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The Crystal Report on Executive Compensation



American Express' Chenault: A Perfect Example of Wall Street Excess

by Graef Crystal

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Kenneth Chenault, the CEO of New York-based American Express Co. (Ticker Symbol: AXP), is a perfect example of the pay dysfunction that was the norm in Wall Street prior to the Big Crash.

Mr. Chenault's compensation committee seemed totally out-to-lunch when it took certain actions on November 30, 2007 and again on Jan. 31, 2008.

Multiple Long-Term Awards

On the latter date, he received multiple long-term incentive awards, as follows:

- A cash-based long-term incentive award opportunity to be predicated on performance during the 2008 through 2010 period. The "target value" of this award was reported in the company's proxy as \$6.5 million.
- A free share award covering 122,124 shares of stock and valued at grant at \$6.0 million.
- A regular option covering 625,000 shares and carrying a strike price of \$49.13 a share and a term of 10 years. This option vests through the passage of time. The company declared the grant date fair value to be \$5.2 million.
- A "special" stock option covering 1,375,000 shares and also carrying a strike price of \$49.13 a share and a term of 10 years. This option will vest only if multiple performance conditions are met over a six-year period. The company declared the option to have a grant date fair value of \$19.4 million.

Add up these four grants and you get a eye-popping \$37 million.

The aforementioned long-term incentive grants were all reported in the proxy covering the year 2008 that was filed with the U.S. Securities and Exchange Commission on March 16, 2009. But it seems clear to me that these grants relate to performance in 2007 and not in 2008. Among other things, they were all made just 31 days following the end of the 2007 fiscal year.

AXP Performance Through 2007

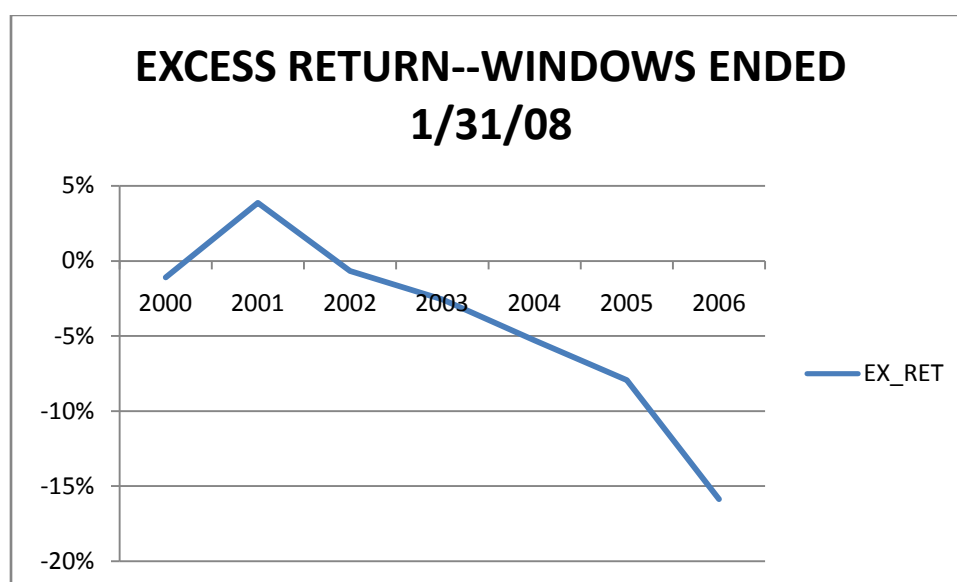
Looking only at AXP's income statement, 2007 was a fairly decent year. Net revenue was up 9.6 percent, operating income was up 8.8 percent and net income was up 8.2 percent. But to my way of thinking, those stats were in no way sufficient to produce an incentive package of the size described above.

Then there is the crucial issue of total return. Let's restate the famous question uttered time and again during the Nixon Watergate hearings: "What did the AXP comp committee know, and when did it know it?"

Mr. Chenault became CEO of AXP on Dec. 31, 2000. Here, I created seven time windows of total return. The first began on Dec. 31, 2000. The start of each succeeding time window was incremented by one year, i.e., Dec. 31, 2001, Dec. 31, 2002, etc. All seven time windows ended Jan. 31, 2008, the day the AXP comp committee showered Mr. Chenault with rewards.

In each of the time windows, I calculated the annualized total return and then, to produce a so-called "excess return" series, subtracted the return on the Standard & Poor's 500 Index for the same time window.

The results may be seen on the following chart:

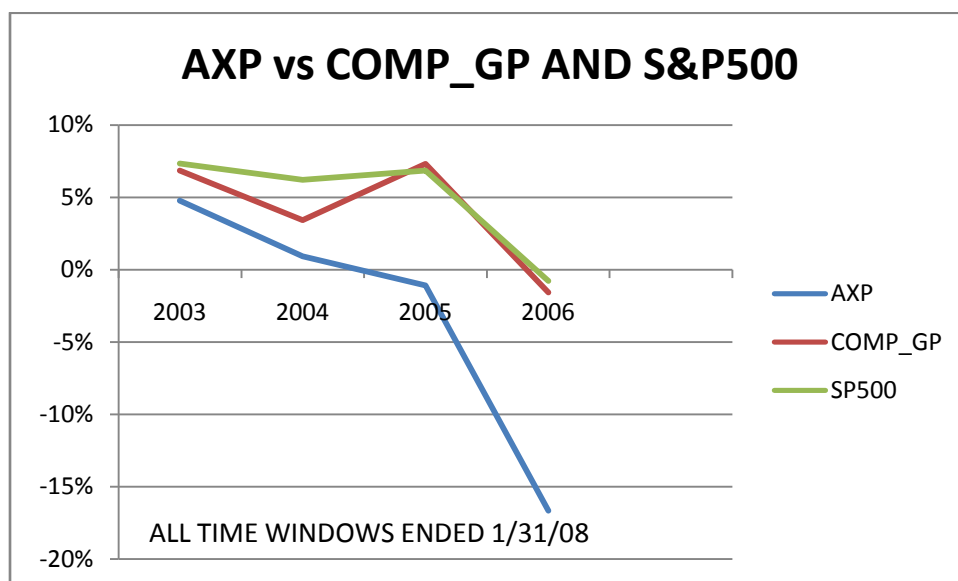


As you can observe, there was but one time window out of seven where the excess return was positive. Moreover it became more and more negative as the time window was narrowed, culminating in a negative 15.9 percent excess return for the period, Dec. 31, 2006 through January 31, 2008.

In its proxy, AXP disclosed its use of a comparator group for pay (and presumably performance) purposes. It consisted of 22 major companies, eight of them in the banking industry, but also such key companies as IBM, Johnson & Johnson and General Electric.

For each of the 22 companies, I calculated its total return in four time windows. The first began on Dec. 31, 2003, the second on Dec. 31, 2004, etc. All time windows ended on Jan. 31, 2008.

Herewith a chart showing for each of the four time windows: 1)The median annual total return for the 22 companies; the return on the S&P 500 Index and AXP's total return:



Two things emerge here. First, there is fundamentally no difference between these 22 companies, taken as a group, and the S&P 500 Index – at least during these periods.

But second, there's a big difference between the performance of these companies and the S&P 500 Index, on the one hand, and AXP, on the other hand. In every time window, AXP underperforms, and as the time window narrows, the degree of underperformance increases.

And remember that, in all these total return analyses, the period ends on Jan. 31, 2008, i.e., before the Big Crash, which didn't occur until around the end of Sept. 2008. From a close price of \$49.13 on January 31, 2008, AXP's stock plunged to \$17.23 a share on Nov. 20, 2008.

The "special" stock option granted on Jan. 31, 2008 – the one covering 1,375,000 shares – wasn't, as it turned out, so "special". That's because the comp committee also handed Mr.

Chenault an earlier “special” option covering the same number of shares. The grant date of this option was Nov. 30, 2007, just two months earlier. It carried a higher strike price of \$58.98 a share and also carried a term of 10 years. The company declared this earlier option to have a grant date fair value of \$24.9 million.

So why did the company make one grant of 1,375,000 shares on Nov. 30, 2007 and a second one two months later? The answer appears to lie in a maximum granting limit of two million shares per year. So to get around that, one simply splits the grant in half --with half being granted in 2007 and the other half being granted in 2008. So much for following the spirit of the share restriction.

In its proxy filed on March 14, 2008, the company said that it made this grant “to provide additional incentive and reward for continuing a high level of performance.” In the same paragraph, the committee also referred to its decision to make the second grant on Jan. 31, 2008.

Let’s parse the quote in the immediately preceding paragraph:

- “Reward for continuing a high level of performance” – In the year ended Nov. 30, 2007, AXP’s total return was 1.46 percent. That compares to a return of 7.7 percent for the S&P 500 Index and a median return of 6.8 percent for the 22-company comparator group. So the question here is: “What high level of performance”?
- “To provide additional incentive” – So let’s see, Mr. Chenault was given a strong motivational boost on Nov. 30, 2007, when the stock was selling for \$58.98 a share. Two months later, when the second 1,375,000 million share grant was made, the stock was selling for \$49.13 a share. Apparently, Mr. Chenault must have needed even more motivation than two grants, each covering 1,375,000 million shares, could provide.
- As if to underscore this last point, consider that AXP stock closed on July 2 at \$22.27 a share.

Of course, neither of these two “special” grants may ever vest, given the performance vesting conditions attached to them. As Martha Stewart is wont to proclaim: “It’s a good thing!”

In fairness to Mr. Chenault and his compensation committee, no bonus was paid for the company’s horrible performance during 2008, which featured, among other things:

- A 30 percent decline in operating income.
- A 33 percent decline in net income.
- A total return of negative 64 percent for the year. That compared to a negative 37 percent return for the S&P 500 Index and a negative 25 percent return for the comparator group.

If you want more proof of Mr. Chenault’s ineptness, consider that as of Dec. 31, 2008, he was holding unexercised options covering 9.6 million shares, and every last share was underwater.

Indeed, given the \$22.27 close price on this July 2, it would take a 31 percent increase in AXP's stock price just to bring the past-granted option with the lowest strike price to the water line. His remaining 13 outstanding options would still be underwater.

It should be noted that, in addition to receiving no bonus for 2008, Mr. Chenault also took a 10 percent salary cut, effective March 30, 2009.

It's never too late to get religion. But AXP's comp committee's actions in Nov. 2007 and Jan. 2008 offer some persuasive evidence – at least before the bottom fell out of the banking stocks and Federal pay controls were imposed– that pay-for-performance was a dead letter at AXP. We just had high pay, period.

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The members of AXP's compensation committee, as reported in the 2009-filed proxy are:

- Jan Leschly, founder and partner, Care Capital LLC
- Peter Chernin, COO of News Corp. (he of the \$8.1 million base salary!)
- Richard McGinn, general partner, RRE Ventures
- Edward Miller, former CEO, AXA Financial Inc.
- Robert Walter, founder, Cardinal Health Inc.

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.