Has Level 3's Executive Compensation Served Shareholder Interests?

Seeking Alpha
David Klein
November 10, 2011

Does executive compensation put executive interests over shareholder interest?

This topic has received a lot of attention over the years due to spectacular failures and the economic environment. Recently I was perusing the web and came across an advertisement for a book titled "Pay without Performance" by Lucian Bebchuk and Jesse Fried. Part of the description is as follows:

> The company is under-performing, its share price is trailing, and the CEO gets...a multi-million-dollar raise. This story is familiar, for good reason: as this book clearly demonstrates, structural flaws in corporate governance have produced widespread distortions in executive pay. Pay without Performance presents a disconcerting portrait of managers' influence over their own pay--and of a governance system that must fundamentally change if firms are to be managed in the interest of shareholders.
>
> Lucian Bebchuk and Jesse Fried demonstrate that corporate boards have persistently failed to negotiate at arm's length with the executives they are meant to oversee. They give a richly detailed account of how pay practices--from option plans to retirement benefits--have decoupled compensation from performance and have camouflaged both the amount and performance-insensitivity of pay…

This brings us to Level 3 Communications (LVLT), a company we've followed over the years. The company has disappointed more times than most would like to remember over the long term. We'll take a look at the CEO's compensation in an effort to determine if the compensation was tied to shareholder interests.

The Board is responsible for evaluating the performance of the CEO. The Compensation Committee (made up of Board members) is responsible for determining the compensation of the CEO, and evaluates the CEO's performance as it relates to his long and short term compensation goals. The Compensation Committee set the goals and objectives for the Executive Bonus Program. That said, is the CEO's compensation in line with the shareholders' interests?

First we'll look at the salary and cash bonus from 2004. This date was chosen due to the availability of form 4's filed with the SEC and company SEC filings detailing compensation.

	Salary	Cash Bonus
2004	$389,423	$2,000,000
2005	$375,000	$3,750,000
2006	$706,731	$4,000,000
2007	$790,385	$0

2008	$812,692	$1,800,000
2009	$815,000	$800,000
2010	$815,000	$1,141,000
2011	note 1	
TOTALS	**4,704,231**	**13,491,000**
1- Year not complete		

The shares awarded (below) are from SEC filings. (Form 4's)

	SHARES AWARDED	
	Before 1:15 split	After 1:15 split
2004	2,389	159.3
2005	1,799,143	119,942.9
2006	237,500	15,833.3
2007	550,008	36,667.2
2008	444,717	29,647.8
2009	982,035	65,469.0
2010	1,682,474	112,164.9
2011	1,428,365	95,224.3
TOTALS	**7,126,631**	**475,108.7**

Over this time period, the CEO sold shares generating proceeds of approximately $5.5 million. The remaining stock awards are worth about $5.2 million. Total compensation will exceed $30 million once 2011 salary and bonuses are disclosed during the above time period.

The stock prices shown (below) are yearly averages calculated by using the average of the monthly totals given on Yahoo finance, along with returns based on the November 8 closing price. Averages were used to avoid cherry picking any daily closing price.

	11/8/11 price=	$22.02
	Ave. yearly price	return
2004	$53.70	-59.0%
2005	$35.68	-38.3%
2006	$71.38	-69.2%
2007	$75.79	-70.9%
2008	$36.70	-40.0%
2009	$17.75	24.1%
2010	$18.29	20.4%
2011	$26.08	-15.6%

The stock performance has not been very impressive over the years, losing 59% from 2004. Granted, the CEO cannot control the market, but he can control the financial performance which affects the market. Below is a summary of the financial performance.

Actual	LVLT performance			
YEAR	Total Rev.	net earnings	Adj. EBITDA	Free Cash Flow
2004	3,712	(458)	527	(346)
2005	3,663	(638)	513	(435)
2006	4,518	(1,614)	711	(154)
2007	4,269	(1,134)	824	(402)
2008	4,301	(290)	988	(36)
2009	3,762	(618)	909	44
2010	6,260	(779)	1,273	(81)
2011	6,552	(855)	1,339	(235)

Actual Pro-forma LVLT and GBLC

Recent revenue has increased through acquisitions, not organic growth. Management has yet to guide top line growth above the single digit percentage range. Free cash flow is a more telling metric than EBITDA, and has not inspired confidence to date. Net earnings have yet to develop any positive trends.

The compensation awarded indicates the CEO is meeting the short and/or long term objectives set by the compensation committee with the exception of 2007, but one could argue there has been no benefit to the shareholder.

Many shareholders are underwater over the period that the CEO has been awarded millions in stock and bonuses. Based on the data we conclude the phrase, "Pay without Performance" applies in this case, or the bar has been set very low.

There are those who would argue that the CEO kept the company out of Chapter 11, and I would agree, but here is the distinction. A CEO who is called in to keep a company out of chapter 11 should be rewarded if successful. However, a CEO who rides a company to the brink should not be excessively rewarded for not teetering off the cliff.

When will shareholders see benefits more in line with executive compensation? When top line growth starts to accelerate above single digit growth rates which will accelerate the other financial metrics given above. When will more visibility be provided? CFO Sunit Patel said the following on the Q3 conference call:

> …we will provide a business outlook for 2012 for the combined business when we announce our fourth quarter results.

A complete set of detailed financial data and projections reflected in this article can be found here.

Disclosure: I am long LVLT.