The VIEW *from* BURGUNDY

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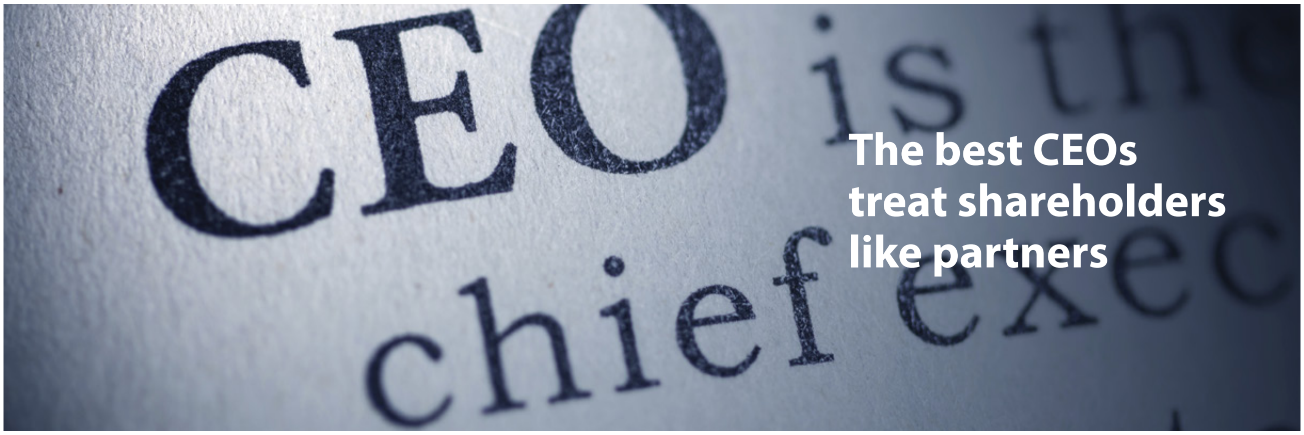


Top Quartile

A Survey of Canadian CEO Compensation Programs

In 1998, we wrote about the unintended consequences that options have on manager behaviours in an issue of *The View from Burgundy* entitled "Stealing a Fortune." We illustrated our thoughts with a story about two companies: Excellent Corporation and Subpar Corporation. Excellent Corp. motivated its CEO (Mr. Topnotch) with a bonus tied directly to share ownership, while Subpar Corp. offered options to its CEO (Mr. Hohum). Excellent Corp. went on to outperform Subpar Corp. through a combination of better capital allocation and better business decision-making.

In the years that followed "Stealing a Fortune," we supported stricter accounting rules, arguing that rational accounting treatment for stock options might temper reliance on stock options and improve alignment between managers and shareholders. In 2004, we were thrilled to witness new accounting rules take effect in Canada, which required public companies to expense stock option compensation through the income statement; however, we have been unimpressed by companies' subsequent abuse of non-GAAP (generally accepted accounting principles) metrics like earnings before interest, taxes, depreciation and amortization (EBITDA) to conceal stock option compensation with the tacit concurrence of some research analysts. In this edition of *The View from Burgundy*, we revisit stock options, surveying Canada's 60 largest companies to understand how stock options are being used a decade after the changes in accounting rules.

A Tale of Two Board Members (and One Advisor)

Topnotch and Hohum are now retired from their corporate manager jobs, and have recently taken up posts on the board of New Corp. to occupy their spare time. At the first board meeting, the duo is charged with the daunting task of designing a compensation package for New Corp.'s CEO, Mr. Newguy.

The compensation committee is meeting in two days, so the panicked duo hires a consultancy, Good Governance Advisors, to help them. Topnotch and Hohum ask the lead partner at Good Governance, Mr. Fairpay, to make a presentation to them the next day.

Fairpay quickly puts his research analysts to work analyzing the compensation programs of New Corp.'s Canadian peer group, the constituents of the S&P/TSX 60 Index. "It is going to be a long night," Fairpay mutters as he begins preparing his speaking notes.

Early the next morning, Fairpay reviews the finished presentation in his office over a much-needed coffee. As he scans the charts, he is astonished at the impact compensation programs have on the behaviour and share ownership of CEOs. "The influence is even stronger than I had guessed," Fairpay says to himself. A ringing phone jolts Fairpay away from his thoughts. "Topnotch and Hohum are here to see you," the receptionist tells Fairpay. "I'll be right there," Fairpay responds absent-mindedly as he ponders the gravity of his team's findings. After a few more minutes, Fairpay finally pries himself away from the presentation and leaves his office.

"Thank you for coming," Fairpay says to the couple as he enters the boardroom. "My team worked all night to get you some answers. I think we've arrived at some very interesting conclusions."

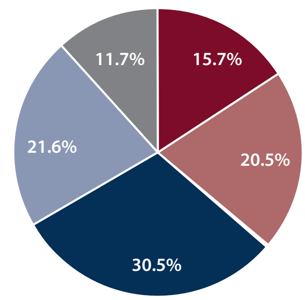
Fairpay hands Topnotch and Hohum copies of the presentation, instructing them to refer to slide 1.

Compensation Packages

"As you can see, the average CEO of a large Canadian company has a diverse compensation package," Fairpay starts. "About half of the compensation involves equity, while the other half is cash and benefits like pensions. Of the equity compensation, share awards are more popular than stock options."

Looking confused, Hohum asks, "You mean options aren't the only way to give managers equity?"

Breakdown of Average CEO Compensation Package



"No," Fairpay clarifies, "share awards are another way. These awards usually take the form of restricted stock units (RSUs).[i] RSUs are a promise by an employer to issue stock to an employee at future vesting dates. Though they are imperfect, share awards are recommended over options by the partners at Good Governance. We prefer share awards because the recipient participates in the upside and the downside of the company's stock price performance. However, for the best management-shareholder alignment, nothing is better than CEOs investing their own wealth in company shares."

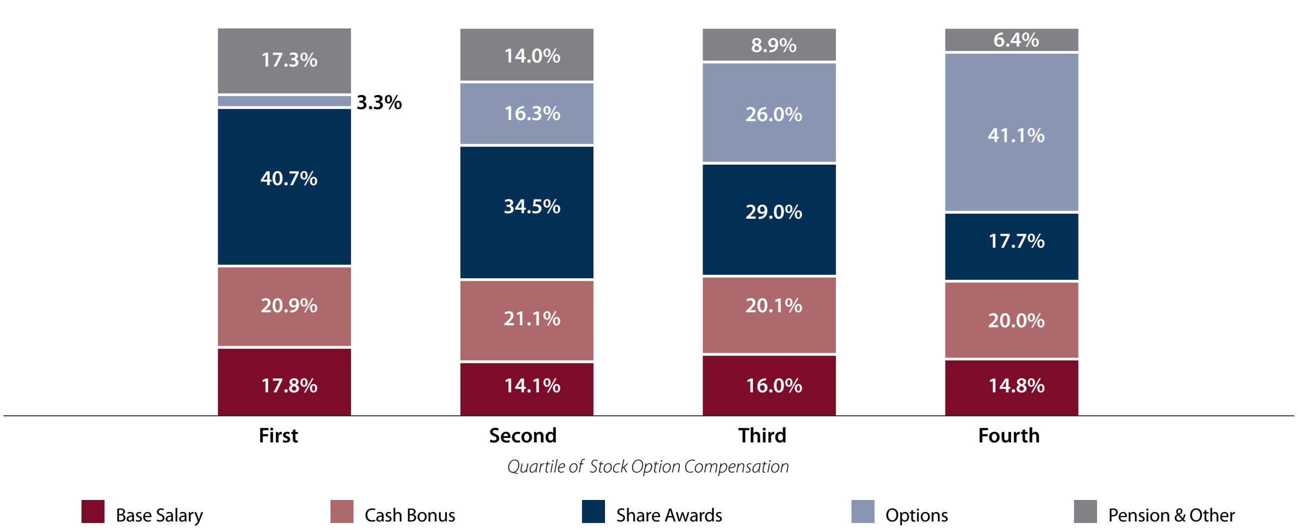
Surprised, Hohum nods his head and stares at the pie chart in silent disbelief.

Option Compensation Quartiles

"On the second slide, we have analyzed the dispersion of equity compensation programs across New Corp.'s peer group," Fairpay proceeds.

"We organized the peers into quartiles, ranked by the percentage of overall compensation offered in stock options. After a closer look, we discovered that some companies offer their non-cash compensation mainly in share awards and pensions, as you can see on the far left, and others offer the majority of their non-cash compensation in options, as you can see on the far right."

CEO Compensation by Option Compensation Quartile



"This is all very interesting," Topnotch says, scratching his head, "but what should we tell our compensation committee about the best way to give equity to Newguy? Which one of these is the top quartile?"

"I was hoping you would ask that," Fairpay says confidently as he flips to the next page of his slide deck.

Common Equity Ownership

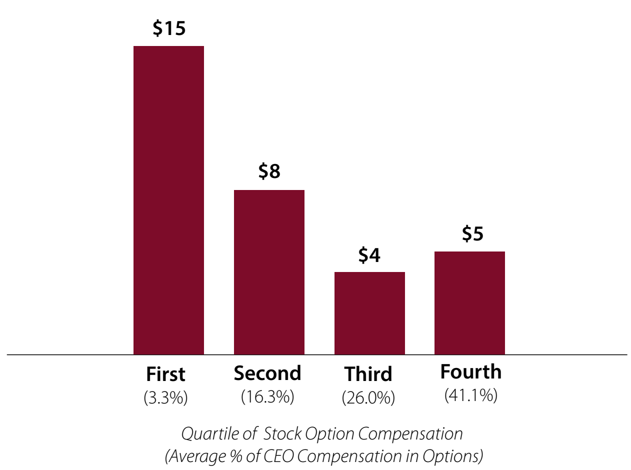
"A good compensation committee will want to know the best way to get Newguy to act like a business owner. The best way to get CEOs to act like owners is to make them owners," Fairpay says knowingly as he points to the left side of the slide. "Our research shows that stock option compensation levels are inversely correlated to CEO ownership levels. The median first-quartile CEOs have $15 million of common stock invested in their companies. This number excludes the value of options and stock awards – it is true common equity ownership. We believe that option compensation is inversely correlated with ownership for a practical reason: the taxes triggered by a stock option exercise often motivate holders to sell their shares."[ii]

"Well of course," Hohum interjects. "Back when I was a CEO, every time I exercised my options, I had to sell shares to pay the tax man. What was I supposed to do?"

"Exactly," Fairpay continues. "So, we think options do a poor job of encouraging CEOs to stay and build equity at their companies. The first-quartile companies in our survey offered significantly larger

Median Value of CEO's Common Equity in Company ($ in Millions)

(Excludes Stock Awards and Options)



pensions, instead of options, which we hypothesize encourages CEOs to think about their careers with a greater sense of permanency."

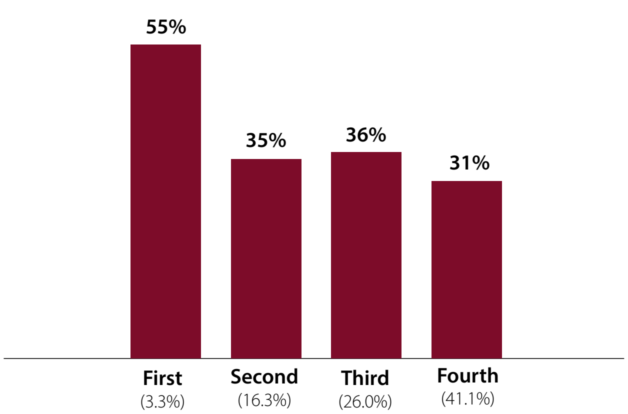
Manager-Shareholder Alignment

By this point, Fairpay worries that the duo's attention is waning. He moves to close out his presentation with one final slide.

"But why," queries Fairpay, "should shareholders care about CEO alignment?"

Topnotch laughs at what he perceives to be a rhetorical question while Hohum gazes questioningly at the slide.

Average Dividend Payout Ratio



Quartile of Stock Option Compensation
(Average % of CEO Compensation in Options)

"Because it affects capital allocation," answers Fairpay. "An option-holding CEO is incentivized to only direct shareholders' capital toward activities that can increase the share price in the short term. This activity often takes the form of share buybacks. While we recognize that share buybacks can create considerable long-term value for the continuing shareholders in a company, they must be conducted at a low price to be effective. Unfortunately, options incentivize managers to conduct buybacks whenever the company has extra cash flow. Paradoxically, this means that an option-motivated CEO may buy back company shares at the top of the market."

After pausing for a moment to let Hohum catch up, Fairpay continues. "On the other hand, an owner CEO is more likely to return capital to shareholders through dividends when there are no better uses for the capital," Fairpay explains, waving his hand at the left side of the slide. "I suspect owner CEOs may also be more likely to make the long-term investments their companies need to sustain competitive advantages."

"Some stock awards are designed to participate in dividends, which strengthens the propensity to return capital through dividends when it is appropriate," Fairpay says in his final assertion. "You can see that on this last slide, which shows that first-quartile companies paid almost twice as much of their earnings out in dividends as fourth-quartile companies."

Sensing his work is done, Fairpay closes his presentation book and begins, "So maybe this is a good time to discuss Good Governance's fee schedule?"

Conclusion

While the concepts in Fairpay's presentation are simple, we keep them top of mind as we make investment decisions. The topic of CEO compensation reminds us of a Warren Buffett quote: "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." Though we are encouraged by the fact that options now account for only one-fifth of the average Canadian CEO compensation package, we remain wary of some imprudent compensation committees that still offer their CEOs the wrong incentives.

In closing, Burgundy's investment principles as they relate to a CEO's ownership, capital allocation policies and compensation include the following ideas:

- We look for CEOs' *common equity* ownership as an indicator of an owner-operator disposition (ownership inclusive of derivatives is of little interest). CEOs with large personal investments in their companies tend to treat shareholders like partners. CEO ownership is also a commentary on how boards have compensated their CEOs in the past and how long CEOs have been investing their careers and capital in their companies.

- We avoid companies that use stock options excessively. We believe CEOs should face the same risk and return profile as shareholders, so stock options are counterproductive. While stock options can be a useful tool to attract management talent in a handful of industries, like early-stage technology and private equity, we agree with Warren Buffett: an option on an established public company is more like "a royalty on the passage of time" than fractional business ownership.
- Share buybacks only create continuing shareholder value if they are conducted at a price below intrinsic value. CEOs are responsible for maximizing long-term shareholder returns by allocating capital between reinvestment, dividends and share buybacks. In this discipline, stock options are also counterproductive because they encourage a myopic focus on the current share price, sometimes at the expense of rational reinvestment and/or dividend payments.
- We prefer companies that reward CEOs with equity investments that pay dividends and participate in the upside and the downside of share price performance. The best way to do this is to hire CEOs who believe in their companies and enthusiastically invest their cash bonuses into company stock. While we prefer share awards to options because they can participate in dividends and share price declines, they lack the "skin in the game" commitment that comes with a good old-fashioned cash purchase of shares.

This issue of The View from Burgundy
was written by Andrew Iu,
Investment Analyst for Canadian small-cap equities.

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i. Another share award is called a restricted stock award, which involves immediately issuing shares that do not transfer to the employee until vesting. These awards are unpopular in Canada because of their unfavourable tax treatment.

ii. Before 2011, Canadian option holders were directly responsible for paying the taxes on stock option exercises. Starting in 2011, a change in tax legislation shifted the burden of collecting withholding taxes on stock options to the employer. In practice, employees usually instruct their employers to sell enough of their share entitlement to fund the withholding tax liability, or employees write cheques to their employers for the withholding tax. The latter approach can also encourage employees to sell their shares to fund the payment to their employers.

Notes

Analysis based on trailing three-year averages of available data (2010-12).

Dividends include regular and special dividends.

Sources

Capital IQ, Bloomberg, company filings. Market data as of May 1, 2014.

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