

What's the Role of Equity in the New Environment?

Any mention of the current economic environment brings a litany of disturbing statistics: 90 percent of Fortune 500 CEOs hold underwater options, according to the November 2008 issue of Equilar Inc.'s *Executive Compensation Trends Newsletter*. The average stock price on the NASDAQ and S&P 500 is half of its June 2007 average. The Dow is just a hair behind with a drop of 44 percent. As for total shareholder return (TSR), 59 percent of the Dow companies showed a negative 10-year TSR in January 2009. The NASDAQ was close behind at 55 percent; the S&P 500 fared marginally better at 42 percent. Clearly, market volatility is at historic levels.

Perhaps most disturbing of all is the fact that aside from the financial institutions at the center of the storm, many companies are collateral victims. Although these companies benefited from and thrived in the good times, they now find themselves being punished severely as markets collapse in credit, stock and housing. For executives managing those companies, the consequences sting; option gains accumulated

QUICK LOOK

- ⇒ Companies are in the position of expensing options that likely will never deliver any value.
- ⇒ While stock option grants were never meant to be a guarantee of wealth accumulation, no one could have anticipated how far "out of the money" options would fall.
- ⇒ For nonperformance-based plans, such as options, make grants more frequently during the year, such as quarterly or semiannually.

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during the last five years or more have been wiped out, while dramatic reductions in profitability have, in many cases, rendered valueless those recently introduced performance-based long-term incentives. Companies are in the position of expensing options that likely will never deliver any value.

With little to offer in the way of rewards, companies worry about keeping their people engaged. Although the job market is anything but robust, top talent is always at a premium, especially in firms facing some of the most pressing challenges of the last 50 years. Consequently, selective retention continues to be a concern.

What is not clear is whether the effect of the current turmoil will be transitory. Will executive payouts return to “business as usual” once the markets recover, or will the current shakeup lead to a fundamental rethinking of how executive compensation, and equity in particular, will work going forward?

2008/2009 Ad Hoc Fixes ... and Some Longer-Term Solutions

Caught in uncharted territory, many companies have adopted ad hoc responses to the challenges they face, from addressing share usage, underwater options and market volatility to confronting the conundrum of how to set goals in an uncertain economy.

Although ad hoc fixes likely will continue, their arbitrary nature makes many compensation committees uncomfortable. They also pose communication challenges, both to outside investors searching for meaning in the Compensation Analysis and Discussion (CD&A) and to participants who have memorized the speech on “target value” as stock prices increased (and the number of options/shares in their awards fell). It’s tough to now explain that lower

stock prices don’t translate into a proportionately larger-sized grant.

What follows is a picture of initial responses occurring on the executive compensation landscape along with our perspective on approaches that may bring more stability to executive pay design and decision-making.

Target-Value Approach

The traditional paradigm for setting long-term incentive awards based on target values (generally derived from historic competitive long-term incentive levels) is being challenged. With low share prices and Black-Scholes values, the number of shares and options required to deliver target values runs the risk of yielding rates of dilution and share requirements versus authorizations that are untenable.

Share Usage

Companies have addressed high levels of share usage and their impact on available shares using one or more of several approaches. Some companies took the view that current market prices did not reflect the true value of their stock. To determine a basis for grant sizes, they employed average prices during a specific period, say six months to a year. Others turned to fundamentals and applied historic market multiples to their projected financials or other means to get a better gauge on a more realistic value for their stock. Still others took an expected value approach and looked at the value that would be realized if stock prices recovered — acknowledging that current low prices reflected bargains with significant upside potential. Many companies shifted their focus to share usage and cut back awards to more affordable dilution levels to remain within the constraints of share availability. A few companies addressed share usage by delivering

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comparable target values either by increasing the use of full-value shares or adopting cash plans to conserve shares.

Outstanding Underwater Options

While stock option grants were never meant to be a guarantee of wealth accumulation, no one could have anticipated how far “out of the money” options would fall. According to Equilar, at the end of 2007, the median percent of Fortune 500 CEO option holdings underwater was just 18 percent; by October 2008, the median was 83 percent. And it no doubt has expanded with recent market drops. Stock options were offered broadly in many companies, so the pain is being felt well beyond the C-suite. Beyond diminishing compensation prospects, the drop in option value strains morale and creates retention headaches for many.

The majority of companies are letting options play out thus far even if underwater. Some companies are offering one-time grants of restricted

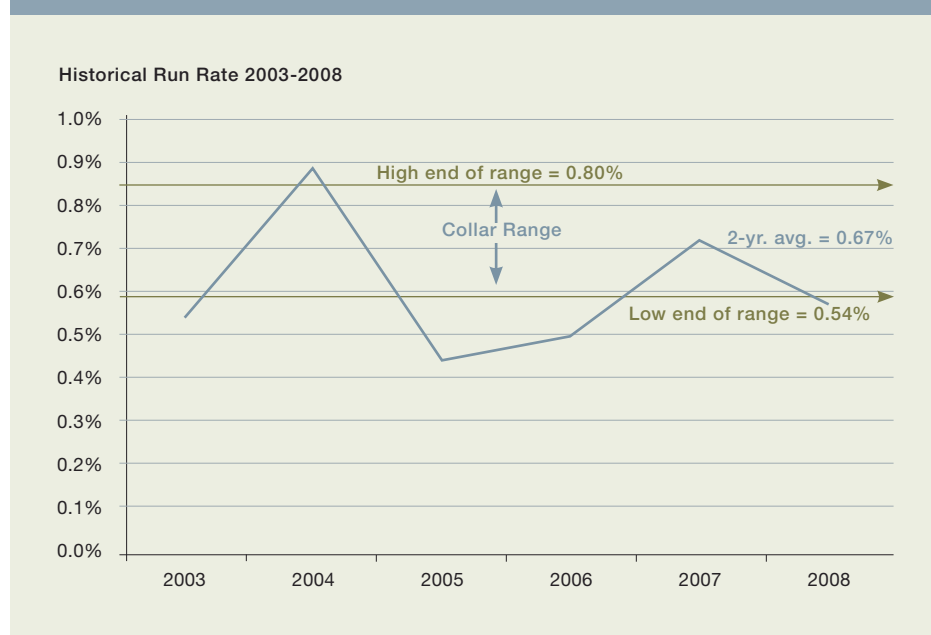
stock targeted at their most valuable and vulnerable talent. Several other approaches are generating talk, but not a lot of action, as they may be unacceptable solutions for most companies. For example, a number of companies have investigated option exchanges to replace options that were perceived to be valueless and for which earnings charges were being accrued. Although still confined to a handful of companies, there has been an increase in option exchanges or the authority to make option exchanges in the future. Equilar reports that in 2008, about “35 companies have completed or proposed” such exchanges. Yet for most companies, an option exchange is not a good alternative. The requirements are stringent and the shareholder optics are poor — employees are getting a chance that shareholders don’t have. Given exchange requirements for shareholder approval, companies that did pursue this route generally had controlling shareholders that were in favor of the action or they adhered to the guidelines suggested by RiskMetrics Group Inc. (e.g., exclusion of directors and most senior executives, exchange on value-for-value basis, etc.)

Perhaps the Better Way

Companies that have not taken any action with respect to shares, or those wondering whether their quick fixes have longer-term viability, may consider three other ways to proceed:

- 1. Target-value approach with a dilution collar:** Awards are allowed to fluctuate in size based on fair values within a predefined range, which specifies a maximum dilution/value-sharing rate should share price dramatically drop. A minimum dilution/value-sharing rate could also be established. (See Figure 1.)

FIGURE 1: DILUTION COLLAR EXAMPLE



2. Switch to an approach that focuses on the value being shared:

Under such an approach, a total award pool would be established whose total fair value was set equal to a specified percent of a company’s market cap and then allocated to plan participants. In periods when individual awards fall dramatically, the amount of differentiation could be increased and participation rolled back. Alternatively, the total pool could be established by looking at the appropriate value sharing given a range of potential growth scenarios.

- 3. Adopt a hybrid approach:** A hybrid approach employs the value-sharing approach, but the value-sharing percents are adjusted when absolute values exceed the competitive 75th percentile or when the market cap grows by more than a specified percentage.

Volatility

Values delivered and option strike prices are highly dependent on timing, and given the market volatility, the risk of new option grants being underwater remains high. In response, companies are

moving some of their long-term incentive opportunity away from options in favor of full-value shares, which vest based on service or performance, or they are adopting or emphasizing performance-based cash plans. Service vesting works best for targeted retention or as a short-term solution when a company needs stability or is going through a strategic shift where goal setting is more difficult. Given the high-performance bias of most institutions, performance shares or performance cash is the way companies are going longer term.

Perhaps the Better Way

Other ways to address volatility and macro-economic factors include:

1. For nonperformance-based plans, such as options, make grants more frequently during the year, such as quarterly or semiannually. For example, a company would make four separate grants throughout the year, but all of the grants vest on the same date. Administering the vesting of quarterly grants can be quite simple, as each grant is viewed as a separate grant that cliff vests after a certain period.

Some companies are introducing shorter performance periods (e.g., one year), but still requiring multi-year vesting (e.g., over two or more years) once the award is earned.

2. Use a portfolio approach to vehicle selection, potentially delivering some value as cash-based long-term incentives that are not subject to the vagaries of the market or performance-based plans with a relative performance component.
3. Push for reconsideration (change in 409a) of partial indexed options (half based on stock price at grant and part indexed to the S&P or some other index, up or down).
4. Strengthen share-retention requirements after vesting or exercise.

Goal Setting

Market volatility makes goal setting close to impossible. How does a company set long-term goals when the current state is filled with so many unknowns? Some companies are introducing shorter performance periods (e.g., one year), but still requiring multi-year vesting (e.g., over two or more years) once the award is earned. Such an approach rewards for performance, which boosts morale, and also bolsters retention, particularly if the payout is worth waiting for. It is particularly helpful in circumstances where “the

future is now,” and one-year performance is critical to company survival.

Other responses include setting annual goals each year during a three-year period, averaging those results, and then adjusting the annual average based on aggregate results. (Note: Companies following this approach forgo the tax deduction under 162(m).) Some companies are flattening the leverage in their payout curves, as well as lowering thresholds and raising maximums. They may set a payout cliff (a threshold level of performance) below which the company is just not open to paying.


Companies in highly cyclical industries, with many direct peers, such as retail, are looking at relative measures. It is easiest to do this type of comparison using total shareholder return (TSR) as the measure; it is much more difficult to make apples-to-apples comparisons with financial measures. Even TSR comparisons have their shortcomings in that the best performers frequently are companies coming out of a turnaround, and peer groups are frequently in flux because of industry consolidation. In addition, relative comparisons are an after-the-fact metric, and participants may feel discouraged by their lack of control over peer results.

Perhaps the Better Way

Any of the above approaches can work. What is important is to conduct a series of analytics to understand how the different approaches might play out in a given situation and to assess the pros and cons.

Final Thoughts

The extreme conditions in today’s world are forcing compensation professionals to rethink overall pay levels and the use of equity. It is painful and unsettling, but it may well yield a different

paradigm all together that may act as a more enduring solution to ensure executives are rewarded in a way that makes sense for all stakeholders and fits each company’s business situation, talent requirements and pay philosophy. Above all, forgo any inclination to follow trends. Circumstances are too different today — every company faces different equity availability, different cash constraints, and different business challenges and talent considerations. While following the crowd was never wise advice for executive compensation, in today’s world it could be riskier than ever before. 

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