New Pay Study Finds Moderate Changes in CEO Compensation in 2018

No Major Impact from Tax Reform and Significant Differences Among Industries

By Ted Jarvis, Director of Product Design

To understand recent changes in CEO pay, we scanned Main Data Group's (MDG) database of more than 4500 public companies, specifically looking for CEOs in the S&P 500 who have occupied the CEO role continuously during the 2016-2018 time period. We believe focusing on these "constant incumbents" provides the most accurate view of pay practices and policies on an ongoing basis by eliminating the data noise arising from new hires, promotions, or other disruptions to the status quo.

Among the results of our study, we conclude:

1. While the Tax Cuts and Jobs Act of 2017 eliminated preferential tax treatment for qualifying incentive-based compensation, CEO pay in 2018 continued to be heavily weighted toward incentives. Companies seem reluctant to make changes that could prove controversial with shareholders and shareholder rights groups, even if the tax rationale for continuing these practices no longer exists.
2. Compensation for CEOs who founded their companies is often very different from that of non-founders. Particularly in the communication services sector, there is a wide disparity between founder-CEOs (who tend to receive very little pay) and non-founders (who receive among the highest compensation levels in any industry).
3. Median base compensation for CEOs grew modestly in 2018.
4. Annual bonus payouts in 2018 were very strong, reflecting a prosperous economy in most sectors.
5. Long-term incentives were almost universal in 2018 and the portfolio of long-term equity incentives continued to shift from options to full-value shares. Options' fall from favor was most noticeable in industries that pay high cash dividends, but the decline in prevalence pertained to all industries.

Non-Performance Based Compensation and Tax Reform

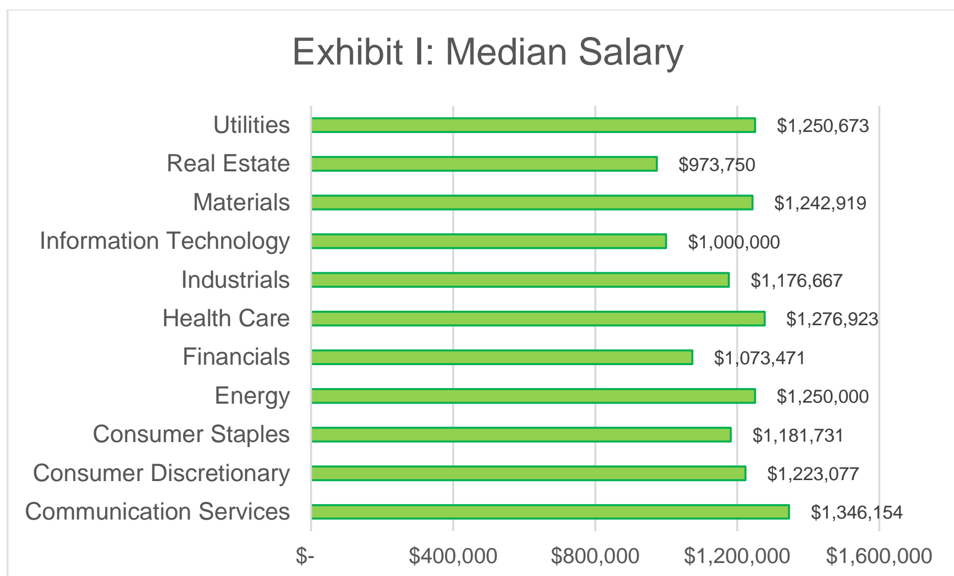
The Tax Cuts and Jobs Act of 2017 eliminated IRC 162(m), the deduction for qualified performance-based compensation and commissions. Under this legislation, all compensation paid to a covered employee in excess of $1 million is nondeductible—a significant change in tax policy for companies that heretofore designed their compensation programs to preserve the deduction by meeting the requirements of IRC §162(m)'s performance-based exemption.

We wanted to see how the new rules impacted compensation, particularly if they prompted a shift in pay mix from variable to fixed. The results indicate that the new legislation did not broadly influence pay practice. At the 90th percentile, year-over-year base pay increased 15.23%, which was lower than the prior year's 90th-percentile increase of 20.28%, when IRC 162(m) was still in force. Over 25% of the CEOs in our sample did not receive a salary increase at all in fiscal 2018. As a percent of total direct compensation, moreover, base salary continued to decline modestly, from a median 10.48% in 2017 and 11.44% in 2016. Collectively, these findings suggest that companies for the most part refrained from aggressively raising base salaries to deleverage their CEOs' compensation packages.

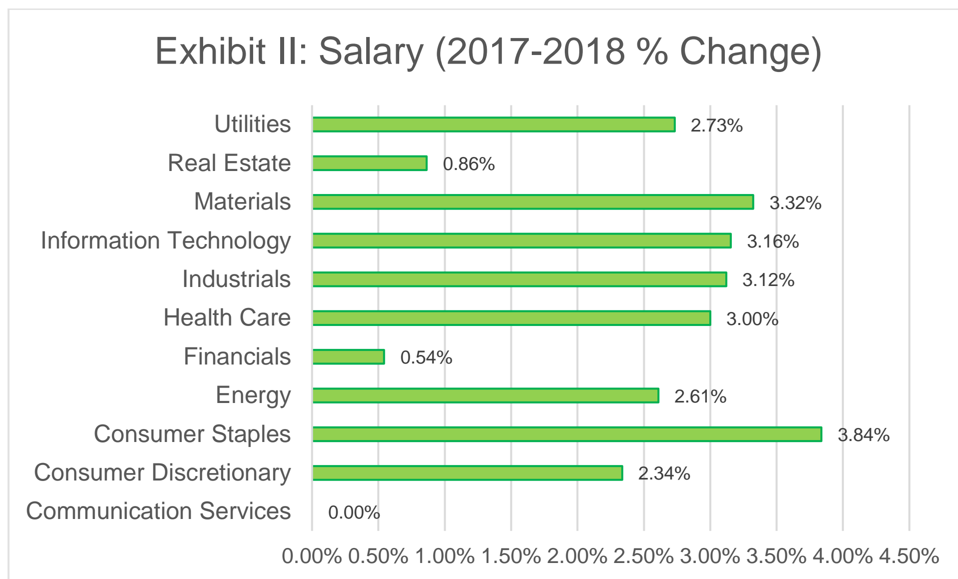
Base Salaries Grow, but Founder Compensation Stands Apart

Median base pay for CEOs in our sample was $1.150 million, a median growth of 2.71% over the prior year. Base salaries accounted for a median 9.97% of total direct compensation (TDC) in 2018, a modest decline from 2016 and 2017. As might be expected, the size of base compensation varied considerably based on industry.

Ten CEOs did not draw a salary at all (or $1, in eight cases), and for the most part, these executives were founders and presumably had access to substantial as-needed liquidity from their stock holdings. Among the S&P 500's 11 standard industry groups, the communication service sector boasts the highest percentage of founders among the CEO population (28%) and, not incidentally, the highest number of CEOs who essentially draw no salary (four of 18). The CEOs in this sector who do receive a salary are, conversely, the highest-paid of all industry groups at the median (Exhibit I).



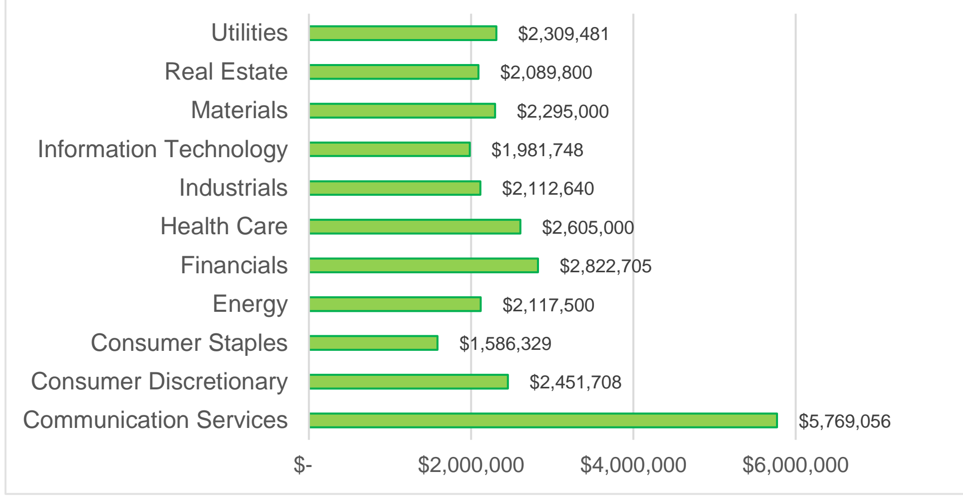
However, communication services CEOs also were most likely to receive no increase from 2017 (Exhibit II).



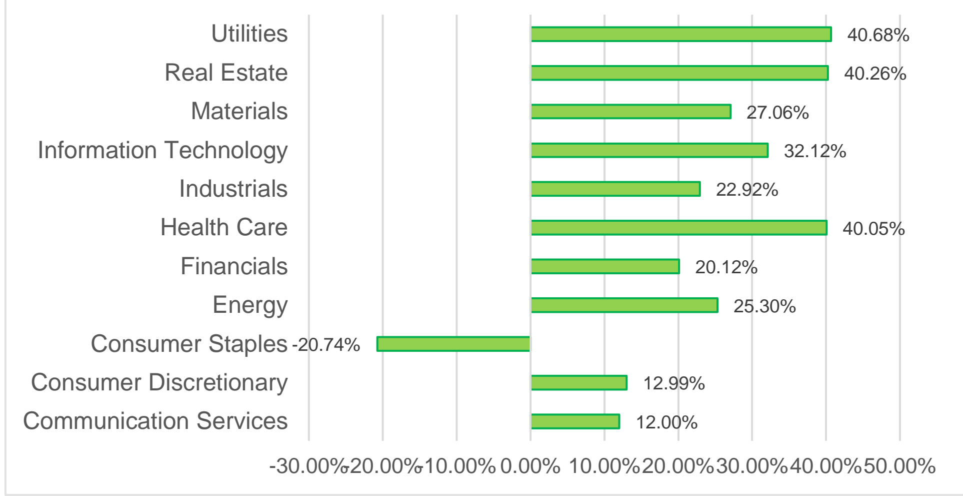
Robust Annual Bonus Payouts in 2018

Ninety-six percent of companies in our sample paid an annual bonus in fiscal year 2018, representing a median 20.62% of total direct compensation. Median payouts of $2.277 million were a median 25.87% premium over target. Here again, we saw little to indicate a significant break from past practice. The median over target was 24.80% in 2017 and 20.20% in 2016. And the prevalence of companies that paid bonuses outside of established short-term incentive plans remained steady at roughly 5%. One might question why targets consistently are surpassed or the rationales for providing pay exceeding the constraints of a formal incentive plan, but those issues are not unique to 2018's results and cannot be laid at the door of the 2017 tax bill. Five CEOs received no payout from their incentive plans.

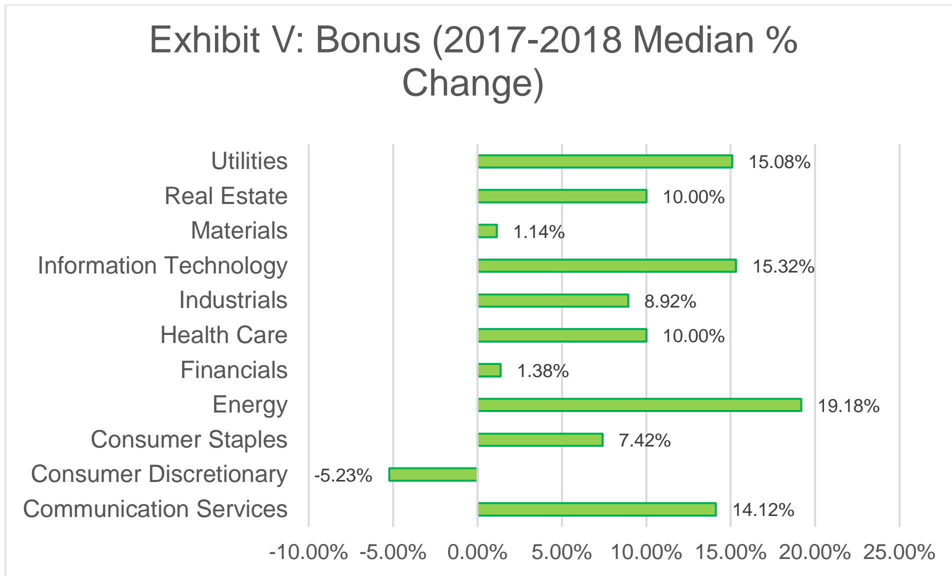
Only 66.67% of the CEOs in the communication service industry received a bonus. As with base salaries, this points to the concentration of founders in this group, for whom presumably an exceptionally high level of stock ownership provides enough of an incentive. The CEOs in this sector who did receive a bonus, however, were compensated substantially higher at the median than in other industries (Exhibit III).



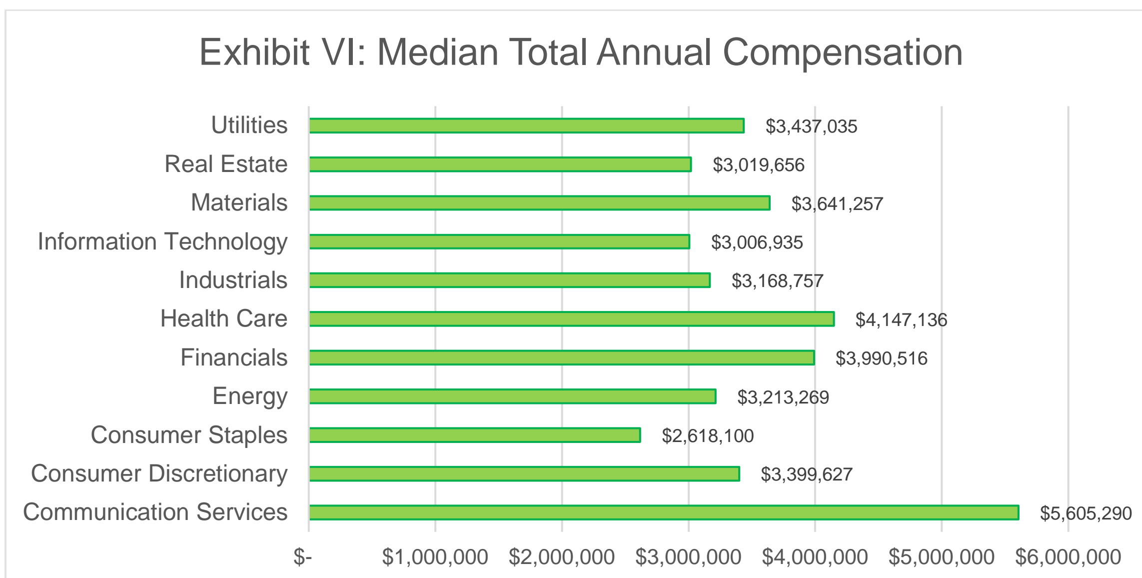
The strong economy in 2018 buoyed short-term incentive payouts in 2018. Consumer staples alone fell short of paying a target bonus in 2018, in part a reflection of challenges to sustaining growth in this sector's many mature brands, changes in consumer tastes, and increasing costs of production. The other groups paid from a median 12.00% to 40.68% above target (Exhibit IV).

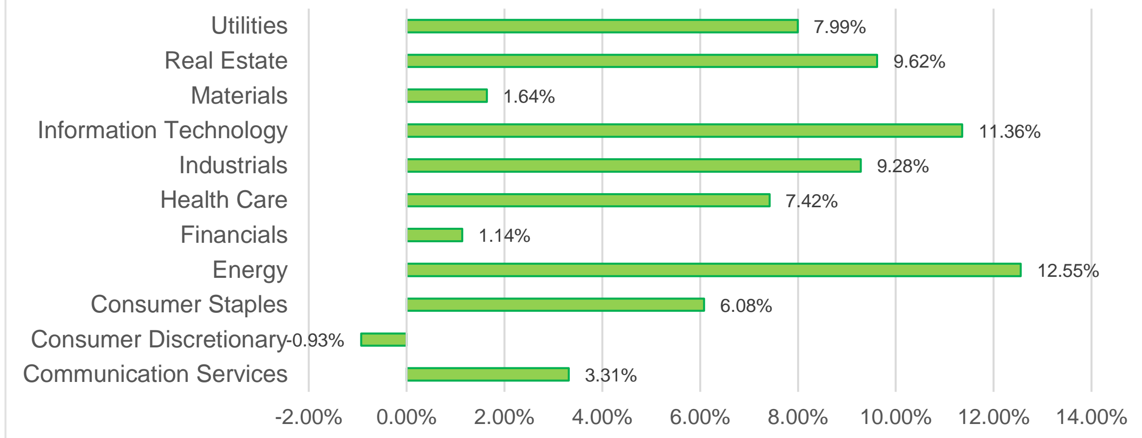


The generally strong economy also accounted for an upswing in payout value, which grew a median 8.67% from 2017. Only the consumer discretionary sector experienced a decrease (Exhibit V).



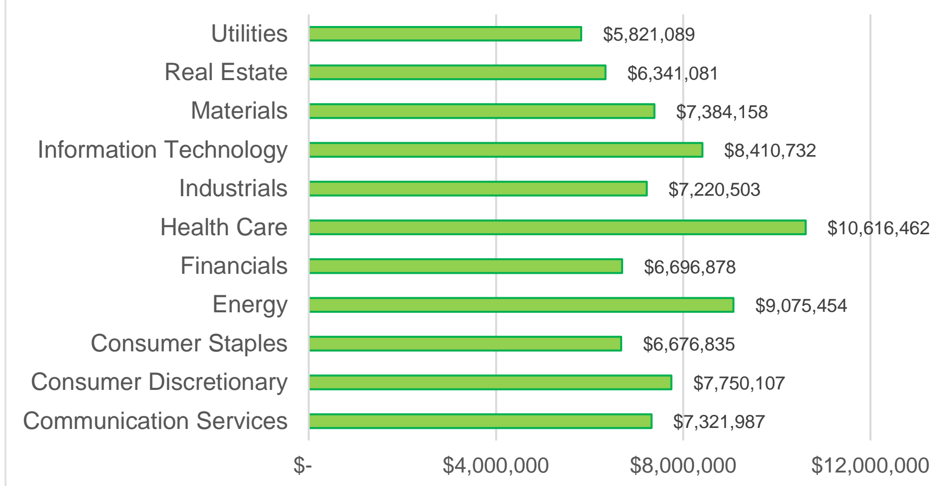
Median total annual compensation (the sum of salary and annual bonus) reached $3.377 million, a median 6.88% increase over the previous year, with substantial differences depending on industry (Exhibits VI-VII).

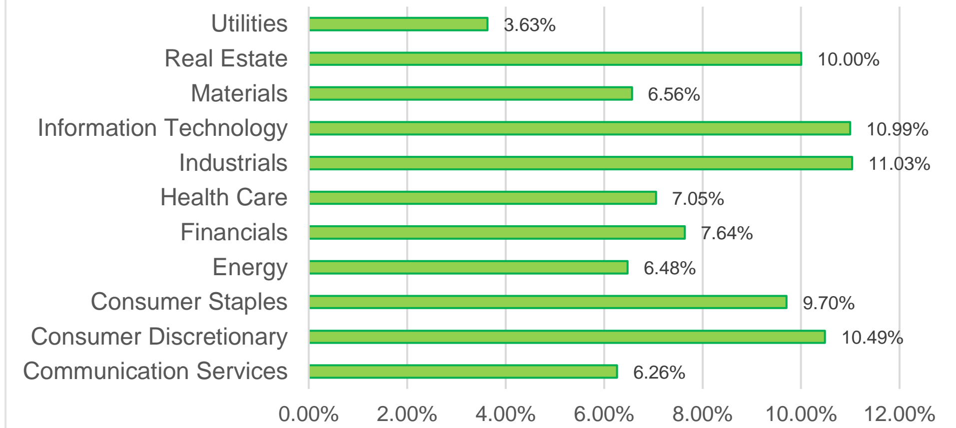




Long-Term Incentives Continue to Predominate

Ninety-six percent of the sample executives received long-term incentives of some type in 2018, with a median value of $7.594 million representing a 9.00% percent increase over the prior year. At the median, healthcare CEOs were granted the highest-value long-term incentives. Utilities CEOs received the lowest value and saw that value increase the least since 2017(Exhibits VIII-IX).



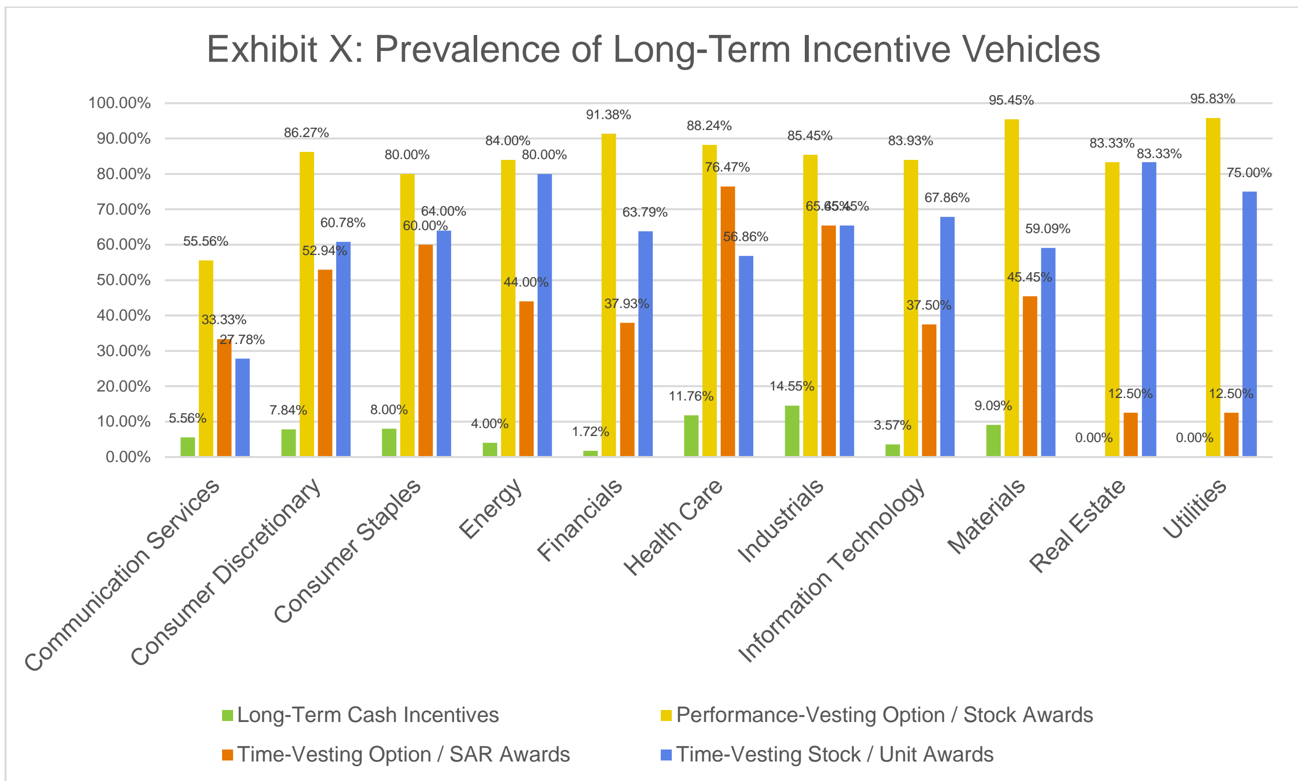


The median portion of total direct compensation consisting of long-term incentives has remained steady for the past three years (68.23% in 2016, 68.07% in 2017, and 68.41% in 2018). The prevalence of performance-vesting equity (in the form of shares, options, or units) continued its longtime upward trajectory. Eighty-six percent of our sample granted them, up from 83% in 2017 and 81% in 2016. This too suggests that sustained demand for a strong pay-for-performance linkage counterbalanced whatever opportunities tax reform presented to restack the compensation deck.

Option and SAR Grants Continue to Lose Favor

The granting of time-vesting stock option or SAR grants became a minority practice in 2018 after years of decline, offered to only 47% of the sample executives, vis-à-vis 51% in 2017 and 54% in 2016. Time-vesting stock and stock units, however, held steady at 64% of the study's universe (vis-à-vis 63% in 2017 and 60% in 2016).

Performance-vesting option or stock awards were the most common type of long-term incentive in all sectors but awarded less frequently in communication services—probably for reasons discussed above. Real estate and utilities companies, which typically pay high cash dividends, were the lowest sectors to award stock options and, conversely, among the highest to award restricted stock (Exhibit X).



Why the Dividend Matters for Stock Option Grants

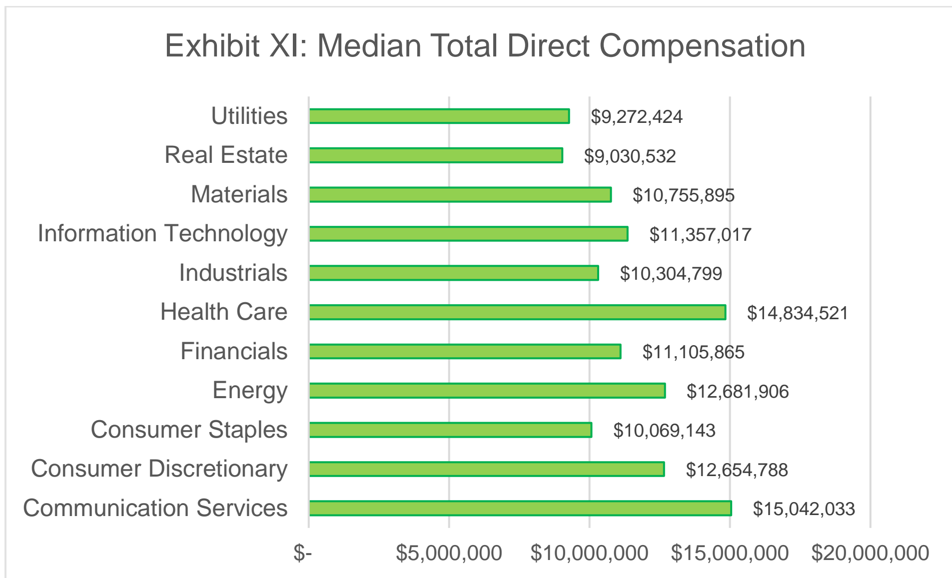
It is no accident that the sectors where options are least popular have the highest dividend yields. Cash dividends are transfers of corporate wealth from the corporation to existing shareholders. For high-yielding companies, these dividends may contribute more to total shareholder return than stock price appreciation. Unless dividend equivalents are granted to supplement option grants—an increasingly rare pairing—option-holders realize value solely from stock price appreciation, so are dealt out of the value attributable to the dividend stream.

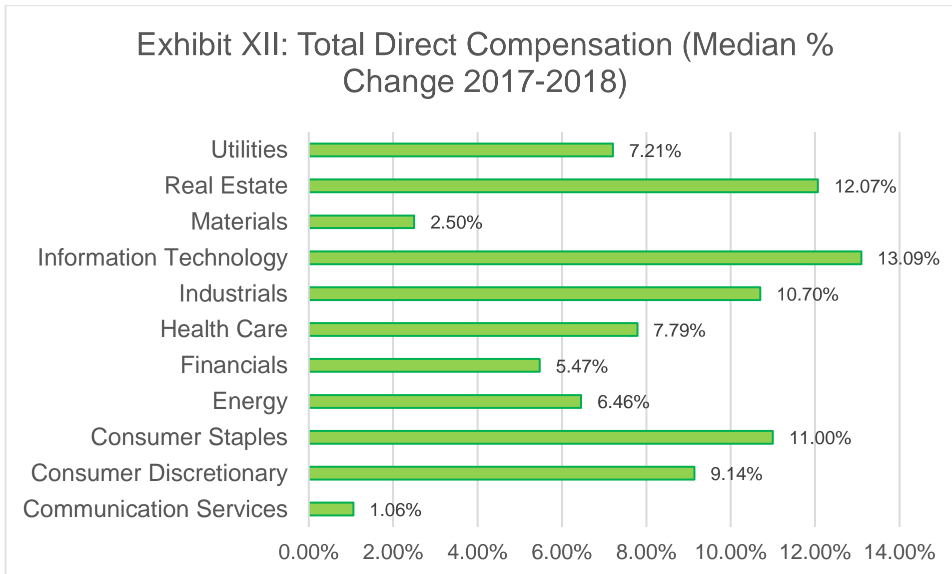
It gets worse. Cash dividend distributions reduce the stock's fair market value on the ex-dividend date without correspondingly adjusting the options' exercise price downwards, so dividend distributions erode the intrinsic spread between strike price and fair market value. In other words, option-holders not only lose out on the dividends themselves but additionally sacrifice a proportional amount of the options' underlying intrinsic value when the dividends are declared. Options are therefore relatively inefficient vehicles for companies such as real estate investment trusts and utilities.

Total Direct Compensation Rises to a Median $11.369 Million; Total Remuneration Reaches $12.211 Million

Total direct compensation—the sum of total annual compensation and total long-term incentives—grew a median 8.08% in 2018, somewhat below the 10.55% increase in 2017. Communications services CEOs who were not founders received the most compensation, with healthcare CEOs a relatively close second. Real estate and utilities CEOs received the least.

Compared to the previous year, however, communications services' total direct compensation increased only 1.06% (Exhibits XI-XII).





Median total remuneration—the sum of total direct compensation, retirement accruals, and all other miscellaneous compensation—grew a median 6.87% in 2018. The prevalence of retirement accruals took a dive in 2018, to 31% from 45% in 2017 and 46% in 2016.

The magnitude of this decrease is not what we would expect, even with as volatile a statistic as retirement accruals, sensitive as they are to movements in interest rates and other assumption. Some of this decrease is likely attributable to companies freezing their defined-benefit plans, although it's doubtful that explains the entire decrease.

In Short: A "Typical Year" in Atypical Times

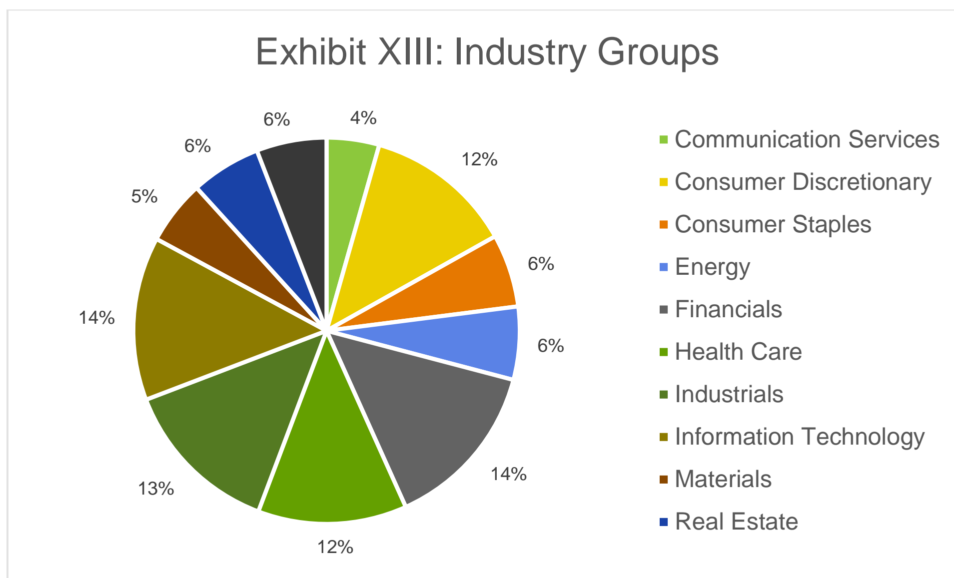
Companies historically have responded quickly to changes in tax treatment affecting executive compensation. When IRC §162(m) went into effect in 1994, they maximized their tax deductions by shifting all but the statutory limit into qualifying performance-based pay. Likewise, companies facing potential takeovers designed arcane workarounds to optimize the after-tax value of parachute payments when IRC §280G became law.

The Tax Cut and Jobs Act of 2017 does not appear to have the same impact; in fact, companies seem to be doubling down on incentive compensation (witness the increasing use of performance shares) and decreasing the role of base salary in the pay mix, contrary to tax treatment that is agnostic with respect to the form of compensation.

Since the 2017 tax reform removed restrictions rather than imposing new ones, companies may simply not feel any urgency to revise their current plans, though they may eliminate obvious artifices (such as the "plan within a plan") that have no reason to exist in the absence of IRC §162(m). Moreover, governance groups have emphatically not relaxed their pay-for-performance criteria, and companies' apparent reluctance to deleverage compensation at this point attests to these organizations' enduring influence. These considerations explain why the trends we see this year are continuations of what we've seen in the past rather than notable changes of direction.

Demographics

Our survey of constant incumbents (executives who held the CEO position for the full 2016-18 period) covered 409 companies in the S&P 500, across all 11 of the S&P 500's industry groups (Exhibit XIII).



Co-CEOs were excluded. The median revenue for this sample was $9.984 billion. Median assets were $19.796 billion and median market capitalization at fiscal year-end was $19.222 billion. Ninety-five percent of the CEOs in our sample were male. The median age was 58 and the median tenure in the CEO position was six years. Five percent were founders of their respective corporations and all occupied a seat on the board of directors.

Methodology

The following data elements were analyzed:

- Salary: As reported in the Summary Compensation Table
- Annual Bonus: Actual short-term payouts (sum of bonus and short-term portion of non-equity incentive payouts from the Summary Compensation Table); target short-term incentives as reported in the Grants of Plan-Based Awards Table
- Long-Term Cash Incentives: Target long-term cash incentives as reported in the Grants of Plan-Based Awards Table
- Performance-Vesting Equity: Target share- and option-based grants as reported in the Grants of Plan-Based Awards Table
- Time-Vesting Options: Target option-based grants as reported in the Grants of Plan-Based Awards Table
- Time-Vesting Stock: Target stock-based grants as reported in the Grants of Plan-Based Awards Table

- Retirement Accruals: Change in actuarial value and above-market interest on nonqualified deferred compensation as reported in the Summary Compensation Table.
- All Other Compensation: All other compensation as reported in the Summary Compensation Table

Statistics were independently arrayed, so medians for each data element cannot be added to other medians.

About Main Data Group

Main Data Group is a provider of high-resolution executive compensation benchmarking and corporate governance analytics. Its mission is to empower executive compensation professionals with comprehensive total rewards and corporate governance information in an affordable, easy-to-use online service. For more information contact us at info@maindatagroup.com or by filling out our contact form at www.maindatagroup.com.