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The Crystal Report on Executive Compensation



Homebuilders Ignore Performance in Setting Bonuses

by Graef Crystal

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No American industry, save possibly banking, has been savaged in the current recession more than the homebuilding industry.

Yet studying eight major homebuilders, I found that five of them paid their CEOs \$10.4 million of bonuses for 2008 – up from \$3.4 million in 2007.

The eight companies are:

- Toll Brothers Inc. (ticker symbol: TOL).
- NVR Inc. (ticker symbol: NVR).
- D.R. Horton Inc. (ticker symbol: DHI).
- M.D.C. Holdings Inc. (ticker symbol: MDC).
- Ryland Group Inc. (ticker symbol: RYL).
- KB HOME (ticker symbol: KBH).
- Pulte Homes Inc. (ticker symbol: PHM).
- Lennar Corp. (ticker symbol: LEN).

Performance

Let's review some stats. First, the companies' net sales in 2008 and 2007:

TICKER	SALES 2008	SALES 2007	PERCENT CHANGE
TOL	\$3,158	\$4,647	-32%
NVR	\$3,693	\$5,129	-28%
DHI	\$6,646	\$11,297	-41%
MDC	\$1,458	\$2,886	-49%
RYL	\$1,976	\$3,052	-35%
KBH	\$3,034	\$6,417	-53%
PHM	\$6,289	\$9,257	-32%
LEN	\$4,575	\$10,187	-55%
MEDIAN	\$3,426	\$5,773	-41%

Next, let's look at the operating income of the companies:

TICKER	OP_EARN 2008	OP_EARN 2007
TOL	-\$308	\$107
NVR	\$172	\$526
DHI	-\$47	\$822
MDC	-\$101	-\$77
RYL	-\$361	-\$420
KBH	-\$786	-\$1,239
PHM	-\$2,442	-\$3,970
LEN	-\$440	-\$2,626
MEDIAN	-\$335	-\$249

Next, let's look at the net income of the companies:

TICKER	NET_INC	NET_INC
	2008	2007
TOL	-\$298	\$36
NVR	\$101	\$334
DHI	-\$2,634	-\$713
MDC	-\$381	-\$637
RYL	-\$397	-\$334
KBH	-\$976	-\$929
PHM	-\$1,473	-\$2,256
LEN	-\$1,109	-\$1,941
MEDIAN	-\$686	-\$675

It's hard to spot any excellent performance in any of the three preceding tables.

Finally, let's look at the companies total returns in their 2008 fiscal years, as well as their excess returns, which were calculated by subtracting from the company's return the return on the Standard & Poors 500 Index for the same period.

TICKER	TOT_RET	EXCESS_RET
	2008	2008
TOL	1%	37%
NVR	-13%	24%
DHI	5%	27%
MDC	-16%	21%
RYL	-34%	2%
KBH	-42%	-4%
PHM	5%	42%
LEN	-54%	-15%
MEDIAN	-15%	22%

Excess returns were surprisingly good in 2008, most likely because the median company among the eight had a negative excess return of 61 percentage points in 2007.

Still, good excess return or no, the median company managed to lose 15 percent of its shareholders' worth.

Pay

Now for the bonuses. Five of the eight CEOs received a bonus in 2008, as follows:

TICKER	CEO	BONUS 2008 (000)	BONUS 2007 (000)
TOL	ROBERT TOLL	\$0	\$0
NVR	PAUL SAVILLE	\$0	\$0
DHI	DONALD TOMNITZ	\$1,848	\$1,586
MDC	LARRY MIZEL	\$2,500	\$0
RYL	CHAD DREIER	\$2,500	\$1,737
KBH	JEFFREY MEZGER	\$2,750	\$98
PHM	RICHARD DUGAS	\$842	\$0
LEN	STUART MILLER	\$0	\$0
	MEDIAN	\$1,345	\$0

The \$10.4 million of bonuses paid out in 2008 was triple the \$3.4 million paid out in 2007.

How any of the companies could pay anything in bonuses for that dismal performance in 2008 is seemingly unexplainable.

That's especially the case, given that performance of the five bonus-paying companies was almost indistinguishable from that of the four non-bonus paying companies.

A Solution

When I started in the pay field in 1959, companies typically funded their executive bonuses through means of a formula.

The typical funding formula had two components:

- A threshold level of performance
- A multiplier that was applied to above-threshold performance to produce a bonus fund.

A typical formula might have been 5% of after-tax income, after first deducting from after-tax income an amount equal to 6% of average shareholders' equity.

There were some fairly standard variants to these type of formulas:

- Some were predicated on pretax income, instead of after-tax income.
- In some, the threshold was long-term capital, i.e., the sum of long-term debt and shareholders' equity. In such cases, interest on the debt was excluded from the definition of profits so as to create a level playing field between equity and debt.

In many cases – perhaps even most cases – these funding formulas were submitted to shareholders for approval.

Indeed, one company in the news today – General Motors – routinely re-studied its formula every five years and re-submitted the same or a revised formula to shareholders for re-approval. Three times running, GM cut the formula because it was producing too much money to provide any funding discipline.

But over time, these formulas fell into disuse, and because of several factors:

- Profits grew faster than bonus funding needs. This was particularly the case as companies started to decentralize their operations and to adopt divisional-level bonus plans. CEOs at these companies were loath to cut the bonus formula – just in case they found a future need for the money,
- Some companies adopted formulas that allowed for any unused bonus money to be carried forward to future years, thereby vitiating the purpose of the formula.
- When President Clinton imposed a \$1 million pay cap, some companies used their bloated funding formulas to prove they were paying for performance but then used so-called “negative discretion” to cut funding to whatever it is they felt they needed that year.

I think it's time to resurrect bonus funding formulas and to have same approved by shareholders and then updated at least every five years, a la General Motors.

Some features I would like to see:

- A threshold that is not lowball but is meaningful in the context of a company's cost of capital.
- A clear declaration on the part of the company of the types of executives who will be covered by the funding formula and the types that will be covered in whole or in part by divisional funding formulas.
- No carryforward provisions.
- A charge against the formula for restricted stock grants that vest only through the passage of time. If that is done, then restricted stock grants can be removed from omnibus equity plans, which will have the effect of tightening such plans.

- Data disclosed to shareholders showing what bonus funds the formula would have produced had it been applied retroactively for three years vs. what funds were actually expended in those earlier years.

With reforms like these, those five homebuilder CEOs would have received nothing in the way of bonuses in 2008. And nothing is precisely what they deserved.

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.