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## **What Has the Recession Done To Option Grants?**

**by Graef Crystal**

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The short answer to the question posed by the title of this article is: Wreaked havoc.

I looked at past-granted options made to 671 CEOs running companies with \$2 billion or more of current market capitalization.

By the term “past-granted”, I mean grants made through the company’s 2008 fiscal year and which were outstanding at the end of that year. My data do not include options granted in the 2009 fiscal year. And my analyses assume, in some cases wrongly, that past-granted options had not yet been exercised as of Aug. 10, 2009, the day I began my analyses.

Shortly, I will be presenting some tabular information.

One column of this information shows the paper profits in all outstanding options as of Aug. 10, 2009. Option traders would term this the “in-the-money” amount.

The second column is designed to show what the “in-the-money” amount of outstanding options would be at the end of the option’s full term, assuming no exercise beforehand. The calculations underlying this column are predicated on the Capital Asset Pricing Model and involve the following assumptions:

- A risk-free rate, which is the Treasury zero-coupon bond rate for a bond having a maturity equal to the rounded (to whole years) remaining term of the option.
- An Equity Risk Premium of 6.5 percent, which according to Bloomberg data, is the average expected amount that equities will outperform bonds in the future.
- The stock’s Beta as of Aug. 10, 2009.

For an example here, let's look at an all-time options champion, Richard Fairbank, of Capital One Financial. For many years, his pay has consisted solely of stock option grants. No salary, no bonus, no benefits, no other long-term incentive plans.

As of Dec. 31, 2008, Mr. Fairbank was sitting on six outstanding option grants covering a total of 7.2 million shares. The strike prices of the six grants ranged from \$48.54 to \$87.28. Problem is, though, that as of Aug. 10, 2009, Capital One's stock price had dropped to \$33.88, meaning that all six grants were, to put it mildly, underwater. (Actually, Mr. Fairbank had a seventh outstanding grant as of Dec. 31, 2008, but it expired on April 28, 2009. Its strike price was \$56.46, while the market price on the date of expiration was \$16.18.)

In rounded terms, those grants have anywhere from two to eight years to go before they expire.

Let's take a look at the most recent of those grants, one granted on Dec. 10, 2007 and covering 1,661,780 shares carrying a strike price of \$50.99 a share and a term of 10 years.

First, let's calculate the expected future stock price appreciation. (I have assumed here, as I have for every CEO, that the company currently pays no dividend. That assumption is incorrect in most cases, but in many situations, the current dividend yield is unduly high because the stock is currently so low. In addition, other companies have discontinued their dividends, but that stance may not last for a long period of time. The effect of my no-dividend assumption would be to somewhat overstate the future stock price gains for the typical CEO):

- As of Aug. 10, 2009, the option had 8.33 years to go before its expiration. For purposes of calculating the risk-free rate, this figure was rounded down to 8 years. The Treasury strip rate on Aug. 9, 2009 for a maturity of eight years was 4.08 percent.
- As previously mentioned, the Equity Risk Premium for all companies was assumed to be 6.5 percent.
- Capital One's Beta on Aug. 10, 2009 was a very high 1.89.
- Hence, the CAPM rate for Capital One was the Risk-Free rate of 4.08 percent + (Equity Risk Premium of 6.5 percent X Stock Beta of 1.89), or 16.37 percent.
- Applying a 16.37 percent assumed annual rate of stock price appreciation to the \$33.88 close price on Aug. 10 for 8.33 years produces an end-of-term stock price of \$119.78.
- On that basis, Mr. Fairbank's 1.66 million option shares would have a final in-the-money value (or Projected Gain) of \$114.3 million.
- Two other of Mr. Fairbank's outstanding, but currently underwater, options would also come into-the-money by the end of their respective terms. But the remaining three options are likely to expire unexercised.

- Counting all three options, the expected gain for Mr. Fairbank, were he to hold all options until the end of their terms, would be \$131 million.

Of course, a number of things may happen to disturb that projected total of \$131 million:

- The future stock price appreciation may be higher or lower than the 16.37 percent a year rate I used. That rate is normative, or, effectively, the midpoint of the normal distribution of future stock prices.
- Mr. Fairbank may not hold his options until the very end of their respective terms.

Still, the point to be made here is that even an option that is out-of-the-money today may not be out-of-the-money at its expiration, so long as there is a decent amount of time remaining in its life.

The first of two tables below show the 30 CEOs with the highest amount of end-of-term projected gains among the 671 CEOs in the study, as well as their in-the-money positions as of Aug. 10, 2009.

And the second table shows the CEOs with the least amount of projected gains.

#### **THE 50 CASES WITH THE LARGEST PROJECTED GAINS:**

<b>COMPANY</b>	<b>CEO</b>	<b>PAPER PROFIT (000)</b>	<b>PROJ. GAIN (000)</b>
GILEAD SCIENCES	MARTIN, JOHN C.	\$265,824	\$422,450
POTASH CORP	DOYLE, WILLIAM J.	\$201,214	\$338,139
GLAXOSMITHKLINE	GARNIER, JEAN-PIERRE	\$112,523	\$308,907
WELLS FARGO	STUMPF, JOHN G.	\$116	\$276,590
JPMORGAN CHASE	DIMON, JAMES	\$38,545	\$261,075
VMWARE	MARITZ, PAUL A.	\$53,797	\$237,235
GOLDMAN SACHS GROUP	BLANKFEIN, LLOYD C.	\$36,952	\$234,642
YUM! BRANDS	NOVAK, DAVID C.	\$139,616	\$230,266
DIAGEO	WALSH, PAUL S.	\$113,260	\$209,539
MOTOROLA	JHA, SANJAY K.	\$0	\$208,077
TD AMERITRADE	MOGLIA, JOSEPH H.	\$131,620	\$207,618
QUALCOMM	JACOBS, PAUL E.	\$44,562	\$199,431
UNITED TECHNOLOGIES	DAVID, GEORGE	\$56,510	\$197,307
CONOCOPHILLIPS	MULVA, JAMES J.	\$87,850	\$183,709
ALLERGAN	PYOTT, DAVID E. I.	\$48,103	\$178,323
DANAHER	CULP, LAWRENCE	\$104,538	\$172,710
SOUTHWESTERN ENERGY	KORELL, HAROLD M.	\$121,532	\$162,946
CHEVRON	O'REILLY, DAVID J.	\$35,504	\$161,102

AFLAC	AMOS, DANIEL P.	\$33,403	\$160,701
HANSEN NATURAL	SACKS, RODNEY C.	\$85,823	\$158,981
FORD MOTOR	MULALLY, ALAN R.	\$5,913	\$158,464
CF INDUSTRIES HOLDINGS	WILSON, STEPHEN R.	\$72,091	\$156,934
FREEMPORT-MCMORAN C&G	ADKERSON, RICHARD C.	\$6,335	\$154,566
MEDCO HEALTH SOL	SNOW, JR., DAVID B.	\$50,879	\$149,646
JOHNSON CONTROLS	BARTH, JOHN M.	\$37,079	\$148,729
CERNER CORP	PATTERSON, NEAL L.	\$48,575	\$144,126
CISCO SYSTEMS	CHAMBERS, JOHN T.	\$51,684	\$143,764
COCA-COLA	ISDELL, E. NEVILLE	\$12,875	\$143,486
AETNA	WILLIAMS, RONALD A.	\$66,881	\$137,401
MONSANTO	GRANT, HUGH	\$56,339	\$136,895
SCHLUMBERGER	GOULD, ANDREW	\$39,551	\$135,144
CANADIAN NATL RAILWAY	HARRISON, E. HUNTER	\$76,596	\$134,465
ILLUMINA	FLATLEY, JAY T.	\$56,623	\$132,468
CAPITAL ONE FINANCIAL	FAIRBANK, RICHARD D.	\$0	\$130,973
BAXTER INTERNATIONAL	PARKINSON, ROBERT L.	\$41,948	\$129,506
INTUITIVE SURGICAL	SMITH, LONNIE M.	\$48,809	\$128,747
COACH	FRANKFORT, LEW	\$30,649	\$127,801
HONEYWELL INTERNATL	COTE, DAVID M.	\$13,086	\$126,363
VORNADO REALTY TRUST	ROTH, STEVEN	\$58,127	\$123,095
BLACKROCK	FINK, LAURENCE D.	\$88,478	\$122,295
SCHERING-PLOUGH	HASSAN, FRED	\$38,918	\$121,100
PROCTER & GAMBLE CO	LAFLEY, ALAN G.	\$15,270	\$118,545
STAPLES	SARGENT, RONALD L.	\$35,595	\$116,219
JOHNSON & JOHNSON	WELDON, WILLIAM C.	\$11,577	\$113,498
UNION PACIFIC	YOUNG, JAMES R.	\$31,013	\$113,329
PRAXAIR	ANGEL, STEPHEN F.	\$34,651	\$110,324
JUNIPER NETWORKS	KRIENS, SCOTT	\$54,848	\$110,142
STARBUCKS	SCHULTZ, HOWARD	\$44,728	\$108,843
HERTZ GLOBAL HLDGS	FRISSORA, MARK P.	\$4,548	\$106,882
TORONTO-DOMIN BANK	CLARK, W. EDMUND	\$46,308	\$106,484
	LOW	\$0	\$106,484
	MEDIAN	\$47,206	\$146,428
	AVERAGE	\$57,825	\$168,000
	HIGH	\$265,824	\$422,450

## THE 50 CASES WITH THE SMALLEST PROJECTED GAINS:

COMPANY	CEO	PAPER PROFIT (000)	PROJ. GAIN (000)
PG&E	DARBEE, PETER A.	\$199	\$689
ENSCO INTERNATIONAL	RABUN, DANIEL W.	\$0	\$674
TEPPCO PARTNERS	THOMPSON, JERRY E.	\$0	\$659
ALTRIA GROUP	SZYMANCZYK, MICHAEL E.	\$295	\$645
MEMC ELECT MATLS	GAREEB, NABEEL K.	\$0	\$624
HARTFORD FINANCIAL	AYER, RAMANI	\$0	\$619
ELI LILLY	LECHLEITER, JOHN C.	\$0	\$580
BOSTON SCIENTIFIC	TOBIN, JAMES R.	\$354	\$577
DISCOVER FINL SVCS	NELMS, DAVID W.	\$0	\$570
MAGNA INTERNATIONAL	WOLF, SIEGFRIED	\$334	\$564
MOHAWK INDUSTRIES	LORBERBAUM, JEFFREY	\$210	\$539
LAS VEGAS SANDS	ADELSON, SHELDON G.	\$0	\$515
STEEL DYNAMICS	BUSSE, KEITH E.	\$239	\$510
VERISIGN	BIDZOS, D. JAMES	\$108	\$458
BEMIS CO	THEISEN, HENRY J.	\$112	\$441
SMITH INTERNATIONAL	ROCK, DOUGLAS L.	\$0	\$437
SUPERVALU	NODDLE, JEFFREY	\$0	\$426
CONSTELLATION ENERGY	SHATTUCK, III, MAYO A.	\$0	\$423
AMERISOURCEBERGEN	YOST, R. DAVID	\$0	\$355
VERISIGN	ROPER, JR., WILLIAM A.	\$85	\$353
M&T BANK	WILMERS, ROBERT G.	\$0	\$279
FIRST HORIZON NATIONAL	JORDAN, D. BRYAN	\$0	\$276
NORTHEAST UTILITIES	SHIVERY, CHARLES W.	\$128	\$263
NY COMMUNITY BANCORP	FICALORA, JOSEPH R.	\$0	\$263
KIMCO REALTY	COOPER, MILTON	\$0	\$256
PERKINELMER	SUMME, GREGORY L.	\$0	\$163
ALLIANT ENERGY	HARVEY, WILLIAM D.	\$0	\$126
MICRON TECHNOLOGY	APPLETON, STEVEN R.	\$0	\$115
LAM RESEARCH	NEWBERRY, STEPHEN G.	\$67	\$94
FIRST HORIZON NATIONAL	BAKER, GERALD L.	\$0	\$21
WHITE MOUNTAINS INS	BARRETTE, RAYMOND	\$0	\$0
ALCOA	BELDA, ALAIN J. P.	\$0	\$0
TEXTRON	CAMPBELL, LEWIS B.	\$0	\$0
CARDINAL HEALTH	CLARK, R. KERRY	\$0	\$0
IAC/INTERACTIVE	DILLER, BARRY	\$0	\$0
MAXIM INTEGRATED PROD	DOLUCA, TUNC	\$0	\$0

<b>SUNOCO</b>	<b>DROSDICK, JOHN G.</b>	<b>\$0</b>	<b>\$0</b>
<b>INTERNATIONAL PAPER</b>	<b>FARACI, JOHN V.</b>	<b>\$0</b>	<b>\$0</b>
<b>GENERAL ELECTRIC</b>	<b>IMMELT, JEFFREY R.</b>	<b>\$0</b>	<b>\$0</b>
<b>CMS ENERGY</b>	<b>JOOS, DAVID W.</b>	<b>\$0</b>	<b>\$0</b>
<b>NOKIA</b>	<b>KALLASVUO, OLLI-PEKKA</b>	<b>\$0</b>	<b>\$0</b>
<b>XCEL ENERGY</b>	<b>KELLY, RICHARD C.</b>	<b>\$0</b>	<b>\$0</b>
<b>ALCOA</b>	<b>KLEINFELD, KLAUS</b>	<b>\$0</b>	<b>\$0</b>
<b>CBS</b>	<b>MOONVES, LESLIE</b>	<b>\$0</b>	<b>\$0</b>
<b>XL CAPITAL</b>	<b>O'HARA, BRIAN M.</b>	<b>\$0</b>	<b>\$0</b>
<b>CITIGROUP</b>	<b>PANDIT, VIKRAM S.</b>	<b>\$0</b>	<b>\$0</b>
<b>BCE</b>	<b>SABIA, MICHAEL J.</b>	<b>\$0</b>	<b>\$0</b>
<b>PROLOGIS</b>	<b>SCHWARTZ, JEFFREY</b>	<b>\$0</b>	<b>\$0</b>
<b>NISOURCE</b>	<b>SKAGGS, ROBERT</b>	<b>\$0</b>	<b>\$0</b>
<b>ELI LILLY</b>	<b>TAUREL, SIDNEY</b>	<b>\$0</b>	<b>\$0</b>
	<b>LOW</b>	<b>\$0</b>	<b>\$0</b>
	<b>MEDIAN</b>	<b>\$0</b>	<b>\$209</b>
	<b>AVERAGE</b>	<b>\$43</b>	<b>\$250</b>
	<b>HIGH</b>	<b>\$354</b>	<b>\$689</b>

Looking at all 671 CEOs:

- The median and average amount of in-the-money paper profits as of Aug. 10, 2009 were, respectively, \$3.4 million and \$10.7 million. Twenty percent of the CEOs had no paper profits at all.
- The median and average amount of projected gains at option expiration were, respectively, \$21 million and \$36.3 million. Here, only three percent of the CEOs finished totally out-of-the-money.

The compensation data used in this article were obtained from Equilar Inc., a leading provider of executive compensation information.

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.