

The Real IMPACT Of Stock Dilution

by Aaron Brown and Brian Cumberland

While the business press looks at the issue of stock options from the executive pay and expensing angle, large investors are more concerned with options' "overhang" impact—how big mega-option plans could dilute their share holdings. The authors suggest that boards look beyond basic overhang measures to judge the options' true "IMPACT."

During the 1980s and 1990s, stock options were virtually an "inalienable right" for many workers throughout the U.S. This mind-set started with the investment community and spread to Corporate America. Executives needed some tie to shareholders and the best alternative from an accounting perspective was stock options.

While shareholders rode the bandwagon of aligning management with themselves, the proportionate interest of their shares was being diluted, sometimes as much as five percent or more annually. Not only did companies have to beat historical growth, but they also had to beat the annual dilution from their stock programs. Companies have traditionally been motivated to use stock options since they bring no charge to earnings and, in most instances, are tax deductible upon exercise.

This may all be about to change.

The organization responsible for setting accounting standards in the United States, the Financial Accounting Standard Board (FASB) has proposed a new standard governing the accounting for stock options. If the proposed standard is finalized by FASB, starting January 1, 2005, it would generally require all options to be expensed at grant-date fair value, and reflected on companies' income statements. This is meant to more accurately reflect the impact of options on a company's financial status.

One of the most widely used ways to determine stock plan dilution is the "overhang" calculation.

Typically, dilution is calculated by adding up all the stock outstanding under employee stock plans and any stock available for future awards under such plans. This is then divided by the company's common shares outstanding. This overhang calculation is commonly used by investors, Wall Street analysts, company management, and corporate boards to help understand the impact of employee stock programs on shareholders.

Institutional investors today look far more closely at measures of whether a stock program is excessive, liberal, costly or excessively dilutive.

Advisory groups are providing advice to institutions on how to vote for company-sponsored proposals to increase stock available for employee compensation programs. For example, Institutional Shareholder Services (ISS) weighs both shareholder value transfer and voting power dilution, and overall dilution must be in line with industry norms with restricted stock counting more than options. Glass, Lewis, & Co. and Investor Responsibility Research Center (IRRC) publish reports on corporate governance including opinions on whether a company's stock program is excessive, liberal, costly, or excessively dilutive.

How are institutions reacting to this dilution issue?

□ CalPERS, the large pension for teachers and other civic workers in California, has flexed its voting muscle by voting down excessive increases in stock plans. CalPERS generally relies on ISS and

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Stock Dilution Surprises
Overhang Not The Same As IMPACT

| | Company A | Company B |
|----------------------------------|--------------|--------------|
| Common shares outstanding | 100 | 100 |
| Options at \$5 | 10 | 5 |
| Options at \$10 | 10 | 5 |
| Total options outstanding | 20 | 10 |
| Overhang | 20% | 10% |
| Current stock price | \$6 | \$20 |
| Current MCAP | \$600 | \$2,000 |
| Current IMPACT | \$10 | \$125 |
| Current IMPACT/MCAP ratio | 1.7% | 6.3% |

* $IMPACT = (current\ stock\ price - option\ price) \times number\ of\ options\ outstanding$

IRRC for voting advice, but they also have their own stipulations, such as limiting total awards for the “Top 5” executives to five percent of any broad-based stock plans.

TIAA-CREF looks carefully at any plans with over 15 percent dilution (overhang) or a two percent overall annual dilution run rate.

SWIB (State of Wisconsin Investment Board) supports plans with less than 10 percent overhang and one percent annual run rate. They will also support up to 20 percent overhang for high performing companies.

Putnam Investments will support an annual run rate of less than 1.67 percent and overhang of less than 10 percent.

Fidelity will vote against overhang over 10 percent unless discussions with the company justify the overhang.

Vanguard Group looks critically at companies with more than a 15 percent overhang or two percent annual run rate.

Overhang measures lack sophistication for properly presenting the effect of stock options. What is the actual impact of those plans on shareholders?

However, it has become evident that overhang lacks the sophistication for properly presenting stock option impact when a company has a volatile stock price. For example, suppose a company grants all its options with an exercise price of \$80 and the stock is now trading at \$10. None of the calculated option overhang would actually result in dilution until the company’s stock price recovered to above \$80 per share, an increase of 800 percent in stock price.

An alternative way to view dilution from employee long-term incentive programs is to calculate the actual impact of those plans on shareholders. We call this calculation “IMPACT Analysis.”

The IMPACT to shareholders represents the actual value of long-term incentive awards outstanding divided by market capitalization (MCAP) of the company (number of common shares outstanding times the current stock price). The value of long-term incentive awards outstanding is the sum of:

Options: What is known in the industry as “in the money” value or “spread” (today’s stock price less option exercise price times the number of options outstanding).

Restricted stock: Each restricted share of stock outstanding times today’s stock price.

Long-term cash programs: Stock Appreciate Rights (SARs), phantom stock units, and cash plans are valued using today’s stock price and performance to date.

The chart (above left) illustrates the differences between overhang and IMPACT. The basic overhang calculation here suggests that shareholders of Company A will experience significantly more dilution than Company B. Company A’s overhang is 20 percent, while Company B’s is 10 percent. In reality it is the other way around given the current stock price. The IMPACT Analysis shows the true dilution is larger on Company B’s shareholders. Of Company B’s market capitalization, 6.3 percent is going to its employees, while only 1.7 percent of

Effect Of Restricted Stock Same Overhang, Different IMPACT Dilution

| | Company A | Company B | Company C |
|----------------------------------|--------------|--------------|--------------|
| Common shares outstanding | 100 | 100 | 100 |
| Options at \$5 | 10 | 5 | 0 |
| Restricted shares | 0 | 5 | 10 |
| Total awards outstanding | 10 | 10 | 10 |
| Overhang | 10% | 10% | 10% |
| Current stock price | \$6 | \$6 | \$6 |
| Current MCAP | \$600 | \$600 | \$600 |
| Current IMPACT | \$10 | \$35 | \$60 |
| Current IMPACT/MCAP ratio | 1.7% | 5.8% | 10.0% |

* $IMPACT = (stock\ price - option\ price) \times number\ of\ options\ outstanding$

Company A's market capitalization is going to its employees.

Overhang focuses only on the number of shares given to employees, without considering whether employees must purchase those shares, or if the shares are an outright award. IMPACT Analysis recognizes that options have a different effect on shareholders than do shares of restricted stock. On a share basis, the dilution value of options is generally *less* than the dilution value of restricted stock.

For comparison purposes, we analyzed the S&P 500 using both typical overhang and IMPACT on dilution to shareholders. The difference between overhang and the IMPACT calculation across industries and even between companies within the same industry can be staggering.

Different industries show major differences in IMPACT calculations. For example, the high-technology industry has generally high overhang values—but lower IMPACT ratios—than the oil and gas industry.

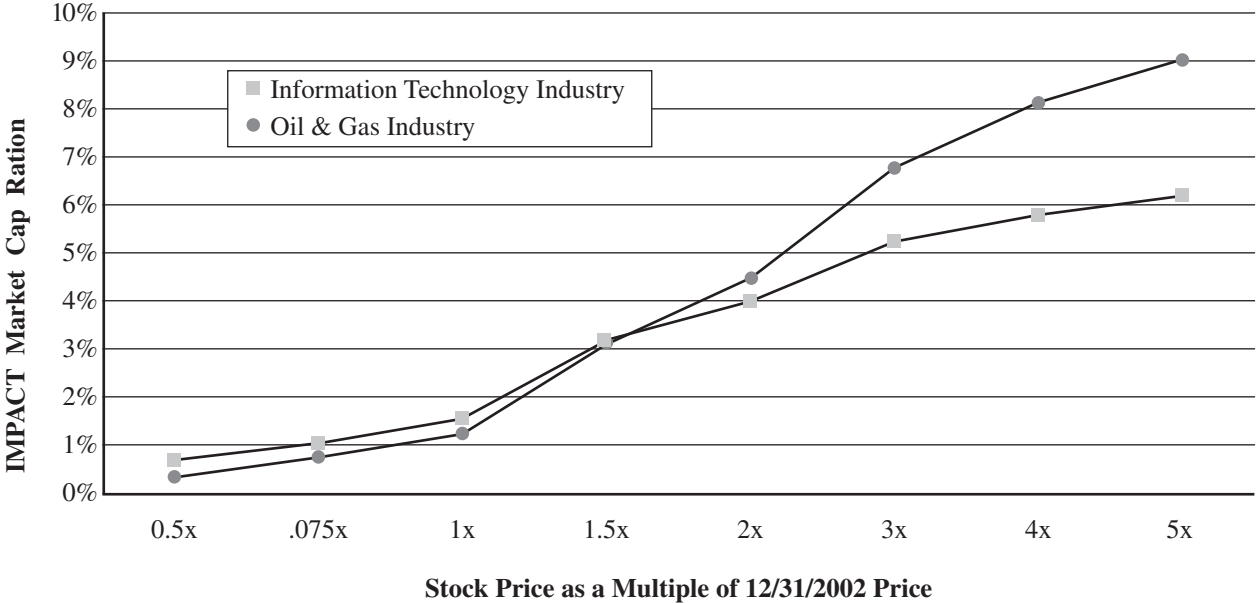
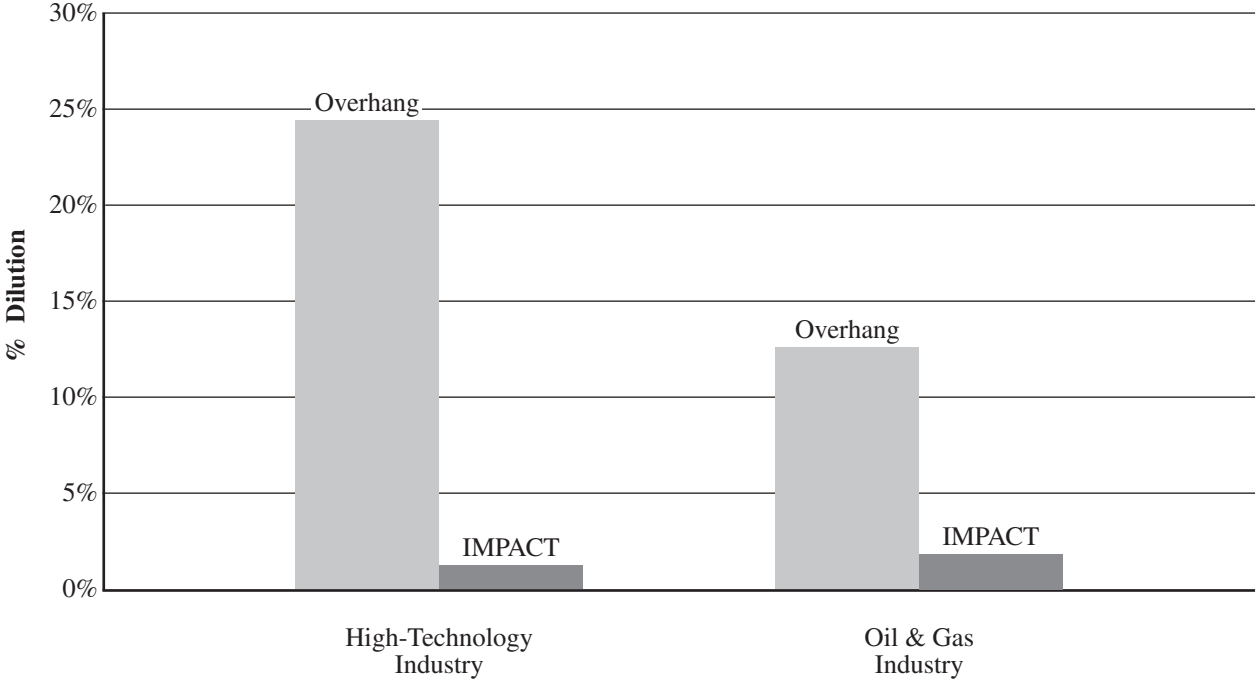
IMPACT also provides a means to better understand the potential dilution long-term incentive programs can have on shareholders in the future. Multiples of today's stock price (.25x, .5x, .75x, 2x, 5x, 10x, etc.) can be used to calculate future IMPACT to shareholders given certain assumptions on future stock price performance.

If all long-term incentives have a similar charge to earnings for their targeted value, companies can use the most appropriate incentives without fear of being penalized.

Overhang, FASB's expense model, and IMPACT should all be used in conjunction to gain a better picture of how a company's long-term incentive program is affecting shareholders. FASB is on the right track with its goal of expensing all types of long-term incentives including options. If all long-term incentives have a similar charge to earnings

Different Industries, Different Dilutions

Overhang And *IMPACT* In The High-Technology And Oil & Gas Industries



for a targeted incentive value, then companies can use the appropriate incentive without fear of being penalized for not using options.

Overhang gives us an upper limit of maximum total dilution that shareholders can experience under the current program. Viewing dilution through IMPACT Analysis can help determine the ideal way to use long-term incentives in the future and assess the effectiveness of long-term incentive programs. When viewed together, both can help answer questions about management retention and expense.

If the overhang is high yet the IMPACT is low, some sort of retention program might be appropriate, especially in industries where circumstances outside of the control of executives played a part in lowering stock prices so that options are underwater. If 100 percent returns are required for the next seven years for options to be in the money, the expense we are required to book for FASB and overhang calculated by advisory groups may never result in actual dilution. More importantly, if those options do result in dilution, shareholders would be ecstatic.

Alternatively, if a company has a relatively high IMPACT ratio versus the rest of its industry, most likely there is already plenty of retention power for its employees. The company may wish to use incentive pay to focus executives on other measures besides stock price, such as the long-term direction set by the CEO and the board. This helps use your incentives as efficiently as possible. In this case of a high IMPACT ratio, shareholders and the board

should be aware that long-term incentives outstanding will have a fully dilutive effect because of either very low exercise prices on outstanding options or high use of restricted stock.

Considering IMPACT also helps the board and shareholders understand how investment analysts value company stock. They consider real dilution to market capitalization from employee stock plans instead of potential dilution to common shares outstanding. Additional questions answered by understanding IMPACT include:

- How do we compare to our peers regarding the portion of our market cap we pay employees?
- Are we in danger of losing our executives?
- How should we present our new long-term incentive program to voting shareholders?
- What is the right program for long-term incentives?
- How will long-term incentives affect our stock price in the future (or the price we want for a merger or acquisition)?

Regardless of the current situation, whether a company has a high or low overhang or a high or low IMPACT ratio, shareholders are better served by reviewing all relevant information before deciding how to vote their shares at the next proxy meeting. Clearly, not all dilution is equivalent. It should be viewed in light of the facts and circumstances of each company, and using IMPACT can help paint a more complete picture of the effect long-term incentive programs have on shareholders of a company. ■

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