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Guest Editorial:

Emerging Option to Stock Options

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When the stock market is down and the value of stock options is "under water," how should compensation professionals respond? An oft-cited remedy, repricing, will not solve the problem, which is caused by the difference between company value and stock price.

To identify an effective solution we must understand the premise on which the use of options was developed: to create a mutually beneficial relationship between the company and the employee that will attract, retain, and motivate key talent. *Specifically:*

• **Options could attract key talent by offering them a means to build wealth as the value of the company increases.** As we have seen, the link between company value (the ability to produce a profit) and stock price is tenuous at best.

• **Options could help companies retain key talent since the participants' potential wealth is deferred.** However, the inability to control the price of the stock brings with it the uncertainty of the wealth actually being there when it is needed. A case in point is Cisco Corp. The current market hysteria notwithstanding, in November 2000, *The Wall Street Journal* reported Cisco's first quarter earnings to be higher than forecasted, with revenue growth of 66%. The reward for such performance was a *decline* in stock price (and a reduction in value of stock options).

• **Options could motivate the leadership to improve the value of the company.** Unfortunately, with a thin link between company value and stock price, this may be an inducement in the wrong direction. *The Economist* reported as early as Jan. 22, 2000 that during the previous two years, non-financial corporations increased their debt by $900 billion, while they retired a debt of $460 billion of equity. "The main reason for these buy-backs is to pay employees in share options without depressing share price. In effect, firms are borrowing staggering sums to finance their pay bill and prop up share prices." During an economic downturn, this debt could jeopardize the existence of many companies. Hardly the outcome one wishes to see from a firm's leadership team.

Why do options persist? With such drawbacks to the design, why would compensation professionals use such a plan? One major reason is that it is perceived as being "free," with little or no impact on the company's financial statements. Well, we are beginning to see that we get what we pay for.

Although companies needn't report stock options as an overhead cost, there is a price. In its Dec. 7, 1999 issue, *Business Week* reported that Bear Sterns & Co. analyzed the cost of stock options. It found that when employees exercise their options, companies must either buy shares in the market or issue new stock, diluting the value of existing shares. "In 1998, earnings at S&P 500 companies would have been *4% lower* if they had included stock options as a labor cost. In 1997, they would have been *3% lower* than reported. The bigger the grant, the bigger the impact on earnings. Semiconductor equipment makers earnings would have been *18% lower*."

Time for new designs. Change forces innova-

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tion, and the recent change in the stock market has created an excellent opportunity for compensation professionals to develop innovative deferred compensation designs that link pay to the real value of the organization—the ability to create profit today and to achieve long-term profitable growth. Without eliminating stock options, these plans could be used to balance executives' pay packages, providing stability to their portfolio of wealth-building mechanisms.

Such plans are appearing in the private sector, where closely held companies do not have the "option" of offering stock and where the objective is to generate profit rather than increase stock price. These are deferred-*incentive* plans. The wealth must be created to be earned.

Internal focus and more. The real value of any company is its ability to generate profit, and the job of senior management is to increase this value. These new plans have an internal focus on the income statement and reward good performance no matter how the stock market performs. These plans are so effective because they create a dynamic tension between achieving short-term results and long-term outcomes. Executives must achieve both to maximize their rewards.

By rewarding short-term (annual) results, the leadership team is required to get the best return from the resources available to them. The rewards are deferred (reducing demand on cash flow) and appreciate over time based on the profitable growth of the company. The degree of appreciation is a function of management's ability to successfully anticipate and plan for future business opportunities and needs.

These plans are effective at attracting, retaining, and motivating key employees because they incorporate behavioral psychology in their design. Behavioral scientists have long known that the most powerful incentive is one that is Positive, Immediate, and Certain (the PIC model.) *Such plans attract the best talent because:*

- The wealth-building opportunity is virtually unlimited (Positive);

- The short-term (annual) rewards provide timely performance feedback that encourages either celebration or corrective action (Immediate); and

- They retain effective talent because performance is guaranteed to build personal wealth (Certain).

If their performance is lacking, participants will "deselect" themselves and go looking for greener (easier) pastures—exactly the results we want in a good retention mechanism. These plans motivate the participants because they are focused on controllable business outcomes linked to personal wealth-building.

An example. One such design, LeaderShare™, is gaining momentum in the Midwest in industries ranging from manufacturing to dot.coms, from telecommunications to retail. The appreciation element uses a simple valuation process based on profitable growth—i.e., the improvement in a company's ability to create profit. Profitable growth determines the appreciation of the annual rewards and thus the wealth that accrues for the executives. For example, a leadership team that over 10 years takes a company with revenue of $5 million and margins of 5% to $15 million and 7% has substantially increased the value of the company—and will be rewarded proportionately.

While it is still early, the outlook for this design appears strong. Owners (and stockholders and boards of directors) like it because there is no free ride. It requires the participants to understand the business, utilize the organization's resources, think strategically, and act tactically. Exceptional performance delivers exceptional wealth to the participants. Average performance may result in minimal wealth accumulation, if any.

Conclusion. While currently finding wide acceptance in privately held companies, it is only a matter of time before public corporations add this design to balance their executive compensation package. Either that or lose their top talent to the private sector.

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