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The Crystal Report on Executive Compensation

Apple Overpays Its COO

by Graef Crystal

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Apple Inc.'s board compensation committee apparently doesn't read the stock charts. In the face of terrible returns, it handed chief operating officer Timothy Cook a free share grant worth $25.6 million.

On Sept. 26, 2008, four days before the end of its 2008 fiscal year, Mr. Cook was granted 200,000 shares. The award vests in full on March 24, 2012, about three-and-one-half years following its grant.

At the time the grant was made, Apple's stock was trading at $128.24 a share, down from its high of $199.83 reached on Dec. 28, 2007.

Since the grant was made, Apple's stock has gone mainly down, closing at $82.33 on this Jan. 16.

To be fair, Apple had a terrific year in 2008, provided you ignore what happened to its stock price:

- Sales rose 35 percent to $32.5 billion compared to $24 billion for 2007.
- Operating income rose 42 percent to $6.3 billion.
- Net income rose 38 percent to $4.8 billion.
- And Diluted EPS rose 36 percent to $5.36 a share.

So why shouldn't Mr. Cook have been handsomely rewarded? (Counting the other elements in his pay package, his total pay for the fiscal year ended Sept. 30, 2008 was $27.1 million.)

Poor Shareholder Returns

Well, consider first that Mr. Cook is not the CEO of the company. COO's make much less.

Even more important, consider the following total return statistics in the six months preceding the grant:

- From March 26, 2008 to Sept. 26, 2008, total return was negative 11.6 percent. The return on the Standard & Poor's 500 Index was negative 8.6 percent, thereby producing a negative "excess return" of 3 percent. (Excess return is the amount by which Apple's return is more or less than the return on the S&P 500 Index.)

- From April 26, 2008 to Sept. 26, 2008, total return was negative 24.4 percent. The return on the S&P 500 was negative 12.4 percent, thereby producing a negative "excess return" of 12.1 percent.

- From May 26, 2008 to Sept. 26, 2008, total return was negative 29.2 percent. The return on the S&P 500 was negative 11.2 percent, thereby producing a negative "excess return" of 18.1 percent.

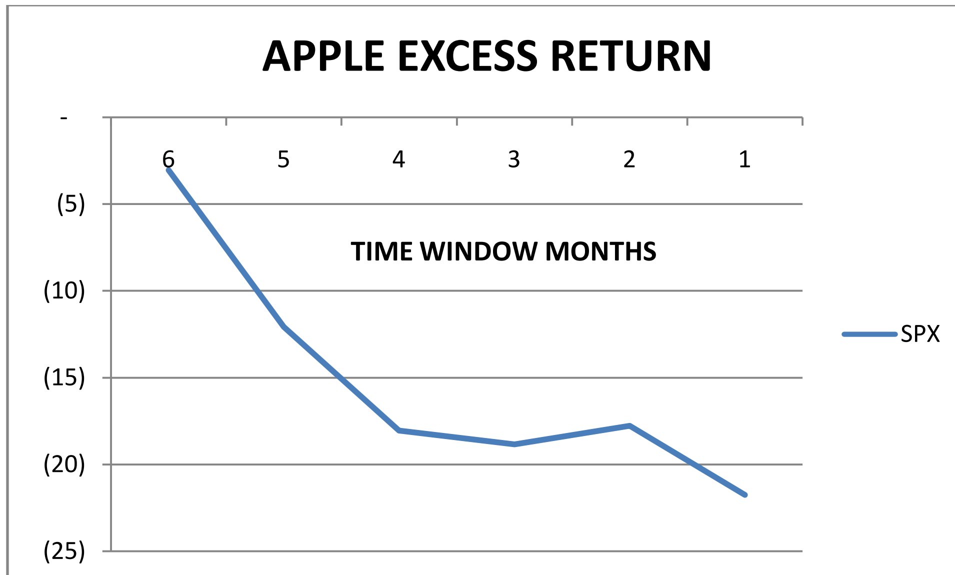
- From June 26, 2008 to Sept. 26, 2008, total return was negative 23.8 percent. The return on the S&P 500 was negative 4.9 percent, thereby producing a negative "excess return" of 18.9 percent.

- From July 26, 2008 to Sept. 26, 2008, total return was negative 20.9 percent. The return on the S&P 500 was negative 3.1 percent, thereby producing a negative "excess return" of 17.8 percent.

- From Aug. 26, 2008 to Sept. 26, 2008, total return was negative 26.2 percent. The return on the S&P 500 was negative 4.4 percent, thereby producing a negative "excess return" of 21.8 percent.

The key stat here is excess return, because it largely removes exogenous factors and allows the reader to get a better picture of Apple's true performance.

The following chart shows Apple's excess return in the six different time windows. The numerals in the chart refer to the length of the time window in months. Thus, "6" refers to the six-month time window ended Sept. 26, 2008, while "1" refers to the one-month time window ended Sept. 26, 2008.



You can see from this chart that things went from bad to worse.

As an alternative, I also compared Apple's returns in the same six time windows, in this case not to the S&P 500 Index, but rather to the 75-member S&P 500 Information Technology Index, a group of companies that includes Apple (which as of Jan. 16 had a weighting of 6.2 percent in the index's computation). The results were essentially the same, except that Apple didn't look quite as bad compared to this alternative index. This can be seen in the chart below.

In my opinion, total return is the most important measure to any shareholder. He can't eat operating income. He can't eat net income. He can only eat stock price appreciation and dividends.

So what could have motivated Apple's board to be so open-handed with Mr. Cook – and especially at the time it did?

Is it possible -- to give voice to one thought -- that even as early as Sept. 26, 2008, the board knew that things were not good for Steve Jobs, healthwise? That could be a rational explanation for a desperate desire to keep in the fold a talented executive like Mr. Cook.

Bloomberg News tracks many major publications. In the six months prior to the Sept. 26 grant date of Mr. Cook's free share award, I found 28 references to Mr. Jobs' health. The first reference during this six-month period occurred on June 13. The most frequent references occurred on July 22 (four references), July 23 (six references) and Sept. 9 (five references). The last-mentioned date was just 17 days before Mr. Cook received his free share award.

But Apple's vaunted PR department has for months put out news suggesting that whatever was ailing Mr. Jobs was not all that bad and could be easily corrected.

Until last week.

The Signals Being Sent

There's something else to consider here. And that involves Apple's use of free shares, as opposed to option shares.

In the olden days of Silicon Valley, the he-men sitting around the campfire lambasted the wimps in other companies who used free share grants. (There were no he-women at the time. Carly Fiorina had not yet showed up. Carol Bartz, who on this Jan. 14 became the CEO of Yahoo! Inc., previously headed Autodesk Inc., but the latter firm is not physically located in Silicon Valley.) To them, real men used stock options. No increase in stock price, no pay. Of course, it also helped back then that stock options did not trigger any charges to earnings.

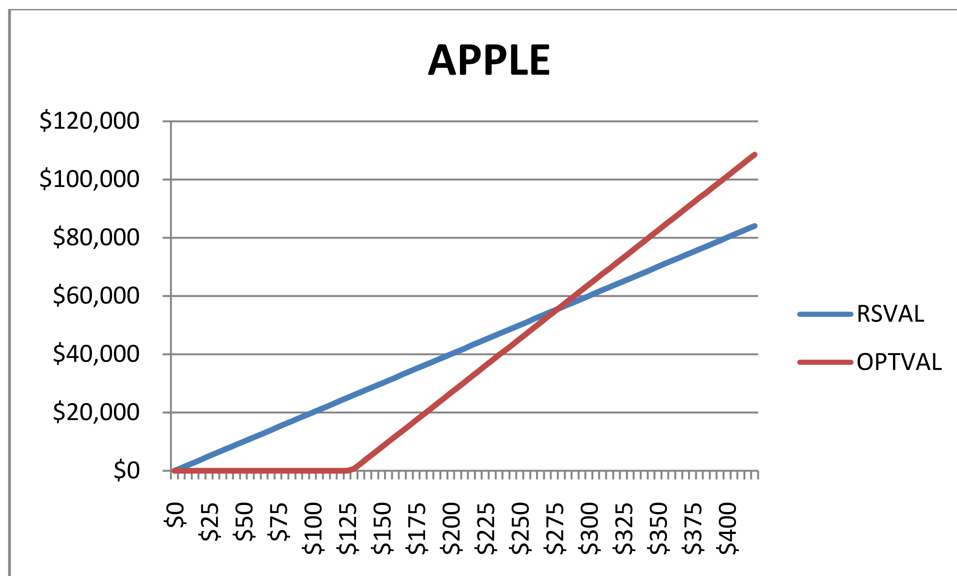
Free share grants, on the other hand, offer downside protection to an executive. Unless the stock price drops to zero, there is always pay. And even if the stock price does drop to zero, there can still be pay, given that the executive would have received any dividends declared before the company's demise.

Question: If 200,000 shares of Apple stock are worth $25.6 million when granted, how many option shares would it take to provide an equal grant date present value?

Answer: 372,059 shares, according to my Black-Scholes analysis.

Another question: At what future stock price, would the value of the 200,000 free shares and the gain in the 372,059 option shares be equal?

Answer: At a future price of $277.30 a share, as can be seen on the following chart:



Given the $128.24 price on the date the free shares were granted, it would take only an 8 percent annual rate of stock price appreciation to achieve a $277.30 price when the option expired at the end of its traditional 10-year term.

So the decision to take free shares in preference to a larger number of option shares may suggest either that senior executives in a particular company are risk averse or that they are not bullish on the future of the company – or both.

Now that Apple's stock has declined to $82.33 from the $128.24 price prevailing when Mr. Cook received his enormous free share grant, you can see that Apple's board made the right choice – for Mr. Cook, as opposed to the company's shareholders. Mr. Cook is sitting with shares still worth $16.5 million. That's a lot of money for driving down your stock price at a steeper rate than the decrease in stock prices at other companies.

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, 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. He is now teaching a course in executive compensation at the University of California at Berkeley's Boalt School of Law.