REUTERS/Brendan McDermid

STOCK BUYBACKS ENRICH THE BOSSES EVEN WHEN BUSINESS SAGS

By Karen Brettell, David Gaffen and David Rohde

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Part 2: Most major U.S. companies tie part of executive pay to earnings per share and other metrics to align the interests of management and shareholders. The trouble is, these numbers can be - and often are - influenced by buybacks and other maneuvers that have little to do with operating performance.

NEW YORK – When health insurer Humana Inc reported worse-than-expected quarterly earnings in late 2014 – including a 21 percent drop in net income – it softened the blow by immediately telling investors it would make a $500 million share repurchase.
In addition to soothing shareholders, the surprise buyback benefited the company's senior executives. It added around two cents to the company's annual earnings per share, allowing Humana to surpass its $7.50 EPS target by a single cent and unlocking higher pay for top managers under terms of the company's compensation agreement.

Thanks to Humana hitting that target, Chief Executive Officer Bruce Broussard earned a $1.68 million bonus for 2014.

Most publicly traded U.S. companies reward top managers for hitting performance targets, meant to tie the interests of managers and shareholders together. At many big companies, those interests are deemed to be best aligned by linking executive performance to earnings per share, along with measures derived from the company's stock price.

But these metrics may not be solely a reflection of a company's operating performance. They can be, and often are, influenced through stock repurchases. In addition to cutting the number of a company's shares outstanding, and thus lifting EPS, buybacks also increase demand for the shares, usually providing a lift to the share price, which affects other performance markers.

As corporate America engages in an unprecedented buyback binge, soaring CEO pay tied to short-term performance measures like EPS is prompting criticism that executives are using stock repurchases to enrich themselves at the expense of long-term corporate health, capital investment and employment.

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"We've accepted a definition of performance that is narrow and quite possibly inappropriate," said Rosanna Landis Weaver, program manager of the executive compensation initiative at As You Sow, a Washington, D.C., nonprofit that promotes corporate responsibility. Pay for performance as it is often structured creates "very troublesome, problematic incentives that can potentially drive very short-term thinking."

A Reuters analysis of the companies in the Standard & Poor's 500 Index found that 255 of those companies reward executives in part by using EPS, while another 28 use other per-share metrics that can be influenced by share buybacks.

In addition, 303 also use total shareholder return, essentially a company's share price appreciation plus dividends, and 169 companies use both EPS and total shareholder return to help determine pay.

EPS and share-price metrics underpin much of the compensation of some of the highest-paid CEOs, including those at Walt Disney Co, Viacom Inc, 21ST Century Fox Inc, Target Corp and Cisco Systems Inc.

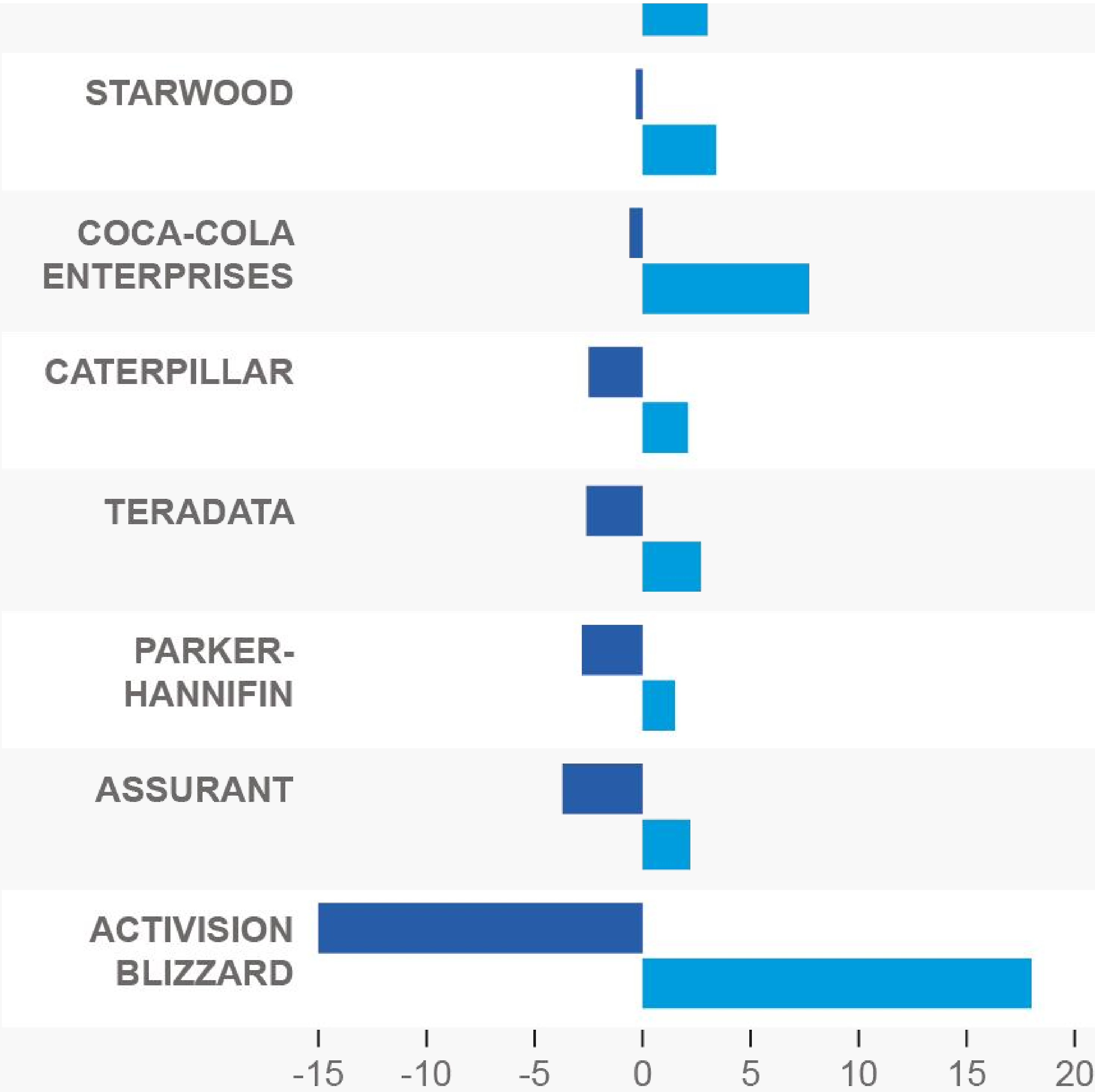
Fewer than 20 of the S&P 500 companies disclose in their proxies whether they exclude the impact of buybacks on per-share metrics that determine executive pay.

Humana would not say whether it adjusted targets to account for its buyback last year. In a statement to Reuters, the company said it sets annual per-share targets for executives that take into account the company's "capital allocation strategy," which includes buybacks, dividends, acquisitions and investments.

Down becomes up

S&P 500 companies that use earnings per share as a performance metric that boosted 2014 EPS as net income fell

Net income, percent change   EPS, percent change



Note: Data excludes extraordinary items.
Sources: Thomson Reuters; company reports

Experts said Humana would not have reached the target without the $500 million buyback. The company told analysts at the time of the repurchase announcement in November 2014 that it expected to report annual earnings per share of between $7.40 and $7.60 for the full year.

"Given the magnitude of the repurchase, the EPS would have been below $7.50 had it not been for the repurchase," said Heitor Almeida, a professor of finance with the College of Business at the University of Illinois in Champaign.

As reported in the first article in this series, share buybacks by U.S. non-financial companies reached a record $520 billion in the most recent reporting year. A Reuters analysis of 3,300 non-financial companies found that together, buybacks and dividends have surpassed total capital expenditures and are more than double research and development spending.

Companies buy back their shares for various reasons. They do it when they believe their shares are undervalued, or to make use of cash or cheap debt financing when business conditions don't justify capital or R&D spending. They also do it to meet the expectations of increasingly demanding investors.

Lately, the sheer volume of buybacks has prompted complaints among academics, politicians and investors that massive stock repurchases are stifling innovation and hurting U.S. competitiveness -- and contributing to widening income inequality by rewarding executives with ever higher pay, often divorced from a company's underlying performance.

"There's been an over-focus on buybacks and raising EPS to hit share option targets, and we know that those are concentrated in the hands of the few, and that the few is in the top 1 percent," said James Montier, a member of the asset allocation team at global investment firm GMO in London, which manages more than $100 billion in assets.

The introduction of performance targets has been a driver of surging executive pay, helping to widen the gap between the richest in America and the rest of the country. Median CEO pay among companies in the S&P 500 increased to a record $10.3 million last year, up from $8.6 million in 2010, according to data firm Equilar.

At those levels, CEOs last year were paid 303 times what workers in their industries earned, compared with a ratio of 59 times in 1989, according to the Economic Policy Institute, a Washington-based nonprofit.

SALARY AND A LOT MORE

Today, the bulk of CEO compensation comes from cash and stock awards, much of it tied to performance metrics. Last year, base salary accounted for just 8 percent of CEO pay for S&P 500 companies, while cash and stock incentives made up more than 45 percent, according to proxy advisory firm Institutional Shareholder Services.

Thomson Reuters Corp, owner of Reuters News, used EPS to determine half of the performance awards in the three-year pay cycle ended in 2014 for CEO Jim Smith and other executives. Smith last year took home $6.6 million in compensation. The company's three-year performance awards going forward are based on both EPS and free cash flow per share. A company spokesman said Thomson Reuters does not adjust for the impact of stock buybacks on those metrics.

Share repurchases can make the difference in meeting preset targets, according to a Reuters review of corporate proxies.

At Xerox Corp, revenue, net income and spending on research and development all declined last year. But the printer and copier maker's EPS target of $1.12 was unchanged from the prior year, and managers hit it exactly after $1.1 billion in share repurchases.

PRINTING MONEY: Buybacks helped Xerox Corp CEO Ursula Burns receive a bonus of $1.98 million last year, even though revenue, net income and research spending declined. REUTERS/Eduardo Munoz/Files

SMARTPLAY: Video game company Activision Blizzard's net income dropped last year, while CEO Robert Kotick received about $22 million in performance pay after the company hit targets for total shareholder return and EPS. REUTERS/Danny Moloshok/Files

"Despite 20 years of trying, we have still failed to come up with an objective performance metric that can't be gamed."

Lynn Stout, professor, Cornell Law School

Half of CEO Ursula Burns's annual bonus target was predicated on hitting that EPS level; ultimately, she received a bonus of $1.98 million out of a possible $2.2 million. EPS is also a major determinant of even bigger bonuses for a three-year performance cycle ending this year.

Xerox repurchased $1.35 billion of its shares in the first three quarters of this year. The company declined to comment. Its proxy statement does not indicate whether it adjusts targets to account for buybacks.

Managers at information technology company EMC Corp hit their EPS target for 2014 of $1.90 with the help of $3.7 billion in share repurchases. Based on the share count before the buybacks, EPS last year would have been only $1.81, little changed from $1.80 a year earlier, according to a Reuters calculation.

The EPS target accounted for half of CEO Joseph Tucci's annual $1.01 million bonus. It also is used to determine 45 percent of bonus share awards for the company's future three-year targets.

EMC declined to comment. Its proxy statement does not address whether it makes adjustments to account for buybacks. It has bought back $3.11 billion in shares so far this year.

Buybacks can boost a company's share price to benefit executives whose shares vest over a period of years. Activision Blizzard Inc, purveyor of "Guitar Hero," "Call of Duty" and other well-known video games, signed Chief Executive Robert Kotick to a contract in 2012 that included $56 million in share awards that vest over time, depending in part on the share price and EPS.

Last year, Kotick ended up getting about $22 million in performance-based cash and stock awards, about the same as the prior year, even as net income dropped 17 percent. How? The stock rose substantially, meeting goals for total shareholder return and increasing the value of share awards.

Total shareholder return was helped by an $8.2 billion repurchase made in late 2013 – when the company and a group of investors led by Kotick and Activision Chairman Brian Kelly bought out a stake held by then-majority shareholder Vivendi. The company said the deal allowed Activision to operate with more flexibility.

The shares rose 33 percent from the date of the buyback announcement in July 2013 through the end of 2014. The share price has continued to rise this year, making the awards even more valuable.

Activision declined to comment.

In 1992, Congress changed the tax code to curb rising executive pay and encourage performance-based compensation. It didn't work. Instead, the shift is widely blamed for soaring executive pay and a heavier emphasis on short-term results.

Companies started tying performance pay to "short-term metrics, and suddenly all the things we don't want to happen start happening," said Lynn Stout, a professor of corporate and business law at Cornell Law School in Ithaca, New York. "Despite 20 years of trying, we have still failed to come up with an objective performance metric that can't be gamed."

Shareholder expectations have changed, too. The individuals and other smaller, mostly passive investors who dominated equity markets during the postwar decades have given way to large institutional investors. These institutions tend to want higher returns, sooner, than their predecessors. Consider that the average time investors held a particular share has fallen from around eight years in 1960 to a year and a half now, according to New York Stock Exchange data.

"TOO EASY TO MANIPULATE"

Companies like to use EPS as a performance metric because it is the primary focus of financial analysts when assessing the value of a stock and of investors when evaluating their return on investment.

But "it is not an appropriate target, it's too easy to manipulate," said Almeida, the University of Illinois finance professor.

In 2011, Amgen Inc CEO Kevin Sharer oversaw $8.32 billion of buybacks, by far the largest in the pharmaceutical maker's history. More than $5 billion of those repurchases came in the fourth quarter of the year.

Soon after, Amgen reported that net income was lower than it had been in the three preceding years. At the same time, the buybacks lifted EPS far above the target level that determined 30 percent of Sharer's bonus, doubling the amount he earned for that portion of his $4.88 million annual bonus. Without the buyouts, EPS would have fallen below the target level.

Sharer left the company in May 2012 and is now on the faculty of Harvard Business School. He did not respond to requests for comment.

The Amgen board's compensation committee removed EPS as a performance metric the next year. It opted, instead, to begin using net income, saying in a 2012 proxy statement that doing so would "align compensation with a measure that more directly correlates with the underlying performance of our operations."

Members of Amgen's 2011 compensation committee declined to comment.

Some companies, including software developer Citrix Systems Inc and kidney dialysis company DaVita Inc, say they avoid EPS in pay calculations because it is too vulnerable to manipulation.

Most companies that use per-share metrics for executive awards, however, say little about whether they adjust results to account for buybacks. A select few, including Johnson & Johnson, FedEx, Time Warner Inc and IBM, do disclose that they strip out the potential effect of buybacks on performance metrics.

FedEx, in its most recent filing, said it excluded the effect of buybacks because the positive effect on EPS "did not reflect core business performance." Time Warner Inc said it adjusts for buybacks "so that payouts were not advantaged" if the media company repurchased more shares than it initially anticipated when setting performance goals.

Steve Pakela, managing partner at Pay Governance LLC in Pittsburgh, Pennsylvania, which advises more than 40 S&P 500 companies on executive pay, said some directors "believe you shouldn't strip out the effect" because share buybacks may be the best use of capital.

In addition to EPS, there is total shareholder return, which typically comprises a company's share price appreciation plus dividends over time. Total return, often used to compare performance among peer companies, has also become a popular performance measure for executive pay.

By providing a lift to a stock's price, buybacks can increase total shareholder return to target levels, resulting in more stock awards for executives. And of course, the higher stock price lifts the value of company stock they already own.

"It can goose the price at time when the high price means they earn performance shares … even if the stock price later goes back down, they got their shares," said Michael Dorff, a law professor at the Southwestern Law School in Los Angeles.

Exxon Corp, the largest repurchaser of shares over the past decade, has rejected shareholder proposals that it add three-year targets based on shareholder return to its compensation program. In its most recent proxy, the energy company said doing so could increase risk-taking and encourage underinvestment to achieve short-term results.

The energy giant makes half of its annual executive bonus payments contingent on meeting longer-term EPS thresholds. Since 2005, the company has spent more than $200 billion on buybacks.

ADDITIONAL TWEAKS

While performance targets are specific, they aren't necessarily fixed. Corporate boards often adjust them or how they are calculated in ways that lift executive pay.

Humana specifies EPS ranges to determine annual bonuses paid to its executives. For the past three years, buybacks of more than $500 million a year increased EPS. That wasn't all, however. For each of those years, the board altered calculations in ways that also bumped EPS higher.

COVERED: Insurer Humana Inc. paid then-CEO Michael McCallister a bigger bonus than it otherwise would have after adjusting its EPS calculation. REUTERS/Shannon Stapleton/Files

SITTING PRETTY: Humana’s current CEO, Bruce Broussard (center right, in orange tie), received his target EPS-based bonus for 2014 after the company made an accelerated stock repurchase. REUTERS/Larry Downing/Files

“I can’t think of a good reason” for an accelerated stock repurchase..

Susan Young, associate professor of acccounting and taxation, Fordham University

For 2012, then-CEO Michael McCallister received a higher bonus than he otherwise would have -- $1.63 million -- after Humana’s board removed litigation expenses from its EPS calculation.

He was succeeded as CEO at the start of 2013 by Broussard. For that year, Broussard’s annual bonus was lifted into the maximum range, for a payment $2.44 million, after accounting for the cost of posting additional reserves against long-term insurance policies.

For 2014, Humana discounted from its EPS calculation losses from paying down some bonds, even as its overall debt levels increased. That adjustment brought the company just below its EPS target of $7.50.

The $500 million buyback the company announced late last year, part of its total $872 million in buybacks in 2014, was an accelerated share repurchase. In this sort of deal, a company buys all the stock from an investment bank in a single transaction. That allows it to book the reduction in shares outstanding immediately, and the bank then buys the shares on the open market over the ensuing months.

Humana’s accelerated share repurchase lifted EPS to $7.51, just above the target.

Susan Young, an associate professor of accounting and taxation at Fordham University in New York, said accelerated buybacks are commonly used to reach compensation targets. “I can’t think of a good reason for this form of repurchase,” she said, noting that the programs restrict a company’s flexibility to reduce or stop buybacks if shares become too expensive.

benefit of accelerated repurchases is to, “in a controlled way, buy a significant slice of available shares early in the program,” before an announced buyback pushes up the share price and increases the cost to the company.

He also said an accelerated program allows shareholders to see immediate action, which is “important to signal a higher degree of confidence in something shareholders care a great deal about.”

In general, he said, “effective compensation committees are aware of impact of share repurchases on EPS, particularly when EPS is part of the equity compensation of management.”

In July, Aetna Inc announced that it would acquire Humana in a deal that at the time valued Humana at $37 billion. If Broussard leaves after the deal, he won’t go empty-handed.

Just before the Aetna deal was announced, Broussard’s compensation agreement was modified to accelerate equity awards and remove restrictions on exercising some stock options if he leaves or is terminated within two years of any acquisition, a regulatory filing shows.

At the end of last year, Broussard held unvested share awards valued at around $12.8 million, which have since increased in value as Humana’s share price has climbed 18 percent.

The Cannibalized Company

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