

GraefCrystal.com

The Crystal Report on Executive Compensation



by Graef Crystal

October 2008

BLENDING DIFFERENT OPTION TYPES

If you think about it, the accounting rules mandating a charge to earnings for stock options can be positively liberating. That's because no option gets favorable accounting treatment, and therefore a level playing field has been created.

Where We Are Today

Today, many companies, if not indeed a majority of companies, have moved away from sole reliance on the at-the-market stock option, i.e., an option where the strike price is equal to the market price at grant. I will refer to this type of option by its initials, ATM. As to the lesser reliance on ATMs, a prime reason that is glaringly obvious these days is that the stock market is going up only if you hold your newspaper upside down.

The preferred lash-up now is a mixture of ATM's and totally free shares. In many cases, all you have to do to earn the shares is breathe in and out 17 times a minute, so long as you do that on the company's payroll. And if the physician shines a light in your eyes, he is supposed to get a reflection back.

There are two problems with this combo, though:

- There is less reward when stock price appreciation is high, compared to an all ATM approach.
- There is too much reward when stock price appreciation is non-existent and the stock plummets in value. After all, you can't lose with a free share grant unless the company pulls a Lehman Brothers. And even then, you may have benefitted from dividends in the interim.

The Terror of Premium-Priced Options

Even in the days when there was no charge to earnings for an ATM grant, there was also no charge for a so-called “premium-priced” grant. By this is meant an option where the strike price is higher than the market price at grant. Why someone decided to label this type of option “premium-priced” mystifies me, because I associate the term “premium” with a more valuable grant, not the truly less valuable grant that it is. I will refer to this option by the term traders use, namely, an out-of-the-money grant. (Henceforth, this grant will be referred to as an OOM.)

There are very few takers for OOM options. A notable one was Michael Eisner, who in 1996, accepted three OOM grants totalling nine million shares at the same time he received an ATM grant containing 16 million shares. Of the three OOM tranches, which each contained three million shares, one was 25 percent out-of-the-money at its grant, while the other two tranches were, respectively, 50 percent and 100 percent out-of-the-money. These three OOM grants contained 15-year terms, a good thing for Mr. Eisner, since that last-mentioned tranche, twelve years after its grant, is still underwater (although it did get its hairline above water for two days in mid-2008).

The Shame of Discounted Stock Options

At the same time people are terrified of OOMs, they think of a discounted option as something to be equated with pederasty. A discounted option is one where the strike price is lower than the market price at grant. Because, this is so, the option is, as the traders say, “in the money” at its birth. (I will henceforth refer to this grant as an IIM.)

But why the shame? Why do so many corporate governance experts excoriate an IIM? After all, those same experts often look benignly on free share grants, which are, at bottom, an option with the ultimate discount – 100 percent.

A New Approach

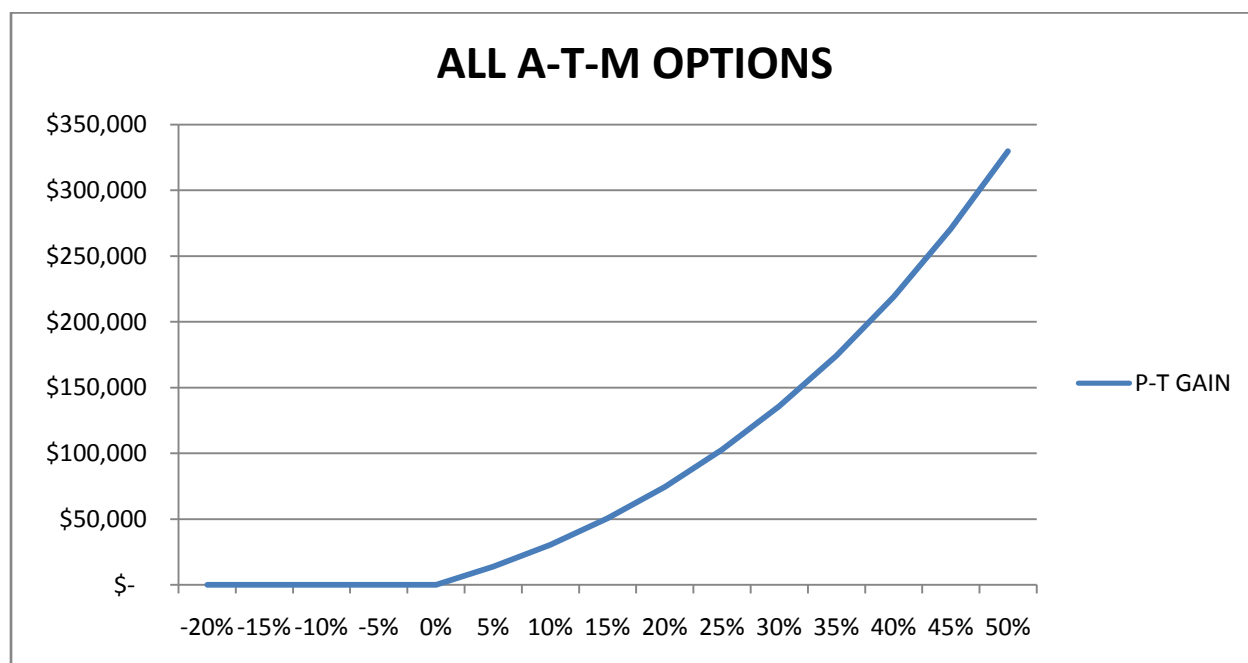
After doing some modeling, I have concluded that combining terror with shame can, amazingly, produce a desirable outcome – sort of like combining two drugs that have mutually-cancelling side effects.

Let’s start here by looking at an ATM option, consisting of 1,000 shares with a strike price of \$50 per share. I have determined that the present value at grant of this option is \$16,000, using the following additional Black-Scholes inputs:

- Expected volatility of 37.7 percent, which as of Sept. 22 was the one-year median volatility (calculated daily) of the stocks comprising the Standards & Poors 500 Index.

- Expected yield of 1.71 percent, which as of Sept. 22 was the median 12-month yield of the S&P 500 group of stocks.
- Expected term of five years, with exercise occurring at the end of the term.
- Risk-free rate of 3.12 percent, which as of Sept. 22, was the yield on a Treasury strip bond with a maturity of five years.

The following chart shows the pre-tax gains five years after grant, as a function of five-year compounded annual stock price appreciation.

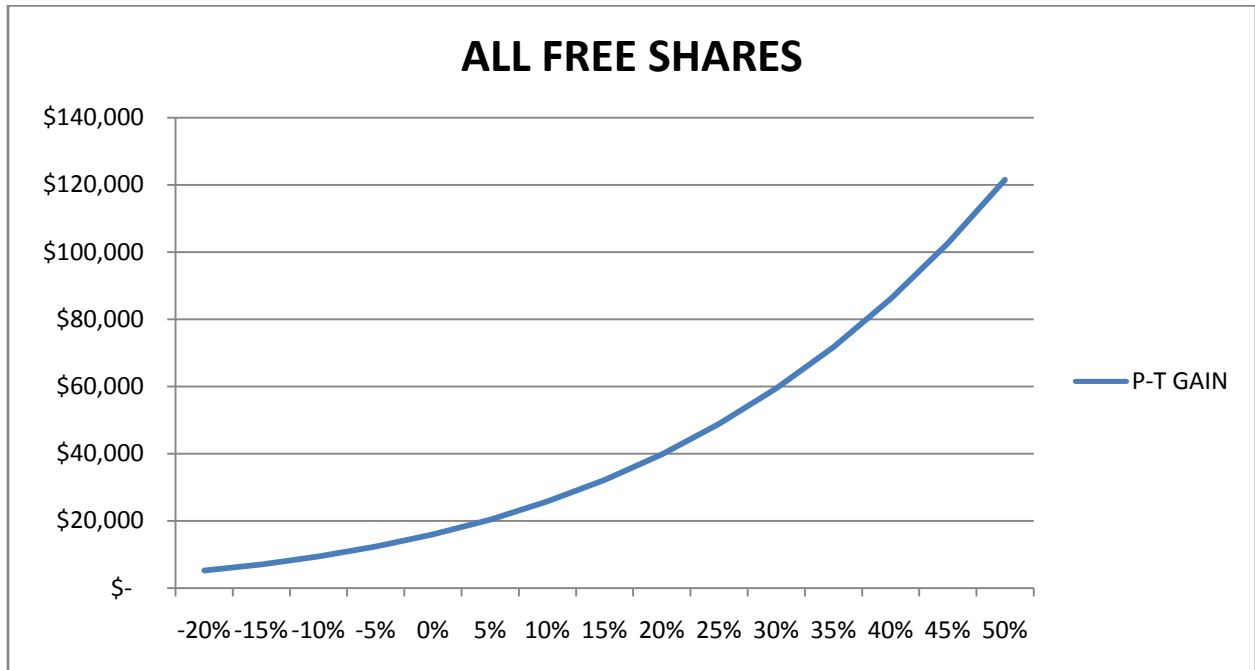


Note two things about this ATM grant:

- As expected, there is no gain if there is no stock price growth.
- As expected, there is a big payout for big growth. Looking at the extreme right-hand side of the chart, the gain for 50 percent per year appreciation – admittedly, awesome performance -- is \$330,000.

Now, let's look at a free share grant by itself. Here, I will assume the grant consists of 320 free shares, which at a grant date price of \$50 per share has the same \$16,000 present value as the ATM grant. For the sake of simplicity, I will assume that there are no dividends on this stock and that 100 percent of the restrictions lapse five years from grant.

Here is a chart of the outcomes.

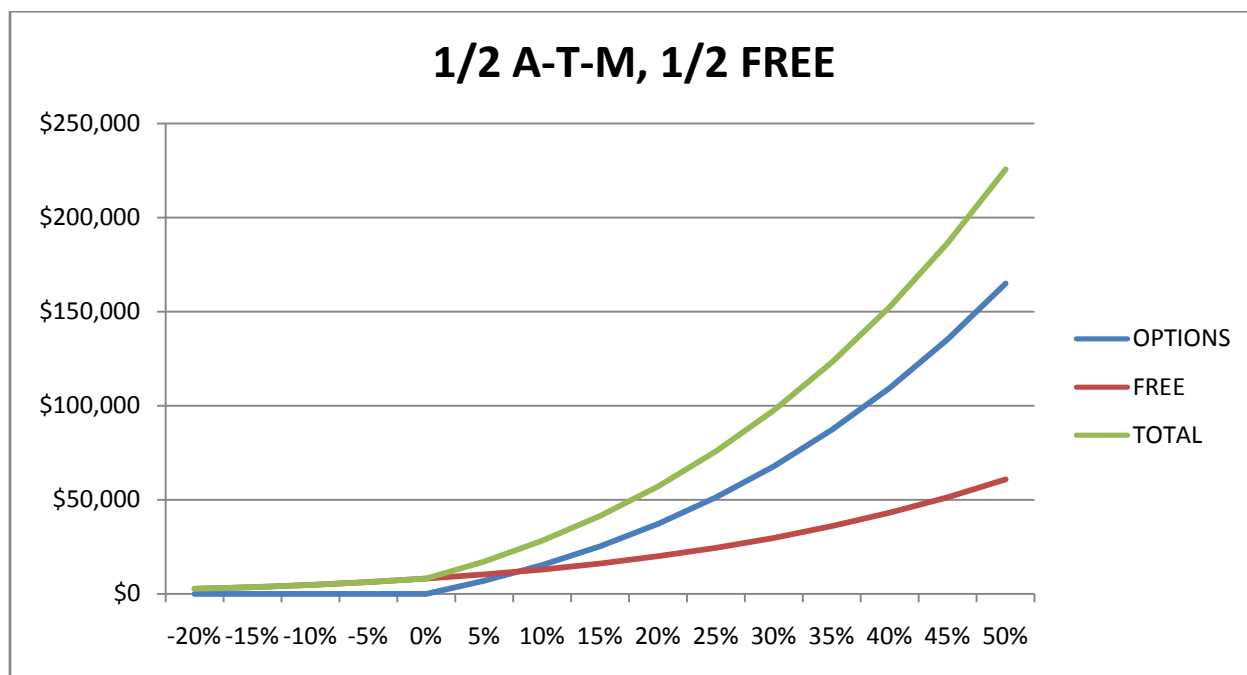


Note two things about this free share grant:

- It offers a much lower payout for truly excellent performance. Whereas the ATM grant produced a gain of \$330,000 at 50 percent per year stock price appreciation, this grant offers only \$121,500 of value for the same performance.
- It offers a payout even if the stock price growth is decidedly negative.

Next, let's look at a combination of ATMs and free shares, with the same combined present value of \$16,000, and with the present value apportioned equally between the two types of grants. That would require a grant of 500 ATM options and 160 free shares.

Here is a chart of the outcomes:



Design Objectives For a New Approach

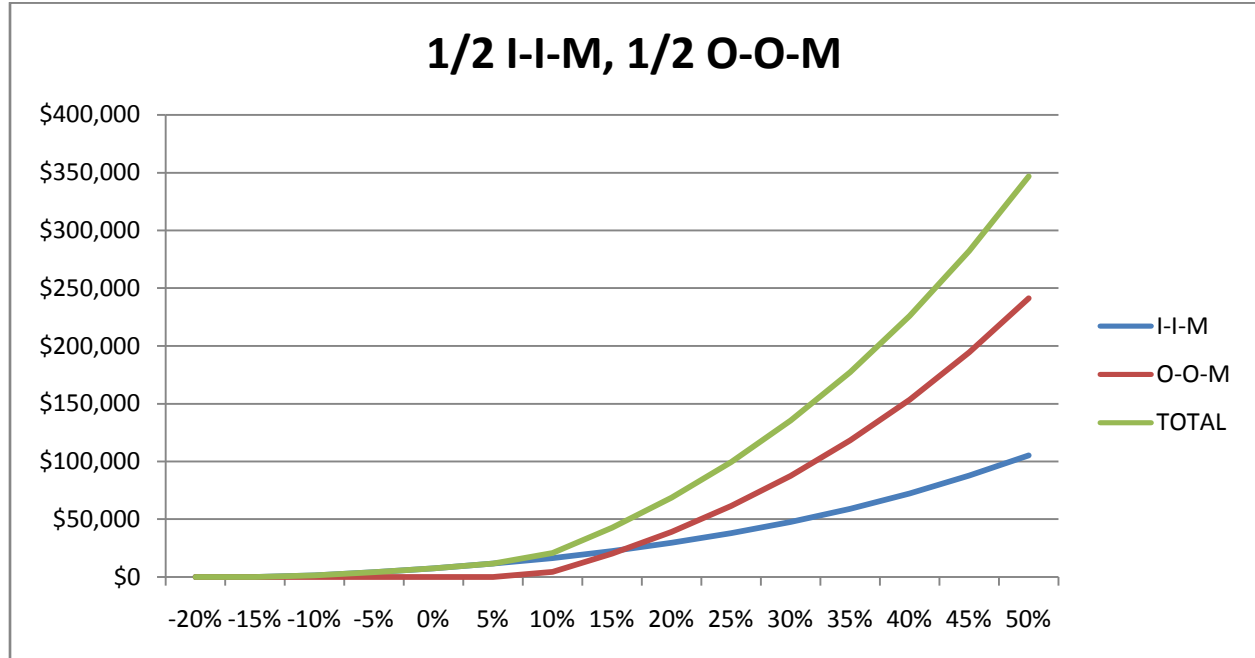
What I would like to see here are these three outcomes:

- Under excellent stock price appreciation, the value gets much closer to an all-ATM option than the combination of ATMs and free shares.
- For modestly-negative performance, there is still some payout.
- Under truly bad performance, the payout is zero.

I'm going to get there by combining an IIM with an OOM, with half the total present value of \$16,000 apportioned between the two grants.

- The IIM grant would consist of 297 shares, where the strike price was 50 percent of the \$50 market price at grant, or \$25.
- The OOM grant would consist of 792 shares, where the strike price was 150 percent of the \$50 market price at grant, or \$75.
- Both grants would have a term of five years, and neither would pay out until expiration.

Here are the results:



Let's compare these different alternatives under four future performance conditions:

TYPE	-10%	0%	10%	20%
ATM	\$0	\$0	\$30,526	\$74,416
RS	\$9,448	\$16,000	\$25,768	\$39,813
1/2 ATM, 1/2 RS	\$4,724	\$8,000	\$28,147	\$57,115
IIM, OOM	\$1,344	\$7,427	\$20,871	\$68,675

As you can see, the combination of an IIM with an OOM pretty much achieves the design objectives for it, as set forth earlier in this article.

Further Design Issues

Here are a few questions that need to be resolved.

Does the IIM-OOM combination require a 50 percent spread between market price and exercise price on both sides? No, that's just an example. You can play around with any combination.

Does the present value have to be equally apportioned between the IIM and ATM grants? No, once again, you can play around.

Does the IIM grant have to have a fixed exercise term. Yes, because of Section 409A of the Internal Revenue Code. I have used a five-year term in my example, but a different term could be used.

Does the OOM grant have to have a fixed exercise term? No, it could be an ordinary option. But for the sake of symmetry, I believe it should also have a fixed term, and the term should be the same as the IIM grant.

Isn't a fixed term confining for the executive? Just because you can do something doesn't mean you should do it. Allowing the executive to choose the timing of exercise can introduce an element of opportunism into the proceedings. It can also turn a truly long-term incentive into a short-term one. For my part, I think fixed terms are lovely.

Do the IIM and ATM options have to be real options, or could they be phantom shares? I believe either would work, and both would have the same accounting, provided the phantom grant were to be paid in shares, rather than in cash. But you need to talk to a compensation consultant about that one – one who, preferably, is not 74 years old and who hasn't been involved in the arcana of the business for more than 20 years.

Doesn't a fixed term expose the executive to stock market volatility? Yes, it would if a corrective were not applied. How would you like your five-year term to come to an end during this substantial market downturn?

What corrective can be applied? Two things come to mind:

- Make more frequent grants. Some Silicon Valley firms grant options every quarter, rather than every year. That way, they sample market prices and help to even out volatility.
- Use a phantom grant and provide that:
 - The base price is not the market price at grant, but some daily average going back for a certain period, for example, the average during the last 60 trading days.
 - The price at the end of the term is not the market price on the last day but a similarly-constructed average of, say, the last 60 trading days.

Start playing around, and maybe you'll find just the right combination for your company. In the famous words of Edward R. Murrow: "Good night and good luck!"

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. In the Spring of 2009, he will be teaching a course in executive compensation at the University of California at Berkeley's Boalt School of Law.