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CEO Sign-On Packages: Is there such a thing as too much?

An analysis of CEO sign-on packages, their impacts on stock price and Say on Pay voting, and key principles for designing an optimal deal.

INTRODUCTION

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One of the most important decisions a Board makes is identifying and hiring the company's CEO. Given the critical nature of this decision, Boards often make major investments in signing packages for new CEOs. These signing packages serve multiple purposes: helping secure new talent to run the company, providing "staking" grants to align the new CEO with shareholders, and, in some cases, buying out existing equity packages.

Given the significant investment these packages represent, Compensation Committees often have four concerns:

1. How are these signing packages typically structured?
2. How do the size of these signing packages affect company stock price? In particular, do very large packages have a negative effect on stock price?
3. What effect do sign-on packages have on subsequent Say on Pay (SOP) votes? Will a special sign-on package (especially if it is out-sized) negatively influence the Say on Pay vote?
4. How should signing packages be structured and explained?

To help address these questions, we analyzed the pay packages for the 18 CEOs that were hired externally at the 300 largest S&P 500 companies between 2010 and 2012.

WHAT'S THE BIG IDEA?

Compensation Committees have to carefully consider CEO sign-on packages, given their high profile and significant cost.

- Competitive practice can provide a starting point for developing a package
- Company's stock price is unlikely to be affected negatively when the package is announced, regardless of the design or amount
- Larger packages might lead to lower Say on Pay results in the following year, however company performance still plays a significant role
- Understanding shareholder policies and following three design principles will lead to the most effective design of these packages

How are these signing packages typically structured?

A well-design pay package is important to ensure it is is properly incentivizing to the CEO, meets corporate governance requirements, and avoids negative reaction that may spill into the Say on Pay vote. The right design will vary by company, and take into account the company's economics, business strategy, and compensation philosophy. However, competitive practice can give a Committee some comfort that the pay package being proposed is reasonable. Among the companies in the sample, there were a range of practices for new CEO sign-on packages.

Purpose: In the vast majority of cases (16 of the 18) sign-on pay was intended to serve either as an inducement to join the company or to stake the new CEO (average of 60% of the package). Disclosure of "make-whole" grants was less common, with only six companies disclosing that a portion of the grant was intended to replace forfeited value from the new CEO's previous employer.

Amount: The most common amount was a total sign-on package between $10-15 million, including sign-on amounts and on-going incentives. This compares to a median ongoing long-term incentive level of $8-$10 million for CEOs among similarly-sized companies. The highest levels generally reflected the buying out of unvested awards from the previous company or the providing of staking grants in the hiring company.

Figure 1. **Distribution of New-Hire Package Sizes**

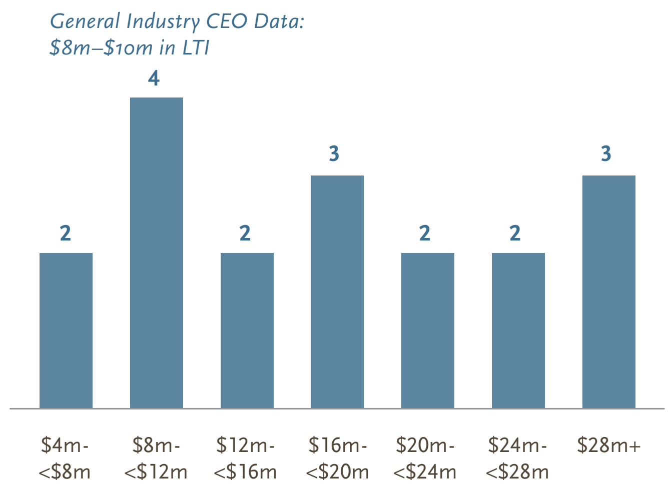
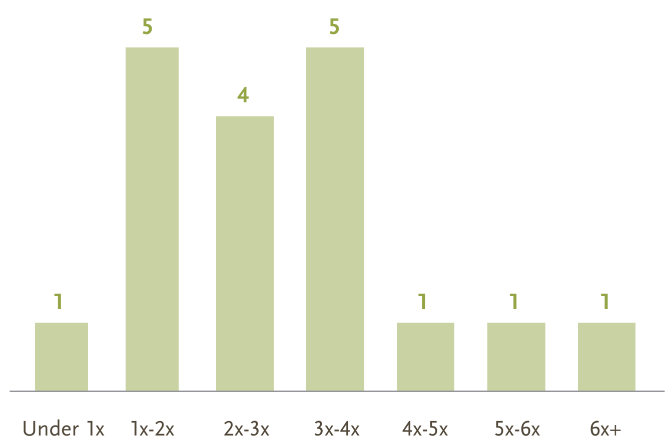


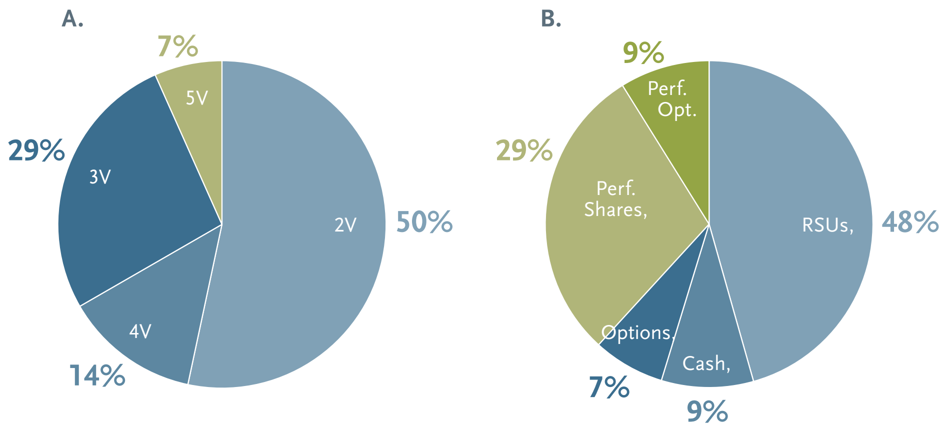
Figure 2. **Distribution of New-Hire Package Sizes by Multiple of Former CEO**



As compared with the departing CEO's package, the incoming CEOs received between 1x and 6x of the departing CEO's ongoing long-term incentive, with a median value of 2.44x.

Package delivery: Most commonly, companies used two vehicles in the CEO sign-on packages. This is consistent with the practice of using multiple vehicles for regular annual grants to CEOs.

Figure 3.
(A) Number of Vehicles in Sign-On Packages; (B) Average Prevalence of Vehicles in Sign-On Packages



LTI mix: Generally, we observed a high use of RSUs (over 50% of the companies use RSUs as the predominant vehicle), perhaps reflecting a buyout of value from the previous employer or a desire on the part of companies to ensure that the CEO has a baseline value even if the stock price declines.

Additionally, the prevalence of performance-based grants was low in the sample, with less than 50% of the package granted as performance-based equity. This is counter to the rise in performance-based equity across general industry. The lower prevalence was likely driven by challenges in aligning the timing of the new CEO's performance goals with the rest of management (especially if hired mid-year) and the difficulty of making a new CEO accountable for goals that he/she did not help in setting.

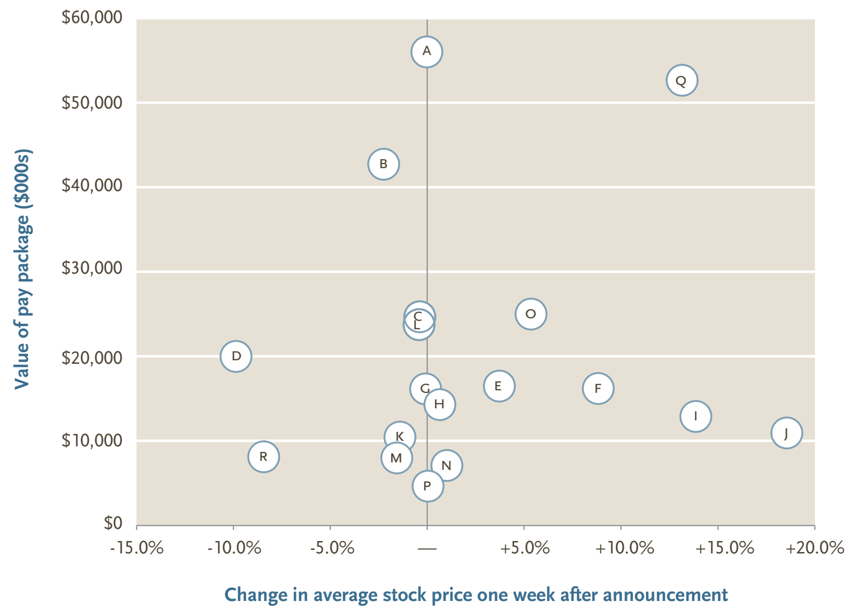
The prevalence of options was also low (5% of the package on average). The lower usage of options mirrors the declining use of options generally. However, given the natural alignment options provide between the CEO's tenure and value creation, the low prevalence was somewhat surprising.

How do the size of these signing packages affect company stock price? In particular, do very large packages have a negative effect on stock price?

Although our research indicates that the announcement of a new CEO's hire had a statistically meaningful impact on the company's stock price 35% of the time, the subsequent disclosure of the CEO's pay package only had a statistically significant effect on the stock price 12% of the time. (Note: We defined statistical significance as a change greater than 2 standard deviations from the company's average volatility in the year.) Moreover, the pay packages in the two instances that were statistically meaningful were relatively small and were not likely the cause of the stock price change.

The absolute size of the pay package also does not seem to have a statistically significant effect stock price. As shown below, the size of pay packages and average stock price movements on the announcement date are not correlated.

Figure 4. **Value of Pay Package and Change in Stock Price following Announcement of Pay Package**



What affect do sign-on packages have on subsequent SOP votes? Will a special sign-on package negatively influence the Say on Pay vote?

In the year following the CEO sign-on package, Say on Pay votes for the companies in our sample were somewhat lower than the average result across all companies. However, it is difficult to isolate the effect of the CEO sign-on package from other factors that impact Say on Pay votes, including in some cases poor company performance that led to the new CEO hire in the first place.

	SAY ON PAY OUTCOME	1-YEAR TOTAL SHAREHOLDER RETURN[1]
Russell 3000	91%	13%
External CEO Hire Sample	78%	-10%

[1]In the year prior to hire.

It should be noted that in cases where the new CEO received a package that was a high multiple of pay relative to the former CEO, the company's Say on Pay vote was markedly lower. (Note data was only available for 13 of the 18 companies).

SIGN-ON PACKAGE (multiple of former CEO pay)	N=	AVERAGE SAY ON PAY VOTE
Under 3x	8	84%
Over 3x	5	70%

How should sign-on packages be best structured and explained?

Although competitive practice is a useful guide for structuring sign-on packages, we believe companies are best-served when they:

- Fully understand the preferences of their shareholders and proxy advisors—this will help ensure that they do no unintentionally run afoul of their guidelines and receive an "against" Say on Pay recommendation/vote.
- Use three principles to help ensure a sign-on package that is compelling to both the new CEO and shareholders.

PRINCIPLE	RATIONALE
Carefully think through and clearly disclose the rationale for the size of a sign-on award, making clear the amounts that are intended to make up for forfeited awards	• New awards will need to be disclosed in the proxy and CD&A so amounts should be defensible • Make whole awards tend to have a significant effect on the size of the package and should be called out
Strive for maximum alignment with shareholders and company performance, while addressing the risks and uncertainty faced by a CEO moving to a new company	• Performance-based awards achieve the best alignment • However, a new CEO might be wary of a highly performance-based program until they are more familiar with the company and have ownership for the goals that are set (balance must be achieved)
Minimize the company's exposure in the event the CEO is not successful, while still providing a package that is attractive enough to secure the new CEO's services	• The package's cost should be contingent on CEO's success so that the company does not bear an undue cost if the new CEO is not successful • However, if contingencies are too severe, they may not be acceptable to the new CEO

Conclusion

An appropriate design is important to ensure the CEO is aligned with company performance and shareholders. A Committee can be comforted that the sign-on package for a new CEO is not likely to have a negative effect on company stock price and will likely not lead to a low Say on Pay vote the following year if appropriately sized and structured. The principles outlined above will likely lead to the most effective design, while balancing the interests of the incoming CEO and the company.

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