Compensation
Advisory Partners

Industry Report // 2018-2019

Investment Banking

Compensation Advisory Partners (CAP) examined executive compensation levels and design practices at 12 publicly traded, U.S. investment banks. CAP also reviewed executive pay levels and practices at three major Wall Street Banks for comparison purposes. This report summarizes the study findings.

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Compensation Advisory Partners (CAP) examined executive compensation levels and design practices at 12 publicly traded, U.S. investment banks. The 12 companies in the study have a revenue range of $139 million to $7.2 billion. The broad revenue range enabled CAP to focus on independent, advisory-focused investment banks and to have a sufficient sample for the study. As an additional reference point for comparison purposes, CAP also reviewed executive compensation levels and practices at three large, diversified financial institutions ("Wall Street Banks") with significant investment banking operations. Revenue at the Wall Street Banks ranged from $35.9 billion to $104.0 billion.[1]

Key Takeaways

- The investment banking pay model and the industry's approach to incentive compensation are distinct from general industry practices, and are important to understand when evaluating market data.
- Median pay levels for Chief Executive Officers (CEOs) increased 11 percent from 2017 to 2018, which reflects strong 2018 operating results. Pay levels for Chief Financial Officers (CFOs) increased five percent, while pay levels for other Named Executive Officers (NEOs) increased 11 percent.
- Two-thirds of the investment banks studied now grant performance share units (PSUs) to their CEOs as part of annual incentive compensation awards. CAP expects a continued increase in the prevalence of PSU awards.
- For the investment banks that grant PSUs to their CEOs, the grant value of PSU awards represents approximately one-half of the total value of the deferred, long-term portion of incentive compensation.

A Unique Industry

From economic, performance and compensation perspectives, independent investment banks stand apart from general industry and other financial services firms. The unique aspects of the industry are important to understand when looking at their executive compensation levels and practices.

Human Capital Focus. The investment banking industry has a strong human capital focus: The industry's assets are its people. Most individuals in the industry are highly educated, trained and compensated. A firm's success depends on its ability to attract, retain and reward highly skilled bankers with strong business networks and deal-execution skills. Given the industry's human capital focus, the largest expense category for investment banks is compensation and benefits.

Year-to-Year Results. Like most professional services firms, investment banks focus heavily on year-to-year financial metrics, such as revenue growth, operating margin and overall profitability. The industry tends to be cyclical and highly sensitive to overall economic conditions. In addition, a firm's results for the year can be skewed by factors such as a large deal closing in January instead of prior to December 31.

A key metric in the evaluation of most senior, non-corporate investment-banking professionals is annual revenue generation. Long-range planning is largely limited to senior corporate executives, and firm investments often generate returns more quickly than in capital-intensive industries.

The Investment Banking Pay Model. Investment banks approach executive compensation in a manner that is distinct from general industry norms. At investment banks, each year a total incentive is determined based on an often highly discretionary review of prior-year performance. The total incentive is then delivered to executives as a mix of annual cash incentive compensation and deferred, long-term incentive compensation. Of the investment banks in CAP's study, 92 percent use this investment banking pay model for top executives, as do all three Wall Street Banks.

The investment banking pay model contrasts with the broadly used, traditional compensation model where annual incentive and long-term incentive components are separate and determined independently. In most other industries, the annual cash incentive is often determined in a highly structured, formulaic manner, and the annual long-term incentive grant target value is largely market-based, with the grant value being typically independent of prior-year performance.

1 When summary statistics are reported in this study, medians are used for the 12 public investment banks, while averages are used for the three Wall Street Banks.

While executive incentive awards in the investment banking industry tend to be more discretionary in nature when juxtaposed with the more formulaic approach used in general industry, the investment banks do base their year-to-year incentive decisions on specific criteria, such as revenue and profitability. In fact, several of the investment banks in the study disclosed information about their incentive decision-making processes, which can be thought of as following a "structured discretion" approach.

2018 Industry Performance

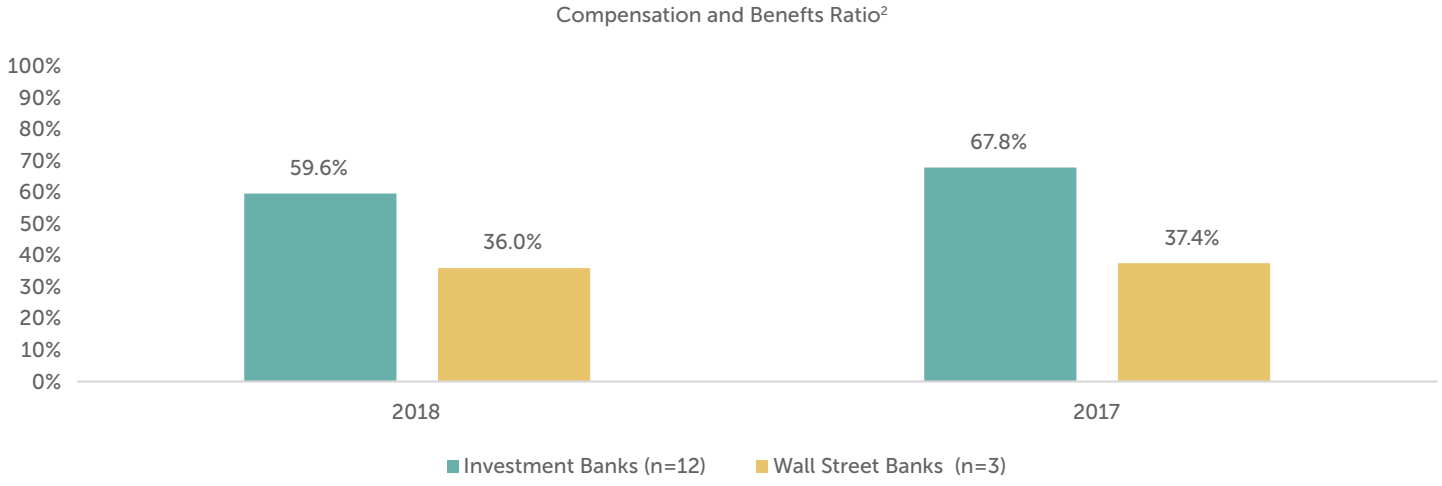
The investment banks in CAP's study reported strong operating results for 2018. Revenue increased 14.9 percent, and pre-tax operating income increased 39.7 percent. Despite this, the investment banks' total shareholder return (TSR) – which takes into account stock price changes and dividends – was down 19.8 percent during 2018, driven by steep declines in the fourth quarter.

The following table summarizes financial and market results for CAP's investment banking sample for 2018 and 2017:

Metric	Median Percent Change	
	Year Ended December 31, 2018	Year Ended December 31, 2017
Revenue	+14.9%	+13.4%
Pre-tax Operating Income	+39.7%	+14.3%
Operating Margin	+2.4%	+0.1%
Return on Equity (ROE)	+4.5%	-1.4%
1-Year TSR	-19.8%	+25.6%
3-Year TSR (compound annual growth rate, or CAGR)	+5.7%	+6.3%

Source: S&P Capital IQ financial database

In addition to the traditional financial and market-based performance measures, investment banks track and report a human-capital metric called the compensation and benefits ratio. The ratio reflects compensation and benefits expenses as a percentage of revenue. The compensation and benefits ratio among CAP's investment banking sample declined by 9.3 percentage points for full year 2018 versus full year 2017. This decrease was driven by the year-over-year change in revenue (+14.9 percent), which outpaced changes in compensation and benefits costs.



Source: S&P Capital IQ financial database

2 When summary statistics are reported in this study, medians are used for the 12 public investment banks, while averages are used for the three Wall Street Banks.

The compensation and benefits ratio is higher for the investment banks in the study relative to the Wall Street Banks. The Wall Street Banks have multiple business lines in addition to investment banking, and have a more diversified workforce in terms of employee roles and pay levels.

Named Executive Officer (NEO) Compensation

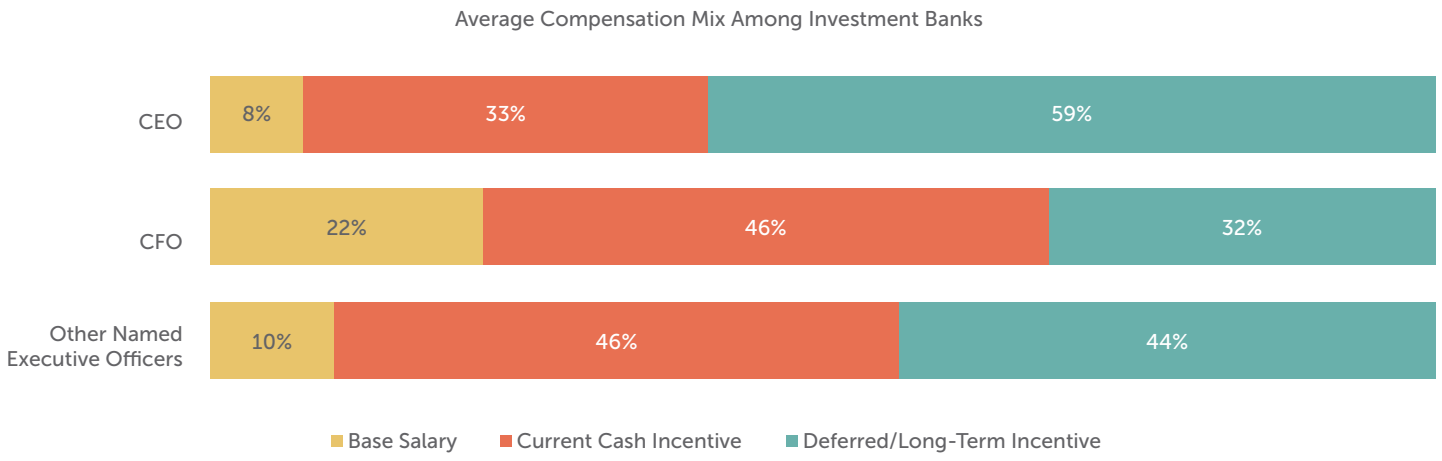
CAP analyzed 2017 and 2018 pay levels for the five NEOs disclosed in the proxy statements for each of the investment banks. While base salaries were flat from 2017 to 2018, total compensation was up year-over-year, reflective of an industry focused on linking pay outcomes with performance outcomes.

Compensation Component	Median Percent Change Year Ended December 31, 2018		
	CEO	CFO	Other NEOs (avg.)
Base Salary	No Change	No Change	No Change
Incentive Pay	+11.8%	+5.1%	+12.2%
Total Direct Compensation	+11.4%	+4.9%	+11.1%

The year-over-year pay increase for the CEO and other NEOs was approximately 11 percent, which reflects the industry's strong 2018 operating performance. The pay increase for the CFO was smaller, at approximately five percent, which is in part reflective of a smaller portion of annual pay being variable for this role, as discussed further below.

Pay Mix and Incentive Compensation

As shown in the pay-mix charts that follow, the investment banking industry places significant emphasis on performance-based, variable incentive compensation. On average, performance-based, variable incentive compensation represents 92 percent of annual pay for CEOs of the investment banks. The other NEOs have a pay mix that is similar to that of CEOs, with 90 percent of annual pay delivered through variable incentive compensation. In contrast, CFOs at investment banks have a slightly less variable pay mix, with about 80 percent delivered through variable incentive compensation and 20 percent delivered in salary.



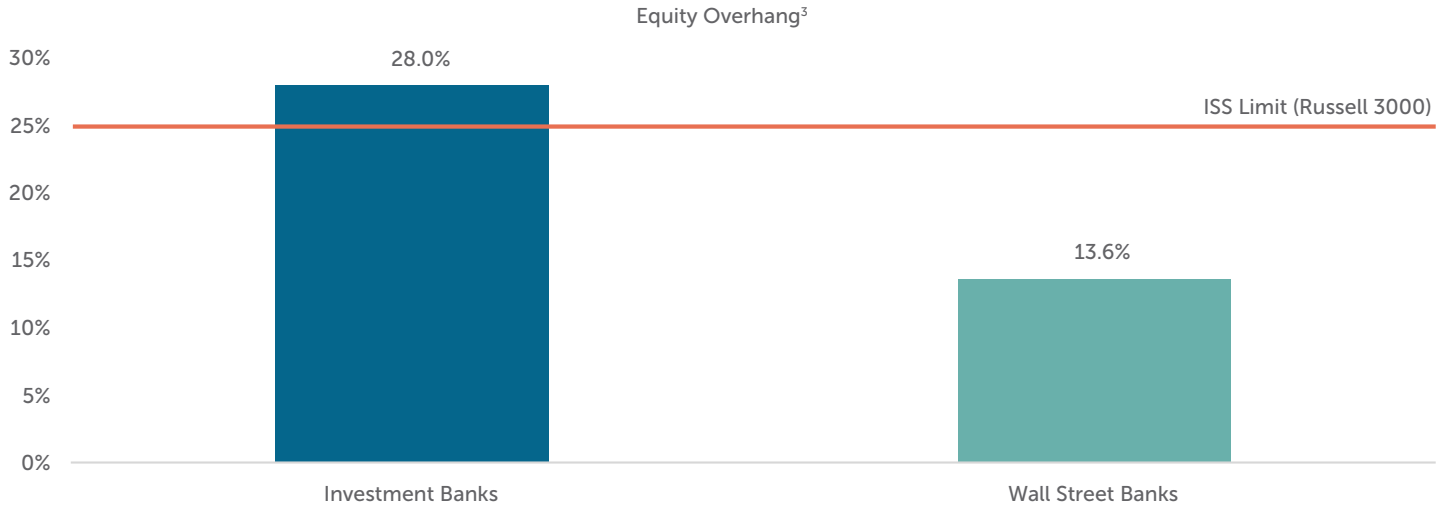
Investment banks deliver incentive compensation using a mix of cash and deferred equity vehicles, such as restricted stock, restricted stock units and performance share units (PSUs). The long-term incentive component adds a retention hook by deferring payment of a portion of annual incentive pay. It also provides a link to the company's long-term shareholder value creation. Among the investment banks in the study, approximately two-thirds of CEO incentive pay and approximately one-half of incentive pay for other NEOs have been deferred over at least three years, most often through restricted stock/units but also through performance share units (PSUs).

A notable change within the investment banking industry has been taking place in terms of long-term incentive vehicle prevalence. PSUs have been increasing in prevalence among study companies. In fact, a majority of CEOs of the investment banks now receive annual PSU awards, with prospective, generally three-year performance requirements. Among the CEOs who receive PSUs, approximately half of long-term incentive compensation is provided through these awards. The most common performance metrics associated with PSU use in the investment banking industry are TSR and return measures, such as return on equity (ROE), followed by revenue growth and operating margin.

While investment banks will continue to focus on prior-year performance in making incentive pay decisions, CAP believes that the use of PSUs for top corporate executives will continue to increase at the investment banks in the study. Investors and proxy advisors (i.e., Institutional Shareholder Services, or ISS, and Glass Lewis) encourage the use of PSU programs with prospective multi-year goals.

Equity Overhang

CAP analyzed equity overhang, which is a measure of shareholder dilution. Median equity overhang for the investment banks is 28.0 percent, which exceeds ISS "excessive dilution" thresholds but should be considered within the context of the industry's human capital focus and the partnership model from which these public companies emerged. The average equity overhang for the Wall Street banks is 13.6 percent.[3]



ISS uses its Equity Plan Scorecard (EPSC) model to determine the shareholder vote recommendation for new share requests for equity and incentive compensation plans. The EPSC includes certain "overriding" factors, one of which is "excessive" dilution. This factor, which applies to S&P 500 and Russell 3000 EPSC models only, will be triggered by ISS when the company's equity compensation program is estimated to dilute shareholders' holdings by more than 20 percent (S&P 500 model) or 25 percent (Russell 3000 model). This overriding factor may warrant an ISS "against" vote recommendation despite an above-threshold EPSC score. All but one of the investment banks in the study are in the Russell 3000, while only two of the companies are in the S&P 500. All three Wall Street banks are in both indices.

Two-thirds of the investment banks have equity overhang levels that would exceed the ISS "overriding" factor threshold. This indicates that, for a majority of publicly traded investment banks, ISS would be likely to recommend that shareholders vote against a new share request no matter what the plan features are or what the benefits of maintaining an ongoing equity compensation plan are to various stakeholders, including the company, employees and shareholders. The ISS "overriding" factor threshold does not make sense for the investment banking industry and exemplifies why industry-specific understanding is important when designing and evaluating compensation programs.

3 When summary statistics are reported in this study, medians are used for the 12 public investment banks, while averages are used for the three Wall Street Banks.

When publicly traded investment banks seek shareholder approval for new share requests, shareholder outreach is advisable, and the resolution should include information that makes a strong case for the share request. Also, setting internal expectations for a likely level of shareholder support is important. For example, among non-S&P 500, Russell 3000 investment banks, median shareholder support for such new share requests during the past three years was approximately 66 percent. ISS recommended that shareholders vote against the proposals, but each time the proposals passed with majority shareholder support (albeit, with lower support than broader market norms, in part driven by proxy advisor policies that do not take into account industry-specific considerations).

Equity Run Rate

CAP also analyzed the equity run rates for the investment banks. Equity run rates measure shareholder dilution from equity grants made in a particular year. In recent years, the median annual *gross* run rate for the investment banks has ranged from about four percent to 7.5 percent.

Given its human capital focus and approach to incentive compensation, this industry often focuses more on the *net* run rate, which takes into account forfeitures and repurchases, than on the *gross* run rate used in most industries. For example, the net run rate is frequently the only version of run rate discussed in new share request proposals in this industry. Among the investment banks, the median *net* run rate has ranged from approximately -1.3 percent to 2.3 percent in recent years. In this industry, buybacks are often viewed as a tool used to limit or net-out annual shareholder dilution from compensation programs.

Peer Groups for Compensation Benchmarking

CAP assessed the size and composition of the peer groups used by the investment banks for compensation benchmarking purposes. Publicly traded companies generally disclose the peer groups they use for compensation benchmarking purposes in their annual proxy statements. Relative to other industries, the peer groups used by the investment banks are smaller and more industry focused.

Among the investment banks studied, the median peer group size is 11 companies, while the 75th percentile is 14 companies. The peer group size for the Wall Street banks is even smaller, with an average of six companies. In contrast, a recent Equilar and CAP study of 500 companies across different industries found the median peer group size to be 17 companies.

The investment banking peer groups are smaller than those used in other industries because the executive compensation programs in this industry are unique, and companies choose to compare themselves mostly with publicly traded direct competitors – of which a limited number exist. This is very different than how peer groups are approached in many other industries where companies are screened more broadly for size and other operating metrics. In the 500-company general industry sample noted above, only eight percent of companies maintained a peer group where at least 75 percent of constituent companies were from the same industry classification, and only 30 percent of companies maintained a peer group where 100 percent of constituent companies were from the same industry sector classification. In addition, only 54 percent of companies maintained a peer group where at least 75 percent of constituent companies were from the same, broader industry sector classification.

Moreover, when developing or validating a peer group used for executive compensation benchmarking, it is typical practice to use quantitative screens for size and/or other operating metrics. Oftentimes, potential peers with less than one-half or more than two times the revenue of the company are eliminated. However, the investment banks studied do not generally use such narrow size screens when developing or validating their compensation benchmarking peer group.

CEO Pay Ratio

In 2017, most publicly traded companies were required to begin reporting in their annual proxy statement the CEO Pay Ratio, which is the ratio of CEO compensation to that of the median employee. For the investment banks, CEO compensation in 2018 was 42 times the compensation of the median employee at the company. This is significantly less than the median CEO pay ratio among Russell 3000 companies as shown in the following table. The lower CEO pay ratio at investment banks is driven by higher median employee pay relative to general industry.

	Investment Banks	Russell 3000
2018 Median CEO Pay Ratio	42x	78x
2018 Median CEO Pay	$5,389,867	$5,422,777
Change from 2017	*+7%*	---
2018 Median Employee Pay	$179,011	$61,782
Change from 2017	*+9%*	---

The average CEO pay ratio for the three Wall Street Banks was 243x in 2018, much higher than both the 42x and the 78x shown above. Among the Wall Street Banks, average CEO pay was approximately $20 million and average median employee pay was nearly $120,000. CEO pay at the Wall Street Banks reflects the size and complexity of the organizations, and the lower median employee pay reflects the greater variety of business lines and employee roles.

Conclusion and Looking Ahead

During 2018, the investment banks in CAP's study rewarded executives commensurately with operating performance outcomes. PSU awards, with prospective, pre-defined multi-year performance goals, are now a significant part of incentive compensation awards for CEOs at the majority of the investment banks in the study. Looking ahead, we expect to see an increasing prevalence of PSU awards for corporate leaders at public investment banks. We also expect to see many companies within this industry enhancing their compensation-related shareholder communication, proxy-based and otherwise. Lastly, we have seen the industry heighten its focus on gender pay equity and representation by women in the management ranks; we expect this trend to continue.

The market for talent among independent, advisory-focused investment banks is highly competitive. Companies can choose to compete or fall behind. Doing so effectively – according to internal and external stakeholders – requires real-time industry insight, deviating from market practices that are common in other industries, and a compensation-related shareholder communication strategy that specifically addresses important industry-specific distinctions.

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Appendices

Key Terms Defined

Compensation & Benefits Ratio	Compensation and benefits expense as a percent of revenue.
Equity Dilution or Overhang	Represents maximum potential dilution (i.e., the sum of all outstanding or available shares under equity plans divided by the sum of the company's common shares outstanding and all outstanding or available shares under equity plans).
Equity Run Rate (also called "Burn Rate")	Represents equity grants (including full-value shares and stock options) made during the year divided by the company's average common shares outstanding.
Investment Bank Compensation Model	Reflects an often highly discretionary review of prior-year performance. The total incentive is then delivered to executives as a mix of annual cash incentive compensation and deferred, long-term incentive compensation.
ISS Excessive Dilution Threshold	ISS policy to vote against new share requests when the company's equity compensation program is estimated to dilute shareholders' holdings by more than 20 percent (S&P 500 company) or 25 percent (non-S&P 500, Russell 3000 company).
Net Run Rate (also called "Net Burn Rate")	Represents equity grants (including full-value shares and stock options) made during the year minus forfeitures and repurchases divided by average common shares outstanding.
Operating Margin	Measures how much profit a company makes on each dollar of revenue. The calculation is operating income, or earnings before interest and taxes, as a percentage of revenue.
Total Direct Compensation (TDC)	The sum of base salary; annual incentives and bonuses; and long-term incentives, such as restricted stock, stock options, and cash- and share-based performance plans.
Total Shareholder Return (TSR)	TSR measures the change in stock price over a period of time, with dividends assumed to be reinvested at the time they are paid.
Traditional Compensation Model	Reflects a compensation structure where annual incentive and long-term incentive components are separate and determined independently. This is the typical pay model across industries.

Investment Banks

Cowen Inc.
Evercore Inc.
Greenhill & Co., Inc.
Houlihan Lokey, Inc.
Jefferies Financial Group Inc.
JMP Group LLC
Lazard Ltd
Moelis & Company
Piper Jaffray Companies
PJT Partners Inc.
Raymond James Financial, Inc.
Stifel Financial Corp.

Selected Wall Street Banks

The Goldman Sachs Group, Inc.
JPMorgan Chase & Co.
Morgan Stanley

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