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Why Stock Ownership Is a Better Incentive Than Stock Options

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Cost-Effective Executive Compensation: Long Run
David E. Travis

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WHY STOCK OWNERSHIP IS A BETTER INCENTIVE THAN STOCK OPTIONS

At the same time that many corporate boards are examining whether stock options have any redeeming values, some companies are expanding plan participation to include all employees. But there are more effective ways to use stock as a motivational tool.

by R. Bradley Hill

A stock option is an option to purchase shares of company stock at a stated price over a given period, frequently ten years. Stock option plans are typically adopted because they facilitate employee ownership in company stock and tie employee gains to shareholder gains. Roughly 80 percent of all major companies in the United States offer stock options to executives.

Recent moves by Pepsico, DuPont, Waste Management, Merck, and Pfizer, to name a few, indicate a growing trend to push stock options deeper into the organization, offering options to employees at all levels. In tandem with this move, some companies are considering the use of stock options to replace a portion of employees' annual salary increases. These trends demonstrate an increasing focus on stock options as a compensation vehicle. Should the total earnings of all employees be tied, in any way, to stock price? This article examines stock options as a form of compensation for the rank and file as well as the other forms of stock compensation that could more meaningfully reward employees.

Factors That Determine Option Value

In order to assess whether stock options are a fair way to motivate and reward employees—that is, whether they encourage employees to work longer, harder, or smarter—one should ex-

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amine the primary factors influencing the value of stock options.

Company Performance. The extent to which a company performs above expectations is a major influence on stock price. For a company that consistently attains a return on equity (ROE) of 25 percent, it may take a heroic ROE of 30 percent to exceed expectations and therefore to budge the stock price. But for a company that regularly realizes a 5 percent ROE, a 10 percent return may send the stock price soaring. It is not necessarily the performance level that determines the market value, but rather performance versus expectations. Options will be much more valuable at the "most improved" company than at the company that has consistently performed at an outstanding level.

External Business Factors. The impact of a competitor's pricing and the cost of raw materials are just two factors that can affect a company's stock price. Looking at the significant impact that oil prices have on airline stock prices, or that the personal computer price wars have had on technology stock prices, alerts one to some of the many business influences on stock price that are outside a company's control.

Market Psychology. The ebb and flow of the general market may lift a stock price higher in times of optimism and high consumer confidence, and it may bring a stock lower in anxious, uncertain times. The market's crash in 1987 was not caused by a broad collapse in companies' ability to perform, but by a collapse in confi-

dence about the future. Not many companies can influence overall market optimism, yet the value of stock options can be drastically swayed by consumer sentiment.

Option Grant Date. The date on which a stock option is granted may profoundly affect its value. A review of the fifty-two-week stock price highs and lows illustrates that it is common for the high to be 50 percent or more higher than the low. If stock options are granted at a low point, the future is bright. If options are granted at a high point, it may be some time before they realize any sizable appreciation. The grant date has nothing to do with employee performance, but a lot to do with an option's value.

Option Exercise Date. Finally, there is an element over which most employees will have some control—the date they exercise the option. Over the option's term, employees will spend hours diligently following the stock price, probably calculating the value of the options in their heads on a daily basis. Then, on the date they feel they can maximize their gains, employees will probably exercise and dispose of the options in one motion.

The Problem With Options

Most investors would agree that in the long term, company performance will be the most significant predictor of stock price. Further, it is admirable to communicate to employees that everyone can make a difference, and to reinforce this message by offering everyone stock options. But with the only item under the employees' control being the option exercise date, it is likely that the only activity at which the employees will work harder or longer is examining the day-to-day movement in company stock price. Stock options for the general employee population will not meet their intended motivational, ownership, or shareholder value objectives for the following reasons.

No Line of Sight. The most powerful incentives are those that link a payout to results that are directly under the employee's control. Few employees can see the impact that their contributions have on stock price. (In fact, few chief executive officers can see the impact their contributions have on stock price.) The inability to link employee efforts directly to stock price destroys the motivational value of options.

Uncontrollable Risk. The rank and file should not be placed in a position where some of their

total compensation is based on stock performance. While the highly compensated may be in a position to "gamble" a portion of their earnings on market performance, the lower paid are not in a position to risk their earnings on a vehicle tossed around by the influences discussed earlier.

Coming up with money to exercise stock options and to pay taxes on the option gain will place a strain on many lower-paid employees.

Cash Flow Problems. If employees want to exercise their options and hold the stock, they must pay for the stock *and* pay any capital gains tax (on the difference between the grant and exercise price) at the time of exercise. Coming up with the money to exercise stock options and to pay taxes on the option gain will place a strain on many lower-paid employees. In fact, most employees will be tempted to sell part or all of their options in order to pay taxes and recognize a modest gain. If stock options are offered in lieu of salary increases, the immediate disposal of options will be even more prevalent as employees search for ways to maintain their standard of living.

Limited Stock Ownership. Stock options granted to executives are typically exercised within five years of the grant date, and many of those exercised are then sold. For lower-level employees, the exercise and sale are likely to be even sooner because of the cash flow problems discussed earlier. Option ownership and stock ownership are not the same thing. The benefits of employee stock ownership will not be recognized by an employee who holds an *option* for one or two years. Stock options are not providing for a long-term investment in the company, and it is unlikely that any organization is benefiting from the higher levels of loyalty and commitment usually attributable to long-term ownership.

Increased Dilution. It is bad enough that shareholders must endure the effects of dilution from executives' stock options. Undoubtedly, the stock options offered to the rank and file will not be at the expense of the executive

group; they will be *in addition to* the executives' options. While we can appreciate the equity achieved by letting all employees in on a little compensation secret that has been making millionaires out of executives for years, the shareholders will end up paying the high cost of dilution (the difference between what the company could get for the stock on the open market and what the employee pays for it).

Better Use of Options

Stock options are not an appropriate vehicle to compensate or reward *all* employees. But, by modifying the design of stock option plans, they may serve to more reasonably tie employee gains to long-term shareholder gains.

While it may be impossible to eliminate the influence of business and market factors on option value, companies that desire to tie employee gains to shareholder gains can eliminate the influence that grant and exercise timing have on option value. One way is to establish a program that rewards employees for achieving a higher average annual market price.

Figure 1 indicates a fairly typical company that experiences a steady increase in average stock price from 1992-1999, the average price increasing in six of seven years. There is also some significant variability between the low and the high in any year. If the company really wants stock options to be a reward for increasing long-term shareholder value, it should motivate employees toward increasing the average annual stock price and not tempt them with the gains realized through the meaningless day-to-day fluctuations that are caused by market noise.

FIG. 1. Stock History of Sample Company

Year	Average Stock Price	Annual	
		Low	High
1992	23	19	28
1993	27	21	36
1994	31	27	37
1995	29	25	39
1996	37	29	45
1997	38	35	49
1998	45	41	55
1999	49	40	71

How does this "average price" option plan differ from the typical stock option plan? First, if the company is going to reward increases in average stock price, it will have to use a vehicle whose value is tied to the average annual price, which means it will use phantom shares, or units, rather than actual shares. For simplicity, assume that the average is calculated one time per year, at the close of market on December 31. (An alternative is to calculate a rolling annual average.)

Using the example in Figure 1, the average stock price in 1992 is \$23. On January 1, 1993, employee A is given 100 average price options with a grant price of \$23/share. If the employee chooses to exercise his options on January 1, 2000, the options would be worth $(\$49 - \$23) \times 100 = \$2,600$. To address the ownership aspect of the plan, the gain should be paid out in \$2,600 worth of stock at the going market price.

Under a typical plan, employee A could have been granted options on 100 shares in 1999 at a price of \$40, and exercised those shares later in the same year for \$67, and realized a gain of $(\$67 - \$40) \times 100 = \$2,700$. Perhaps the run-up in stock price is attributable to speculation of a takeover that never transpires.

By taking control of the exercise date, the employee could have made more in one year under the typical plan than he made in seven years under the average price option plan. But the reason for that one-year gain had nothing to do with individual or company performance, and the stock option surely did not serve as a reward for increasing long-term shareholder value.

Those who remain committed to the virtues of stock options should contemplate using such variations of the stock option as the following:

- Indexed options (which pay out for stock price gains relative to a peer group's gains);
- Premium options (which set the grant price at some premium to the current market price);
- Performance options (which tie stock option vesting to certain stock price increases);
- Average price options.

Alternatives to Stock Options

Although the modified stock option plans discussed above represent improvements over the popular typical stock option, they will still not fairly compensate, motivate, or reward the general employee population. The benefits of broad em-

ployee ownership can better be realized in the following ways by focusing on stock ownership instead of on stock options.

- Companies can use stock as an integral part of the employees' retirement program, motivating employees to invest a portion of their retirement savings in stock through a match or an employer contribution. This will orient the employee to the long-term value of the stock. For every \$1 the employee invests in stock, the company can invest \$0.50 on the employee's behalf. If the company already has a match program for all investments, it can make a more favorable match for investments in company stock.
- Companies can offer employees a choice of rewards at merit increase time, such as (1) a 5 percent base pay adjustment; (2) a 5.5 percent lump-sum payment; or (3) a stock grant equal to 6 percent of base pay. Such a scheme recognizes and compensates the employee for taking risk and eliminates the cash flow dilemma of stock options.
- Companies can pay out group incentives or gainsharing plans in company stock. Instead of paying out an incentive equal to 2 percent of salary, pay out company stock in a like amount. This eliminates the cash flow dilemma of stock options, ties rewards to factors under the employees' control, facilitates employee stock ownership, and links employee gains to shareholder gains.

- Companies can pay out spot bonuses in company stock. This is a common practice at many high-tech companies. Instead of a \$500 check, issue a certificate, for example, for ten shares of company stock. This may help to create some excitement around stock ownership and encourage others to buy stock.

These alternatives to stock options either (1) pay out only extraordinary compensation (above the base salary level associated with maintaining the employee's standard of living) in the form of company stock; or (2) encourage the employee to own company stock by offering premium awards for choosing stock over an alternative.

Ownership Makes Better Sense

Employee stock ownership has the ability to reinforce loyalty and commitment to an organization. But stock options and stock ownership are not the same, and, for many employees, stock options will never result in stock ownership. If stock options are granted as part of the necessary compensation package of all employees, then companies are unfairly linking the livelihood of individuals to the uncontrollable, unexplainable movements in stock price. Companies committed to the benefits of employee stock ownership should examine alternatives to stock options, such as stock awards or offering company stock as a retirement plan investment option. ■