



Restoring Long-Term Incentives

by Pearl Meyer

With long-term incentives, including stock options, now underwater at about 70% of the top 500 U.S. corporations and the number increasing daily, companies are seeking solutions to a double conundrum: first, fairness to shareholders whose investments have tanked and whose approval may be needed for remedial action, and second, fairness to critical executives and employees who have also realized losses and need to be retained, paid competitively, incented and rewarded in their struggle to overcome difficult economic conditions. It is apparent that judgment will be required in that “the baby may indeed have to be cut in half.”

Interestingly, the answer to the first issue may be simpler than the second.

Shareholders can either choose to vote with their feet by selling at a loss or, as sophisticated investors, realize that as owners of the business, they need to take a longer view. After careful analysis, shareholders may find that the most intelligent and cost-effective way to recoup lost value is to incent management to affect a turnaround in performance and stock price. With this realization should come the understanding that underwater incentive programs are demoralizing and de-motivational, and the solution to this problem must be sought in tandem with a strategy for recovery. It is management's responsibility to develop and “market” such a solution to its directors and a majority of its holders, as well as its executives and employees.

Timing has proven as problematic as marketing. Each time action has been planned over the last few months, the market dropped further, as did profits. While a few companies repriced options or restructured their incentives, most have adopted a “wait-and-see approach.” After several false starts, companies are generally poised to move, hopefully early in the New Year along with their annual 2009 grant cycle, as the stock market and economy appear to be approaching bottom.

Briefly, the following approaches to out-of-the-money options and SARs should be considered:

- Outright exchange of underwaters for new option or stock SAR grants with shareholder approval. Such repricing will require setting an exchange ratio. The ratio can be set based (i) on an even value-to-value exchange basis using Black-Scholes, which is generally the most stringent and best approach, often involving only a very minimal accounting charge, (ii) on a one-to-one basis (the most generous), or (iii) an arbitrary point somewhere in between. A more generous exchange ratio can be used if some or all of the exchanged grant is priced at a premium or step up over current market. New future service vesting is generally required with any such repricing.

All other things being equal, the required shareholder approval will be influenced by recommendations of the voting advisories unless significant ownership rests with a few holders with whom management should consult at the outset. Individual institutional investors are often persuaded to vote for the program once familiarized with its benefits to them. In addition to re-motivating employees, such benefits include cancellation of outstanding underwaters and recapture of shares, which generally result in reduced overhang, far lower rates of potential dilution depending upon the exchange ratio used, and no cash outlay or significant cost. It should also be noted that while optionee consent is needed, it is rarely, if ever, withheld. With regard to the voting advisory services, each has its own set of requirements, generally preferring or mandating that senior management be excluded.

- Should shareholder approval not be available or sought, a second alternative is to grant a new set of options or stock SARs capped at the exercise price of the underwaters to prevent doubling up. For example, if the underwaters carry an exercise price of \$30 and current fair market is \$16, a new grant at \$16 would have its appreciation capped at \$14. It would also carry additional service vesting and other requirements.

One potential limitation of this approach is the need to use additional shares to make the new grant.

- A third approach, which would not strictly require shareholder approval, is to “buy-out” underwaters for cash at their Black-Scholes value and start fresh after a suitable period with new grants at fair market. Unlike a buyout for stock, which does require shareholder consent, approval of a cash transaction is not required under NYSE rules. However, it is likely to draw negative, after-the-fact comment from the voting advisories, which view a cash buy-out as a type of repricing. Such cash should be deferred and paid out over an extended future service period for retention purposes. A performance-related interest factor may be considered as an incentive element.
- Another approach focused on retention and morale is to grant restricted stock or RSUs with stringent future service vesting and/or performance requirements. The value of such grants could be set independently or geared to the value of the underwater portion of each participant’s sunken options/SARs.
- Again, assuming shares are available, a fifth alternative is to shift to performance shares which may be earned based on long-term business results. The value of such grants may also be tied to the value, number or deficit of the underwaters, or granted as a “new start.”
- There are a multitude of other variations, including career shares and grants based on book value which can be paid out in cash or shares.

In addition to underwater options and SARs, innumerable long-term incentive programs are also out-of-the money. Alternatives to be considered include:

- Leaving ongoing cycles to lapse and revitalizing the program with new realistic metrics using a series of upfront start-up cycles of one, two and three years each to avoid several “black hole” years.
- For maximum impact, if turnaround is feasible or within management/employee reach or control, institute a new design as a “Challenge Grant” with a double-sized award value, motivational upside opportunity and a shorter-term performance period, perhaps two rather than the standard three years, with the next cycle to start upon completion of the challenge period.
- Should times be truly difficult, use a “first penny” design and a hockey-stick yield curve which pays out very minimally for little performance with major opportunities when credible goals are attained, using either quantitative and/or measureable strategic objectives.
- Using stock, consider PARS (performance accelerated restricted stock) which are shares of stock or RSUs that vest and are deliverable at the end of a lengthy period of future service, such as five or more years. Should performance objectives be achieved prior to completion of the service period, vesting and delivery of the shares are accelerated. The same approach may be used with stock options (PARSOPS or performance accelerated stock options).

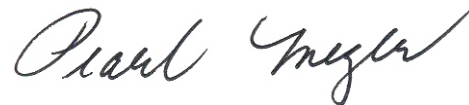
The most difficult aspect of resuscitating long-term incentives, as well as annual plans, is “tomorrow.” The dilemma is how one sets credible long-term goals in today’s business environment. Feasible alternatives that work include:

- Setting rewards based on cumulative or average achievement of a series of one-year goals.
- Using relative performance measures which reflect results against an index of the competition; however, this works only where the company has a sizeable group of well-defined and truly comparable peers. The most frequently used relative measure is, of course, TSR, so instead of a defined peer group, one may measure against a market index.
- Commonly used in cyclical businesses such as retail and financial services is the LY (last year) system which measures current performance and the years to come against historic results. This “look back – look ahead” approach avoids all goal setting or discretion and often hinges on affordability; basically a form of profit sharing, but often viewed as encouraging end-of-cycle manipulation.

- Those in cyclical industries may find the traditional funding formula effective. This approach combines shareholder protection and Board exercise of negative discretion to avoid excessive compensation and take into account other relevant considerations. A funding formula example is the old standard of 6% of profits in excess of a 6% return on equity or capital.
- Another approach is to use “aspirational goals” which generally are set during one phase of a company’s business cycle, most often growth or turnaround. However, such goals are prone to become obsolete when reality sets in or conditions change.

Needless to say, there may be no one good answer for all seasons, so flexibility is the key since we are dealing with living entities – not fixed in concrete.

Which approach to consider is a function of the company’s strategy, business and stock market prospects, competitive environment, shareholder and Board relations, plan share availability and, most importantly, the allegiance, morale and motivational needs of the team. The company’s objectives should be to enhance retention, as well as create the motivation and commitment to restore and grow future shareholder value.



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