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Abercrombie's Jeffries: Lousy Performance, High Pay

by Graef Crystal

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Michael Jeffries, the CEO of Abercrombie & Fitch Co. has been in his job a long time. Too long. His performance suggests that it's time for this 64-year old to go. Yet his board just signed him to a lucrative new five-year employment agreement.

Jeffries' Performance in 2008

Let's start with Mr. Jeffries' abysmal performance for the single year ended Jan. 31, 2009:

- Revenues dropped 5.6 percent.
- Operating income dropped 41 percent.
- Net income dropped 43 percent
- Diluted EPS dropped 41 percent.
- And for the piece de resistance, total return for the year was negative 77.2 percent. That compares to negative 38.6 percent for the Standard & Poor's 500 Index. Shareholders with a \$100 investment at the beginning of Abercrombie's 2008 fiscal year ended up with \$22 and change.

For that lovely set of stats, Mr. Jeffries received total pay of \$23 million in FY2008. (This figure includes the present value of option grants made in the same year.)

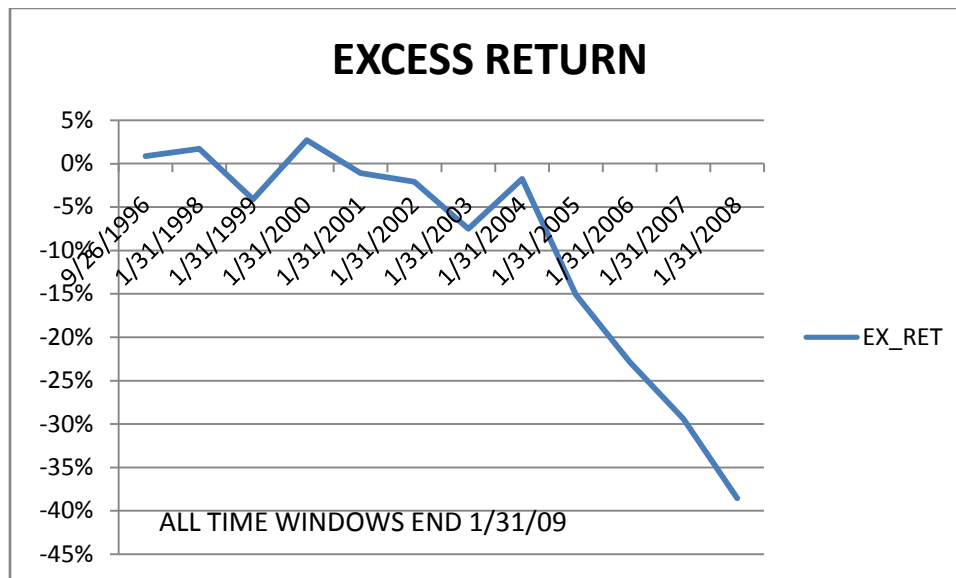
Jeffries' Performance over Longer Timespans

Mr. Jeffries took over Abercrombie in Feb. 1992. But the company did not go public until Sept. 26, 1996.

I measured Abercrombie's total return in 12 time windows. The first began on Sept. 26, 1996. The second began on Jan. 31, 1998. Thereafter, the start of each succeeding time window was incremented by one year, i.e., Jan. 31, 1999, Jan. 31, 2000, etc. All time windows ended on Jan. 31, 2009.

In each time window, the total return on the S&P 500 Index for that window was subtracted from Abercrombie's total return to produce an "excess return" series.

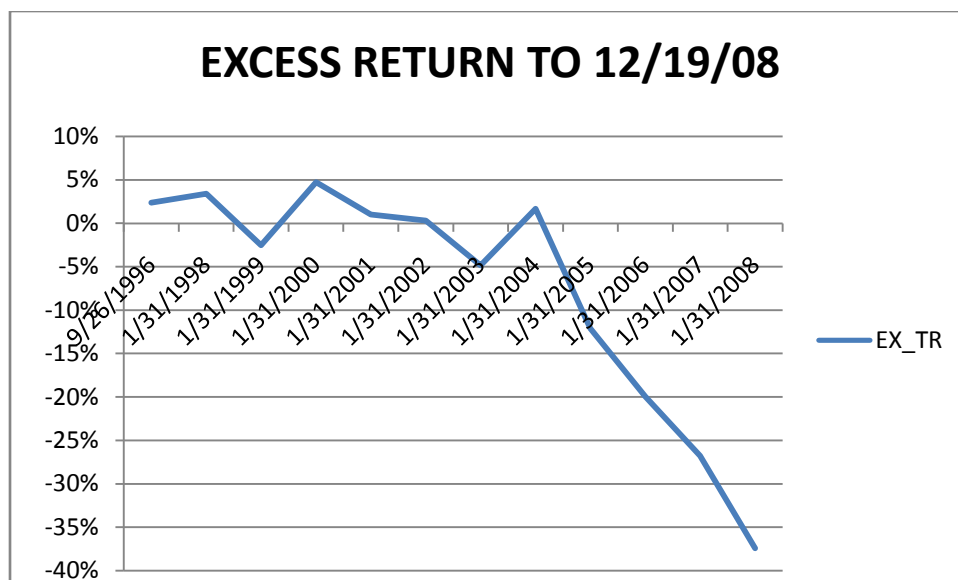
Here are the results:



As you can see, Abercrombie's excess return, which had hovered near zero for the first six time windows began to deteriorate sharply thereafter, reaching negative 15 percent, negative 23 percent, negative 29 percent and negative 39 percent in the most recent four time windows.

Still, what really matters is what Abercrombie's board compensation committee knew when on Dec. 19, 2008, it upped and gave him a new five-year employment agreement, one that will keep him working until just a few months before he reaches age 70.

Here is another chart, with the same start times as the earlier chart but with end times as of Dec. 19, 2008:



One has to ask the question here: Why reward a 64-year CEO with a new five-year employment agreement when his performance has been so dismal during the four-, three-, two- and one-year periods preceding the date of contract signing?

In fairness to Mr. Jeffries, it should be noted that his horrible performance in FY2008 was the root cause of the dismal showing in the two above charts.

If my time windows are re-calculated, but this time with end points, not on Jan. 31, 2009, but on Jan. 31, 2008, every time window shows a positive excess return, with the median time window generating a 12 percent excess return.

But what cannot be explained away is why his board, in extending him a new contract, blithely ignored the fact that the company's total return between Jan. 31, 2008, the beginning of the 2008 fiscal year, and Dec. 19, 2008, the date of contract signing, was negative 71 percent at a time when the Standard & Poor's 500 Index return was negative 34 percent.

“Stay” Bonus

In its Fiscal 2008, Abercrombie paid Mr. Jeffries a “stay bonus” of \$6 million. The payout was a holdover from his previous employment agreement, in which he was promised the \$6 million payout if cumulative EPS in the four fiscal years, 2005 through 2008, grew 13.5 percent a year or more.

In my experience, there are three different ways to measure EPS growth:

- Cumulative – In which a base period EPS figure – typically the EPS for the year prior to the beginning of the measurement period – is compounded by, in this case, 13.5 percent

four times. The four figures are added together. Then the actual EPS for the four years is compared to the cumulative target. It doesn't matter what the incidence of EPS is during the performance period, so long as the cumulative EPS for the four years hits or exceeds the target. This is the method Abercrombie used, and it was sufficient to ring the bell for Mr. Jeffries, despite that 41 percent decline in EPS in FY2008.

- **Point-to-Point** – In which the EPS in the fourth year are compared to the EPS in the year preceding the start of the four-year period. The EPS figures for the first, second and third years of the four-year performance period are ignored. On this basis, EPS growth at Abercrombie was 7.2 percent to 7.7 percent a year, depending on which definition of EPS you choose to examine. Under his former employment agreement, any EPS growth of less than 10.5 percent would have resulted in a “stay bonus” of zero.
- **Regression**—In which the base period EPS and the four EPS figures during the performance period are all plotted on a graph and a least squares trendline drawn. On this basis, EPS growth for Abercrombie would have been in the 9.2 percent to 10 percent range – better than the results under the point-to-point method but still less than the results obtained from the cumulative method. Again, had this method of measuring EPS growth been in effect, Mr. Jeffries’ “stay bonus” would have been zero.

Given his terrible performance in FY2008, it seems to me in retrospect that Abercrombie chose the wrong method.

Seasonal Bonus

On top of his \$6 million “stay bonus”, Mr. Jeffries also received a “seasonal bonus” of \$482,400 for his performance during the “Spring Selling Season”. He did not receive a bonus for the “Fall Selling Season”. It is highly unlikely that he would have received any bonus had the entire year’s results been taken into account. Abercrombie is not the only company that pays bonuses on less than a full year’s results. But all such companies, I believe, are wrong in doing so.

Out-of-Money Option Grants

A centerpiece of Mr. Jeffries’ new employment agreement is a multi-tranche option granted on Dec. 19, 2008, on which date the stock closed at \$22.84 a share:

- 800,000 shares carried a strike price of \$22.84, the market price at grant.
- 200,000 shares carried a strike price of \$27.41 a share, a figure that was 20 percent higher than the market price at grant.
- 200,000 shares carried a strike price of \$31.98 a share, a figure that was 40 percent higher than the market price at grant.

- 200,000 shares carried a strike price of \$36.54 a share, a figure that was 60 percent higher than the market price at grant.
- 200,000 shares carried a strike price of \$41.11 a share, a figure that was 80 percent higher than the market price at grant.

My first reaction was: That's pretty gutsy. At a time when a lot of CEOs are pulling the plug on stock options and going to squishy free shares, here we have Mr. Jeffries taking a big risk.

But that reaction became muted when I found that Abercrombie's stock was trading as high as \$84.51 a share on Oct. 10, 2007, little more than one year prior to the date of Mr. Jeffries' out-of-the-money option grants.

Mr. Jeffries has done very well with options in the past. Through Jan. 31, 2009, he realized gains upon exercise of \$221 million. As of the close on this April 17, though, all but 800,000 of his 7 million option shares outstanding were underwater. (The one that was above water was above water by \$816,000. That, ironically, was the at-the-market tranche of his multi-tranche option granted on Dec. 19, 2008.)

These new out-of-the-money options provide Mr. Jeffries with an insurance policy. Just in case the company's stock comes back, he stands to make a lot more money, even though he is treading the same ground more than once.

Indeed, if the stock reverts back to its \$84.51 high and if Mr. Jeffries exercises at that point, he would reap gains of \$341 million from his outstanding options as of Jan. 31, 2009, including \$90 million from the grants made on Dec. 19, 2008.

Aircraft Usage

Finally, we have a little item in the proxy that says Mr. Jeffries was given free personal air travel worth \$1.1 million, not counting the \$177,000 of tax gross-ups to pay for the personal travel.

Like many companies, Abercrombie does not calculate the true cost of travel by private jet. Excluded are the depreciation of the aircraft and monthly management fees. That depreciation is a big item.

It must take many, many flight hours to rack up a bill of \$1.1 million in **personal** travel. Maybe all those flight hours help to explain why the results for fiscal 2008 were so terrible.

To sum up, it seems to me that Mr. Jeffries' board should not have given him a new five-year employment agreement. Rather, it should have given him a gold watch, a fancy retirement dinner and then shown him the door.

2009 marks Graef Crystal's 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay.