



Underwater Stock Option Exchanges

Is Your Company a Good Candidate?

There is a wealth of available resources that address the current underwater stock option problem. Most focus on offering an exchange program that allows employees to tender their underwater options for a specified number of at-the-money replacement options. Radford's own ongoing research includes an array of information on our Exchange Portal (www.UnderwaterExchange.com).

Our research shows that 72 companies filed tender offer exchange documents with the SEC in 2008; 51 companies have filed through June 2009. This is a large jump from the 49 companies that filed over a three-year period from 2005-2007. Although the increase has been staggering, this is but a fraction of the companies with publicly-registered common stock.

In fact, we believe there are only a small percentage of companies that fit the necessary criteria to make them an ideal candidate to offer an exchange program. Within this white paper, we analyze the underlying circumstances that make a company a good candidate, which is separate from specific design and shareholder considerations.

While each company's facts and circumstances for conducting an exchange has been slightly different, we believe there are a few criteria that should generally be satisfied before one explores offering an exchange:

- > Overhang, Burn Rate, and Available Shares
- > Percent of Overhang Underwater
- > Level and Period of "Underwater-ness"
- > Level of Institutional Ownership and Impact of Corporate Governance Oversight Groups
- > Business Case
- > Company Performance Outlook
- > Potential Value Created as a Multiple of Cost

This white paper explores each of these criteria in depth, offers an example of an appropriate candidate, and provides additional Radford commentary. For illustrative purposes, we have created a hypothetical Life Science company: ABC Pharma. We also rely on Radford's proprietary Equity Trends database for equity usage rates and practices.

Conducting an exchange program can be an effective way to accomplish multiple objectives

Criteria 1: Overhang, Burn Rate, and Available Shares

Conducting an exchange can be an effective way to accomplish multiple objectives. In addition to restoring retentive value to your equity awards, an exchange can potentially address overhang, burn rate, or plan share reserve concerns. A well-balanced, shareholder-approved exchange program will reduce the issued overhang and the need to grant new shares; however, it is important to note that it may necessitate retiring the canceled shares not used as part of the regrant (net shares) rather than returning them to the pool for future grants.

While overhang has steadily decreased over the past few years, we anticipate a significant increase in 2009 due to systemic underwater issues. Meanwhile, burn rates have generally remained steady, but our expectation is for them to increase slightly in 2009 as companies use more equity to address retention issues with current underwater holdings.

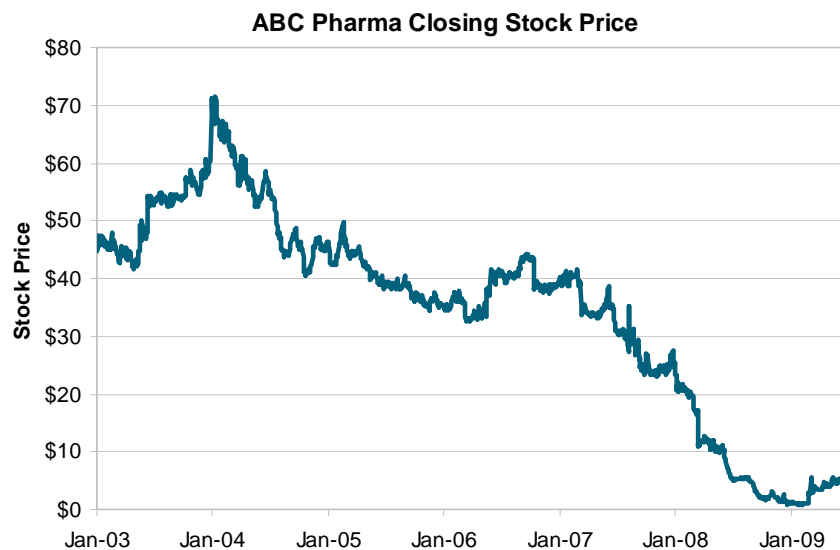
Our case study company, ABC Pharma, has a total overhang of 22% (issued overhang 21% plus 1% available for grant in plan reserves) and a three-year average burn rate of 4.2%. To further complicate the situation, they have nearly depleted their share pool and will be required to request additional shares at next year's shareholder meeting. They anticipate a challenge in receiving investor approval for new shares because of their high overhang and historic burn rate. Offering an exchange to employees will allow ABC Pharma to retire the net shares returned to reduce their overhang, and may also pave the way to ask shareholders for a larger replenishment. Alternatively, they may be able to return a portion of the returned awards to the pool for future grant considerations, thus delaying the need to ask shareholders for more shares.

Radford commentary: While having a high overhang and burn rate is not a requirement to be a good candidate, it does limit some of the alternatives to an exchange that may be available to another company with lower rates. Offering an exchange program can be a great way to reduce issued overhang and create retentive value without issuing additional shares.

Criteria 2: Percent of Overhang Underwater

One of the metrics we considered in Criteria 1 is the current overhang level. An important aspect of that figure is the proportion of the issued options that are currently underwater. ABC Pharma had an issued overhang of 22%. Of that percentage, nearly 90% of those outstanding options have strike prices above \$6.00 (52-week high of ABC Pharma stock).

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The value-neutral exchange rate for ABC Pharma's underwater stock options is 3 to 1. That is, for every three underwater options exchanged, the award holder would receive one new at-the-money option. Assuming 100% participation, ABC Pharma could potentially reduce their issued overhang by 30%. However, not all of the underwater options may be considered eligible for the exchange. Most shareholder-approved exchange programs do not include options granted to the Board and Named Executive Officers (NEO) (see Criteria 4). Further, some programs exclude recent grants, non-US locations, and other groups for various reasons.

Radford commentary: ABC Pharma clearly has a significant portion of their issued options underwater. However, there is no bright line for this criteria test. As a rule of thumb, if the potential reduction is more than 20% of the current level (e.g., 4% if issued overhang is 20%), then the company is a good candidate.

Criteria 3: Level and Period of "Underwater-ness"

In ABC Pharma's stock price chart shown above, nearly all of the options granted have never been vested and in-the-money at the same time (decreasing stock price from 2004 to 2008) and they are significantly underwater (steep decline during 2008). This means that ABC Pharma employees have had virtually no opportunity to exercise their stock options and likely attribute little value to these awards. While these awards have low or no perceived value, we note that companies would have a difficult time getting their employees to return those "worthless" options without any other consideration. The more common scenario is for the employee to walk away from these underwater awards only when at-the-money new-hire options are offered by a competitor.

An exchange program offers a great vehicle for ABC Pharma to replace these awards on a Topic 718 (formerly FAS 123(R)) value-neutral basis, but at ratios that employees consider beneficial to them. Our research has shown that employee participation rates run in the mid-to-high 80% range. We believe this high participation rate is a result of the Topic 718 fair value of the underwater options and is typically higher than the employee's perceived value.

Radford commentary: A good candidate does not have to have the same stock price scenario as ABC Pharma. However, a company is not a good candidate if most of their options are within striking distance (e.g., less than 30%) of where the current stock price is trading or if the options are only recently underwater (e.g., past 12 months).

Criteria 4: Level of Institutional Ownership and Impact of Corporate Governance Oversight Groups

Unlike exchanges offered a few years ago, shareholder considerations have taken on a much greater focus this time around. Corporate governance groups, such as RiskMetrics Group (RMG), have had a significant impact on the design of exchange programs. Companies with a high level of institutional ownership will likely need to comply with these "shareholder-friendly" requirements. Radford published a white paper in 2008 that discussed the impact these requirements (e.g., exclude Board and NEOs, 52-week-high price floor, value-neutral ratios, etc.) have had on plan design and shareholder approval. However, we now look at this issue from a different perspective: what percent of underwater options would be considered eligible if the company needs to comply with RMG's guidelines?

In Criteria 1, we showed that ABC Pharma had the potential to reduce its issued overhang by 30% if they complied with the 52-week high requirement and had 100% participation; however, this did not consider whether underwater options held by executives and Board members would be eligible. ABC Pharma intends to comply with RMG guidelines and will exclude NEOs and the Board of Directors. Less than 25% of the underwater options are held by these two groups and should not prevent ABC Pharma from considering an exchange.

Radford commentary: Companies need to consider which employees hold the majority of

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underwater options. If the majority of the underwater options are held by groups that would be excluded (e.g., Board and NEOs) and the company needs to comply with RMG's guidelines, then the company may not be a good candidate.

Criteria 5: Business Case

RMG has a gamut of guidelines to follow before they will consider recommending a vote in favor of an exchange program. A number of these requirements are very clear and concise as outlined above. However, the company's rationale for why the exchange is necessary to its business is just as important as these objective criteria. The financial crisis and general market downturn alone is not considered sufficient by many shareholders. Many companies cite retention as a key reason for conducting an exchange. While the job market may look bleak right now for potential job changers, it is reasonable to believe that it will rebound at some point. And history has proven that companies who retain their top talent are more likely to come out ahead relative to their competitors who did not.

ABC Pharma is not immune to this risk. To address the general market downturn, ABC Pharma took aggressive action to reign in unnecessary expenditures, created a leaner workforce through targeted layoffs, and even froze pay and benefits at current levels. While most of their employees understood the motivation and were accepting of these tough decisions, these actions were not retentive in nature. To further complicate matters, many of their competitors have completed or announced exchanges in the past six months. ABC Pharma recognizes that they need to take steps to increase workforce retention, and an exchange program can be an effective way to meet that goal without incurring significant costs.

Radford commentary: While competitive pressure alone may not be sufficient to offer an exchange program, it can be a huge piece of the overall rationale. Investors recognize that it is important for companies to put themselves in a strong position coming out of a recession, and retaining their top talent is an integral part of that strategy.

Criteria 6: Company Performance Outlook

Companies also need to examine the likelihood that the stock price could rebound in the next 12 to 24 months based on specific business circumstances. This process should involve developing a set of scenarios that could result in a future stock price such that many of these currently underwater options would be near or in-the-money. Once these scenarios and the underlying occurrences have been identified, Management and the Board should assess the overall likelihood of these outcomes. If there is a probable, even reasonable chance they may occur, then we would caution a company from conducting an exchange, especially since they can take six to 12 months to successfully implement.

ABC Pharma has a number of candidate drugs that are in very early development, and do not anticipate any significant drug news in the next 24 months. However, they are acutely sensitive to retaining their employees because any key scientist turnover could prolong the road to clinical trials and potential success.

Radford commentary: Conducting an exchange is a signal to the market that you do not expect the stock price to return to a level where the eligible options would have value anytime in the near term. If a biotech company expecting Phase III drug news in the next 12 months conducts an exchange, it may send a poor signal to the market or potentially expose them to accusations of market timing with inside information.

Criteria 7: Potential Value Created as a Multiple of Cost

If a company satisfies all of the above criteria, one final consideration before launching into an underwater exchange is the ratio of potential value created for eligible employees as a multiple of the cost of the program to the company. The cost of an exchange program can be

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measured as the sum of two components: cash outlay for third-party vendors and Topic 718 incremental expense. The value created from the exchange can be measured in a variety of ways, but for consistency, we are using the aggregate fair value of the newly-issued awards. Actual cash cost can range from \$100,000 for the most simplistic exchange to \$1,000,000 for the most sophisticated and complex exchanges – without consideration for the tremendous amount of time required by internal staff to successfully execute the exchange. Incremental expense varies across programs, but can be minimized through good planning and execution.

ABC Pharma expects to spend \$250,000 with an estimated incremental expense of \$750,000. Assuming 100% participation, eligible option holders can turn in 15 million underwater options in return for five million at-the-money options with a fair value of \$2 per option. ABC Pharma thus has the opportunity to offer \$10 million in potential value for a total cost of \$1 million.

Radford commentary: Companies should evaluate the ratio of potential value created as a multiple of cost. The higher the ratio, the more return on investment a company stands to gain.

Conclusion

This white paper explored the question of what makes a company a good candidate for an underwater exchange. While there are a significant number of factors that influence a company's decision to move forward with an exchange, and each company has a slightly different amalgamation of these reasons, we focused on seven specific criteria that Radford believes are essential for a company to review before determining whether an exchange program is appropriate for them. And while we believe the majority of public companies are **not** good candidates, there are many companies that could benefit from an exchange program. If your company is considering action to address underwater options and would like to explore your particular circumstances, please contact Jon Burg at +1 (415) 486-7137 or jburch@radford.com for additional assistance.

About the Author

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Vice President

Jon Burg is Vice President and West Coast Practice Leader of Radford Valuation Services, the equity valuation group of Aon Consulting. He is a Fellow of the Society of Actuaries and an Enrolled Actuary with over eleven years of compensation and benefits consulting experience. Jon has written and spoken about a number of equity design and valuation matters, including the issues surrounding underwater stock options. Over the past year, Jon has assisted numerous organizations through the design, valuation, and successful implementation of their underwater option exchange. He is based in San Francisco.

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About Radford

For more than 35 years, Radford has provided compensation market intelligence to the technology and life sciences industries. Global survey databases, which include 3.6 million incumbents, offer current, reliable data to more than 2,000 clients. Leveraging Radford survey data, our thought-leading global Radford Consulting team creates tailored solutions for the toughest global business and compensation challenges facing companies at all stages of development. In addition to our consulting team, we also offer equity valuation assistance via Radford Valuation Services, and leading-edge market analyses and survey services with Radford Analytic Services. Radford's suite of surveys includes the Global Technology, Sales, and Life Sciences Surveys, as well as the US Benefits Survey. For more information on Radford, please visit www.radford.com.

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