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*The Crystal Report on Executive Compensation*



## **Changing the Rules to Preserve Your Bonus**

**by Graef Crystal**

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At Hovnanian Enterprises Inc., a New Jersey-based homebuilder, it would seem that if you're playing basketball and have a low score, you suddenly claim that you were playing golf all along. Low scores are not desired in basketball, but they are highly-prized in golf.

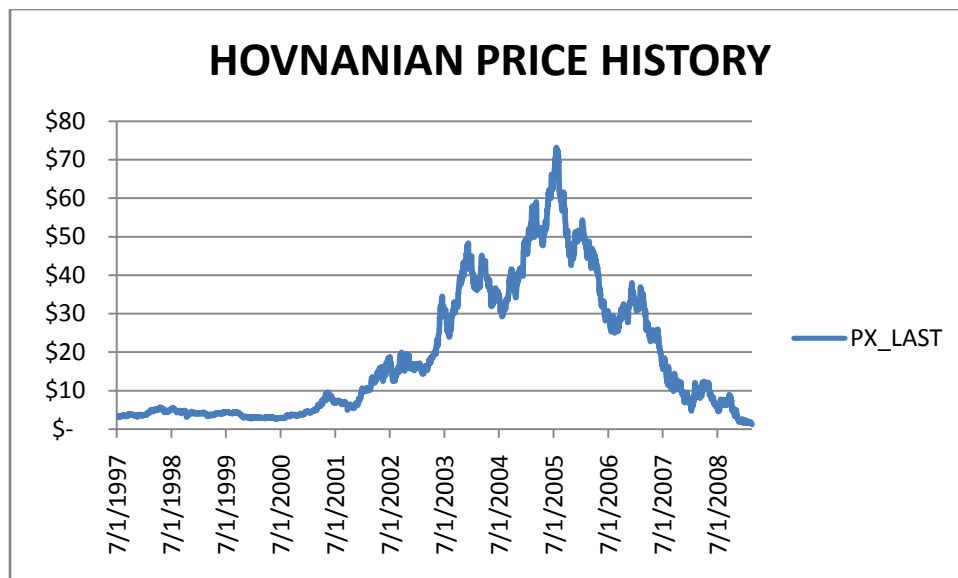
And so it was that Hovnanian decided that it, too, was really playing golf when it threw out its old bonus formula and adopted a complex new one that – what do you know – resulted in a goodly-sized bonus for its CEO, Ara Hovnanian.

### **Hovnanian's Performance**

But before we get to the details of that switch, let's look at the company's performance, which, not to put too fine a point on it, has been horrible.

Mr. Hovnanian has been CEO since sometime in July 1997.

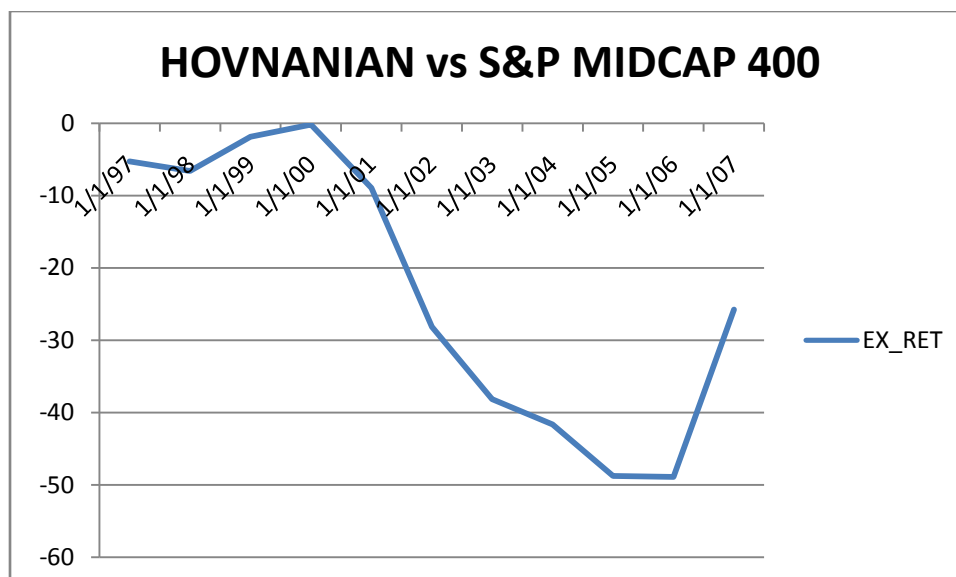
The following chart shows the company's price history between July 1, 1997 and this Feb. 13.



Talk about a normal distribution! This company seemingly has been run using a table of random numbers.

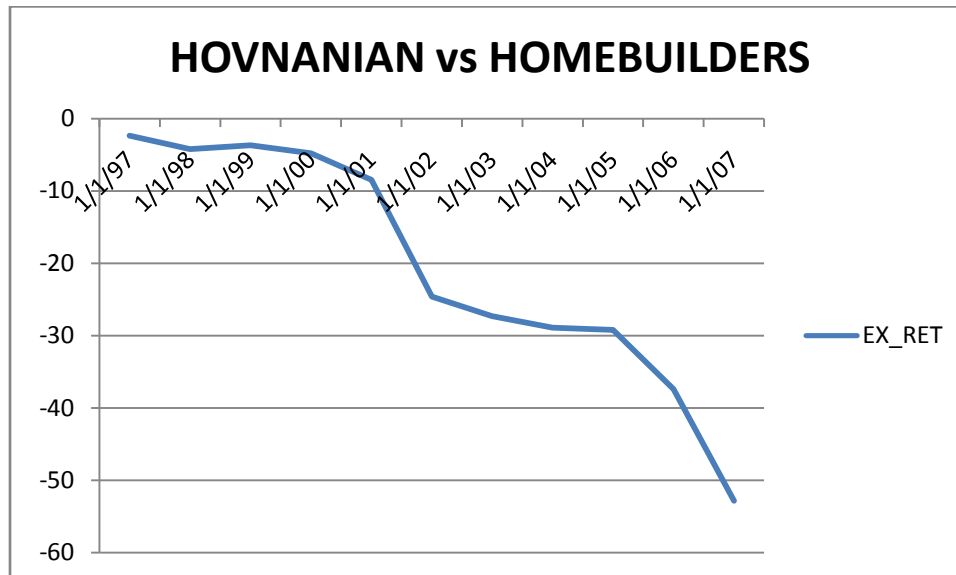
I have also looked at the company's annual total return in 11 different time windows, every one of which ended on Oct. 31, 2008, the date of the company's most recently-completed fiscal year. The first time window started July 1, 1997. The second started Oct. 31, 1998. Thereafter, the start of each succeeding time window was incremented by one year, i.e., Oct. 31, 1999, Oct. 31, 2000, etc.

The following chart shows Hovnanian's annual returns in the 11 time windows. In each case, the return on the S&P 400 Midcap Index (of which Hovnanian is a member) was deducted from the company's actual return to produce a so-called "excess return".



The median excess annual return for the 11 time windows was negative 26 percent.

A second chart shows Hovnanian's excess returns, not against the broad S&P 400 Midcap Index, but rather against a more narrowly-focused sub-index, the S&P 400 Homebuilders index, which includes Hovnanian and four other home builders (MDC Holdings Inc., NVR Inc., Ryland Group Inc. and Toll Brothers Inc.)



In this series, the median excess return was negative 25 percent, in the very same range as the figures derived from comparing Hovnanian's total returns to those of the S&P Midcap Index.

So, even comparing against peers in an industry that has gone nowhere but downhill in the last few years, Hovnanian stands out – in my view -- as a complete dog.

And since Oct. 31, 2008, the picture has become even worse. Between Oct. 31, 2008 and this Feb. 17, Hovnanian's return was negative 70 percent – and that's for just three-and-half-months. This compares to a return of negative 14.2 percent for the S&P 400 Midcap Index and negative 13.1 percent for the homebuilders' index. On Feb. 13, the stock closed at \$1.51.

Turning to Hovnanian's income statement, revenue for the fiscal year ended Oct. 31, 2008 dropped to \$3.3 billion from \$4.8 billion. The company's operating income was negative \$208 million, while its net income was negative 1.1 billion.

### **Ara Hovnanian's Pay**

Now if anyone deserved to receive no bonus for 2008, it was Mr. Hovnanian. Yet he did receive a bonus – one for \$1.5 million.

Before its 2008 fiscal year, Hovnanian's metric for determining the amount of bonus to pay Mr. Hovnanian was return on average common equity. But for 2008, Hovnanian's return on average common equity was negative 129 percent. That score is even too low for a game of golf.

Now Mr. Hovnanian could have taken his lumps – strike that, should have taken his lumps. He should have received no bonus at all.

But what do you know? Basketball morphed into golf. The company decided, after consulting with Pearl Meyer & Partners, a well-known executive compensation consulting firm, that a second measure of performance needed to be added to the incentive plan, in this case the reduction in the company's net debt.

Then a subtle piece of language was added, which gave Mr. Hovnanian the GREATER of the bonus determined using return on average common equity OR the bonus determined by net debt deduction.

And that's all it took, folks. He received a cash bonus of \$979,000 and restricted stock worth \$420,000, all of it based on the new measure presumably introduced by the company's seemingly accommodating consultant.

But even that wasn't enough. Mr. Hovnanian's generous board upped the stock portion of his bonus by a further 20 percent, based, it would appear, on the theory that he should get extra pay because his bonus was not paid wholly in cash.

There may be a rational case for doing that. With his performance, Mr. Hovnanian may yet sink his company. In that environment, cash is always preferable to stock.

Hovnanian's board even managed to cough up a bonus of \$889,000 for Mr. Hovnanian's 85-year old father, who is the non-executive board chairman.

Mr. Hovnanian was also awarded a stock option in 2008, one covering 375,000 shares and carrying a strike price of \$6.46 a share and a 10-year term. The company declared this option to have a present value at grant of \$1.3 million.

In December 2008, though, Mr. Hovnanian permitted the company to cancel four of his earlier option grants totalling 1.5 million shares. The stated purpose was to reduce equity overhang.

It is unusual for an executive to voluntarily give up options that have time to run and then get nothing in return (See Jobs, Steven, who received 10 million free shares when he traded in 55 million underwater option shares). The options that were cancelled had terms extending to May 2016.

But the options were, for all practical purposes, worthless. The strike prices involved ranged from \$32.33 to \$56.82. The average closing price of Hovnanian stock in December 2008, the month the surrender occurred was just \$2.06.

I have used a probabilistic distribution of future stock prices to determine what the chances were that any of the four underwater options might finish in-the-money prior to the end of their terms. I learned that the probability of that happening was only 1 percent in the case of three of the options and only 2 percent in the case of the one with the lowest strike price.

This is not to say that Mr. Hovnanian did not do something for his shareholders by handing back those wildly out-of-the-money options. But at bottom, it was trifling compared to his receiving a bonus and a new stock option grant at a much lower strike price that, though currently underwater, has more than nine years to run.

Hovnanian is an early proxy reporter because of its Oct. 31 fiscal year. Maybe it will prove to be an outlier as I look at hundreds more proxies that will be released in the “proxy monsoon” that starts in the next couple of weeks.

But my own prediction is that what Hovnanian’s board has done for Mr. Hovnanian will be repeated, more or less, at quite a few companies.

Face it, friends, almost every American has developed over the last decades a sense of entitlement. We are *entitled* to Social Security, even though we are running out of funds. We are *entitled* to Medicare even though that fund will be depleted even faster than the fund covering Social Security. We are *entitled* to tax cuts. We are *entitled* to being bailed out if we make bad financial decisions, whether we are a bank or a sub-prime mortgage borrower.

So why shouldn’t we expect that same notion of entitlement when it comes to senior executive bonuses. “Hey, my idea of sacrifice is that maybe, worst case, you can freeze my bonus. But cut it? No way, Jose?”

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, 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. He is now teaching a course in executive compensation at the University of California at Berkeley's Boalt School of Law.