ADAPTING STOCK PLANS TO NEW REALITIES

For the last decade, the toughest question many companies faced about long-term compensation was: "How many stock options should we give out, and to whom?"

Today, we are in the midst of unprecedented change in every aspect of long-term and stock compensation, and plans and practices need to be examined in light of:

- **NEW ACCOUNTING RULES –** *FAS 123 makes options expensive; it also changes the accounting for other stock vehicles, which need to be considered anew.*
- **NEW SHAREHOLDER ATTITUDES & APPROVAL REQUIREMENTS –** *Not only are shareholders lashing out against stock options, they are imposing strict controls on overall share use for stock plans, and proposed exchange rules reinforce their control.*
- **CHANGED EMPLOYEE ATTITUDES –** *In the post-bubble stock market, perceived option values are being risk-adjusted; and their value to employees is often much less than their cost to the company.*

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As U.S. companies review their current stock option or other long-term compensation plans, they need to see clearly that going forward the old, familiar rules will not be the same. Tried and true assumptions on what's right or even what works are already problematic at best. Companies need to plan how to adapt now, or evolution is likely to pass them by.

For most of the past decade, stock options were the primary equity vehicle. They were described as aligned with shareholder interests, desired by employees, motivating productivity and creativity, sharing wealth created, and they had no P&L impact. Some companies continued to supplement their stock options with restricted stock or cash long-term performance plans—but stock options were the vehicle of choice.

Today, as companies look forward, that simplicity has been replaced by a confounding complexity and a profound need to understand a sometimes bewildering array of new attitudes, new constraints, new consequences and new vehicles.

Said directly, for many companies, the days of just issuing options are over, whether they know it yet or not. Options are the victims of '90's abuses, an overheated market, shareholder activism, radical accounting changes and a difficult economic environment. And, the alternatives to stock options have themselves been affected and changed by these same forces.

In deciding what to do now, it is essential for companies to understand the forces driving change and the practical, real world pros and cons of various potential changes and vehicles.

This report, then, is an effort to set the record straight on the basics of what should be considered, and why, to maximize success in a difficult transition. Undoubtedly, new techniques will continue to emerge in this environment of profound change, but the basics of adaptation are clear.

THE EMERGING ENVIRONMENT FOR STOCK OPTIONS & OTHER LONG-TERM PAY VEHICLES

There are four primary drivers of change we will discuss, along with their design implications. But, the bottom line is that most companies now face, or will face:

- **Less stock for option or other pay programs authorized by shareholders**
- **Less value assigned by employees to their options, and less attraction/retention from options given, except in exceptional circumstances**
- **Increasing investor focus on FAS 123 accounting and on *earnings after option expense*, and hence pressure to reduce stock plan expense**
- **Increasing use of other vehicles like restricted stock, cash long-term incentives and/or performance stock or performance option plans**

THE FOUR DRIVERS OF CHANGE

There are four considerations which will be the ongoing touch points, the realities around which plan design choices will need to be made over the next few years.

1. Option Expensing **–** The FASB has made it clear that it intends to require that stock options carry an income statement expense as early as 2004 and no later than 2005, removing one compelling reason to choose options over other vehicles. This means that as early as *next year*, all U.S. companies may be required to adopt FAS

123, "fair value" accounting for stock options.[1] In practice, option expense will begin to affect analyst perceptions of corporate results now, in 2003. This will be driven by the over 200 companies voluntarily expensing options in their reported earnings, and by the new quarterly FAS 123 footnote expense report for everyone else.

Importantly, it is not just about expensing options—it's about the requirement to account for *all* stock based program costs under FAS 123—and that changes the accounting for a wide variety of existing and potential stock vehicles.[2]

2. Shareholder Activism – Shareholders seem almost to be in revolt against stock options. A number of prominent shareholder activists and investors have made public statements against options, and in favor of other vehicles like restricted stock or cash performance plans. There is no unanimity among critics. John Bogle of Vanguard directly asks companies to replace options with restricted stock; others deride restricted stock as "pay for pulse". In our view, some of the extreme views are overblown; options still only have value when the share price rises; restricted stock provides alignment with shareholders, if not to the degree of options. And performance vehicles have their own uses and issues, as we will see later in this piece.

Importantly, institutional shareholders/ organizations have stepped up scrutiny of companies' share usage for equity incentive plans, opposing resolutions for what they consider excessive use of shares. Getting approval of enough shares to fund your long term programs is now problematic for many companies with high run rates and overhang. Indeed, some companies seem to be suffering share use and overhang hangovers from '90's option binging. Quite simply, most companies need to consider other programs which will use fewer shares than the current option plans.

3. Employee Attitudes – Employees looked at stock options as lottery tickets with a high probability of winning in the heyday of the bull market. Generally, that perspective has more than sobered. If anything, most employees' recent experiences with underwater options have caused them to put way *too little* value on option grants. While a market recovery will help, we are unlikely to see most employees in most situations assigning the kind of values to options they did in the '90's.

4. Stock Exchange Guidelines – Both the NYSE and NASDAQ have proposed new rules limiting companies to shareholder approved options (no more so called "broad based" plans). These will be approved soon by the SEC. And, the NYSE has proposed shareholder votes for any repricing of underwater options.

As a result of these four forces, many companies face the worst of all compensation worlds: *expensive stock options viewed negatively by shareholders and not valued by employees.*

In this context, companies need to revisit their pay strategy to determine whether more than just stock options are appropriate for long-term incentives. The degree to which each of these forces affect one company versus another, and ultimately the best long-term incentive approach, will vary, but everyone needs to rethink their current approach given the new realities.

HOW TO CHOOSE & USE ALTERNATIVES TO STOCK OPTIONS UNDER FAS 123

We believe stock options will continue to have a role in many long-term incentive programs, particularly for senior management, where the primary incentive focus should be on increasing shareholder value. However, including other

[1] " Fair Value" today means assigning an expense to all stock vehicles at grant. For options, it means Black Scholes or Binomial value models. Barring some new methodology, it is only wishful thinking to believe that this approach will not continue when FAS 123 becomes mandatory.

[2] Long term vehicles like performance shares, performance restricted stock and performance or indexed options are accounted for much more favorably, as are stock appreciation rights (SARs) settled in stock. Restricted Stock accounting does not change, but can now be compared favorably to expensive options. However, many Employee Stock Purchase Plans become compensatory and more expensive, as does changing existing option exercisability or vesting.

vehicles as part of a company's long-term incentive program will quickly become common in the new environment. In sorting through alternatives to stock options, companies should consider other long-term vehicles relative to their specific circumstances and the forces driving change – expense impact, share constraints, shareholder perspectives, and employee attitudes. Alternatives to stock options can be grouped in the following three general buckets:[3]

- **Restricted Stock**
- **Performance Plans – Performance Shares, Performance Restricted Stock or Cash Long-Term Incentive Plans**
- **Performance-Based Stock Options – Indexed Options, Performance Options**

We believe that Restricted Stock and Performance Plans are the most practical vehicles for companies to consider. Combining restricted stock and/or performance plans with stock option grants in a "blended" long-term incentive approach can lead to a number of benefits for companies:

- Reduced share use from employee incentive plans, to mitigate concerns about run-rate and overhang,
- Reduced income statement expense relative to an options-only approach (assuming options will be expensed), and
- A better set of incentives that balance linkage with shareholders (stock options are best for this), direct reward for achievement of specific performance goals (a well designed performance plan is best for this) and attraction/retention effectiveness (restricted stock is best for this).

Below we discuss the benefits of each alternative vehicle relative to the forces compelling change in long-term incentives and provide implementation guidance for the most viable alternatives – Restricted Stock and Performance Plans.

RESTRICTED STOCK – ONE ALTERNATIVE TO STOCK OPTIONS

Restricted stock is stock that becomes owned by the employee after service-based restrictions lapse. It is a viable alternative to stock options because of the large benefits from an expense, share use, attraction/retention, employee attitude and sometimes shareholder perspective – *particularly below the senior most management levels.*

- *Expense Impact* – Restricted stock, if structured properly, can lead to lower expense than options only. Restricted stock has significant tangible value versus the theoretical (Black Scholes) value of an option, and should not be traded off on a pure value for value basis. Under a set of conservative assumptions, a typical company moving *half* its long-term awards to restricted stock instead of stock options could save 2 cents in EPS per year *for each year's grant* versus options-only. As grants continue to be made over several years, this could build up to 10 cents in EPS savings *per year*.

- *Shareholder Perspective* – Restricted stock uses many fewer shares than stock options, so run-rate and overhang decrease. Using restricted stock also aligns with some recently voiced shareholder perspectives. Companies must be cautious in how much restricted stock is given and to whom to avoid future backlash – see following implementation guidance.

- *Employee Attitudes* – Restricted stock is an employee-friendly vehicle. It provides tangible value to employees. It is also less confusing to employees than a stock option as employees are receiving the full value of a share when it vests and the share will have value to them even if the price declines after grant. Restricted stock provides significant retention power as employees view restricted stock as real value that they would be walking away from if they decided to leave (particularly after several years of grants).[4]

[3] We believe that under FAS 123, a number of hybrid vehicles may also emerge, combining the best features of each; some are being worked on even as we go to press. Additionally, specialized vehicles, like Stock Appreciation Rights (SARs) paid in stock have the potential to replace options directly, and significantly reduce share use and thus overhang.

[4] Note also that, under FAS 123, dividends on Restricted Stock which vests have *no extra expense charge*. This could be even more significant if dividends become tax free to recipients.

Implementation Guidance:

1. **Manage the conversion ratio**. Recipients of restricted stock naturally value real shares higher than options. We believe that companies and their shareholders are ill-served by replacing the Black Scholes value (and thus expense) of an option with an equal grant value in restricted stock. It is *not* necessary. We have developed several such replacements at a substantial discount to Black Scholes value and employees were happy to have it. As illustrated in Table 1, companies with higher Black Scholes values could trade fewer options for each restricted share, while companies with lower Black Scholes values could trade more options for each restricted share. The result is to deliver higher value with less expense than options.

2. **Mix**. Senior executives should still receive at least a substantial portion of their potential value in the form of stock options or other performance related incentives, as they still need to be rewarded for growing shareholder value. As grants are made to middle and lower levels, more emphasis on restricted stock may make sense, even using restricted shares exclusively at lower levels where pay delivery and retention are the primary objectives.

   Where restricted stock grants are made to the senior most executives, *performance restricted stock*[5] often makes sense, since the U.S. tax code 162 (m) stipulates that time-vested restricted stock gains for the top five officers do not qualify as "performance related" for tax deduction purposes. Performance criteria can be share price increase or financial goals. Alternatively, a variation on restricted stock, restricted stock units, can be used to defer receipt of the shares, and also solves the 162(m) issue.

3. **Vesting**. Vesting on long-term incentive awards plays a retention role. In setting vesting, companies need to find the balance between getting the most service time possible with the degree to which recipients discount future potential income when that potential is too many years away. Since restricted stock is valued more highly by employees and is a tangible value at grant, a longer vesting period may be appropriate. For example, where prevailing practice in options has been to fully vest shares over three years, vesting restricted stock either ratably or cliff in four years may make sense.

4. **Consider share ownership or retention guidelines**. Restricted stock undeniably involves a "gift" element for recipients. One way for companies to increase the return on these grants is to incorporate them into the levels of share ownership or share retention they require of executives.

TABLE 1
Conversion Ratio - Restricted Stock for Options *

Black Scholes Value	Conversion Ratio 1 New Restricted Stock Share: # Replaced Options
High (50%+)	1:3
Average (25% - 50%)	1:4
Low (<25%)	1:5

* These conversion ratios can also be explained as roughly reflecting the present value of the potential stock price increase over the vesting period of the restricted stock, making the value more comparable to the options surrendered.

[5] Note that under FAS 123, performance restricted stock has the same accounting expense as regular restricted stock; however, it may not be valued by employees as highly per share as regular restricted stock.

PERFORMANCE PLANS – ANOTHER ALTERNATIVE TO STOCK OPTIONS

Performance plans are awards of stock or cash tied to achieving specific performance objectives over a multi-year period.

The primary performance alternatives to stock options include:

- Performance Share Plans – which pay out differing numbers of shares based on performance
- Performance Restricted Stock – which is in essence the same, but involves a contingent grant of actual shares
- Cash Long-Term Incentive Plans – which pay cash awards based on performance

These plans all can provide expense, share use, shareholder and employee benefits relative to stock options.

- *Expense Impact* – Performance plans provide tangible value in the form of cash (in a Cash LTIP) or full share value (in a Performance Share[6] plan), but it has to be earned. Depending on the performance goals and employee attitudes to stock options, employees may perceive this tangible value to be higher than the theoretical value of stock options.

  While the expense for *maximum* performance payouts is likely to be as much, or more, than the expense for options, it will generally be so only when financial performance is high, and the extra expense affordable.

  Accounting expense for performance plans will be based on how many dollars (or how many shares) are ultimately earned, so companies should carefully calibrate awards above and below target performance, keeping expense impact in mind.[7] There is strong appeal to Performance Share Plans under FAS 123, because the expense is based on the stock price at grant, not the potentially higher stock price at payment (typically 3 years later).

- *Shareholder Perspective* – Performance share plans use fewer shares (and no shares for a cash LTIP) than stock options because of the full per-share value. This helps run-rate and overhang.

  If performance plans are well designed, they can provide clarity on what specific performance is being rewarded, eliminating some of the unearned potential gain from market driven stock price increases with options. If badly designed, however, these plans can lead to shareholder backlash if meaningful payouts may be made for what are perceived as a poor level of performance.

  And when well designed they can motivate behavior changes to drive shareholder value.[8]

- *Employee Perspective* – Well designed performance plans can be effective and valued by employees. The tangible value of cash or shares, along with clear performance objectives, can be highly motivational and also provide significant retention. If poorly designed, however, these plans can have the opposite impact and be de-motivating or worse.

Implementation Guidance:

1. **Planning:**
   Take care, and time, in designing and implementing performance plans. For a company new to paying for multi-year performance goals, it makes sense to thoroughly understand the effects of implementing such a plan. These types of plans are the most likely compensation tool to go awry. Issues with respect to the choice of measures and flawed goal setting have led to goals which drive the wrong kind of behavior,

[6] Every reference to Performance Share, should also be seen as applying to Performance Restricted Stock–they are essentially the same.

[7] Ultimate expense for performance share plans is based on the total number of shares awarded, but at the grant date fair market value expense. Expense for Cash LTIP's is based on the total cash value ultimately paid out.

[8] Performance Share Plans can be particularly effective for Business Unit Long Term Incentives, where a subsidiary's performance improvement is the measure rewarded, but some element of overall corporate performance is retained by the corporate share price effect on payout value.

having too easy goals, or too unattainable goals. At their worst, ill designed performance plans can lead to a focus on the wrong results and a host of unintended consequences–they take careful thought and modeling.

2. **Careful focus on key design parameters**:
<u>Measures</u> Used individually, most financial measures have a significant shortcoming (see Table 2), but in combination, measures from different categories help offset some shortcomings. The most successful combinations of financial measures feature a growth-oriented measure with an efficiency-oriented measure, weighted in accordance with a company's (or business groups) perceived challenges. Beware of accounting distortions. Stock price increase measures can be used—but they provide no focus on what to do differently.

<u>Goals/Goal Setting</u> Goals can include *absolute performance* against pre-established targets, and *relative performance* against an external benchmark (for example, a peer group or index).

Absolute goals require that a company is able to project performance for several years and can be very effective motivators as they clarify for participants what performance is required for success.

Relative goals appear attractive on first blush since they reward less for performance that simply matches the comparator group and account for industry conditions. In practice, however, they can lead to endless adjustments and wrangling over adjustments to peer financials to make them "comparable". They may also make the sightline to what needs to be done less clear, and thus less motivating.

<u>Mechanics</u> In establishing formulas for determining incentive payouts, companies should resist the temptation to try to engineer perfection. Performance plans are most effective when it is clear what performance is required to drive payments, and this means payout calculations should be relatively simple and clear.

TABLE 2

	Measure	Potential Negative Behaviors	Potential Unintended Consequences
Growth	Revenue/ Unit/ Market Share Growth	Cut prices Acquire poorly performing companies	Unprofitable growth Earnings are flat or decline, margins shrink, returns (ROA, ROI, etc.) decline
Growth	Income or EPS Growth	Overly cut costs and development Invest in low return business / projects	Earnings increase through low margin business with inadequate return on capital
Efficiency	Margins	Cut costs severely Turn away from lower margin business	No growth or shrinking of business Walk away from business with margins that are still economic to maximize margin
Efficiency	ROE	Fund expansion/ acquisitions with debt Reduce equity	Too much debt and impairment of long-run viability of business Shrinking the business
Efficiency	Cash Flow, ROA, ROI, NOPAT–Capital Charge	Cut capital spending severely	Inadequate investment can impair long run viability of business, and lead to little or no growth or shrinking the business Missed opportunities for investment
Shareholder Return	Stock Price/ Total Return to Shareholders (TRS)	Focus on market fads over business fundamentals	Long-term business sustainability not stewarded Payouts affected by macro market forces over accomplishments
Shareholder Return	Competitive Stock Price/ TRS	Peer/index selection issues Overemphasis on drivers of peer stock price	Performance may look too good against a "soft" comparator group or too bad against "tough" comparators Loss of focus on company-specific performance

3. **Participation:**
   Participation should be focused. Companies should generally limit participation to key employees who are able to significantly influence company or business unit performance on the plan's measures.

PERFORMANCE-BASED STOCK OPTIONS

Performance-based stock options are stock options structured so that the number or value of the option depends on performance either relative to performance objectives or peers.

Performance stock options, including indexed stock options and other forms of performance stock options, in practice are usually **less viable alternatives to regular stock options** than restricted stock and performance plans. Although there are shareholder-friendly elements to these types of grants, they are likely to be more expensive, and more share intensive, to companies, given their low perceived value to employees. They may make sense as part of a long-term incentive approach for the most senior management as a way to emphasize creation of shareholder value for this group, but need to be approached very carefully in the real world.

- *Expense Impact* – On a per share basis, performance stock options may be less expensive than plain vanilla stock options. However, employees will discount the value of these grants even below regular stock options for their performance conditions. This means that companies will need to grant more shares to deliver the same value to employees, which can drive expense charges and share use up relative to regular options.

- *Shareholder Perspective* – Performance stock options are attractive to shareholders in that they require achieving performance objectives or beating an index/peer performance to determine employee gains. However, the high share usage from these vehicles will drive up run-rate and overhang, a negative for shareholders.

- *Employee Perspective* – Stock options with performance features will be perceived by employees as less likely to have value than plain vanilla options, and can be more confusing. In some markets a vehicle like an indexed option could be viewed as virtually worthless. To deliver equivalent value to employees, companies would be required to grant many more performance options.

SUMMARY

In short, a blended long-term approach which includes restricted stock, and potentially a performance plan at the right time can be a more effective long-term grant approach for companies in today's environment than using stock options only. A blended approach can provide the benefits of reduced share usage, reduced expense, increased retention and ownership, and direct motivation on key performance factors. However, introducing new long-term elements such as restricted stock and performance plans can be dangerous if not done carefully. Considerations such as value trade-offs between vehicles, effective matching of vehicles to plan goals, and goal setting for performance plans require thoughtful and careful design.