It's Good to Be the CEO

We haven't ranted in a while, and we really do love a good rant. So we return in this installment to one of our favorite topics for a diatribe: executive compensation. CEOs and their upper management colleagues get paid way too much for what they do, and it's maddening. So that you can share in our wrath, we want to look at one particular example of CEO pay gone wrong. There are many examples we could have picked, but this one was pointed out to us by the great Chris Bloomstran of the Semper Augustus Investments Group and we liked Chris' idea so much that we decided to expound upon it here.

Getting Paid for Missing Targets

We're going to look at General Mills (GIS), owner of such branded food icons as Pillsbury, Betty Crocker, Häagen-Dazs, Yoplait, Cheerios, Annie's, Wheaties, Bisquick, and many others. As you may be aware, over the last decade or two Americans have been slowly shifting their preferences away from processed foods to healthier choices, and this shift has not been kind to General Mills or its similarly-positioned competitors such as Kraft Heinz or Kellogg.

So how does GIS' board of directors incentivize its management personnel to fight against these trends? This is America, and we are capitalists, so cash is the primary carrot that's dangled in front of the C-suite folks to get them to keep the company moving forward. Cold, hard cash, and lots of it.

For fiscal year 2019, GIS' CEO was paid a base salary of $1.2 million. That's a heck of a lot of money, but it doesn't strike us as excessive. However, Base Salary is just one part of the three-part pay package, with an Annual Incentive of $1.8 million added on top (for meeting short-term one-year goals), and a Long-Term Incentive (for meeting rolling three-year goals) on top of that.

The Long-Term Incentive portion of the CEO's pay is determined by a fairly simple formula: 50% based on organic sales growth and 50% based on the cash earnings generated by the business. ("Organic" here means that it excludes the effects of things like acquisitions and currency fluctuations.)

The target for organic sales growth for 2017-19 at GIS was 0.0%, and the target for the cumulative cash generated by the business in those three years was $6.5 billion. In other words, for the first half of that equation GIS' board is saying to its management to do its best to not shrink the business. (By the way, that 0.0% sales target in 2019 is down from 3.0% just two years ago. That seems like an awful big way to move the goalposts in such a short amount of time, but as we'll soon see that's just one of the ways that the compensation system can be gamed.)

Anyway, how did they do for 2019? They missed the first target by a pretty wide margin: instead of average organic sales growth of 0.0%, they actually achieved an average sales *decline* of 1.6%. They also missed the second target by about 10%: earning $5.9 billion instead of the $6.5 billion target.

OK, so that seems pretty simple to figure out the Long-Term Incentive portion of management's compensation: they missed the first target, they missed the second target, and each target accounts for 50% of the total, so therefore they should not earn any Long-Term Incentive comp in 2019. Right? No. Oh, no no no no no no. Seriously, no. That's just not how this works at all.

According to this chart from GIS' proxy statement, they actually earned 57% of their Long-Term Incentive target bonus, which entitled the CEO to a further $4.7 million in pay. That's *four times* more than his base salary, and yet he missed both targets!

Fiscal 2017-Fiscal 2019 PSU Measures and Weightings *($ in millions)*	**Target**	**Actual Performance(3)**	**Award Achievement %**
Average Organic Net Sales Growth (50%)(1)	0.0%	-1.6%	60%
Cumulative Free Cash Flow (50%)(2)	$6,450	$ 5,852	54%
Fiscal 2017-Fiscal 2019 PSU Performance Achievement			57%

(1) Organic Net Sales Growth: growth in sales for the company, excluding any impacts from acquisitions and divestitures and foreign currency exchange.

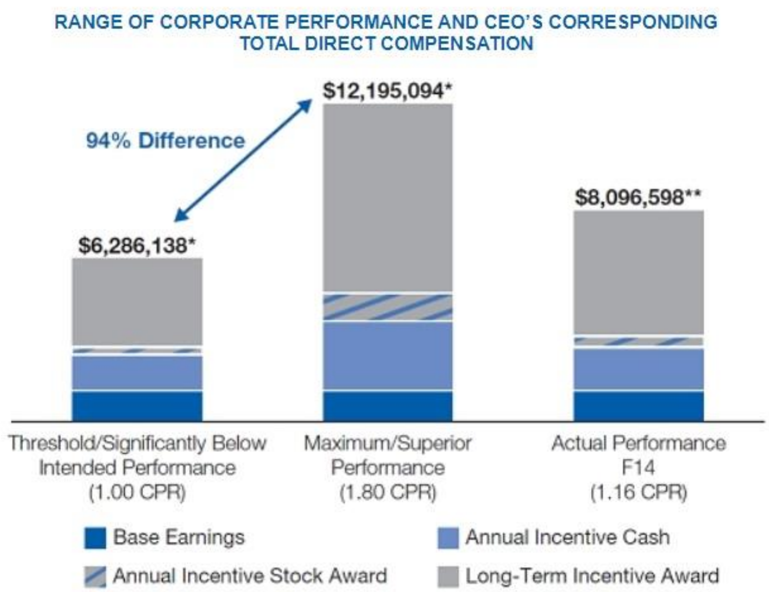
(2) Cumulative Free Cash Flow: cash generation performance measured by cash flow from operations, less capital expenditures.

(3) Actual Performance: cumulative free cash flow has been adjusted for restructuring projects and acquisitions and divestitures not included in original targets. Average Organic Net Sales Growth and Cumulative Free Cash Flow are non-GAAP measures. For more information on the use of non-GAAP measures in the Proxy Statement, and a reconciliation of non-GAAP measures to the most comparable GAAP measures, see Appendix A.

source: General Mills

Heads I Win Huge, Tails I Win Big

So the CEO was still given an additional four times his base salary in 2019 despite missing both long-term targets. That seems pretty messed up, right? To give you a sense of how messed up the system is, we're going to look next at a chart which will show the CEO's pay in various scenarios. GIS no longer publishes this chart each year, but here is what it looked like in its most-recent iteration (from the 2014 proxy):



source: General Mills

The middle column shows what the CEO could possibly earn in the maximum scenario by hitting all his targets. As you can see, the dark blue portion of the column (representing base pay) is by far the smallest component, and the gray portion (long-term incentive pay) is by far the largest. Which is as it should be.

However, in the left column, which shows the CEO's total pay in the base case (i.e., what he would earn if the company's performance was "significantly below intended performance"), the long-term incentive pay is *still* by far the largest component.

How can this be? How have we gotten to a place where we are rewarding performance that is not up to the standards that we set?

The First Two Culprits

Two of the more obvious culprits we see are peer benchmarking and compensation consultants. To make that first point, we'll quote from a recent General Mills proxy statement, "The size of each executive officer's standard award is periodically benchmarked against the long-term incentive awards made by compensation peer group companies to executives holding comparable positions." In other words, "we're going to pay our executives similarly to the way that our competitors pay their executives. We want our management to be able to keep up with the Joneses." So if General Mills looks to Kellogg as a barometer for its compensation, and if Kellogg looks to Campbell Soup for its own, and then if Campbell looks to General Mills …. well, you can see what sort of upward-spiral this can lead to.

As for those consultants, consider this. Frederic W. Cook & Co. has been the outside compensation consultant for General Mills for the last ten years. If you were the compensation consultant, and your invoices were paid by the management personnel at the company you're consulting, would you advise them to pay themselves a lot, or a little?

As recently as 2009 (the last year before FWC was hired), here is a quote from a company filing that contained almost all the details of how it calculates its executives' compensation: "Pay is performance-based." OK, that's not entirely fair. The 2009 proxy does have seven text-only paragraphs under the heading Annual Incentive compensation. However, that disclosure pales in comparison to the full 25 pages devoted to executive comp in the 2019 proxy, with lots of charts, graphs, definitions, and equations. Those compensation consultants are really trying to earn their fee.

Gaming the System

While peer benchmarking and compensation consultants play their part, we saved the biggest culprit of all for last: gaming the system. GIS' own compensation system allows for its executives to do things for their own benefit to the possible detriment to shareholders. Think again to the formula for Long-Term Incentive pay: 50% based on organic sales growth and 50% based on cash generation.

General Mills management is well within their rights to increase the cash generated by the business by doing stupid things such as cutting advertising spending. Advertising is the very lifeblood of consumer packaged goods, and cutting it could harm the business, but management could do so if it wanted to boost cash flow and thereby increase its compensation.

For an example of how to game the organic sales growth portion of the equation, consider what General Mills did last year: it paid $8 billion to buy fast-growing pet food maker Blue Buffalo. Before the acquisition, GIS had about $16 billion in revenue and was struggling just to keep that flat year to year. Blue Buffalo had a little more than $1 billion in revenue, but it was growing closer to 12%. If you add that smaller, faster-growing business into the larger one, in the first year its sales will not be included in the compensation calculation because they will not be deemed organic (since they came via acquisition). However, in the second year that Blue Buffalo is a part of the GIS fold, it will contribute a full 1% to General Mills' "organic" growth, which could mean many more millions of dollars could find their way to the bottom of GIS executives' pockets.

Bottom Line

There are already dozens of variables an investor has to keep track of when analyzing a company, but reading the proxy statement and tracking how a board incentivizes its executives to perform can help you to see what metrics they will focus on, and whether they align with your interests as a potential shareholder.

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