THE "TRUMP TRADE": WILL STOCK OPTIONS MAKE A COMEBACK?

Corporate Board Member *spoke to Bob Romanchek, partner and consultant with Meridian Compensation Partners, about the expected use of stock options going forward.*

At one time, the use of stock options for executive pay purposes was a strong majority practice. What changed and why?

If you go back in history to the late 1980s and 1990s, for a considerable period of time stock options were all the rage. Many companies used stock options—both incentive stock options (ISOs) and nonqualified stock options (NQSOs)—for 70% or more of the value of long-term incentive grants. At that time, there was no accounting expense associated with the grant, so many viewed these as "free," from a financial accounting standpoint. Further, like today, the exercise of an NQSO generated a corporate income tax deduction, and the company could actually receive a cash inflow, if the exercise price was paid by the exercising executive in cash. Stock options became so popular that dilution levels were pushed way up over the years, to unsustainable levels. It was not unusual for companies to have dilution levels from stock options approaching 20%.

During that historical period, with the stock market marching upward and taking all shares up, some executives made out very well with options, regardless of actual underlying company performance. Due in part to the considerable value being delivered through stock options, accountants, after more than 20 years of deliberation, finally decided that the grant of a stock option should be expensed against the profits of the company (starting in 2004) and required a compensation expense. This accounting charge, along with shareholder pressure to reduce excessive and unsupportable dilution levels, resulted in a decline in the use of stock options, which corresponded with a decline in the stock market. Since the 1940s, the prevalence and use of stock options is strongly correlated to the direction of the stock market—in periods of high growth, stock option use increases, and in times of stagnation or decline, stock option use decreases. As a side note, the hefty stock option gains also prompted the enactment of the million-dollar tax deduction limits under tax code Section 162(m). Ironically, stock options by design are typically exempt from these limits as being "performance based."

One additional point—many proxy advisory firms do not consider stock options to be performance based. I believe this difficult-to-understand stance is based upon earning the stock option right based solely on continued employment (with no performance requirement) regardless of the ultimate "spread" value. This advisory firm policy has also added more recently to the decline in stock option use.

What catalysts exist today, including the results of the presidential election, that could trigger a reemergence of the use of stock options?

There are multiple catalysts now in place that could prompt an increase in the use of stock options. The single strongest factor is the recently created expectation of economic growth. The articulated policies of President Trump have caused the stock market to jump in anticipation of a much stronger rate of US economic growth than we have seen for years. Recall that from the historic barometer, economic growth means some compensation committees may return to the use of stock options to incent further share price growth and to capture this upside (which is leveraged around 3 or 4 to 1, since economically, it typically requires the grant of three or four stock options to equate to the grant value of one restricted share or performance share—so potential upside is significantly higher with the use of stock options).

Additional catalysts include the much lower dilution rates that now exist across US public companies (making room for option grants). Also, the initial shock of requiring an accounting expense for stock options has long since worn off. The accounting cost is now mostly neutralized, since all types of long-term incentive vehicles require an expense charge of about the same magnitude (note, although the Black-Scholes expense for a stock option, in simple terms, may be approximately one-third of the grant price, since it often takes three times as many NQSOs to equal the grant value of restricted shares, the expense comes out about the same).

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Finally, there is still the benefit of a corporate income tax expense and possible cash inflow for the company at exercise. And stock options have always been a great income tax deferral mechanism for executives, although tax deferrals may not be quite as valuable in the future, with the likelihood of lower marginal income tax rates.

Why would a compensation committee go back to using stock options now? What benefit would there be in doing so?

Stock option use is at the absolute lowest level in decades. Even so, most top executives still receive around 25% of their annual long-term incentive grant value in the form of NQSOs—so, there must be some reason options have survived. This prevalence has bottomed out and will likely not decrease further. Couple this with the massive increase over the last five years in performance share programs, which pay out based upon financial metrics or relative total shareholder return (TSR) over a three-year period. Many companies are just now experiencing the end of the first or second three-year performance period of TSR programs and are realizing that determining the largest portion of executive pay based upon a comparison to the TSR of a peer group of uncontrollable and unrelated companies may not be the best approach.

A stock option avoids the need to establish a long-term performance goal (similar to a relative TSR plan, but does not overlay a comparison to stock price performance of other companies). Further, as previously mentioned, a typical NQSO is leveraged three to four times to the upside, which will grab the "incentive" attention of top executives to drive share price. A typical NQSO is simple and understandable in design and has a 10-year life (presuming the executive remains employed), with the exercise timing decision after vesting left solely up to the executive.

Also, consider that for years, most private equity firms have continued to use stock options as the sole (or, by far, largest) vehicle for companies they invest in and take private—since the only way anyone makes money is if the stock value goes up! Some add performance goals (often based upon profit or cash flow) to a portion of the NQSOs. Clearly, understanding the long-standing executive pay practices of PE firms in their investment companies is another valid way to understand what works from a senior executive long-term incentive pay perspective.

Therefore, with all the transition in the current environment, consider the "Trump Trade" as a catalyst for many companies to reconsider the use of stock options in the near future.

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