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Valley takes a new look at stock options

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Stock options may be the gas that Silicon Valley runs on, but two years of falling stock prices left a lot of tanks on empty last year. Yet as it heads into a new decade, the valley's options culture remains surprisingly resilient.

The answer for some companies in 2009, including Google, Intel and eBay, was to hit the reset button by exchanging options that became worthless (or were "underwater") because of the falling stock market for ones that reflected the new, lower share prices.

Options give workers the right to buy company stock at a preset price, offering them the opportunity to profit if those shares increase in value.

For companies that did not do an exchange, the improving economy and rising share prices helped take care of the problem, lifting many options near or above the water line.

A study by Equilar, a Redwood City executive compensation research firm, shows options of top officers at 140 valley companies gradually surfacing above water during the last half of the year.

At the end of their fiscal years, an average of 61.4 percent of top executives' options were underwater, the study found, but by Christmas Day, only 46.9 percent of those options were, reflecting the economic rebound of the year's fourth quarter.

"We've had a rough year but stock compensation continues to be an essential tool in the total compensation," said Emily Cervino, director of the Certified Equity Professional Institute at Santa Clara University.

"Here in Silicon Valley, if a company is not willing to pay talent with some form of equity compensation, they just don't have the ability to compete for that talent. It's almost a right of passage."

But their luster has dimmed. They've been challenged by accounting rule changes, competition from other forms of employee incentives and especially a decade of stock declines.

"They're not incentives when they are not worth anything," said Scott Fingerhutt of Equilar.

Companies are reassessing their use of options, said Don Lindner of WorldatWork, a nonprofit association that studies compensation.

"Everything I've seen is that stock options are a very important aspect of compensation, especially in the high-tech area, and will remain so," Lindner said. "Have they toned them down some? Yes."

Companies grant options with a "strike price," which is the price at which an employee can buy shares. The options must be held for a period of time before they can be exercised. The gain from options comes from the difference between the strike price and the price of the stock when it is

purchased. When they exercise options, employees can choose to sell the stock right away or hold onto the shares. Most employees sell to lock in the gains they've experienced.

Options are perceived by companies as a way of motivating, rewarding and retaining workers. But they work best for companies in a growth mode whose stock prices are advancing rapidly. That wasn't the story for most of this decade, which saw the Nasdaq plunge 44.2 percent.

"Pretty much every company has some options underwater," said Ann Costelloe, who heads the Bay Area executive compensation practice for Watson Wyatt.

Google took a straightforward approach to the problem that few companies could afford. It issued a new option for every underwater option in March at a strike price of $308 a share when the stock hovered near its lowest point in 2009. Google closed Thursday at $619.98 a share. It was an expensive gesture, since Google had to account for that switch as an expense on its books.

Advanced Micro Devices did an option exchange earlier in the year for employees, excluding top executives. A spokesman said Wednesday that all of the exchanged options are now above water, although they won't vest until August.

Two years ago, the company began to move from options for the general employee population to restricted stock — shares that cannot be sold for a fixed period of time.

Even before the turmoil of the past two years, other tech companies were becoming more selective about who gets options, according to compensation experts.

"For a while, they provided grants across the board, and quite honestly, a lot of folks didn't value them, particularly when they went underwater for so long," said Costelloe of Watson Wyatt.

Also, a change in accounting rules in 2004 took away the tax advantages of using options as part of compensation.

Although options are still favored by many valley companies, there is a trend toward balancing them with restricted stock. The advantage of restricted stock for employees is that they can profit from any increase in the share price, like an option, but the shares will still have value even if the price of the stock falls below the price at which the restricted shares are granted, because employees can sell the stock at the lower price and reap the proceeds.

Big companies have another challenge — they are years past their startup days, when their stock was posting large, regular gains.

"It's very easy in a hot startup to grow stock value from pennies to dollars," said Adeo Ressi, founder of TheFunded.com , a site where entrepreneurs review venture capital firms. "It's very hard, in a 10,000- to 30,000-person organization, to move your stock price."

But despite the bruising market decline and these other factors, it's not as though the valley has lost all interest in options.

"Silicon Valley is still very much the place of broad-based employee equity," said Brett Harsen, a vice president of Radford, a San Jose compensation consulting firm. "It's definitely not the place of options to the extent it was a decade ago, but

they're still very important."

In fact, while the drop in share prices sent many options underwater, it also made new options much more attractive, Harsen said. "There is a motivation for companies to double down on their options when the stock market is down. You can load up your employees with a lot of low-priced stock options."

And after the worst decade in history, things may be looking up for options, said Lindner of WorldatWork. "Going forward, this could be the best time, as the market comes back. I've been through five recessions, and during at least two or three of them, I've heard 'death of options' or of some other component of compensation. It never happens."

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