As Companies Step Up Buybacks, Executives Benefit, Too

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By Scott Thurm and Serena Ng
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Safeway Inc. Chief Executive Steven Burd received a $2.3 million stock award this past March in part because he oversaw a 61% jump in the company's per-share profit last year.

The earnings increase didn't come from the grocery chain's sales, which barely budged. And it didn't result from Safeway squeezing out more profit as its operating margin narrowed.

What made the difference was $1.2 billion in stock buybacks mostly financed with borrowed money. By reducing the number of shares by which Safeway's profits had to be divided, the buybacks lifted per-share earnings growth by about half. That improved a metric used to determine the CEO's incentive pay.

As corporations step up stock repurchases to return cash to shareholders, compensation targets tied to per-share earnings—a common factor in executive-pay calculations—are helping to increase many executives' pay. The link worries some investors and compensation advisers because they fear the figure is too easily manipulated. The debate is a tricky one, though, because buybacks are generally seen as a plus for shareholders and thus something to be encouraged.

The critics argue that executives have too much leeway to inflate per-share results via buybacks without improving their companies' operating performance. "If you're a CFO or a top executive, you can determine if the EPS goes up or not based on a stock buyback," said Robin Ferracone, chief executive of pay consultant Farient Advisors. She said some companies have abandoned per-share earnings as a metric because of the concerns.

Safeway spokesman Brian Dowling said the buybacks "had no impact on Mr. Burd's 2012 compensation" and defended repurchasing so many shares. "Whenever a company's stock is selling well below its intrinsic value, repurchasing shares can be one of management's best investment choices," he added.

Many big U.S. corporations are making that same choice, cheered on by shareholders who often prefer that companies return cash via dividends or buybacks rather than let it pile up in the bank or be plowed into marginal investments.

Companies in the Standard & Poor's 500 stock index spent nearly $408 billion on share buybacks last year. Their net income grew 5% on average from 2011, but per-share earnings rose 6.1%, according to David Bianco, chief U.S. equity strategist at Deutsche Bank. Thus buybacks contributed nearly a fifth of the growth in per-share earnings.

Those gains can feed into pay. Per-share earnings are the most popular financial-performance yardstick in executive-compensation plans, used by nearly a quarter of the 1,500 companies in the S&P stock indexes, according to a Farient Advisors study.

That makes sense, because many investors grade companies on that metric. But in practice the trend highlights the complexity of paying for performance. Goals can be set too low, and numerical targets often involve relatively subjective judgments about what should be counted. Moreover, the targets can encourage short-term moves that may not pay off in the long run.

Other companies at which active stock-buyback programs appear to have increased executive pay in recent years include drug distributor AmerisourceBergen Corp., retailer CVS Caremark Corp., and consumer-product conglomerate Jarden Corp.

AmerisourceBergen last year reported a 1.7% increase in net income to $719 million. But thanks to $1.16 billion spent on share buybacks, the company's per-share earnings jumped 10%, beating a target and contributing to a $1.3 million bonus for CEO Steven Collis. Growth in per-share earnings is also a factor in a three-year bonus plan that continues through 2014.

A company spokeswoman said that repurchasing shares with excess cash has long been part of AmerisourceBergen's strategy to improve shareholder returns. "It is something that is core to how we operate, and we try to balance the repurchases with investing in our business for the future," she said, adding that "a buyback assumption" was included in the company's internal plan for its 2012 fiscal year. Its long-term goal is to increase per-share earnings by an average of about 15% annually, according to its regulatory filings.

CVS last year spent $4.3 billion on share buybacks. That included $1.2 billion for a so-called accelerated share-repurchase program that allowed the company to increase its per-share earnings more quickly than a regular buyback, which can take months, would have. From 2009 through 2012, CVS reduced its share count 11.7%.

The lower number of shares helped CVS CEO Larry Merlo qualify for a $2.8 million three-year performance bonus paid in cash and stock. The company's long-term incentive plan tied payouts to per-share earnings growth target averaging 8.7% from 2010 to 2012.

A CVS spokeswoman said the retailer bought back more shares than projected because it generated more cash than expected. "Share repurchases are initiated when management believes they will create value for shareholders," she said.

Researchers say companies that tie executive pay to per-share earnings are more likely to buy back stock. In a recent paper, Carol Marquardt, an accounting professor at Baruch College, and two co-authors found that companies that use accelerated share repurchases are even more likely to reward executives for increasing per-share earnings.

But researchers are divided over whether that hurts investors. "Just because these people are getting rich doing these repurchases, that doesn't mean it's bad for shareholders," said Jesse Fried, a professor at Harvard Law School. Mr. Fried is a frequent critic of executive-pay schemes, but he said per-share earnings targets can be valuable.

Some firms that use per-share earnings measures say they adjust their financial results to account for the buybacks when determining pay. Videogame retailer GameStop Corp., for example, excludes those shares from per-share calculations.

A spokesman said GameStop's board wants to "deter any type of management of actual financial results through artificial means." He said directors don't want executives to reach the earnings target through buybacks without considering the company's return on capital and its stock price.

Other companies don't adjust the results but say they take planned share repurchases into consideration when setting goals for executive-pay plans.

Safeway has been among the busiest buyers of its own shares. In November 2011, the company borrowed $700 million primarily to repurchase stock. Its average share count fell 28% last year, to 246 million.

Amid tough competition from Wal-Mart Stores Inc. and others, Safeway's 2012 operating profit fell for a fourth consecutive year. Its stock declined 14%. Under a formula that doesn't include per-share earnings, Mr. Burd's annual cash bonus fell 43%, to $1.3 million.

Investors have long grumbled about Mr. Burd's pay because of Safeway's lackluster stock performance. At last year's annual meeting, the grocer's executive compensation plan lost over 49% of the vote in a nonbinding "say on pay" referendum.

Amid those concerns, Safeway directors last year created a new performance-share program for Mr. Burd and other executives. According to Safeway's proxy statement, the number of shares awarded would vary based on the growth in Safeway's per-share earnings compared with per-share earnings growth at other S&P 500 companies. In the proxy statement, Safeway said directors chose per-share earnings because it "bears a direct relationship to value appreciation for our stockholders."

Earlier this year, directors concluded that Safeway's per-share earnings had grown faster than earnings at the median of S&P companies, and they awarded Mr. Burd, who plans to retire, 91,000 shares valued at $2.3 million. Mr. Dowling, the Safeway spokesman, said the comparative target was appropriate because other S&P companies also bought back stock.

Some investors and advisers disagree. Institutional Shareholder Services, which advises many big investors, recommended that shareholders vote against Safeway's executive-compensation plan at the May 14 annual meeting "due to persistent misalignment of pay and performance."

ISS also questioned Safeway's use of per-share profit as a performance metric in light of the buybacks and the lagging share price. In a securities filing Friday, Safeway said ISS's criticism was "unwarranted" and Mr. Burd would have qualified for the bonus even without the buybacks.