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The Crystal Report on Executive Compensation



Stock Options Winners and Losers

by Graef Crystal

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It can make a big difference as to when in a fiscal year a CEO receives a stock option. If the strike price turns out to be ultra-low, he could reap extra millions. If the reverse, he could be penalized. Yet neither the reward nor the penalty may have much to do with his true long-term performance.

I looked at the options granted in 2008 to 356 CEOs running companies with current market caps of \$2 billion or higher. I then decided -- to make things easier -- to focus on companies with calendar year fiscal years. Among these companies, I found 643 option grants made to CEOs.

Next, I looked for option grants where the strike prices, viewed in the context of the company's stream of 253 daily closing prices during 2008, were extremely low or extremely high.

Two Case Examples

Let's look at one of those cases. He is John Wren, CEO of New York-based advertising giant, Omnicom Group Inc.

On Dec. 29, 2008, two days before the end of the fiscal year, he was granted an option covering 1 million shares and carrying a strike price of \$25.48 a share.

Was that a lucky strike price for him? Or an unlucky one?

During 2008, Omnicom's closing prices ranged from a low of \$22.23 on Nov. 20, 2008, to a high of \$49.90 May 15, 2008. The average closing price was \$40.54.

Mr. Wren was lucky. His strike price of \$25.48 was the ninth lowest closing price among the 253 closing prices during the year.

The standard deviation of those 253 closing prices was \$7.62. Therefore, Mr. Wren's strike price was a negative 1.98 standard deviations from the mean (Actual strike price of \$25.48 – Average price of \$40.54) / Standard deviation of \$7.62.

In a normal distribution, a reading of negative 1.98 standard deviations places you at the 2.4th percentile of the distribution, meaning that 98 percent of the closing prices during the year were higher than that particular closing price. In Omnicom's case, and using its actual stream of closing prices, Omnicom ranked at the 3.2nd percentile.

Either way, Mr. Wren got a really nice deal. Compared to having been granted an option carrying a strike price equal to the annual average, he started out \$15 million to the good.

Was the timing of this option a fluke or based on something else? Given Omnicom's calendar year fiscal year, it would seem reasonable to make an option grant right near the end of the year. But it's hard to place that grant date in any recent historical perspective, since the last option grant Mr. Wren received was in 2001.

On the other side of the spectrum, we have Bruce Smith, the CEO of San Antonio, Texas-based oil refiner and marketer, Tesoro Corp.

On January 30, 2008, Mr. Smith was granted an option covering 268,700 shares carrying a strike price of \$40.40 a share.

But the average price for the year was \$22.25, with a standard deviation \$10.30, placing his grant 1.76 standard deviations above the mean, or at the 96th percentile.

In Tesoro's case, the stock pretty much declined the entire year. Had Mr. Smith been granted an option carrying a strike price equal to the annual average of \$22.25, he would have ended up potentially better off by \$4.9 million.

In examining my database, I decided to focus on large options, where a difference between the strike price and the average price would have a relatively significant impact. I defined these options as having a Black-Scholes present value of \$3 million or more. That reduced the overall number of cases to 188.

I also screened further to focus on those options where the strike price was 1.3 standard deviations (equal to the 10th percentile of the distribution of strike prices) or more below the mean or 1.3 standard deviations (equal to the 90th percentile of the distribution) or more above the mean.

It turned out my two groups were not symmetrical.

In the group of "winners" (those where the standard deviation was negative 1.3 or lower), I found 22 cases. The total advantage for these 22 cases (comparing the actual strike prices to the annual average prices) was \$165 million.

But in the group of “losers” (those where the standard deviation was positive 1.3 or higher), I found only half as many cases – just 11. The losers, as a group, were disadvantaged by a total of \$52 million.

Ironically, one CEO – Olivier Filliol of Switzerland-based Mettler-Toledo International Inc. – ended up on both the winners and losers list. He received two different options during 2008. One had a strike price that materially overshot the annual average closing price, while the second materially undershot it. His “loser” transaction was a grant made on Jan. 3, 2008, while his “winner” transaction occurred on Nov. 6, 2008, following the market crash

Was this asymmetrical outcome – more than twice as many winners as losers -- simply luck? Or was there some opportunism involved in picking the “right” date of grant?

There’s one argument to be made in favor of pure luck.

2008 was an unusual year for stocks. The market drifted slowly downward until the end of September and then fell off a cliff in the wake of the Lehman Brothers bankruptcy and the systemic financial failure around the world.

It seems telling here that the median grant date of the 22 “winners” was Nov. 13, 2008, while that for the 11 “losers” was March 3, 2008.

But why did the “winners”, taken as a group, receive their grants late in 2008 compared to the “losers” who received their grants early in 2008? Was that the normal time for the “winners” to receive grants? Or were some of them capitalizing on what they saw as an ultra-low stock price?

Looking at the entire database, I strongly suspect the latter. But I’ll leave it to my readers to decide whether a specific CEO was “just plain lucky” or whether he and his comp committee put its collective thumb on the scales.

Eliminating the issue

One simple way to eliminate this phenomenon is to make an option’s strike price equal to the average daily closing price during the 12 months preceding the date of grant. And to make sure the option really constitutes a true long-term incentive, it would not be exercisable until the end of the fifth anniversary of the grant date. The market price used at the time of exercise would be the average daily closing price for the 12 preceding months. The economic benefit could be paid in shares of stock or even in cash.

I recognize that such an approach would likely require that earnings be charged for the entire gain. But the normalizing used in determining the strike price and the final price for calculation of the gain should mitigate the volatility of such charges.

Herewith are two tables:

- The first lists the 22 “winners”, showing for each the percentile rank of the actual strike prices against the distribution of closing prices during the year, as well as the net advantage.
- The second shows the 11 “losers”.

CASES WHERE CEOs WIN:

COMPANY	CEO	PCTILE RANK	ADVANTAGE (millions)
BCE INC	COPE, GEORGE A.	1.3	\$10.0
DAVITA INC	THIRY, KENT J.	1.4	\$6.3
ASTRAZENECA PLC	BRENNAN, DAVID R	1.5	\$1.5
FIDELITY NATL INFO SVCS	KENNEDY, LEE A.	1.9	\$4.4
LIFE TECHNOLOGIES CORP	LUCIER, GREGORY T.	1.9	\$7.9
ST JUDE MEDICAL INC	STARKS, DANIEL J.	2.0	\$6.1
OMNICOM GROUP INC	WREN, JOHN D.	2.4	\$15.1
BROOKFIELD ASSET MGMT	FLATT, J. BRUCE	2.5	\$10.2
NEWMONT MINING CORP	O'BRIEN, RICHARD T.	2.6	\$4.9
TERADATA CORP	KOEHLER, MICHAEL	3.5	\$5.2
ECOLAB INC	BAKER, JR., DOUGLAS M.	4.1	\$3.4
METTLER TOLEDO INTL	FILLIOL, OLIVIER A.	4.6	\$2.3
DEVON ENERGY CORP	NICHOLS, J. LARRY	4.7	\$7.1
FOSTER WHEELER AG	MILCHOVICH, RAYMOND J.	5.3	\$29.0
CAMERON INTL	MOORE, JACK B.	5.6	\$4.8
COCA COLA ENTER	BROCK, JOHN F.	5.8	\$8.6
ANADARKO PETROLEUM	HACKETT, JAMES T.		\$12.6

		6.2	
GILEAD SCIENCES INC	MARTIN, JOHN C.	8.1	\$2.6
CANADIAN NATL RES	LAUT, STEVE W.	8.8	\$5.5
PUBLIC SVC ENTER GRP	IZZO, RALPH	9.1	\$4.5
AFFILIATED MGRS GROUP	HEALEY, SEAN M.	9.4	\$10.1
BARRICK GOLD CORP	WILKINS, GREGORY C.	9.7	\$2.7
		TOTAL	\$164.7

CASES WHERE CEOs LOSE:

COMPANY	CEO	PCTILE RANK	ADVANTAGE (millions)
WELLPOINT INC	BRALY, ANGELA F.	90.5	-\$5.0
BROADCOM CORP	MCGREGOR, SCOTT A.	90.8	-\$1.5
WISCONSIN ENERGY	KLAPPA, GALE E.	91.2	-\$1.0
XTO ENERGY INC	HUTTON, KEITH A.	92.6	-\$2.0
HUMANA INC	MCCALLISTER, MICHAEL B.	92.8	-\$3.5
METTLER TOLEDO INTL	FILLIOL, OLIVIER A.	92.8	-\$1.2
CHARLES SCHWAB	BETTINGER, WALTER W.	93.1	-\$2.8
VORNADO REALTY TR	ROTH, STEVEN	93.8	-\$15.3
CALPINE CORP	FUSCO, JACK A.	95.6	-\$12.9
TESORO CORP	SMITH, BRUCE A.	96.1	-\$4.9
		TOTAL	-\$50.0

The compensation data used in this article were obtained from Equilar Inc., a leading provider of executive compensation information. Please click here to go to Equilar:

<http://www.equilar.com>

2009 marks Graef Crystal's 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay.