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CORPORATIONS

STOCK OPTION EXCHANGE PROGRAMS

Author: RICK SCHWARTZ AND AMY THOMAS

RICK SCHWARTZ is a Managing Director in the Financial Engineering practice of Duff & Phelps Corporation in the Silicon Valley, California office. AMY THOMAS is a Vice President in the Seattle, Washington office.

As stock prices have declined to historical lows, they have often pushed employees' stock options significantly underwater, with exercise prices so far above the current stock price that the prospects of being in-the-money once again seem dim. The value that stock options provided when originally issued may well have evaporated, decreasing morale and reducing companies' ability to motivate performance and retain key employees.

To address these issues, many companies are looking closely at option repricing and exchange programs, or at modifying the market-based vesting conditions for options and restricted stock grants. Successful option exchange programs minimize compensation expense and shareholder dilution, maximize employee participation through well understood and desirable terms, and address accounting requirements and the need for transparent, well supported valuations. For companies whose programs have limits on how many employee stock options can be issued, redemption of underwater options can also replenish the shares available for issuance.

The accounting treatment of stock options is governed in the U.S. by the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 123 (revised 2004) (SFAS 123R), and abroad by the International Accounting Standards Board's Financial Reporting Standard 2 *Share Based Payment* (IFRS 2). These provisions are crucial to understanding the implications of alternative exchange program approaches.

Historically, one approach was to “reprice” underwater options by lowering their exercise price to close the gap from the current stock price. Google, Inc. implemented a repricing program in February 2009, but such programs are the exception. While there is obvious benefit to employees, shareholder concerns with repricing programs may be substantial due to the associated compensation expense and potential dilution of shareholder value.

More common than repricing programs are option exchanges, in which underwater options are redeemed for at-the-money options, restricted stock, or cash according to specified exchange ratios. Exchanges are often structured as “value-for-value” or “at fair-value”: Employees' new grants are equal in value to their exchanged options—for example, one newly issued at-the-money option per five underwater options—based on the vesting schedule, term, and exercise price of the old and new grants. Employees may view the exchange as beneficial, and if the exchange ratios are designed carefully, minimal compensation expense hits the financial statement.

To ensure that an exchange program achieves as close to a value-for-value exchange as possible, several questions need to be addressed at the design stage:

- Which options are included in the program? Typically this involves a floor on the exercise price of outstanding options—such as the 52-week high stock price—above which shares are eligible for exchange.

- Which employees are included? The board of directors and executive officers are sometimes excluded from option exchange programs, due in part to shareholder and proxy advisory firms' concerns.
- What vesting provisions will replacement shares be given? There are many possible approaches, including introducing a new vesting schedule that is shorter or longer than the original schedule, or having previously vested shares of the underwater options be subject to additional vesting requirements.
- What exchange ratios will be offered? Eligible outstanding options are usually segmented into groups of similar-valued shares, with separate exchange ratios established for each such group. Ideally, the variance in the value of shares within a group is low, to reduce the chances that there is excess value and thus compensation expense with the replacement shares, or conversely, that the replacement shares are less valuable than some of the outstanding shares in the group, making exchange unattractive. For pragmatic reasons, the groups should be few in number and defined by key value drivers that are easily identified, such as the time until expiration or the exercise price of outstanding shares.

Program design occurs well before the exchange or modification date of the program. It is critical that design decisions consider the range of possible future scenarios based on valuations that are entirely consistent with those that will be required for financial reporting. For example, the stock price on the exchange date could be significantly higher or lower than its current price. This could cause the valuation for financial reporting to differ from the valuation on which the design of the program was based. Thus, in designing the program, one should understand the sensitivity of the result to the future stock price on the exchange date.

Valuations need to address both replaced and replacement options or restricted stock, and be done both at the program's design stage and again as of the exchange or modification date. Two important issues should be kept in mind:

- Application of a Black-Scholes model requires a supportable expected life assumption consistent with SFAS 123R and IFRS 2 requirements. Under the “simplified method” provided in the SEC's Staff Accounting Bulletin No. 107, a uniform distribution of exercises over the period available for exercise is assumed, but this assumption is clearly not valid when options are significantly underwater and may continue to be underwater through most or all of the exercise period. If one assumes instead that underwater options are not exercised until the end of their remaining contractual life, the value of the outstanding options may be overstated. To develop a supportable expected life assumption and value the underwater options consistent with SFAS 123R and IFRS 2 requirements, Monte Carlo simulation, binomial lattice, or equivalent closed-form approaches will usually be needed.
- Valuations must be set up to facilitate consideration of many scenarios, including which shares and employees are included, different ways in which included options are segmented when determining exchange ratios, and different vesting schedules and other terms for the new shares. An Excel model, for example, can be used to manage the valuations of individual grants and enable rapid analysis of alternative inclusion scenarios and exchange terms.

Through careful and flexible analysis, companies are able to structure an exchange program that most closely achieves their desired goals, which include satisfying shareholder concerns, minimizing corporate expense, and maximizing employee participation.

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