EXPERT VIEW

The New ROX Index

Gauging companies' "return on executives" reveals surprise findings.

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REPORTS IN THE PRESS are replete with examples of what the media depicts as modern-day robber barons. The charges have become so commonplace that it now is almost passé to serve up the usual cast of CEOs as poster children of pay excess.

Somewhat surprisingly then, a new Exequity study of the top 20 companies in the S&P 500, the MidCap 400, and the SmallCap 600 showed that some of the most pilloried CEOs delivered shareholder returns that handily beat many of the paragons of virtuous executive pay. Or that the top executive teams of some of the most criticized companies turned in some of the very best "Return on Executive" scores in 2006.

Most companies as well as investors, in fact, can't always tell if they are paying for performance. The reason is that 95 percent of all pay analyses simply look at whether executives are awarded "competitive pay" opportunities. They add up base salaries, target annual incentive awards, and long-term incentives valued as of the date of grant using valuation models such as Black-Scholes for stock options. But importantly, while most financial models accept Black-Scholes as a predictor of value, the measurement does not calculate the amount of pay actually earned. Black-Scholes measures the theoretical value of the opportunity given at the date of grant, however, from that point forward, the true spread value of the option is entirely based on stock price, but few seem to be measuring that.

So how might true performance be gauged? While companies reference a variety of financial metrics, it begs the more efficient question: Why not just measure stock price performance itself, as that is ultimately what shareholders are asking of management? The most rational measurement of pay would then be to consider what an executive earned during a given period along with the executive's wealth created through the value of his or her equity.

The new proxy rules governing executive pay disclosures now provide a better platform for gathering pay information that can be compared on a consistent basis. Exequity has analyzed the new 2007 proxy disclosures with an eye toward comparing relative measures of shareholder value added[1] in comparison to the "real cost" of the executive team.[2] Through measuring the total value forwarded by the company to an executive— through all vehicles of compensation, including equity appreciation— and comparing this expenditure to the company's change in shareholder value over the year, we can derive a fundamentally new way of looking at compensation, the company's "return on executives" or ROX .

ROX Scores

High	
Large Cap	$24,665
Mid Cap	2,586
Small Cap	659
Median	
Large Cap	$633
Mid Cap	73
Small Cap	66
Low	
Large Cap	$119
Mid Cap	13
Small Cap	17

Large-Cap Companies and the Top 5 The median ROX score for the 20 largest companies in the S&P 500 — that is, the median amount of shareholder value delivered in 2006 for each real dollar of total pay for the top five executives was $299. There are numerous surprises: Several pilloried companies and their executive teams score quite high on the ROX metric while some companies viewed as being exemplary in their executive pay practices do not.

CEO Pay at Large-Cap, Mid- Cap and Small-Cap Companies We expanded this analysis by looking at the CEO's pay at each of the study companies. As expected, the value enhancement for each dollar delivered to the CEO was lower for the smaller companies. The median shareholder value delivered for each dollar of CEO pay in 2006 for the mid-cap companies was $73, versus $66 for the small-cap companies. The range of ROX scores for these companies was tighter than for large-cap companies, reflecting the greater leverage a top executive group can apparently make at a large company.

The ROX scores generally tend to bear out the notion that executives of large companies have the potential to preside over more substantial value creation, and that, when they do, the return on the pay delivered to the executive group reflects more extreme results. We believe that the ROX metric provides companies with a useful tool to evaluate the executive team's performance over time in relation to executives at peer organizations, and to gain a better understanding of how wellspent the company's executive pay truly is.

Overall, the ROX coefficient seems to be an improvement over the more typical analysis that currently is performed to determine the cost of the executive team in relation to shareholder wealth generated under the executives' stewardship. After all, isn't that ultimately what shareholders are asking—to get the best bang for their buck?

ROX Scores Top 20 S&P 500 Companies in 2006

Company	Total FY06 Comp From Summary Comp Table ($mil)	Real FY06 Comp Cost to Share-holders ($mil)	"Real" Minus "Accounting" Cost ($mil)	One Year TSR (%)	Increase in Shareholder Value ($bil)	ROX ($mil)
Pfizer	36.540	28.029	(8.511)	15.30	25.839	$922
Google	10.206	15.204	4.988	11.00	13.750	904
ExxonMobil	45.158	166.117	120.958	39.09	129.831	782
Verizon	57.869	48.851	(9.018)	33.95	29.777	610
Coca-Cola	63.697	48.383	(15.313)	23.08	21.845	451
IBM	48.781	56.763	7.982	19.74	24.839	438
GE	72.882	83.613	10.731	9.32	33.839	405
Citigroup	78.770	132.240	53.470	19.34	45.871	347
AT&T	122.937	155.549	32.612	52.47	49.883	321
Chevron	65.444	139.464	74.021	33.62	41.703	299
Bank of America	71.166	145.899	74.733	20.66	43.160	296
Johnson & Johnson	64.791	81.549	16.759	12.43	21.936	269
AIG	63.400	56.157	(7.242)	6.04	10.748	191
Altria	95.582	160.015	64.433	19.33	30.143	188
JPMorgan Chase	148.028	203.304	55.277	25.45	35.052	172
Wachovia	52.494	66.757	14.263	11.93	10.412	156
Wal-Mart	66.861	62.536	(4.325)	4.92	9.447	151
Wells Fargo	59.728	150.163	90.436	16.8	17.777	118
Conoco Phillips	69.650	264.341	194.691	26.44	24.397	92
Intel	34.406	(31.695)	(66.101)	-17.22	(24.916)	N/A
Average	66.419	101.662		19.18	29.767	374

[1] Shareholder value created is derived by taking the average common shares outstanding during the period and multiplying that by the share price at the beginning of the period, further multiplied by the total shareholder return during the year. These numbers were obtained from Compustat.

[2] In summary, the "real cost" of the executive team is derived by taking the CEO, CFO and next three highest paid executives who were employed at the end of the most recent fiscal year. Their compensation "real cost" is derived by taking their Total Compensation from the Summary Compensation Table with the following changes: (i) stock options are included based on the increase/decrease in spread value year over year plus gains recognized at exercise, (ii) restricted stock is included based on the increase/decrease in value year over year plus shares vested during the year, and (iii) performance shares are included if earned during the year.