Paying for Performance

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Overview

1. Is pay linked to performance?
2. Is linking pay to performance necessary or desirable?
3. Is pay linked to the right measures of performance?
4. What can be improved?
1. Is Pay Linked To Performance?

“There is no perceivable link between corporate financial performance and the sums paid out to CEOs. There is academic evidence to suggest that this link is in any case statistically weak or non-existent”
RESTORING RESPONSIBLE OWNERSHIP
ENDING THE OWNERLESS CORPORATION AND CONTROLLING EXECUTIVE PAY

BY CHRIS PHILP MP
WITH AN INTRODUCTION BY
NEIL WOODFORD CBE AND
LORD MYNERS OF TRURO CB

CONTRIBUTIONS BY PAUL MARSLAND OF THE HIGH PAY CENTRE
1. Is Pay Linked To Performance?

- “There is clear evidence that high CEO pay is no longer strongly associated with performance, and two academic studies clearly show in fact high CEO pay negatively correlates with performance”
1. Is Pay Linked To Performance?

- “Wall Street CEOs who helped destroy the economy, they don’t get police records. They get raises in their salaries”
1. Is Pay Linked To Performance?

- “There is no perceivable link between corporate financial performance and the sums paid out to CEOs. **There is academic evidence to suggest** that this link is in any case statistically weak or non-existent”

- **There is clear evidence that** high CEO pay is no longer strongly associated with performance, and **two academic studies clearly show** in fact high CEO pay negatively correlates with performance”

- There is academic evidence to show nearly everything
  - See TED talk, “What to Trust in a Post-Truth World”
MSCI: “Evaluating the Effectiveness of Equity Incentives”

![Scatter plot showing the relationship between Annual CEO Total Summary Pay and Ten Year Total Shareholder Returns.](image)
A Crucial Omission

- Studies measure link between performance and *flow pay*—cash, bonus, new equity grants
- But the vast majority of incentives come from *stock pay*—existing holdings of shares and options
- A 10% stock price fall is equivalent to a pay cut of $10 million in the U.S. and £1.2 million in the U.K.
  - £6.6 million average holding * 10% / (1-45%)
- “While we have not completed a full statistical evaluation of this relationship, we believe the findings are sufficiently compelling to serve as a basis for further review and discussion”
2. Should Pay be Linked to Performance?

- John Cryan (Deutsche Bank): “I have no idea why I was offered a contract with a bonus in it because I promise you I will not work any harder or any less hard in any year, in any day because someone is going to pay me more or less”
  - But extrinsic motivation may add to intrinsic motivation
- Steven Kerr (1974): “On the folly of A, while hoping for B”
- In the long-run, the stock price captures all channels (incl. intangible) through which CEOs affect value
  - Employees (Edmans (2011, 2012))
  - Customers (Fornell et al. (2006))
  - Environment (Derwall et al. (2005))
  - Material ESG factors (Khan et al. (2016))
The Value of Incentives

- Von Lilienfeld-Toal and Ruenzi (2014): high-equity firms beat low-equity firms by 4-10%/year
- Stronger if
  - Low institutional ownership
  - Weak governance
  - Weak product market competition
  - High sales growth
  - CEO is founder
- Pay CEOs like owners, not bureaucrats. Give them a slice of the pie
3. Is Pay Linked to the Right Measures of Performance?

- *In the long-run,* the stock price captures all channels (incl. intangible) through which CEOs affect value
  - But CEO may care about short-term stock price
- Show that CEOs cut investment when they sell shares
  - But poor future prospects could cause investment cuts and stock sales
- 2007: Katharina Lewellen (Dartmouth) and I discussed using vesting of *previously-granted* equity as an exogenous driver of equity sales today
  - But no data on this. Execucomp studies total equity, not when it vests
- January 2012: I learned about the Equilar dataset at a conference. We revisited the idea and I brought on Vivian Fang (Minnesota)
- Bought the Equilar dataset for $11,000 and started writing the paper
Improving the Paper

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The Peer Review Process

- Revise-and-resubmit at the *Review of Financial Studies* in August 2015
  - “One reviewer has recommended the paper be rejected, and the other that the paper be returned for revisions and invited for resubmission. The more positive is very lukewarm and offers only a “weak” offer ... R1 leaves the door open, but only a tiny crack and only for a major revision.”
  - 14 pages of comments (plus Editor’s mark-up)
  - 47 page response document plus overhauled paper, including recalculating data from scratch
- Second R&R in July 2016
- Conditionally accepted in November 2016
- Accepted in December 2016
- Published in July 2017
The Value of Long-Term Incentives

- Edmans, Fang, and Lewellen (2017): vesting equity linked to
  - Cuts in investment (R&D, capital expenditure)
  - Just meeting earnings targets

- Flammer and Bansal (2017): long-term compensation improves
  - Return on assets, net profit margin, sales growth
  - Innovation (number, quality, novelty of patents)
  - Stakeholder value (environment, customers, society, esp. employees)
3. Is Pay Linked to the Right Measures of Performance?

1. Edmans, Gabaix, and Jenter (2017)
Problems with Performance Targets

- Bennett, Bettis, Gopalan, and Milbourn (2017): firms that just meet EPS goals have lower R&D and higher accruals than those that just miss.
- Ambiguity of performance measures, thresholds, weightings
  - Morse, Nanda and Seru (2011): weightings change after the fact
- Theory, e.g. Holmstrom and Milgrom (1987): kinks / step-changes in contracts are suboptimal
  - Give the CEO a constant incentive pressure
4. What Can Be Improved?

- Move away from LTIPs to restricted stock
  - Simple: no need to choose measures, weightings, targets
  - Transparent: easy to value; we know the basis for pay
  - Symmetric: punishes downside as well as rewarding upside; captures almost all measures of performance
  - Sustainable: encourages long-term performance
- Matches what long-term investors themselves hold
- Can be given to all employees
Concerns with Restricted Stock

- With bonuses, it’s clear what the CEO should do to get paid – hit a profit target of £4b, or a sales growth target of 5%. The long-term stock return is so far off that the CEO doesn’t know how to hit it.
- With stock-based pay, the payouts to a CEO are unbounded. Since firm value can rise without limit, the value of an CEO’s shares can rise without limit.
- If we removed the threshold in performance shares, the CEO would receive her shares regardless of performance and the link between wealth and performance would be substantially weaker. She effectively receives shares for free.
- Even the long-term stock return depends on factors outside the CEO’s control, such as a rise in the stock market. So the CEO gets a windfall.
Further Information

- The Purposeful Company Study on Deferred Shares
- “Grow the Pie: How Great Companies Deliver Both Purpose and Profit”, Chapter 5
- “Simplicity, Transparency, and Sustainability: A New Model For CEO Pay”
  www.alexedmans.com/simplicity