compensation focus

Underwater Stock Options: What Have We Learned?
By Jon Burg and Brett Harsen

Media coverage of the employee equity landscape over the past two years was dominated by stories of companies offering underwater stock option exchange programs or re-pricings to their employees. The majority of these programs allowed employees to exchange underwater options for typically a lesser number of new at-the-money options (or a comparable value of restricted stock awards). With the stock market's strong rebound since March 2009, we are probably at the end of the road for these exchange programs and attention has likely shifted to the next big issue. However, a number of interested parties have asked the question of whether these programs were successful and worth the cost and effort. The challenge in addressing that question is determining how to measure success and from whose perspective?

- Is it the incremental paper gain of the new awards for employees?
- Additional incentive and retention value for the company?
- Excess shareholder return for investors?

All of these attempts, even if they could be reliably measured today, are premature and miss the point that employee stock options are intended to be long-term incentive vehicles. The vast majority of the stock options exchanged were outstanding anywhere from two to nearly 10 years. Further, since the bulk of programs were conducted in 2009, the newly issued replacement awards have been outstanding for less than a year. We may not be able to adequately measure success for a few years. However, this article focuses on some of the things we have learned from the perspective of each stakeholder through an analysis of participation rates and other quantifiable observations Radford compiled from public filings in addition to key anecdotal evidence.

Were Shareholders in Favor of these Programs?
It is still too early to measure total shareholder return and incremental dilution for companies that offered an exchange relative to their peers. The vast majority of shareholders voted for the programs when they were designed in a balanced fashion. However, there were a couple examples of prominent and widely held companies that successfully solicited their shareholders directly despite receiving an "AGAINST" recommendation from institutional shareholder advisor RiskMetrics Group. The few unsuccessful companies with shareholders were pushing the envelope on one or more of the shareholder-friendly design elements (e.g., executive officers and options less than the 52-week high). While the general belief may have been that shareholders were not supportive of these programs, the voting told a different story.

Did Employees Appreciate the Opportunity?
Many professionals believe that the typical employee receiving stock options either does not understand the full value of the instrument or does not assign a value commensurate with the accounting cost. Suffice it to say the employee's perceived value of a stock option is less than the accounting value the company records. This perception gap widens when the options fall underwater. While an employee may quickly dismiss an underwater option as "worthless," the accounting rules assign a value based on the probability the stock price will rebound in time.

These exchange programs allowed employees to exchange the old underwater options for a certain number of new awards based on a ratio defined by the company. This ratio was often determined based on an accounting value-neutral basis. If you believe the premise above, this allowed companies to offer exchange ratios that were viewed favorably by employees. An examination of employee participation rates shows that an average of nearly 80% of eligible awards was exchanged for all companies conducting an exchange since 2008. Not surprisingly, companies offering a one-for-one or pure re-pricing of options had the highest average participation rate of 91%. However, even the less employee-friendly value-neutral exchanges still enjoyed an average participation of 77%.

Did the Program Really Create Retention?

Both the approval of the program and the high participation rates can be viewed as potential barometers for success from the company's perspective. Others may point to reduced overhang, additional shares available to grant and issuance of new equity awards with minimal expense incurred as quantitative measures of success. However, all of these miss the mark of truly measuring the program's overall success. Two of the most commonly cited strategic goals outlined in proposals taken to shareholders were increasing retention and re-incentivizing employees.

Both of these measurements will require more time and information to accurately measure. However, we can point to revelations that two companies shared at the WorldatWork Total Rewards 2009 Conference based on information gained from their employees after the exchange. A common deterrent to participating was the additional vesting requirement. In one case, the company found that the employees were, for a variety reasons, not likely to continue working for the additional 12 months of vesting. In another situation, the company examined participation rates by job level and found those that did not participate were also the job levels with the highest turnover rates.

While this is a very limited sample size, it potentially speaks to the added retentive value of the exchange. When we explore the publicly disclosed participation rates and control for the vesting requirements of the new awards, we find a pattern to support this assertion. Companies that simply mapped the vesting schedule of the old awards to the new ones had the highest average participation rate at 84%. The participation rate decreased steadily as the length of additional vesting increased.

Parting Thoughts

Considerably absent from the above discussion is the notion of whether the exchange was really worth it. It is too early and subjective to attempt to measure success now. Instead, we narrowed our focus considerably and cited a few observations gleaned thus far. These remarks may be viewed as generally supportive of exchange programs, but it is important to note they were also costly and time-consuming endeavors. The ultimate measure of whether these underwater stock options exchange programs were worth the cost and effort will have to wait until we can adequately evaluate from both a long-term and holistic perspective.

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