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IN THIS ISSUE:

In Honor of Marc Hodak

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FROM THE EDITOR

A Message from the Editors

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Journal of Applied Corporate Finance

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By the time Marc Hodak began his career at Stern Stewart in 1993, he had earned degrees in aerospace engineering and finance, passed the bar exam, and gained experience in corporate management. The common thread in this journey was an interest in mechanism design, specifically how incentives and constraints influence people to create value. Marc pursued this interest both as a practitioner and a professor, ultimately becoming one of the world's leading experts in management incentives.

As a corporate manager, Marc observed smart people making "dumb" decisions, meaning decisions that were rational based on their organizational incentives but that they wouldn't make if they owned the company. Marc saw Stern Stewart's EVA program as a solution and crossed the client-consultant fence to implement it at dozens of companies. Over his decades as a corporate advisor, Marc met many financially savvy peers, some trained as engineers, and several former lawyers, but very few who had worked under pay plans created by compensation consultants. This gave him an advantage in understanding how incentives shape corporate behavior and vice versa.

Marc's distinctive cross-disciplinary background supported both his work, eventually as a partner at Farient Advisors—an international compensation and governance advisory firm—and his academic endeavors, including teaching corporate governance at New York University's Stern School of Business as well as regular guest lectures at the University of St. Gallen in Switzerland. In pushing the frontier of applied mechanism design, Marc wrote numerous articles over the decades based on his thinking and experience. The JACF published nine of them.

Marc's first two JACF articles discuss EVA as a tool for companies to scale with confidence. "How EVA Can Help Turn Mid-Sized Firms into Large Companies" (1994) explains how EVA provides a focal point for leaders pursuing value-added growth while maintaining maximum strategic flexibility in realizing that value. "Value Creation in the Internal Corporate Market: Designing Effective Intra-Company Charges" (1995) describes how to push EVA down to the business unit level in a complex organization while accounting for their collateral revenues and costs in a manner that promotes value creation.

Marc's third article, "The End of Cost Allocations as We Know Them" (1997), presents a model for distributing shared costs and investments across business units, introducing the *transfer auction* as a mechanism for promoting capital-efficient growth. Adopted by companies in the U.S., Europe, and Australia, the economics of investment across global businesses promoted by this mechanism have increasingly been overwhelmed by complex tax rules that undermine rational capital allocation.

Marc's first article after starting his own consulting firm was "Alignment Exposed: How CEOs are Paid and What Their Shareholders Get For It" (2004). This paper presents the author's extensive research on the alignment of management and shareholder interests. Based on this research, he developed a methodology for rating the effectiveness of incentive compensation plans in achieving this alignment, including simpler plans focused on profit growth with 'soft caps' on upside rewards. "High aligned" firms that rated well outperformed the market by about 3.5% per year in back-testing. A hedge fund, Rapidan Capital, invited the author to implement his rating system to create a portfolio that, over the next three years, would consistently achieve the back-tested result.

His next article, "Letting Go of Norm: How Executive Compensation Can Do Better than 'Best Practices'" (2005), identified widespread practices that harm shareholders, as well as practices that research suggested would benefit shareholders.

Marc then developed "The Hybrid Option: A New Approach to Equity Compensation" (2009). He begins by explaining why in-the-money options are, in principle, the most potent equity instrument for executive pay, and proposes workarounds to the existing tax and accounting constraints on such options, including the use of the performance-share/option framework. Variations of this instrument have since been adopted by numerous firms over the past 15 years.

During the first two decades of this century, Marc was drawn increasingly into the private equity arena as the number of public companies shrank significantly and the number of large firms managed by private equity increased—in no small part because of proliferating constraints on public company compensation governance. In "The Growing Executive Compensation Advantage of Private Versus Public Companies" (2014), Marc explained that private equity's superior performance stemmed from a fundamental *governance* advantage of private equity—namely, the presence and active participation on portfolio company boards of the companies' largest investors who have "a much stronger interest in outcomes" than the directors of most public companies. In his words, "rules intended to deter excessive CEO pay are now… [making it] increasingly difficult for public companies to put in place the kinds of simple, powerful, and efficient incentive plans that are typically seen at private companies—plans that often feature bonuses funded by an uncapped share of profit growth, or upfront 'mega-grants' of stock options with service-based vesting."

Joining Farient Advisors as a partner in 2018 brought Marc back into the world of large public companies and their increasingly complex compensation programs. He focused on the most significant factor driving that complexity in his article, "Are Performance Shares Shareholder Friendly?" (2019). He found that investors, who were decrying compensation complexity, were indeed getting something for companies' use of performance shares—higher compensation costs and poorer returns. This paper ignited investor concern about performance shares, eventually prompting them to press proxy advisors to reconsider their guidelines that all public companies should include copious performance shares in their long-term incentives. This is one of the few JACF articles pinned on the walls of some of the world's largest asset managers.

As Marc looks beyond consulting, he is starting to tackle larger questions of income and work. His latest article, "Body and Soul: The Price of Paradise" (2025), recounts well-funded attempts to create a worker's paradise as models for more pro-social enterprises. This article builds on Marc's longstanding concern for aligning the interests of owners and employees, or, in business history terms, resolving the tensions between labor and capital. Marc states that there is much more to come based on data he has collected from over 250 attempts at egalitarian/utopian societies, and regrets that the JACF will no longer serve as a venue for his future explorations.

And one last note in closing: After 45 years of putting out the JACF and its predecessors the *Chase Financial Quarterly* and the *Midland Corporate Finance Journal*, my longtime associate editor John McCormack and I have decided, with a mixture of pride and some sadness, to discontinue the journal, at least in its current "long" format, at the end of 2025. That said, we are considering possible "short-form" continuations, including brief blog-like commentaries on topical issues. We would welcome any missives or blog posts from our readers in this connection.

We want to thank all of our many distinguished contributors and loyal subscribers for your interest and support during our wonderful 45-year run, which has proved a good deal longer and more rewarding than either of us suspected when setting out with Joel Stern and Bennett Stewart at the Chase Manhattan Bank back in 1981 (John came on a few years later with Stern Stewart).

We also want to thank our partner and benefactor, Carl Ferenbach, for his guidance and generous financial support for the past 12 years since leaving Morgan Stanley in 2013.

Thanks again for all your ideas and valuable contributions over the years. We encourage you to get in touch with us if you have any questions or suggestions about how we might best make use of our 45 years of back issues—Don Chew don.chewnyc@gmail.com, and John McCormack johnlmccormack@gmail.com.

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Executive summaries

BODY AND SOUL: THE PRICE OF PARADISE

Marc Hodak and Jack Masterson

The authors discuss the efforts of very successful businessmen to achieve social goals in the context of their businesses. These projects were much more ambitious than the traditional investments these men made. Often called "next stage of capitalism" ideas, they involved being more generous to their stakeholders, particularly their employees and communities, and providing cleaner and healthier environments to work and live in, with the expectation that these benefits would ultimately benefit the companies offering them. As Hodak and Masterson put it, they believed that "doing good" would lead to "doing well."

Hodak and Masterson review the history of three ambitious and well-funded attempts to reach the next stage by creating new communities to improve workers' living conditions so as to form a more sustainable relationship between capital and labor. These three attempts at transformational change were led by rich, progressive, and successful entrepreneurs, namely, railcar entrepreneur George Pullman, who built Pullman, Illinois; chocolate-maker Milton Hershey, who built Hershey, Pennsylvania; and George McMurtry, President of Apollo Iron and Steel, who built the town of Vandergrift, Pennsylvania. These 19th-century visionaries were confident that investments in social advances would result in higher financial returns or, at the very least, not lower returns.

Unfortunately, all of these projects were eventually abandoned despite the great investment of capital and planning that went into them. Significantly, the businessmen backing the projects faced the same economic constraints that all businesses must contend with. They could not achieve adequate rates of return on invested capital.

ARE PERFORMANCE SHARES SHAREHOLDER-FRIENDLY?

By Marc Hodak

Performance shares, or PSUs, have become the largest element of pay for top executives in corporate America. Their spread was ignited by institutional investors looking for more "shareholder-friendly" equity awards—as opposed to restricted stock and stock options, which have been characterized as "non-performance" equity. Although that characterization has been challenged by many directors and compensation professionals, proxy advisers like Institutional Shareholder Services have continued to insist that the majority of stock be granted based on performance, compelling public companies to conform to that standard.

With over a decade of experience with PSUs, the evidence is in regarding their net effect:

- PSUs greatly complicate long-term incentives. Pay disclosures are dominated by discussion of PSUs, including metrics, goals, performance, and vesting, and any differences in one grant year versus the next over three overlapping periods.
- PSUs may be contributing to the increase in pay. Companies issuing a significant portion of their long-term incentives in the form of PSUs have been granting about 35% more in value than companies granting only restricted stock and stock options.
- Shareholders don't appear to be getting anything for that added complexity and cost. S&P 500 companies using PSUs have underperformed their sector peers, and companies using solely "non-performance" equity have significantly outperformed their sector peers in every single year over the last decade.

Given these findings on PSUs, it is time for institutional investors and their proxy advisors to reconsider their view of these vehicles as "shareholder-friendly" and rethink their unqualified promotion of their use by the companies they invest in.

THE GROWING EXECUTIVE COMPENSATION ADVANTAGE OF PRIVATE VERSUS PUBLIC COMPANIES

By Marc Hodak

Private companies have a natural governance advantage over public companies—one that stems mainly from the presence on their boards of their largest owners. This governance advantage is reflected in the greater effectiveness of private company executive pay plans in balancing the goals of management retention and incentive alignment against cost. Private company investor-directors are more likely to make these tradeoffs efficiently because they have both a much stronger interest in outcomes than public company directors and more company-specific knowledge than public company investors.

Furthermore, private company boards do not have to contend with the external scrutiny of CEO pay and the growing number of constraints on compensation that are now faced by the directors of public companies. Such constraints focus almost entirely on one dimension of compensation governance—cost—in the belief that such constraints are required to limit the ability of directors to overpay their CEOs.

In practice, any element of compensation can serve to improve retention or alignment, as well as being potentially costly to shareholders. Furthermore, any proscribed compensation element can be "worked around" by plan designers, provided the company is willing to deal with the complexity. For this reason, rules intended to deter excessive CEO pay are now effectively forcing even well-intentioned public company boards to adopt suboptimal or overly complex compensation plans, while doing little to prevent "captured" boards from overpaying CEOs. As a result, it is increasingly difficult for public companies to put in place the kinds of simple, powerful, and efficient incentive plans that are typically seen at private companies—plans that often feature bonuses funded by an uncapped share of profit growth, or upfront "mega-grants" of stock options with service-based vesting.

THE HYBRID OPTION: A NEW APPROACH TO EQUITY COMPENSATION

By Marc Hodak

Equity compensation can provide part of the expected reward needed to attract and retain talent while strengthening the unity of interest between management and its shareholders. But more can be done. Until now, managers and boards have used standard equity instruments such as restricted common stock and at-the-money stock options. Boards typically place various restrictions on these instruments to improve retention or alignment, or mix and match them according to taste or fashion. But each of these standard instruments has well-understood limitations. For example, employee stock options that are granted at the money are worth considerably less, on the day of the grant, to the managers that receive them than to the shareholders of the companies that give them. And the values of both options and restricted stock depend heavily on variables, like the general state of the economy, that have little or nothing to do with managerial performance.

An instrument designed specifically for executive compensation can overcome these limitations. More specifically, the author proposes the use of options that are both in-the-money—to limit their value-to-cost discount—and indexed to industry and market-wide variables—to tie rewards more directly to firm-specific performance. Properly designed, such a hybrid instrument could meet all the equity-based compensation objectives for a given company, greatly simplifying its compensation plans, while improving the balance among the compensation governance criteria of retention, alignment, and cost control.

LETTING GO OF NORM: HOW EXECUTIVE COMPENSATION CAN DO BETTER THAN "BEST PRACTICES"

By Marc Hodak

With executive pay under the media spotlight, the corporate search for "best practices" is in reality a drive toward common practices as cautious boards gravitate toward a safe norm. But are current trends in compensation structure as good for shareholders as they are for the consultants who implement them? This article explores some of these trends and derives some conclusions about their role in shareholder value creation based on detailed data on executive plans and stock price performance for the S&P 500.

One key finding is that rewarding managers for profit growth produces higher stock price returns than rewards based on multiple measures or balanced scorecards. Also, the popular practice of adding long-term incentive plans to the compensation mix does not appear to improve long-term performance. Finally, the granting of equity based on the past year's performance rather than in annual fixed-value amounts appears to be good for shareholders because of additional incentives created by performance-based grants as well as the elimination of the perverse incentive of rewarding poor stock price performance with more shares.

ALIGNMENT EXPOSED: HOW CEOs ARE PAID AND WHAT THEIR SHAREHOLDERS GET FOR IT

By Marc Hodak

This article begins by arguing that, for many companies, there is a significant "disconnect" between how managers are paid and what is actually achieved for shareholders. This paper answers two questions of prime importance to investors: Is there a way to know *beforehand* whether managers' incentives are well aligned with those of their shareholders? And does such alignment actually make a difference in the returns one is likely to see?

In answering the first question, the author argues that cash bonuses and performance-based equity grants (i.e., grants based on managers' meeting accounting-based operating targets) are likely to provide stronger, more cost-effective incentives than grants of stock or options because the former are generally based on measures over which managers have significantly more control than the stock price.

Using this insight, the author develops a method for evaluating compensation structures based on the variability of compensation, the number and type of compensation metrics purportedly driving that variability (including the award of performance shares or options), the stability of those metrics over time, and the apparent level of discretion in the use of those metrics to either fund or distribute bonuses (including equity). All these elements are disclosed to varying degrees in the proxy statements or annual reports of companies.

Using his compensation scores for 140 companies and their return history over the last 8 years, the author concludes that "high alignment" companies outperform their "low alignment" peers by more than 5% per year in total shareholder returns. Furthermore, increases in alignment scores by individual companies over time tend to lead to higher total shareholder returns, and degradation of scores leads to lower returns. In short, observable improvements in compensation structure appear to pay off in the form of significant abnormal returns.

THE END OF COST ALLOCATIONS AS WE KNOW THEM

By Marc Hodak

This paper critiques conventional cost allocation methods in multi-unit organizations and proposes a market-oriented solution called the "transfer auction." Traditional cost allocations—used to distribute the expenses of shared plants or services among business units—are depicted as fundamentally flawed, producing arbitrary results and failing to foster good business decisions.

Management often seeks to allocate costs to measure unit profitability, ensure cost coverage, or assess the contribution of lines of business. However, there is no objective "true cost" to allocate, and attempts at disaggregating sunk or shared costs are inherently fruitless. Standard cost-based approaches, whether driven by accounts, fixed ratios, or elaborate models, result in unproductive energy spent on internal disputes and misaligned management incentives. Real value creation is measurable only at the consolidated company level, not within artificial internal constructs.

Instead of artificial allocations, the author advocates for a price-based system that mimics real market dynamics. In this framework, the cost "transferred" from, for example, a plant to a sales unit is set through negotiation, as if the units were independent firms contracting with one another. If there is no external market price, the author proposes a "transfer auction" in which consuming units (like sales divisions) bid on how much of a new or ongoing cost they are willing to absorb in exchange for receiving additional capacity or services. If the total committed by these internal customers does not match the provider's required price—presumably above their costs–the investment or cost is not incurred. Transfer auctions improve resource allocation, investment decisions, and operational efficiency by encouraging business units to "buy in" to costs transparently, rather than having expenses imposed arbitrarily. Even in the absence of a formal auction, the mere threat of refusal or third-party arbitration engenders efficient negotiation. The system aligns incentives and risk-sharing naturally as the parties have incentives to reveal their true "reservation" prices.

THE VALUE CREATION IN THE INTERNAL CORPORATE MARKET: DESIGNING EFFECTIVE INTRA-COMPANY CHARGES

By Marc Hodak

Intra-company charges are accounting items that show up on the books of one business unit when it provides goods and services to another business unit but are eliminated at the consolidated level. Most firms use one or more types of intra-company charge to get a "fairer" picture of individual business unit contribution to the overall firm. This paper reviews traditional methods of levying intra-company charges and then suggests improved, more innovative methods.

Common cost allocation systems will spread departmental costs among business units according to some variable, such as revenue or headcount. But these methods do not regulate the internal demand for services, do not motivate suppliers to manage costs or quality, and result in high monitoring costs. Without a true price mechanism, both service providers and users inside the firm lack incentive for optimal resource use, leading to resource waste and inefficient interactions.

The author argues that internal charges create value when they mimic market characteristics. Three requirements are essential: assignability (charges are linked to identifiable users and services), value-basis (charges reflect the true value of services, not just allocation of costs), and refusability (users can reject services or seek alternatives, including outsourcing). When these are absent, internal prices become exercises in accounting rather than tools for meaningful measurement and motivation.

He outlines a four-step process for improving intra-company charges: defining the relevant business units, cataloging service flows, evaluating services for assignability, value, and refusability, and then applying appropriate charging methods. For professional services, he recommends negotiated or benchmark-based charges modeled after external contracts. For more repetitive or commoditized services, longer-term agreements or benchmarked rates may be suitable. For joint and common costs, he advocates a capital-allocation approach where users essentially "bid" their willingness to support shared investments.

HOW EVA CAN HELP TURN MID-SIZED FIRMS INTO LARGE COMPANIES

By Marc Hodak

The author examines why many large companies lose their entrepreneurial edge and how mid-sized firms can avoid stagnation as they grow. He explores why traditional centralized control fails once companies reach a certain level of complexity, highlighting the failure of mid-sized, single-product companies to establish incentives and constraints that promote capital efficiency as they scale into multi-product, multi-unit firms.

As companies grow, they often become bureaucratic and less adaptive, stifling the innovation that made them successful. Many firms maintain centralized control of investment decision-making as they grow in complexity, and top management has less insight into the true potential for business unit investments. Some firms attempt to recapture their dynamism by decentralizing decision-making, but they nevertheless require some centralized control over capital allocation. In either case, control structures cannot replace effective incentives for prudent capital allocation with managers acting as "owners" of their business units.

The author argues that the key to enabling single-product or single-market firms to make the transition to the next stage of corporate development is to decentralize authority and accountability for both profits and capital spending on high-return opportunities. Measures like traditional ROI or cash flow often bias managers toward risk aversion or short-term results that discourage strategic investment.

The author recommends Economic Value Added (EVA) as a superior internal measure for complex firms. EVA links operating profit to the cost of capital, making managers accountable for true value creation. Used at companies like AT&T and Coca-Cola, EVA offers a way to decentralize decision-making while maintaining the shareholder perspective inside the business units. Firms adopting EVA can preserve entrepreneurial energy and capitalize on organic growth, avoiding the bureaucratic sclerosis typical of mature corporations.

A VALUE CREATION STRATEGY (VCS) FRAMEWORK: ARCHETYPES FOR ACHIEVING TOP QUARTILE TOTAL SHAREHOLDER RETURNS

By Marwaan R. Karame

This article introduces the Value Creation Strategy (VCS) Framework, a fact-based approach to strategic planning and investment decision-making derived from an empirical analysis of 678 publicly traded companies in the S&P 900 (excluding financials and real estate) from Q1 2014 to Q3 2024. The author identifies six "Lean-Grow Archetypes"—Thriving Value Leader, Emerging Value Leader, Lean Cash Machine, Comeback Contender, Emerging Growth Engine, and Bold Pivot—that demonstrate a strong relationship between Residual Cash Earnings (RCE) Trend and Total Shareholder Returns (TSR).

Each of these archetypes is characterized by how they perform based on two key attributes of RCE Trend that are mutually exclusive yet collectively exhaustive (MECE): Growth Contribution and Efficiency Improvement. These same archetypes can be more broadly applied to categorize investment opportunities beyond a portfolio of stocks, but also within a portfolio of business units, market segments, customers, and products of a company, enabling firms to align investments with value creation drivers.

The VCS Framework enhances clarity, resource allocation, risk management, decision-making consistency, and strategic communication. His findings, based on 21,167 observations across 32 rolling three-year periods, show that archetypes with positive RCE Trends consistently deliver top quartile TSR, offering practitioners a robust tool for maximizing shareholder value. By simplifying complex strategy processes into self-explanatory qualitative archetypes, the VCS Framework bridges qualitative intuition with operational drivers and financial outcomes, providing actionable insights for corporate leaders.

A WHAT INFLUENCES SHAREHOLDER VOTES ON GOLDEN PARACHUTE PAYMENTS?

Stuart L. Gillan and Nga Q. Nguyen

The Dodd–Frank Act's mandated shareholder vote on change-in-control payments (golden parachutes) when firms are sold led to heightened scrutiny of parachute payments. We studied deals and parachutes both before and after the new voting requirement to provide perspective on how the new voting requirement was associated with shareholder value. While most parachutes received substantial support from shareholders, parachute features such as single-trigger payouts and tax gross-ups correlated with lower backing from proxy advisors and investors. Although we observed some evidence of reduced deal premiums post the Dodd–Frank period, we found no significant relationship between premiums and parachute features viewed unfavorably by shareholders and proxy advisors. Given the role of parachutes in incentive alignment and the increased focus on such payments, understanding these issues has become an increasingly important governance issue.

FROM FINANCIAL EFFICIENCY TO STRATEGIC RESILIENCE: A CORPORATE CASE FOR ARMOR-CAP

Frank J. Fabozzi, Johns Hopkins University

Capital allocation is no longer just a matter of financial optimization in an era of contested markets, fractured supply chains, and legal asymmetries. This paper describes ARMOR-CAP (Allocation for Resilient Markets and Operational Readiness—Capital Allocation Protection), a strategic overlay for CFOs and boards to assess the survivability of capital plans under systemic stress. While ESG frameworks remain central to board-level governance discussions, they are structurally incomplete. ESG emphasizes corporate intent under cooperative global conditions; ARMOR-CAP focuses on operational viability amid geopolitical and legal disruption. The framework offers diagnostic tools for integrating resilience into treasury operations, M&A diligence, board oversight, and corporate disclosure, reframing fiduciary responsibility for a world where continuity cannot be assumed.