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AN ACTIVIST VIEW OF CEO COMPENSATION

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INTRODUCTION

Understanding CEO compensation plans is a continuing challenge for boards of directors, investors, the media, and members of the public. Surveys of institutional investors unflinchingly demonstrate the frustration that shareholders face in evaluating the size, structure, relation to performance, and potential risk of CEO pay.¹ This has led to considerable controversy as to whether CEOs are paid the correct level and whether CEO compensation plans are structured to provide “pay for performance.” On one hand are those who argue that pay levels represent optimal contracting. This group contends that compensation plans are awarded through an efficient process driven by market forces and that boards negotiate pay through an arm’s-length contract in the best interest of shareholders. On the other hand are those who contend that CEO pay does not represent an efficient economic process. This group argues that CEOs exert influence over boards to extract compensation in excess of what would be awarded on a competitive basis and that the size and structure of CEO compensation plans are indicative of entrenched management’s ability to extract wealth at the expense of shareholders (“rent extraction”). Scientific research provides support to both sides of the argument, and comprehensive studies are generally inconclusive.²

The challenge that boards of directors and shareholders face in evaluating CEO compensation plans derives in part from disclosure laws and general industry practices for quantifying and describing pay. The Securities and Exchange Commission mandates a standard framework for disclosing pay amounts by award type. These requirements rely heavily on calculating the “fair value” of awards as of the grant date and presenting those data in a Summary Compensation Table in the annual proxy. The expectation is that the standardized presentation of the fair value of CEO pay elements allows for a side-by-side comparison across companies. The main problem with this approach is that the fair value of awards is a static (expected) number that does not reflect how a plan scales to performance. The sensitivity of a compensation

plan to performance is not uniform across companies, nor is the rigor of targets that companies use to structure incentive compensation.³ These elements can sometimes be discerned from the details of SEC filings but are not made explicit, are not readily evident even to a professional reader, and often do not make it into the analyses upon which boards of directors make compensation decisions.

A FRAMEWORK FOR ANALYZING CEO PAY

One solution is a framework developed by activist fund ValueAct Capital which strips down and systematically reconstructs the compensation figures presented in the annual proxy, allowing for a step-wise evaluation of the conditions under which variable compensation is paid out to the CEO and the relation of this pay to operating and stock-price performance. This framework can also be employed to compare CEO pay packages across companies within an industry (see Exhibit 1).

The first step is to distinguish between “fixed” and performance-linked compensation and calculate an estimate of the minimum payout that a CEO receives in a given year. This figure includes base salary plus time-vested restricted stock grants. An important assumption here is that time-vested restricted stock has a very high likelihood of becoming vested. In addition, it is reasonable to expect that the CEO will receive at least some payout from annual bonus and long-term incentive plans, even for performance that does not meet stated targets. Most plans are designed so that payouts could theoretically be zero, but in reality performance targets are set to be achievable, and a zero payout almost never occurs in practice. It seems reasonable to assume that a CEO will receive a payout at 50 percent of the target values of the annual and long-term incentive plans, and we add these values to the base salary and restricted stock grants to arrive at an estimate of minimum pay.

The second step is to calculate how much incremental compensation the CEO stands to receive for achieving performance milestones at (1) the target level and (2) the maximum

level, holding stock price constant. This analysis highlights how much upside potential is available to the CEO for achieving performance milestones, even if shareholders see no appreciable return. It also illustrates the potential disconnect that can occur between the financial outcomes of shareholders and the CEO.

The third step is to add the incremental compensation the CEO will receive assuming some reasonable stock-price appreciation. (Here, we assume a 50 percent increase—although higher or lower return scenarios are equally valid.) This calculation adds the incremental payout from stock options and the appreciation of restricted stock and performance shares. Treating stock-price appreciation as an independent analytical variable allows us to see how equity awards add leverage to the pay package and the degree to which CEO pay outcomes and shareholder interests are aligned.⁴

Taken together, this framework provides a foundation for analyzing the scale and structure of CEO pay. It provides a rigorous and systematic method for evaluating critical issues, such as the:

- Degree to which pay is “guaranteed” or “at-risk”;
- Degree to which payouts are driven by operating versus stock-price performance;
- Sensitivity of CEO compensation to stock-price returns;
- Importance and rigor of performance metrics;
- Potential risk embedded in the CEO pay package.

Compare this to the static target grant-date fair value framework, which highlights only a single question: Is the target value of the CEO pay package larger or smaller than peers?

Large incremental payouts can be indicative of strong “pay for performance” depending on how aggressively targets are set. However, very high levels of contingent pay might also encourage the CEO to take risks that are not consistent with increasing shareholder value. The compensation committee will need to determine whether these risks are appropriate given the constraints of the firm’s risk tolerance. This will lead to second-order considerations, such as the degree to which performance measures are verifiable and subject to possible manipulation. The board might be willing to accept a risky compensation scheme, but it might want to increase monitoring to assure that performance outcomes are appropriately achieved without subjecting the organization to excessive risk.

By contrast, compensation plans with a large minimum component might be indicative of a disconnect between pay and performance. This can lead to questions about governance quality and whether a CEO is given sufficient motivation to perform.

This framework also easily lends itself to comparison across companies within an industry. In Exhibit 2, we compare the compensation of 10 CEOs in the retail industry using a standard target grant-date fair value approach (calculated from the compensation discussion and analysis of proxy statements) and the framework above.⁵ These approaches yield vastly different results and insights. The target grant-date fair value provides a fixed view of compensation without a sense for how pay varies with performance. By contrast, pay presented according to the framework above allows the reader to quickly understand the degree to which pay is fixed and variable, how pay scales with the achievement of operating and share-price results, and how these compare across competitors.

Note, for example, the compensation at The Gap (GPS). Under the target grant-date fair value approach, the CEO of the Gap appears to be at the lower end of the peer group. Our alternative approach reveals that, in reality, he stands to receive considerable variable compensation for achieving performance milestones and stock price returns that would place the value of his compensation at the top of the industry. It is up to the board and shareholders to determine whether this compensation arrangement is fair and appropriate, given the company’s situation at the time. However, we clearly see how performance impacts CEO pay and the tremendous leverage in the plan.

In contrast, L Brands (LB) exhibits a similarly high level of pay, but notice that large portions of this pay are included in the base minimum amount and can be earned even in the absence of stock-price appreciation. This indicates that pay for the CEO of L Brands is potentially much less aligned with the interest of shareholders.

WHY THIS MATTERS

1. The framework described in this Closer Look takes a step-wise approach to deconstructing CEO pay by isolating minimum, milestone-based, and stock-price related compensation. How valuable is understanding the relative size and contribution of these elements to the overall compensation package? Does this approach provide relevant information to assessing the “pay for performance” in CEO compensation plans?
2. This framework treats milestone-based incremental pay separately from stock-price driven incremental compensation. How important is this distinction to understanding the degree to which CEO pay can diverge from shareholder outcomes (so-called “pay for no performance”)? What insight does it provide into the governance quality of different firms? Are large minimum and milestone-related payments indicative of

CEO power and rent extraction?

3. A compensation plan that scales significantly with operating and stock price performance might be consistent with pay for performance but at the same time might also encourage extreme risk taking to achieve that outcome. How might a board ramp up its monitoring function to ensure that the CEO is not taking actions detrimental to the long-term health of the company in order to increase the value of variable compensation awards? Does an appropriate set of key performance indicators exist that would allow the board to perform this monitoring function on a quarterly or annual basis? Can activists and other large shareholders play a role in monitoring CEO and firm behavior, given their very detailed understanding of the company and its business model?
4. The data in Exhibit 2 demonstrate that the outputs of this analysis are significantly different than those currently disclosed in proxy statements. What does it say about SEC disclosure requirements that a layered approach to analyzing CEO pay yields vastly different results than the target grant-date fair value approach required by the agency? ■

¹ For example, in a 2015 survey of institutional investors by RR Donnelley, Equilar, and the Rock Center for Corporate Governance at Stanford University less than half (38 percent) of institutional investors believe that executive compensation is clearly and effectively disclosed in the proxy. Responses are consistently negative across all elements of compensation disclosure. Sixty-five percent say that the relation between compensation and risk is “not at all” clear. Forty-eight percent say that it is “not at all” clear that the size of compensation is appropriate. Forty-three percent believe that it is “not at all” clear whether performance-based compensation plans are based on rigorous goals. Significant minorities cannot determine whether the structure of executive compensation is appropriate (39 percent), cannot understand the relation between compensation and performance (25 percent), and cannot determine whether compensation is well-aligned with shareholder interests (22 percent). Investors also express considerable dissatisfaction with the disclosure of potential payouts to executives under long-term performance plans. See RR Donnelley, Equilar, and The Rock Center for Corporate Governance at Stanford University, “2015 Investor Survey: Deconstructing Proxies—What Matters to Investors” (2015). See also David F. Larcker and Brian Tayan, “The Ideal Proxy Statement,” Stanford Closer Look Series (February 17, 2015), and David F. Larcker, Brendan Sheehan, and Brian Tayan, “The ‘Buy Side’ View on CEO Pay,” Stanford Closer Look Series (September 1, 2016).

² See Carola Frydman and Dirk Jenter, “CEO Compensation,” *Social Science Research Network* (2010). See also David F. Larcker and Brian Tayan, “CEO Pay Levels,” Quick Guide Series: Research Spotlight (2017) available at: <https://www.gsb.stanford.edu/faculty-research/publications/ceo-pay-levels>.

³ See David F. Larcker and Brian Tayan, “Sensitivity of CEO Wealth to Stock Price: A New Tool for Assessing Pay for Performance,” Stanford Closer Look Series (September 15, 2010); and David F. Larcker and Brian Tayan, “Pro Forma Compensation: Useful Insight or Window Dressing?” Stanford Closer Look Series (July 28, 2015).

⁴ In reality, these steps cannot be treated entirely independently, particularly among companies where total shareholder returns (TSR) is included as a performance metric in long-term incentive plans. Furthermore, it is difficult to assume that achieving maximum target milestones would not also be associated with at least some increase in stock price in most situations. Still, there are benefits to analyzing the distinct contributions that performance milestones and stock-price appreciation lend to the CEO pay plan.

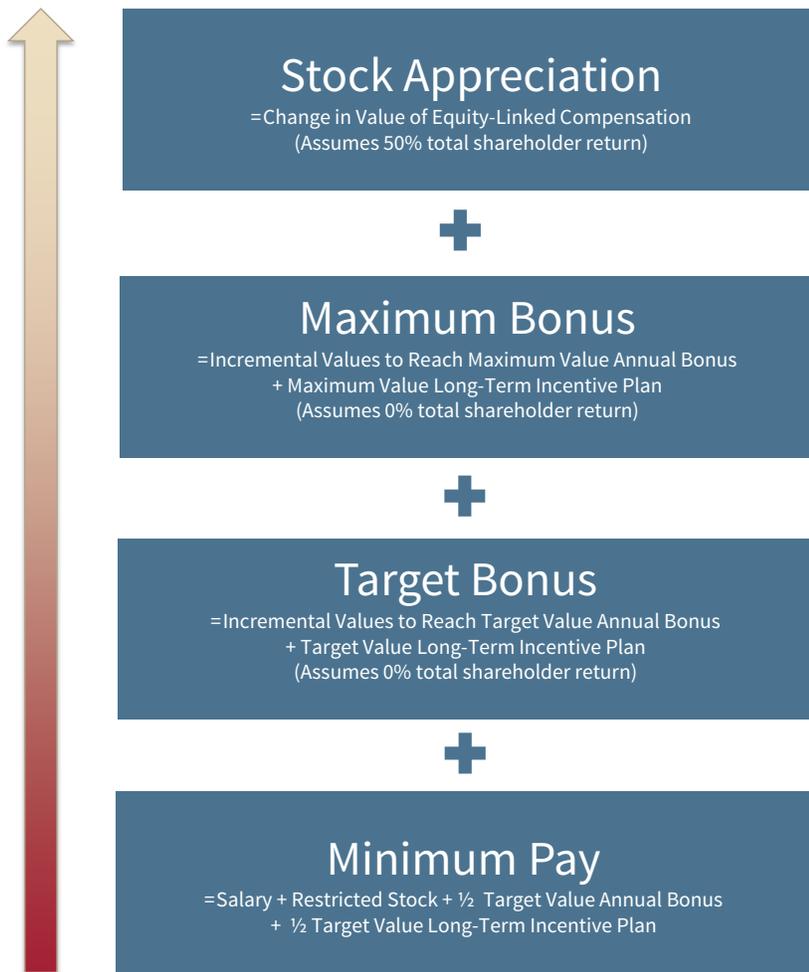
⁵ We calculate target grant-date fair value using a prospective viewpoint, i.e. based only on target payouts unmodified by actual performance. This replicates what the compensation committee would typically see when designing a compensation package. Specifically, this is calculated as base salary plus target annual cash incentive compensation plus target value of restricted stock units (RSU) and performance stock units (PSU) awards plus the Black-Scholes value of option grants.

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The Stanford Closer Look Series is a collection of short case studies that explore topics, issues, and controversies in corporate governance and leadership. The Closer Look Series is published by the Corporate Governance Research Initiative at the Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University. For more information, visit: <http://www.gsb.stanford.edu/cgri-research>.

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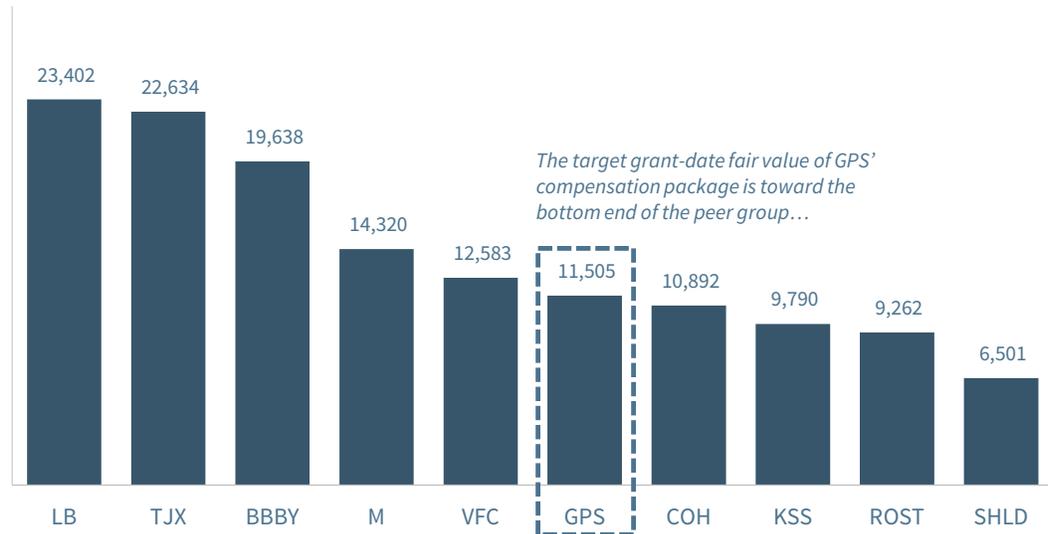
EXHIBIT 1 — DECONSTRUCTING CEO COMPENSATION



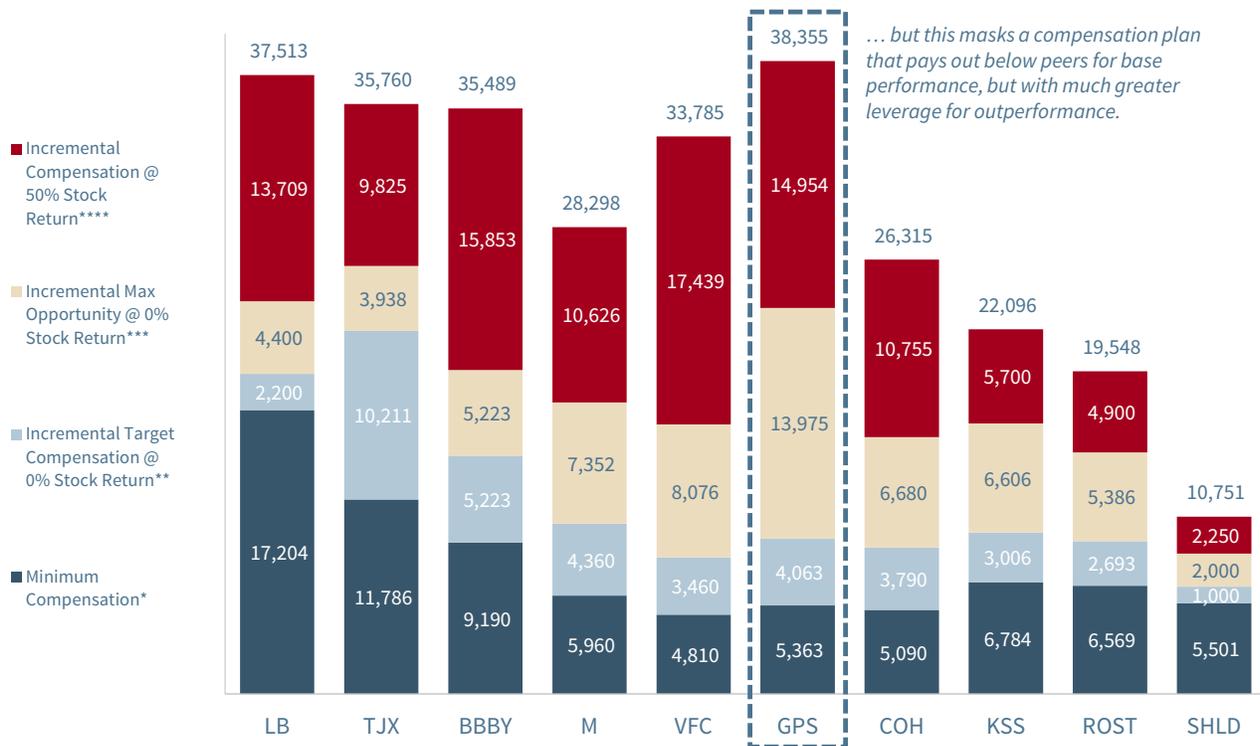
Source: The authors.

EXHIBIT 2 — TARGET VALUE VS. PROSPECTIVE PAY FOR PERFORMANCE

TARGET GRANT-DATE FAIR VALUE



PROSPECTIVE PAY FOR PERFORMANCE



* Assumes 0% stock appreciation and multipliers pay out at 50% of target
 ** Assumes 0% stock price appreciation and multipliers pay out at 100% of target
 *** Assumes 0% stock price appreciation and all multipliers pay out at max (including relative TSR)
 **** Assumes 50% stock price appreciation and multipliers pay out at max

Source: Forms DEF 14A filed with the Securities and Exchange Commission (most recent as of August 1, 2016). Research by the authors.