# Executive Compensation: Underpaying the Best, Overpaying the Rest?

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**At industrials, executive compensation rarely reflects value creation, on the contrary it is regressing to the median and underpaying the best. To realign with value creation, Governance should consider three questions.**

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Over the last five years, the average compensation of the CEOs of 1,224 publicly listed industrial companies has increased at a compound annual growth rate of 6 percent. Has this growth been a fair representation of the shareholder value created?

In fact, at these companies, only a quarter of CEOs were paid in line with shareholder value creation, according to the Fernweh Executive Compensation Index. Another quarter were underpaid, while the majority received more than the value they generated. Strikingly, high-performing CEOs and CEOs of smaller companies were the most likely to be underpaid.

This article digs into our data to explain five reasons why today's model is flawed. Then we offer a framework companies should consider using to align compensation more closely with value creation.

# Executive Compensation: The Fundamentals

During the period 2016–20, average compensation of the CEOs of 1,224 publicly listed industrial companies reached $5.8 million, growing at a compound annual growth rate of 6 percent (Exhibit 1). Over the same period, realization rates—measured as the ratio between actual and target compensation—rose from 1.2 in 2016 to 1.6 in 2020. In other words, CEOs' compensation was exceeding the targeted amounts more and more over the five-year period (Exhibit 1).

*Exhibit 1*

From 2016 to 2020, the average industrial CEO's total compensation grew at 6 percent per year, reaching $5.8 million in 2020.


[1] Excludes compensation for TESLA CEO.
Source: Reported CEO compensation as per 2016-2020 companies' proxy statements for ~1,224 CEOs of publicly traded industrial companies North America

Viewing compensation at the level of individual companies, we found additional patterns. Most striking, compensation structure for CEOs is remarkably similar across all the companies. When industrial companies set executive compensation targets, they typically apply a framework that has three main components: a base salary, short-term incentives, and long-term incentives (Exhibit 2).

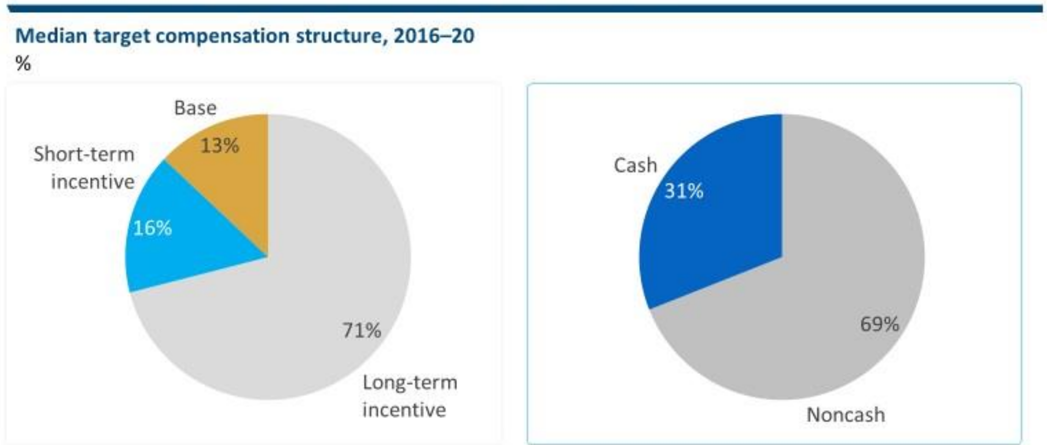
The base *salary* is typically a fixed cash amount designed to attract and retain qualified executives and compensate for competencies, skills, experience, and responsibilities.

The typical *short-term incentive* is an annual variable cash incentive linked to near-term operating performance targets, such as organic revenue growth, adjusted operating income, and free cash flow. To ensure alignment with stockholders' interests, executive compensation usually emphasizes *long-term incentives.* This component is an equity-based incentive that rewards executives for achievement of the company's long-term financial targets. It also promotes retention because it includes multiyear vesting terms that require continuous employment. Long-term incentives consist of a combination of multiple vehicles:

- **Restricted stock units (RSUs).** RSUs are a time-based incentive that is granted annually. They generally vest in three years—either 100 percent in year three or in increments of 33 percent per year. Vesting is generally subject to continued employment during the period.
- **Performance stock units (PSUs).** Also granted annually, PSUs are a performance-based incentive. They are granted each year based on performance relative to a two- or three-year preestablished performance plan. The actual number of shares to be granted is determined at the end of the vesting period, typically based on a range of 0 to 200 percent.
- **Stock options.** Like RSUs, stock options are a time-based incentive granted each year. They generally vest in three or four years and have a 10-year expiration. The strike price is the stock price at grant date.

*Exhibit 2*

The median industrial company in 2016–20 stressed pay for performance, with about two-thirds of compensation being noncash.




Source: Reported compensation data and financial statements for ~1,224 companies from S&P Capital IQ; Sentieo; companies' proxy statements, 2016–20

# Fernweh Executive Compensation Index

To structurally assess the strength of the link between companies' executive compensation packages and shareholder value creation, we have introduced the Fernweh Executive Compensation Index (FECI).

This measure of the efficacy of a company's CEO compensation plan provides insights for better aligning CEO compensation with shareholder value creation (see sidebar, "About the Fernweh Executive Compensation Index"). An FECI near 1—in the range of 0.8 to 1.2—indicates that an executive's compensation is aligned with the shareholder value created. Indexes below 0.8 signify executives whose compensation package is not fully reflecting the value created, and indexes above 1.2 signify overpaid CEOs, meaning they have received compensation higher than the value they generated.

***Fernweh Executive Compensation Index provides insights for better aligning CEO compensation with shareholder value creation***

## About the Fernweh Executive Compensation Index

The Fernweh Executive Compensation Index (FECI) has been developed based on the assessment of 1,224 executive compensation packages of publicly listed industrial companies in North America. The index incorporates three elements:

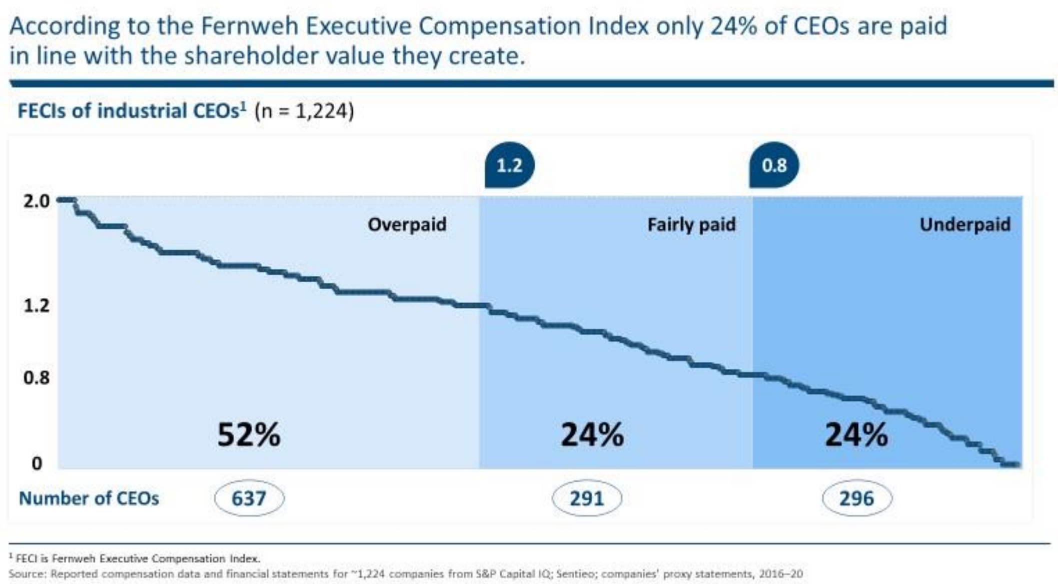
- **Structure of the target compensation package.** This element measures the target compensation's exposure to long-term company performance. The metric is long-term compensation's share of total target compensation.
- **Target setting.** This element measures the linkage between actual compensation and the shareholder value created. To do this, it compares the compensation realization rate, computed as actual compensation over target compensation, with the relative performance against relevant benchmarks for several metrics (total shareholder returns, EBITDA, free cash flow, revenue growth).
- **Absolute compensation amount**. This element measures the CEO's absolute actual compensation versus that of CEOs within the same relative performance cluster.

For each CEO's compensation package, the analysis assigns each element a score between 0 and 2. Each score is then weighted to reflect its relative importance. The sum of the weighted scores is the FECI, a value between 0 and 2, with 1 representing a distinctive alignment between executive compensation and shareholder value creation.

By using this measure to assess the 1,224 industrial CEOs in our sample, we found that only one-quarter of CEOs (24 percent) are paid fairly (Exhibit 3). Another 24 percent are underpaid, and 52 percent are overpaid.

***Only one-quarter of CEOs are paid fairly. 24 percent are underpaid, and 52 percent are overpaid.***

*Exhibit 3*




Digging deeper, we found that underpaid executives are not evenly distributed among industrial companies. Viewed by company performance, they are most likely to be found among top performers—33 percent of total, versus 15 percent among other performance groups (Exhibit 4). In particular, underpaid top performers display lower exposure to performance-based incentives (12 percent of total compensation) and uncalibrated plans (those achieving only a 33 percent realization rate).

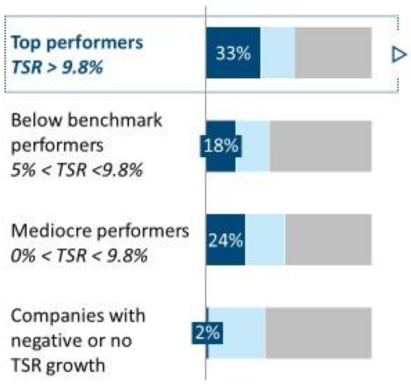
In addition, we found a large amount of underpaid CEOs among companies with revenues less than $1 billion (34 percent), as well as a significant 21 percent at companies where revenues were between

***Underpaid executives are most likely to be found among top performers and among smaller companies with revenues less than $5 billion***

*Exhibit 4*

Top performers have the largest share of underpaid CEOs, as they provide lower exposure to performance-based incentives and have uncalibrated plans.

Underpaid | Fairly Paid | Overpaid




| | PSU target % | Long-term incentive target, % | Realization rate[1], % | Realization rate vs. TSR |
|---|---|---|---|---|
| **Underpaid** | **12** | **53** | **33** | **<0.1x** |
| Overpaid | 28 | 64 | 320 | <1x |
| Fairly paid | 15 | 50 | 72 | >2x |

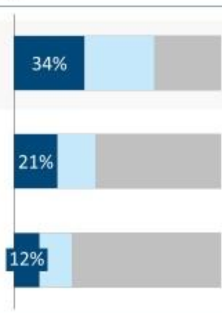
[1] The ratio between actual and target compensation
Source: Reported compensation data and financial statements for ~1,224 companies from S&P Capital IQ; Sentieo; companies' proxy statements, 2016–20

$1 billion and $5 billion (Exhibit 5). In contrast, where revenues were at least $5 billion, underpaid CEOs were much less common, at 12 percent.

*Exhibit 5*

CEOs at smaller industrial companies are more likely to be underpaid due to a smaller target compensation and lower exposure to upside.

Underpaid | Fairly Paid | Overpaid




| Revenue cluster $ billion | Target compensation $ million | Total shareholder returns (TSR), % | PSU target, % | Long-term incentive target, % | Realization rate vs. TSR |
|---|---|---|---|---|---|
| <1 | 1.3 | 226 | 9 | 41 | 0.36x |
| 1–5 | 3.9 | 60 | 21 | 56 | 1.95x |
| >5 | 7.8 | 71 | 28 | 64 | 2.36x |

Source: Reported compensation data and financial statements for ~1,224 companies from S&P Capital IQ; Sentieo; companies' proxy statements, 2016–20

# Why current model is flawed

Analyzing in detail the compensation packages of the 1,224 CEOs, we found five main causes of the weak link with shareholder value creation:

- There is a regression to the median. Company governance is overrelying on peer benchmarking to set target compensation for the CEO.
- Performance targets underlying the long-term incentive are often underwhelming. Targets are set as incremental improvements rather than anchored in the company's full potential.
- Long-term incentives are skewed toward time-based elements. RSUs and options are often trumping the relevance of PSUs.
- Year-over-year CEO adjustments to compensation have only a weak link with financial performance.
- High-performing CEOs are paid only incrementally higher relative to their peers.

## Regression to the Median

Across the board, industrial companies promote a compensation philosophy anchored around common principles aimed at attracting the best talent and reinforcing the link with shareholder value creation. Companies express these principles with various terms, such as pay competitiveness, long-term retention, pay for performance, and stock ownership.

Given companies' different starting points and the value at stake, we would expect CEO compensation packages to be fully customized. Indeed, at first glance across CEO compensation packages, there is significant variation, both in total amount and in structure (the mix of base salary, short-term incentives, and long-term incentives). However, when we dig deeper and look at CEO compensation packages by subsegments and revenue clusters, we find that despite the best principles and good intentions, there is a regression to the median, with CEOs' compensation packages looking increasingly similar within each cluster.

***[…] despite the best principles and good intentions, there is a regression to the median, with CEOs' compensation packages looking increasingly similar***

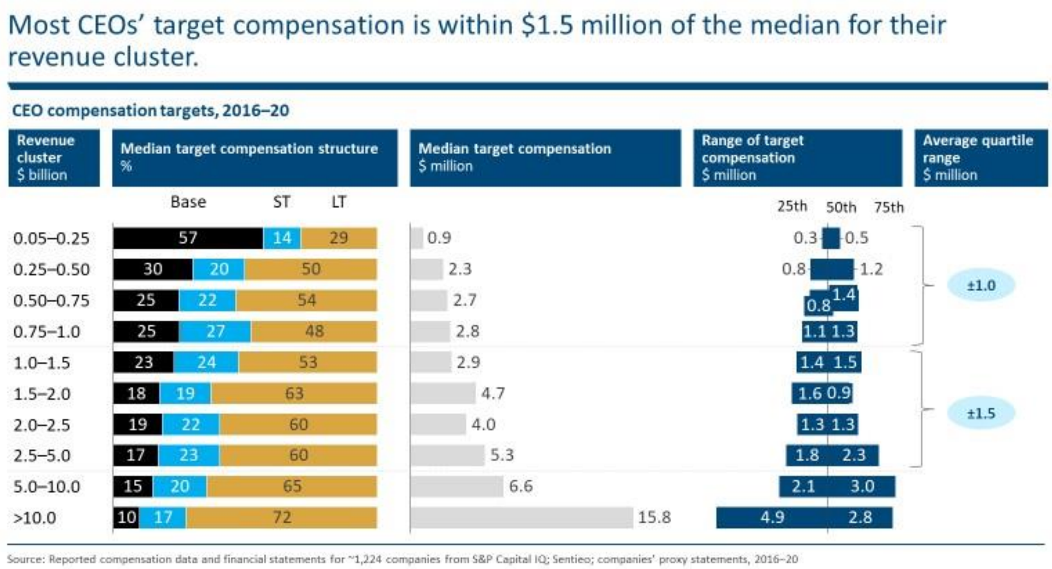
Company governance's reliance on peer group benchmarking is not a secret. Every public-company proxy statement discloses how the peer group leveraged is built and which companies are used for comparison. However, our analysis suggests that peer benchmarking is trumping everything else. The strongest pattern emerges when we categorize compensation packages by company size in terms of revenues.

In general, compensation packages are consistently larger for larger companies, and long-term incentives are a greater share of compensation at larger companies.

> ***[…] peer benchmarking is trumping everything else***

Perhaps most notable, however, is how little compensation varies within revenue clusters (Exhibit 6). There is a regression to the median in the sense that pay is closer to median for the cluster than performance differences would account for. Most CEOs earn within plus or minus $1.5 million.

*Exhibit 6*




## Underwhelming Targets

In addition to a regression to the median, we have observed that a large number of CEOs are achieving and going beyond their target compensation. This triggered our attention to pressure-test whether this is driven by outstanding performance or enabled by easy-to-achieve targets.

An aspirational target would be one that fully reflects the company's true full potential and that only a few companies succeed in meeting—or, at the very least, a target that, if met, would make companies stand out by generating returns higher than the relevant benchmark. Nevertheless, despite companies' best intentions to reward for performance, we found that during the 2016–20 period, only 17 percent of companies posted returns above the industrial S&P 500, but more than twice as many CEOs (35%) exceeded their target compensation (Exhibit 7).

This is driven by the common practice of setting targets as incremental improvements relative to the previous year's performance, rather than based on the true full potential a company could achieve.

***[…] common practice of setting targets as incremental improvements, rather than based on the true full potential a company could achieve.***

*Exhibit 7*

Though only 17 percent of CEOs outperformed the market, about 35 percent met targets.


Source: Reported compensation data and financial statements for ~1,224 companies from S&P Capital IQ; Sentieo; companies' proxy statements, 2016–20

Consider the examples of two industrial machinery companies (Exhibit 8). The first company's targets include improving EBITDA margin to 19 percent, only one percentage point above the company's average over the previous three years. The second company set the revenue hurdle rate, the threshold at which long term incentive is triggered, at $1.49 billion, which is only 1 percent higher than the company's previous three-year average revenue of $1.47 billion.

*Exhibit 8*

**Example of "easy targets": Performance targets at these industrial machinery companies are incremental improvements over the previous year.**

| Company | Metric | Hurdle rate | Target | Last 3-year average |
|---|---|---|---|---|
| Company 1 **Short-term metrics** | Organic net sales growth | **−2.0%** | 0.1% | 3% |
| | Adjusted EBITDA margin[1] | **18%** | 19% | 18.3% |
| | Free cash flow (FCF) | **$89M** | $104M | $130M |
| | Return on invested capital | **10.9%** | 14.5% | 10.57% |
| Company 2 **Long-term metrics** | Adjusted operating income | **$155M** | $185M | $148M |
| | Adjusted FCF | **$110M** | $140M | $105M |
| | Adjusted revenues | **$1,490M** | $1,560M | $1,470M |

[1] Earnings before interest, taxes, depreciation, and amortization (EBITDA) divided by revenues.
Source: Selected companies' proxy statements, 2016–20

# Long-Term Incentives That Are Significantly Time Based

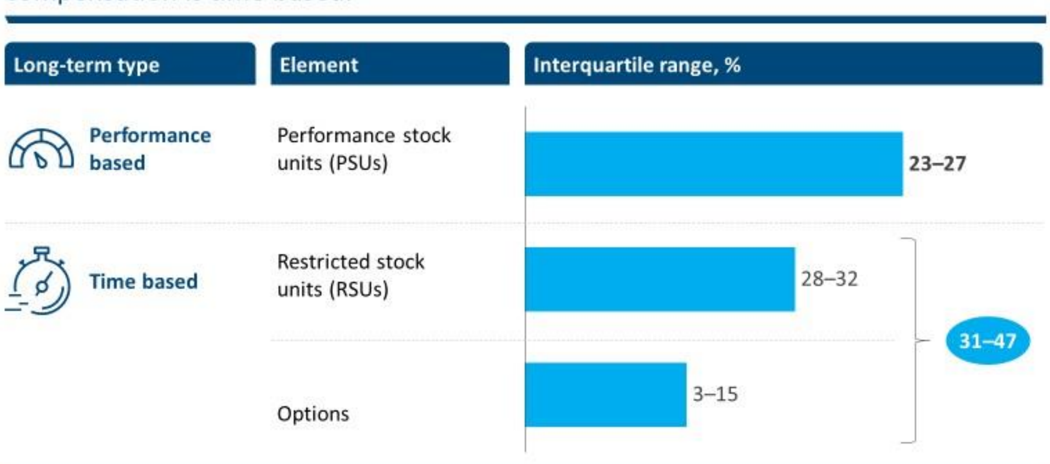
Stock ownership is a great tool for aligning shareholders' value with CEO compensation. The vehicles for doing so—RSUs, PSUs, stock options—have different mechanisms and are triggered by different hurdle rates. At the highest level, RSUs and options are mainly time-based incentives, as they are vested over a predetermined time frame and can be monetized as long as CEOs continue employment. This is somewhat different from PSUs, which are performance based, meaning that vesting occurs only if the company achieves predetermined performance results within a predetermined time frame.

A heavily performance-based plan would therefore include a significant share of PSUs; however, we don't see this happening. On the contrary, we see that long-term incentives are heavily skewed toward time-based incentives, at 31 to 47 percent of total compensation (Exhibit 9). This diminishes the weight of performance-based incentives. As long as CEOs stick around and don't destroy value, they are still achieving a significant part of their long-term compensation.

> ***As long as CEOs stick around […], they are still achieving a significant part of their long-term compensation.***

*Exhibit 9*

At a median industrial company, up to 47 percent of long-term incentive compensation is time based.




Source: Reported compensation data and financial statements for ~1,224 companies from S&P Capital IQ; Sentieo; companies' proxy statements, 2016–20

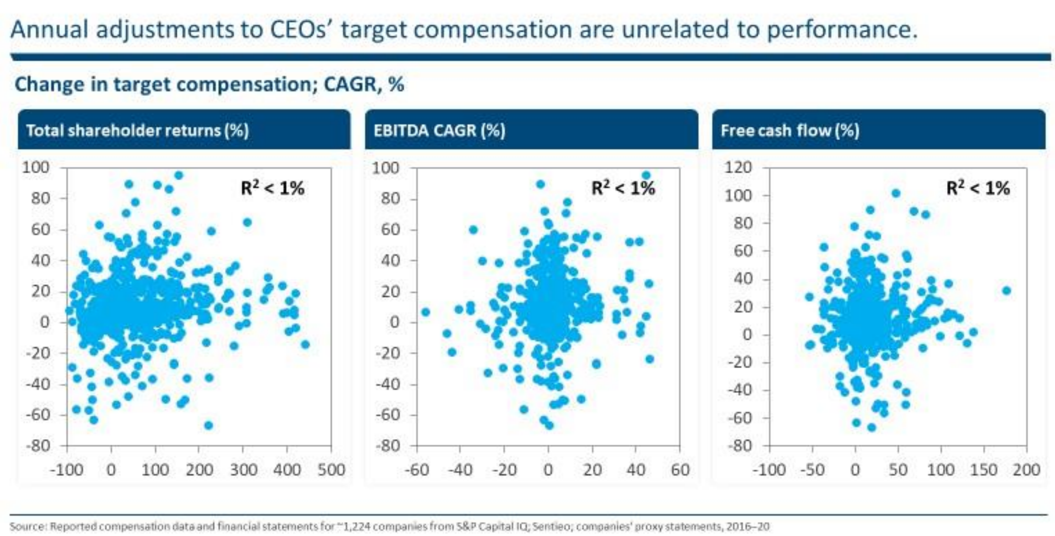
# Arbitrary Annual Adjustments

Each element of a CEO's compensation package is adjusted every year. In a pay-for-performance culture, we would expect that target CEO compensation packages would be adjusted in line with the company's intrinsic performance.

However, at the companies in our analysis, annual adjustments to target compensation were unrelated to the most important performance metrics, such as total shareholder returns, EBITDA growth, and free cash flow (Exhibit 10). For all these measures, the correlation coefficient, R-square, is less than 1 percent. This statistical term means the impact of performance on adjustments to CEO compensation is negligible; less than 1 percent of the observed variation can be explained by changes in performance metrics.

> ***[…] the impact of performance on adjustments to CEO compensation is negligible;***
> ***less than 1 percent of the observed variation can be explained by changes in performance metrics.***

*Exhibit 10*




# Inadequate Compensation of High Performers

As a result of the practices just described, industrials tend to pay their CEOs about the same amount as CEOs are earning at their peers of similar size. However, some of those companies are outperforming the market, while others lag. This situation raises a question of fairness, assuming we agree that a leader who creates more value for a company's shareholders should earn more than a leader who merely maintains the status quo.

> ***[…] a leader who creates more value for a company's shareholders should earn more than a leader who merely maintains the status quo.***

- To understand the magnitude of this bias, we sorted companies into four groups:
- Top performers—those whose total returns to shareholders exceeded 9.8 percent, the average growth rate achieved for the S&P 500 Industrials
- Below benchmark performers—those with a TSR of 5 to 9.8 percent
- Mediocre performers—those with TSR growth up to 5 percent
- Negative or no TSR growth

The top performers—the CEOs of companies that outperformed the S&P 500 industrials over the 2016–20 time frame—received more than below benchmark performers, averaging $9.3 million in total compensation versus $8.7 million (Exhibit 11). However, the difference was less than $1 million.

*Exhibit 11*

What if a company's improvement under a CEO is truly dramatic—say, propelling a bottom-quartile company into the top quartile? We find that even CEOs who moved their companies to top-quartile performance earned payouts that were in line with the average. Those who moved their companies from the bottom quartile to the top in terms of total shareholder returns earned on average $6.5 million,

> ***[…] even CEOs who moved their companies to top-quartile performance earned payouts that were in line with the average.***

Those who moved their companies from the bottom quartile to the top in terms of total shareholder returns earned on average $6.5 million, versus $5.8 million on average for all the CEOs in our sample (Exhibit 12). Their compensation realization rate, computed as actual performance over target performance, averaged 135 percent, versus 160 percent for all the CEOs.

*Exhibit 12*

Even CEOs who moved their companies to top-quartile operating performance in total shareholder returns were paid in line with those they outperformed.

**Actual compensation, 2016–20, $ million**

| 2016 Performance | 2020 Performance: Top Q | 3rd Q | 2nd Q | Bottom Q |
|---|---|---|---|---|
| Top Q | 10.4 | 5.8 | 4.3 | 1.9 |
| 3rd Q | 16.9 | 6.8 | 2.7 | 1.3 |
| 2nd Q | 9.3 | 5.0 | 2.7 | 1.5 |
| Bottom Q | 6.5 | 3.3 | 2.0 | 1.3 |

**Compensation realization rate, 2016–20, %**

| 2016 Performance | 2020 Performance: Top Q | 3rd Q | 2nd Q | Bottom Q |
|---|---|---|---|---|
| Top Q | 126% | 202% | 130% | 67% |
| 3rd Q | 186% | 160% | 107% | 59% |
| 2nd Q | 160% | 112% | 72% | 115% |
| Bottom Q | 135% | 68% | 60% | 58% |

Source: Reported compensation data and financial statements for ~1,224 companies from S&P Capital IQ; Sentieo; companies' proxy statements, 2016–20

# Fixing the Compensation Formula

To bring CEO compensation at industrial companies into alignment with value creation, corporate governance ought to consider three questions:

- **What is the right absolute target compensation?** The target compensation needs to be linked to the level of value creation the company aspires to achieve, not a peer group benchmark. It also should take into account the level of effort required. For example, to move from the bottom quartile to the top will take more effort than a small improvement that will leave the company in same performance quartile.

- **What is the right structure?** Companies need to balance short-term and long-term incentives, as well as time-based incentives (RSUs and options) and performance-based incentives (PSUs). The objective should be to ensure the most effective alignment between executives' interests and competing company priorities, such as generating immediate positive free cash flow versus executing a programmatic long-term M&A strategy.

- **How should we measure performance?** Governance needs to set targets up front and calibrate them to achieve next-quartile or top-quartile performance, not just incremental improvements over previous years. Payouts should be multitiered, with CEOs unlocking the first tiers by delivering against controllable operating metrics. Rewards are compounded and reach their maximum when operating performance translates into growth in shareholder value in excess of a predetermined relevant benchmark.

Answering these questions will require careful analysis of the company's starting point, an understanding of its true potential, and recognition of the transformative effort required to achieve that potential. Average company governance may be tempted to revert to benchmarking and set targets as incremental improvements versus previous years. Virtuous ones, instead, will do the hard work required for linking compensation to value, which offers the double benefit of protecting shareholder value and rewarding their CEOs fairly.

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