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The Crystal Report on Executive Compensation



J.C. Penney's Board Doesn't Get It

by Graef Crystal

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If the action just taken by the board of Texas-headquartered retailer J.C. Penney Co. Inc. is an early indication of how the 2008 proxy season will unfold, this country is going to be ripe for revolution.

What you're about to learn should cause the original James Cash Penney to turn over in his grave. This company founder decreed that no one in the company should earn a base salary of more than \$10,000 a year. There was an annual bonus plan that restored some degree of progressivity to upper management pay. But that \$10,000 a year salary cap lasted until the early 1970s. His management heirs changed things shortly after his death in Feb. 1971 at the age of 95.

On this Dec. 16, in a Form 8-K filed with the U.S. Securities and Exchange Commission, J.C. Penney (hereafter referred to by its ticker symbol JCP) offered its CEO, Myron Ullman III, the opportunity to earn as much as \$25 million during the three-year period that began on this Dec. 15.

The grant consists of up to 500,000 free shares to be earned as a function of the company's compounded annual return during the three-year period ending Dec. 14, 2011.

So what's wrong with that? Pay for performance, right? To earn all 500,000 shares requires that total return be a lofty 29.1 percent a year or more. (Total return is actually measured between Dec. 9, 2008, the day preceding the date of grant and the average closing price during the 60-day period ending Dec. 14, 2011.)

There's plenty wrong here. If Mr. Ullman rings all the bells and takes title to the 500,000 free shares, he will have succeeded essentially in getting his company's stock price back to where it was when he came in from the outside as CEO on Dec. 1, 2004. And that would be after seven years in the job.

Ullman's Past Performance

Before getting into the details of this new grant, let's review Mr. Ullman's performance.

The following table presents JCP's total return in five time windows. The first time window starts on Nov. 30, 2004, the day prior to Mr. Ullman's coming in from the outside as CEO. Thereafter, each time window starts on Jan. 31, which is the end of JCP's fiscal year. The end date for all five time windows is this Dec. 19.

For each of the five narrowing time windows, three figures are presented:

- JCP's compounded annual total return.
- The amount by which JCP's return exceeds (or is under) the equivalent return on the Standard & Poor's 500 Index (the so-called "excess return").
- The amount by which JCP's return exceeds (or is under) the return on the 80-member S&P 500 Consumer Discretionary Index.

START DATE	END DATE	JCP ANNUAL TOT. RET.	S&P 500 EXCESS TOT. RET.	S&P CONS. EXCESS TOT. RET.
11/30/04	12/19/08	-14%	-9%	-4%
1/31/05	12/19/08	-17%	-12%	-7%
1/31/06	12/19/08	-29%	-19%	-16%
1/31/07	12/19/08	-52%	-31%	-25%
1/31/08	12/19/08	-62%	-24%	-25%

As you can see, Mr. Ullman's performance was not only bad, but it got worse and worse as the time windows narrowed to the present.

One additional performance factoid: During the first three quarters of the 2008 fiscal year, JCP's EPS were cumulatively \$1.56. That was 46 percent lower than the \$2.86 cumulative EPS earned during the first three quarters of 2007.

Payout Schedule

With those dismal performance stats as backdrop, here's the payout schedule for Mr. Ullman's new grant:

- For total return of less than 11.3 percent a year during the three-year performance period, no shares are earned at all.
- For total return of exactly 11.3 percent a year, 200,000 shares are earned.
- For total return of 17.9 percent a year, 300,000 shares are earned.
- For total return of 23.3 percent a year, 400,000 shares are earned.
- For total return of 29.1 percent a year or more, 500,000 shares are earned.

In no event will the payout, in dollars, be greater than \$25 million. In addition, no dividends will be paid during the performance period.

Let's focus on the optimum scenario, the one where Mr. Ullman earns all 500,000 shares.

Currently, JCP pays an annual dividend of \$0.80 a share. Bloomberg forecasts suggest that dividend isn't going to be raised anytime soon. So let's leave it at \$0.80 for each year during the three-year performance period.

The base period for measurement of the three-year total return would appear to be Dec. 9, 2008, the day prior to the actual date of grant. The stock price on that date was \$21.41. (On this Dec. 19, the stock closed at \$19.92.)

Question: Assuming a constant \$0.80 annual dividend, at what rate would JCP's stock price have to increase to produce an annual total return of 29.1 percent a year, the rate required for Mr. Ullman to earn all 500,000 shares in his grant?

Answer: 26.08 percent a year. At that rate, the stock price at the end of the three-year performance measurement period would be \$42.91.

So what's wrong with that? For delivering fabulous stock price growth of 26.08 percent a year and fabulous total return performance of 29.1 percent a year, Mr. Ullman takes title to 500,000 shares worth \$21.5 million.

Well, how about the fact that the stock price on Nov. 30, 2004, the day before Mr. Ullman walked in the door to run JCP, was \$38.60.? Viewed in that context, a stock price of \$42.91 seven years after his hire doesn't sound like much performance to me. That works out to only 1.5 percent growth a year, a far lower rate than an investor could have taken, and with no risk, by investing in Treasury bonds.

And while you're at it, consider that on Feb. 21, 2007, JCP's stock price closed at \$86.35.

And also while you're at it, consider that as of Jan. 31, 2008, Mr. Ullman was holding two options: One expiring on March 21, 2016 and covering 187,735 shares at a strike price of \$60.50 and a second expiring March 3, 2017 and covering 201,511 shares at a strike price of \$78.50.

Think about what JCP's board did not do: It did not predicate the earn-out of the 500,000 shares on the company's future performance against that of the S&P 500 or another peer group. No, it chose absolute total return, which when you're laboring up from the third sub-basement may produce what looks a triumph, even though you have only moved up to street level.

Why Do This?

So what would prompt JCP's board to make this grant right now?

It couldn't be because Mr. Ullman's performance was terrific in the past. Get real.

It couldn't be because Mr. Ullman had a great 2008. The results for the first three quarters are dismal. And the outcome of the all-important Christmas season is not even known, although forecasts for retailers are even more dismal.

How about because JCP's stock price has sunk so low that the board figured that they could pile millions of dollars into Mr. Ullman's bank account and dress up the old girl in a pay-for-performance gown?

When all the pay results for 2008 are in, maybe what JCP has done will be viewed as an aberration. But if not, this country will be in for, in what other countries, is called class warfare..

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. In the Spring of 2009, he will be teaching a course in executive compensation at the University of California at Berkeley's Boat School of Law.