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## **Decoupling Pay from Performance at Flextronics**

**by Graef Crystal**

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How does a board justify a CEO pay package worth \$30 million when the company's shareholders lost 69 percent of their investment in a single year?

The company is Flextronics International, a Singapore-headquartered company providing electronics manufacturing services. The CEO is 52-year old Michael McNamara, who has been in his job since January 2006.

For its fiscal year ended this past March 31, Flextronics's total return was negative 69 percent, at a time when the return on the Standard & Poor's 500 Index was negative 38 percent.

In its income statement, Flextronics also disclosed a 31 percent decline in operating income. As for its net income, the percentage decline is not capable of calculation. For the year ended March 31, 2008, net income was negative \$639 million. For the year ended March 31, 2009, it was about 10 times worse – negative \$6.1 billion.

### **McNamara's Pay Package**

Mr. McNamara's base salary was frozen last year compared to the year before. And his bonus went down – to \$2.9 million from \$6 million, for a decrease of 52 percent.

That's a substantial decrease. But the aforementioned performance offers strong evidence that the bonus should have declined, not to \$2.9 million from \$6 million, but rather to zero from \$6 million. One reason it did not is that Flextronics allows for three bites at the bonus apple: At the end of the first quarter, at the end of the second, and at the end of the third and fourth quarters. So one bad quarter, or even more than bad quarter, can mitigate the damage to one's bonus.

In fairness to Flextronics, this practice of less-than-annual bonus periodicities has come into favor at quite a few high-tech firms. In an age, though, where Barack Obama, Timothy Geithner and Barney Frank are all preaching that the root cause of our recent near-death experience was short-term bonuses, the notion of quarterly bonuses may today be seen as outmoded, if it ever was “moded”.

Mr. McNamara participated in multiple incentive grants in its 2009 fiscal year:

- The aforementioned bonus plan.
- A performance share grant covering the FY2009-2011 period, with a reported grant date present value of \$5.3 million. (Given the company’s performance in FY2009, the comp committee is not optimistic that the share grant will ever vest.)
- A long-term cash bonus award with a target value of \$3 million. (The comp committee is not optimistic about this award either.)
- A free share grant covering 500,000 shares worth \$970,000
- And four different option grants, each covering 2 million shares.

### **Comparator Group**

In its proxy filed on this Aug. 7, Flextronic’s comp committee listed 24 high-tech companies as comparators, the great bulk of them electronics companies. The companies were selected by the committee’s independent compensation consultant, Frederic W. Cook & Co. (The complete list may be found on page 31 of Flextronic’s proxy statement.)

On its face, the group seems totally relevant for comparison purposes.

Let’s look at the total return performance of these 24 companies for their most recently-completed fiscal years.

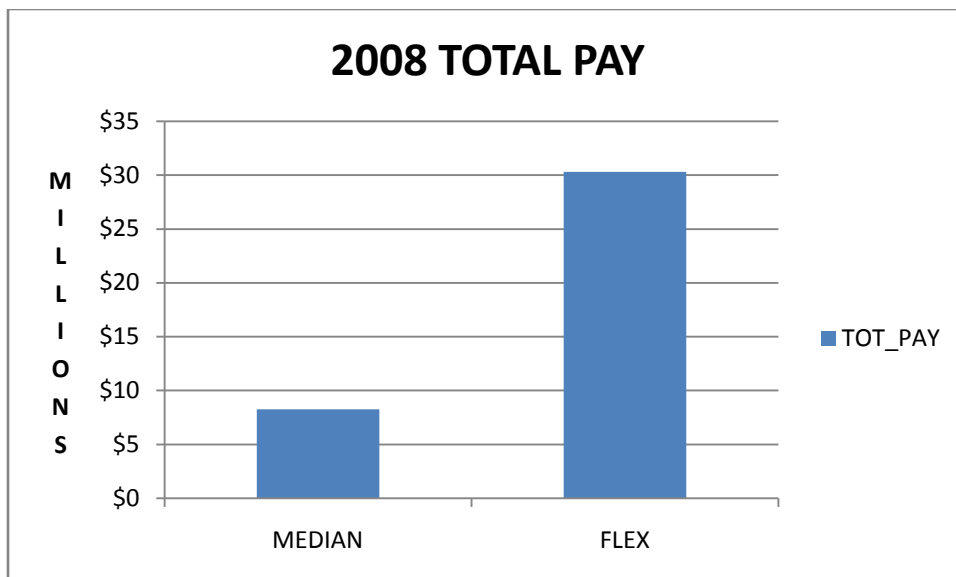
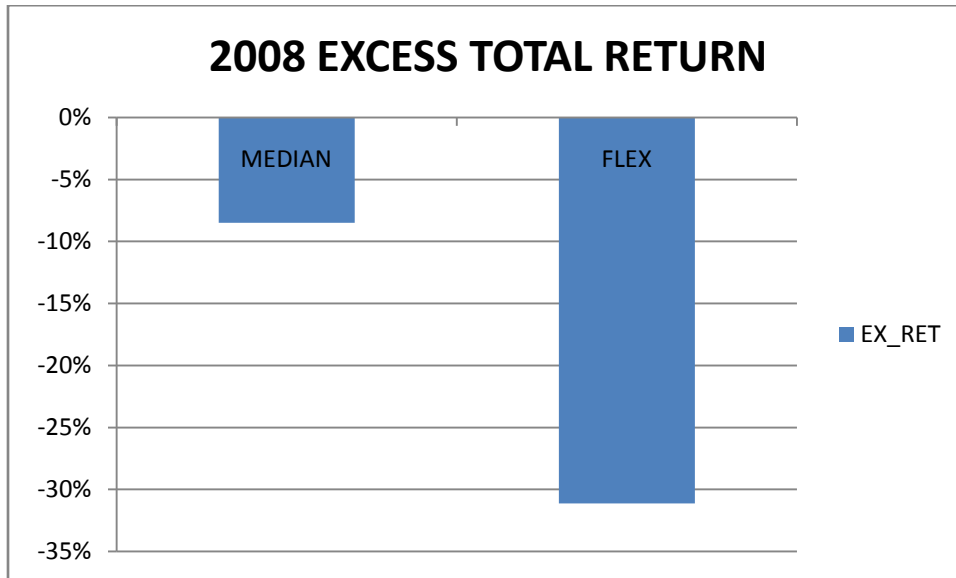
In each case, I calculated an “excess return” for the company by subtracting from its total return in the company’s most recently-completed fiscal year the total return on the S&P 500 Index. For the median company, the excess return was negative 8.5 percent. For Flextronics, it was negative 31.1 percent.

Turning to pay, the median company, according to Equilar data (the option values of which were discounted by me by 22 percent to account for the fact that executives rarely wait until the last day of an option’s term to exercise it), paid its CEO \$8.2 million versus the \$30.3 million paid by Flextronics.

(Total pay, as used in this article, is the sum of: 1)Base salary; 2)Annual Bonus; 3)The target value of long-term performance grants [shares or cash] made during the year; 4)The value at

grant of free share grants made during the year; 4)The grant date present value of option grants made during the year; 5)The value of deferred compensation grants during the year; 6)The increase in lump-sum pension value; and 7)Miscellaneous compensation [mostly perquisites.]

The following two charts tell the story. The first compares Flextronic's total return to that of the median company in its comparator group. The second compares Flextronic's CEO total pay to that of the median company in the same group.



It's hard to make out a case of pay-for-performance when a company's performance is roughly four times worse than that of its comparators, while its pay is roughly four times higher.

Mr. McNamara's long-term performance record is a bit better than his record in Flextronic's last fiscal year.

Mr. McNamara became CEO on Jan. 3, 2006. Between that date and March 31, 2009, the end of Flextronic's last full fiscal year, excess return for the company was negative 21.2 percent a year. That compares to a median return of negative 3.8 percent for the 24-company comparator group.

There is some good news to report, though. Between March 31, 2009, the end of Flextronic's fiscal year and the close on this Sept. 15, Flextronic's total return was a spectacular 139 percent. That compares to a return for the median company in the comparator group of 64 percent and a return on the S&P 500 Index of 33 percent

### **Option Grant Timing**

Earlier, I mentioned that Mr. McNamara received four different option grants during the fiscal year ended March 31, 2009, each covering 2 million shares.

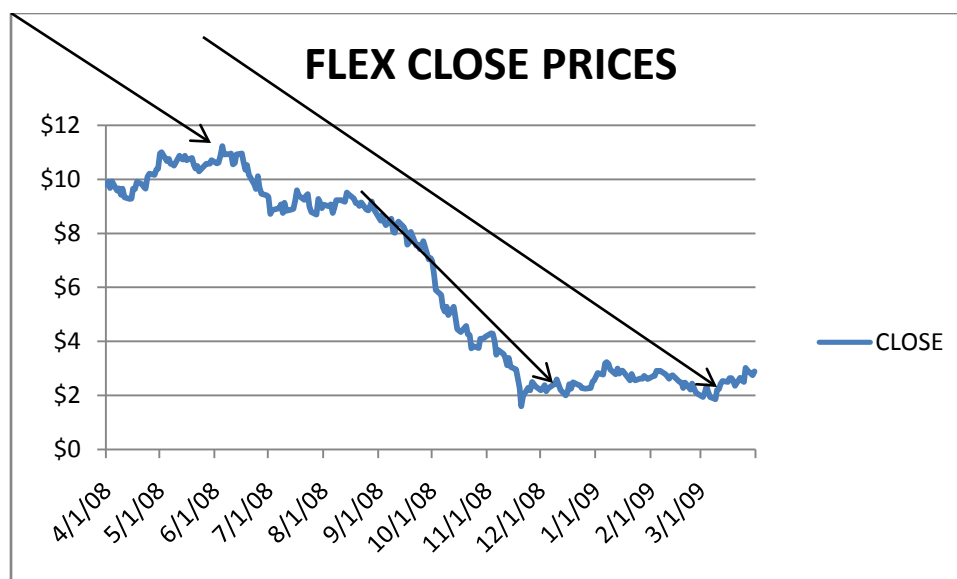
The first two grants were made on the same day, i.e., June 2, 2008. They both contained a strike price of \$10.59.

To put that price in perspective, Flextronic recorded a high closing price of \$14.25 in the three years preceding this grant. That high price was attained on July 20, 2005.

The third grant was made on Dec. 5, 2008. By this point, the stock had sunk to \$2.26.

The fourth grant was made on March 2, 2009. At that time, the stock price had declined all the way to \$1.94.

Herewith a chart of daily closing prices showing the positioning of the four option grants:



If the two June 2, 2008 grants covering 4 million shares failed to motivate Mr. McNamara, why did his comp committee decided to reinject him – not once more but twice more – with this failed drug?

Well, there’s one thing we know, and one thing one might suppose.

The thing we know is that Flextronic’s outside compensation consultant, Frederic W. Cook & Co., had nothing to do with these last two grants. The decision to make those grants was made by Flextronics’ comp committee on its own.

And for the supposition? When a stock drops from \$10.59 on June 2, 2008 to \$2.26 on Dec. 5, 2008 to \$1.94 on March 2, 2009, that decline is not infrequently viewed as “party time!”.

Two points need to be made here. The first applies not merely to Flextronics but to many high-tech companies, and it comes under the admonition: “Be careful what you pray for”.

For many years, but especially in the 1980s and 1990s, if a high-tech company’s stock sagged, the remedy of choice was to “reprice” stock options. So, to use Flextronics as an example, if you received on June 2, 2008 options covering 4 million shares and carrying a strike price of \$10.59, and if the stock price subsequently plunged to \$2.26 or \$1.94, you invited the executive to return his 4 million now-underwater shares to the company, and you re-issued him 4 million more shares carrying the lower strike prices.

But that practice of repricing attracted strong criticism, none more pungent than from yours truly. As a consequence, many companies quietly shifted to the approach used by Flextronics, namely, keep your 4 million now-underwater option shares and here’s 4 million more shares. That approach was abetted by the Sac’s then proxy disclosure rules, which required that a company

doing a repricing include a 10-year table showing all past repricing for all listed executive officers, even those who had already left the company – or, for that matter, left the earth.

This alternative approach attracts less criticism, but in the end, it could cost the shareholders dearly, i.e., when the future stock price before expiration of the earliest-granted option rises above that option's strike price and causes that option to go into-the-money.

So it's hard for me to heap too much blame on Flextronics, when it is merely following the same undesirable practices of many other high-tech companies.

The second point involves backdating vs. opportunistic pricing.

Option backdating – the practice of deciding after the fact that you really gave an option at an earlier date when the stock price was to your taste – is clearly illegal.

But Flextronics did not backdate its options. Its Dec. 5, 2008 grant, the one carrying the stock price of \$2.26 a share, was reported to the SEC on Dec. 8, the very next trading day. And its March 2, 2009 grant, the one carrying the stock price of \$1.94, was reported to the SEC on March 3.

It is not illegal, though – so far as I know – to time an option grant when the market price seems to be ultra-low.

The Flextronics comp committee didn't quite hit the low in the stock price, which occurred seven days after the March 2, 2009 grant, when the stock closed at \$1.86. But it got awfully close.

On Sept. 15, the stock closed at \$6.92. That means those last two option grants – the ones the consultant didn't recommend be granted – have produced paper profits for Mr. McNamara of \$19 million. And that in only about seven months after the grants were made.

The Flextronics case points up the need for boards, comp committees and consultants to ponder seriously these two questions:

- Is there any reasonable rationale for dropping the periodicity of a bonus below one year?
- What should a company do with stock options in a falling stock-price environment? Repricing has odiferous PR. Allowing the executive to keep his underwater grants and then giving him new ones could have negative cost consequences. Indexing the option's strike price to that of a comparator group may help but also introduces an added element of randomness to the proceedings. And finally, doing nothing at all could cause a drain of vitally-needed talent. In short, there do not appear to be any perfect solutions here.

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The members of the Flextronics compensation committee are:

- James Davidson, 50, co-founder and managing director of Silver Lake, a private equity investment firm.
- Rockwell Schnabel, 72, founding partner and advisory director of Trident Capital Partners. Mr. Schnabel is retiring from the board following the Sept. 22 annual meeting.

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.