

REWARD VALUE





A WORLD THAT WORKS. BUT FOR WHOM?

How executive remuneration can go wrong – detailed analysis

Executive remuneration has become a central point in corporate governance debates and at the Annual General Meetings (AGM) of companies. Critics of executive remuneration argue that remuneration is too high and too focused on short-term shareholder value maximization, whilst disregarding environmental, social and governance (ESG) considerations.

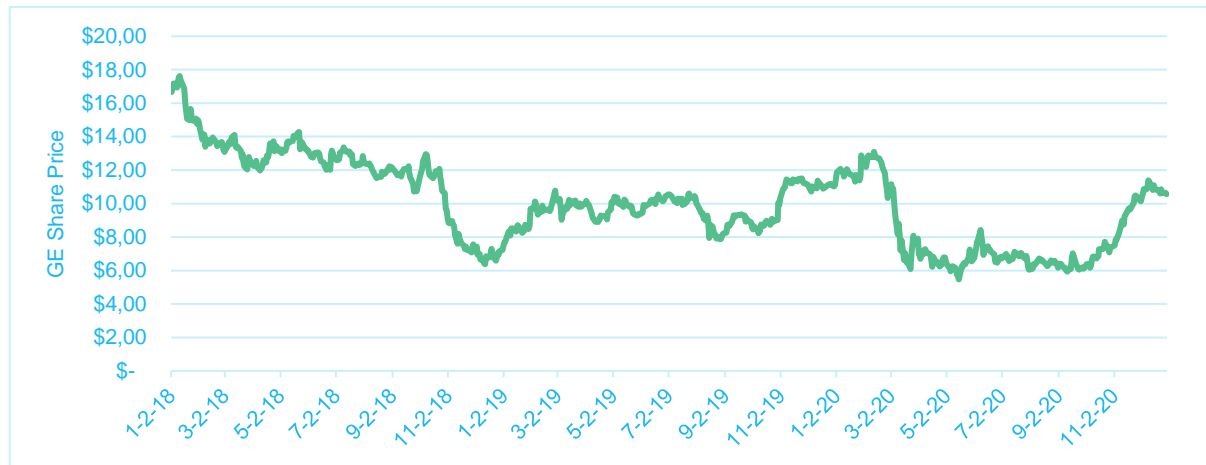
The Financial Times of 30 December 2020 highlighted such concerns -- *Unions blast \$47m bonus for GE boss after share price target lowered*. GE's SEC 8-K filing of 18 August 2020 reported the Board's decision to change some terms and conditions in CEO's Larry Culp's contract. Amidst difficult circumstances caused by the COVID-19 pandemic, the Board had felt it necessary to extend his contract beyond 2022 and at the same time lower the performance thresholds on the special one-time grant made to the CEO at the time of his nomination on 1 October 2018. The former grant was cancelled and replaced by a new one-off grant per 18 August 2020. Under the original plan, Culp could earn between 2.5m and 7.5m shares based on share price increases to at least US\$ 18.60 and US\$ 31.00 respectively. At the time of the original grant, GE traded at US\$ 12.40. Subject to reaching the thresholds, the value of the one-off grant would be between US\$ 46.5m and US\$ 232.5m. Under the new plan, share price performance thresholds have been lowered to US\$ 10.00 and US\$ 16.68, whilst share grants have increase to at least 4.6MM or at most 13.9MM respectively. At the time of the amended grant, GE traded at US\$ 6.67, In both plans, shares would vest if thresholds were breached for 30 consecutive days anywhere during the (4 year) performance period.

The amendment is a big pay change in favor of the CEO. Mr. Culp has already secured 4.6MM shares as the price of the stock reached its first threshold (for the required 30 consecutive days) of US\$ 10 per share. This is a US\$ 46.5MM payout

REWARD VALUE

for share price performance *lower than even the original reference share price* of US\$ 12.40. If the share price continues to rise to the original lower threshold of US\$ 18.60, the value of this grant increases to US\$ 86.4MM (an additional US\$ 40MM compared to the original plan for the same performance). At a share price of US\$ 18.60 however, the number of shares granted increases and the value of the grant rises correspondingly to US\$ 259.3MM (an additional US\$ 212.8MM compared to the original plan for the same performance). In the case the higher threshold is reached the incentive value would reach US\$ 432.2m instead of the original planned US\$ 232.5m.

FIGURE 1 GE share price



This ‘moving of the goalposts’ at GE is reflective of poor pay governance and compensation design for a number of reasons.

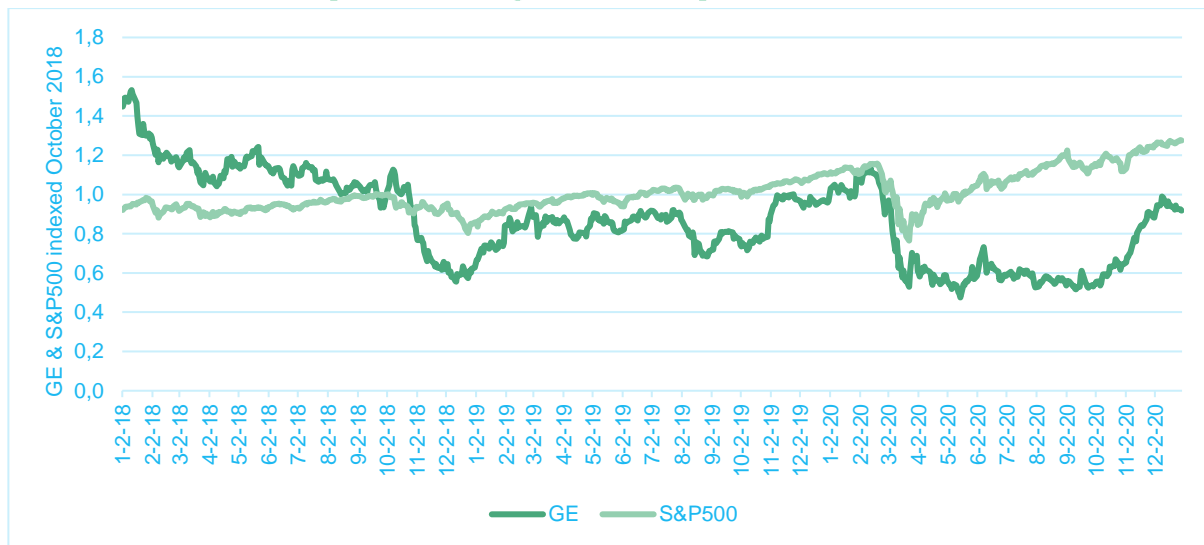
- By maintaining the same nominal payout at lower performance thresholds, the link between pay and performance is weakened. Lower value creation for shareholders should imply lower pay for executives, and not (tens to hundreds of millions of) extra pay for the same (original) performance goals.
- Amending the structure mid-way in a global crisis is even more questionable. Such amendments tend to only occur in bad times to protect the CEO and not in good times to protect the shareholder for any excessive outcomes due to windfalls. Changing objectives almost makes them irrelevant. In the case of GE, it is especially concerning that the new lower threshold was set at a level that reflected just-pre-COVID values, implying that a ‘normal recovery’ would result (and in fact has resulted) in a significant payout.
- Relatedly, it is questionable to what extent the current US\$ 46.5 MM payout is the result of a recovery driven by purposeful CEO behavior instead of a market wide recovery. Since the March 2020 COVID-shock in asset prices, indexed values of the S&P500 index and GE’s share price have increased by roughly the same amount (0.8 to 1.3, and 0.5 to 0.9), whilst GE has structurally underperformed since October 2018 (and especially since March 2020).
- This last point also bears on GE’s overall compensation design. The opportunity cost of an investment in GE is not taken into account. Incentives should focus on rewarding CEOs for delivering performance in excess of normal market movements. Relative performance measures would not have been amended as a result of the pandemic, because all competitors are confronted with the impact of COVID-19. The question is whether any payout is warranted, even under the original contract as GE has structurally underperformed the market as a whole. Investors would have been better off buying and holding a market portfolio than GE. This is

REWARD VALUE

immediately apparent from Figure 2. More detailed calculations based on the LIVA-metric¹ suggest that when the cost of capital is taken into account, GE destroyed around US\$ 48 B in shareholder value during 2018 and 2019 alone making it the worst performing US company over that period.²

- Lastly, with respect to compensation design it is concerning to see that thresholds are specified so that all that is needed to qualify for a payout is a 30-day consecutive share price hit anywhere during the performance period. This could spur short-termist behavior that could very well negatively impact the long-term value creation of the company.³ If not now, this will certainly become an issue closer to the end of the performance period.⁴ In any case, if share prices now fall, the executive has still secured a significant payout. This is not reflective of long-termist pay-for-performance.

FIGURE 2 Indexed GE share performance against indexed performance of S&P500



Corporate governance is a critical factor in ensuring appropriate executive remuneration. Non-executives should provide a safeguard against undue value extraction from the company. In addition, good governance increasingly requires moving beyond the traditional shareholder value paradigm toward the sustainable performance of the company in relation to employees, customers, and society at large. While the CEO is given a sweetened offer to compensate him for the effects of the pandemic, GE has laid off a massive number of employees. Clearly a group of stakeholders not taken into consideration when designing the amendment to the CEO incentive. The Unions are right to point this out. But beyond Unions, investors should also be concerned. Amending compensation contracts during a crisis is indicative of weak governance, and the original compensation contract was sub-par to begin with for not taking the cost of capital into account and for not providing safeguards against short-termist incentives.

¹ See Wibbens, P. & Siggelkow, N. (2020) Introducing LIVA to measure long-term firm performance. *Strategic Management Journal* 41(5), 867-890.

² See <https://phebo.shinyapps.io/liva-global/>. Currently, data is available up to and including 2019. It is unlikely that the incorporation of 2020 data would make GE a positive investment case in LIVA terms over the 2018-2020 period given GE's structural underperformance to the S&P500 based on the adjusted close prices for GE and the S&P500 index.

³ Analogously, Edmans, A., V. Fang & K. Lewellen (2017). Equity Vesting and Investment. *Review of Financial Studies* 30(7), 2229-2271., Edmans, A., L. Goncalves-Pinto, M. Groen-Xu & Y. Wang (2018). Strategic News Releases in Equity Vesting Months. *Review of Financial Studies* 31(11), 4099-4141., and Edmans, A., V. Fang, & A. Huang (2020). The Long-Term Consequences of Short-Term Incentives. *ECGI Working Paper 527/2017.*, document harmful short-termist behavior surrounding vesting dates.

⁴ See Edmans, A., X. Gabaix, T. Sadzik & Y. Sannikov (2012). Dynamic CEO Compensation. *Journal of Finance* 67(5), 1603-1647., as well as Marinovic, I. & F. Varas (2019). CEO Horizon, Optimal Pay Duration, and the Escalation of Short-Termism. *Journal of Finance* 74(4), 2011-2053.

Boards and shareholders should take their responsibility and ensure that executive remuneration is:

- purpose driven;
- inclusive of the interests of the wider stakeholder community;
- linked to long-term sustainable value creation (incorporating financial and non-financial impact over the long-term);
- linked to relative performance targets, rewarding for added value and not for value creation that would have happened anyway;
- simple, objective, transparent, measurable, non-manipulable, comparable, and as non-discretionary as possible;
- structured by means of fixed pay supplemented with a true long-term incentive payable (in majority) post-term; and
- stress tested to fully understand the consequences of the incentive contract in different scenarios. This includes understanding the behavioral impact of the incentive contract. To decide the incentives of a corporation's executives is to influence the firm's behavior. Understanding executive behavior in response to remuneration policies is of vital importance.

All in all, the GE case is another stark illustration of why executive compensation reform is much needed. We look forward to working with the investment and business communities, as well as societal stakeholders and leading academics towards better compensation practices that promote long-term share- and stakeholder value creation. Details of the new approach to executive remuneration can be found in the [Green Paper](#) of Reward Value. It is time to understand the influence of executive remuneration and to make it a force for good. Executive pay, structured well and focused on the long-term, can be the catalyst for change. A change to a sustainable circular economy for the long-term benefit of all stakeholders (social and environmental), including shareholders.

