High CEO Salaries Can Mean Lower Profits

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Profitability tends to suffer when chief executives get paid significantly more than their senior executive cohort, new research shows.

And Deutsche Bank analyst Tim Jordan, building on recent US studies, has confirmed that the new measure of company underperformance -- the "CEO pay slice" -- applies to Australia.

Executive pay will figure prominently as the annual general meeting season starts this week, with investor groups threatening to embarrass companies that pay their chiefs too much. "CEO pay slice is negatively correlated with accounting profitability," Mr Jordan said. 'Firms with a high CEO pay slice tend to have a lower industry-adjusted operating income to assets ratio."

The slice is defined as the chief executive's share of the aggregate compensation of the top five executives.

Mr Jordan applied the measure to Australia's ASX 200 companies and found that shares in companies with a flat structure, where the chief executive got less than 20 per cent of the pool, had outperformed the ASX 200, which in turn had outperformed the companies where the chief got more than 50 per cent of the top five pool.

He said Cabcharge, Centennial Coal, Crane Group, Panoramic Resources, Paladin Energy and Wotif.com were the companies where the chief executive got the biggest slice of the top-five pie over the three years his survey covered.

At Cabcharge, for instance, he calculated that long-time chief Reg Kermode's $2.44 million total pay package last year gave him a 57.3 per cent slice of the pie, beaten only by Centennial Coal's Bob Cameron with 59.7 per cent and Panoramic Resources' Peter Harold on 61.7 per cent.

The highest paid of the three on just over $5 million a year was Mr Cameron, who sold the company profitably to Thai coalminer Banpu last year after spending 22 years building it up almost from scratch.

Mr Jordan expressed no view as to whether the pay packages were excessive, adding that "it is not the case that all companies with high CEO pay slices are poorly managed and would benefit from reducing the CEO's share of executive pay".

"While a high or low CEO pay slice does not necessarily reflect an underlying problem, it is important for investors to establish whether an abnormal level is warranted, and to understand how the CEO's share of top executive pay might affect a firm's performance."

The US research Mr Jordan worked with, by economists Lucian Bebchuk, Martijn Cremers and Urs Payer, produced five conclusions about companies with a high chief executive pay slice. Aside from the negative correlation already noted, they said that such firms tended to make
worse acquisition decisions; were more likely to make opportunistically timed option grants to their chiefs; were less likely to see the exit of a chief after poor profit performance; and that their market performance at the time of filing proxy statements tended to be lower for periods when the chief’s pay slice increased. In other words, markets do not like seeing chief executive increase their pay slices.

Mr Jordan said that in Australia there was not a strong correlation between high CEO pay slices and return on equity and total shareholder return.