CEO Compensation and Controlled Companies

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Executive Summary

The stakeholder demographics of a publicly traded organization directly affect the organization’s culture as well as the compensation practices. In this whitepaper, we compare CEO pay level similarities and differences focusing on investor demographics, delineating controlled companies that have few majority shareholders and their non-controlled counterparts with diverse constituent shareholders. The impact of the other stakeholders, such as customers and employees, also needs to be considered when reviewing executive pay practices for companies; however, analyses of these additional factors are not within the scope of this paper.

A controlled company has few majority shareholders that can be a parent or other corporate entity, a private equity or venture capital firm, and/or founders along with their immediate and extended family. These shareholders will “control” the outcome of shareholder votes typically over a long-term period. The term “closed company” is sometimes used to refer to a controlled company in this context as well, although it generally means a company that is privately held by a few “owners.”

In a non-controlled corporation, shareholders are diverse and able to respond to business/market opportunities that may require electing new board members and/or hiring new executives. There is some degree of control in these companies by an institutional investor which can be large organizations (i.e., banks, finance companies, insurance companies, labor union funds, mutual funds or unit trusts, or pension funds) that manage the investments on behalf of another commercial entity. Institutional investors are the largest participants in the stock markets and considered more knowledgeable investors with fiduciary and governance standards to uphold because of their role.

Both company financial metrics and compensation analytics are evaluated as part of this research. First, we review revenue and assets relative to three market capitalization segments (e.g., small, mid, and large) and their investor demographic category, controlled or non-controlled. We analyzed both mean and median values. The key findings follow:

- 1-Year Total Shareholder Return was higher across all segments and company groups than the 3-Year TSR.

Then, we reviewed the CEO compensation components reported in Summary Compensation Tables (SCT) of proxy statements for controlled companies included in the S&P Composite 1500 Index as of July 2013 relative to the corollary non-controlled companies in the Index. We analyzed the mean values of compensation components. The key findings follow:

- Total Cash pay mix was higher for controlled companies than non-controlled companies across all segments. Both Bonus and Non-equity Incentive mean values were notably higher for controlled than non-controlled companies in the large cap (e.g., 2X greater) and mid cap segments.
- Total Equity in controlled companies had a lower pay mix relative to Total Compensation than non-controlled companies.
- CEOs of controlled companies in the small cap and mid cap segments have lower Total Compensation than their non-controlled counterparts, whereas the CEO in controlled companies had greater than 39% higher Total Compensation than their non-controlled counterparts.

Our findings suggest that controlled companies generally will not want to part with equity and dilute their control or ownership of the organization. These same companies are also able to achieve better financial results in the long term.

Research Scope

The parameters and operational definitions of this research are as follows:

- The benchmark job, Chief Executive Officer, is the focus of analysis.
- The data set reflects years 2000–2012 and includes the fiscal year-end executive compensation and financial data from Proxies and 10Ks filed.
- Compensation Variables: Salary, Bonus, Stock Awards, Option Awards, Non-Equity Incentive Plans (NEIP), Change in Pension Value & Non-Qualified Deferred Compensation Earnings, and All Other Compensation from the Summary Compensation Tables (SCT) disclosed in annual filings.
- Several financial metrics were incorporated into the regression and other statistical analysis conducted. We incorporated the
The most prevalent financial metrics related to executive compensation, including the following:

- **Revenue** is the gross annual money received from sales, interest, dividends earned, and other business transactions.

- **Assets** are a balance sheet item reflecting what a company owns and are a resource with economic value from which future benefit can be derived.

- **Total Shareholder Return (TSR)** is a measure reported for a one-year as well as three-year period. At ERI, we apply a rolling 12-month and 36-month period to report this metric. TSR is cash flow to shareholders and calculated using a specific formula:
  \[ \frac{(\text{Stock Price end of period} - \text{Stock Price beginning of period}) + \text{Dividends}}{\text{Stock Price beginning of period}} \]

- **Market Capitalization** (market cap) is the estimated value of the business and calculated based on Current Stock Price TIMES Number of Outstanding Shares. We will refer to three segments based on the three market cap ranges:
  - Small cap: 300M to Under 1B
  - Mid cap: 1B to 5B
  - Large cap: Over 5B

### Methodology

The descriptive statistics discussed in this study were computed over 1,415 of the companies included in the S&P 1500. Analysis entailed measuring company financial metrics relative to the market capitalization segments and the two groups, controlled and non-controlled companies. We reviewed both mean and median values to highlight any notable differences in revenue, assets, 1-Year TSR, and 3-Year TSR. For the compensation analytics, the CEO compensation components for the controlled companies in our sample are compared to the rest of the S&P 1500 for the measurement period based on the three market capitalization segments. All historic values were adjusted for inflation using the September 2013 Consumer Price Index and indexed to 2012 U.S. dollars.

With compensation analytics, making mean to median comparisons of the individual executive pay components at times can be difficult because the median value may be zero if fewer than 50% of CEOs were paid via a given component. This can be attributed to company philosophy, business objectives, as well as the employee risk profile tolerance that determines the pay mix in a CEO compensation package and which often results in some (not all) compensation components being reported. Few CEOs are paid all of the analyzed compensation component, and ignoring the zero values when computing a median can be misleading. Hence, we focus on the mean values for presenting findings related to compensation components. The comparisons are between the controlled and non-controlled companies in the sample and across the three market capitalization segments.

As an extension to simply comparing means, we used regression analysis to control other factors that likely affect compensation. The controlled factors included measures of the size of and industry of company operations, as well as company performance (e.g., revenue, assets, 1-Year TSR, and 3-Year TSR). Logarithmic transformations of the data were done where certain company financials and pay components tend to have right-skewed distributions. This analysis tested whether the pay differences were simply a result of differences in these additional contributing factors. The findings showed similar pay differences, though mostly smaller in absolute terms, between controlled and non-controlled companies as compared to analyzing means. The discussion in this paper will be primarily based on the results of the regression analyses.

### Financial Metrics

In addition to industry-specific measures, there are some financial metrics that cut across all sectors which shareholders reference to determine the size of the organization and use as input to bench-
setting relative pay-for-performance targets, among other things. We have included revenue, asset, and TSR as financial metrics for the basis of analysis. Table 2 summarizes the revenue and asset metrics for each of the three market capitalization groups comparing the median and mean for controlled and non-controlled companies.

A general observation is that the absolute values of the medians tend be notably smaller than the mean values. The differences comparing median to median in controlled vs. non-controlled ranged from -24.78% to 20.51%. The range was much broader for the difference in means, from -43.09% to 159.18%. Controlled companies resulted in higher revenues and lower asset levels across the board, which can suggest that controlled companies are more efficient with the use of their resources.

Other than internal financial metrics as indicators of company results, most publicly traded companies will report a metric related to stock price movement to shareholders since it resonates with their interests. Some companies use the absolute value of stock price (e.g., if stock prices reach $10, then cash payout or award vesting is triggered). The TSR has become a prevalent metric in this regard and is depicted in the above graph across the three segments for both controlled and non-controlled companies.

In our analysis of the 1-Year and 3-Year TSR metrics, the general observation is that 1-Year median and mean values were consistently larger than the 3-Year values. The one exception is large cap controlled companies. For this segment, the 1-year TSR and 3-Year TSR for both mean (22.54% and 23.26%) and median values (24.07% and 22.81%) were very similar. Berkshire Hathaway Corporation (Warren Buffet’s controlled corporation) would essentially be in this segment, and these TSR values are indicative of this company’s performance. The small cap segment for both groups had the highest differences in both the mean and median values for both controlled and non-controlled companies.

Within these business contexts, how are the CEO pay levels different in controlled and non-controlled companies? To begin, it is helpful to look at the pay mix of Total Cash (e.g., Salary, Bonus, and Non-Equity Incentive Plan) and Total Equity (e.g., Option Awards and Stock Awards) relative to Total Compensation. Some organizations may grant Stock Awards and not Option Awards. The two types of awards can be deemed “substitutes” for Equity Compensation with very distinct attributes. Similarly, with Bonus and Non-Equity Incentive Plan (NEIP) components, one can draw similar conclusions excluding tax and accounting implications. The descriptive statistics for the CEO Total Cash and Total Equity pay differences in mean values as well as the percent of Total Compensation are summarized in Table 3.

Even after controlling for financial metrics, TSR, and industry differentials, CEOs in large cap segment controlled companies earned almost $2M more than non-controlled CEOs. The most notable difference in salaries was with large cap companies where controlled companies paid 55.03% more than non-controlled companies (i.e., $1.57M vs. $1.02M). The large cap non-equity incentives for controlled companies were 60.76%+ higher than in non-controlled, and the bonus for this same group was 99.06% higher. In the mid cap segment, salaries again were higher within controlled companies, and controlled CEOs earned 59.35% higher bonuses.
The mid cap segment, however, had a -4.76% difference in Total Compensation, the lowest of three segments. For the small cap segment, controlled companies paid more than 10% higher salaries but lagged in all other Total Cash and Total Equity components including Total Compensation; non-controlled companies paid more Total Compensation, mostly driven by higher Stock Awards and Non-Equity Incentives. The small cap controlled companies paid slightly lower for Bonuses and Non-Equity Incentive plan values, -6.65% and -15.68% respectively.

Summary

Pay for performance and company results are reviewed by shareholders in the context of executive compensation. Gaining insight to company performance and the relevant financial metrics like revenue and assets relative to market capitalizations, one can see that controlled companies generally achieved higher revenues. Non-controlled companies tended to have lower revenues yet higher assets. Then, looking at compensation analytics, it was clear that shareholder demographics do drive meaningful pay level differences, especially in the pay mix of Total Cash and Total Equity relative to Total Compensation. Controlled companies’ Total Cash pay mix was higher than non-controlled companies, and their Total Equity pay mix was lower.

A holistic analysis of this and related topics requires incorporating a number of different variables related to shareholder demographics, financial metrics, industry and geographic differentials, as well as market conditions tied to stock price. At ERI Economic Research Institute, we have been providing compensation analytic solutions to thousands of subscribers for decades. If you have any questions regarding the content of this whitepaper or would like to explore similar analyses for your organization, please contact ERI at 1-800-627-3697 or visit www.erieri.com.

Table 3. Compensation Analytics

<table>
<thead>
<tr>
<th></th>
<th>Total Cash</th>
<th></th>
<th>Total Equity</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Salary</td>
<td>Bonus</td>
<td>Non Equity</td>
</tr>
<tr>
<td>Large</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Control</td>
<td>1,573,739</td>
<td>1,447,202</td>
<td>2,451,529</td>
</tr>
<tr>
<td>Non-Controlled</td>
<td>1,015,140</td>
<td>727,003</td>
<td>1,524,988</td>
</tr>
<tr>
<td>% Difference</td>
<td>55.03%</td>
<td>99.06%</td>
<td>60.76%</td>
</tr>
<tr>
<td>Mid</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Control</td>
<td>800,276</td>
<td>495,713</td>
<td>685,192</td>
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<tr>
<td>Non-Controlled</td>
<td>704,823</td>
<td>311,091</td>
<td>609,047</td>
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<tr>
<td>% Difference</td>
<td>13.54%</td>
<td>59.35%</td>
<td>12.50%</td>
</tr>
<tr>
<td>Small</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Control</td>
<td>614,901</td>
<td>200,579</td>
<td>252,634</td>
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<tr>
<td>Non-Controlled</td>
<td>554,363</td>
<td>214,877</td>
<td>299,623</td>
</tr>
<tr>
<td>% Difference</td>
<td>10.92%</td>
<td>-6.65%</td>
<td>-15.68%</td>
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