

PUBLIC COMPANY DIRECTORS HAVE WEAK INCENTIVES DESPITE GETTING 60% OF PAY IN EQUITY

Public company directors have weak incentives despite getting 60% of pay in equity; Stephen F. O'Byrne, Shareholder Value Advisors, explains

There have been four big changes in U.S. public company director pay in the last 20 years. First, pay levels have increased dramatically. Adjusted for inflation, the median S&P 1500 director's pay increased from \$109,000 in 2002 to \$297,000 in 2024. Second, as shown in Figure 1, the average percentage of pay in equity has increased from 37% in 2002 to 57% in 2024. Third, the percentage of pay in equity has become much more similar across companies. As shown in Figure 1, the standard deviation of the percentage of pay in equity has declined from 0.31 in 2002 to 0.16 in 2024, a decline of almost 50%. Fourth, director pay has converged on market pay, defined as average pay for directors in companies of equal size in the same industry. The standard deviation of the log difference from market pay has declined from 0.61 in 2002 to 0.31 in 2024, a decline of almost 50%.

These changes reflect a growing consensus that optimal pay for directors is market pay for the director's company size and industry, with about 60% of pay in annual equity grants. This model pay plan, in the conventional wisdom, will achieve three basic objectives of director pay. Not letting target pay fall below market levels will ensure it is high enough to attract and retain qualified directors. Not letting target pay rise above market will limit shareholder cost, and providing 60% of

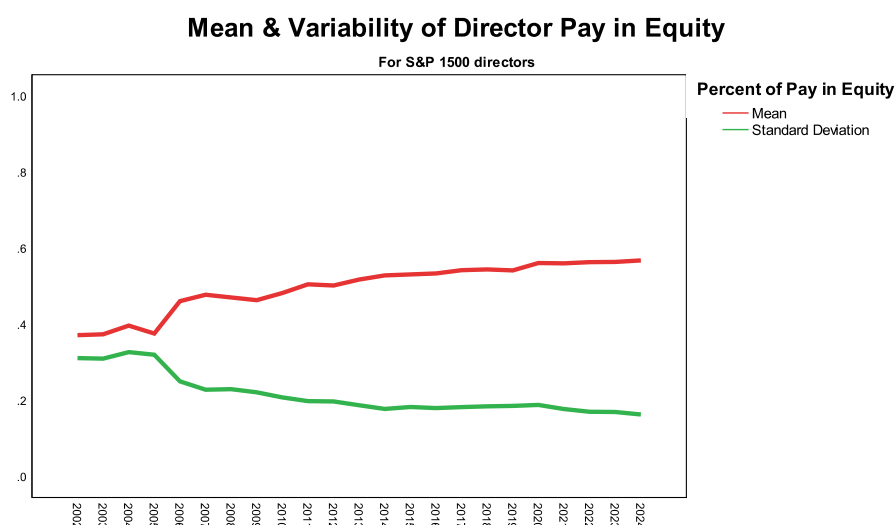


Figure 1

annual pay in equity will give directors a strong incentive to increase shareholder value.

Wealth leverage and pay leverage

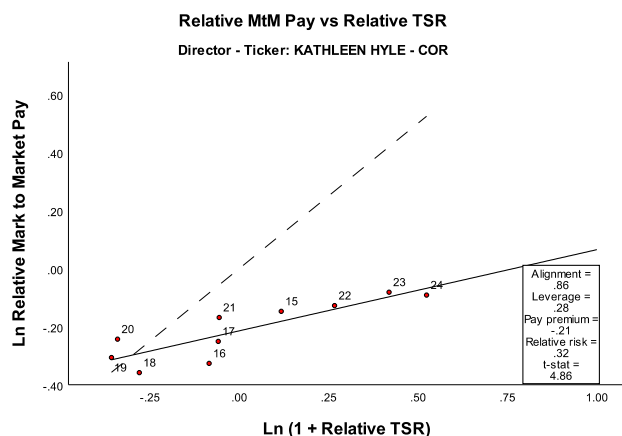
Most institutional investors and their advisors think that getting 60% of pay in equity provides an incentive similar to having 60% of your wealth in company stock. With 60% of your wealth in stock, a 1% increase in shareholder wealth increases your wealth by 0.6%. The ratio of the percent change in investor wealth to the percent change in shareholder wealth, 0.6, is called wealth leverage. We can measure the incentive provided by pay using a related concept: pay leverage. Pay leverage measures the sensitivity of cumulative pay to shareholder wealth. Figure 2 shows a ten-year pay leverage

calculation for Kathleen Hyle, a Director of Cencora.

Pay leverage is the slope of the regression trendline relating relative pay (vertical axis) to relative shareholder wealth (horizontal axis). Relative pay is cumulative actual pay divided by cumulative market pay, where actual pay is measured on a mark-to-market basis from the beginning of 2015. Pay leverage tells us the percent change in cumulative pay associated with a 1% increase in relative shareholder wealth.

What is Hyle's pay leverage?

Hyle's pay leverage is only 0.28, even though, on average over the ten years, she received 57% of her compensation in stock. Figure 3 shows that the median S&P 1500 director has long had



Solid line is the director trendline. Dashed line is leverage = 1.0 with pay premium of zero

Figure 2

a similar pay leverage shortfall from percent of pay in equity. The red line shows the median value of the 10-year average percent of pay in equity, and the green line shows median pay leverage over the past 10 years. Median pay leverage in 2024, 0.24, is less than half of the median percent of pay in equity over the ten years ending in 2024, 0.55.

To understand why Hyle's pay leverage is less than half of her percent of pay in equity, we need to draw on prior research which shows that there is a simple pay plan with annual grants of performance shares that provides a perfect correlation of relative pay and relative performance with pay leverage of 1.0. ⁽¹⁾ This perfect correlation pay plan differs from the conventional practice in three ways. First, target pay is not market pay; it is market pay adjusted for trailing relative performance. As in a conventional pay plan, grant shares are equal to target pay divided by the stock price at the start of the year. Second, there is a vesting multiple, and it removes the industry component of the post-grant stock return (it equals $1/(1 + \text{the industry return from the date of grant})$). Third, all shares are held until retirement (or until the end of the ten years shown in Figure 2).

Conventional practice, where target pay is equal to market pay regardless of trailing relative performance, creates a systematic 'performance penalty' that reduces pay leverage. When the stock price rises, a director is penalized by a reduction in equity grant shares to avoid exceeding market pay. When the stock price declines, the director is rewarded with an increase in equity grant shares to keep target pay from falling short of market pay.

A way to raise pay leverage

The blue line in Figure 3 shows that we can use the concepts of the perfect correlation pay plan to get a director pay plan with pay leverage that matches the percent of pay in equity. The cash component of pay is equal to market pay $\times (1 - \text{the target percent of pay in equity})$, but the equity component is adjusted to mimic the perfect-correlation pay plan. First, target equity compensation is not market pay $\times$ target percent of pay in equity, but market pay $\times$ target percent of pay in equity $\times (1 + \text{relative TSR from the start of 2015})$. Second, the stock award is not simple restricted stock; it's subject to a vesting condition that makes the vesting shares equal to the granted shares multiplied by $(1 + \text{the industry return from the date of grant})$. Third, all the shares are held until the end of the ten

Percent Equity and Pay Leverage

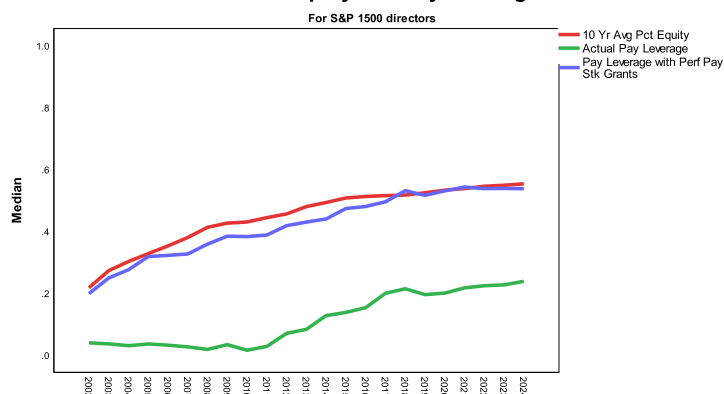


Figure 3

years we're using to measure pay leverage. In practice, the holding period would extend to the director's retirement from the board.

While the median director's per cent of pay in equity has risen to almost 60%, the growing practice of providing market pay regardless of past performance makes the median director's financial incentive much weaker than one might expect from that per cent. Pay leverage, not percent of pay in equity, is the key measure of a director's financial incentive.

Reference

1. Stephen F. O'Byrne, 2012, 'Achieving Pay for Performance', Conference Board Director Notes, Vol 4, No 24 (December).

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