CEO Compensation and Real Estate Prices: Pay for Luck or Pay for Action?

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Abstract of paper

- “We use real estate prices shocks to study the sensitivity of CEO compensation to luck, and to responses to luck (action).
- “Pay for luck can be optimal when CEOs are expected to react to unanticipated luck.
- “Our identification of pay for action relies on real estate asset sales and debt issuance. We also rely on the fact that accounting performance, unlike market performance, only reflects real estate prices shocks if the CEO responds to them. We show that CEO compensation is associated with responses to real estate luck, which mostly explains pay for luck.”

Overall thoughts

- Interesting idea
  - We need to get inside the black box of incentive contracting to understand what's going on
  - …

Empirical approach: Pay for luck

- In essence, estimate the compensation function using OLS regression
- Very difficult to interpret coefficient on RE(92) x HPI(t-1)
  - What are the descriptive statistics of RE(92) x HPI(t-1)? Do magnitudes make sense?
  - How many CBSAs follow the basic pattern of general appreciation with “blips” around 2007-2008?
  - What is relation between HPI and commercial real estate prices?
  - Putting aside fixed effects (e.g., firm and MSA-year), paying for RE(92) x HPI(t-1) in year t is paying for appreciation from 92, …, t-1. Why?
  - Once fixed effects are considered, mind boggles …

Empirical approach: Pay for action

- Idea is that firms want to motivate CEOs to take actions in response to “luck” and that action here is selling real estate
- In essence, estimate the compensation function using OLS regression
  - Claimed coefficient of interest is that on RESales*Exp*HPI, where RESales = $RESales/TA, Exp = RE92/TA, so Exp*HPI ~ $RE/TA. So RESales*Exp*HPI = $ RE sold * RE/(TA^2) = % RE sold * (RE/TA)^2.

Data issue

- Measure value of real estate using PPENT – PPENME – PPENLS.
  - But PPENME and PPENLS are missing for *all* firms from 1999 onwards and almost all firms for 1996 - 1998
  - So measure of real estate is actually PP&E.
- Don't observe "real estate" sales, so measure this using change in "real estate value", which includes effects of capital expenditure and depreciation
  - Plausibly "real estate sales" are decreases in PP&E due to depreciation in excess of capital expenditure
  - Also unclear what negative RESales means: "we only look at cases when this difference is negative"; but see Table 1

What is the implied contracting problem?

- Taking the estimated compensation contract literally (in terms of claimed coefficient of interest) and putting aside unusual aspects of functional form:
  - When real estate prices are high and firm has exposure to real estate, then want managers to sell:
    - Real estate prices are high: HPI in t – 1 is high
    - Firm has exposure to real estate: RE/TA
  - But HPI in t – 1 and RE/TA are both observable prior to year t, so what's the contracting issue? Why write an outcome-based incentive contract on an observable action?

What might be the real contracting problem?

- Perhaps managers have private information about real estate markets and this cannot be contracted on
- Optimal action might be to sell real estate when prices will go down; buy real estate when prices will go up
  - This suggests optimal contract should be a function of HPI in $t - 1$ relative to HPI in t

What might be the real contracting problem?

- But, seriously, is real estate management of this kind a significant issue for most firms?
  - Do firms ever cite real estate transactions in justifying pay?
  - What are the plausible magnitudes of the value created from real estate transactions relative to all the other things that CEOs can do?
  - Even with very well-specified tests, it seems detecting impact of real estate transactions would be difficult.

Channel analysis: Table 5

- Coefficients on ROA and Log(Debt) interacted with value of real estate are positive.
- Rather than providing assurance or evidence of a causal channel, seem to raise questions about the basic approach
  - Why would ROA in period *t* be a good proxy for the "impact on operating performance due to selling real estate to take advantage of higher real estate prices" in period *t*?
  - Why would Log(Debt) in period *t* be a good proxy for the "lower cost of funds attributable to debt raised through secured lending taking advantage of higher real estate prices" in period *t*?

Event study: Table 7

- Event-study analysis focused on sale-leaseback transactions
  - Presumably sale-leaseback transactions are embedded somewhere in the regression analyses of Table 4 (and Table 5 and Panel B of Table 6)
  - Basically, there are positive short-window announcement returns of 1–2%
- But not conditioned in any way on real estate appreciation
  - Sale-leaseback just secured lending (Santander sold HQ for €1.9 billion and leased back for 40 years with repurchase option; Ben-David [2005])
  - If SLB is unequivocally good, why not pay managers for that?

Real estate financing by corporates

- I worked on an $832 million real estate financing transaction for General Motors in 2003
  - Relevant performance measure was cost of funds relative to alternatives (even this is flawed because secured lending is eating up balance-sheet capacity)
  - Real estate appreciation only relevant in terms of capacity for security
  - Reality is that assets are highly firm-specific, real estate risk remains with borrower, no operational impact by design
  - This deal was rounding error

Cross-sectional analyses: Tables 8 and 9

- Table 8 is cross-sectional analysis using splits based on measures of governance
  - While de rigueur in accounting research in 2019, I think one can always split sample on some partition and find "consistent" results
  - The idea of "good governance" is dubious and difficult to measure … HHI and board independence?
- Table 9 is cross-sectional analysis using split on "real estate exposure" (measure unclear)
- Inference based on difference between coefficients across regressions needs to be done with test statistics
  - I suspect "twice as high" coefficients are not statistically distinguishable

Abstract of paper: Reprise 1/2

- "We use real estate prices shocks to study the sensitivity of CEO compensation to luck, and to responses to luck (action)."
  - For reasons discussed above, not clear what is been measured in either case.
- "Pay for luck can be optimal when CEOs are expected to react to unanticipated luck."
  - If the goal is to motivate reactions to unanticipated luck, then pay should be a function of reactions
  - More plausibly, pay for luck is about paying managers to position themselves for luck (e.g., holding real estate when prices will increase … selling it when they will fall).

Abstract of paper: Reprise 2/2

- "Our identification of pay for action relies on real estate asset sales and debt issuance."
  - Not clear that measure is truly real estate asset sales
  - Not clear why debt issuance is optimal
- "We also rely on the fact that accounting performance, unlike market performance, only reflects real estate prices shocks if the CEO responds to them."
  - Not sure about this.
- "We show that CEO compensation is associated with responses to real estate luck, which mostly explains pay for luck."
  - I don't see where the "mostly explains" conclusion comes from … which empirical analysis?

Overall thoughts

- Interesting idea
  - We need to get inside the black box of incentive contracting to understand what's going on
  - But not sure that setting is quite right
    - Real estate is surely not that big a deal, leading to concerns about real power
    - "Identification strategy" idea often means looking for keys under the lamppost … not clear that identification issues are first-order here
  - As is, empirical analysis is not particularly persuasive:
    - "There are more things in heaven and Earth, Horatio,
      Than are dreamt of in your philosophy"

Suggestions

- Focus analysis on situations where real estate *matters* (paper ditches companies in real estate business)
- Conduct qualitative analysis: Is this even plausible as a phenomenon? If so, how important?
- Identify a plausible contracting issue (hidden action, hidden information) that and seriously model this
  - Not plausible that contract would involve t – 1 information and period t observable action, even as noisy proxy
  - Managers should *not* be rewarded for selling real estate in period t because t – 1 prices are high … if t + 1 prices are even higher!
- Provide more descriptive statistics and contextual data
- Examine magnitudes of coefficients
- Explain regression controls (e.g., why Log(Assets) x HPI(t-1)?)