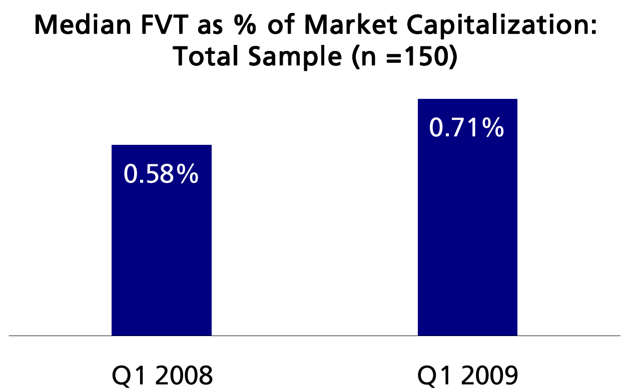
June 9, 2009

Fair Value Transfer – Changes in 2009

This alert letter provides real-time aggregate fair value transfer (FVT) data comparing the first quarter of 2009 to the first quarter of 2008 to provide insight into how companies changed their grant practices to address the sudden market decline. FVT rates (fair value of equity grants as a percentage of market capitalization at grant) increased in 2009 across all industry and size cuts of our 150-company sample. This increase in FVT was not the result of higher absolute equity compensation grant values, but was because companies granted more shares to offset stock price declines. At the median, the dollar-value of equity compensation decreased (-25%), but not as much as the median decline in stock price (-41%).



BACKGROUND

Traditional tests of annual share usage from long-term incentive (LTI) award programs are insufficient since stock options and restricted/performance shares do not provide equivalent compensation value or incur the same cost per share. To ensure that a company's LTI program is competitive and cost-effective, companies should evaluate their *fair value transfer* (FVT), which is the total pre-tax expense of LTI awards as a percentage of market capitalization at grant.

FVT measurement:

- Quantifies the aggregate pre-tax compensation cost of LTI grants in a given period (the cost of which will likely be spread over multiple years for purposes of determining earnings).
- Normalizes equity compensation values and costs for differences in stock price and resulting market-cap size.
- Facilitates trade-offs between various LTI vehicles since all types of awards are expressed on an economically equivalent basis.

When changes in stock price and market capitalization are fairly stable year-over-year, multi-year historical FVT averages provide an appropriate backdrop for future compensation planning. However, the sudden market decline in late 2008 forced companies to set their annual LTI budgets with unexpectedly depressed stock prices and market capitalizations, which made past practice irrelevant. Consider the following example: Company A's stock price has declined 50%, leaving several years of stock option awards underwater. For retention purposes, the Company would like to maintain the dollar value of its annual LTI awards, but the 50% decline in stock price requires twice as many shares to be granted. Thus, its grant rate would be twice as high and its 2009 FVT would exceed its past FVT practice during the three previous years (2006-08). The purpose of this study is to determine, through examination of real-time practices in the latest 10-Q filings, whether companies with a significantly lower stock price have increased their grant rates to maintain similar grant values or whether they have held the number of shares constant and provided less value.

METHODOLOGY

FVT Calculation

FVT measures the pre-tax "fair value" of equity awards granted during the period. For the purposes of this report, the pre-tax fair value of equity awards was calculated for the first quarters of fiscal 2008 and 2009 using each sample company's Form 10-Q disclosure. The research sample was limited to companies with fiscal years ending between September and December so that the 2009 equity awards captured occurred after the severe market downturn in the final months of 2008. In addition, to ensure that grants in the first quarter of 2009 represent a reasonable proxy for full-year data, only companies that granted at least 40% of their total 2008 LTI compensation in the first quarter of 2008 were included.

Fair value was calculated as follows:

- Options were valued using the weighted-average fair value of options granted during the quarter if available.
  - If fair value was not disclosed in public filings, it was calculated using the Black-Scholes option pricing model and the company's reported FAS 123R input assumptions.
- Restricted shares were valued at the closing stock price on the grant date.
- Performance shares were valued at their grant date fair value, assuming target performance.
- Due to limitations of 10-Q disclosure, the value of cash-based long-term incentives was generally excluded from the calculation.
  - This was not anticipated to have a material effect on the data since cash-based long-term awards are usually a small part of most companies' aggregate LTI award budgets.

FVT as a percentage of market capitalization was calculated using the weighted-average market capitalization at the time grants were made.

	An example calculation of FVT is shown below:	
a	Options Granted	1,000,000
b	Weighted-Average Exercise Price	$50.00
c	Weighted-Average Fair Value of Options	$20.00
d = a x c	*Aggregate Pre-Tax Fair Value*	$20,000,000
e	Restricted/Performance Shares Granted	200,000
f	Weighted-Average Grant Date Fair Value	$50.00
g = e x f	*Aggregate Pre-Tax Fair Value*	$10,000,000
h = d + g	***FVT***	$30,000,000
i	Weighted-Average Basic Shares Outstanding	50,000,000
j = b x i	Weighted-Average Market Capitalization	$2,500,000,000
k = h ÷ j	***FVT % of Market Capitalization***	1.20%

Research Sample

To identify patterns in FVT rates among companies of different sizes and industries, we reviewed the public disclosures of roughly 500 publicly-traded companies selected by market capitalization and industry classification according to Standard & Poor's Global Industry Classification Standard industry sector codes. A total of 150 companies provided sufficient disclosure and met the 40% of full-year grants threshold:

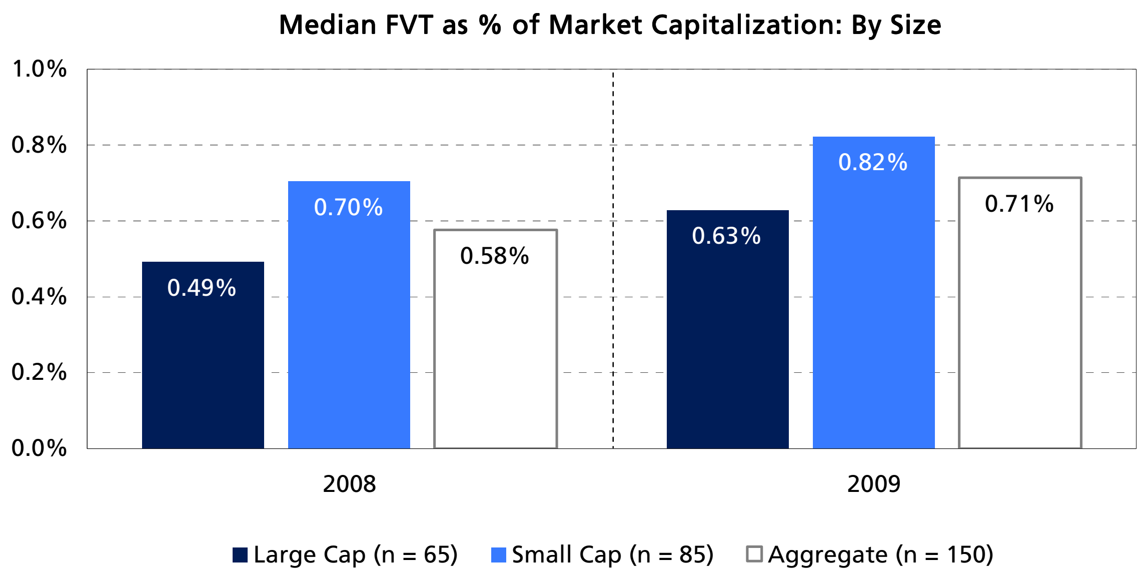
	Large Cap (Mkt. Cap. > $3B)	Small Cap (Mkt. Cap. < $3B)	**Total**
Financial	18	18	**36**
Healthcare	18	20	**38**
Industrial	19	21	**40**
Technology	10	26	**36**
Total	**65**	**85**	**150**

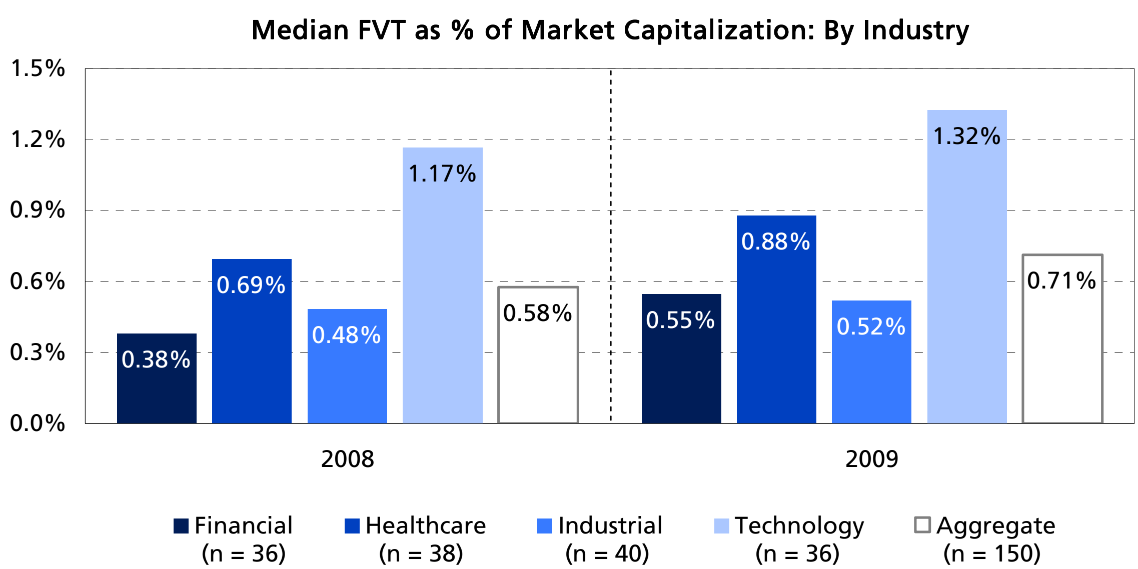
Market capitalization as of April 30, 2009, and last 12 months' revenue for the research sample companies are as follows:

	Market Capitalization as of 4/30/09 ($ Millions)			**Last 12 Months Revenue as of 4/30/09 ($ Millions)**		
	25P	Median	75P	25P	Median	75P
Size Categories						
Large	$4,538	$6,947	$15,854	$2,946	$5,207	$13,997
Small	$240	$634	$1,562	$152	$518	$1,569
Industry Sectors						
Financial	$680	$3,354	$7,819	$506	$2,238	$6,297
Healthcare	$526	$1,896	$5,155	$135	$1,440	$4,954
Industrial	$1,040	$2,704	$6,278	$1,093	$3,637	$7,030
Technology	$231	$1,323	$3,678	$161	$828	$3,574
Total Sample	***$526***	***$2,085***	***$5,957***	***$691***	***$2,285***	***$6,169***

SUMMARY FINDINGS

In aggregate, median FVT as a percentage of market capitalization increased 22% from 0.58% to 0.71% in the first quarter of 2009 compared to the first quarter of 2008. A similar increase occurred across all industry and size cuts:

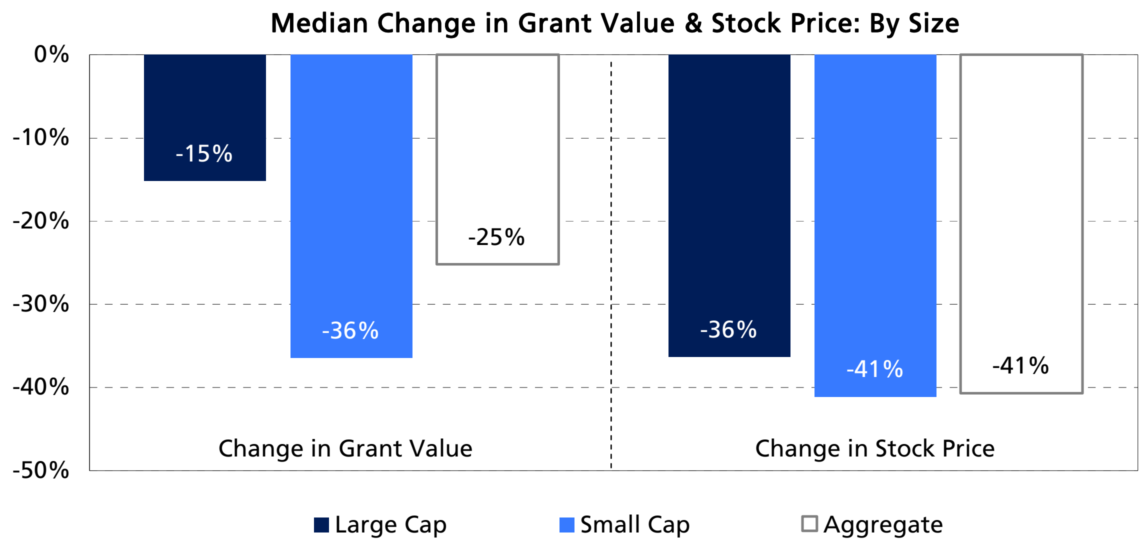


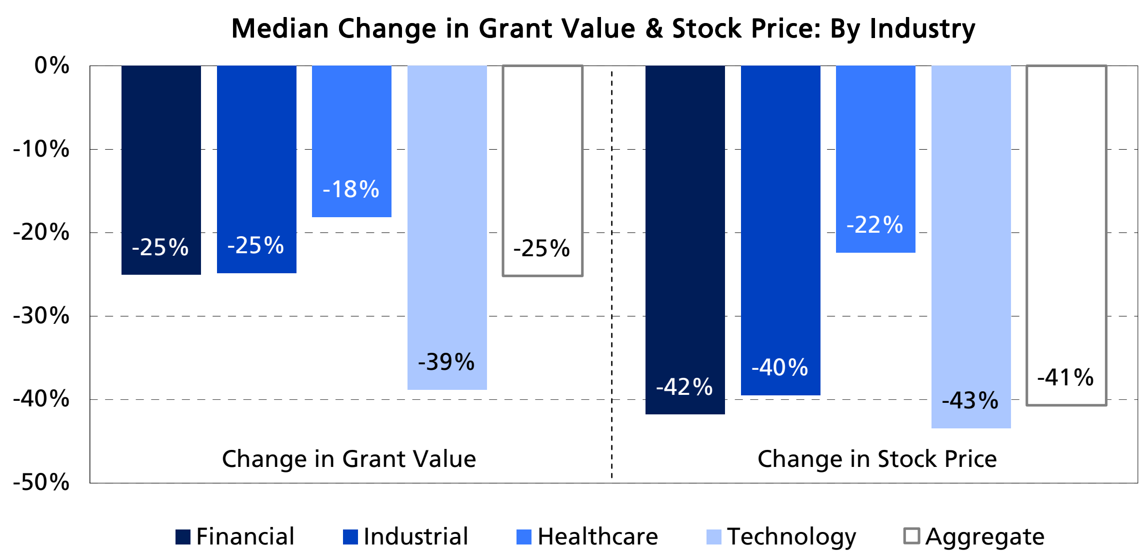


The traditional differences in long-term grant practices between large and small companies and across industries were evident in the data:

- There was an inverse relationship between FVT rates and market capitalization as competitive pay levels increase less than one-to-one with increases in market capitalization.
- Healthcare (including Biotech) and Technology companies continued to grant higher percentages of their total equity value to employees, which is consistent with their human-capital intensive business models.

A key finding is that while the total fair value of long-term incentive compensation increased *as a percentage* of market capitalization value, the absolute dollar-value of awards granted declined compared to the first quarter of the previous year.





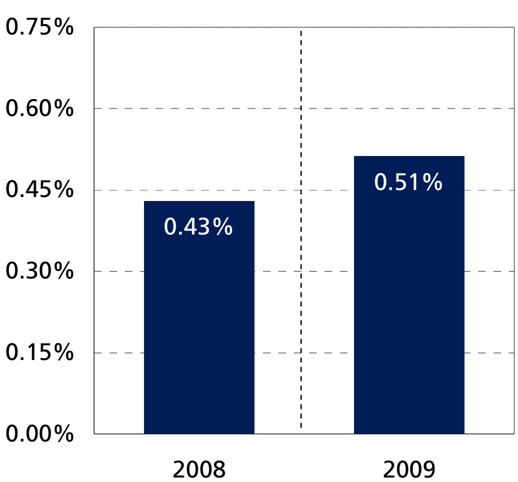
At the median, grant values did not decline as much as stock prices. Interestingly, at large cap companies the median decline in grant value was almost half the median decline in stock price, indicating that many companies took a "split-the-difference" approach where the number of shares granted was increased to offset half of the decline in grant value due to a lower stock price. At small cap companies, the decline in grant values was closer to the decline in stock prices, suggesting greater immediate cost sensitivity and pressure to preserve the share reserve for future equity awards. The findings may also indicate that large companies are more likely to have value-based grant guidelines that increase the number of shares granted when prices fall, while more small companies have FVT- or dilution-based (i.e., fixed-share) grant guidelines that are not affected by price changes.

This bifurcation in practice based on company size was consistent across industries, with larger companies in all sectors more likely to "split-the-difference" by increasing award sizes to offset price declines.

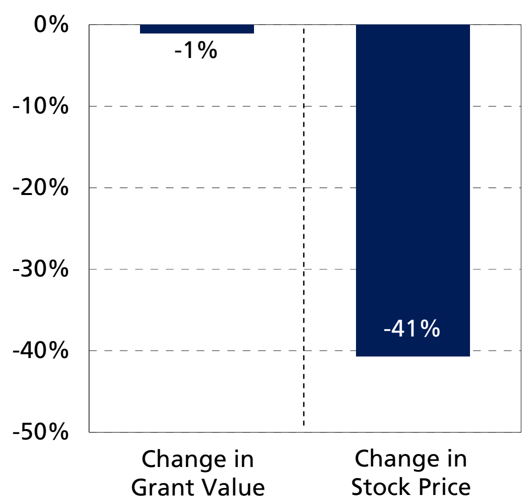
	Median Change In Grant Value	*Median Change In Stock Price*
Large-Cap		
Financial	-13%	-36%
Healthcare	-12%	-19%
Industrial	-15%	-41%
Technology	-29%	-42%
Small-Cap		
Financial	-37%	-45%
Healthcare	-29%	-37%
Industrial	-37%	-38%
Technology	-41%	-45%

Lastly, the 19 largest companies in the research sample (market capitalization greater than $15 billion) provided nearly identical grant values in 2009 as in 2008. This required a 19% increase in FVT with share prices down 41% at median. This shows the greatest devotion to a fixed-value approach of any subset in the sample.

Median FVT as % of Market Capitalization: Very Large Companies



Median Change in Grant Value & Stock Price: Very Large Companies



CONCLUSION

It is not surprising to see that FVT rates increased in Q1 2009 considering the decline in stock prices over the last year. It is a challenging task to augment retention, drive performance, and pay competitively while balancing dilution from equity compensation. The partial reduction in grant values can be viewed as a sign of increased awareness of all factors on the part of compensation committees.

It will be interesting to see whether the spike in FVT rates is isolated to 2009. Presumably, companies will exhaust their equity plan authorizations sooner and shareholders will be asked to decide whether they can accept greater potential dilution for the promise (or hope) of greater returns.

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This letter is intended to alert compensation professionals about developments that may be useful to their companies and should not be relied on as providing specific company advice. General questions about the subjects in this letter may be directed to Michael Reznick at (310) 734-0136 or by email at mpreznick@fwcook.com or to Kenneth Sparling at (310) 734-0138 or by email at khsparling@fwcook.com. Copies of this letter and other published materials are available on our website at www.fwcook.com.