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*The Crystal Report on Executive Compensation*



## **Cisco's Chambers Wimps Out**

**by Graef Crystal**

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There's good and bad to like about what Cisco System's comp committee did for John Chambers, its longtime CEO. The company's proxy statement covering the year ended July 31, 2009 was filed with the U.S. Securities and Exchange Commission on Sept. 23.

### **THE GOOD**

First, the good:

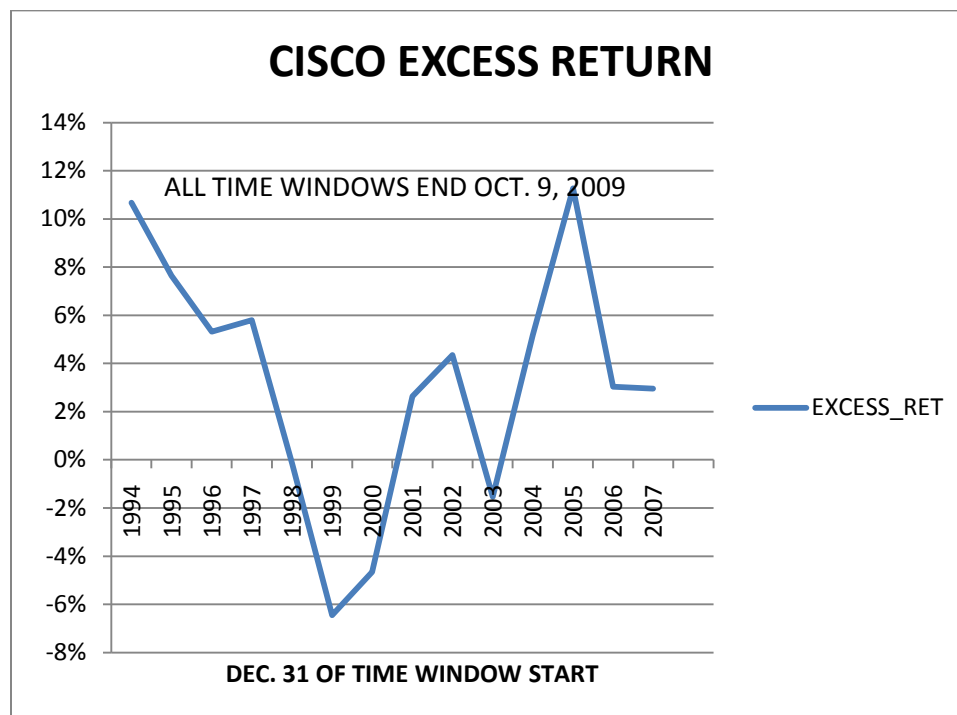
- His short-term and long-term performance has generally been fine.
- At least for the past three years, he has been paid far less than his peers.

I examined Cisco's total return in 14 different time windows. The first began on Dec. 31, 1994, the end of the month before Mr. Chambers became CEO. It ended this Oct. 9. Each succeeding time window's start date was incremented by one year, e.g., Dec. 31, 1995, Dec. 31, 1996, until we reach the time window beginning Dec. 31, 2007. In the case of all 14 time windows, the end date was the same Oct. 9, 2009.

For each time window, I calculated Cisco's "excess return", defined as the amount by which the company's total return exceeded (or was under) the return in that time window for the Standard & Poor's 500 Index.

Looking at all 14 time windows, Cisco's median excess return was 3.7 percentage points. The company had a positive excess return in 10 of the 14 time windows, or in about two-thirds of the windows. More than that, the excess returns in the four narrowest time windows were all positive.

The following chart tells the story:



In each of the last three years, I have examined Mr. Chambers' total pay and compared it to the pay of several hundred other large-company CEOs, after controlling for differences in company size and pay risk. (The latter is defined as the ratio of option present value to total pay, options being generally considered the most risky portion of a CEO's pay package.) The most recent of the three analyses, that for 2008, covered 356 companies, all with then market caps of \$2 billion or higher.

(Total pay means the sum of: 1)Base salary; 2)Annual bonus; 3)The grant date fair value of stock options and free share awards made during the year; 3)The target value of long-term performance grants made during the year; 4)The present value of additional pension benefits; 5)Deferred compensation; and 6)Miscellaneous compensation.)

For Cisco's fiscal years 2007, 2008 and 2009, Mr. Chambers' total pay positioned him, respectively, 31 percent, 30 percent and 60 percent below the market.

Good performance combined with below-market compensation is the "sweet spot" in the pay tennis racket. And Mr. Chamber's racket has a large sweet spot.

So after all that good stuff, what could be bad about his pay?

## THE BAD

Well, the first thing is his bonus of \$2 million for the year ended this July 31. Considering that Cisco's revenue dropped to \$36 billion from \$40 billion; that its operating income dropped to \$7.4 billion from \$9.4 billion; that its net income fell to \$6.1 billion from \$8.1 billion; and that its Diluted EPS fell to \$1.05 from \$1.31, he was not entitled to a bonus. And that's not me talking. That's his bonus plan talking. Yet his comp committee decided to give him a bonus anyway to recognize that he was working in a tough business environment.

Of course, had no bonus been paid, Mr. Chambers would have fallen even further below the market. But I'm sort of a purist. If you point to centerfield and then fly out, you should not receive any rewards for "trying" or because the wind was blowing against you when you hit the ball.

Then there is Mr. Chambers' long-term incentive package.

My friend and colleague Matt Ward at Radford used to draw a sharp contrast between the Silicon Valley companies and what he called the "Stodgecos".

The Stodgecos were fond of long-term incentives with soft creamy centers – the kind where you couldn't break a tooth when biting into them. The purest example of such an incentive is a free share award, which is earned by breathing in and out 17 times a minute for, typically, three to four years. You don't really have to perform so much as stick around. And if the stock drops, you still are rewarded, save only if the stock drops to zero and then only if you haven't reaped any dividends before the cataclysm.

The Silicon Valley firms, on the other hand, were "he-men" (some of them were even women). None of that soft creamy center stuff. These folks bit down on nuts and chews and not infrequently lost a few teeth. Their favorite way of paying people was to give them stock options.

In the real world, of course, things got somewhat blurred. The Silicon Valley folks may have favored options, but if the stock dropped, they often "repriced" the options, or worse, let the CEO keep his underwater options and gave him a shiny new one with a lower strike price.

In Mr. Chambers' case, he was reported to have received stock options in every proxy statement filed electronically. (The first statement covered the year ended July 31, 1995.) And he did not receive any of the soft, creamy stuff.

Until the year just ended, when for the first time, he did not receive a stock option at all but rather was handed a 135,000 free share award that vests over four years. The company declared the award to be worth \$3.1 million at the time of its grant.

This wimpy behavior prompted me to look at 32 large companies (including Cisco), all in the GIC Industry Groups covering computers, semiconductors, software, telecommunications and the internet.

Options continued to be favored by these 32 companies, with 22 of them making grants in 2008.

But 15 of the companies also granted free shares. And nine granted long-term performance awards.

Since the aforementioned three numbers add up to 46 and since there are only 32 companies in the group, it is obvious that several of the companies made more than a single long-term incentive grant.

So John Chambers is certainly not alone in reaching for the creams in the box of chocolate.

But I'm afraid that, given these stats, Matt Ward's sharp distinction between the Stogecos and the Silicon Valley crowd has been blurred to the point of no longer being useful.

There's no more sitting around the campfire and telling manly stories. Now your typical Silicon Valley CEO can be found at Starbucks sipping a latte with his newfound Stodgeco friends.

The compensation data used in this article were obtained from Equilar Inc., a leading provider of executive compensation information. Please click here to go to Equilar:

<http://www.equilar.com>

2009 marks Graef Crystal's 50<sup>th</sup> 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.