



# Are They Coming Back? Brush Up on Stock Options

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# Agenda

- A brief history of options
- Trends in option grants
- Why grant options?
- Option valuation
- Taxes
- Shareholder considerations
- Option variants

# A Brief History of Options

Ancient Greece: olive speculation



1973: Black-Scholes published; CBOE opens



Late 1990s: Dot-com boom, everyone's a millionaire!

2006: FAS 123R: They're not free anymore



Today: Back on the rise?

1800s: OTC trading

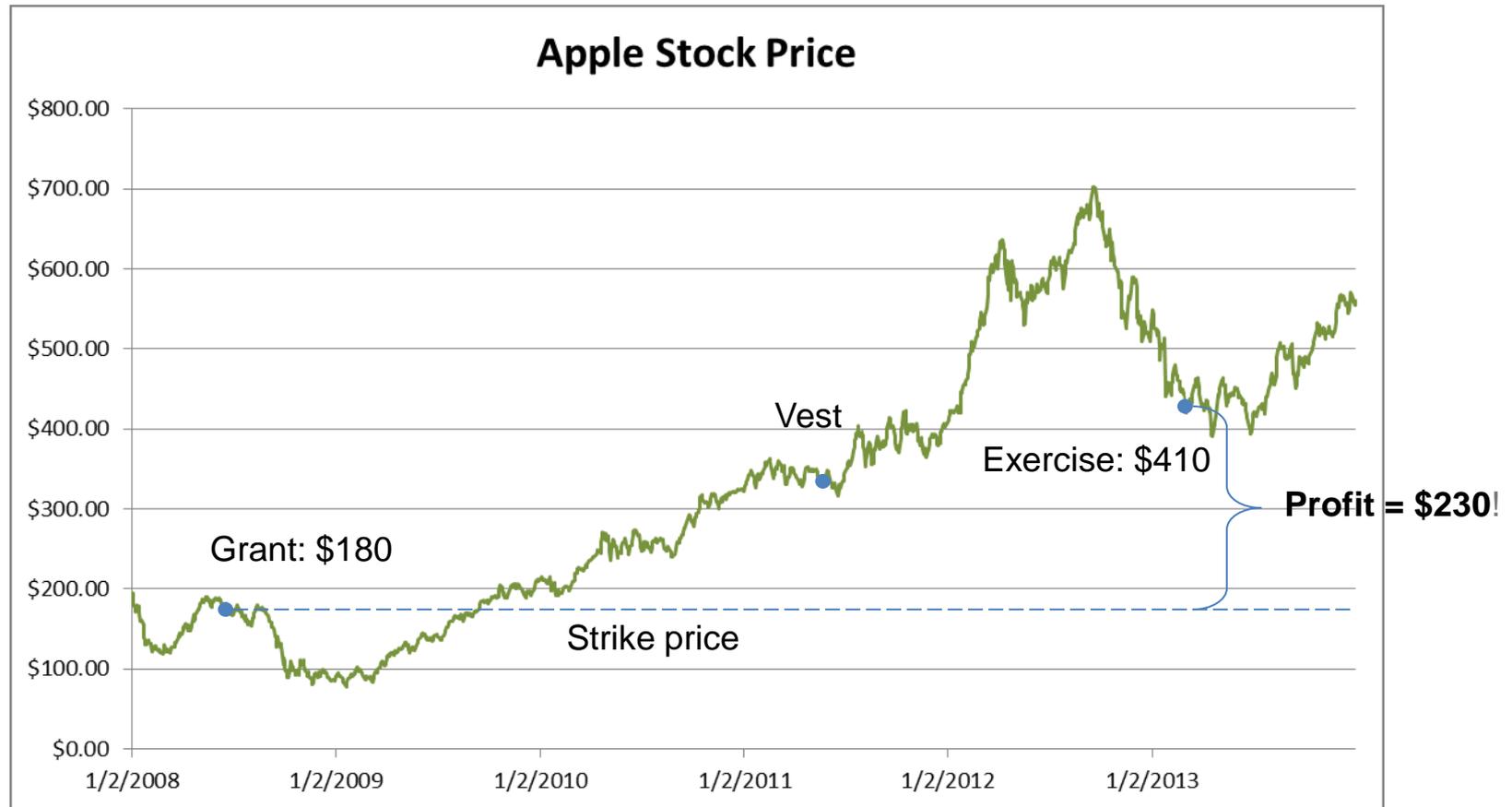
1980s-90s: ESOs become common. They're "free!"

Early 2000s: Dot-com bust, not so enthusiastic

2008-09: Market crash, underwater options



# An Example

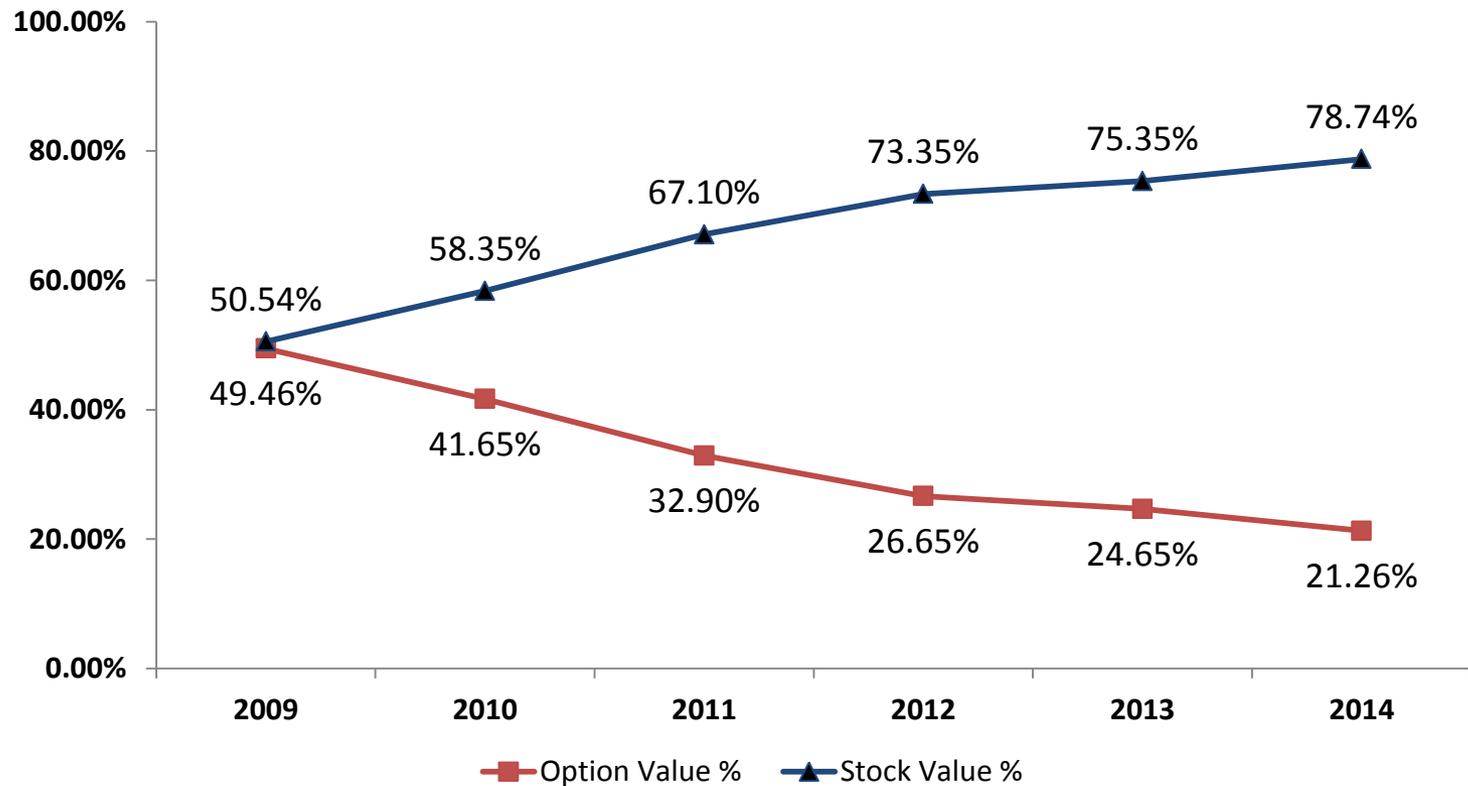


# Methodology

- Equity mix information
  - Sample of 304 S&P 1500 companies with data from 2014
  - Results in line with those of full S&P 1500 samples available for prior years.

# Equity Mix – Options and Stock Balance

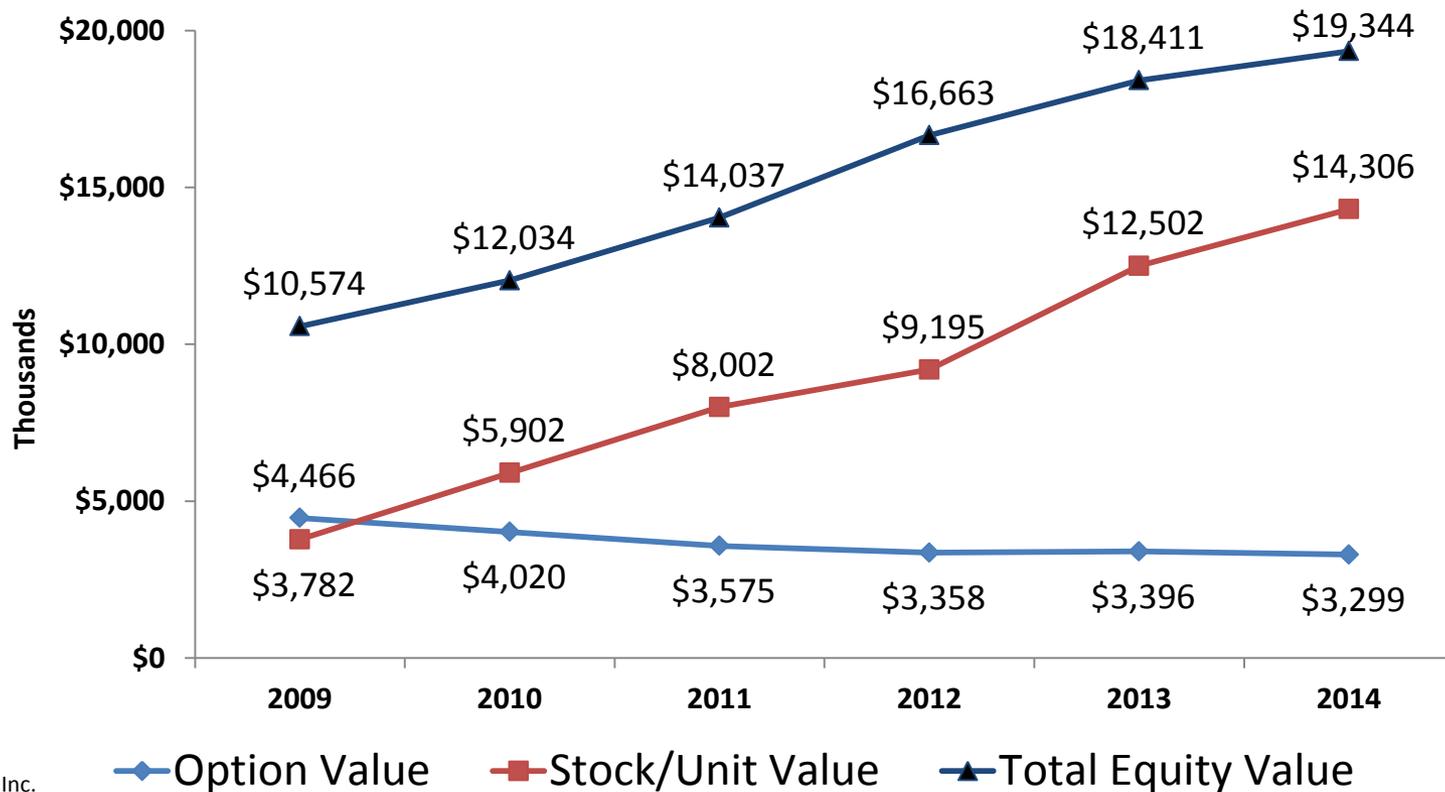
More than three quarters of equity value is currently being granted in full value shares like stock and units. In 2009, the balance was almost 50-50.



Source: Equilar, Inc.

# Equity Mix – Value of Annual Grants

The median total value of options granted has declined by 26% while total value of stock/unit awards has increased by 278%. Total equity granted has grown by 83%.



Source: Equilar, Inc.

# What Is Driving These Trends?

## Investors

- Lower dilution and better performance alignment expectations

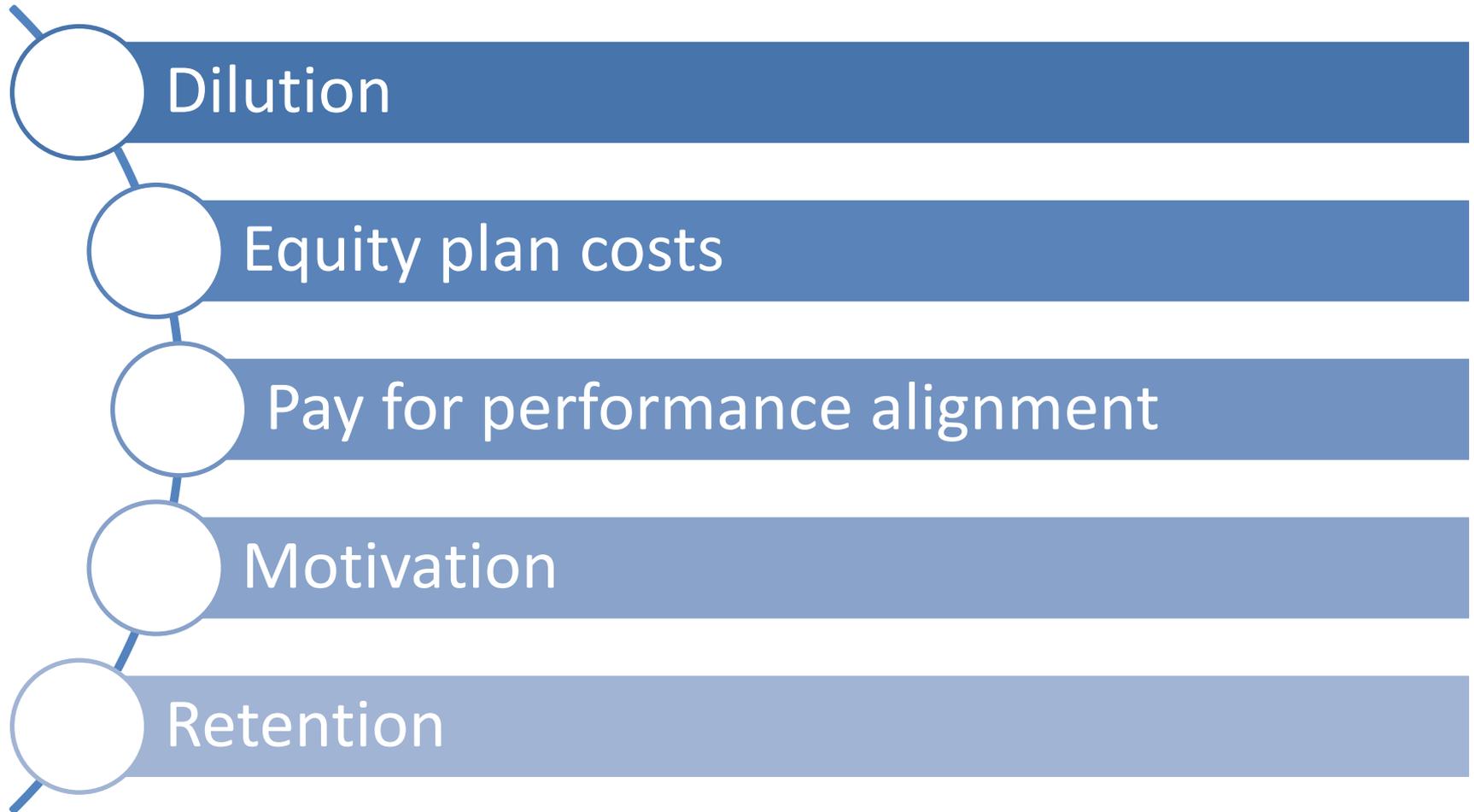
## Proxy Advisors

- Recommendations against equity plans with high dilution

## Employees

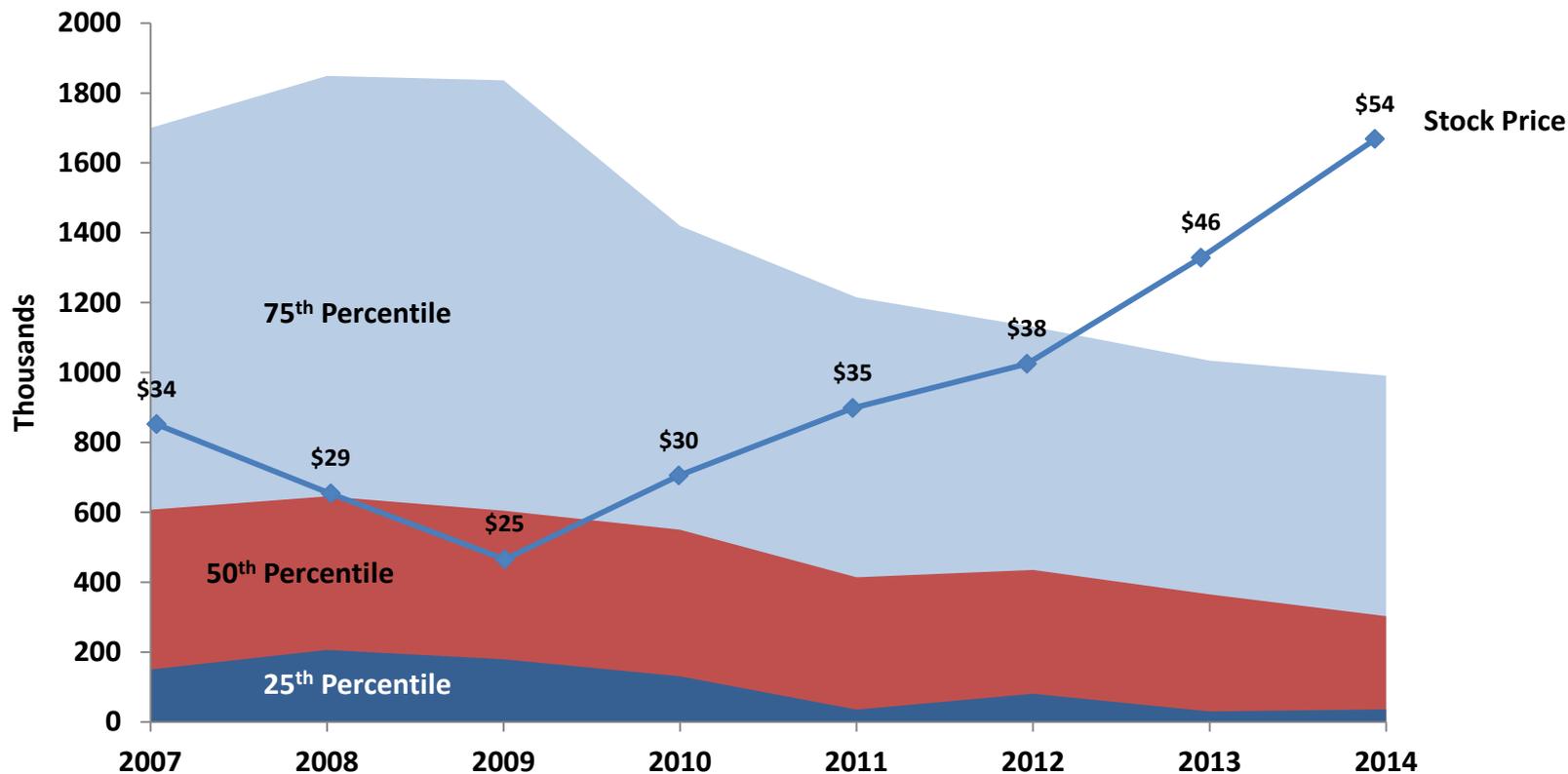
- Easier to understand restricted stock and more motivating

# What Are The Company Concerns?



# Options & SARs – Annual Grants

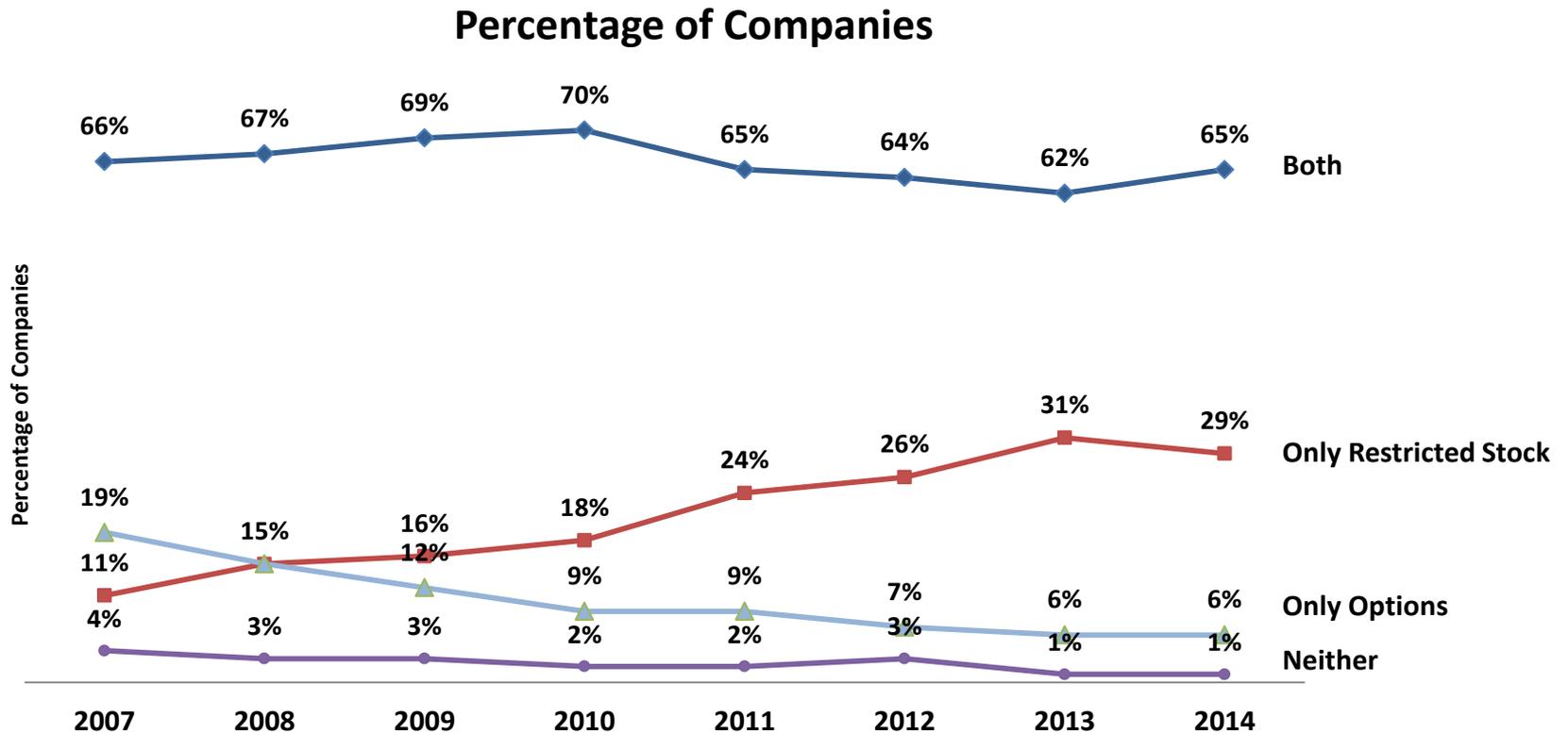
The amount of options being granted has been decreasing for a decade except when the market fell in 2008 & 2009.



Source: Equilar, Inc.

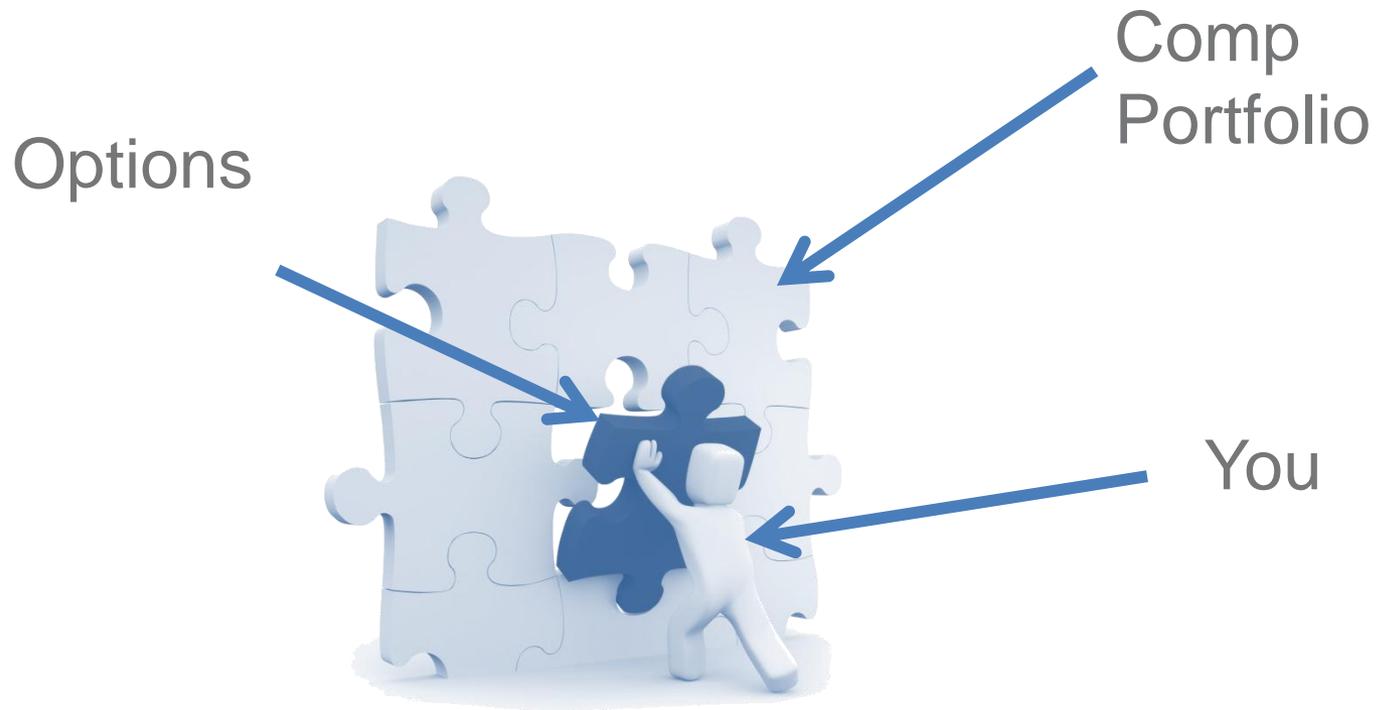
# S&P 1500 Equity Mix

Companies are switching to full value shares and away from options but most are still maintaining a mix.



Source: Equilar, Inc.

# Options: A Piece of the Puzzle

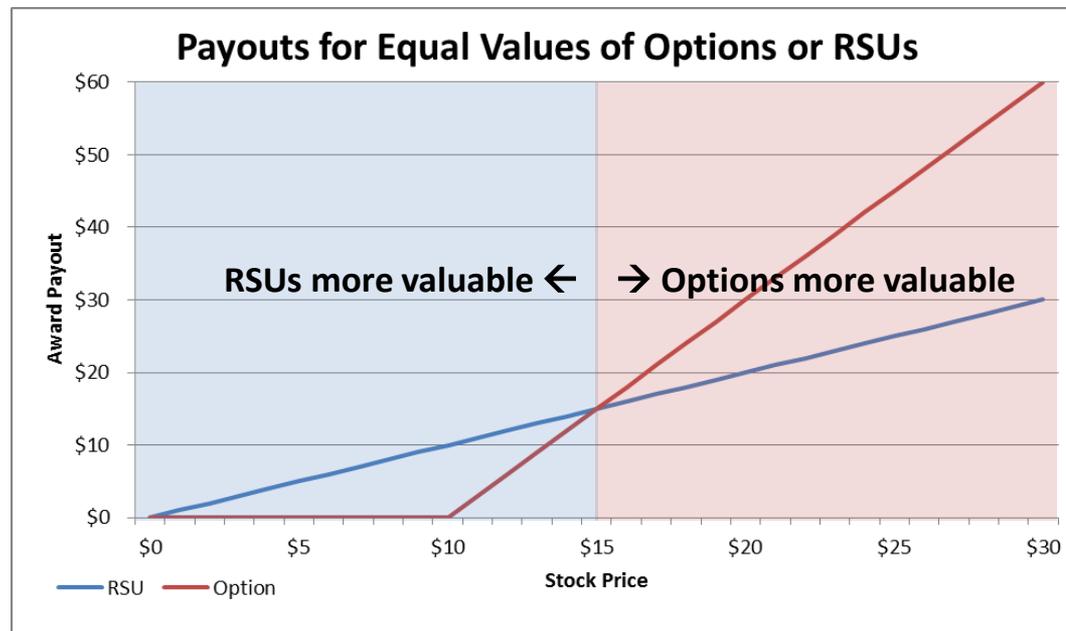


# Why Grant Options?

- Much more “bang for the buck” when growing
  - Lower cost means many more can be granted
  - Upside is still 1:1 like an RSU
- They are true *long-term* incentives
  - Most LTIPs cover only three years
  - Options typically cover 7-10
- No reward for negative performance
  - Good fit for executives with line-of-sight to stock price performance
- As an equity-based instrument, no cash is required from the issuing company
- Attracting and retaining top talent
  - A standard part of the comp package in some industries, just like health insurance is
  - High payout potential is attractive to high performers

# Why Leverage Can Be a Good Thing

- Above a certain stock price, the higher number of option shares is more valuable than the equivalent in full value RSU shares
- This makes it a great instrument to issue in growth scenarios



# Option Valuation Basics

- Here are the basic inputs needed to estimate the fair value of an employee stock option:

An increase here...	... changes fair value	What can you do about it?
Grant price (at the money)	↑	Not much; stock price on grant date
Expected term	↑	Contractual term, vesting schedule
Volatility	↑	Nothing directly; consider implied volatility
Risk-free rate	↑	Nothing; very mechanical
Dividend yield	↓	Nothing (for the people in this room!)

# Tax...a simple, unified perspective

- Lots of people care about the life of an option, and it's confusing...because they all care about different things

	Perspective	Grant Date	Vest Date	Exercise Date	Sale Date
	Corporate Expense	Start expense	Stop expense 	Doesn't care	Doesn't care
	Corporate Tax	Going to save some tax later (an asset)	Doesn't care.	Time to recognize that tax benefit. 	Doesn't care.
	Personal Tax	Doesn't care.	Doesn't care.	Asset is "bought" at strike price	Asset is sold 

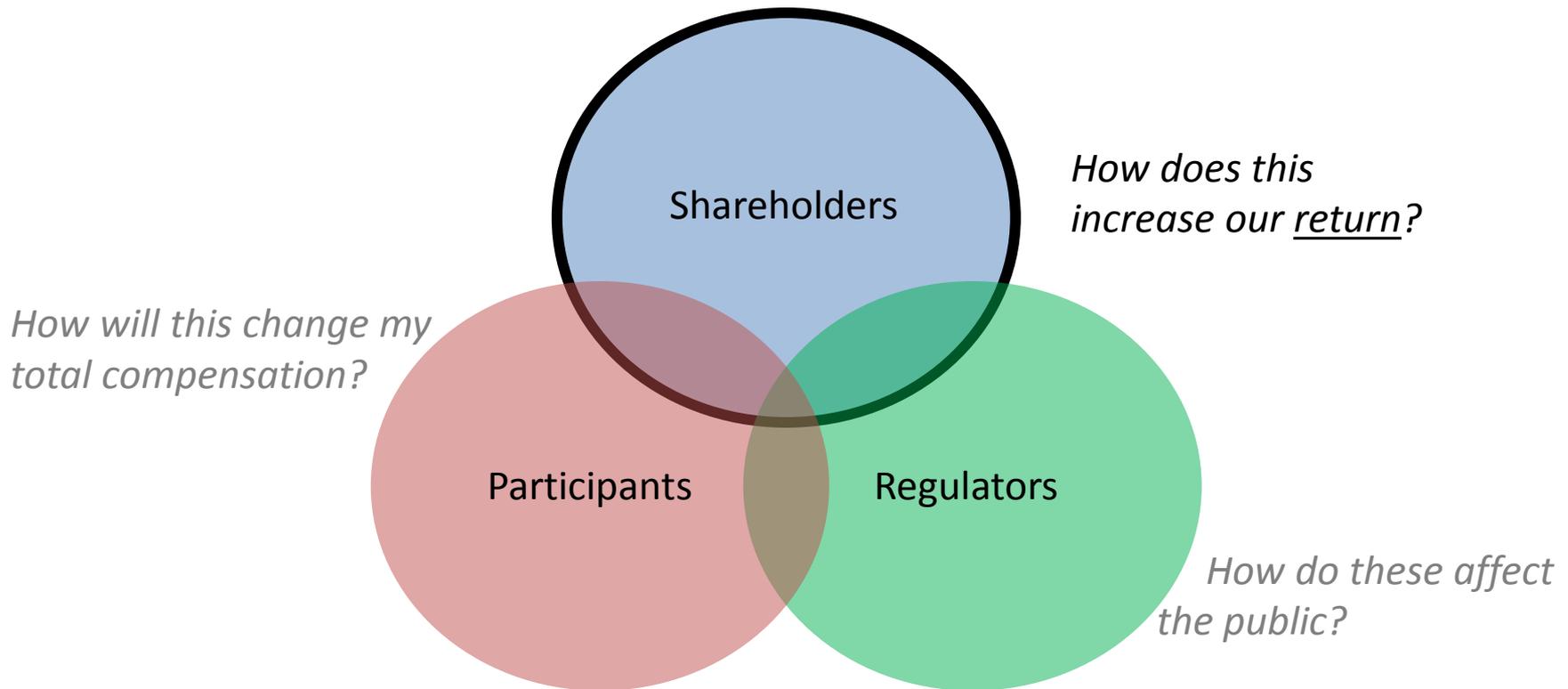
# The Unexpected

- What happens when the unexpected happens?

Termination Event	Type	Considerations
Retirement	Voluntary	<ul style="list-style-type: none"><li>• Do options accelerate?</li><li>• Retirement eligibility plays a role before retirement actually occurs</li></ul>
Resignation	Voluntary	<ul style="list-style-type: none"><li>• Usually lose options</li></ul>
For cause	Involuntary	<ul style="list-style-type: none"><li>• Usually lose options</li></ul>
Not for cause/Good Reason	Involuntary	<ul style="list-style-type: none"><li>• Depending on terms, may keep, accelerate, pro rata payout</li></ul>
Merger/Acquisition	Involuntary	<ul style="list-style-type: none"><li>• Options assumed by new entity?</li><li>• Cash payout?</li></ul>
Disability/death	N/A	<ul style="list-style-type: none"><li>• Various</li></ul>

# Shareholders' Perspective

Shareholders have a unique set of considerations for option grants



# From the shareholders' perspective

Options are great, but unfortunately they aren't free

- It can be complicated to figure out how much options (equity compensation in general) hurt shareholders
- Dilution issues
  - Diluted earnings per share
  - Options overhang
- Governance groups
  - Options are not “performance based”
- Investors
  - Are options expense really something we care about? After all, it is just “accounting”



*Dilution is a necessary downside of granting equity*

# Vanilla Too Boring? Lots of Other Flavors!

- If you want the benefits of options but you prefer something less one-size-fits-all, there are plenty of variations you can add
- Out-of-the-money options
- Performance options
  - TSR based: relative or stock price hurdle
  - Performance based: operational target or major milestone (IPO, drug approval)
- SARs (cash-based)
- Various combinations of features





Questions?

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