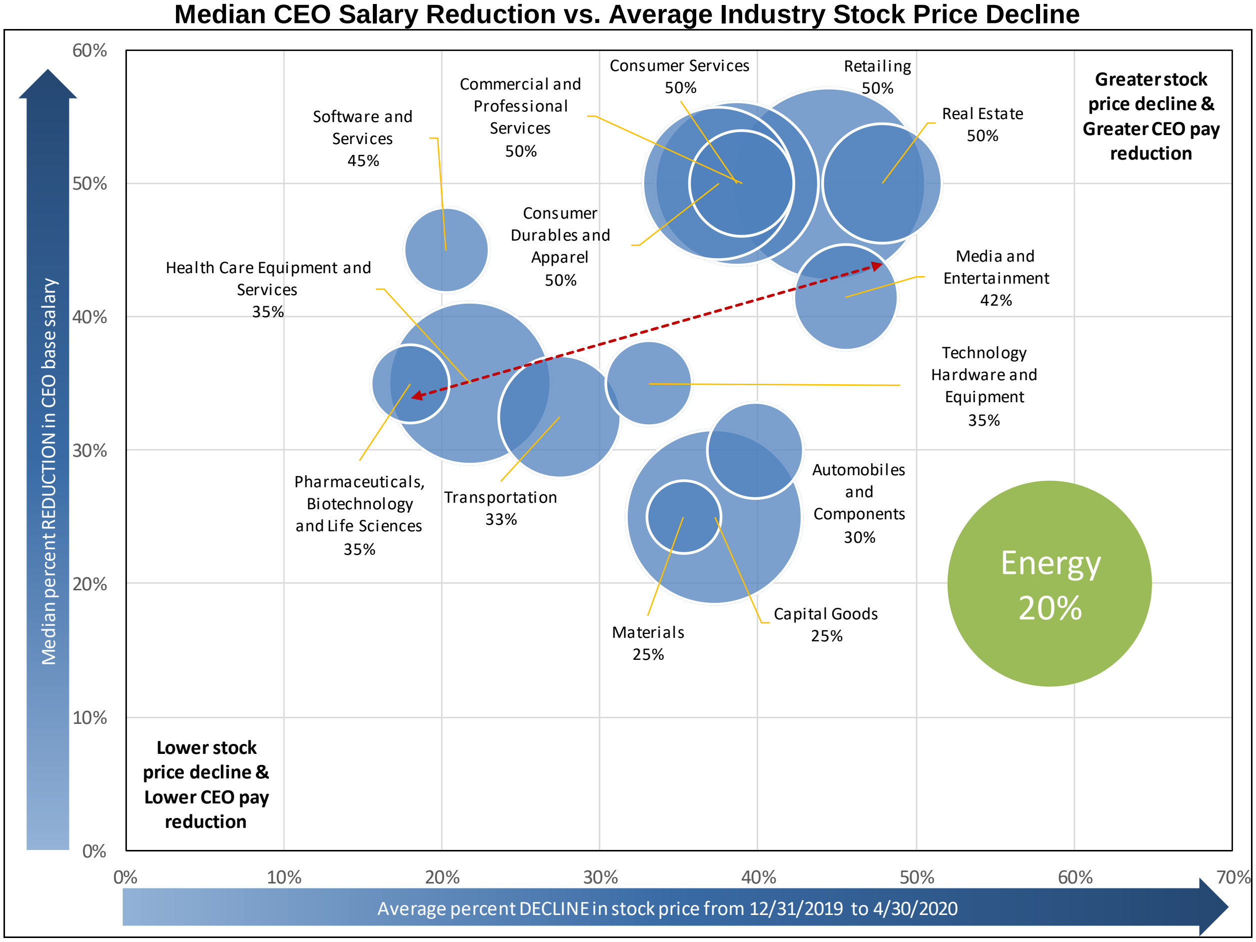
Post #59: Executive Salary Reductions in Oil & Gas: What's the Message?

From: David Bixby, Lead Consultant, The Woodlands, Texas

Through 4/30 we have tracked nearly 60 energy industry companies that have announced CEO salary cuts, the most of any industry group in our COVID-19 database. The fact that so many energy industry companies have reported salary reductions should not be surprising; the double black swans of record production and cratering demand have driven industry stock prices further down on average (-58%) than in any other industry sector in the U.S. since the end of December. However, salary reductions in oil & gas, at least on the surface, do not seem to be proportionate to share price impact. Median CEO salary reduction in the sector (20%) is the lowest in our database.

Median CEO Salary Reduction vs. Average Industry Stock Price Decline



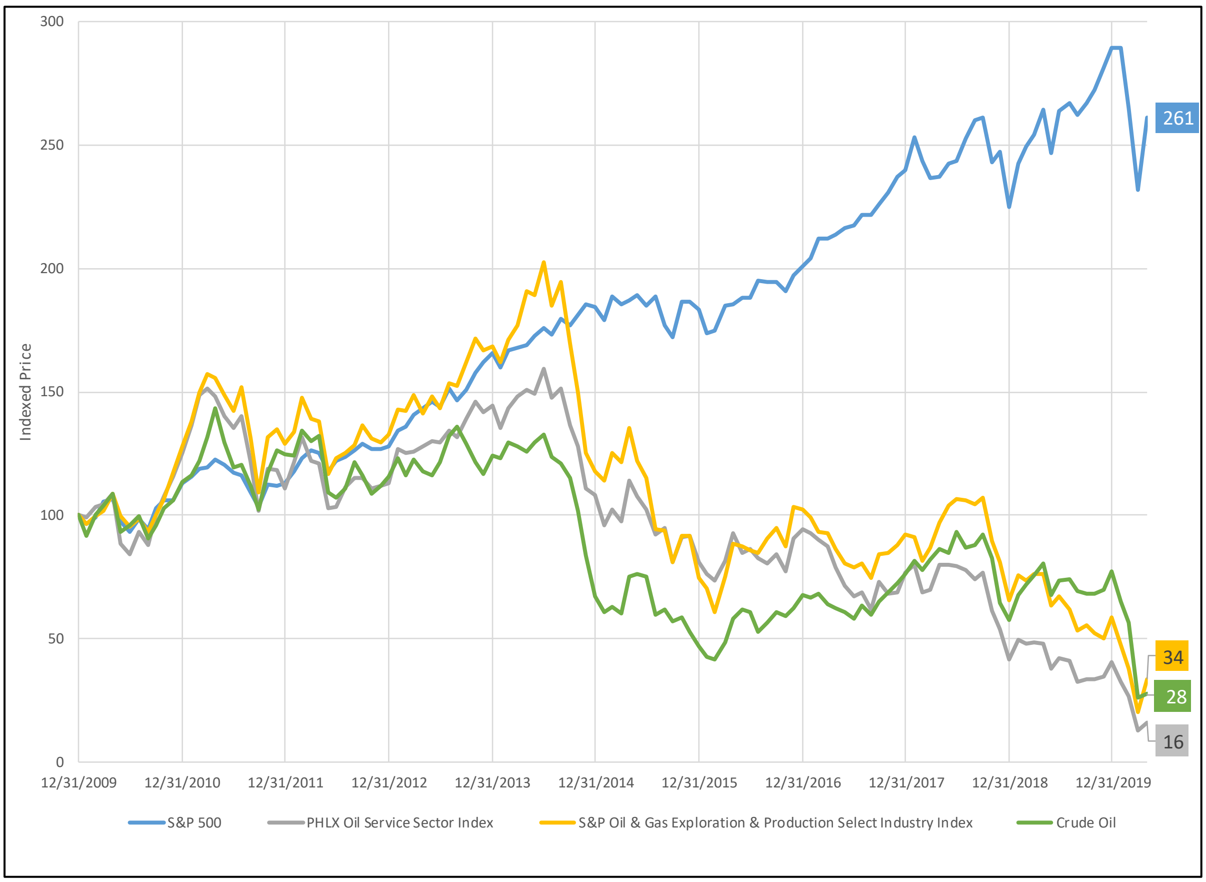
Note: bubble size corresponds to number of cases in our database, and labels indicate the median percent decrease in CEO salary by sector.

Does this level of salary decrease suggest that energy industry companies are not taking this downturn as seriously as management teams in other sectors? I don't think so. [As has been discussed here on our Energy Insights blog](), energy industry companies and their boards have a longer-term focus.

Historical Context

Voluntary salary reductions are nothing new for oil & gas companies in a downturn. Typically, these voluntary reductions are short-term, the cycle eventually turns, and management teams who stick out the downturn are handsomely rewarded as stock prices recover. That expected recovery in equity value has always been a critical part of the "deal" for management teams in oil & gas – particularly upstream. However, this latest shock feels different, in large part because equity values in the industry have not recovered from the last big shock to commodity prices in late 2014. The chart below provides a comparison of stock price performance for the S&P 500 to two representative oil & gas industry indices since the end of 2009.

Sustained Stock Price Declines Put Oil & Gas in a Different Boat



As shown, while the S&P 500 has taken a hit since the beginning of 2020 and shareholders and employees in multiple industry sectors are facing significant pain and uncertainty, the broader market is still well above where it was ten years ago – and the long-term trend is still upward. Stock prices in the oil & gas sector, in contrast, are not only well down from their last peak in mid-2014 but prices are a <u>fraction</u> of what they were at the end of 2009.

What this means from an executive compensation standpoint is that not only have management teams in the sector failed to see any gain on their equity awards in more than five years, but the promise of a significant future equity-based payoff to offset near-term losses is uncertain at best. Crucially, for the many senior executives in the sector who have entered the C-suite within the past five years and watched their predecessors realize huge equity gains, there has yet to be any big payoff to go with their increasing workload and nominally larger compensation "opportunity."

Against this backdrop of equity value erosion, compensation committees may believe that deep reductions to base salaries are a step too far. There is also a growing sense that this round of salary reductions may last longer than prior, clearly temporary, adjustments.

So What's the Narrative Around Salary Reductions?

It's about sharing the pain: for most companies in the sector, salary reductions are about fairness and communicating shared pain with employees and shareholders. Companies have cut capital spending by up to 50% in many cases, reduced headcount, and scaled back compensation and stopped hiring. Leadership cash compensation reductions send an important interim message of solidarity through a critical period.

Reductions may be temporary, but not necessarily: a minority of companies (about 35%) in our multi-industry COVID-19 database have placed a formal time limit on salary reductions, with the majority committing to keeping actions in place until there are signs of recovery. Even fewer energy companies (10%) have disclosed an anticipated duration for salary cuts. While this may be partly due to greater long-term uncertainties for oil & gas companies, it may also be due to a growing realization that pay levels across the industry may need to be recalibrated to a new reality.

The entire deal needs to be reconsidered: oil & gas companies have historically paid more for talent (executive and otherwise) than comparably sized companies in other industry sectors, particularly in the form of equity incentives. There are multiple reasons why this has been true, including a persistent concern about attracting and retaining qualified technical talent. Sustained poor TSR performance, reduced profitability, and reduced manpower needs have changed things. The promise of an eventual, outsized equity-based payday has changed as well. In the latter half of this year companies across the sector will begin wrestling with the question of what the new "deal" should look like for their employees. For now, 2020 is all about conserving cash. However, the future deal may mean increased cash compensation opportunities with scaled-back equity opportunities if equity valuations remain low. Regardless, base salary is only a part of the discussion.

Keep checking back here for more thoughts on what comes next.