Are U.S. CEOs Overpaid?

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Three common perceptions of CEO pay and corporate governance in the 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 the 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;
  
  - a combination of these and other forces.
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 2013 (in millions of 2013 $)

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

What has happened to average CEO pay since 2000?
- Up?
- Flat?
- Down over 40% in real terms.

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

While there are outliers that receive attention and likely drive the perception, means and medians indicate that they are not the general rule.
Similar pattern for averages non-S&P 500 CEOs.

Average & Median Total Pay (estimated )
of Non-S&P 500 CEOs from 1993 to 2011 (in millions of 2010 $)

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

What about relative to corporate income and 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.
Estimated CEO Pay to Net Income of S&P 500
1993 to 2012

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

- Percentage peaked in 2002 at 6% of Net Income.
- Percentages since 2010 are lowest in last 20 years!
  - Since 1993, CEO pay up 4 X, but Net Income up 6.8 X.

- With this result, Bebchuk and Grinstein would conclude that CEO pay is not high and, may be too low?
U.S. S&P 500 CEOs

- What about relative to the median household?
  - Ratios twice as high as in early 1990s.
  - Ratios about where they were in 1997 / 1998.
  - But, at 200 X, still very high.
    » undoubtedly contributes to the perception that CEOs are overpaid.
Average & Median Total Pay (estimated) of S&P 500 CEOs Relative to Median Household Income from 1993 to 2013

Source: ExecuComp, Census 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?
Perception versus reality of CEO pay and corporate governance in the 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.
    - Probably even more now with rise of activists.
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) of S&P 500 CEOs Relative to Average AGI of Top 0.1% of Taxpayers from 1993 to 2013

Source: ExecuComp, Piketty and Saez (2013)
Over last 20 years, CEO pay relative to top 0.1% has remained relatively constant.

- Average CEO pay relative to the top 0.1% is:
  - roughly the same today as in 1994 for S&P 500 CEOs.
  - lower than in 1994 for non-S&P 500 CEOs.
What about other groups?


- Look at income for executives and managers of businesses that are:
  - more likely to be public (executives earn more in salary than in business income); versus
  - those more likely to be closely held (executives earn more in business income than in salary).
% of Total Income from Executives, Mgrs., and Supervisors in top 0.1% by Salaried or Closely-held

Source: Bakija Cole Heim

- Salaried (Public?)
- Closely-Held (Private?)
% of Executives, Managers, and Supervisors in top 0.1% by Salaried or Closely-Held

Source: Bakija Cole Heim (2012)
What about other groups?

- Larger pay increases for executives of private, closely-held businesses than executives of publicly-held businesses.

- Fewer agency problems / managerial power issues at the private, closely-held businesses.
CEOs are not the only ones who earn more / earn a lot

Average Pay of Top 25 Hedge Fund Managers
AR Magazine "Rich List" from 2001 to 2012 (in millions of $2012)

Source: AR Magazine Rich Lists
CEOs are not the only ones who earn more / earn a lot

Total Pay of 25 Top 25 Hedge Fund Managers Relative to Total Estimated Pay of 500 S&P 500 CEOs from 2001 to 2012

Source: ExecuComp, AR Magazine Rich Lists
What does this mean?

- 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.
  
  - If one uses evidence of higher CEO pay as evidence of managerial power or capture, one must also explain why the other professional groups have had a similar or even higher growth in pay.
What does this mean?

- Suggests that the market for talent has played an important role in the increase in CEO pay.

- 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
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 is the Evidence on Perceptions?

- CEOs are overpaid and their pay keeps 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 operating income where it was in mid-1990s.
    » relative to net income lower than in early 1990s.
  - Pay for private company executives has increased by more than for public company executives.
  - Average CEO pay has been roughly the same percentage of average firm value since the late 1970s.
What is the Evidence on Perceptions?

- CEOs are not paid for performance?
  - CEOs are paid for performance.
    » Can ask whether pay-for-performance could be stronger.

- Boards do not penalize CEOs for poor performance?
  - Turnover has increased.
  - Turnover is strongly related to poor performance.
    » Can ask whether that relation could be stronger.
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?
Over 98% of companies received majority approval

Say-On-Pay Favorable Votes in 2011
Russell 3000 and S&P 500 (from Equilar)
What Do Shareholders Think?
80% of companies received more than 80% approval

Say-On-Pay Favorable Votes in 2011
Russell 3000 and S&P 500 (from Equilar)
Similar results in 2012 and 2013
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.

- 2012 to 2014 election results qualitatively very similar.
How Have Companies Performed?

- Financial crisis.
- Deep recession.
- Modest recovery.

- What has happened to
  - S&P 500 operating margins?
  - S&P 500 balance sheets?
  - corporate profits?

- Given negative perceptions of corporate governance, one might think performance to have been poor,
How Have Companies Performed?

- Large companies, particularly non-financials, appear to have performed well.
  - Record operating margins.
  - Healthy balance sheets.
  - Average Operating Income up by 2 X (real) since 1993
  - Net Income up by 4 X (real) since 1993.
    » Performance is net of compensation.

- If governance is so bad, why are profits and operating margins so high, and balance sheets so healthy?
Summary - Perception

- 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.
- Reality is more complicated. Evidence at odds with the perceptions.
Summary - Challenges
What Does This Mean?

- Explanations?
  - “It’s complicated.” Likely that “efficient contracting, managerial power, and political paradigms co-exist and interact.” Murphy (2012).
  - There have been corporate governance failures and pay outliers where managerial power is surely exercised. E.g., backdating.
    » This is a source of the common perceptions.
  - The pay numbers are large relative to the median household.
    » This is a source of the common perceptions.
  - That said,
    » a meaningful part of pay appears driven by the market for talent.
    » pay is tied to performance.
    » boards increasingly hold CEOs accountable.
Summary - Challenges
What Does This Mean?

- 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 very visible high pay levels, prominent examples of managerial power, and lackluster economy creates political and popular criticism.
What Does This Mean?

- 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.

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