Stock Options: march 06

Why Stock Options Still Make Sense

By James Kim and Edward Graskamp

News reports herald their demise, but two consultants argue that stock options - used by 90 percent of the largest U.S. companies -remain the cornerstone of U.S. equity compensation, and for good reasons.

The new conventional wisdom is that stock options are on the way out, with restricted stock and other forms of long-term incentives replacing options as the predominant form of executive compensation. Microsoft Corp.'s abandonment of stock options in favor of restricted stock units received great attention in 2003. A similar shift by Amazon.com Inc. demonstrated that even growth companies are engaging in the trend.

On the surface, the reasons for the shift are plentiful. Foremost was a new Financial Accounting Standards Board (FASB) accounting rule that imposes an explicit recognition of stock option expense. Investors were increasingly concerned about dilution levels and corporate governance issues linked to excessive option grants. The appetite for risk on the part of employees waned considerably following the collapse of overall share prices from 2001 to 2003. Changes in the tax law also enhanced the appeal of corporate dividend payments, which are generally available for restricted shares, but not stock options.

But, the reports of the demise of stock options have been greatly exaggerated. In fact, stock options remain the cornerstone of equity compensation in corporate America. Even among the largest of U.S. companies, option usage, at 90 percent, still remains well ahead of restricted stock, the second-most popular vehicle, used by two-thirds of companies. Overall, companies are rethinking but not eliminating the role stock options play in their total compensation portfolios.

Stock options will and should continue to be a major component of executive compensation, given the potential for superior long-term wealth-creation power for executives and the benefits for shareholders. There are shortfalls to the traditional use of stock options; obviously, they are not going to be an effective equity compensation vehicle for every company. But the decision to retain or drop, or to modify, the traditional use of stock options should be based on solid analysis and objective consideration, rather than reaction to trends and conventional wisdom.

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The Power of Leverage

In March 2003, Apple Computer Inc. CEO Steve Jobs voluntarily turned in 55 million stock options, with a weighted average exercise price of $18.31, in exchange for 10 million restricted shares worth $74.5 million (based on a $7.45 share price). What seemed to be a great deal at the time may have turned out to be largest all-time individual opportunity loss.

The value of the restricted shares has climbed to $856 million (based on the closing share price on Jan. 13, 2006 of $85.59). But the original stock option grants would be worth $3.7 billion.

This example illustrates the power of leverage that is unique to stock options. Restricted stock offers immediate tangible value, but the trade-off arrives in the form of fewer shares when compared with stock options. While the value of restricted shares can climb, it is always in direct proportion with share prices.

The annualized historical return for U.S. stocks is generally in the range of 8 percent to 12 percent. Consider that the average stock option holding period for executives at large-cap companies is approximately seven years. Frederic W. Cook calculations indicate that only a 6 percent annualized rate of return is required before stock options overtake restricted stock in terms of wealth creation. While the appeal of restricted stock is apparent at the start, if one factors in historical returns, it becomes clear that stock options offer superior rewards over time.

Risk Allocation Between Management and Shareholders

The choice between stock options and restricted stock can be boiled down to risk allocation between management and shareholders. At one extreme, shareholders could agree to pay management entirely in restricted stock, thus taking on substantially the entire equity risk burden.

Such risk is manageable, since shareholders can diversify through a portfolio of investments. In exchange, they would also reap all the excess returns, thus providing adequate returns on a risk-adjusted basis. Management would receive a guaranteed number of shares over time, and while the share values will fluctuate with the price, there would be little leverage opportunity.

At the other extreme, management could receive its entire equity compensation in stock options. Since each option is worth less than a restricted share, more options can be granted in order to offer equivalent initial value. This could be determined using an option-pricing model, such as the Black-Scholes model, where the conversion ratio of stock options to each restricted share might range from 2:1 to 5:1, depending on particularly the volatility of the company's stock price and the expected option term.

In the Apple example, the grant of 55 million stock options - which subsequently fell underwater - presumably was deemed to be worth the same as 10 million whole shares. As long as the share price did not climb above a certain level, Jobs would be better off with the restricted shares. But climb it did, and the excess return of approximately $2.8 billion is now collectively owned by Apple shareholders. By agreeing to "pay" for the underwater stock

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options with guaranteed shares (subject only to time vesting), Apple shareholders absorbed the risk and have reaped the rewards as if they were themselves option holders.

Under more traditional circumstances, understanding risk allocation can help determine the role of stock options and restricted stock. Companies operating in extremely risky industries, such as biotechnology, may need to rely solely on stock options, since the companies' fortunes are likely to be one of two extremes: success or failure. Restricted stock would not offer enough upside to offset the probability of the latter.

Mature companies - or those operating as regulated monopolies, such as utilities - are unlikely to offer significant growth in share price. Stock options in such companies could be less effective, as the hurdle rates may become unachievable. Companies offering significant dividends, which suppress pure share price growth, should offer restricted stock with dividend rights in order to reflect total returns.

The allocation of risk and reward sharing among shareholders and executives can also be used to induce the appropriate degree of risk-taking by risk-averse executives. An all-restricted stock portfolio, for example, may not provide sufficient incentive for executives to take the risks needed to be successful. In contrast, too rich a blend of options could encourage an imprudent degree of risk-taking.

Taxation Implications

Holders of non-qualified stock options, the predominant option form, are taxed at ordinary income rates based on the gain at exercise. In other words, the option holder retains the right to decide the timing of taxation, thus allowing the opportunity for tax-deferred build-up of value.

Holders of restricted stock, however, are faced with taxation as vesting restrictions lapse. For most grants, the lapses occur annually over three or four years, so taxation occurs based on a predetermined schedule. While tax deferral can be obtained through restricted stock units, the process is cumbersome in light of recent tax legislation that, for example, may require that the distribution date be determined many years in advance.

The tandem of tax deferral and timing flexibility serve as major tools at the disposal of the option holder. Since careful tax planning is often an essential activity in maximizing long-term wealth, executives may not be eager to give up stock options in exchange for restricted stock.

Addressing the Problems with Stock Options: Excessive Risk Exposure

Executives face considerable risk exposure due to the concentration of their individual wealth tied to a leveraged equity instrument denominated in a single security. Yet the overwhelming practice for most public companies is to make a single annual grant, with new employees usually given slightly larger awards at or near the commencement of employment. While this is acceptable for a company with low price volatility, others should proceed with caution.

A better approach would be to structure the option award with exercise prices set over a period of time, thus achieving a weighted average more reflective of a true baseline price. Moreover, companies with higher share price volatility should be engaging in more dollar-cost averaging.

The concept of limiting volatility risk should not be interpreted as a means for eliminating pay-for-performance. Quite the contrary, the goal should be to make gains reflective of management performance rather than luck or random timing.

Diversification and Short Term Liquidity Needs

Despite the clear evidence that stock options can offer superior wealth creation opportunities, most employees exercise their options well before realizing the full benefit. Early stock option exercises result in accelerated tax recognition and the forfeiture of any remaining time value. This could be interpreted as short-sightedness, but the underlying reasons warrant careful consideration.

The two chief reasons for early exercise are: 1) the desire for diversification; and 2) supplemental cash. Executives' needs are likely to differ, but companies can consider using restricted stock to reduce the amount of early option exercises and maximize efficiencies.

By granting restricted stock in lieu of some portion of stock options, not only is overall risk reduced, but regular income opportunities can be created by selling restricted shares as they vest. Once diversification and cash needs are met, executives are better positioned to retain stock options and generate maximum returns.

Despite recent trends, the underlying characteristics of stock options remain inviolate; if designed correctly, they can provide the potential for superior, long-term wealth creation opportunities for executives, strengthen pay-for-performance and allow for optimal allocation of risk. Companies should carefully examine these characteristics and create customized approaches that balance risk, leverage and rewards that benefit all of the parties.

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Stock-Settled SARs

A growing trend among companies is the substitution of stock options with stock appreciation rights settled in stock (SSARS). The economics of the two vehicles are identical for the recipient, meaning the potential wealth derived at exercise is the same. However, the underlying mechanics differ and create subtle, yet important implications for both the company and the recipient.

The recipient, while in many cases indifferent, may actually prefer stock options for several reasons. Many companies now require executives to acquire minimum levels of stock over a period of time. Stock options offer the ability to acquire all the underlying shares at a discount (since the option is exercised at a gain) and allowing for taxes to be paid with cash out-of-pocket. While most employees choose the cashless exercise, whereby the underlying shares are sold in their entirety, some executives may wish to acquire all the shares in order to build ownership.

Now consider the financial implications for the company granting SSARs essentially as a stock option, whereby there is an automatic share buy-back with the exercise proceeds (and in some cases, the tax deduction). This may ultimately be the route for some companies (usually ones engaged in share buy-back programs or that pay dividends), but others may rely on the cash inflow to reduce financing needs. Whatever the current cash financing needs, no one can argue that some flexibility is better than none.