More Nickels on Top

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In most years, it's good to be king. In 2004, it was great to be king.

For the first time, average total compensation for Minnesota CEOs climbed past $1 million in 2004.

The median increase for company heads in the state was just shy of 20 percent, nearly twice the national average. Meanwhile, the inflation-adjusted pay for U.S. hourly workers last year dropped slightly.

The trend holds even when the extraordinary $124.8 million pay package of UnitedHealth Group Inc. CEO William McGuire is excluded.

At the median - where half the pay packages are higher and half lower - total CEO compensation grew 19.6 percent to $1.124 million, according to the Star Tribune's 2004 CEO pay report. That's the highest total compensation level since 1997, when we began to track total compensation using the same methodology. Total compensation includes salary, bonus, gains from previously issued stock options and other compensation.

Each year, the Star Tribune ranks the 100 highest-paid executives from among more than 150 Minnesota-based publicly held companies. Total compensation for this group declined in 2002, reflecting the stock market's troubles in 2000 and 2001. Executive pay recovered its upward trajectory in 2003, and in 2004 the afterburners kicked in on the compensation rocket.

The lowest-paid of the CEOs took home $342,000 last year, up about 15 percent from 2003.

Stock options made an important contribution to the overall pay boost. For the second consecutive year, more Minnesota CEOs exercised more options and realized bigger gains than the year before.

But actual cash compensation grew even faster than total pay. Median salary-plus-bonus for the 100 highest-paid Minnesota CEOs jumped 22 percent to $663,790 in 2004. That compares with a salary-and-bonus bump of about 11 percent nationwide, according to compensation consulting firm Towers Perrin.

BusinessWeek's recent survey found that total CEO pay nationwide rose about 11.3 percent, excluding the extraordinary $230 million pay package of Yahoo CEO Terry Semel.

The strong rebound in corporate profits, and stock prices, in 2004 helped CEOs cash in. And the above-average performance of many Minnesota companies explains, in part, the outsized jump in CEO pay here. The Standard & Poor's 500 index rose 10.9 percent for 2004, while the

Bloomberg-Star Tribune index of Minnesota's largest companies climbed a brisk 17.1 percent.

Lonely at the bottom

Double-digit pay increases have become the norm at the top of the economic food chain, but the small fry struggled in 2004 against a strengthening current of consumer price increases.

"Real wages" for average U.S. hourly workers fell in 2004 by 0.6 percent, after adjusting for inflation, according to the U.S. Bureau of Labor Statistics. For the past three years, real hourly wages have remained flat.

In other words, overall wages have been stuck in neutral since 2002 while executive compensation has soared.

Whether this politically sensitive divergence is permanent or temporary remains to be seen. One school of thought holds that because so much of the U.S. economy is exposed to global competition and because U.S. companies also bear relatively higher pension and health care costs, wages are sure to feel the squeeze.

Others say that anemic pay rates are just temporary and that real wages have slipped only because of the sudden increase in oil prices.

Minnesota state economist Tom Stinson said lower oil prices "would make a difference" for hourly wage earners. "But that assumes oil will drop sometime soon. There is no big decline expected."

Stinson noted that futures prices indicate that energy traders expect oil prices in the high $40s per barrel through the end of the decade.

At any rate, raises for most salaried and hourly workers, before factoring the effects of inflation, remain in the low-single-digit range. According to World at Work, an Arizona-based salary survey firm, the average hourly worker in the Midwest saw his pay climb about 3.6 percent (up from 3.4 percent in 2003) while the average salaried worker saw her paycheck rise about 3.5 percent (up from 3.4 percent in 2003).

The pay gap

In their 2004 book, "Pay Without Performance: The Unfulfilled Promise of Executive Compensation," Lucian Bebchuk and Jesse Fried report that in 1991 the average large-company CEO received about 140 times the pay of an average worker. By 2003, the ratio had enlarged to about 500 to 1.

Stock options are most responsible for creating that gap. Conceived as a way to align the interests of top managers with the company's shareholders, options became wildly popular, especially with tech companies in the early 1990s. Options essentially are a "buy-low-sell-high" tool that allows the holder to trade a low-priced "option" for a higher-priced share of stock. The

stock typically is sold and the difference - or gain - goes to the seller. Options hold value only if the company's stock price hits a predetermined "trigger price."

In 2004, gains from stock options fueled the big paydays for Minnesota's highest-paid CEOs.

Fifty of the 100 CEOs exercised stock options last year, up from 38 in 2003 and 25 in 2002.

UnitedHealth's McGuire realized the biggest 2004 gain ($114.5 million) followed by U.S. Bancorp's Jerry Grundhofer ($33.1 million) and Target's Robert Ulrich ($31.7 million).

Gains from exercised stock options jumped both in total dollars and as a percentage of total CEO pay. For each dollar of total 2004 compensation, option gains accounted for 62 cents. Excluding McGuire's large stock gain, the figure still is 50 cents.

Options-related compensation has come under heavy fire in recent years from shareholders and regulators. The huge windfalls riding on whether a company's stock price reaches target levels created great temptation to manipulate financial numbers or make decisions favoring short-term gains. That occurred at Enron and WorldCom before those frauds were exposed. Sweeping corporate reforms since 2002 have led to much tighter financial scrutiny inside public companies.

Separately, the Financial Standards Accounting Board has pushed for rules requiring companies to account for the cost of issuing options on their financial statements. Those rules are expected to take effect in 2006 and 2007. Some companies, including U.S. Bancorp, TCF Financial, Target Corp., General Electric and Microsoft, already account for the expense of options.

Shareholders, whose own stock value is diluted by the additional shares granted to executives via options, have pressured boards of directors to be less generous toward CEOs. There is evidence that these efforts are having an effect in Minnesota and across the country.

The number of newly issued stock options peaked in 2001 nationwide and declined about 25 percent by the end of 2004, said Gary Locke, managing director of the executive compensation practice for Towers Perrin.

The number of Minnesota CEOs getting new options declined in 2004 to 64 from 79 in 2003 - a 19 percent drop.

"What you are observing in Minnesota is consistent with what is happening nationally," Locke said. "Clearly they are no longer as popular. But the death of stock options has certainly been overstated."

Because options can take up to 10 years to vest, the "overhang" from previously issued options will persist for years.

Locke said companies are moving from the "best practices" compensation model of the 1990s, which strongly favored the use of stock options, to a "best fit" pay model, where options are used

more sparingly - or not at all - depending on the type of business.

At UnitedHealth Group, for example, options remain in heavy use. CEO McGuire received 1.3 million additional options in 2004. At electronics retailer Best Buy, however, CEO Brad Anderson didn't get any new options.

Robert Kennedy, professor of management at the University of St. Thomas College of Business, cites "shareholder fatigue" as another factor for options' waning popularity.

"For shareholders, who have to bear the expense of options, when the stock languishes, they are much less tolerant of these huge rewards to top management," Kennedy said.

Other compensation

In recent years, as the fortunes of some companies made it difficult, or in some cases impossible, for Minnesota CEOs to harvest their options, compensation committees found other ways to reward them - usually through awards of restricted stock.

Unlike stock options, restricted shares simply vest on a set date.

In 2002, a bearish year for most stocks, "other" kinds of compensation - including restricted stock awards, payouts for meeting long-term goals, 401(k) contributions, payments to supplemental executive retirement plans, life insurance and other perks - totaled $43 million for Minnesota's 100 highest-paid CEOs.

In 2003, compensation in that category fell to $38.4 million for the group. In 2004, however, other compensation rebounded about 26 percent to $48 million, even though it was a bumper year for stock-option gains.

With compensation up broadly in all major categories, are all CEOs being paid for performance?

"That's a really hard question," said V. John Ella, a Minneapolis attorney who helps executives negotiate pay packages. "You can find examples where it clearly is not working."

Three-year total return is positive at 71 of the 91 companies for which we have comparable data. Of those, 68 beat the S&P 500 three-year total return of 10.2 percent and 57 beat the Bloomberg Star Tribune Index, which posted a 37.8 percent total return for the three years ended Dec. 31, 2004. (Total return includes price appreciation of shares and dividends.)

Standouts in this group include Select Comfort (up 797 percent), Stratasys (661) and Sportsman's Guide (544).

Among larger-capitalization stocks, Toro returned 224 percent, UnitedHealth Group 149 percent and Patterson Companies 141 percent.

Yet a closer look reveals some mixed signals.

Although two-thirds of their companies beat the S&P 500 Index in the past three years, 84 CEOs got bonuses, up from 77 in 2003. Of those, 19 got $1 million or more - up from 15 in 2003.

But CEO bonuses declined last year at 19 companies, including big ones such as General Mills, Medtronic, St. Paul Travelers and Xcel Energy. Nine CEOs saw their bonuses disappear.

Seven CEOs didn't get any bonus in 2004 or 2003, including former Northwest Airlines chief Richard Anderson, who left the airline last fall for a senior post at UnitedHealth Group. Northwest's total return dropped 30 percent in the past three years, but Anderson was highly regarded as a CEO in an industry ravaged by terrorism, high fuel costs and cutthroat competition.

External negative events can mask a superior performance by a CEO just as positive external events - a frothy market, for example - can mask mediocre CEO performance.

"That the CEO of Northwest leaves to be a lieutenant at UnitedHealth Group shows the skittishness of the airline industry and the unstoppable momentum of UNH," Ella said.

Finally, we can report some progress on the gender issue. One more woman joined this overwhelmingly male club, putting six female CEOs on our 2004 list.

Sally Smith, president and CEO of Buffalo Wild Wings, is Minnesota's highest-paid female CEO, ranking No. 33.

Janet Dolan of Tennant is No. 56, Susan Engel of Department 56 ranks No. 59. Marti Morfitt of CNS ranks 69th. Karen Gilles Larson, president and CEO of Synovis Life Technologies, ranked 81st, and Kathleen Iverson of Cyber Optics Corp. joins the list at 84.