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## **Dividend-Protected Stock Options May Be Good**

**by Graef Crystal**

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I have great admiration for Gretchen Morgenson, a distinguished business columnist for *The New York Times*. But I must respectfully disagree with the thrust of her column published on May 16.

In that column, Ms. Morgenson took aim at \$475,000 of cash payments made to Robert Silberman, the CEO of Arlington, Virginia-based Strayer Education Inc. The payments represented dividends on stock options that had not yet been exercised.

She went on to quote Bob Gabele, principal of 3D Advisers, an independent research firm: "In my 30 years of analyzing insider behavior, this is the only time I have seen this sort of practice."

To the extent that these dividend equivalents were added after the option grants were made, Ms. Morgenson and Mr. Gabele have a point. And from my analysis of Strayer's past proxy statements, that after-the-fact behavior could well be the case.

But it is not at all unheard of to grant a stock option that, from day one of its grant, confers on the optionee the privilege of receiving dividends.

The grant of such an option goes under the name "Dividend-Protected Stock Option."

Obviously, getting an option grant with dividends attached is, on a share-for-share basis, more valuable than the traditional option that does not provide dividends.

But if the company making such dividend-protected grants is acting rationally, the optionee will pay a price in the form of a lesser number of option shares.

To illustrate, let's take a stock where the current market price is \$50 a share and where the company's expected dividend yield is 2.54 percent (a figure equal to the median current yield on the stocks comprising the Standard & Poors 500 Index as of this May 18). Let's also assume the

stock option carries a term of 10 years and a strike price of \$50. Finally, let's assume that the option is not dividend-protected.

The intrinsic reasoning behind the Black-Scholes is that the stock, in the hands of the optionee, is not worth \$50 a share. That's because the outside investor who buys the share for \$50 receives that 2.54 percent dividend yield, whereas the optionee does not.

To determine what the stock would sell for if the dividends were removed, the Black-Scholes model takes the current price of \$50 and then discounts it by the 2.54 percent yield for the number of years in the term, in this case,  $\$50 * (1-.0254)^{10} = \$38.66$ .

Then the option is valued as if it were an out-of-the-money grant, with a market price of \$38.66 and a strike price of the current \$50.

If I add in some additional Black-Scholes assumptions (estimated volatility of 48 percent, the current median implied volatility on the S&P 500 stocks; and a risk-free rate of 3.72 percent, the current Treasury strip rate for a 10-year term), I obtain a Black-Scholes value of \$22.27 a share.

But if the option is dividend-protected, there would be no discount applied to the market price at grant because the optionee receives the same dividends as an ordinary shareholder. In the Black-Scholes model, this is reflected by assuming that the estimated future dividend yield is 0 percent.

In that case, then, both the market price and the strike price would be entered into the Black-Scholes as \$50.

If that one assumption is changed, the grant date present value rises to \$31.58 a share from \$22.27.

On that basis, 705 dividend-protected option shares would confer on the optionee the same grant date present value as 1,000 regular option shares that did not offer dividend protection.

Thus, economically speaking, there is no free lunch here.

But there may be an advantage in granting dividend-protected stock options. I used Google to search for information on such options, and the first thing I found was an abstract of a 2005 academic paper written by Markus Arnold and Robert Gillenkirch, both of the University of Goettingen in Germany (among its more distinguished alumni was J. Robert Oppenheimer, who received his doctorate in physics there and later went on to preside over the development of the atomic bomb).

The abstract states: "Stock Option Programs have become the dominant compensation instrument for top-management in the nineties. Usually, they are not dividend-protected, i.e., any dividend payout decreases the value of a manager's options. Empirical evidence shows that this results in a significant decrease in the level of corporate dividends and, at the same time, into an increase in share repurchases."

That makes sense to me. If I am a CEO receiving non-dividend-protected stock options, why pay a dividend at all? Or at least, why increase the dividend? Instead, why not keep the money in the business and reinvest it, even if the incremental return is sub-optimal? And if all else fails, why not do a share buyback and hope that the market price will rise? For it is only with a rising price that I receive more money myself.

It can be argued that, from that standpoint, restricted stock grants are more fair to shareholders, because the executive receives dividends as well as stock price appreciation.

But rather than pay the dividend equivalents in cash, as Strayer has done, I would translate each dividend payment into some additional free shares. To illustrate, if the number of shares in the option grant is 1,000 and the dividend is \$1.00 per share and the market price at the time of dividend declaration is \$55, then the number of free shares credited would be  $1,000 * \$1 = \$1,000 / \$55$ , or 18.18 shares. Then the next time a dividend were declared, the amount to be translated into free shares would be 1018.18 shares times the then dividend per share.

Those reinvested shares would be paid out only if the option is exercised. That would generally mean that the option would be in-the-money at the time of its exercise. But an optionee with a slightly underwater option might wish to take the loss on the option exercise so she could retrieve the dividend shares that had been built up since the date of grant.

Bottom line: I would strongly favor making all option grants dividend-protected, but with one caveat: Recognize that, share-for-share, they are worth more and therefore don't grant as many.

2009 marks Graef Crystal's 50<sup>th</sup> anniversary 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 has written six books and more than 1,600 articles on executive pay.