

NASPP 2002 Annual Conference

Beyond the Whim of the Market **Performance Alternatives to FMV Stock Options**

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Stock Options Under Fire

Alternatives to Traditional Stock Options

Effectiveness of Alternatives

Performance Measures and Goals

Stock Options Under Fire

Hype: Unrelenting Criticism

- Distort earnings
- Encourage fraud
- Outsize rewards for mediocre performance
- Obscene rewards, then stock craters

2002 Media Quotes

**“Pricking One More Bubble:
Outlandish CEO Enrichment”**

WSJ

**“...heavy use of stock options
...make[s] top executives
adopt overly risky
strategies...”**

Business Week

**“Cash in... get out...
doesn't matter if the company
is bankrupt ...”**

CBS News

**“Options are the ultimate
free lunch.**

**Free to executives...
free to companies ...”**

CNN Money

**“Shareholders lost their shirts,
but executives went... on
raking in the dough.”**

Business Week

**“Options do a poor job of
linking executives to...
shareholder interests.”**

Forbes

Stock Options Under Fire

Reality: FMV Stock Option Use Will Decline

- **Weak retention in bear market**
- **Likely expense charge**
 - ▶ **Significant EPS dilution increase**
- **New share usage constraints**
 - ▶ **Stock exchange rules**
 - ▶ **Institutional investor limitations**
- **Option weaknesses**
 - ▶ **Value affected by timing (grant and exercise)**

Stock Options Under Fire

Despite Criticism, Options Will Still Be Used...

- Linkage to shareholders
- Wealth sharing opportunities
- More value for less cost
 - ▶ If options expensed, only when stock price rises

...But will be supplemented by other vehicles

- Alternatives' strengths and weaknesses need to be re-assessed



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Stock Option Alternatives

Performance Stock Options

Characteristics...

- Financial or stock price goal achievement to vest
- Forfeit if fail to achieve goals
- Variable accounting expense

Impact...

- Reduces unearned bull market gains
- With financial goals, can focus on key value drivers
- Expensive

- Cost will limit use
- Premium-priced options better vs stock price goals

Stock Option Alternatives

Performance Accelerated Stock Options

Characteristics...

- Cliff vests (typically 5 to 7 years)
- Financial or stock price goals to vest early
- No expense today; fixed accounting expense in future

Impact...

- Focus on goals; no change in gain or expense
- Little more performance orientation than traditional FMV options

Better shareholder optics

Stock Option Alternatives

Premium-Priced Stock Options

Characteristics...

- Exercise price exceeds FMV
- Typically structured in tranches
- No accounting expense today; fixed and less than FMV in future

Impact...

- Premium price reduces future option charge
- Weak retention and attraction
 - ▶ Except startups, turnarounds and exceptional growth prospects
- More shares than FMV options

Share constraints will limit use

Stock Option Alternatives

Indexed Stock Options

Characteristics...

- Exercise price tied to a market index
- Reward for relative rather than absolute performance
- Variable accounting expense

Impact...

- More shares than FMV options
- Strong shareholder alignment
- Reduced value to recipients

Interesting concept, but limited use

Stock Option Alternatives

Restricted Stock

Characteristics...

- Time vesting
- Fewer shares than options
- Fixed accounting expense
- 162(m) exclusion from tax deductibility

Impact...

- Strong retention
- Weak link to shareholders
- Can force sale at vesting for taxes

More common in future, given share usage constraints and bear market...

...Particularly below executive level, where compensation and attraction/retention important

Stock Option Alternatives

Performance Restricted Stock

Characteristics...

- Financial or stock price goal achievement to vest
- Forfeiture if goal not met
- Variable accounting expense

Impact...

- No reward without goal achievement
- With financial goals, focus on value drivers
- With stock price goals, expense worse than premium-priced options

- In practice, same as performance shares
- May be used more at executive level

Stock Option Alternatives

Performance Accelerated Restricted Stock

Characteristics...

- Cliff vests (typically 5 to 7 years)
- Financial or stock price goals to vest early
- Fixed accounting expense
- 162(m) exclusion from tax deductibility

Impact...

- Weak shareholder link
- With financial goals, focus on value drivers
- Gain and expense same as restricted stock

Better shareholder optics
Some focus on specific performance goals

Stock Option Alternatives

Cash Long-Term Incentive Plan / Units

Characteristics...

- Two typical structures
 - ▶ Cash LTIP with min, target, max performance levels
 - ▶ Unit grants — unit value varies with performance
- Pre-set cycle, typically three years
- Value not related to stock price (unless a performance goal)
- Variable, but capped accounting expense

Impact...

- With financial goals, focus directly on value drivers
- Maximum potential earnings charge known in advance

Tangible reward for achievement

Stock Option Alternatives

Performance Shares

Characteristics...

- Grant of potential shares
- Only earn with performance (stock price or financial)
- Value depends on ending stock price
- Pay in cash or shares
- Pre-set performance cycle, typically 3 years
- Variable accounting expense

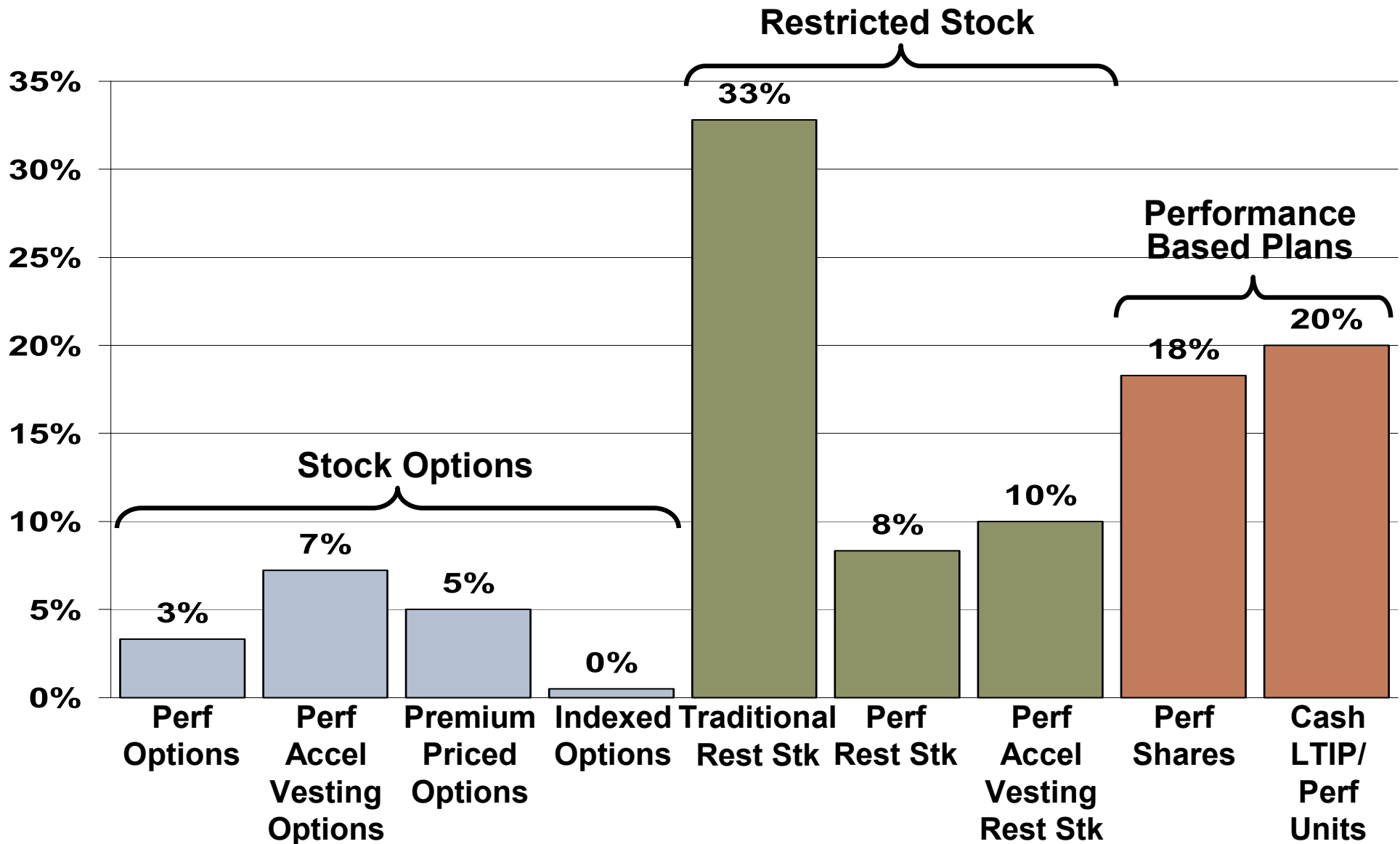
Impact...

- Financial goals focus on value drivers
- Maximum potential earnings charge *not* known
- More EPS dilutive than cash LTIP

Effectively same as performance restricted stock

Stock Option Alternatives

Plan Prevalence





Stock Options Under Fire

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Effectiveness of Alternatives

Performance Measures and Goals

Effectiveness of Alternatives

Key Choices

Stock Options	Performance Plans	Restricted Stock	Enhanced Stock Options
<i>Accelerated Vesting FMV</i>	<i>Units, Shares, Performance Restricted Stock</i>	<i>Time or Accelerated Vesting</i>	<i>Performance, Premium, or Indexed</i>

Virtues

<ul style="list-style-type: none"> ■ Shareholder Alignment ■ Cost / Value Ratio* ■ Simplicity ■ Wealth Potential 	<ul style="list-style-type: none"> ■ Value Driver Focus ■ Tangible Rewards ■ Controllable Results 	<ul style="list-style-type: none"> ■ Retention ■ Tangible Rewards 	<ul style="list-style-type: none"> ■ Shareholder Alignment ■ Unearned Gain Protection ■ Lower Cost (Premium & Indexed)
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Issues

<ul style="list-style-type: none"> ■ Share Use ■ Perceived Value ■ Market Timing 	<ul style="list-style-type: none"> ■ Discipline ■ Complexity ■ Variable Cost 	<ul style="list-style-type: none"> ■ Reward Longevity ■ Taxes/ Stock Sales 	<ul style="list-style-type: none"> ■ Share Use ■ Perceived Value ■ Variable Cost (Performance)
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* In future option expense environment, options will still be cost effective when stock prices rise

Effectiveness of Alternatives

Sample Future Plan #1 — Turnaround Company

Goals

- Reduce share usage
- Maximize attraction and retention
- Control expense increases

Top Executives

- 2/3 FMV options
- 1/3 Performance restricted stock

Senior Managers

- 1/2 FMV options
- 1/2 Restricted stock

Mid-Level Managers

- 1/3 FMV options
- 2/3 Restricted stock

Others

- Exception basis restricted stock

Restricted stock at 1:4 ratio to options versus Black-Scholes value of 1:2

Effectiveness of Alternatives

Effects of New Plan — Turnaround Company

■ Reduces shares used

- ▶ 1:4 ratio of restricted stock to options replaced
- ▶ Overall effect equals about 50% share reduction
 - 1/2 of options replaced by 1:4 shares
 - Lower level options largely replaced (exception basis only)

■ Expense increase essentially neutral

- ▶ Expense charge for 1:4 restricted shares balance future expense charge for extra options

■ Enhances performance focus and retention

- ▶ Tangible value for meeting restricted stock goals

Effectiveness of Alternatives

Sample Future Plan #2 — Profitable Performing Company

Goals

- Increase focus on performance/drivers
- Link wealth creation to performance
- Keep share usage reasonable

Top Executives

- 1/3 FMV options
- 1/3 Premium-priced options
- 1/3 Performance shares

Senior Managers

- 1/2 FMV options
- 1/4 Premium-priced options
- 1/4 Cash LTIP or performance shares

Mid-Level Managers

- 1/2 FMV options
- 1/2 Cash LTIP or performance shares

Others

- FMV options

Effectiveness of Alternatives

Effects of New Plan — Profitable Performing Company

■ Share use neutral

- ▶ More premium-priced shares; fewer performance shares

■ Shareholder friendly

- ▶ Seniors fully share only above premium price
- ▶ Performance plan financial goals ensure results to earn awards (and finance costs)

■ Significant wealth opportunities preserved

- ▶ If financial/stock performance strong

■ Controllable results in performance plan provide retention in bear market

- ▶ Better line-of-sight in business units

■ Adds variable accounting expense, partly balanced by financial goals

Effectiveness of Alternatives

Sample Future Plan #3 — High Growth / High Prospect Company

Goals

- Attract exceptional talent with wealth potential
- Meet shareholder performance requirements without increasing share usage

Top Executives

- 1/3 Premium-priced options
- 1/3 FMV options
- 1/3 Cash LTIP

Senior Managers

- 2/3 FMV options
- 1/3 Cash LTIP

Mid-Level Managers

- 1/2 FMV options
- 1/2 Restricted stock (1:3 ratio to options)

Others

- FMV options

Effectiveness of Alternatives

Effects of New Plan — High Growth / High Prospect Company

■ Shareholder friendly

- ▶ Initial stock price increases only partly shared with executives

■ Significant executive wealth potential

- ▶ Leverage of extra shares balances premium on options

■ Cash LTIP and mid level restricted stock offsets premium-priced share usage

■ Cost increase manageable in future option expense environment

- ▶ Premium-priced option expense less than FMV per option
- ▶ Restricted stock expense offset by 1:3 ratio

Effectiveness of Alternatives

Design Objectives Drive Ultimate Choices

Situational Objectives	Stock Options	Premium Stock Options	Perf Stock Options	Rest Stock	Perf Rest Stock	Cash Perf Plans	Perf Shares
Focused Motivation							
Retention Power							
Cost (today)							
Cost (future)							
Share Conservation							
Shareholder Alignment							

Not Favorable
 Significantly Favorable
 Most Favorable



Stock Options Under Fire

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Performance Measures and Goals

Performance Measures and Goals

Three Categories of Long-Term Incentive Performance Measures

Stock Price Measures

Financial Measures

Operational Measures

**Least
Line-of-
Sight**

**Greatest
Line-of-
Sight**

**Direct
Shareholder
Alignment**

**Indirect
Shareholder
Alignment**

Performance Measures and Goals

Types of Measures

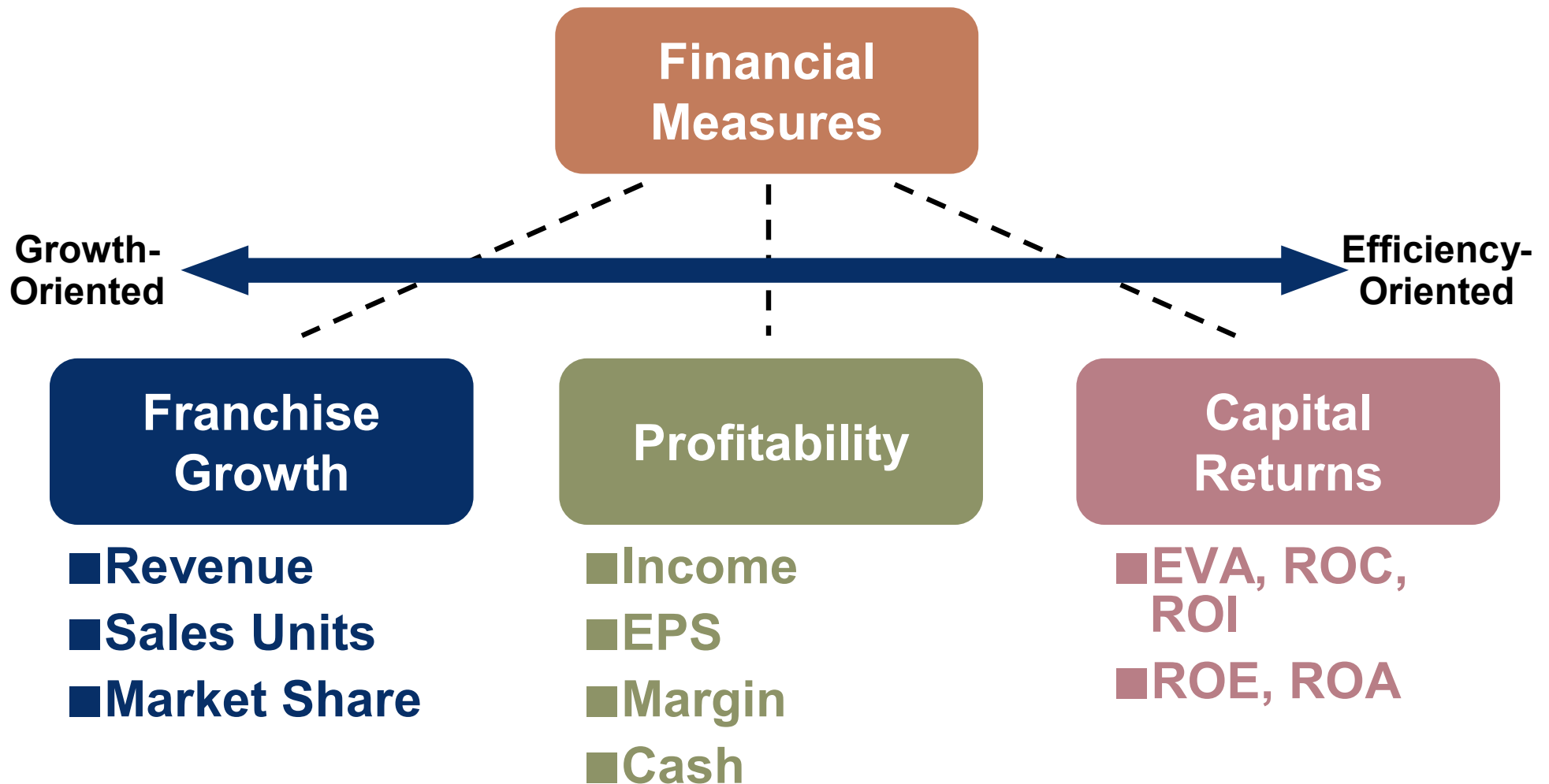
Stock Price Measures

- Stock Price Goals
- Total Return to Shareholders

- Often used with options or restricted stock to accelerate vesting
- Combined with financial/operations measures, provide direct shareholder alignment
- Measure achievement over time, not a single day (e.g., 20 consecutive trading days)

Performance Measures and Goals

Types of Measures



Performance Measures and Goals

Types of Measures

Operational Measures

- Productivity
- Transaction or Unit Cost
- Quality
- Customer Satisfaction
- Safety

- Often industry specific
- More directly controllable by larger group of employees
- Less frequently used as LTI measure than financial
 - ▶ Can be critical drivers
 - ▶ Can be “soft” measures

Performance Measures and Goals — Goal Setting

Plan

- Performance versus long-term plan or budget
- Reflects current economic expectations
- Subject to regular negotiation

Growth Based

- Performance versus prior years' performance
- Rewards improvement only

Standards Based

- Performance versus pre-set standard
- Subject to one-time negotiation
- Absolute standards align with shareholder interests
- May produce unrealistic goals in extreme conditions

Relative

- Performance versus peers or stock index
- Only TRS readily comparable
- Reflects changing environment
- Communication challenge when goal “moving”

Performance Measures and Goals

Choosing the Right Measures...

- Reflect key strategic objectives
- Consider unintended consequences
- Enhance shareholder value long term
- Provide guidance on what to do differently
- Focus on critical needs
- Balance annual measures
- Reflect cumulative results
- Situational (can change)
- No more than three measures

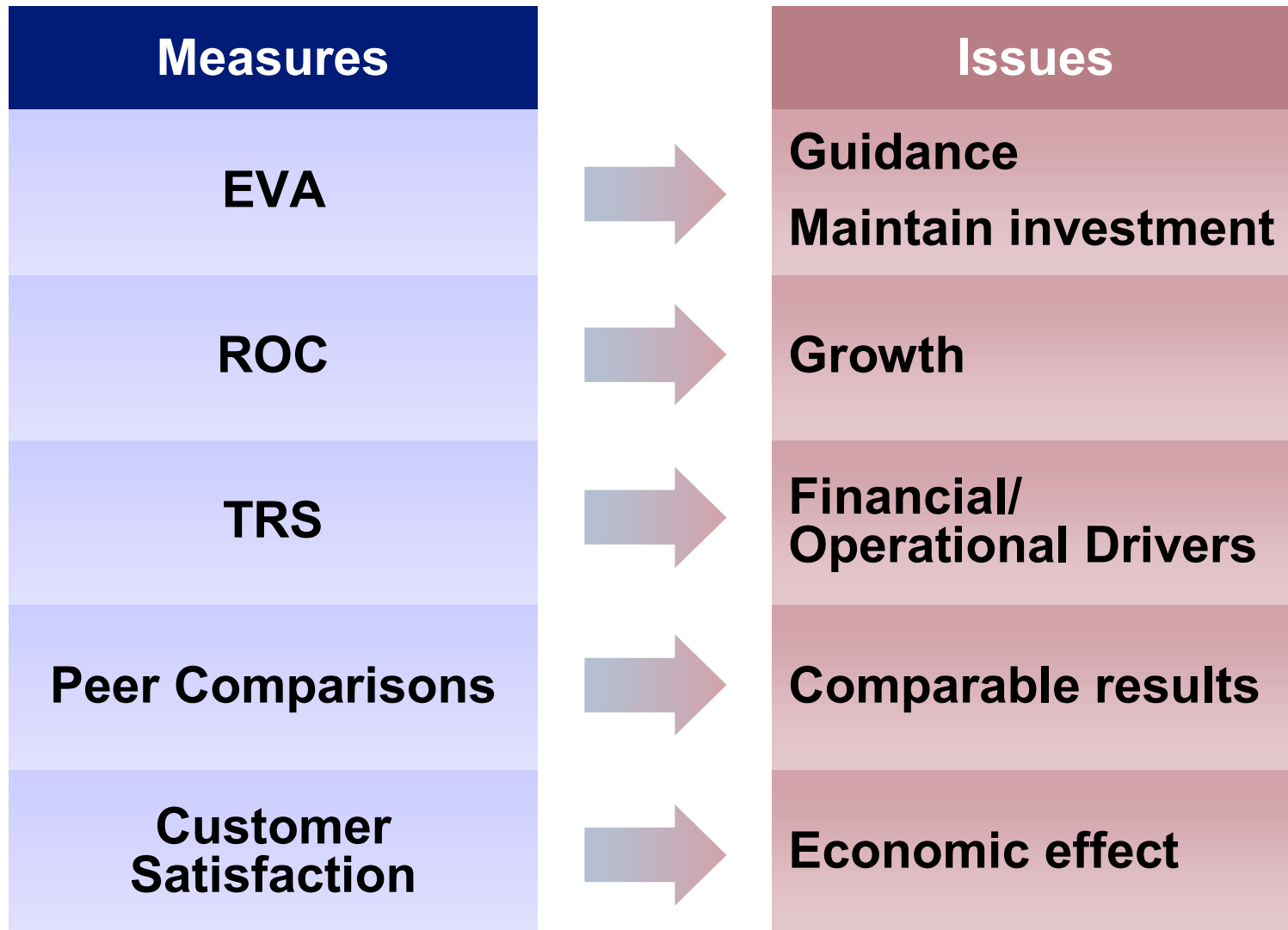
Performance Measures and Goals

Risks of Typical Measures

Measures	Issues
Revenue Growth	Margin Capital cost
Margin	Growth Capital cost
Cash Flow	Maintain investment
EBIT or EBITDA	Capital cost Taxes
EPS	Guidance Capital cost

Performance Measures and Goals

Risks of Typical Measures

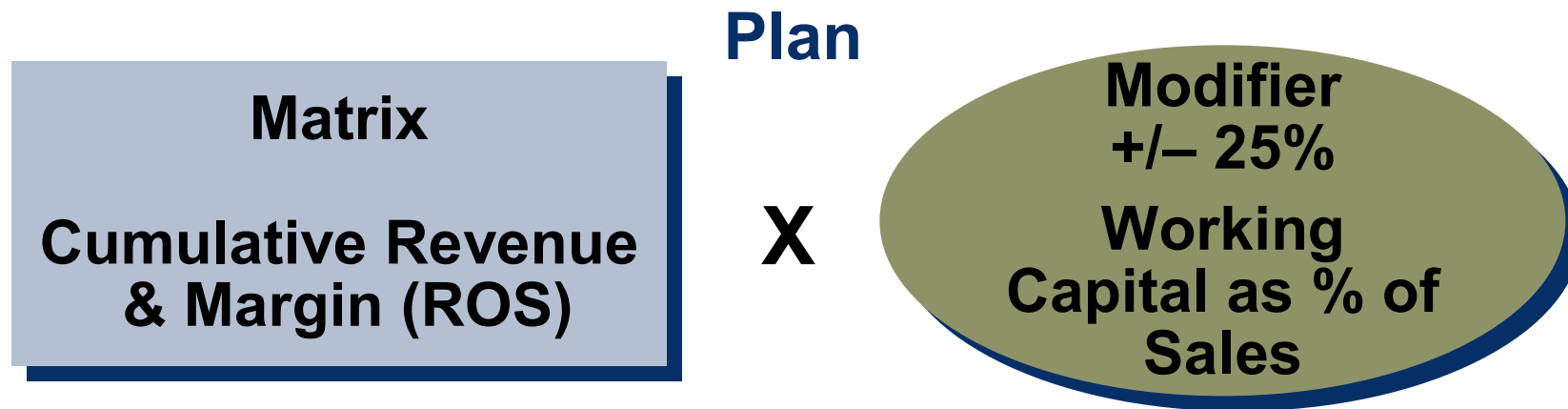


Performance Measures and Goals

Example #1

Strategic Issue — Revenue Growth

Operational Issue — Excess Working Capital



Illustrative Matrix

Cumulative Revenue

		Low	High
Margin (ROS)	High		Maximum
	Low	No Payout	Target

Performance Measures and Goals

Example #2

**Strategic Issues:
High Capital Use**

Plan

**EVA
or
ROC**

- **Duration — Until fixed**
- **Investment exceptions**

Performance Measures and Goals

Example #3

**Strategic Issues:
High Debt
Strong Earnings but Low Conversion to Cash**

Plan

**Free
Cash Flow**

Duration — Two years, then replace