

Options Pain: executives drop billions in shares slump

The bear market has stripped billions of dollars from the wealth of the nation's senior executives as the value of stock options plunges, increasing pressure on boards to scrap the controversial practice and find new ways to keep their senior staff motivated during the downturn.

At Macquarie Group, the top 20 per cent of staff are \$1.46 billion underwater on the options that were designed to retain and motivate the investment bank's best and brightest.

An analysis by *The Australian Financial Review* also reveals that Toll Holdings, Amcor and Boral are among large companies whose executives are holding worthless options.

But many of them won't get too much sympathy from the boardroom if they argue for compensation.

"It's life... your aligned with the shareholders – that's just stiff," says Toll chairman Ray Horsburgh.

"They're the market forces. You've just got to take the good with the bad."

Horsburgh's blunt approach is echoed by National Australia Bank chairman Michael Chaney, who estimates that executive share schemes issued by the bank over the past five years are underwater by more than \$200 million in part because performance hurdles have not been met.

"In the case of option schemes, the fact that they are underwater means that the original purpose, to increase the share price, hasn't been achieved and no such benefit is warranted. The executive shares the pain with the shareholders," Chaney says.

And Horsburgh has no time for the trend in the United States for companies to reprice options that are underwater. "I don't think it's right. You've got to be able to have your senior management understand that times are tough... I think it's a very dangerous practice to start

modifying reward policies when markets are down because you think of the retirement funds, the major investors in our company, a lot of those people are suffering. It's not because you think of our company's performance by the way. It's because of the general market."

He stresses that while options might be out of the money at the moment, executives have done well historically.

The market rout has led to a staggering destruction of wealth at companies, rendering outstanding share options underwater or almost worthless because the company's share price has plunged far below the strike price on the options.

Major companies such as Australia and New Zealand Banking Group, Woolworths, QBE Insurance and Tabcorp Holdings are just some of those that have witnessed a massive slide in the value of share options since the Australian stockmarket's benchmark S&P/ASX 200 Index tumbled 47 per cent from the peak of the bull market in November 2007.

The *AFR* analysis was based on the most recent company annual reports and the closing share prices yesterday. Many of the options have strike prices far above the market still have vesting periods two or more years out. However, the research identified large tranches of options that vested, or will soon vest, with no value. For example, according to its 2008 annual report, 5.89 million Macquarie options would have vested in the past 12 months with an average strike price of \$44.27 against the close yesterday of \$23.80.

The option programs formed a key part of executive remuneration in the past decade, and have been particularly important to smaller companies that have struggled to compete with the large pay cheques offered by the big corporations.

Designed to retain and motivate staff, options were popular during the bull market because they could often be exercised at strike prices well below the company's share price. Executives could even adopt them without even opening their cheque books by instructing their broker to sell the shares, then repatriate the strike price back to the company that issued the options, collecting the difference in cash.

But now some have dubbed them the 'fair-weather option'. The market woes have hit executives with a double whammy: share prices have fallen, while most options were issued at the soaring prices of recent years.

The phenomenon is forcing many company boards to rethink their use of options. It is particularly expected to accelerate the trend for big companies to adopt so-called performance rights schemes over options. Performance rights have been more popular since the dotcom implosion because, unlike options, they have no strike price.

Organizations including AMP have already largely ditched options in favour of performance rights, which, like options are long-term incentives.

Remuneration experts say that, faced with falling morale and the risk of losing key staff to competitors, companies have been busily reviewing their use of options and reframing incentive packages.

Recruiter Chandler Macleod's executive general manager, Peter Gleeson, says companies are having to ramp up their short term incentives to attract and retain top executives wary of options. "A lot of them have lost half their wealth already, so it's about cash in hand, based on performance," he says. "The attractiveness of options has very much gone out the window and, certainly in the financial services industry, it's not often used as an

incentive for bringing people on board anymore."

Some companies are shying away from option schemes and instead offering other equity-based incentives such as restricted stock; others are cancelling worthless existing options and conducting wholesale reviews of their approach to pay; some, meanwhile are topping up the fixed pay component of the compensation package. Perhaps ironically, other companies are developing option plans, confident that as the sharemarket recovers, they will deliver windfall gains.

Egan Associates principal John Egan expects some companies to temporarily abandon employee option schemes over the next 12 months and use cash bonuses to motivate their staff. "Unless they're very confident that in the next couple of years their share price will improve dramatically, companies may well abandon long-term equity-based incentive schemes," he says.

"In the current climate options represent a lottery effect. They would be criticized if they issued a bucket-load of options and management walked away with millions and shareholders just recovered their positions. They would have a very unhappy group of executives if they granted options and the market remained volatile and went down further."

Boards are also looking at the issue against a red-hot pay debate about executive pay and excess. Last week, the Rudd government launched a Productivity Commission enquiry into executive pay, headed by former competition regulator Allan Fels. That will examine the role of equity-based payments and incentive schemes.

Australian Institute of Company Directors chief executive John Colvin confirms boards are indeed struggling with the matter. "One of the

big risks for boards is if you award options at the current market price, you might be overly rewarding executives for market movements, without any real performance issues behind them," he says.

"One of the red flags to boards now is if they were to use options, they have some mechanism to put a cap or boundary on what they would this would be a reasonable end result."

And he says boards are anxious to ensure executives are not "overly compensated just because they happened to be in the right place at the right time".

And there are concerns that worthless options have little value in retaining executives. "The previous option allocations are so far underwater that they have no bite in terms of their incentive or retention value" Remuneration Strategies Group director Gary Fitton says.

Option plans give an employee the right to buy a certain number of shares in the company at a fixed price, typically after a period of three years. Generally they are also subject to performance hurdles. Options have been popular in the financial services sector, where executives have sometimes received lower base salaries and then this is topped up by options and other forms of discretionary remuneration such as bonuses.

Fitton says that one tactic being pursued is cancelling existing options. "Where it's quite plain that the options are so far underwater that they have no impact and are worthless in the eyes of the employee, they're cancelling them. These are so far underwater they can be a disincentive. This is the contra side of share plans," he says.

This can be followed, he says, with reviews of entire long-term incentive programs before the possible adoption of differently designed instruments.

Fitton says that, increasingly, companies are issuing options annually instead of every three years. This means that options that are underwater lapse and are automatically replaced by the issue of new options.

In the US in recent weeks, companies including Google and Starbucks have been asking shareholders to allow them to reprice or exchange stock options.

This could prove highly challenging in Australia. "There are technical, legal and shareholder-alignment problems with repricing executive options," says Guerdon Associates principal Paul Riggs. "Repricing executive options is a bad look for any company."

In Australia, the Australian Securities Exchange listing rules prohibit changing an option to reduce the exercise price, increase the number of underlying securities, or changing any period of exercise. However, the ASX has indicated it is generally prepared to grant a waiver for changes to employee incentive schemes when the change is made to reflect changes to the scheme itself that are either insignificant or have shareholder approval.

Small companies are believed to have approached the ASX about the issue.

Egan says: "There are some small market cap companies that aren't in the top 300 that I know have approached the ASX... to say 'Look, we have this problem'."

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