The Next Steps in Evaluating Executive Pay vs. Performance

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Employee Compensation Executive Compensation

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The executive compensation disclosures mandated by the U.S. Securities and Exchange Commission (SEC) two years ago have been seen in many circles as another layer of expensive-to-produce paperwork that most investors don't read. But our analysis of the S&P 500 points to relevant data and potentially a new way to benchmark compensation. In our paper, we show there is much more work that can be done to turn this compliance exercise into business strategy.

But first, a little background. Starting with fiscal years ending after Dec. 15, 2022, most public companies are required to provide compensation disclosures under Item 402(v), the Pay Versus Performance executive compensation disclosures (SEC 2023). These disclosures introduced a new definition of compensation measurement called Compensation Actually Paid (CAP). An example can be seen in Table 1.

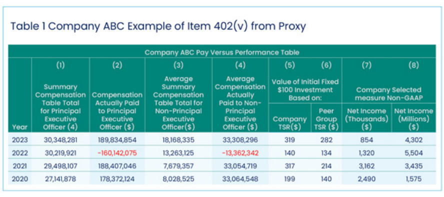

Table 1 Company ABC Example of Item 402(v) from Proxy

Company ABC Pay Versus Performance Table

Year	(1) Summary Compensation Table Total for Principal Executive Officer (4)	(2) Compensation Actually Paid to Principal Executive Officer ($)	(3) Average Summary Compensation Table Total for Non-Principal Executive Officer($)	(4) Average Compensation Actually Paid to Non-Principal Executive Officer ($)	(5) Value of Initial Fixed $100 Investment Based on: Company TSR($)	(6) Value of Initial Fixed $100 Investment Based on: Peer Group TSR ($)	(7) Company Selected measure Non-GAAP: Net Income (Thousands) ($)	(8) Company Selected measure Non-GAAP: Net Income (Millions) ($)
2023	30,348,281	189,834,854	18,168,335	33,308,296	319	282	854	4,302
2022	30,219,921	-160,142,075	13,263,125	-13,362,342	140	134	1,320	5,504
2021	29,498,107	188,407,046	7,679,357	33,054,719	317	214	3,162	3,435
2020	27,141,878	178,372,124	8,028,525	33,064,548	199	140	2,490	1,575

THE CONFUSION AROUND COMPENSATION ACTUALLY PAID

Compensation Actually Paid (CAP) does not represent what most executives consider as actual income. While items such as salary and bonus payments are included in CAP, the largest driver of CAP tends to be the change in the value of unvested equity awards over the year (or through the vest date). Consequently, if a company's stock price goes up, that company will typically see an increase in CAP. Conversely, if the stock price goes down, CAP will generally decrease, and can even be negative.

It is also worth noting that CAP is concerned only with measuring the value of equity through the vest date. The value an employee ultimately realizes (upon sale of restricted stock units [RSUs]/performance stock units [PSUs] or upon exercise of options) does not affect CAP. Stoudt (2024) provided more details on how CAP is calculated.

Because of the nature of the calculation, the CAP disclosed in a single given year is not very meaningful for analysis. The example in Column 2 of Table 1 has a very large CAP of $188 million in 2021, which is followed by a negative CAP in 2022 of -$160 million. This negative CAP in 2022 can be explained by a drop in stock price relative to 2021, which causes a negative CAP despite the fact that the four-year company return is still positive, at 219%. This highlights the interdependency between consecutive years of CAP, with any single year's results being only meaningful in the context of the whole disclosure.

BEST PRACTICES FOR ANALYZING COMPENSATION ACTUALLY PAID

Thoughtful analysis needs to begin with the accumulated CAP over the entire disclosure period (currently four years and will grow to five years next year). The accumulated CAP will eliminate the interdependency between the disclosed years by creating an aggregate value for CAP over the disclosure period. The four-year accumulated CAP for Table 1 would be $396,471,949 (sum of Column 2). Further, the company and peer total shareholder return (TSR) is also disclosed as an accumulated TSR over the disclosure period, allowing for an apples-to-apples comparison between accumulated CAP and TSR. The value of $100 after four years is $319, or a four-year return of 219% in Table 1, Column 5 of the sample disclosure.

Despite the confusion around CAP, the data yielded from the new disclosures and accumulated CAP can be quite rich. Understanding how difficult it can be for companies to navigate the new disclosures, Infinite Equity chose to study all public disclosures for the S&P 500 to get a better understanding of what's behind these data.

Behind this analysis is the theory that the pay disclosed in the Summary Compensation Table (SCT and Column 1 of Table 1) is generally the market rate of pay with a normalized expectation of future stock price performance for equity granted during the year. However, for the market rate of pay, a company should also be expected to have stock returns comparable to the market, and consistent with the returns of the selected Peer Group TSR (Column 6 of Table 1).

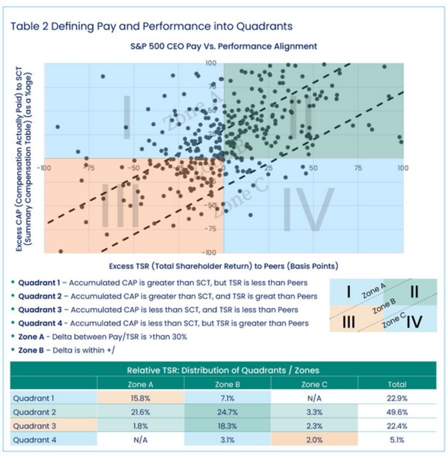

Table 2 Defining Pay and Performance into Quadrants

S&P 500 CEO Pay Vs. Performance Alignment

- **Quadrant 1** – Accumulated CAP is greater than SCT, but TSR is less than Peers
- **Quadrant 2** – Accumulated CAP is greater than SCT, and TSR is great than Peers
- **Quadrant 3** – Accumulated CAP is less than SCT, and TSR is less than Peers
- **Quadrant 4** - Accumulated CAP is less than SCT, but TSR is greater than Peers
- **Zone A** - Delta between Pay/TSR is >than 30%
- **Zone B** – Delta is within +/

Relative TSR: Distribution of Quadrants / Zones

	Zone A	Zone B	Zone C	Total
Quadrant 1	15.8%	7.1%	N/A	22.9%
Quadrant 2	21.6%	24.7%	3.3%	49.6%
Quadrant 3	1.8%	18.3%	2.3%	22.4%
Quadrant 4	N/A	3.1%	2.0%	5.1%

Table 2 illustrates the alignment between Pay versus Performance for the analyzed company filings from S&P 500 companies. It graphs the ratio of the accumulated CAP to the accumulated SCT on the y-axis, and the excess TSR on the x-axis, all separated into four distinct quadrants (Quadrants 1-4). Quadrants 2 and 3 are generally aligned results, while Quadrants 1 and 4 generally are misaligned results. Further, we have created Zones A–C, which separate each into broad degrees of alignment.

Company ABC in Table 1 would be displayed in Quadrant 2/Zone A. The Quadrant 2 classification means there is an alignment of growth in CAP with outperformance of peers in TSR. The Zone A classification highlights that Company ABC's CAP is significantly greater than the expected pay (SCT), with only moderate outperformance of peers. To get to this classification, we calculate the company's excess TSR return to peers of 37% ($319-$282). Further, we calculate the excess CAP to SCT as the ratio of accumulated CAP (sum of Table 1, Column 2) of $396 million to accumulated SCT (sum of Table 1, Column 1) of $117 million, yielding an excess CAP to SCT ratio of 238% calculated

$$\left(\frac{(\text{Accumulated CAP})}{(\text{Accumulated SCT})} - 1 \times 100\%\right)$$

EXPLORING ALIGNMENT IN PAY VERSUS PERFORMANCE

A first look at Table 2 shows that 49.6% of companies are in Quadrant 2 (CAP exceeds SCT and TSR exceeds peers) and 22.4% are in Quadrant 3 (CAP is less than SCT and TSR is less than peers). Therefore, 72.0% of companies are directionally aligned in both overperformance and underperformance against Peer TSR. In these cases, we have calculated a sharing ratio (as defined in the appendix) of the excess (or shortfall) in CAP compared against any excess market capitalization growth. The sharing ratios have been summarized below in Table 3 based on the GICS Sector.

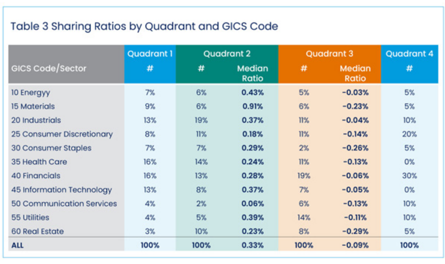

Table 3 Sharing Ratios by Quadrant and GICS Code

GICS Code/Sector	Quadrant 1 #	Quadrant 2 #	Quadrant 2 Median Ratio	Quadrant 3 #	Quadrant 3 Median Ratio	Quadrant 4 #
10 Energyy	7%	6%	**0.43%**	5%	**-0.03%**	5%
15 Materials	9%	6%	**0.91%**	6%	**-0.23%**	5%
20 Industrials	13%	19%	**0.37%**	11%	**-0.04%**	10%
25 Consumer Discretionary	8%	11%	**0.18%**	11%	**-0.14%**	20%
30 Consumer Staples	7%	7%	**0.29%**	2%	**-0.26%**	5%
35 Health Care	16%	14%	**0.24%**	11%	**-0.13%**	0%
40 Financials	16%	13%	**0.28%**	19%	**-0.06%**	30%
45 Information Technology	13%	8%	**0.37%**	7%	**-0.05%**	0%
50 Communication Services	4%	2%	**0.06%**	6%	**-0.13%**	10%
55 Utilities	4%	5%	**0.39%**	14%	**-0.11%**	10%
60 Real Estate	3%	10%	**0.23%**	8%	**-0.29%**	5%
ALL	**100%**	**100%**	**0.33%**	**100%**	**-0.09%**	**100%**

To understand what a sharing ratio means, let's review Company ABC from Table 1. This company would have a sharing ratio of 1.40% using the initial market cap from the start of the reporting period of $54 billion and the disclosed company and Peer TSRs.

$$\text{Expected Market Cap} = \text{Beginning Market Cap} \times \text{4 year Peer TSR} = \$54{,}030\text{M} \times 282\% = \$152{,}366\text{M}$$

$$\text{Actual Market Cap} = \text{Beginning Market Cap} \times \text{4 year Company TSR} = \$54{,}030\text{M} \times 319\% = \$172{,}357\text{M}$$

$$\text{Sharing Ratio} = \frac{(\text{Accumulated CAP} - \text{Accumulated SCT})}{(\text{Actual Market Cap} - \text{Expected Market Cap})} = \frac{(\$396\text{M}-\$117\text{M})}{(\$172{,}357\text{M}-\$152{,}366\text{M})} = 1.40\%$$

This 1.40% sharing ratio would mean that for every $1 billion in excess market cap growth, then an additional $14.0 million is being paid to the CEO.

We have found the following trends:

- **Trend 1 – Sharing ratios decrease as the size of the company increases.** Having a higher sharing ratio than market means you may be giving away more equity ownership than the market for your level of performance. By reviewing your sharing ratio next to appropriately sized peers you can quantify and benchmark the leverage of your executive compensation package to better align pay and performance. Company ABC's sharing ratio of 1.40% could be appropriate for a small company, but it far exceeds the median S&P 500 sharing ratio of 0.33% as seen in Table 3.

- **Trend 2 – Different GICS sectors have different median sharing ratios.** As would be expected, industries can have different norms when it comes to executive compensation. As always it is important to perform benchmarking utilizing similar industry peers. Company ABC's higher sharing ratio would be more appropriate in the materials sector but less so in other sectors, as seen in Table 3. Company ABC should assess its compensation strategies to ensure it is benchmarking pay appropriately for the company's size and industry to improve its alignment.

- **Trend 3 – Sharing ratios are higher in Quadrant 2 (outperformance) than in Quadrant 3 (underperformance).** Consistently, companies reward executives with increased compensation when delivering excess returns, as compared to punishing executives for underperforming returns. There is a careful balance between wanting to retain executives in volatile markets through low-risk compensation and providing a pay package that drives performance. Evaluating the relationship between Quadrant 2 and 3 sharing ratios for companies of similar size and industry to your own can help ensure your executive compensation programs are fair but rigorous.

EXPLORING MISALIGNMENT IN PAY VERSUS PERFORMANCE

Digging deeper into Table 2 shows 22.9% of companies in Quadrant 1 (CAP exceeds SCT and TSR is less than peers) and 5.1% in Quadrant 4 (CAP is less than SCT and TSR is greater than peers). Therefore, 28.0% of companies are directionally misaligned and should review their results qualitatively. Are there extenuating circumstances that cause the misalignment such as the vesting of an award at a relatively high stock price during the year, or is there an emphasis on internal metrics or absolute stock price growth that are not matching with the performance against peer companies?

Our initial quantitative review focuses on stock price performance relative to peer performance. This is a critical way to assess performance because most investors seek to outperform the market.

Another way to assess company performance is absolute stock price growth. Even when removing the relative stock price component of comparing TSR to peers and focusing solely on stock price appreciation, 17.6% (6.4% in Quadrant 1 and another 11.2% in Quadrant 4) of companies continue to be misaligned in their pay versus performance.

Infinite Equity has performed a qualitative review of each of the 22.9% of S&P 500 Quadrant 1 companies (companies this analysis would consider as overpaying their executives) to determine what factors were the source of the misalignment.

We have found the following trends in our qualitative review:

- **Trend 1 – High usage rates of performance equity.** 85% of Quadrant 1 companies placed more than 50% weight on PSUs in their LTI mix. Performance equity provides additional upside and/or downside leverage to traditional equity incentives based on set performance goals. This can help better align pay and performance so long as one uses appropriate metrics and appropriate rigor levels.

- **Trend 2 – High usage rates of operating metric performance goals/low usage rates of relative TSR.** 55% of Quadrant 1 companies placed more than 50% weight on operating metrics PSUs in their LTI mix, while only 10% of Quadrant 1 companies placed more than 50% weight on relative TSR PSUs in their LTI mix. A difficulty of operating metric PSUs is setting appropriately rigorous long term (3-10 year) goals to earn target and maximum payouts. Relative TSR can solve this problem, determining payout by comparing company stock performance against peer stock returns. This helps ensure pay is always aligned with investor returns regardless of current market conditions.

- **Trend 3 – Disclosed Company Selected Measure (CSM) is based on operating measures.** 98% of Quadrant 1 companies selected internal operating metrics for their CSM, the highest of any quadrant. The CSM is supposed to be the single most important metric used in compensation. Internal operating measures can move independently of other market-based measures such as stock price and TSR, which better represent the investor view on performance. When using operating measures in executive compensation, it is important to ensure that final payouts are still aligned with investor interests.

- **Trend 4 – Frequent performance equity payouts above target.** 87% of Quadrant 1 companies had performance equity payouts above target over the disclosed period, signaling a potential lack of rigor in goal setting. Low-rigor goals can increase payouts even when performance may be less than market, thus misaligning pay and performance outcomes.

CONCLUSION

Our preliminary analysis using accumulated CAP to divide companies into quadrants of performance is a first step in turning these new executive compensation disclosures into a useful tool for executive compensation analysts.

Our analysis suggests that a company wishing to strengthen current pay-versus-performance alignment should consider employing the sharing ratio in its arsenal of compensation benchmarking strategies while sharing company success and failure with their executives at appropriate rates benchmarked to size and industry. A company seeking to improve pay-versus-performance alignment may want to consider the rigor and metrics being used in its performance equity. This can be through incorporating relative TSR, which can eliminate the challenge of setting rigorous long-term goals, or by investigating its own sources of misalignment that are being reflected in these new disclosures.

There is still much more analysis to be done on these new Pay Versus Performance Executive Compensation Disclosures. But our analysis of the S&P 500 suggests a treasure trove of valuable trend information and potentially a new way to benchmark compensation to market using market cap and/or sector-specific sharing ratios.

With the relative ease and accessibility of the data, much more work can be done to turn this compliance exercise into true strategic insight.

APPENDIX – DEFINING THE SHARING RATIO

Defining the Excess/Shortfall in Compensation

The magnitude of excess/shortfall in compensation can be defined as the difference in CAP (as disclosed in the Item 402(v) disclosures) as compared to the market rate of pay. For purposes of defining the market rate of pay, we have considered Summary Compensation Table (SCT) earnings as well as various adjustments that can be made to SCT earnings. We have determined that while the latter is theoretically more pure, the former can be used as a quick publicly disclosed shortcut for the purposes of defining a sharing ratio.

Defining the Excess/Shortfall in Market Capitalization

The magnitude (excess/shortfall) of market capitalization can be defined as the difference in organic future market capitalization (based upon the initial market capitalization times stock price returns) as compared to the expected market capitalization. This expected market capitalization can be absolute or incorporate an implied growth rate. The implied growth rate can be determined in numerous ways from GICS codes to custom peer groups.

Defining the Sharing Ratio

The sharing ratio quantifies the rate at which compensation is affected by performance. It is the ratio of the excess/shortfall in compensation over the excess/shortfall in market capitalization. In quantifying this alignment, we focus on companies in Quadrant 2 and 3, assigning a positive value to those in Quadrant 2 and a negative value to those in Quadrant 3.

For this analysis, we focus on the relative sharing ratio utilizing the management identified bespoke peer groups in the new Item 402(v) Pay Versus Performance Executive Compensation Disclosures. This highlights how a company is compensating its executives relative to its idea of market performance, establishing a universe of sharing ratios for comparison.

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