Fall 2012

# Industry Comparison of Executive Compensation and Equity Considerations

Louis Chan
*University of New Hampshire - Main Campus*

# Industry Comparison of Executive Compensation and Equity Considerations

Honors Thesis
Louis Chan
ADMN 799H
Dr. Yixin Liu
Fall 2012

## Abstract

The executive compensation a company decides for its CEO can affect the firm's leadership and long-term position. Industries differ in their evaluation of executive performance; however, a well-balanced package will satisfy shareholders, the company and the executive. Companies should allocate a larger percentage of earnings to long-term equity incentives in order to guarantee future profits. Deferred cash compensation can amplify the company objectives.

## Introduction

With the global economic downturn, World Financial Crisis and numerous, recent financial scandals, companies and corporations no longer possess the prominence that they once enjoyed. Shareholders foster a lack of trust for the executives of large corporations whom they believe only have personal interests in mind. A recent, significant controversy in the media is executive compensation which is "compensation paid to CEOs, CFOs and certain other high-ranking executive officers of public companies" (*Executive Compensation*). Executive managers are rewarded substantial amounts of money in the form of base salaries, bonuses, stock awards, stock options, pension plans, benefits, etc.

The objective of any chief executive officer is to maximize shareholder profitability and ensure long-term growth and profitability. Their specific skill sets and experience should justify the considerable amounts that they earn. However, the government, shareholders, employees and stakeholders question why corporations remunerate such generous earnings to their executives. In order to achieve objective congruence, executive compensation must tie the various forms of earnings to company performance. An appropriate compensation structure will lead to mutual rewards between executives, shareholders and the company.

## Methods

Executive compensation comprises of several key elements that combine to form a payment package. Each individual element has desirable attributes that can influence an executive's performance. However, the structure of the compensation ultimately determines the decisions and strategy that the executive decides upon. In order to understand the various compensation components, a general overview and review of each must take place.

From there, a detailed analysis and comparison of Chief Executive Officer Compensation packages will be performed. A selection of one large and small company from five various industries within the S&P 500 will aid in determining a general executive compensation recommendation. The five industries are: Information Technology, Consumer Discretionary (Automotive), Energy, Consumer Staples and Healthcare (Personal Products). The large and small companies from each are: Apple Inc. and Quality Systems Inc., Ford Motor Company and Tesla Motors Inc., Exxon Mobil Corporation and Callon Petroleum Company, Kraft Foods Inc. and Annie's, Inc., and Johnson & Johnson and Hain Celestial Group, respectively.

## Overview

Executive compensation of publicly traded companies is determined by the Compensation Committee which consists of independent members of the Board of Directors. "The Compensation Committee is responsible primarily for reviewing the compensation arrangements for the Company's executive officers, including the CEO, administering the

Company's equity compensation plans, and reviewing the compensation of the Board" (Apple Inc.). An independent compensation consultant is also employed in order to assess the performance and compensation of peer/benchmarking companies in the same industry.

All compensation packages begin with a salary which is the base level of income. It provides a certain, cash payment that is based on the executive's "individual work experience, leadership, time in position, knowledge, and internal parity among those performing like jobs" (Johnson & Johnson). Salary increases are predominantly based upon the individual performance of the executive. In addition, companies may offer an annual performance cash bonus or incentive based bonus in order to reward executives for achieving short-term performance goals or to recognize them for their individual contributions and performance. The performance measures are typically based on sales and operating income. They are calculated as a percentage of the annual salary and may range from 30% to 200% of the total base salary.

Companies reward their executives with stock based compensation in the form of restricted stock units (RSU's) and stock options. Restricted stock units are "grants valued in terms of company stock, but company stock is not issued at the time of the grant. After the recipient of a unit satisfies the vesting requirement, the company distributes shares or the cash equivalent of the number of shares used to value the unit" (*Restricted stock units (RSUs)*). Stock options give an employee the right to purchase stock at a predetermined price (usually fair market value at grant date). They may also involve vesting requirements and are only valuable to the employee if the market price of the stock exceeds the grant price. Both restricted stock units and stock options are intended "to align the personal financial interests of executives with the long-term interests of shareholders and encourage a long-term shareholder perspective" (Exxon Mobil Corporation).

Non-Equity Incentive Plan Compensation differs between companies but usually is cash-based bonuses for individual contributions or meeting company performance objectives. Some companies allocate bonuses under the Non-Equity Incentive Plan and vice versa. It is calculated as a percentage of base salary. Pension plans are fixed, annual payments beginning after retirement. They are designed to attract talent and entice employees to stay for long periods of time or until retirement. They are usually based on the number of years of employment and a percentage of average ending years' salary. All Other Compensation are benefits given to executives such as life insurance premiums, defined contribution plans such as 401K's, personal security, tax reimbursements, personal use of company aircraft, car expense reimbursements, use of company properties, financial planning, etc.

## Comparison and Analysis

*Apple Inc. and Quality Systems Inc.* operate within the Information Technology industry. Apple produces and distributes consumer electronics worldwide, most notably their operating systems, iPhone and MacBook products. The CEO is Timothy Cook who recently replaced the founder and genius behind Apple, Steve Jobs. Due to company executive compensation policy, Mr. Cook's salary of $900,017 was purposely set below the executive compensation levels of peer companies. His compensation was tremendously weighted towards Restricted Stock Units; greater than 99% of total compensation (*refer to Figure 1*). Apple "believes RSUs create incentives for performance and further align the interests of executives with those of shareholders because an RSU's value increases or decreases in conjunction with the Company's stock price" (Apple Inc.). Mr. Cook's cash bonus was $900,000, RSU's were $376,180,000 and other compensation was $16,520.

Quality Systems develops and markets healthcare information systems in the United States. The CEO is Steven Plochoki whose annual salary was $539,688, option awards were $236,748, and non-equity compensation was $151,250 (*Figure 2*). Executives within the company are required to hold at least a 25% value of their annual salary as common stock. Upon signing his employment agreement, he was awarded 100,000 stock options with an exercise price of $20.04/share. Mr. Plochoki had no RSU's awarded in his compensation package.

Executive compensation in technology firms is heavily weighted towards stock awards and stock options. This is because the company is aligning the interests of the managers and the shareholders through the compensation structure. Innovation is a key factor in the long-term success of tech firms; they rely on research and development in the current period to produce new products for future profitability. "R&D efforts typically take many years to materialize [52], creating additional monitoring challenges that are often resolved by relying less on salary and more on long-term pay components such as stock options and long-term incentive plans, both of which are also performance-contingent [43, 53]" (Finkelstein, 2009). By shifting compensation towards long-term incentives, the companies are ensuring that CEO's are strategizing long-term.

*Ford Motor Company and Tesla Motor Inc*. are publicly traded entities in the Automobile industry. Ford manufactures commercial and consumer automobiles, heavy trucks, tractors and automobile components globally. Alan Mulally is the CEO of Ford Motor Company whose compensation policy is based on performance tied to the ONE Ford objectives. His salary was $2,000,000, cash bonus of $1,820,000 along with RSU's worth $13,924,993 and stock options worth $7,499,992 (*Figure 1*).

Tesla Motor Inc. designs and manufactures electric automobiles. Elon Musk is the CEO and received an annual salary of $33,280 based on minimum wage requirements under California law. The Tesla Compensation Committee chose to award Mr. Musk "3,355,986 options to purchase shares of our common stock at an exercise price of $6.63 per share representing 4% of our fully-diluted share base prior to such grant as of December 4, 2009 (Tesla Motor Inc.).

In past years, automotive companies have experienced severe downturns which included government bailouts of industry leaders. Only in recent years have they slowly returned to profitability. The automotive industry allocates significant portions of executive compensation in the form of long-term equities. This promotes long-term stockholder interests in regards to CEO directives and leadership. Less emphasis is placed on the cash compensation. The Board of Director's key objective is ensuring future profitability which is a result of model production, research and development, and sales.

*Exxon Mobil Corporation and Callon Petroleum Company* are in the Energy industry. Exxon Mobil is the largest company in the world in terms of revenue. It's main line of business is refining and manufacturing oil and gasoline. Rex W. Tillerson is the CEO and earned $2,387,000 in annual salary, cash bonus of $4,368,000 and $17,890,875 in stock awards (*Figure 1*).

Callon Petroleum is an independent oil and natural gas company based in the United States. The CEO is Fred Callon who earned an annual salary of $464,520, cash bonus of

$464,520 and RSU's of $1,156,650 (*Figure 2*). The company does not have a preset compensation structure but allocates more towards performance based measures as executive responsibility increases.

Companies in the Energy sector rely heavily on 'pay for performance' measures such as revenues and stock prices. This is because "The IRS allows companies to deduct certain top executives' pay over $1 million, but only if it qualifies as "performance-based incentives" (Stern, 2011). Cash bonuses, RSU's and stock options are awarded as performance incentives and the latter two also tie company performance, executive interests and shareholder interests. An interesting development is shareholder resolution to tie executive compensation with sustainability metrics. This incorporates responsibility within company practices in the case of oil spills, environmental awareness and practices, etc.

*Kraft Foods Inc. and Annie's, Inc*. operate in the Consumer Staples industry. Irene Rosenfeld is the CEO of Kraft Foods which is a food and beverage conglomerate. Her 2011 salary was $1,540,712, her RSU's totaled $7,754,472 and her stock options were $1,933,709 (*Figure 1*). Her common stock ownership is required to be eight times the value of her salary under Kraft's Executive Stock Ownership policy.

Annie's, Inc. makes natural/organic pastas, meals, snacks and condiments. The company only recently became a publicly traded entity. The CEO is John Foraker whose compensation consisted of a salary of $336,583, stock awards of $224,998 and option awards of $450,000. Other compensation was $516,570 which consisted of stock option purchases (*Figure 2*). Mr. Foraker was offered significant stock options during the transition from private to public.

Consumer Staples companies base executive compensation on performance measures and equity remuneration. Market saturation is evident and compensation packages are more weighted towards long-term incentives because they reward future profitability. Emerging markets are of particular attention for the future because market share in established markets is in the mature stage. In addition, the industry structure is changing due to the relatively new introduction of “Natural/Organics” staples.

*Johnson & Johnson and Hain Celestial Group* are in the Healthcare industry. Johnson & Johnson is a New Jersey based pharmaceutical, medical device and consumer goods manufacturer. They employ a vast diversification strategy that ranges from Internet publishing to medical products. The CEO is William Wheldon who earned a salary of $1,907,215 and equity based compensation worth $6,798,177 (*Figure 1*).

Hain Celestial Group produces natural and organic foods along with personal care products. The CEO is Irwin Simon who founded the company in 1993. Mr. Simon is required to hold stocks at six times the value of his annual salary under the Stock Ownership Guidelines. His annual salary was $1,470,840 and his RSU compensation was $4,585,451 (*Figure 2*).

Healthcare companies are shifting their executive compensation policies towards pay for performance metrics. Financial ratios are a measurable way to determine if the executive managers performed well compared to their peers. Johnson & Johnson altered their policy this year due to dismal shareholder voting on executive compensation. They discontinued cash based long-term incentives in favor of equity based incentives. The goal congruence between shareholders and executives is imperative for long-term decisions and strategies. Without the proper pay structure, shareholder wealth maximization would not be achievable.

**Recommendation**

An adequately balanced and structured executive compensation package will ensure the short and long-term profitability of a company in any industry. Although critics claim that the level of compensation is too elevated, it is an easily justifiable quantity. For instance, a firm generates $1 billion in revenues and compensates their chief executive officer with a total compensation package of $5,000,000. This would only represent .5% of their total revenues. Proportionally, it is not a main concern.

The distribution and structure of the compensation is the key to shareholder wealth maximization. A well balanced package should include a smaller percentage of earnings as the annual base salary. If 100% of an executive's compensation was based on salary, then the performance of the firm would have no bearing on his/her earnings. A greater portion should be allocated to stock options and awards. By basing an executive's remuneration on stocks with long-term vesting requirements, the CEO must ensure that his guidance and leadership in the present time period will result in long-term profits. Vesting periods of five to ten years would provide a considerable amount of time for executive decisions to take effect/produce favorable outcomes.

In addition to the long-term equity based compensation, deferred compensation in the form of cash could also be used to induce long-term decision-making. By withholding executive salaries until a later date, companies could further align shareholder and executive interests. The deferred compensation would serve as a type of insurance policy against which executives would be liable for company profits and net earnings goals. The withheld funds could also be used as capital for investments or short-term returns.

## Conclusion

Various industries place an emphasis on different measurable characteristics in regards to performance evaluation. The ultimate goal is to design an efficient compensation package that meets the needs of the company, shareholders and top manager. In order for the three parties to benefit, a balance must be made between the proportions of the short and long-term components. The most effective package differs among different industries, but relies on the same instruments to provide the most successful results.

References

Annie’s, Inc. 2012 *Proxy Statement.* Berkeley, CA: Annie’s Inc. 2012.

Apple Inc. *2012 Proxy Statement*. Cupertino, CA: Apple Inc. 2012.

Callon Petroleum Company. *2012 Proxy Statement*. Natchez, MS: Callon Petroleum Company 2012.

DeCarlo, Scott. "America’s Highest Paid CEO’s." Forbes. 04 April 2012: n. page. Web. 4 Sep. 2012. <http://www.forbes.com/sites/scottdecarlo/2012/04/04/americas-highest-paid-ceos/>.

Edmans, Alex. "How to Fix Executive Compensation." Wall Street Journal 27 Feb 2012, U.S. Edition n. pag. Web. 4 Sep. 2012. <http://online.wsj.com/article/SB10001424052970203462304577138691466777460.html>.

Exxon Mobil Corporation. *2012 Proxy Statement*. Dallas, TX: Exxon Mobil Corporation 2012.

Finkelstein, S. (2009). Why is industry related to ceo compensation?: A managerial discretion explanation. *The Open Ethics Journal*, *3*, 42-56. doi: 1874-7612/09

Ford Motor Company. *2012 Proxy Statement*. Dearborn, MI: Ford Motor Company 2012.

Hain Celestial Group. *2012 Proxy Statement*. Melville, NY: Hain Celestial Group 2012.

Johnson & Johnson. *2012 Proxy Statement*. New Brunswick, NJ: Johnson & Johnson 2012.

Kraft Foods Inc. *2012 Proxy Statement*. Northfield, IL: Kraft Foods Inc. 2012

Quality Systems, Inc. *2012 Proxy Statement*. Irvine, CA: Quality Systems, Inc. 2012

*Restricted stock units (RSUs)*. (2012, Dec 08). Retrieved from https://scs.fidelity.com/webxpress/help/topics/learn_rsus.shtml

Stern, G. (2011, July). Pay for performance. *energybiz*, Retrieved from http://www.energybiz.com/magazine/article/227511/pay-performance

Tesla Motors Inc. *2012 Proxy Statement*. Palo Alto, CA: Tesla Motors Inc. 2012

United States Securities and Exchange Commission. *Executive Compensation*. Securities and Exchange Commission, 2011. Web. <http://www.sec.gov/answers/execomp.htm>.

# Appendix

## Figure 1. S&P 500 Large Companies

| Industry | Company | CEO | Annual Salary | Cash Bonus | Restricted Stock Units | Stock Options | Non-Equity Incentive Plan Compensation | Change in Pension Value and Nonqualified Deferred Compensation Earnings | All Other Compensation | Total Compensation |
|---|---|---|---|---|---|---|---|---|---|---|
| Information Technology | Apple Inc. | Timothy D. Cook | $ 900,017 | $ 900,000 | $ 376,180,000 | $ - | $ - | $ - | $ 16,520 | $ 377,996,537 |
| Automobile | Ford Motor Company | Alan Mulally | $ 2,000,000 | $ 1,820,000 | $ 13,924,993 | $ 7,499,992 | $ 3,640,000 | $ - | $ 612,587 | $ 29,497,572 |
| Energy | Exxon Mobil Corporation | Rex W. Tillerson | $ 2,387,000 | $ 4,368,000 | $ 17,890,875 | $ - | $ - | $ 9,755,401 | $ 519,230 | $ 34,920,506 |
| Consumer Staples | Kraft Foods Inc. | Irene Rosenfeld | $ 1,540,712 | $ - | $ 7,754,472 | $ 1,933,709 | $ 4,232,000 | $ 6,207,428 | $ 276,373 | $ 21,944,694 |
| Healthcare | Johnson & Johnson | William C. Wheldon | $ 1,907,215 | $ 3,065,280 | $ 2,608,694 | $ 4,189,483 | $ 11,271,114 | $ 3,435,000 | $ 321,153 | $ 26,797,939 |

## Figure 2. S&P 500 Small Companies

| Industry | Company | CEO | Annual Salary | Cash Bonus | Restricted Stock Awards | Option Awards | Non-Equity Incentive Plan Compensation | Change in Pension Value and Nonqualified Deferred Compensation Earnings | All Other Compensation | Total Compensation |
|---|---|---|---|---|---|---|---|---|---|---|
| Information Technology | Quality Systems Inc. | Steven T. Plochocki | $ 539,688 | $ - | $ - | $ 236,748 | $ 151,250 | $ - | $ - | $ 927,686 |
| Automobile | Tesla Motors | Elon Musk | $ 33,280 | $ - | $ - | $ - | $ - | $ - | $ - | $ 33,280 |
| Energy | Callon Petroleum | Fred L. Callon | $ 464,520 | $ 464,520 | $ 1,156,650 | $ - | $ - | $ - | $ 60,646 | $ 2,146,336 |
| Consumer Staples | Annie's | John M. Foraker | $ 336,583 | $ - | $ 224,998 | $ 450,000 | $ 198,000 | $ - | $ 516,570 | $ 1,726,151 |
| Healthcare | Hain Celestial Group | Irwin D. Simon | $ 1,470,840 | $ 200,000 | $ 4,585,451 | $ - | $ 2,941,680 | $ - | $ 59,513 | $ 9,277,484 |