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*Viewpoint on Executive Compensation*

# CEOs Are Paid for Performance: Using Realizable Pay to Demonstrate Alignment with Total Shareholder Returns

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## Introduction

Executive pay, perennially controversial, is receiving more criticism than usual amid the current down economy. Various critics — including mass media organizations, the public, regulators, other government officials and some shareholders — believe that CEO pay is generally not proportionate with corporate performance. These critics claim that, in many cases, CEOs of low-performing companies are paid as much or more than those of high-performing companies. They view this lack of alignment as being extremely unfriendly to shareholders.

Our recent research, based on the 2011 proxy statements of about four hundred large companies, discredits this criticism by demonstrating that, when the appropriate pay metric is used, there is no factual basis for it. Findings show strong alignment of companies' stock-price performance with realizable CEO pay: CEOs at high-performing companies earned higher realizable pay than their counterparts at low-performing companies. As shown in Figure 1, cumulative realizable pay for CEOs from stock incentives at high-performing companies over three years was $19 million, which was 55% higher than that of CEOs at low-performing companies. Their performance was also proportionately higher. We have found similar alignment in other studies we have conducted over the past decade.

## Analysis and Discussion

In our study of 2011 proxy statements, the difference in realizable pay between high- and low-performing companies correlates with a wide disparity in total shareholder return (TSR). The three-year TSR for high-performing companies was 5.6%, compared with -8.0% for the low-performing companies. For the typical $10 billion-market-cap company, this disparity corresponds to a difference of about $1.4 billion in valuation.

There is no universally accepted methodology —among the SEC, academics, the media and shareholders — for evaluating alignment between CEO pay

and corporate performance. Nevertheless, our realizable-pay methodology is a logical and robust formula that any company can use to demonstrate that the interests of the executives and shareholders are aligned via the compensation program, especially stock-based incentives. Our study shows that high-performing companies tend to have relatively highly paid CEOs and low-performing companies, lower paid CEOs.

The challenge for companies to demonstrate such alignment in the 2011 proxy season became especially critical with the advent of Say on Pay (SOP). These votes have empowered proxy advisory firms — e.g., Institutional Investor Services (ISS) — and created additional complexity and concern for companies. In 2011, many companies have enhanced their pay-for-performance linkage and explained their philosophies on the subject to shareholders. In some cases, these disclosures have provided shareholders with insights into analyses conducted to assess this linkage.

Shareholders, who have benefited from these disclosures, have reacted positively. Overall, shareholders agreed that pay was indeed aligned with performance at most companies, as evidenced by SOP votes. In these votes, more than 98% of large companies received a shareholder endorsement of their executive pay programs.

Nevertheless, whether a given pay program has strong pay/performance alignment remains the subject of debate among different interests because there is no definitive way to demonstrate it. Further, though the SEC may soon require the disclosure of the relationship between performance and pay actually earned by named executive officers, it is not clear how the agency would structure this requirement.

Assessing pay/performance alignment involves answering three key questions:

1. What is the best way to measure CEO pay for this purpose?
2. Are CEOs at high-performing companies relatively high paid and those at low-performing companies relatively low paid?
3. What are the primary factors that can misalign CEO pay and corporate performance?

We address the first two of these questions below; the third question will be explored in a future *Viewpoint*.

**What is the best way to measure CEO pay in the context of assessing pay/performance alignment?**

There are several different ways to measure executive pay. These include:

- **Pay opportunity.** This includes target cash compensation and the value of equity incentives on the date of grant (generally, as represented in the Summary Compensation Table of a company's proxy statement). At many companies, figures for pay opportunity are similar to those for target total direct compensation.

- **Realized pay.** This includes actual cash earned, the value of exercised stock options (as opposed to the value at grant) and the value of vested shares. The value of realized pay is approximately the same as actual pay, which is similar to W-2 earnings.

- **Realizable pay** (the method we prefer). This is the sum of actual cash compensation earned, the aggregate value of in-the-money stock options, the current value of restricted shares, actual payouts from performance-share or -cash plans, plus the estimated value of outstanding performance shares and/or performance-contingent cash.

Realizable pay is the best measure for assessing alignment, as it is a truer representation of the value most likely attainable by an executive in a given time/performance period than is pay opportunity or realized pay.

This is because realizable pay allows for comparisons of pay and performance over concurrent time periods. By contrast, pay/performance alignment assessments that use pay opportunity and realized pay are thrown out of kilter because the time period used to measure pay opportunity is not typically concurrent with that used to measure performance.

For this reason, when working with our clients on specialized pay/performance studies of their industries and in conducting broad research, we have consistently used realizable pay. Typically, we make comparisons over three-year periods, though we have used longer periods, capturing individual executives' compensation over their entire careers. In these studies, we have found alignment between realizable pay and corporate performance at a preponderance of the hundreds of companies evaluated. This is largely because these companies' compensation packages contain substantial amounts of stock-based incentives.

ISS uses its own version of pay opportunity — including new grants of stock options and full-value shares — for its renowned, widely scrutinized and highly controversial pay-for-performance test. Much to the dismay of their boards, hundreds of companies have failed this test. These results showed high or rising pay (based on opportunity) but a recently declining stock price and/or low returns to shareholders relative to the ISS-defined comparator groups.

At many companies that failed this test, confusion and consternation ensued because this failure ran contrary to the pay experience of executives and their boards. These executives experienced lower pay due to underwater stock options, forfeited performance-share grants and shrinking cash bonuses — all paralleling low or negative returns to shareholders. Accordingly, realizable executive pay at these companies was indeed correlated with corporate performance. Yet the ISS test failed to reflect this reality because it did not measure realizable pay. Unlike the ISS analysis, analyses using realizable pay can identify scenarios involving declines in executive pay that are

concurrent with declines in shareholder returns. (A future *Viewpoint* will discuss new research on this issue.)

**Is there alignment between CEO pay and company performance?**

We conducted a pay/performance study that examined three years (2008–2010) of pay and performance regarding the long-term stock-based incentives of CEOs at 374 S&P 500 companies who had been incumbent for three or more years. The study was limited to companies that had filed proxy statements and had held SOP votes by mid-June in 2011. The median revenue and market capitalization of these companies were $8 billion and $11.7 billion, respectively. When we applied all components of realizable pay, the results for all of these companies were nearly identical.

Contrary to the claims of compensation critics, there was a strong relationship between pay and performance, as reflected by realizable pay. For this analysis we focused on long-term incentives. CEOs at high-performing companies — as indicated by total shareholder return (TSR) — had significantly higher realizable pay values (55% higher) than their low-performing counterparts. High-performing companies delivered shareholders a median return of 5.6%. The typical CEO of the high-performing companies received $19 million in realizable long-term incentive value, which was 140% of his or her pay opportunity (see Figure 2). The low--performing companies had TSR of -8%, and hence, CEOs received realizable pay of “only” $12.3 million — 70% of the value of granted LTI opportunity. These differences are economically and statistically significant.

***Figure 1: Relationship Between Company Performance and Realizable LTI Value***

| **Group** | **Count** | **Aggregate Over Three-Year Period (2008–2010)** | | |
|---|---|---|---|---|
| | | **Total Shareholder Return (TSR)** | **Realizable LTI Value** | **Ratio: Realizable LTI Value to LTI Opportunity** |
| Companies with high TSR | 187 | +5.6% | $19.0M | 1.4X |
| Companies with low TSR | 187 | -8.0% | $12.3M | 0.7X |
| All companies | 374 | +0.3% | $15.0M | 1.1X |

The analysis shown above bifurcates the sample of companies according to performance (e.g., high TSR means TSR above the overall median) and shows the median values of three-year TSR and realizable LTI and the ratio of realizable LTI value to opportunity for each of high- and low-performing subgroups.

Significantly, when pay opportunity is used instead of realizable pay, the pay/performance relationship reverses. CEOs at the low-performing companies were granted a higher level of pay opportunity, thus worsening the apparent relationship between pay and performance—though we know from the data in Figure 1 that pay and

performance are actually aligned. Unfortunately, this comparison is the one often cited by shareholder advocacy groups and media organizations to support their criticisms when rallying against executive pay.

There are some perfectly logical and sound business reasons why pay opportunity may not be correlated with performance, including the board's desire to attract and motivate new hires, provide significant incentives to achieve turnaround goals or retain high performers at critical junctures, as well as short-term fluctuations in the stock price which can result in the pay opportunity being "high" while the current value (or realizable pay) is "low." Nevertheless, this is an area that individual companies and their compensation committees need to monitor carefully, as it affects disclosure, SOP votes and ISS recommendations.

**Figure 2: Relationship Between Company Performance and LTI Opportunity**

| **Group** | **Count** | **Aggregate Over Three-Year Period (2008 – 2010)** | |
|---|---|---|---|
| | | **Total Shareholder Return (TSR)** | **Cumulative LTI Opportunity** |
| Companies with high TSR | 187 | +5.6% | $13.1M |
| Companies with low TSR | 187 | -8.0% | $16.3M |
| All companies | 374 | +0.3% | $14.8M |

Though the distinction between pay opportunity and realizable pay is clearly critical, it does not receive due attention. All too often, that attention is trumped by pay opportunity, as it is readily available in the proxy Summary Compensation Table. Realizable pay, on the other hand, requires some calculations using several tables in the proxy.

Committees determine pay opportunity using market data, typically setting it around the median of their markets. Though recent stock-price performance should be considered, market data is considered to be far more important. Nonetheless, the amount of compensation that is ultimately realizable from granted opportunity is highly dependent upon future stock price and corporate financial performance.

While many committees expect realizable pay to be significantly affected by these future performance factors, they understand opportunity to be relatively immune to recent stock price performance. Hence, seeking to encourage executive performance, they tend to focus on two things that are under their direct control: setting the level of pay opportunity appropriately and ensuring that the design of pay elements is primarily performance- based.

Hence, seeking to encourage executive performance, they tend to focus on pay opportunity, which is directly under their control. Compensation critics ignore this key distinction, and focus on pay opportunity instead of the sensitivity of pay to performance, as captured by realizable pay, leading to the incorrect conclusion that there is a widespread disconnection between CEO pay and corporate performance.

While most companies exhibit alignment between realizable pay and performance, and have appropriate levels of opportunity, some companies face challenges in this area. Our research has shown that setting pay opportunity too high or too low, as well as the form and design of incentives' delivery, can damage their perceived pay/performance alignment. We will share our research on this topic and explore some alternatives in a future *Viewpoint*.

**Conclusion**

Creating close pay/performance alignment requires far more than making decisions about and disclosing pay-opportunity levels. Committees must not only determine market-competitive pay opportunities to attract, motivate and retain executive talent, but also ensure that compensation programs reflect corporate performance.

In this new, highly sensitive disclosure environment, companies must communicate this flexibility convincingly to shareholders who now perennially voice their concerns in SOP votes. As we await the SEC's decision on pay/performance disclosures, committees should proactively assess alignment using realizable-pay analyses.

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*Pay Governance LLC is an independent executive compensation advisory firm. Our focus is on providing sound advice and counsel on how pay programs attract, retain, and motivate executives to create shareholder value. The firm helps compensation committees and management ensure that compensation programs align pay with performance, while being supportive of appropriate corporate governance and risk structures.*

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