HEINZ'S WILLIAM JOHNSON: TOO MUCH PAY FOR TOO LITTLE PERFORMANCE

by Graef Crystal

August 2008

William Johnson, the chief executive officer of Pittsburgh-headquartered H.J. Heinz Co. has created a money machine – for himself.

But his performance has sadly lagged his pay. It's not that he's a poor performer as much as a ho-hum performer.

He became CEO on April 30, 1998, succeeding Anthony O'Reilly, who was my client. (I was Heinz's compensation consultant from about 1972 until late in 1988.)

Johnson's Performance

Let's look at his total return performance two different ways.

For the first way, I calculated Heinz's annual total shareholder return between April 30, 1998, the day Mr. Johnson became CEO, through April 30, 2008, which was the end of Heinz's most recently-completed fiscal year. Then I narrowed the time window by one year, calculating annual total return for the period April 30, 1989 through April 30, 2008. And so forth, until I was down to a one-year period, the one year ended April 30, 2008.

I then calculated the so-called excess return in each time window by deducting from Heinz's actual return the return on the Standard & Poors 500 Index. For a second comparison, I deducted from Heinz's total return the return on the S&P 500 Consumer Staples Index, which comprises 41 companies. (As of Aug. 7, Heinz had a 1.27 percent weight in this index).

Here are the results:

BEGIN	END	HNZ ANNUAL TOTAL RETURN	EXCESS RETURN S&P500	EXCESS RETURN S&P 500 CONS
4/30/1998	4/30/2008	3.0%	-0.9%	-1.5%
4/30/1999	4/30/2008	4.8%	2.8%	0.0%
4/30/2000	4/30/2008	9.2%	8.1%	0.4%
4/30/2001	4/30/2008	7.8%	4.5%	0.9%
4/30/2002	4/30/2008	7.2%	1.0%	1.8%
4/30/2003	4/30/2008	13.0%	2.4%	2.4%
4/30/2004	4/30/2008	8.8%	1.0%	1.2%
4/30/2005	4/30/2008	12.1%	3.9%	2.2%

4/30/2006	4/30/2008	9.9%	5.1%	-1.8%
4/30/2007	4/30/2008	3.2%	7.8%	-2.4%

For the second way, I calculated Heinz's total return, not in time windows of decreasing size, but rather in annual windows, each conforming to a fiscal year. I then calculated the excess return using the S&P 500 Index and also the S&P 500 Consumer Staples Index.

BEGIN	END	HNZ ANNUAL TOTAL RETURN	EXCESS RETURN S&P500	EXCESS RETURN S&P 500 CONS
4/30/1998	4/30/1999	-12.2%	-34.0%	-13.8%
4/30/1999	4/30/2000	-24.5%	-34.6%	-2.3%
4/30/2000	4/30/2001	19.6%	32.6%	-3.2%
4/30/2001	4/30/2002	11.5%	24.1%	-4.8%
4/30/2002	4/30/2003	-17.6%	-4.3%	-0.6%
4/30/2003	4/30/2004	31.7%	8.9%	8.0%
4/30/2004	4/30/2005	-0.5%	-6.9%	-1.4%
4/30/2005	4/30/2006	16.5%	1.1%	10.2%
4/30/2006	4/30/2007	17.2%	1.9%	-1.2%
4/30/2007	4/30/2008	3.2%	7.8%	-2.4%

Herewith Heinz's median excess return in each of the fours series:

- For the time windows of decreasing size, using the S&P 500 Index: Plus 3.3 percentage points.
- For the time windows of decreasing size, using the S&P 500 Consumer Staples Index: Plus 0.7 percentage points.
- For the annual time windows, using the S&P 500 Index: Plus 1.5 percentage points.
- For the annual time windows, using the S&P 500 Consumer Staples Index: Negative 1.9 percentage points.

The bottom line – at least for me – is that Mr. Johnson pretty much kept up with the overall market. But he certainly didn't stand out in a crowd.

Johnson's Pay

For that sort of performance, you might expect Mr. Johnson to be given a pretty much average pay package.

Not so.

Here are the elements of his pay for the year ended April 30, 2008:

- A base salary of $1.1 million.

- An annual bonus of $4.7 million.

- A stock option grant in FY2008 covering 368,000 shares that, at its grant, had an estimated Black-Scholes value of $2.1 million (which value was calculated by me using my own assumptions.)

- A grant of 30,303 restricted (i.e. free) shares in FY2008 worth $1.4 million at the time of grant.

- Participation in a long-term incentive plan covering the years FY2009 and FY2010. If Mr. Johnson hits the targets, he would earn a further $3.2 million. But if he rings all the bells, he could earn as much as $6.3 million. Payouts are predicated on one or more factors chosen by Heinz's compensation committee, including, but not limited to, such metrics as return on invested capital and total shareholder return.

- An increase in the actuarial value of his pension in the single year 2008 of $7.7 million.

- Miscellaneous compensation of $924,000.

The total of these pay elements is $21.1 million.

So how high is $21.1 million?

I first compared Mr. Johnson to 505 other CEOs, all running companies with $3 billion or more of market cap. After controlling for differences in company size, as measured by sales, and for what I call pay risk (the ratio of stock option present value to total pay, stock options being the most risky form of compensation), I found Mr. Johnson to be sitting 125 percent above a competitive rate. That would place him at the 94th percentile among those hundreds of peers, meaning that only about six percent of the companies, after adjusting for size and pay risk, would have paid as much or more than Mr. Johnson received.

(Most of the raw data for this article were obtained from Equilar, Inc., a leading provider of executive compensation data.)

I also compared Mr. Johnson's pay to that of 14 consumer companies among the larger group that Heinz uses as its pay comparator group. (The actual number of companies in the Heinz group is 16, but I could not obtain data on either ConAgra Foods Inc. or on General Mills Inc., because, as of this writing, neither had yet released its current pay figures.)

Among that group, Heinz's 125 percent above-market positioning ranked it first. (In second place was Coca-Cola Co. whose CEO was positioned 83 percent above the norm for the overall group of companies.)

But looking at excess total return (using the S&P 500 Index as the benchmark) for the single year 2008, Heinz's excess return of 7.8 percent ranked it sixth among the 14 consumer companies.

Number one in pay. Number six in performance. Hardly a match made in heaven.

I find three aspects of Mr. Johnson's pay package to be particularly troubling.

First, he participates in, not one and not two, but three different long-term incentive plans: stock option grants, free share grants and a long-term performance plan. Many studies I have done show that the number of long-term incentive plans extended to a CEO is a good predictor of whether he will be overpaid. What happens is that when a company adds another long-term incentive plan, it may cut back on the long-term incentive plan(s) it already has, but it rarely cuts back sufficiently to accommodate the new long-term incentive plan. The result: Aggregate long-term incentive compensation rises and so does total pay.

Second, and in my opinion, a long-term performance plan that has a two-year time window of measurement is an oxymoron. Even three years, which is what most companies use as a time window, is suspicious.

Johnson's Pension

Finally, there is the matter of Mr. Johnson's pension.

Permit me to provide some history here.

Prior to 1974, IRS-qualified defined benefit pension plans were the norm, and the CEO and other executives derived their entire pension from these plans.

Then Congress created the Employment Retirement Income Security Act, known as ERISA. (A client of mine at the time, Dick Furlaud, who used to run Squibb Corp., told me that ERISA stood for Every Rejected Idea Since Adam!)

Before ERISA, there was no limit to the pension that could be paid to an employee, provided there was equal treatment. So you could give the CEO a pension of 60 percent of his final pay after, say, 30 years of service, provided you gave every employee the same 60 percent of their final pay for the same length of service.

Moreover, the definition of pay had to be the same for every employee. So you couldn't, for example, predicate the CEO's 60 percent on the sum of his salary and bonus, without also predicating the worker's 60 percent on the sum of his salary and overtime.

Because most employers were singularly unenthusiastic about paying pensions on overtime, the effect was that the CEO's pension was based only on his salary.

But ERISA changed that by capping the dollar amount of pension that could be paid under a qualified pension plan at $75,000 a year (since adjusted, more or less, for inflation).

So before ERISA, a CEO whose final salary was $500,000 and a worker whose final salary was $20,000 could each receive 60 percent of their final pay as a pension -- $300,000 for the CEO and $12,000 for the worker.

But with ERISA, the worker still got his $12,000, with the CEO being limited to $75,000.

In response to this cap, companies quickly adopted what first came to be called ERISA Restoration Plans. The CEO was told the following: "Look, we can only pay you a pension of $75,000 from our main plan. But we will pay you a further pension of $225,000 from our ERISA Restoration Plan. Now under IRS rules, contributions that go to the main plan leave the company and go into a trust, and the amounts so paid are immediately taken as a deduction against corporate income. As to the ERISA Restoration Plan, payments cannot be deducted until they are actually paid, and should the company go belly up, you could end up with no payment at all. But leaving aside that remote possibility, the only inconvenience to you is that you will henceforth be receiving two pension checks a month, instead of a single check."

Well, all that seemed innocent enough. But by decoupling the pension plan for the CEO and other major executives from the pension plan for everyone else, the world of annuities began to undergo profound change.

Here are snippets from successive boardroom conversations:

- "You know, in the days when he had a single pension plan, we couldn't predicate pensions on salary and bonus, without paying a pension on worker overtime. But we can leave the qualified plan as it is (i.e., pensions on salary only), while recognizing the bonus in our definition of pay for our ERISA Restoration Plan. Oh, and by the way, if we do that, the plan is no longer an ERISA Restoration Plan. So lets give it a new name, a Supplemental Executive Retirement Plan (SERP). And remember, we can have whoever we want in this plan, and the IRS can't do a thing about it."

- A bit later: "You know, the workers have to stay until age 65 to get a normal pension. But in our SERP, we could offer a full pension, with no actuarial reduction, at, say, age 60."

- A bit later: "You know, the workers have to be with us for 30 years to get a full 60 percent pension. But in our SERP, we can give a full pension for, say, 20 years of service.

Indeed, if a CEO is coming in from the outside, we can credit him with 20 years of service the day he walks in the door."

- And finally: "You know, where does it say we have to predicate pensions only on the sum of salary and bonus. How about predicating pensions on the sum of salary, bonus and free share grants?"

And there you have it. You have the lovely pension plan extended to Mr. Johnson.

As to the workers, Heinz froze defined benefit pensions as of Dec. 31, 1992, presumably replacing them with some sort of defined contribution plan.

But the senior executives at Heinz seemed to cruise through that bit of turbulence untroubled. They still had their SERPs.

Then on May 6, 2002, Heinz's board souped up Mr. Johnson's pension plan even more. Without getting into the details, the end result is the likelihood of an actuarially unreduced pension of 60 percent at age 60, with the 60 percent being applied not just to salary, and not just to salary and bonus but the sum of salary, bonus and free share grants. (Mr. Johnson is currently 59 years old.)

The total accrual for Mr. Johnson's pension for the fiscal year ended April 30, 2008 was $7.7 million, of which $4.7 million is directly traceable to the pension amendments made on May 6, 2002.

Thus, Heinz has ended up with a SERP within a SERP. Senior executives get a SERP, but Mr. Johnson gets a special SERP.

What is particularly troubling to me is that Heinz has included restricted (i.e., free) share awards in its definition of pensionable pay. Shorly after handing him this special SERP in May 2002, the board compensation committee declared in its proxy report that only a free share award in lieu of cash bonus would be included in pensionable pay. Somehow over the years, that morphed into the inclusion of any regular restricted stock award. For the years ended April 30, 2007 and April 30, 2008, Mr. Johnson received restricted stock awards that, at their grant, were worth, respectively, $800,000 and $1.4 million.

In a way, we have a little game going on here. A company may decide that offering a pension of more than 60 percent of final pay will draw a lot of flak. So the company quietly discloses a shift in the definition of pensionable pay, in this case from the sum of base salary and annual bonus to the sum of base salary, annual bonus and free share awards. That bit of capework is most often lost on the crowd. But it surely does soup up one's pension in dollars, while appearing to be continuing a "60 percent of final pay" policy.

Including free shares as part of the pensionable earnings base is not standard practice, so far as I know. And a leading compensation compensation consultant with whom I talked confirmed that point of view.

Heinz's board compensation committee, in a display of toughness, has drawn a line, though: Options profits will not count in determining Mr. Johnson's 60 percent of pay. I suppose we should be thankful for at least that favor.

Years ago, I had a client that kept pushing me to predicate his pension not only on base salary and bonus but also on option profits. I kept refusing. Finally, I said to him in exasperation: "Look, why don't we cut to the chase. We'll not only include the option profits in the defnition of pensionable pay but also the pension itself. I know that creates a mathmetical circularity, but with modern high-speed computers, we can run endless iterations – at least until your pension exceeds the revenues of the company!" Suffice it to say, my client quickly became my former client.

Throughout the Compensation Discussion & Analysis section of its various proxies, Heinz's board compensation committee has been at pains to justify what it has done in light of the practice of other comparable companies. Yet when I examined the accrued pensions for the CEOs of 14 companies listed as special pay comparators (as mentioned above, two other companies on the list have not yet released their proxy statements), I found that the pension accrual of $7.7 million for Mr. Johnson was not only the highest among the 14 companies but was 9.3 times higher than the accrual for the median company.

It is more than ironic that Heinz's board compensation committee chose to extend such largesse to Mr. Johnson on May 6, 2002. Between April 30, 1998, the day he became CEO, and May 6, 2002, Heinz's total return was negative 2.7 percent a year. That caused it to lag the S&P 500 Index by 2.7 percentage points and the S&P 500 Consumer Staples Index by an even worse 6.1 percentage points.

Heinz's 10-K says that its total pension contributions for 2008 were $60 million for all employees. I'm not sure whether that $60 million includes or excludes the $7.7 million accrued for Mr. Johnson. But either way, the result, in my opinion, is an obscenity. You have thousands of employees scratching after $60 million, while you have one employee carting away $7.7 million.

The Heinz compensation committee needs to be awakened from its evident stupor. Barring finding a way to get Mr. Johnson to soup up his performance for shareholders, the committee needs to hire a tree surgeon and take a chainsaw to his pay package.