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The Crystal Report on Executive Compensation



Abercrombie Does Out-of-the-Money Options

by Graef Crystal

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Abercrombie & Fitch Co., the New Albany, Ohio-based specialty retailer, has signed its longtime CEO, Michael Jeffries, to an unusual pay contract, which runs to February 2014.

In its proxy statement filed on May 10, the company declared that the total value of Mr. Jeffries' 2009 pay package (for the fiscal year ended Jan. 31, 2010) was an extremely-high \$36.3 million.

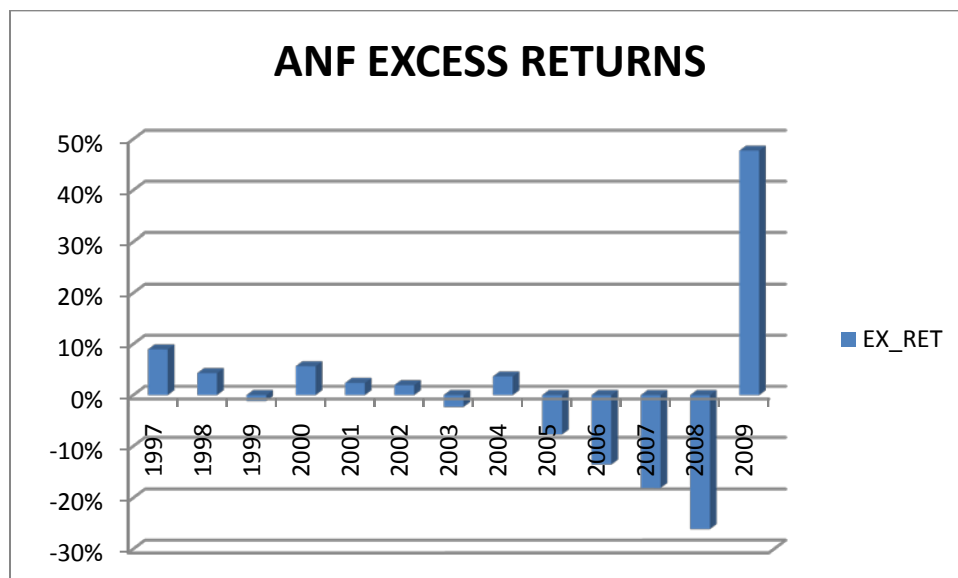
That level of pay puts him in third place in a database I created containing the 2009 total pay of 302 CEOs running companies listed in the Standard & Poors 500 Index, who had held their jobs for two or more years. (The first and second places are held by, respectively, John Hammergren of McKesson Corp. (total pay of \$54.6 million) and Leslie Moonves of CBS Corp. (total pay of \$43.2 million).

In the long-term, Mr. Jeffries has been a decent, but not a spectacular, performer. He became CEO of Abercrombie in Feb. 1992, but a seamless stock price history did not start, until, effectively, 1997.

I examined his total return performance in 13 different time windows. The first began on Jan. 31, 1997. Thereafter, the beginning of each time window was incremented by one year, with the last time window beginning Jan. 31, 2009. All 13 time windows ended on Jan. 31, 2010. The time windows varied in width from 13 years down to 1 year.

From the annualized total return for each time window, I deducted the equivalent return on the Standard & Poor's 500 Index to produce a so-called excess return.

The results may be seen in the following chart:



Mr. Jeffries did not receive a bonus for the most recent full fiscal year because financial results were quite poor.

But he more than made up for that lack by being granted enormous numbers of stock options and stock appreciation rights with a declared Grant Date Present Value of \$33.3 million.

It's not unheard of to receive an option mega-grant of the size just described. But what's unusual is that many of the options granted to Mr. Jeffries were out-of-the-money on the date of their grant.

On March 2, 2009, he received the following grants:

- 600,000 shares carrying a strike price of \$20.75, which was fundamentally the closing price on the grant date.
- 150,000 shares carrying a strike price of \$24.90, a price that was 120 percent of the market price at grant.
- 150,000 shares carrying a strike price of \$29.05, a price that was 140 percent of the market price at grant.
- 150,000 shares carrying a strike price of \$33.20, a price that was 160 percent of the market price at grant; and

- 150,000 shares carrying a strike price of \$37.35, a price that was 180 percent of the market price at grant.

Then, on Sept. 1, 2009, the entire process was repeated, but this time the market price at grant had risen to \$31.66.

(Mr. Jeffries also received the same, but a somewhat larger, sequence of grants in Dec. 2008, but those were made during Abercrombie's 2008 fiscal year.)

Finally, on Sept. 22, 2009, he was given yet one more option grant, this one covering 1,043,367 shares and carrying a strike price of \$33.53 a share, which was the market price at grant.

Were Mr. Jeffries to hold all 11 grants until the last day of their terms, his likely stock price appreciation at that point would be \$106 million, using the original market values at grant.

One can argue that shareholders would have been better off had Mr. Jeffries received a lot fewer option shares, all with strike prices equal to the market price at grant.

But it's so unusual for a CEO to step up to the plate and accept an out-of-the-money option that I, for one, applaud what happened at Abercrombie.

It's also important to note that Mr. Jeffries does not have all the time in the world to get his company's share price up. His 11 grants made in FY2009 carry option terms that vary from 6.24 years to 7 years. The normal option term at most companies is 10 years.

As mentioned earlier, the company declared that the Grant Date Present Value of all 11 option grants was \$33.3 million.

Now it is often the case that a company "lowballs" its Grant Date Present Values, principally by either reducing its future stock volatility assumption or, more likely, its assumption as to when the options will be exercised.

To shed some light here, I performed my own Black-Scholes valuations on all 11 grants, using real-world assumptions, including full terms of exercise. The figure I obtained for all 11 grants was \$32.1 million, an amount that was slightly smaller than Abercrombie's reported \$33.3 million.

So further congratulations are in order for not "lowballing".

There's one further point of interest here. In his new employment agreement, Mr. Jeffries can himself decide how his long-term incentive package grants in 2011 and later years are structured. He can choose an all-options diet, an all free-share diet or anything in-between.

It is unusual to offer such a choice to a CEO.

But if I were an Abercrombie shareholder, I would pay close attention to what Mr. Jeffries does. Choosing all options suggests bullishness about his company's future stock price. On the other, choosing all free shares suggests that he may not all that enthusiastic about his company's future.

Speaking for myself, I think that Abercrombie has done something useful here. If there has to be pay this high, let it be accompanied by commensurate risk.

Graef Crystal's is now in his 52nd year in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. (He still contributes occasional columns to Bloomberg News.) He has written six books and more than 1,600 articles on executive pay.