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The Crystal Report on Executive Compensation



Gilead's Martin: Super Performance, The Right Incentives

by Graef Crystal

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After serving up one critical article after another, it's time for a change-up pitch – to deliver some high praise.

The praisee in this case is John Martin, the long-serving CEO of San Francisco area-based Gilead Sciences Inc.

Performance

It's easy for many a CEO to claim he is a high performer, provided you allow him to select a single beginning and a single ending date during which to measure his total return to shareholders.

But it's a lot tougher for a CEO to show up as high performing when his performance is measured in multiple time windows during his tenure, stretching from a window covering his entire tenure down to a single-year time window.

Dr. Martin (he holds a Ph.D. in chemistry from the University of Chicago) is in that rare latter category.

I measured his performance in 13 different time windows. The first began on April 30, 1996, the day before he became CEO. The second began on Dec. 31, 1996. Thereafter, each succeeding time window began one year later, i.e., Dec. 31, 1997, Dec. 31, 1998, etc. All time windows ended Dec. 31, 2008.

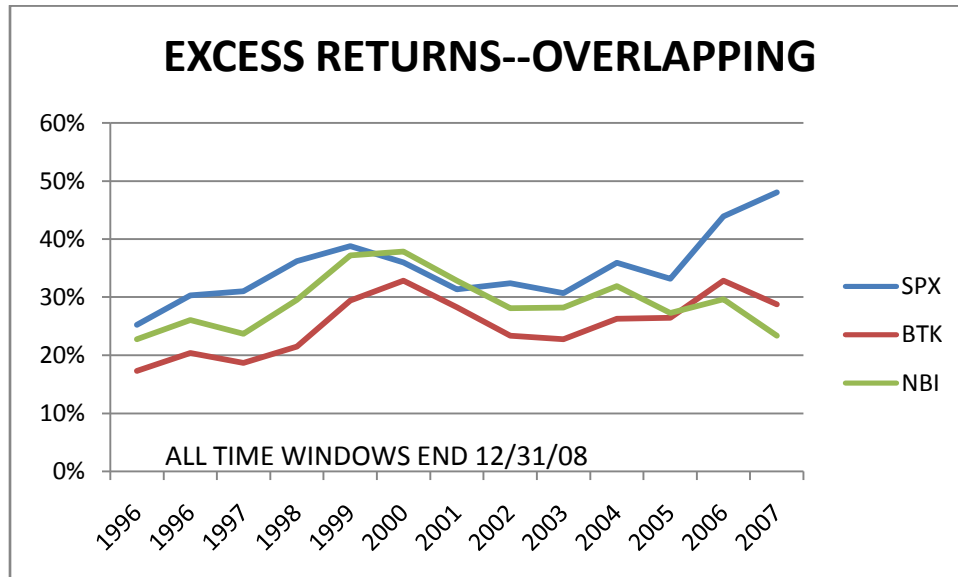
For comparison purposes, I selected three indices:

- The Standard & Poor's 500 Index.

- The AMEX Biotechnology Index (BTK), consisting of 20 members, including Gilead.
- The NASDAQ Biotech Index (NBI), consisting of 133 members, including Gilead.

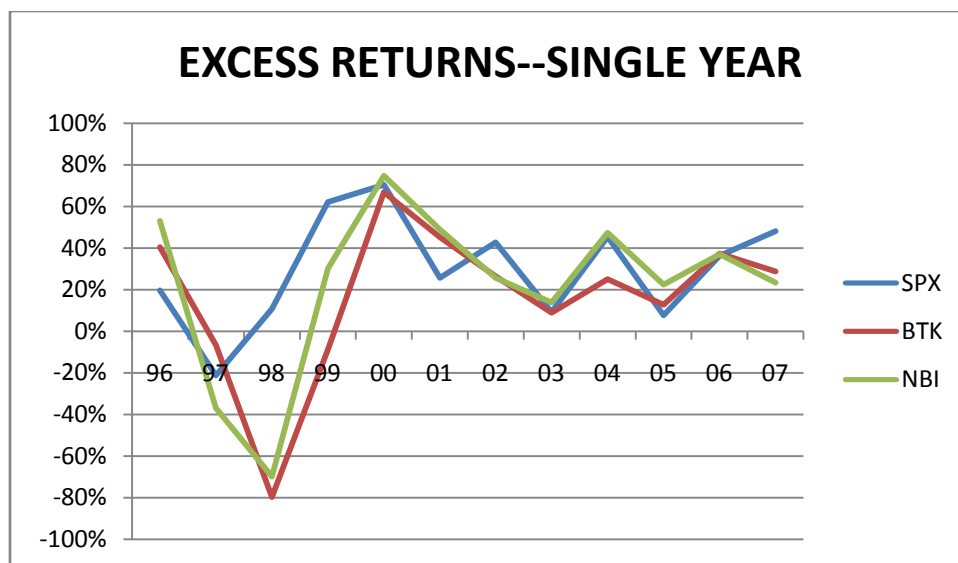
In each case, I subtracted the compounded annual total return on the particular index from Gilead's return to produce a so-called "excess return".

Herewith a chart showing the excess returns in all 13 time windows for the three indices.



As you can see, Gilead produced a substantial positive excess return in all time windows. The median excess returns for the three indices were: 33 percentage points for the S&P 500; and 26 percentage points for both the Amex Biotechnology Index and the NASDAQ Biotech Index.

A second chart shows the year-by-year excess returns for the three indices. In this case, each time window consists of a single year, beginning with the year shown on the horizontal axis.



The median excess returns for all single year time windows were 31, 26 and 28 percentage points for the three indices, and in the order discussed above.

So this we know: Dr. Martin is no flash-in-the pan performer. He has a long track record. And it is superb.

Pay

For the years 1996 through 2006, Dr. Martin received a single long-term incentive: stock options.

As of Dec. 31, 2008, he had reaped gains of \$155 million. But as of the same Dec. 31, 2008, he was holding 19.6 million unexercised option shares. Assuming all those shares were still unexercised as of the close on this May 15, they would contain paper profits of a further \$635 million.

There was no namby-pamby restricted stock grants made during all those years.

However, in 2007 and 2008, the company adopted a second long-term incentive plan: contingent performance shares to go along with option grants.

A cynic could see this as a diversification move designed to shield Dr. Martin from an intense downturn in his company's stock price.

And to some degree, that cynic might be right.

Another reason for the new plan might be the fact that the company now has two compensation consultants – one for the management and one for the compensation committee. Compensation

consultants do not maximize their revenues by declaring things to be fine as they are. (I remember a *New Yorker* cartoon from years back. A management consultant is standing in front of a CEO seated at his desk. The consultant says: “We have looked into all facets of your business, and we find you are doing everything right. Here’s our bill for \$500,000”.)

Still, the new performance share plan is itself pretty tough – at least under a number of outcome scenarios. It rewards according to a two-variable matrix.

The first axis is Gilead’s total return over three years vis a vis a group of biotech peers. The second axis is the company’s revenue growth over the same period and against the same comparator group.

To earn the maximum payout of 200 percent of the shares contingently awarded requires not only a total return at the 80th percentile or higher but also growth in sales at the 80th percentile or higher.

On the other hand, Gilead could achieve an 80th percentile or higher ranking in sales but rank at the very bottom of the pack in total return, yet Dr. Martin and other top executives would still earn 100 percent of their contingently-granted performance awards.

Even so, the performance shares occupy a smaller role in Dr. Martin’s long-term incentive package than his option shares. In 2008, he was granted the opportunity earn up to 98,560 performance shares, with a target award of 49,280 shares. Using the target award as an indication of grant date present value, the value of this award at grant would have been \$2.8 million. But Dr. Martin’s grant of 440,000 option shares was declared to have a grant date fair value of \$6.9 million.

Still, if I had been asked, I would have recommended sticking with an all-options diet. It worked for Dr. Martin for years. And it is clean. And it provides a needed risk element to justify the possibility of large future rewards.

Dr. Martin has made a ton of money from his stock option grants. And what do you know, he deserved to make a ton of money.

If people really believe in pay-for-performance, they will see what has happened as justice, not excess.

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.