PHARMACEUTICAL COMPANIES PAY WELL – BUT IN LINE WITH OTHER INDUSTRIES

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Next to the oil companies, everyone's favorite corporate villains are the pharmaceutical companies, which subsidize just about everyone living in other countries at the expense of Americans.

But even though drugs – at least those whose patents have not yet expired – are selling at sky-high prices, the chief executive officers of pharmaceutical companies – though certainly not wearing a pay hairshirt – are not unreasonably compensated compared to their U.S. counterparts in other industries.

I analyzed the total pay of 18 pharmaceutical companies, each with $3 billion or more of market capitalization at the time I performed the study this past April.

Total pay, for purposes of this analysis, was defined as follows:

- Base salary.
- Bonus for annual performance.
- The value at grant of free shares granted during the year.
- The estimated present value at grant (using the Black-Scholes model) of stock options granted during the year.
- The "target" value of prospectively-granted performance shares or units granted during the year.
- The present value of pension accruals made during the year.
- And, as defined by the U.S. Securities and Exchange Commission, miscellaneous compensation.

The total pay of the 18 CEOs ranged from a low of $1.8 million for Roger Boissonneault of Hamilton, Bermuda-headquartered Warner Chilcott Ltd. to the $30.8 million received by Miles White of Abbott Park, Illinois-headquartered Abbott Laboratories. Average pay for the 18 CEOs was $14.6 million, while median pay was $12.3 million. (Most of the pay data for this study was obtained from Equilar Inc.)

So what accounts for why one CEO received $1.8 million and another 17 times more?

I started my analyses using 505 CEOs in a variety of industries, all running companies with $3 billion or more of market cap.

It turns out you can account for 37 percent of the variation in the pay levels of these 505 CEOs if you take account of two factors:

- The net sales of the company. Increase the net sales by 10 percent, and total pay increases by 3.4 percent.

- The percent of the total pay package that was received in the form of 2007 stock option grants. Such grants carry more risk than the other elements in the pay package. Hence, this percentage becomes an indicator, if a crude one, of the pay risk the CEO is taking. Increase the percentage of the pay package represented by stock options by 10 percentage points, and total pay increases by 7.9 percent.

I also included a third variable as a predictor of total pay, namely, the company's excess return for its fiscal year 2007. Excess return is the company's actual return less the return on the Standard & Poor's 500 Index for the same period.

After controlling for net sales and pay risk, I found that the excess return factor could not explain any further variation in pay at a statistically-significant level.

So in the U.S., we pay plenty for bigness but nothing extra for goodness. Sad, isn't it?

After I constructed my pay model, I then determined whether or not pharmaceutical companies paid more or less than other companies, again after controlling for company size and pay risk. The answer is they pay neither more nor less. In contrast to Wall Street CEOs, where heretofore excessive pay came right out of the pockets of shareholders, I conclude that the source of egregious drug prices does not seem to be unduly affected by the pay of senior executives.

Two pharmaceutical CEOs attracted my attention. One paid its CEO too much in 2007, while the other paid considerably below the market. At least, that's what my pay model told me.

On the high side, we have Gregory Lucier, the CEO of Carlsbad, California-headquartered Invitrogen Corp. He was not the highest-paid in absolute dollars, but his $29 million pay package put him 583 percent over the market, based on company size and pay risk.

The centerpiece of Lucier's pay package was a giant grant of performance-contingent free shares made on March 1, 2007. On that date, he was promised a payout of as many as 809,722 shares, depending on Invitrogen's stock price performance during the three year period ended Feb. 28, 2010. (The number of shares and subsequent prices have been adjusted for the 2-for-1 split that occurred on May 28, 2008.) The value of those 809,722 shares on the March 1, 2007 grant date was $26 million.

These shares will vest only if the company's stock price rises to at least $40 a share by the end of the three-year period. And then, only five percent of the shares will vest. To earn all the shares, Lucier will have to get the stock price up to $52.50 a share. On March 1, 2007, when the grant was made, the stock closed at $32.14 a share.

To reach the threshold price of $40 a share over three years requires minimum annual stock price appreciation of 7.6 percent. To earn all 809,722 shares requires minimum annual appreication of a hefty 17.8 percent. These are not the sort of nerf-ball targets you find in other companies' so-called "performance share" plans.

Lucier came close to vesting in all his shares. On Jan. 10, 2008, Invitrogen's stock closed at $48.40 a share. But as of the close on July 7, the stock closed at a lower $38.67 a share.

A recurring issue arises in the case of Lucier, namely, that in its report to shareholders, his board compensation committee stated that he would not receive another equity award until after Dec. 31, 2009.

So that being the case, why not spread the $26 million present value of this award over the three-year period and charge only one-third, or $8.7 million, to Lucier's 2007 compensation.

Experience has taught me to take declarations of "no more for three years", or "no more for five years" with several grains of salt.

You'd think that to be a board compensation committee member, you'd have to have a pretty good memory for what you did in the past. But you'd be surprised at the compensation committees that promise to do nothing for a period of years and then grant a new equity award much sooner.

My cynicism here underlies my philosophy, which is "You grant it, I count it!"

On the other side of the spectrum, we find Warner Chilcott's Boissonneault. His $1.8 million pay package positioned him 51 percent below the market.

What kept him on the low side was a total absence of long-term incentives. He earned a base salary of $900,000 and a bonus of the same amount. And that was it, except for $35,000 of miscellaneous compensation. No stock options, no free shares, no performance shares.

Looking at all 18 pharmaceutical companies together, the median company delivered a 1.4 percent excess return in 2007. In other words, about the same as the S&P 500. But counterbalancing that unimpressive performance was the fact that the median pharmaceutical CEO earned total pay that was only 3 percent above the market, after controlling for company size and pay risk.

Still, median total pay of $12.3 million is not chicken soup. Although these 18 pharmaceutical CEOs are not paid differently from other CEOs, it cannot be a source of abiding comfort to the shareholders of these companies that you get essentially nothing (compared to buying an index fund) for all those millions.

Herewith a table showing some relevant statistics for pay and performance during 2007 for each of the 18 pharmaceutical companies.

Ticker	Company	Executive	2007 EXCESS TOTAL RETURN	TOTAL PAY (millions)	PERCENT ABOVE/ (BELOW) MARKET
IVGN	INVITROGEN CORP	LUCIER, GREGORY T.	59.6%	$29.02	583%
SGP	SCHERING-PLOUGH CORP	HASSAN, FRED	8.2%	$24.78	110%
ABT	ABBOTT LABORATORIES	WHITE, MILES D.	12.5%	$30.82	90%
WYE	WYETH	ESSNER, ROBERT	-16.9%	$24.91	87%
JNJ	JOHNSON & JOHNSON	WELDON, WILLIAM C.	-1.9%	$29.72	58%
MRK	MERCK & CO INC	CLARK, RICHARD T.	31.9%	$19.60	47%
GILD	GILEAD SCIENCES INC	MARTIN, JOHN C.	36.2%	$13.30	40%
DNA	GENENTECH INC	LEVINSON, ARTHUR D.	-22.8%	$17.39	20%
CRL	CHARLES RIVER LABS	FOSTER, JAMES C.	46.6%	$5.44	10%
AMGN	AMGEN INC	SHARER, KEVIN W.	-37.5%	$11.79	-4%
WPI	WATSON PHARM. INC	BISARO, PAUL M.	-1.2%	$7.88	-6%
BMY	BRISTOL MYERS SQUIBB	CORNELIUS, JAMES M.	-0.7%	$11.19	-10%
LLY	ELI LILLY & CO	TAUREL, SIDNEY	0.2%	$9.68	-10%
PRGO	PERRIGO CO	PAPA, JOSEPH C.	2.3%	$4.03	-17%
PFE	PFIZER INC	KINDLER, JEFFREY B.	-13.6%	$12.82	-29%
HSP	HOSPIRA INC	BEGLEY, CHRISTOPHER	21.5%	$5.35	-38%
BRL	BARR PHARM. INC	DOWNEY, BRUCE L.	0.5%	$3.79	-45%
WCRX	WARNER CHILCOTT LTD	BOISSONNEAULT, R.	22.8%	$1.83	-51%
		LOW	-37.5%	$1.8	-51%
		MEDIAN	1.4%	$12.3	3%
		AVERAGE	8.2%	$14.6	37%
		HIGH	59.6%	$30.8	583%

As to total return performance since Dec. 31, 2007 (the 2007 fiscal yearend for most of the companies) and the close on July 7, please see the table on the following page.

Ticker	Company	Company Return	S&P 500	Excess Return
IVGN	INVITROGEN CORP	-17.8%	-13.1%	-4.7%
SGP	SCHERING-PLOUGH CORP	-25.2%	-13.1%	-12.1%
ABT	ABBOTT LABORATORIES	-1.3%	-13.1%	11.8%
WYE	WYETH	7.8%	-13.1%	20.8%
JNJ	JOHNSON & JOHNSON	-1.0%	-13.1%	12.0%
MRK	MERCK & CO INC	-32.6%	-13.1%	-19.5%
GILD	GILEAD SCIENCES INC	11.0%	-13.1%	24.1%
DNA	GENENTECH INC	16.2%	-13.1%	29.3%
CRL	CHARLES RIVER LABS	-4.4%	-13.1%	8.6%
AMGN	AMGEN INC	9.5%	-13.1%	22.5%
WPI	WATSON PHARM. INC	0.4%	-13.1%	13.5%
BMY	BRISTOL MYERS SQUIBB	-18.4%	-13.1%	-5.3%
LLY	ELI LILLY & CO	-10.3%	-13.1%	2.8%
PRGO	PERRIGO CO	-5.0%	-13.1%	8.1%
PFE	PFIZER INC	-19.5%	-13.1%	-6.5%
HSP	HOSPIRA INC	-9.4%	-13.1%	3.6%
BRL	BARR PHARM. INC	-18.3%	-13.1%	-5.3%
WCRX	WARNER CHILCOTT LTD	-3.6%	-13.1%	9.5%
	LOW	-32.6%	-13.1%	-19.5%
	MEDIAN	-4.7%	-13.1%	8.4%
	AVERAGE	-6.8%	-13.1%	6.3%
	HIGH	16.2%	-13.1%	29.3%