C-SUITE

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All on Board

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Narrowing the gap between investors and boards

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Compensation trends around the world

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Beyond the Proxy

Examining 2016 CEO pay trends

By Ryan Villard

Ryan Villard is a research analyst with Equilar. For more information on Equilar's CEO Pay Trends 2016, featuring commentary from Meridian Compensation Partners, please visit ***equilar.com/reports.html****.*

A Chief Executive Officer (CEO) is both the managerial leader and the figurehead of his or her company, representing it to its employees, shareholders and the general public. In times of growth and success, but also in turmoil and failure, a company's CEO must persevere and plan their next course. Consequently, CEOs take on incredible responsibilities, and companies seek to pay them in line with those risks and opportunities.

Due to these factors, investors, advisors, the media and the general public closely scrutinize CEO pay, and this tenor has increased in pitch in the wake of Dodd-Frank and Say on Pay. Under these pressures, executive compensation—especially CEO pay—has been shifting toward long-term value generation and retention through stock awards, while salary and bonus levels have begun to stagnate. Equilar's recent *CEO Pay Trends 2016* report, which featured independent commentary from Meridian Compensation Partners, analyzed CEO pay trends in the S&P 500 over the last five years, examining pay structures, elements and values in the face of this changing corporate landscape.

Rising CEO pay often catches media attention as unnecessarily large, or "exorbitant," especially compared to stagnating workers' wages, but criticisms must be taken with a grain of salt. While groups like AFL-CIO criticize income inequality—calculating the average CEO-to-worker pay ratio at 335-to-1 according to its Executive Pay Watch—broad ratios often don't tell the whole story, generalizing workers and not accounting for variable pay elements or wage growth. In fact, while median reported CEO compensation increased 1.6% from 2014 to 2015, the Economic Policy Institute's Nominal Wage Tracker found that private employees' actual year-over-year wage growth was 2.6%.

Rising Total Compensation: More Than Meets the Eye

S&P 500 companies have steadily increased CEO compensation over the past five years. Median reported CEO total compensation rose 16.9% from $8.9 million in 2011 to $10.4 million in 2015. This

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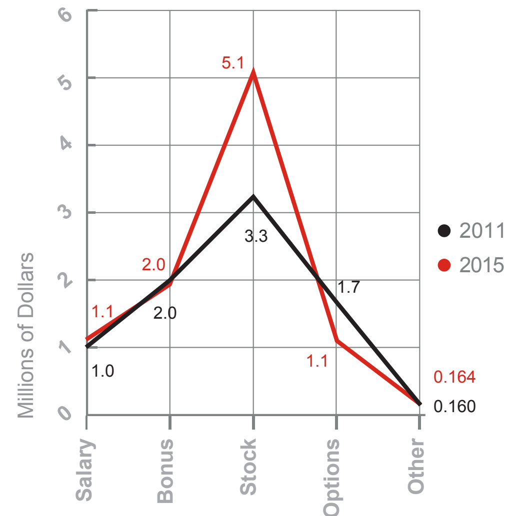
growth generally occurred incrementally, only rising more than 3.5% in any given year in 2013 where CEO pay increased 10.5%, or nearly $1.0 million ($970,042).

"When looking at CEO compensation, there are two ways to frame it. You can view CEO compensation in terms of actual payouts or in terms of structure/target opportunity," said Gerard Leider, a partner with Meridian Compensation Partners. "The proxy summary compensation table disclosure is a mixed comparison of both actual and target accounting value."

"The number of different definitions companies have to tell their story is not to confuse the reader, but to add clarity across appropriate components of pay," added Donald Kalfen, Partner and Technical Lead at Meridian Compensation Partners.

In other words, there's a mismatch in the way that the SEC requires companies to report pay, and therefore practitioners take special care to evaluate these figures in a larger context. There's no denying the size of CEO pay in the S&P 500, but recent scrutiny has drastically affected how it has changed, refocusing on equity-based compensation with major increases appearing in largely growing sectors like healthcare and technology largely due to grants of non-cash compensation.

Graph 2
S&P 500 Median Reported Pay Components



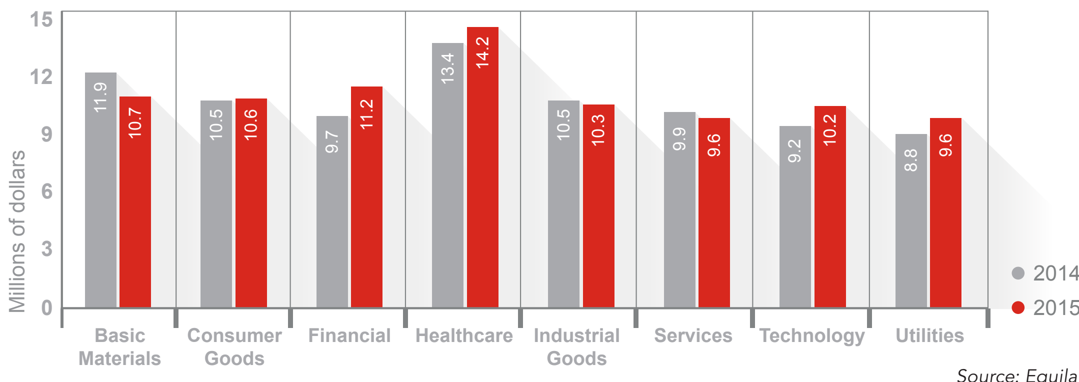
Source: Equilar

One Size Does Not Fit All

Market performance relies on external factors that affect each sector differently—consequently, CEO pay did not rise equally across every sector. Reported total compensation increased modestly in the consumer goods sectors, and dipped slightly in the industrial goods and services sectors in 2015. Meanwhile, healthcare and utilities continued a steady growth while technology rose after a 2014 dip (Graph 1). The basic materials sector was down 10.2%, while the financial sector saw a 15.5% increase at the median over 2014.

These changes reflect the aforementioned CEO pay package design changes that emphasize equity compensation. Equity compensation in the form of stock and options made up 65.3%, 63.1% and 65.5% of their CEOs' pay mix in the healthcare, utilities and technology sectors respectively.

Graph 1
S&P 500 Median Reported Total Compensation by Sector



Source: Equilar

In fact, across all sectors, stock awards were the only pay component to show meaningful growth. Median reported salary has increased incrementally, while bonuses and options awards decreased in the past five years. Meanwhile, median stock awards surged, increasing by over $1.8 million at the median (Graph 2).

"I would argue governance factors are more

significant in driving pay structure than just the proxy-disclosed pay data," explained Leider. [Shareholders] are looking for better pay for performance in executive pay, greater transparency around pay programs and enhanced governance policies and oversight of CEO pay by boards and committees."

Pay for Performance Drives CEO Comp Design

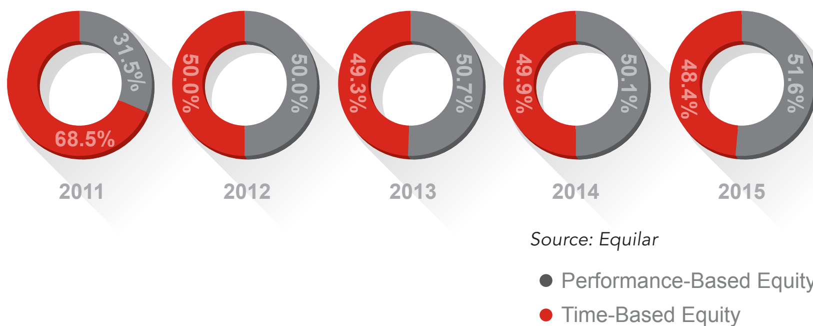
Companies award equity as either stock options or full-value shares of restricted stock, doing so in two primary formats: time-based and performance-based. Dodd-Frank and its financial reforms led the transition from the former to the latter, leading to and popularizing more deliberate and transparent pay for performance strategies. In 2012, the number of S&P 500 companies granting performance awards surpassed those giving time-based options awards, and this trend continued through 2015, with the prevalence of companies offering performance awards peaking at 80.5% versus just over half of still paying CEOs with time-based options.

Performance-based equity has also increased and surpassed time-based equity in S&P 500 companies' median equity mixes, balancing the scales between fixed and variable, or "at-risk," pay components. While in 2011 performance-based equity made up only 31.5% of median equity mixes, with time-based equity filling the remaining 68.5%, these values shifted dramatically in 2012 where they met at 50.0% each. This trend fluctuated year-over-year, but most recently performance-based equity accounted for a slight majority, representing 51.6% of equity compensation, compared to time-based equity making up 48.4% (Graph 3).

> **Dodd-Frank and its financial reforms led to the popularization of more deliberate and transparent pay for performance strategies.**

Graph 3

S&P 500 Median Time- vs. Performance-Based Equity Mix



Source: Equilar

● Performance-Based Equity
● Time-Based Equity

"Time-vested and performance-vested stock awards both have grown in prevalence for different reasons," said Leider. "Time-vested equity takes on a primary goal of talent retention given the lack of performance required to earn the grant, even in a declining market, while in contrast, performance equity, otherwise defined as performance shares or units, only vests when certain goals are achieved over the measurement period, requiring goals to be set and achieved before payout."

Furthermore, performance awards amplify stock as an innate performance award because its payout value relies on company performance, in addition to company valuation—the amount of stock they receive relies on how well the CEO performs, beyond simply relying on how well the stock performs. Equity incentives clarify and connect executive compensation to actual company metrics, demonstrating and clearly linking CEO pay and company growth to shareholders.

While companies design CEO awards to motivate growth and generate shareholder value, certain performance metrics can lead to the pursuit of short-term strategies to meet performance targets over long-term growth. Some studies have found that executive compensation reliant on earnings per share and granting stock options often correlates with increased share buybacks. Critics oppose these repurchases because they often take the place of long-term investments in company growth and development. While connecting pay and performance clarifies components that compose CEO pay, careful design becomes important to ensure that the goals promote strategic decisions and shareholder value. CS

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