

Management compensation contracts and distribution policies in the US technology sector

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Synopsis

This empirical research examines the impact of executive compensation practices in the US technology sector on decisions to distribute profits and on the choice of distribution channel. Equity-based executive compensation is intended to align managers' interests with those of shareholders. We find that when technology firms compensate their managers using executive stock options (ESOs), they tend to distribute less profit to shareholders. In contrast, technology firms using stock awards to compensate executives make greater distributions across all distribution channels. We also provide strong evidence in favour of the traditional agency and leverage distribution explanations of distribution decisions and specifically, we find signalling to be a strong motivation for repurchases in undervalued firms.

Introduction and Background

This research focuses on the effect of equity-based executive remuneration (stock options and awards) on the distribution policy (both the decision and the channel) of the US technology sector from 2007 to 2013. While there is evidence that a firm's distribution decisions are influenced by equity-based compensation, there is a lacuna in the literature pertaining to how the particular compensation policies of firms in the technology sector influence the distribution decision and the distribution

channel (dividends, share repurchases or both). In addition to examining executive compensation as a driver of distribution policies, we also examine the traditional drivers such as agency, leverage and signalling.

The US technology sector is well-known for its emphasis on equity-based compensation and equally, many high profile technology firms initiated share repurchases in the study period (Intel, IBM, Microsoft, among others). The technology sector is characterised by high growth, constant innovation and large research and development expenditure. Therefore, a decision by firms to return cash to shareholders may be interpreted as evidence that the firm's investment opportunities are shrinking (signalling) and consequently, decisions to increase distributions are not taken lightly. Decisions around the distribution choice and channel may be driven by selfish reasons, as managers and shareholders are affected unequally by distributions. There is some evidence, albeit mixed, that paying dividends may reduce the value of ESOs, whereas repurchasing shares transfers wealth to the owners of ESOs.

Issues and Questions Considered

ESOs increased in popularity in the 1990s, but their demise began in earnest after the internet bubble ended in 2000. New rules were passed in the US that required all equity plans to secure

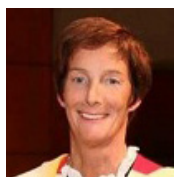
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shareholder approval. Another large impact on the popularity of ESOs was an accounting change in 2005, which treated ESOs to executives as an expense. Consequently, there has been a significant move towards stock awards (restricted stock). Restricted stock does not provide managers with the same scope for capturing the benefits of equity-based remuneration without delivering enhanced performance. Restricted stock awards are considered to be a better instrument to curb selfish managerial behaviours.

We examine the impact of executive remuneration patterns of ESOs or stock awards on (a) the decision to distribute and (b) the distribution channel. Many companies who pay dividends also repurchase stock and therefore, they should not be considered straightforward substitutes. Dividends normally follow a smooth persistent time series. Repurchases are not necessarily repeated and there is no promise of future earnings growth when firms repurchase shares. Dividends reduce the value of ESOs, thus the use of ESOs is predicted to be negatively related to dividends and positively related to repurchases.

Why do firms repurchase their shares? Firms are likely to repurchase when they have accumulated large amounts of cash or wish to adjust their capital structure. A firm that wishes to increase its leverage (debt) can borrow and use its borrowings to repurchase stock. The cost of capital generally reduces for firms that repurchase. Firms with low leverage are more likely to repurchase when compared to firms with high leverage. Paying dividends and repurchases from free cash flow (FCF) reduces the amount of FCF available to management, attenuating agency costs. The signalling hypothesis suggests that dividends and repurchases are signals of under-pricing or of better prospects for the firm. Therefore, we also include variables to test these traditional influences on the distributions by firms, including FCF, leverage, market-to-book value, among others to comprehensively explore the relationship between ESOs and stock awards in executive compensation contracts and the distribution decision of firms.

Methodology

We posit that the distribution decision is made sequentially: a firm first decides on whether or not to distribute and having decided to make a distribution it then decides on the appropriate channel for the distribution. We first examine

the decision to distribute against the alternative of no distribution, using a logit model. Then, we estimate three models employing a multinomial logit model where the choice is no distribution versus distribution firstly in the form of dividends, secondly in the form of repurchases and thirdly, using both channels. The results are robust to a number of checks including the Global Financial Crisis years, 2008-2009. We also tested our findings with different governance variables, which had no impact on our results.

Outcomes and Findings

Widespread use of ESOs and share awards along with an increase in share repurchases, supports the importance of enhancing our understanding of the impact executive remuneration structure has on the distribution decision. We examine the unintended consequences of equity-based compensation to executives on the distribution decision of firms, in addition to the traditional corporate finance explanations. Rewarding executives with ESOs leads to less distribution. Our multinomial model reveals that the negative relationship between ESOs and distributions is confined to distribution in the form of dividends. There is no relationship between ESOs and distributions in the form of repurchases.

In contrast, rewarding executives with share awards has a positive association with all three channels of distribution. The result for ESOs is not consistent with our prediction that self-serving managers who hold ESOs will choose to repurchase, which would transfer wealth from shareholders to executives. In fact, we find that when these technology firms compensate their managers using ESOs, they generally tend to distribute less profit to shareholders. Technology firms using stock awards to compensate executives make greater distributions across all distribution channels.

We also provide strong evidence in favour of the traditional agency and leverage distribution explanations and in particular, we find signalling is a strong driver for repurchasing shares in undervalued firms. Overall, the exogenous shock of the internet bubble in 2000 and the change in accounting treatment of ESOs paid to executives has precipitated a change in executive remuneration patterns and distributions practices of US technology firms, confirming the impact of executive remuneration structure on the distribution decision and channel.

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