Market or Racket?

Do We Need a New Approach to Executive Pay?

Steve Kaplan
University of Chicago Booth School of Business
Three common perceptions of CEO pay and corporate governance in U.S.:

- CEOs are overpaid and their pay keeps increasing;
- CEOs are not paid for performance;
- Boards do not penalize CEOs for poor performance.
Three common perceptions of CEO pay and corporate governance in U.S.:

- Key question: To what extent is CEO pay / governance driven by
  - the power of CEOs over their boards leading CEOs to be overpaid;
  - a competitive market for managerial talent with CEOs being paid appropriately;
What are CEOs paid?

- Two ways to look at pay:
  - Grant-date or estimated. What boards give CEOs.
    » Salary + Bonus + Restricted stock +
      Expected value of options (calculated using Black-Scholes).
    » More relevant for evaluating what boards are doing.
  - Realized. What CEOs actually get.
    » Salary + Bonus + Restricted stock +
      Value of options exercised / realized.
    » More relevant for evaluating pay-for-performance.
U.S. S&P 500 CEOs

- What has happened to average CEO pay since 2000?
  - Up?
  - Flat?
  - Down?
Estimated CEO Pay (inflation-adjusted)

Average & Median Total Pay (estimated)
of S&P 500 CEOs from 1993 to 2018 (in millions of 2018$)

Source: ExecuComp
U.S. S&P 500 CEOs

- What has happened to average CEO pay since 2000?
  - Up?
  - Flat?
  - Down over 30% in real terms.

- CEO pay does not continue to increase.
  - Average CEO pay has declined since 1998.
  - Median CEO pay has been up slightly since 2000.

- While there are outliers that receive attention, means and medians indicate that they are not the general rule.
Realized CEO Pay (inflation-adjusted)

Average Total Pay (Realized) of S&P 500 CEOs from 1993 to 2018 (in millions of 2018$)

Source: ExecuComp, Steven Kaplan
U.S. S&P 500 CEOs

- But, S&P 500 companies have gotten much larger over time.
- What about relative to corporate profits?
  - Bebchuk and Grinstein (2005):
    » “The aggregate compensation to top-five executives increased from 5% of aggregate earnings in 1993-1995 to about 10% of aggregate earnings in 2001-2003.”
  - Frequently cited.
- Right comparison is relative to pre-tax income.
Estimated and Realized CEO Pay to Profit Before Tax of S&P 500
1993 to 2018

Source: ExecuComp, CompuStat, Steven Kaplan
Median Estimated CEO Pay to Profit Before Tax of S&P 500 from 1993 to 2018

Source: ExecuComp, CompuStat, Steven Kaplan
U.S. S&P 500 CEOs

- Percentages since 2017 are lowest in last 25 years!
- Bebchuk and Grinstein would conclude CEO pay may be too low!
Why? Larger (and fewer) public companies.

Figure 1. The number of listed U.S. firms and their aggregate market capitalization.

Source: The Center for Research in Security Prices (CRSP)
U.S. S&P 500 CEOs

- What about relative to the median household?
  - Ratios about where they were 20 years ago.
  - **But, at 200 X, still very high.**
    » Contributes to perception that CEOs are overpaid.
Average & Median Total Pay of S&P 500 CEOs (estimated) to Average Worker Pay from 1993 to 2018

Source: ExecuComp, NIPA Accounts, Steven Kaplan
What has happened to CEO turnover?

- Bernadette Minton and I studied CEO turnover in Fortune 500 firms from 1992 to 2010.

- Turnover has increased since 1997.
  - Turnover levels (including takeovers):
    » 13% per year from 1992 to 1997.
    » 16% per year from 1998 to 2010.
  - Turnover levels (not including takeovers):
    » 10% per year from 1992 to 1997.
    » 12% per year from 1998 to 2010.
    » 10% per year in the 1970s and 1980s.

- CEO job appears riskier.
  - If pay adjusted for turnover, 20% lower today versus 20 years ago?
What has happened to CEO turnover?

- PWC data consistent with roughly 13.8% turnover per year for U.S. cos. from 2011 to 2018.
- Virtually the same as 13.5% from 2000 to 2010.
- CEO job appears riskier than pre-2000s.
Perception versus reality of CEO pay and corporate governance in U.S.

- CEOs are not paid more and more.
  - Average CEO pay is roughly where it was in 1997 / 1998.
    - Same for average pay to operating income.
    - Average pay to net income lower than it was in 1993.
  - Median CEO pay is at 2000 levels.
  - CEO tenures have declined relative to 1980s and early 1990s.
How Have CEOs Done Relative to Others?

- Still, CEOs are paid a lot relative to the typical household/worker.
- Are they overpaid?
- Compare them to similar groups.
- Can measure CEO pay as a fraction of the very top brackets.
  - S&P 500 CEO (estimated) pay vs.
  - AGI of average taxpayer in top 0.1%.
    » About 140,000 taxpayers.

- How have CEOs fared since 2000?
  - Better than others?
  - Same?
  - Worse?
Average Pay (Estimated and Realized) S&P 500 CEOs Relative to Average AGI of Top 0.1% of Taxpayers from 1993 to 2018

Source: ExecuComp, Piketty and Saez (2018)
CEO pay relative to top 0.1% has not changed a lot.

- Average CEO pay (estimated) relative to the top 0.1% is where it was 25 years ago despite the fact that the companies have gotten bigger.

- Average CEO pay (realized) relative to the top 0.1% is where it was 20 years ago despite the fact that the companies have gotten bigger.
What about other groups?

- Larger pay increases for executives of private, closely-held businesses than executives of publicly-held businesses.
  - Smith, Yagan, Zidar and Zwick access IRS tax return data.
  - Look at income for the very top.
  - Conclude that entrepreneurial owner-managers play the leading role in driving top inequality in the U.S. since 2000.

- Management consultants, lawyers, hedge fund investors, private equity investors, athletes, entertainers …

- Fewer agency problems / managerial power issues at the private, closely-held businesses.
What About Top Lawyers?

Average Profit Per Partner at Top 50 Law Firms from 1994 to 2018 (in millions of 2018 $)

Source: American Lawyer
Top Law Partners Have Done Better on Average Than CEOs Since 1996.
S&P 500 CEO Estimated Pay Relative to Average Profit Per Partner at Top 50 Law Firms from 1994 to 2018

Source: ExecuComp, American Lawyer
What about Investors?

- Hedge fund investors make a lot of $.
  - 2 / 20 compensation.
  - Top 10 hedge fund investors regularly make as much as the 500 S&P 500 CEOs.

- PE investors make a lot of $.
  - 2 / 20 compensation.
  - Have seen a huge increase in capital committed to PE firms.
Roughly $1 Trillion Committed to PE in Last 5 Years.

Commitments to U.S. Private Equity / LBO Partnerships
1980 - 2018 (in $ billions)

Source: Private Equity Analyst, Steven N. Kaplan
Pay increases have been pervasive at the very top.

- Other groups -- investors, lawyers, athletes etc. have seen significant pay increases where there is a competitive market for talent and no agency problems exist.
  » Increases are at least as large as for CEOs.

- Private company executives with fewer agency problems have increased by more than public company executives.

Suggests that the market for talent has played the most important role in the increase in CEO pay.
What does this mean?

- In last several decades, technological change and greater scale have increased the returns / productivity at the top end.
  - Can manage / apply talent to greater assets / larger companies than in the past.
  - Can trade large sums much more efficiently.
  - Can access larger audiences.

- Those forces, not poor governance, have bid up the pay of CEOs.
  - As firms become more valuable and technology increasingly has allowed CEOs to affect that value, boards respond by spending more to attract and motivate talent.
Are CEOs Paid for Performance?

- Compare stock performance of most highly paid CEOs relative to least highly paid CEOs.
  - Look within similar sized firms (because pay increases with size).

- Realized pay is highly related to performance.
  - I.e., there is strong pay-for-performance.
Realized pay is highly related to performance. I.e., there is strong pay-for-performance.

Figure 3: Three Year Performance Relative to Value Weighted Industry, CEOs Only

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Are CEOs Paid for Performance?

  - CEO wealth strongly tied to firm performance since the 1930s.
  - Relationship “strengthened considerably” after the mid-1980s.

- Murphy (2012) reports “equity at stake” – the change in CEO wealth from a 1% change in stock price – for median S&P 500 CEO is almost $600,000 in 2010.

- Realized CEO pay and wealth are strongly tied to firm performance.
  - See also conclusions in Frydman and Jenter (2010) and Murphy (2012) surveys.
Do boards monitor?  
Are CEOs penalized for poor performance?

  - Turnover strongly related to poor performance.

- Jenter and Lewellen (2010) looks at CEO turnover in the S&P ExecuComp database -- over 1,600 firms.
  - Boards aggressively fire CEOs for poor performance.
Meaningful difference in turnover for poor performers.
What Do Shareholders Think?

- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 mandated that firms with over $75 million in publicly-traded stock hold an advisory (i.e., non-binding) shareholder vote on the compensation of the top five executives.
  - These votes are known as Say-on-Pay (SOP) votes.
  - The law went into effect for proxy votes in 2011.

- If governance perceptions were correct, would expect a lot of dissatisfaction with executive compensation and corporate boards.
What Do Shareholders Think?
At least 97% of companies receive majority approval.
At least 72% by a 90%+ margin.

Source: Semler-Brossy
What Do Shareholders Think?

- Overwhelmingly positive votes:
  - not consistent with perception that system is broken;
  - consistent with stronger role for a competitive market for talent than for managerial power.

- Some negative votes consistent with:
  - some exercise of managerial power;
  - avenue for shareholders to put pressure on companies that have questionable policies.
How Have Companies Performed?

- Concern is that companies have become too profitable.
  - Profits have increased.
  - Potentially at expense of those with middle incomes.
  - Again, driving force is technology and globalization.
    » Not poor governance.
Summary
Three Perceptions

- Three perceptions of CEO pay and corporate governance in the U.S.
  - CEOs are paid more and more;
  - CEOs are not paid for performance;
  - Boards do not penalize CEOs for poor performance.
CEOs do not appear to be overpaid; pay does not keep increasing!
- Average CEO pay has declined since 2000. Median is flat.
- Relative to other highly paid groups, average CEO pay
  » has declined substantially since 2000.
  » has returned to historically average levels.
- Average CEO pay relative to pretax income is lowest it has been since the early 1990s.
- Pay for private company execs has increased by more than for public company execs.

CEOs are paid for performance.

Boards do penalize CEOs for poor performance.
Summary

Challenges

- Boards and shareholders face a difficult problem.
  - Markets for talent push to reward top people a lot.
    » Pay levels are high.
    » Not just in U.S., but in many countries.
    » Hence the rise in top end incomes and income inequality.
  - Combination of visible high pay levels, examples of bad behavior and lackluster gains for middle class creates political and popular criticism.
Summary
Challenges

- Challenging to:
  - pay enough to retain / hire talented executives; and
  - pay for performance; but
  - at the same time, not pay more than shareholders will approve;
  - remain within political and public constraints.
Thank you.

Steve Kaplan
Neubauer Family Professor of Entrepreneurship and Finance
University of Chicago Booth School of Business
Steven.kaplan@chicagobooth.edu