

Silicon Valley companies looking to reprice underwater stock options

By Brandon Bailey
Mercury News

Posted: 12/06/2008 03:21:00 PM PST

Glug, glug, glug. As the trading price of many tech stocks has plummeted in recent months, thousands of Silicon Valley workers have seen the value of their employee stock options sink rapidly underwater.

The cost of exercising some options is now higher than the value of the company stock for about 4,600 workers at Advanced Micro Devices — which means those options are currently worthless. One analyst has estimated the same is true for 6,400 workers at Google. It's been a problem for 1,100 employees at VMware, which this fall offered to exchange old options for new ones with a lower strike price.

"It's a huge issue in the tech industry," said analyst Brett Harsen of the compensation advisory firm Radford Surveys and Consulting, who noted that Silicon Valley has long relied on stock options to recruit and reward top talent and even mid-level employees. He predicted a wave of tech companies will ask shareholders for authority to address the issue by repricing or exchanging old options in coming months.

Some of those efforts may run into opposition if investors complain that no one is offering to make up the value they have lost in recent months. And investors could also be frustrated if the swaps lead to more shares on the market, diluting the value of each share.

"Right now, given the size of this market decline, investors are surly," said Patrick McGurn, special counsel at RiskMetrics Group, a shareholder advisory service. But he agreed with experts who said new regulations and guidelines, introduced after the Internet bubble collapse prompted an earlier round of repricing, can make exchanges more palatable to investors.

Even in tough economic times, Harsen warned, the best workers may have opportunities to change employers. That's the concern cited by executives at VMware, which makes virtualization software, when they proposed exchanging about 4.3 million employee stock options earlier this year. Those options had been granted with an average exercise price of \$71.06, or more than twice the stock's trading price over the summer.

"This circumstance has caused our board of directors to conclude that we may be at risk of losing key contributors across our work force," the company said in an Aug. 1 proxy statement.

The problem lies with options granted in happier economic times, when stock prices were higher. Options give employees the right to buy stock in the future at the price for which it was selling when the option was granted. When a company's stock goes up, workers profit because they can pay the older price.

But with the stock market's decline in recent months, more than three-quarters of Silicon Valley's 150 largest public companies have at least some options outstanding that are most likely "out of the money" — meaning their exercise price is higher than the current trading value, according to Equilar, an executive compensation research firm in Redwood City.

"Many of the stock options granted in the last five to

The Mercury News

MercuryNews.com

10 years are probably worthless," said Equilar research manager Alexander Cwirko-Godycki.

Several major Silicon Valley employers declined to comment on the issue this week.

"While we don't discuss the details of our compensation or benefits, we regularly review them to make sure they are effectively attracting and retaining our key talent," said a Google spokeswoman.

But tech analyst Sandeep Aggarwal, at the Collins Stewart investment firm, recently estimated that nearly a third of Google's 19,600 employees have underwater options. In a report to investors, Aggarwal wrote: "So the big question remains — will Google reprice the options to make their employee retention strategy work for them?"

VMware answered the question in September. Employees surrendered about 4.1 million old options, or most of the outstanding options that were underwater, and received new options with an exercise price of \$33.95 a share.

The company's stock was trading for around \$23 last week, which illustrates a potential downside of option exchanges: Stock prices can continue to fall. But VMware employees who made the trade are still better off; the old options had exercise prices as high as \$117.

Under new accounting rules, companies must recognize a cost on their books for the value of stock options they grant, using a complex formula that takes into account such factors as the strike price and the change in the stock's value. VMware reported the exchange will cost the company an additional \$18 million over the four-year period in which the new options become vested.

Other companies, including AMD, are considering exchanges structured to avoid new costs by swapping old options for a lesser number of new ones. In an Oct. 22 proxy statement, AMD outlined a proposal to exchange one new option for roughly two to three old ones, depending on the age and exercise price of the old options.

That's one of several steps recommended by RiskMetrics and other experts to address objections from investors, who don't want to see new options dilute the value of their own shares.

Another recommendation, adopted by both VMware and AMD, is to exclude top executives and board members from participating in an exchange. In general, McGurn said, the rationale is that officers' and directors' compensation should be directly linked to the company's stock price.

"We're trying to be fair to employees but also to be fair to our shareholders," said Matt Martin, AMD's vice president for compensation and benefits.

Under securities rules enacted in recent years, experts said, most companies must obtain shareholder approval for an exchange. Attorney Joseph Yaffe, who advises AMD and other tech clients on compensation issues for the law firm of Latham & Watkins, said he's spoken with officials at numerous Silicon Valley companies about the issue recently.

"You're going to see a large number of stock option repricings or exchanges," he said, "in the next round of annual stockholders meetings this spring."

Contact Brandon Bailey at bbailey@mercurynews.com or (408) 920-5022.

How companies are repricing stock options

VMware offered employees a 1-to-1 exchange for

The Mercury News

MercuryNews.com

underwater stock options. AMD is asking shareholders to approve a more complicated system based on the shares' exercise price. The company's shares closed Friday at \$2.13, but the new options' exercise price would be aligned with the share price at the time the proposal is implemented.

AMD exercise price

Number of shares outstanding

Average price of shares

Exchange ratio

\$10.01-\$14.99

8.9 million

\$13.82

2 for 1

\$15-\$19.99

9.7 million

\$17.22

2.5 for 1

\$20 and above

5.1 million

\$23.15

3.25 for 1

Source: AMD proxy statement MERCURY NEWS