"Treading Water" – The Responsible Use of Stock Option Exchange Programs

HUGESSEN CONSULTING

By: John Skinner and Michael Small *May 2020*

The start of 2020 has been a turbulent time for many corporations, as macroeconomic forces related to the COVID-19 pandemic have sent the share prices tumbling. Companies that have historically relied on equity compensation, namely stock options, now face challenges with such instruments, especially those granted at the height of the 2018-2019 bull market that have since experienced significant value depreciation. This is particularly felt by many firms in the energy industry, where stock options have been heavily utilized in compensation programs and share prices have dramatically (arguably structurally) declined due to external market factors.

In our experience, such circumstances can place significant pressure on talent retention and motivation efforts at cash-strapped issuers. That said, boards need to carefully consider the appropriateness of any actions to recalibrate pay outcomes to improve management positions. Acting in the interests of all stakeholders to ensure pay-for-performance alignment requires a diligent assessment of the alternatives available, including those which boards may have historically shied away from. This article provides a general background on one such approach – a stock option exchange program – and provides guidance to assist boards in assessing the circumstances where use may be warranted.

What is a stock option exchange? How does it differ from option repricing?

This briefing focuses on "value-for-value" stock option exchanges, which involve an exchange of the current economic value of outstanding, significantly out-of-the-money options with a grant of typically far fewer at-the-money new options that have an equivalent economic value. Specifically, a value-for-value exchange consists of:

1. Revaluing the underwater options using current market inputs
2. Cancelling the outstanding options, and
3. Granting fewer new options (or other equity instruments) with the same economic value (or grant-date fair value as determined using an accepted option valuation method – e.g. Black-Scholes) equal to the current market value of the underwater options

It is important to distinguish a value-for-value option exchange, which **does not** convey any incremental value to participants, from simple one-for-one option repricing, which **does** transfer value from the shareholders to the participants (and is widely disliked by the shareholder community). For instance, in a value-for-value exchange, an option holder experiences a reduction in **both** the strike price and the number of options held (i.e. maintains equivalent economic value before and after the exchange), while in a repricing, the option holder experiences **only** a reduction in the strike price (i.e. gains economic value). The intent of a value-for-value exchange is not to make the participant any better or worse off economically, but to replace a potentially disincentivizing, high-risk instrument with one that provides better "line-of-sight" and motivation to the participants. **See page 5 for a detailed example.**

Why and when to conduct a value-for-value option exchange?

Value-for-value stock option exchanges are typically conducted to support continued employee motivation and engagement when there are significant long-term structural changes in a business (and its operating environment) that have negatively impacted the share price. At the same time, they can act to preserve equity reserve levels for future use through the cancelling of a greater number of options than those regranted. In any case, when options are significantly out-of-the-money, boards may be concerned about retaining key talent and feel inclined to use a value-for-value exchange to get better retentive "value" for no change in economic value.

The last significant and systematic downturn happened during the financial meltdown in 2008 / 2009. Canadian companies were able to largely "stick to the program" and not make any changes to outstanding awards while continuing to grant competitive awards. In fact, for publicly traded Canadian companies, option repricing and exchanges were extremely rare. In contrast, prevalence among American companies was somewhat greater (albeit still uncommon), with some large issuers like Intel and Starbucks conducting value-for-value exchanges for non-executives and directors. The infrequency of such exchanges is in part because issuers had responsible and sustainable annual granting practices, and in part because the market and economic fallout was not systematic and long-term. Today, in certain industries, most notably oil & gas, there has been a structural downturn that is long-term from both a backward and forward-looking point of view. While this has led to outstanding option positions that are significantly underwater, more importantly, build up in the equity overhang has resulted in significant challenges with designing sustainable long-term incentive programs going forward.

Factors Supporting a Stock Option Exchange:

- There has been a dramatic (arguably structural) share price decline due to external factors beyond the company's control (versus management missteps), which the board believes creates tangible retention risks among key talent
- The business has undergone a fundamental change whereby the underlying value of the firm's assets are significantly and permanently impaired
- The industry has been in a long-term decline resulting in several years of significantly underwater options
- Management and the Board can demonstrate that the company would be on the verge of a precipitous decline in value in the event of employee departures, and that those departures are highly likely in the short-term
- The option overhang is at a level that precludes any further granting of options (i.e. it is difficult to administer a sustainable go-forward long-term incentive program)

Factors Opposing a Stock Option Exchange:

- There is a reasonable expectation of the share price returning to "normal" levels in the short to medium-term (i.e. a market event is expected to pass, the economy is at a natural trough in the business cycle – hopefully true for most companies once COVID-19 is in retreat)
- A strong culture or career opportunity, such that executives perceive strong value in remaining with the company, notwithstanding the recent decline (e.g. company is regarded as a "high-performer")
- The decline in the company's compensation value has been accompanied by a significant reduction in the demand for executive talent among industry peers
- The compensation design includes:
    - Multiple long-term incentives including time-vested, whole value equity, such as restricted and deferred share units
    - Other forms of long-term wealth accumulation or retirement savings vehicles, such as a defined benefit pension plan
- The issuer wants to avoid "serial" option exchange programs to correct for poor historical equity allocation
- The issuer's relative total return has underperformed its peers

What are the benefits and risks of a value-for-value option exchange?

Before conducting a value-for-value option exchange, we encourage boards to take a holistic view of the merits and potential pitfalls outlined below.

Benefits

- Provides perceived value to participants who believe current options will never be in-the-money, and addresses the potential negative psychological effects of holding substantially underwater options
- Re-establishes the retentive element of the instrument

- Reduces "unproductive" dilution and pressures on equity reserves, as outstanding options are cancelled (and returned to the pool) and fewer new options are granted
- Reduces equity overhang for shareholders, increasing fully diluted earnings (all else equal)
- Lowers the ongoing stock option compensation expense (as the value of replacement grants will be less than the initial grants that have fallen underwater and continue to be expensed)

Risks

- Potential for poor optics due to:
  - Perceived similarity to stock option repricing
  - Expected dilution from the new issuance (i.e. previously out-of-the money options are more likely to be exercised in the future
  - Potential for "windfall" gains if there is a significant gain in share price
  - Top executive and / or director participation
- May signal a lack of faith in the company's future value
- Sets precedent for "backtracking" from compensation decisions which may diminish the integrity of the incentive compensation programs going forward
- May require shareholder approval based on listing requirements and timing (i.e. if a new grant is made within a certain period following the cancellation)

Practical considerations for value-for-value option exchanges

When contemplating the appropriateness of a value-for-value option exchange, we outline practical considerations for boards below:

Option Exchange Design

- The board will need to establish parameters around which options grants will be considered for the exchange (i.e. what exercise prices or grant dates)
- To prevent any "us versus them" divides within the organization, boards should allow all employees with applicable options to participate (or all non-executive employees – e.g. consider excluding Named Executive Officers)
- Consider how badly impaired LTIP carrying values are and how this could impact the overall compensation picture
- The board will need to determine whether the replacement grant should be in the form of options or another equity vehicle (e.g. RSUs). As a general rule, replacement grants should closely reflect the original terms and conditions of the cancelled options (i.e. term, vesting conditions, etc.)

Market Response and Disclosure

- The board may want to test the idea, perhaps initially on a no name basis, with shareholders and proxy advisors
- The board should provide detailed disclosure within the proxy circular about the rationale, decision-making process, quantitative impact, and valuation calculations related to the program
- Proxy advisors will opine on a case-by-case basis and assess the appropriateness of the exchange based on a variety of factors, including the elapsed time the options have been outstanding and the share price at cancellation relative to the original strike price

Regulatory and Tax

- Option exchanges may be subject to certain regulatory requirements depending on the listing location of the corporation, and boards should seek independent legal advice before conducting an exchange
  - For Toronto Stock Exchange (TSX) listed issuers, shareholder approval is required if the regrant occurs within three months of the related cancellation

- Depending on the jurisdiction, option exchanges may have tax implications to both the organization and the individual, which should be reviewed by professionals
    - Maintaining the options' preferential capital gains-like tax treatment for participants will be an important design objective
- Generally, corporations cannot outright cancel outstanding options and require the agreement from participants to forfeit their options in exchange for new ones; as a result, full cancellation of all eligible options is not guaranteed
    - Review and understanding of the underlying stock option plan and amendment provisions is a critical initial step

Conclusion

While the long-term impact of current macroeconomic forces remains uncertain, the downward trend of equities is presenting pressing challenges for boards. In certain sectors that showed cracks before the recent broad market pullback (e.g. oil & gas), boards are keen to reduce or eliminate unproductive equity dilution and are actively endeavouring to retain and motivate key talent. While a value-for-value option exchanges may be an attractive response, careful consideration of the various legal, tax, and accounting implications, along with strong governance and communication, is needed to safeguard continued program integrity and external reception.

As current macroeconomic forces continue to evolve, we are working with our clients to address the complexities and issues arising in this turbulent time. We invite you to reach out to a Hugessen consultant for further information, or for support with addressing the unique circumstances of your organization.

John Skinner
Manager
(416) 868-4420
jskinner@hugessen.com

Michael Small
Analyst
(416) 868-4417
msmall@hugessen.com

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Appendix: Mechanics of a Value-for-Value Stock Option Exchange

For example, ABC Corp. granted 500,000 stock options in January 2018 (t = 0) at a share price of $5.00, implying in a grant date fair value of $1MM (based on 40% Black-Scholes value). ABC Corp. experiences a significant share price decline to $1.00 (t = 0 + x), and based on current market inputs, the value of the outstanding options depreciate to $25,000 (5% Black-Scholes value). At the current share price and market inputs, the prevailing Black-Scholes value for an equivalent at-the-money option remains at 40%. Therefore, a value-for-value exchange would consist of cancelling the 500,000 out-of-the money options (currently worth $25,000) and granting the equivalent value in new at-the-money options (or other equity, such as RSUs) based on current market information. In this example, this would result in the grant of 62,500 new options, or an 8 to 1 exchange ratio. The net result of this value-for-value exchange is the option holder retaining the same economic value in options, however, the strike price is now $1.00 instead of the $5.00 in the original grant. This contrasts with an option repricing, where the outstanding options (500,000) are not cancelled and simply have the strike price reduced to $1.

ABC Corp. Value-for-Value Exchange Example

1. Initial grant of options ***(t = 0, share price = $5.00)***

Grant Date Fair Value (GDFV) = $1,000,000
Black-Scholes Value = 40% ($2.00)
Number of Options Granted = 1,000,000/($5 x 40%) = 500,000

2. Revalue options at new share price ***(t = 0 + x, share price = $1.00)***

Revised Black-Scholes Value = 5% ($0.05)
Revised Market Value of Options = (500,000) x ($0.05)
= $25,000

3. Replace Outstanding Options with New Equity ***(t = 0 + x, share price = $1.00)***

Replace with Stock Options
Black-Scholes Value of Current Shares = 40% ($0.40)
Number of Options = $25,000 / ($0.40) = 62,500

Replace with RSUs
Number of RSUs = $25,000 / $1.00 = 25,000