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What's Wrong with the Current System? Compensation without Long-Term Value Creation

High Compensation without Revenues—Now That's a Problem

Reflecting on the spate of dot.com explosions and implosions during the past few years, selecting stocks based on fundamental analysis seems more difficult than ever.[1] In the late 1990s, some stocks went

1. Fundamental investment is an approach made famous by authors/investors Benjamin Graham and David Dodd in books such as *Security Analysis* (1934) and by Graham in *The Intelligent Investor* (1940). This approach to buying stocks requires an analysis of balance sheet and income statement data and looks for value creation based on improvements in asset growth and organization management.

up without profits and, in extreme cases, without revenues. Spirited M&A activity and soaring compensation didn't always coincide with stock price increases and the only ones who seem to have prospered were the deal makers, consultants, bankers, and executives who cashed out along the way. The current system seems broke and it's already attracting the attention of regulators. Change is inevitable and companies will need to grow revenues and compensate people in a different manner. Management can wait for new regulations or risk using old methods. Alternatively, management can pursue an SEU path now.

Part of the problem with the current system may lie in compensation that rewards stakeholders for behavior that does not create long-term value for shareholders.[2] But these highly compensated individuals may be simply taking advantage of a configuration and playing by rules that they didn't create. Each may be trying to move the company in a way that provides personal benefit at the expense of another party. And this is just a start. There may be plenty of other parties with specific biases that may not necessarily move the company forward in a path beneficial to all.

Identifying the problems is only part of the battle. Getting people to fix a situation when it runs counter to their financial best interests is appreciably more complex. However, in recent years, developments in the financial community suggest that major change may be imminent. The SEC has fined major Wall

2. We distinguish shareholders from "other stakeholders" because stakeholders represent the broader group that may include (among others) stockholders, employees, suppliers, debt holders, members of the community, board members, and so forth. Sometimes, the interests of all of the stakeholders may not be aligned. This means that money going to one party may come at the expense of another member in the group. This is the general problem being addressed in this opening paragraph.

Street firms over $1.4 billion in inappropriate business practices and has permanently banned certain research analysts.[3] Furthermore, senior U.S. senators and other government officials are now pushing for reform because they see self-regulation by the capital markets "as a complete abject failure."[4] Such contemplation may have been inconceivable even a few years ago. However, the poor economy early in the new millennium and the revelations of gross improprieties and conflicts of interest may provide a window of opportunity for changing compensation models.[5] The rules for growing a company are absolutely changing and senior management needs to stay current with new conditions. The first change will undoubtedly focus on money and be forced on major institutions by regulatory agencies. That is, unless companies choose to change on a voluntary basis. Compensation has been and continues to be a major issue that needs to be addressed one way or another.

3. In a May 1, 2003 report, Forbes.com cited fines for financial firms of $2.95 billion for 2002 and over $3 billion for 2003. On December 20, 2002, the U.S. Securities and Exchange Commission (SEC) fined some of Wall Street's largest firms $1.335 billion, including Bear Stearns, Credit Suisse Group, Deutsche Bank, Goldman Sachs, J.P. Morgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley, Citigroup, and UBS. Salomon Smith Barney, a unit of Citigroup, will pay the largest fine of $400 million. Credit Suisse First Boston will pay $200 million with other firms paying between $80 million and $125 million. The settlement also banned two analysts from the securities business for life. This includes former Merrill Lynch & Co. Internet analyst Henry Blodget as well as Jack Grubman, who was previously the top telecommunications analyst at Salomon Smith Barney (unit of Citigroup, Inc.).
4. Quote attributed to New York Attorney General Eliot Spitzer in Reuters, May 7, 2003, "Senators Skeptical on Wall St. Settlement."
5. In one particularly egregious case, Jack Grubman allegedly used his Wall Street connections to gain his children admission to a prestigious Manhattan nursery school by changing his rating on AT&T stock to win favor from the company CEO, Sanford Weill (November 14, 2002, Forbes.com, "Weill-Grubman Dealings were Child's Play").

Money Is Not Everything—But It's Pretty Darn Important

Perhaps nothing exemplifies the over-exuberance of the 1980s and 1990s as much as the over-the-top compensation earned by executives and dealmakers. Some of these guys made big money—huge amounts of money. During the go-go years in the 1980s and 1990s, new compensation records were broken each year. First it was $100 million, then $500 million, and later $1 billion.[6] No amount of cash, bonus, or stock options seemed inappropriate. After all, compensation experts reasoned, most of the executive compensation came in the form of stock options. Since stock options could only earn money when the stock price went up, so long as the stock price increased, all parties gained. This implies that no stakeholders lose. This was the logic built into compensation plans throughout the 1980s and 1990s.

Those who disagreed with this logic would risk being shunned from the marketplace. After all, an appreciating stock market is said to establish right from wrong. The markets supposedly incorporate future expectations into the existing price and know best. In the 1990s the market had boundless energy coinciding with skyrocketing compensation levels. It was not by coincidence. More deals create more growth, which justifies higher salaries, bonuses, and options. This was a wild ride fueled, in part, by insatiable greed and cheap financing. It was a great time to be an executive of a large company. Actually, it was a great time to be an investment

6. In Business Week Online (April 19, 1999), a chronology of compensation milestones are cited including: Disney CEO Michael Eisner's 1998 compensation at $577 million and Roberto Goizueta, CEO of Coca Cola, earning over $1.3 billion on his stock options.

banker, compensation consultant, venture capitalist, or average investor on the street. An unprecedented amount of money could be earned in a relatively short time period.

Whatever Goes Up…

Bad compensation mechanisms cannot be blamed for all of our stock market and economic woes. But bad compensation mechanisms were certainly a big part of this mess. Compensation mechanisms were tied in with the greed that gripped our markets. Individuals had economic incentive to behave in a manner that might not contribute to the long-run wealth creation of the organization. Another factor was that when our capital market systems gather momentum, there is little that can slow them down. Rising stock markets create new wealth, which enables companies to use inflated stock as currency to buy other companies. New infusions of risk capital then enter the market, providing funding for additional investments. With rising equity levels, companies can borrow additional bank debt, driving leverage and risk to new heights. This may result in yet another round or cycle of appreciating stock, harvests, and new investments. Reality may not set in until much later when it becomes too late to reverse a large transaction.

Once the first ripple of quarterly reports indicates that the high-profile companies missed their financial projections, things begin to unwind. This is bad news with markets adjusting quickly. Over recent years, the investment cycle of (1) invest, (2) harvest, (3) invest again, can also move rapidly in reverse. However, in the opposite direction it appears as (1) sell, (2) sell lower, or (3) liquidate the assets. The stock market crash of 2000–2003 was just this type of reversal of fortune.

Return without Risk: Not Bad if You Can Get It

Managers, executives, and entrepreneurs who deliver strong performance *should* collect compensation and rewards commensurate with their work. Investors providing capital to risky ventures *should* be entitled to high, risk-adjusted returns if the venture proves successful. Employees and investors who provide above-average performance or take above-average risk are *entitled* to above average compensation. Financial rewards flow to those who have earned them. Risk and return are the cornerstones of our capital markets. The presumptions of rational capital markets depend on motivated individuals attempting to maximize their investment return.

However, during the 1980s and to a greater extent during the 1990s, those in a position of influence could easily manipulate the organization to personal advantage without taking large, personal risk in the short term. If management desired organizational growth they certainly had the option to grow slowly through internal expansion (organic manner). Or, they could raise capital and acquire growth through the purchase of other companies. Whereas the first path was slow and tedious, the latter could be accomplished very fast. Moreover, for many it may have been glamorous.[7] The 1990s clearly demonstrated a go-go era.

7. See, for example, David Schweiger's *M&A Integration: A Framework for Executives and Managers,* (McGraw Hill, 2002). In this book the author describes the glamour in deal making (e.g., late nights with lawyers and bankers). However, he explains that most mergers fail to earn their expected value because the unglamorous job of integration is often ignored during the deal and mishandled afterward.

Want Growth? Just Acquire It

Through the 1990s, large companies were apt to grow through acquisition rather than through organic means. This is clearly illustrated in Table 3.1, which shows the rise and subsequent fall of IPOs, M&A transactions, New York Stock Exchange (NYSE) value, NASDAQ value, and Dow Jones Industrial Average (DJIA) value. Several explanations may be offered. First, the cost of debt financing was very low, coinciding with relatively strong institutional investor demand.[8] Thus, firms could acquire other firms with relatively cheap debt funding. Also, the public equity markets were very strong, creating an opportunity to issue new equity for acquisition financing. IPOs were very popular during this time period. Finally, and perhaps most important, the rising stock market inflated company values, thus enabling acquiring firms to buy more companies by employing a stock for stock

Table 3.1 Market Values in Millions

	1996	1997	1998	1999	2000	2001
Number of IPOs*	771	519	337	508	351	110
Number of M&As*	13,068	13,907	16,002	13,766	12,885	8,853
NYSE market value	$7,300	$9,413	$10,865	$12,296	$12,372	$11,714
NASDAQ market value	$1,512	$1,835	$2,589	$5,205	$3,597	$2,900
DJIA market value	$6,800	$7,800	$9,300	$11,700	$10,500	$9,870

* Only U.S. IPOs and M&As. Data provided by National Venture Capital Association and SDC Platinum (2002).

8. The demand for debt is inversely related to the interest rate: As demand rises, the bond price increases and the effective cost or yield declines.

swap.[9] As the stock markets continued to rise, acquiring companies were inclined to make even more acquisitions while the timing was right. The rationale among some managers was that they wanted to use their company's inflated stock price to buy up assets while the opportunity was available (i.e., before the stock price dropped and the opportunity would be lost).[10] However, one of the pitfalls of an overheated stock market includes unjustified bidding wars among potential buyers leading to the "winners curse." Those who won the bidding ultimately may have been "cursed" by paying too much. At the extreme, buyers paid billions of dollars in company stock for organizations that had no profits and in some cases no revenues.[11] During the mid-to-late 1990s, Lucent, Cisco, Nortel, and other telecom companies were among the most eager participants in the acquisition game.[12] In the years subsequent to their acquisitions they were also among the companies that experienced the largest loss in shareholder value.

At first, the stock markets didn't react very strongly to the acquisitions, but over time it became clear that many of the acquisitions were not working. Analysts usually need a couple of quarters before deciding whether or not an acquisition will lead to the hoped-for economies of scale or revenue expansion. During this time period, companies

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9. Because stock prices were rising quickly for the acquiring firms, they would need fewer shares or a smaller percentage of their company to buy up another company using stock. Financiers refer to this situation as "reducing dilution," meaning that the ownership interest of existing shareholders will not be allocated to as many different new investors as much when the stock prices rise. Alternatively, a rising stock price also enables the buyer the opportunity to pay more for an acquisition.

10. See, for example, *Red Herring,* "Mergers and Acquisitions Insight: Big Deals Weaken Stocks" (August 2000). The article describes the displeasure among investors that "overvalued companies are using their inflated stock to not only buy, but to pay a premium to acquire other overvalued companies."

11. Lucent Technologies paid $20 billion for Ascend Communications, which had $1.1 billion in revenue and was losing money. Later, Lucent paid $4.8 billion for Chromatis, which had no revenues. They closed the company less than one year later.

12. According to *ZD Net Technology News* (August 1999), Lucent had spent over $30 billion for acquisitions in the prior three-year period.

need to sort out management changes and infrastructure adjustments. At best, a large acquisition requires six months to one year before benefits can be noticed, and many of these high-rolling acquirers were completing multiple acquisitions per quarter. Thus, sorting out the final year-to-year performance numbers was a difficult challenge. A November 1999 study by the accounting firm KPMG found that 83% of the 700 "most expensive deals" completed during the period 1996–1998 either broke even or lost money (53% lost money and 30% were considered break even). By contrast, 82% of the surveyed 107 executives from these participating firms believed that these deals were "successful." A study conducted by Booz, Allen, and Hamilton (2001) found similar results in the success and failure rate for companies that merged during the time period 1997–1998.[13] Many other academic studies also show that many mergers did not provide the intended cost savings or strategic benefit. Yet, even as evidence emerged indicating that many deals were not working as planned, individuals still pushed acquired growth initiatives forward. Why?

CEOs May Serve Themselves First

The fact that M&A deals continued despite mounting evidence that they may not have been in the best interests of corporate stakeholders at first seems counter-intuitive. But executives in larger organizations generally earn more than executives in smaller

13. Professor Robert Bruner summarized 130 empirical studies of M&A activity conducted between 1971–2001 in his paper "Does M&A Pay? A Survey of Evidence for the Decision Maker," University of Virginia, October 2001. In this evaluation, Professor Bruner cited the KPMG November 1999 report, as well as a 2001 Booz, Allen, and Hamilton study (among many others), which found that large mergers reduced shareholder value during the mid-to-late 1990s. His paper provides a balanced view of the evidence for other periods that had different results.

organizations.[14] Consequently, they may have economic incentive to acquire other firms and grow their own organization. Coinciding with the incentives of the acquiring executive, new research suggests that executives from the acquired firms also may have economic incentive to acquiesce to new ownership. In a study examining 40 large "mergers of equals," including companies such as Traveler's Group and Citicorp, AOL and Time Warner, Viacom and CBS, Daimler-Benz and Chrysler, Dean Witter and Morgan Stanley, and Bell and GTE, Wharton Professor J. Wulf suggested that CEOs from acquired firms may "trade away a better price for their shareholders in exchange for more job security for themselves." Thus, CEOs from both sides of the transaction might have economic incentive to complete a transaction.[15] Furthermore, much of the SEC fines issued during 2002 and 2003 (discussed earlier) address the strong conflict of interests that members of the financial community have regarding the completion of deals and dissemination of that information to the public.

Given the potential for a conflict of interest, a CEO of a large, public company needs to be careful about responsibilities to the shareholders and recognize that growth in revenues does not necessarily translate into greater shareholder return. Senior managers

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14. See, for example, "Performance Pay and Top Management Incentive," Jensen and Murphy, *Journal of Political Economy,* 1990, Vol. 98, No. 2 or "CEO Incentives and Firm Size," Hall and Baker, Harvard Working Paper, 2002.
15. Professor Julie Wulf, Research at Penn, August 2001, "CEOs Serve Themselves First in Mergers of Equals." In her study evaluating 40 major transactions of mergers of equal size, Wulf concluded that CEOs of target companies often traded away a better price for their shareholders in exchange for more job security for themselves (or possibly their employees). "Merger agreements that appoint a larger share of target directors to the post-merger board and that include CEO/chairman succession plans are associated with lower target shareholder returns." Her study included companies such as Traveler's Group and Citicorp, AOL and Time Warner, Viacom and CBS, Daimler-Benz and Chrysler, Dean Witter and Morgan Stanley, and Bell and GTE.

can lead the firm to new heights or drive it off a cliff. Obviously, any major decision is subject to board and shareholder approval, but top managers can dictate the direction of the organization. Given their unique opportunity to shepherd resources, acquire other companies, or radically change the fabric of the entire organization, this group has power. Big power. But if they are to take advantage of their unique power they will need to move fast. Their stay at the top lasts for only a short while. Nowadays, most executives leading large, publicly held companies survive, on average, 3-4 years before they move on. In many respects, their career at the top approximates the life of a National Football League running back.[16] If they are to make significant change within the organization, or hope to make a big score in compensation, they will only have a short window of opportunity in which to accomplish it.

Management by the Numbers: Executive Compensation and Shareholder Return

The media frequently evaluates whether or not management earns its pay. Comparisons of salaries to corporate performance often appear once the latest compensation figures are made public in the spring.[17] Does extraordinary compensation correspond with high stock returns? Increasingly, the answer appears to be no. In 2002,

16. We searched company records of CEO duration at *Fortune* 500 companies over the time period 1995–2000 and came to an average duration of approximately four years. A study reported by East Bay Business Times (July 2002), "Revolving Doors for CEOs Turning Quicker," conducted by human resource firm DBM, evaluated 481 public and private firms in 25 countries during 2000 and 2001. They found the average duration among U.S. CEOs was only three years.
17. See, for example, "Executive Pay," *Business Week,* April 17, 2000.

three of the top six wage earners all worked for Tyco, a company that in the prior year was under intense scrutiny for corporate impropriety and greed. Despite the 22% stock market decline in 2002 for the S&P 500, the executive compensation for *Fortune* 100 executives rose 14% to $13.2 million. This has created outrage among shareholders and as one pay consultant has put it, "not only does executive pay seem more decoupled from performance than ever, but boards are conveniently changing their definition of performance." As famed investor Warren Buffet noted: the "acid test for reform will be executive compensation."[18] This suggests that going forward management actions will perhaps need to be more closely linked to total stakeholder performance.

But, compensation experts are divided on the problems related to management excess. Since greater than 90% of all executive compensation is now in the form of long-term stock options, many experts contend that the problem is self-correcting.[19] Executives don't earn benefits related to stock options unless they help the stock price rise. The argument contends that if executives earn exceptional compensation, it is only because they have lifted the stock price to which their interests are directly aligned.

There are, of course, counter-arguments that are relevant for our purposes. The first one addresses timing. If executives can "game" the stock price such that it rises high enough to exercise some of their options in the immediate term, they will gain. If, later on, the stock price ultimately plummets, they will have gained at the expense of the shareholders, though their future options may expire without value. All of this presumes that management can help influence the price movement of the stock. In actuality,

18. See "CEO Pay: Have They No Shame?," *Fortune*, April 13, 2003.
19. See, for example, "What You Really Need to Know about Stock Options," Hall, Harvard Business Review, March 1, 2000.

management's behavior may be completely unrelated to any stock price movement. In a strong "Bear" market, even Herculean management efforts may be insufficient to move the stock price up. Similarly, in a rising "Bull" market, the stock price may benefit irrespective of management's mistakes.

Critics maintain that stock options are best applied when they are measured or calibrated relative to some meaningful benchmark. This, they suggest, eliminates extraordinary levels of compensation for mediocre performance or uncontrolled externalities. Critics worry that compensation boards tend to be lax with their controls, and that CEOs have far more power and influence over their own salaries than they should be entitled.[20] Statistics back up the critics' claims. During the decade 1990–2000, CEO compensation increased by an average of 1,300% compared to the average employee salary increase of 43%.[21] Moreover, the gap between U.S. and international CEO pay continues to widen.

Aside from the question of whether such a differential is appropriate, there are other questions concerning the market's response.[22] Can executives who reap these enormous financial rewards keep their companies going strong? The data suggests that they can't. Further, the most highly compensated executives tend to pursue above-average M&A activity. Some executives may be using transaction activity to demonstrate growth and help justify their

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20. See "CEO Pay: Have They No Shame?," *Fortune*, April 13, 2003.

21. Executive Pay: The Great CEO Pay Heist," *Fortune* magazine, June 11, 2001. See also, "Are CEOs Really Paid Like Bureaucrats?," Hall and Liebman, *NBER,* August, 1998.

22. As an interesting sidebar, Executive Pay watchdogs are becoming more vigilant and organized in their monitoring behavior. For example, in 2003, Executive PayWatch organized by the AFL–CIO, is monitoring 16 *Fortune* 500 companies being targeted for "extraordinary executive pension cases." To the extent that these efforts become more widely disseminated, they may help stem the gap between the average worker and executive officer.

salaries for personal benefit. Future growth models need to ensure that the interests of all stakeholders are more closely aligned for both short- and long-term considerations.

Highest Paid = Highest Performance? A Look at *Business Week*'s Top 20

Business Week's most highly compensated executives include some of the most closely monitored individuals at some of the most celebrated organizations. It is almost a mathematical certainty that in order to make *Business Week*'s Top 20 Compensation list, the stock had to rise precipitously over the prior period. In some situations, the high compensation represented one terrific year for the company, whereas in other situations the high compensation represented an executive selling a lifetime's accumulation of stock options. Either way it is interesting to assess how the stock performed in the periods *after* the executive harvested his options.[23] The data generally show that the more highly compensated CEOs had more revenue growth with their companies and considerably higher M&A activity (up to 4 times greater) compared to similar companies in the same industry! Moreover, the stock of highly compensated CEOs generally performed worse than the S&P 500 (benchmark index) in the periods after the CEO harvested his stock options. Furthermore, the evidence suggests that on average, if a highly paid executive is in office for more than 10 years (i.e., well-entrenched executive), the executives are more likely to under-perform the industry benchmark after cashing out of stock options. The exceptions to this rule were Jack Welch at General Electric and company founders (e.g., Andy Grove at Intel, Bill Gates at Microsoft, Larry Ellison at Oracle, and Michael Dell at Dell Computers) that continued to outperform the market.[24] Consequently, in the years before the executives cashed out of their stock options, their companies had more M&A activity (on average); in the years after they cashed out, their company stocks (on average) performed poorly. Clearly, future models of growth would benefit by examining potential long-term growth and compensation developments.

CEO Influence: Examples of Style

If, in fact, M&A activity is related to poor subsequent stock performance, executives should seek fewer deals than they do. More important, it is counter-intuitive that executives get financially rewarded for pursuing transactions that *in the long run* reduce stakeholder value. In a few high-profile transactions like,

23. We examined the potential for CEO influence on stock returns and organizational growth. In particular, we searched our *Fortune* 500 database for highly compensated executives to determine whether or not a relationship existed between individual compensation incentives and organizational growth. In determining our list of highly compensated executives, we ranked the top 20 most highly compensated executives provided by COMPUSTATs EXECUCOMP database (also listed in *Business Week* and *The Wall Street Journal*) for the period 1993–2000 and compared the results for organizational revenue growth, stock price appreciation, and subsequent performance. Invariably, in order for the executives to be listed on the most highly compensated list, it was necessary for the stock to perform well preceding the executive's sale of stock options. This was the case in every situation because company stock options comprised the bulk of executive compensation. The bigger question was, What was the stock performance like after the executive sold his stock?

    We were also interested in the type of growth that occurred with high compensation, so we searched the Securities Data Corp. (SDC) for M&A activity. In each case we compared the M&A activity of companies in our sample (i.e., those representing highly compensated CEOs) with other companies in the same respective industry peer group.

for example, Travelers Group and Citigroup, senior executives sold their firms to rivals, pocketing an enormous windfall as they walked away.[25] Many subordinates would be later fired or pushed out in the consolidation and often the combined entity would not reap the projected advantages of synergy. Given these obvious potential conflicts of interest, shouldn't compensation programs address these potentially disastrous developments?

Lessons Learned?

Poorly designed organizational compensation incentives are largely to blame for the problems experienced through much of the 1990s.[26] Many of the individuals who were listed among *Business Week's* top paid executives were among our list of fastest revenue-growing firms during the same time period (or were involved in

24. We also found other interesting relationships regarding the variance of executive compensation and stock performance. We found a modest relationship between the variance between the top two executives and stock performance. For example, in the case of General Electric, our top-performing company, the CEO consistently earned between 1.8 and 2.2 times more than the second-in-command. By contrast, at Disney, a company whose stock returns lagged that of many others in our database, the CEO in some years earned up to **50** times the amount of the second-in-command. Although the data are inconclusive regarding this statistic, we would expect that the company culture would be appreciably different at the two companies. Also, we found that bringing together two members of the *Business Week* highly compensated list into one team was detrimental for stockholders (AOL and Time/Warner merger). More insights are available at Executive Compensation and Stock Returns, Joel Shulman working paper, with the guidance of Brian Hall, Harvard Business School, 2000.
25. Professor Julie Wulf, Research at Penn, August 2001, "CEOs Serve Themselves First in Mergers of Equals." Her study included companies such as Traveler's Group and Citicorp, AOL and Time Warner, Viacom and CBS, Daimler-Benz and Chrysler, Dean Witter and Morgan Stanley, and Bell and GTE.
26. In his June 9, 2002 article, "Heads I Win, Tails I Win," *The New York Times,* Lowenstein cited an example of how a CEO (Edward Whitacre) at SBC earned $82 million for a very mediocre performance.

management impropriety). However, revenue growth (particularly growth gained through acquisition) did not lead to strong stockholder performance. Because acquired growth can accomplish an organizational overhaul very quickly, it is probably not surprising that this methodology has been subject to abuse. Ultimately, the shareholders lost, despite management's predictions that their organization might perform well with the acquired assets.[27]

Although acquired growth may not benefit shareholder wealth creation, it offers a path for senior management to create personal wealth. And, the bias toward creating deals may result, in part, from the short duration of CEO tenure. Given their relatively short stay at the top (i.e., three to four years), CEOs have great incentive to promote M&A activity or other transactions that will foster growth, facilitate a culture change, or manipulate a stock option harvest. Furthermore, given the large wealth transfer with M&A activity, many deals may also have been driven by pressures from investment bankers, venture capitalists, lawyers, and other financial advisors who would substantially gain from the harvest.

Do Senior Agents Represent Themselves More than Other Stakeholders?

Clearly, growth through acquisition was not the best path to increasing shareholder return, yet acquisitions continued at an aggressive pace for over a decade. This appears to be a problem of "Agency Costs" when agents for the firm consume corporate

27. See KPMG, November 1999 study of merger activity on 700 large transactions between 1996–1998. Although 83% of the 700 M&As evaluated during the time period either performed poorly or broke even, 82% of the executives involved in the transaction described them as "successful."

perquisites at the expense of other stakeholders.[28] For example, managers may choose to fly first class or pay themselves large bonuses. Other agents, such as investment bankers, may drive deals to generate fees irrespective of whether value is created for their clients. In the case of the Daimler Chrysler merger, Goldman Sachs received a reported $65 million in fees, whereas CS First Boston received approximately $55 million.[29] Other examples may include management that chooses to acquire companies for personal benefit. Management at the acquired firm often gets fired as part of the cost reductions with a horizontal (similar industry) consolidation. Thus, completely independent of cost savings or market share issues, management from the acquiring firm may believe that there is job security, as well as personal financial gain, to be found in buying other organizations.

Incentive Orientation: Things Need to Change

What methods can successfully grow an organization if the leaders of the entity are gaming the system for personal benefit? Before stock options became popular in the 1980s, executives focused on corporate perquisites, a nice salary, and respect among peers and coworkers. Things were simpler and more predictable in the past. In our newer economy, time in the job has shortened and the rules of engagement are different. Most of an executive's compensation and wealth creation now comes from stock appreciation. Thus

28. For a discussion of agency costs, see "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," Jensen and Meckling, *Journal of Financial Economics,* October, 1976, Vol. 3, No. 4.
29. Levy Zuckerman, "Merger Mayhem," *Bloomberg Magazine*, October 1998.

management has incentive to push the stock price higher, even for just a little while.[30] However, management becomes dependent on the marketplace to recognize value in their collective efforts. If the entire market drifts down, or their efforts are not recognized as valuable, then no matter how hard they work, their large rewards will not be recognized.

Considerable time and attention are placed on the company's stock price. Management is under great pressure to push the price higher. Yet management does not have much time. Thus, it has become the norm in many cases for management to expend great efforts to boost the price up quickly. Mergers, divestitures, refinancings, equity carve-outs, venture funds, extensive layoffs and cost-cutting, strategic alliances, and so forth, are all considered for the sake of expanding corporate revenues and profits. The status quo is not an attractive option, nor is slow growth.

As discussed in Chapter 5, the best growth comes about through strategic expansion and organic growth. Growth through acquisition does not contribute to good stock performance though growth through organic means (i.e., internal expansion) contributes to strong stock performance. It may take longer and may not push revenues soaring as quickly as acquired growth, but it has a stronger impact on the stock price in the long term.

More of the incentive structure should be focused on creating organic growth rather than growth through acquired means. Compensation mechanisms in many firms have become short-

30. Actually, the wealth creation comes from stock options (in a rising stock market) with salary and bonus providing a floor. Individuals closely monitor the stock option exercise price or strike price (the point where they can buy the stock) and have incentive to push the market price above this level. Because stock options enable great return for relatively small price movements, they can create much greater wealth accumulation in a shorter period of time compared to the outright stock purchase.

term-oriented with managers being concerned about immediate shareholder gratification. Organizations need to do a better job of tracking performance based on the value added by key talent.

During the 1990s, corporate behavior entered a new arena that has since become scrutinized and criticized. The markets are now ready for a change in corporate compensation. Shareholders, regulators, government officials, and employees are demanding change now. Executives at major organizations are now being more heavily scrutinized in regard to their compensation. Board members are being more closely monitored too.

In Chapter 7 you consider modifications to the existing incentive structure. The changes are not meant for the entire organization, but rather, a small element that can be affiliated with the parent. If successful, the approach might become influential on the parent, but changing the culture of the parent is an extraordinarily complex task beyond the scope of this text. Furthermore, much of the discussion in this chapter focused on the behavior of senior management. As you explore in the next chapter it is unfair to place the burden solely on the shoulders of senior management and their advisors. In the past 20 to 30 years, middle management has been the cause of some large-organization decay as well. In the next chapter you look at how large organizations might be better able to utilize their human capital in the middle. Then, in subsequent chapters you consider modifications to existing compensation structures in which all employees might be able to work together to help create long-term value for their stakeholders.