Company C	22,400	22,400	–	0%	13,530	(8,870)	-40%
Company A	205,395	11,105	(194,290)	-95%	205,395	–	0%

then Company A's CEO would have earned only $11 million, or $194 million less than he actually earned. Conversely, if the CEOs of both Company C and Company B had received only stock options, then the pay of both these CEOs would have been 40 percent less than they actually realized. Although stock options have been almost universally denounced, they do help to contribute to improved alignment between executive pay and the gains realized by shareholders.

Our analysis sought answers to four important questions that compensation committees should be asking.

To get a more complete picture of the pay-performance dynamics of the various pay programs, we also determined what each CEO would have earned under a broad spectrum of performance scenarios ranging from 1 percent to 25 percent annual stock price growth rates.

Low-Growth Scenarios. Up to this point, Company A's pay program has appeared to provide a far better deal for shareholders than the other two companies. However, at a 1 percent stock price growth rate, Company A's program pays out 0.68 percent of the value delivered to shareholders, considerably more than the 0.37 percent delivered to Company B's CEO and the 0.16 percent delivered to Company C's CEO. *(See Exhibit 5.)* So, under low-growth scenarios, Company A's program appears to break down.

EXHIBIT 5: 2001-2005 Pay/performance scenarios

SCENARIO 1: What if stock price growth rate was 1%?

Company	TDC ($000)	TRS ($ Millions)	TDC as a % of TRS
Company B	$42,270	$11,320	0.37%
Company C	29,015	18,210	0.16%
Company A	14,780	2,180	0.68%

SCENARIO 2: What if stock price growth rate was 10%?

Company	TDC ($000)	TRS ($ Millions)	TDC as a % of TRS
Company B	$96,735	53,205	0.18%%
Company C	64,460	99,100	0.07%
Company A	51,275	26,115	0.20%

SCENARIO 3: What if stock price growth rate was 25%?

Company	TDC ($000)	TRS ($ Millions)	TDC as a % of TRS
Company B	$222,855	$161,105	0.14%
Company C	152,100	307,465	0.05%
Company A	128,225	87,765	0.15%

This appears to be attributable to two factors. First, Company A's cash pay is higher than that of Company C and Company B relative to both its size and earnings delivered. Company A's plan pays out almost 0.4 percent of its annual earnings in total cash compensation (TCC), whereas TCC for Company B and Company C is closer to 0.1–0.15 percent of annual earnings. Second, because Company A's stock price was declining during 2001–2002, the grant prices for the CEO's options were below the overall stock price for those years. As a result, Company A's CEO realized gains that were higher than those realized by Company A shareholders who purchased stock at the beginning of 2001. The serendipitous effects of option grant timing are an inherent shortcoming of options.

High-Growth Outcomes. At higher stock price growth rates, Company A's value sharing improves — it is more in line with Company B's, but still leads Company C's by a wide margin. However, even at higher stock price growth rates, Company A's high levels of cash pay and low option grant prices keep its value-sharing percentage high relative to what the other two companies' programs would have delivered.

By subjecting all three companies to a range of performance assumptions and holding performance the same for all companies at each level of performance, we find that Company A's program also has its flaws.

Does the payout fit the company's business and talent characteristics?

Pay/performance relationships cannot be considered in a vacuum. Rather, they need to reflect a company's business and talent situation. A company going through a turnaround would likely evidence poorer relative pay and performance and higher value-sharing rates than one in a more stable situation. The same would likely be true for a company in early stages of growth versus a more mature company. In both these situations, the price of the talent needed to guide the company is likely not to be commensurate with the company's performance. However, this should be only a transitory phenomenon that should be corrected over the longer term once the CEOs are successful in achieving the desired level of performance.

Design takeaways

The analysis provides a compelling story about the aspects of design that contribute to good alignment

between pay and performance. Compensation committees can adopt the following guiding principles to ensure that shareholders will be better served by their executives' compensation programs:

• *Pay primarily for sustained results, measured both on an absolute basis and relative to peers.* Evaluate how actual pay relates to actual performance over time and how much value is being shared with executives relative to shareholders. This also means avoiding guarantees of safe landings in the event of failure.

• *Balance risk and reward appropriately.* Model pay and performance prospectively versus peer compensation programs to fully understand the tradeoffs. To create true performance-based pay, leverage is critical. Despite their tarnished image, stock options still have a role to play in creating leverage. Service-vested restricted stock limits leverage and can lead to overpayment. While companies that are struggling may need some "retentive" aspects to their compensation programs, this portion of the program should not become overweighted. Performance (versus service) vesting requirements can also create leverage within a restricted stock plan. Company C's program actually included performance shares, but only as a small proportion of the total LTI package. When properly constructed, performance restricted stock can create leverage greater than or equal to stock options and focus executives on key strategic imperatives.

• *Going forward, structure pay more selectively and strategically.* Go beyond "competitive" or "technically sound" programs to programs that are truly aligned with the business situation and talent characteristics of the organization. No formula can guide compensation committees to a right answer. Yet pay/performance alignment and value sharing analyses coupled with prospective modeling put the richness of a CEO's pay into perspective, creating better understanding of the program and its outcome compared to benchmarks. Ultimately, committees must apply judgment based on the business situation, talent needs, absolute and relative results, and possible performance scenarios that consider a range of events that could impact performance outcomes. These are the factors that will allow compensation committees to establish CEO pay that is "just right" for the company, the executives, and the shareholders. ■

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