

LARRY ELLISON: JUST A BOY WHO CAIN'T SAY NO

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That headline comes from the musical “Oklahoma”. The original song was: “I’m just a girl who cain’t say no.”

Lawrence Ellison, the chief executive officer of Redwood City, California-headquartered Oracle Corp., was holding, as of Feb. 15, 2008, 1.15 billion shares of his company’s stock. At the close on July 18, they were worth \$24 billion.

Other billionaire-CEOs or former CEOs are worth even more – think here about Warren Buffett and Bill Gates.

But there is a fundamental difference between these two last-mentioned gents and Mr. Ellison: They pay themselves hardly anything, while Mr. Ellison, the way I see it, likes to back an 18-wheeler into his Treasury and fill it with everything it’ll hold. All perfectly legal, of course, if, in my opinion, unseemly.

Ellison’s Share Sales and Option Exercises

First, on Sept. 25, 2007, Mr. Ellison began to sell 1,000,000 shares a day of his vast holdings. He did this according to a plan filed with the U.S. Securities and Exchange Commission under Rule 10b5-1, which permits a systematic disposition of stock without subjecting the seller to insider trading charges. The practice is perfectly legal.

Mr. Ellison kept up his 1,000,000 share a day sales for the next 99 days, until he had sold, in all, 100 million shares. His total proceeds from these share sales were \$2.1 billion. Talk about walking around money!

Second, on Dec. 4, 2007, Mr. Ellison also began to exercise stock option shares, at the rate of 1,000,000 shares a day. By Jan. 6, 2008, he had exercised 30 million option shares, garnering in the process pre-tax gains of \$447 million.

These gains come on top of \$1.2 billion of earlier option gains, realized between FY1995 and FY2007. Thus, his total gains between FY1995 and Jan. 16, 2008 were \$1.66 billion.

Quite a few people will think that \$1.66 billion of option gains is a tad too much. But there is one group of people who just love seeing Mr. Ellison make money, i.e., the California Franchise Tax Board, the group that collects the state income tax. The federal government must also love him, and for the same reason.

Oracle's Performance During Ellison's Tenure

One explanation for Mr. Ellison's \$1.66 billion of option gains is his superb long-term performance. He co-founded Oracle in 1977, but the company's stock did not start trading publicly until April 15, 1986.

On that day, the stock closed at \$0.0648 per share, after adjusting for all subsequent splits. On this July 18, it closed at \$21.09. The compounded annual appreciation was 29.7 percent a year. Had a person invested \$1,000 in Oracle on its IPO date, he would be sitting on this July 18 with stock worth \$325,000.

By comparison, the total return on the Standard & Poor's 500 Index during the same period was 10.3 percent a year. A investment of \$1,000 in that index would be worth, on this July 18, \$5,400.

For the single fiscal year ended this May 31, total return was 17.9 percent, a level that beat the S&P 500 by 24.6 percentage points.

But his fine past performance is only one reason behind Mr. Ellison's vast option gains. The other can be traced to the enormous size of many of his option grants.

Think here of a farmer. If you want to predict how many bushels the farmer will harvest, you will naturally consider the growing conditions that season, e.g., seed quality, fertilizer, rain, sun, etc. Those growing conditions are the equivalent of stock price changes.

But there's another factor that is useful in predicting how many bushels the farmer will harvest. And that is the number of acres he planted. Other things equal, the greater the acreage, the more the harvest.

Carrying that analogy over to Mr. Ellison, he has not only had excellent growing conditions. He has planted the entire state of California in stock options.

Ellison's 40-million Share Option Grant

Those 30 million option shares Mr. Ellison recently exercised have an interesting provenance. They were part of a gargantuan, split-adjusted 40-million share option grant made on June 4, 1999, with a 10-year term and a split-adjusted strike price of \$6.875 per share.

It turns out that the \$6.875 strike price was the seventh lowest closing price of Oracle stock between June 4, 1999, the grant date, and this July 18. What is more, the six lower closing prices were not that much lower. They ranged from \$6.28 to \$6.78. And all six of them were close in time to the actual June 4, 1999 grant date, ranging from June 8, 1999 to June 15, 1999.

That strike price of \$6.875 was not the actual closing price on the June 4 grant date. Oracle used as its strike price the closing price on June 3, the day before the grant date. That practice is not uncommon.

It turned out, though, to help Mr. Ellison, because the actual close price on June 4 of \$7.17 was 4.3 percent higher than his strike price. Now, a 4.3 percent difference doesn't sound like much, but a stock growing 4.3 percent in every trading day will, after one year and through the magic of compound interest, be selling for 41,000 times its starting price.

It is also interesting to note that on June 16, 1999, just 12 days after the grant was made, Oracle's stock rose 31.1 percent in a single day, to \$8.23 a share. In that short period between June 3, 1999 and June 16, 1999, the stock was now trading 20 percent higher than Mr. Ellison's strike price. So in that twelve-day period, Mr. Ellison achieved a paper profit of \$54 million, none of it exercisable at the time, though.

A person with a paranoid bent might suspect that option backdating was involved. But Oracle strenuously denies that this was the case. And if the transaction was investigated by the U.S. Securities and Exchange Commission, no charges were ever brought that I know of.

It is, of course, possible to be exceedingly lucky. There's no law against that.

In fairness, it needs to be noted that in giving him a gargantuan option grant in FY2000, his board compensation committee decreed that Mr. Ellison would not receive a further grant until at least FY2004. The promise was kept.

To that, some would say: "Big deal". But you'd be surprised at the number of companies that make promises like that and go on to make new grants earlier than they had said they would.

As to the timing of his exercises, Mr. Ellison could have reaped total gains from all 40 million shares of \$1.6 billion, had he exercised on Sept. 1, 2000, just before his stock, along with other tech stocks, crashed. But he couldn't exercise at that time, or at least not more than 25 percent of his shares. Vesting restrictions were in effect back then.

In its proxy filed in August 2006, Oracle said that from then on, it would grant Mr. Ellison options only during the 10 business-day period following release of the company's fourth quarter earnings. It has followed this policy since.

Competitiveness of Ellison's Pay in FY2007

For the fiscal year ended May 31, 2007, Mr. Ellison, by my methodology (which includes the Black-Scholes value at grant of stock options), received a pay package worth \$52 million, including:

- A salary of \$1 million.
- A bonus of \$8.4 million.
- A stock option grant covering 7 million shares and carrying a strike price of \$14.57 per share.
- And miscellaneous compensation of a further \$1.7 million.

I calculated the Black-Scholes value at grant to be \$41 million, a figure that was \$9 million less than what the company said the option was worth in its proxy statement.

Oracle is the rare company that uses the Black-Scholes model without altering anything. According to the company's 10-K filed in 2007, the weighted average valuation assumptions used were:

- An expected future volatility of 26 percent. (I also used 26 percent).
- An expected dividend yield of 0 percent. (I also used 0 percent).
- A risk-free rate of 5.0 percent. (I used 5.32 percent).

So why the difference, then? Although Oracle said in its 10-K that its weighted average term assumption was 4.9 years for all options granted in FY2007, I figure that for Mr. Ellison the company used the full 10-year term. That is the only way I could replicate the Black-Scholes value of \$50 million that the company used.

(Note: Under regulations promulgated by the Financial Accounting Standards Board, the rulemaking body for American accounting, a company is not required to use the full term of the option in valuing it. It can rely on the actual past exercise behavior of its employees. It is the rare person who waits until the last day of a 10-year term to exercise, even though the statistical models suggest he should if he wants to maximize his gain. In the real world, as opposed to the world of fancy mathematical models, once a stock price takes off, there is a tendency to "take the money and run".)

For my part, I started by using a full 10-year term assumption, too. But then I discounted my value by 20 percent. Based on a study of hundreds of option grants in 2007, I determined that a discount of 20 percent was needed to equalize my Black-Scholes values (using the full term of exercise) with the average Black-Scholes value reported in the various companies' proxy statements.

I congratulate Oracle in not pulling any punches in the \$50 million figure produced in its proxy statement. But the way I see it, they went too far.

Looking at the pay of 505 CEOs in 2007, all running companies with market caps of \$3 billion or more, Mr. Ellison's \$52 million pay package positioned him 184 percent above a competitive

level, after controlling for differences in company size and pay risk. That would make him the 16th most relatively-overpaid CEO among the 505 executives in my study.

Ellison's Option Grants in July 2007 and July 2008

We don't yet know what Mr. Ellison's total pay will be for the fiscal year ended May 31, 2008, because Oracle's proxy statement has not yet been released. (Its most recent two proxy statements were filed with the SEC on Aug. 23, 2006 and Sept. 14, 2007.) But on July 5, 2007, he was granted an option on 7 million shares, the Black-Scholes value of which I estimated to be \$59 million.

We also know at least one further bit of information. On this July 3, Mr. Ellison received another option covering another 7 million shares. This one carried a strike price of \$20.73 a share. It had a present value at grant that I estimated to be \$64 million.

Interestingly, his 7 million share option made one year earlier – on July 5, 2007 – carried a strike price of \$20.49 a share.

So in the intervening year, the price of Oracle stock was fundamentally flat.

Why then, one might ask, reward Mr. Ellison with yet another 7 million share option grant? The one made in 2007 certainly didn't seem to motivate him.

And does he really need any further motivation anyway considering the 1.5 billion shares he currently owns?

To me, it is inappropriate for a person of Mr. Ellison's net worth to be scrambling for ever more pay. I like the way Warren Buffett and Bill Gates do it much better.