How to address the collective action problem of executive remuneration

The remuneration of the Chief Executive Officers (CEOs) of large publicly listed companies continues to attract attention. The size of the remuneration is often the most discussed aspect of CEO reward especially when it is compared to the average worker. Few would question the rewards earned by CEOs of companies that are deemed very successful such as Apple or Google. Where value has been created then the CEO should be rewarded accordingly. The scrutiny of CEO pay has intensified since the 2008 financial crisis, although progress will be limited because the debate revisits the same issue of the size of remuneration rather than how it is determined. To address the challenge of CEO remuneration and its current design, requires an understanding of the collective action problem that is entrenched in a conventional wisdom composed of three key misconceptions.

Conventional wisdom

Misconception 1 - profit, earnings, EPS, P/E = value

"Wall Street's love affair with this hocus-pocus intensified as the 1960s rolled by. The Street's denizens are always ready to suspend disbelief when dubious maneuvers are used to manufacture rising per-share earnings."
(Warren Buffet 2014 Letter to Shareholders)

Companies generate value when their results cover or exceed their weighted average cost of capital or WACC. To gain insights into value generation one needs to use the information from all the financial statements not just the profit and loss accounts. Among the metrics used to assess performance is the metric of profit which needs to be carefully defined. While appealing it needs to take into account the quality of the profit and align with whether or not the company is generating value. In addition, 'profit' needs to be clarified whether it is pre-tax or post tax. When a company covers its WACC this performance is net of tax.

Earnings related metrics based on 'profit' or net income are widely considered as a proxy for company performance. Earnings are composed of two parts cash and accruals (company management's expectations of revenues and expenses that have been incurred but not recorded during the accounting period). Earnings play a key role also because they are often the basis of metrics to measure the performance of CEOs. Earnings are also the focus of market commentators and many market participants. While the yearnings for earnings may be intuitively appealing, the limitations of earnings as a valuable metric are often overlooked.

One of the key limitations of earnings and metrics based on earnings such as earnings per share (EPS) are that earnings only provides information from the profit and loss statement and do not provide information about whether a company has covered its WACC. In essence, a company can grow earnings as fast as it likes but if it is not covering its cost of capital, it is destroying value just as fast as it grows earnings.

Another limitation of earnings is they are prone to being 'managed'. Given the role played by earnings in terms of executive remuneration and market attention, the earnings number can be subject to financial shenanigans. While accrual accounting is accepted practice, corporate and financial history is characterised by some companies willing to engage in inappropriate activity to convey a positive representation about the financial health of their organisations; Enron being a case in point. Hence, CEOs could 'manage' earnings in a variety of ways such as borrow to buyback shares to boost EPS; or in extreme cases engage in fraud.

According to one study by Graham et al (2006) "real earnings management" (such as deferring value enhancing projects and investment to meet earnings expectations to minimise the cost of equity capital) has destroyed more value than that destroyed by those companies involved in high profile fraud cases. These events highlight the undesirable consequences of "running a company with the sole aim of raising the share price" in the short-term.

Therefore, any performance metrics based on earnings such as net income, EPS, EBITDA etc are not a robust enough insight into the whether the company is generating value. Both boards and investors need to be vigilant to financial shenanigans as well as having clarity about whether or not the company is generating value.

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Misconception 2 - shareholder value is all about the share price

"Share prices have almost nothing to do with shareholder value."
(James Montier)

As a visible sign, the share price has intuitive appeal regarding the success or otherwise of a company. Share price performance via capital gains plus dividends or total shareholder return (TSR) also plays a key part in executive remuneration contracts. The emphasis placed on the share price may be intuitive although it does not always align with the fundamentals of a business or the value it generates. The equity markets can misallocate capital and mis-price risk as was evident during the dot.com bubble and the period leading up to the 2008 financial crisis. Furthermore, the TSR is relative to a peer group of similar (not identical) companies. However, such relative performance does not take into account the relative riskiness of these companies. Despite these weaknesses, the desire to retain these less than robust metrics remains strong.

According to KPMG (2015) 92% of performance metrics used by FTSE 350 companies for directors' remuneration include EPS and/or total shareholder return (TSR), which appears to have maintained the status quo and thereby demonstrate resilience to change.

Misconception 3 - its only about the shareholders

The focus on equity owners is correct as they take the most risk and are considered the owners of the company. However, all capital providers need to engage in the debate about executive remuneration as equity and non-equity capital providers rely on the same source of cashflow and require an adequate expected return for the risk they are taking by investing in the company. According to McKinsey (2013) global equity was just over 20% ($50 Tln) of the total global debt and equity outstanding in 2012. Excluding government debt, the amount of financial bonds, corporate bonds, securitised and non-securitised loans amounted to $131 Tln. Given the higher proportion of non-equity capital and that often these types of capital are provided on contractual terms that include covenants, one would expect these non-equity capital providers to be more active and potentially have more influence than shareholders alone. In essence, any concerns about a company's ability to cover its cost of capital over an appropriate time horizon is a collective action problem for all capital providers not just shareholders.

The collective action problem

The three misconceptions of conventional wisdom combine to create a collective action problem that can be best demonstrated by a hypothetical example.

Figure 1 – a hypothetical tale of the CEOs of two listed companies

	CEO of Company A	**CEO of Company B**
CEO tenure	10 years	10 years
Sector	Widget manufacture	Widget manufacture
EPS (current)	100 pence	100 pence
P/E multiple	20	20
10 year P/E multiple growth	100%	100%
10 year earnings growth	100%	100%
Total shareholder return 10 years (capital growth plus dividends)	500%	500%
Average 10 year WACC	**12%**	**12%**
Average 10 year economic profits (return on capital)	**8%**	**15%**
Remuneration package (performance metrics are earnings and total shareholder return only)	Same as CEO of B	Same as CEO of A

Figure 1 provides a hypothetical example of two CEOs of identical companies which manufacture widgets. They are the only two companies in the widget manufacturing sector. Both companies have identical performance using the most common metrics and both CEOs have identical remuneration packages. Where the concern arises is how A and

B differ in their ability to create value. Both companies have a weighted average cost of capital (WACC) of 12% yet B has created value by generating returns in excess of its WACC while A has been destroying value for a very long period of time; so why is CEO of B on the same remuneration package as the CEO of A? It is also interesting to note that company B has not been rewarded by the ‘market’ because its P/E multiple is the same as the P/E multiple of A, both P/E ratios have grown by the same amount and reached the same level. It appears there is a collective action problem and the possibility that the CEO of A may be overpaid and perhaps the CEO of B may be underpaid. This asymmetry is created by a collective governance action problem that can be identified as follows –

1) Corporate governance –

"The corporate governance of HBOS (Halifax Bank of Scotland) at board level....represents a model of self-delusion, of the triumph of process over purpose."

(Parliamentary Commission on Banking Standards)

It appears that the boards at both A and B are unaware of the value generated/destroyed by their respective companies. If they were then perhaps CEO of B would have been able to negotiate better terms. Conversely, the CEO of A may have been dismissed sooner. However, given that both remuneration packages are based on shareholder return and earnings, the boards of A and B will be content they have exercised their duties effectively. Sadly, based on the respective return on capital, both boards have fallen short of their responsibilities, moreso in the case of company A. Companies that cannot cover their cost of capital are unlikely to survive. Companies that cannot face economic realities will be prone to take riskier actions to maintain the illusion of a thriving business. Boards that fail to understand if their companies generate value will be less than effective stewards of the resources in that business. We also need the senior executives especially the CEOs to be not fixated by share price movements but this is difficult when TSR is a metric in their remuneration package. Underlying the issue of corporate governance is the independence of remuneration consultants. With the metrics used in most remuneration packages looking very similar there appears to be little in the way to distinguish between CEOs

2) Capital market governance –

"In the case of HBOS, neither shareholders nor ratings agencies exerted the effective pressure that might have acted as a constraint upon the flawed strategy of the bank."

(Parliamentary Commission on Banking Standards)

Companies that generate value should be rewarded by investors by reducing the price of risk associated with those organisations and thereby lower the opportunity cost of capital employed in those businesses. Conversely, companies that destroy value continuously should face market discipline through lower share/debt prices and higher costs and stricter conditions for non-equity capital. When capital markets fail to reward value generation and do not punish value destroyers this results in a market integrity problem. Financial history provides us with several episodes where capital was misallocated and risk mispriced, examples include the inflation of the dotcom bubble and more recently the inflation of the credit bubble prior to the 2008 financial crisis. Similarly, corporate history is littered with examples of companies engaging in financial shenanigans that mask the precarious nature of their economic health which can be overlooked by capital providers. Equity and non-equity capital providers need to improve market integrity so that the risks of capital market governance failure are reduced. These efforts need to be enhanced by other gatekeepers such as auditors and ratings agencies.

3) Effective regulation –

"The picture that emerges is that the FSA's (Financial Services Authority) regulation of HBOS was thoroughly inadequate...From 2004 until the latter part of 2007, the FSA was not so much the dog that did not bark as a dog barking up the wrong tree."

(Parliamentary Commission on Banking Standards)

When corporate governance and capital market discipline fail then there is scope for the regulator to intervene. For example if company A in the above example had resorted to financial shenanigans to maintain its picture of superficial health then questions need to be asked of the related parties. The Financial Reporting Council should question the auditors, the financial services regulator would need to question capital providers regarding their due diligence and finally other parties may need to question the board of company A as to why the organisation has been allowed to destroy value and misallocate resources. This also raises the questions about the efficacy of codes especially when codes cannot be enforced.

The way forward for executive remuneration

1) Paradigm shift needed

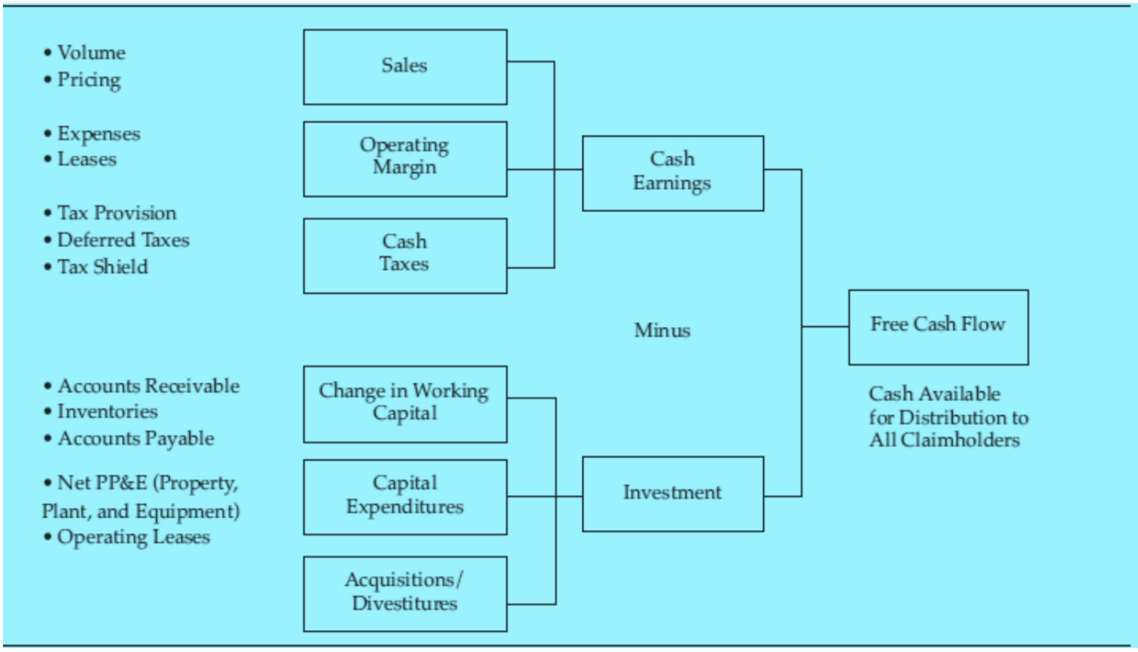
Move from classical agency theory to the behavioural agency model (BAM). The foundation for the prevailing metrics used to determine executive remuneration is standard agency theory where the executive is considered risk averse and the principal (the owner/shareholder) is risk neutral. However, the behaviour of executives when it comes to remuneration is akin to the BAM; whereby the executive is loss-averse and so is risk averse at the prospect of gains but risk preferring when faced with the prospect of losses. Hence, CEOs with remuneration anchored to share prices and earnings will focus on these metrics more and overlook the key issue of value generation.

2) Value generation – greater emphasis on economic profits

To address the conventional wisdom and collective action problem one needs to define what is 'value' and how it can be measured. First principles dictate that one needs to take into account the opportunity cost of capital. As stated above, a company generates value when it generates returns that cover or exceed its WACC. How this opportunity cost is measured may vary although the principle should be the basis of any assessment for business performance. For well established non-financial companies the starting point should be free cash flow and this is very different from earnings or profit.

Figure 2 is taken from 'Expectations Investing' by Michael Mauboussin and demonstrates why it is crucial to look at more than earnings. To understand the value generated by a company the focus should be on free cash flow as the value of a company will be the present value of future cash flows discounted by the appropriate cost of capital or WACC. Free cash flow can be considered as the all the cash that could be paid out to capital providers after all the operation costs and the costs associated with maintaining the assets of the company have been met. As one can observe from Figure 2, free cash flow relies on using information from all the financial statements whereas earnings is a much narrower measure.

Figure 2 – Cash flow derivation



Next, one has to estimate the cost of capital and this will be a weighted average of the cost of debt capital and the cost of equity capital. The return generated by the company could be considered the free cashflow to all capital providers and dividing this by the value of all the capital the business is using provides an indication of the return on invested capital. If this measure equals or exceeds the cost of capital then the company is generating value. One would expect that the differential between the cost of capital and the return on capital will vary year to year, however a value generating CEO should at least match the cost of capital over the appropriate time horizon.

Boards need to focus on WACC and should be open to this fundamental economic principle.

3) Market integrity - the link between value generation and the share price

Even though globally listed equity is just over 20% of the total debt and equity in issuance, the equity centricity that prevails will need to be acknowledged but should not absolve the debt investors and lenders of their responsibility. In an equity market that has the ability to assess the value generated by a company, the share price should reflect the extent to which the company covers its cost of capital. To provide further insight and make the analysis accessible we use the example of an all equity financed company where the cost of equity is 8%. Figure 3 is also taken from Michael Mauboussin's 'Expectations Investing'.

Figure 3 – Price earnings multiple (P/E) and the return on invested capital (ROIC)

Earnings Growth	ROIC 4%	ROIC 8%	ROIC 16%	ROIC 24%
4%	6.1×	12.5×	15.7×	16.7×
6	1.3	12.5	18.1	20.0
8	NM	12.5	21.3	24.2
10	NM	12.5	25.5	29.9

NM = not meaningful.

Note: Assumes all equity financed; 8 percent WACC; 20-year forecast period.

Figure 3 provides three very valuable insights and illustrates the direction of the relationship between the share price and value generation. The key relationship is the extent to which the company's return on invested capital (ROIC) meets/exceeds its cost of capital in this case 8%.

Insight 1 – When ROIC exceeds the cost of capital (i.e 8%) the price earnings multiple should increase. It is important to note that when the P/E is rising it has to be verified by ROIC exceeding WACC. Enron had a P/E of 70 before its collapse, a sign of either falling earnings or the market was not fully aware of the value destruction taking place.

Insight 2 – When ROIC matches WACC the P/E ratio should remain constant regardless of the growth rate of earnings.

Insight 3 – When ROIC is less than WACC, the P/E multiple should fall to reflect the value being destroyed by the company. This indicates that the company is misallocating resources.

<u>To reiterate a key concept, no matter how fast a company grows its earnings, if it does not cover its cost of capital it is destroying value just as fast as it grows earnings.</u>

Benefits and risks of the focus on economic profits

<u>The benefits of an emphasis on value generation are</u> –

1) Greater attention paid to resource allocation and efficiency.
2) Encourages focus on the economics of the business rather than the share price.
3) Aligns the interests and provides common ground for capital provides, the senior management and the board.
4) Scope for senior management to be recognised for their contribution rather relying on comparisons with peer groups that may differ in a variety of ways.
5) Reduce the emphasis on the size of remuneration and instead strengthen the link between remuneration aligns with value generation.
6) Scope to have customised remuneration contracts and the potential for value generating executives to distinguish themselves from non-value generating ones. Thereby addressing the adverse selection problem inherent in current remuneration contract design.

7) May underpin support for justifying mergers and acquistions where the scope would be on improving the value generation of the new entity rather than relying on ‘synergies’.
8) Encourages the review of information in all the financial statements not just the profit and loss statement.

The risks of the focus on economic profits

1) Calculating the cost of capital is not without challenge although worth the effort. However, boards and capital providers should already have a good sense of the approximate WACC of the companies they are involved with. Perhaps listed companies should report estimates of their WACCs and how company performance aligns with this measure.
2) Status quo bias – there may be reluctance to move away from current practices of assessing performance.
3) Different approaches would need to be used for financial companies (banks and insurance companies), private companies, start-ups etc. However, the principle is the same, companies generate value when they generate returns that match or exceed their WACC.
4) WACC is not fool proof or impervious to fraud. Meeting WACC may involve financial shenanigans although given that this would need to affect all the financial statements the incentive may be less than when the emphasis is on earnings only. Of course where fraud is involved to demonstrate WACC is covered this may still lead to misleading results. WACC is not fraud proof.

Conclusion

The current debate on executive remuneration is a collective action problem based on conventional wisdom. To make progress requires a paradigm shift where the focus should not be on the quantum of remuneration but on its mechanics. Financial and corporate history together with other evidence supports the need for a paradigm shift. We need to move away from conventional metrics such as earnings and total shareholder return and focus on value generation as measured by economic profits. The key focus for boards, equity and non-equity investors is the extent to which companies cover their cost of capital over an appropriate time horizon. Where company management engage in financial shenanigans greater efforts should be made by the relevant authorities to hold those responsible to account. The UK has a productivity challenge and so the onus is on listed companies to demonstrate that they are allocating resources appropriately. By focusing on economic profits we can gain better insights into a company’s productivity, however this requires remuneration contracts to place less emphasis on the prevailing metrics and focus on metrics that demonstrate value generation. Until there is collective action to focus on value generation, the debate about executive remuneration will continue to perpetuate the current folly of ploughing the same barren furrow; in the words of Albert Einstein –

“Insanity: doing the same thing over and over again and expecting different results.”

(3471 words excluding references)

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