Stock Option Values:
A New Rule of Thumb for Large Caps

- by Michael Powers and Mike Meyer

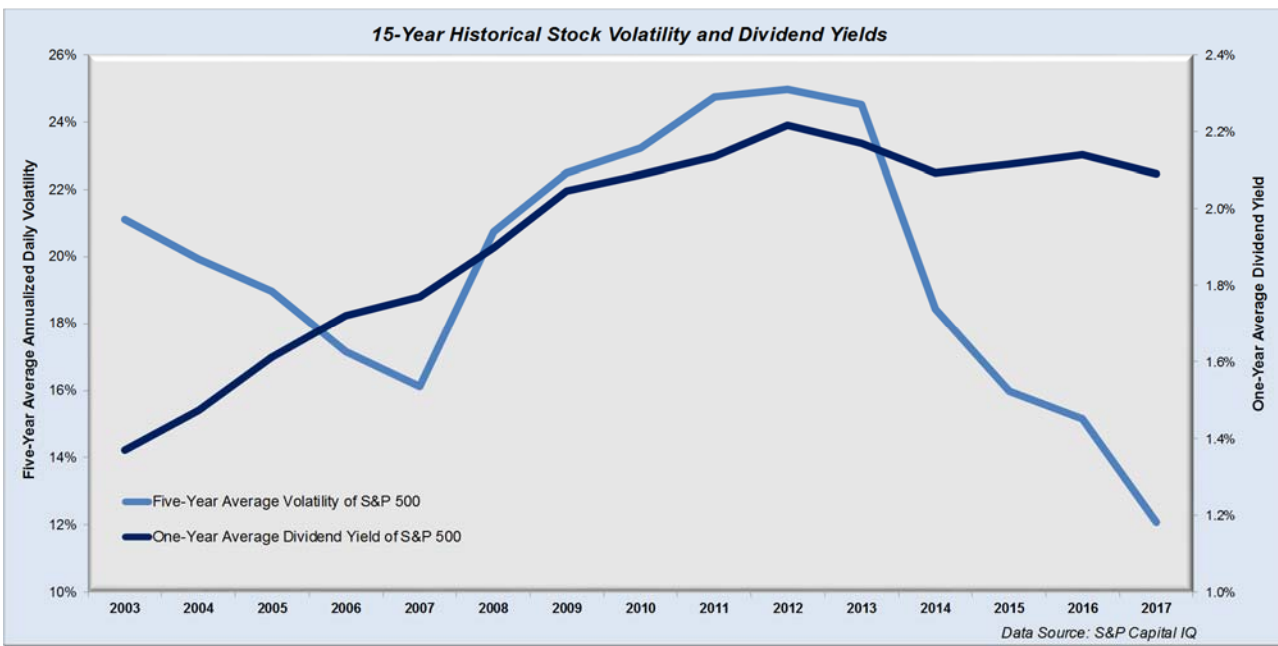
While the use of stock options as a primary vehicle for executive equity awards has tapered recently, the common belief that stock options are worth about one-third of face value has remained. Although this rule of thumb held true for many years, for reasons described below, that may no longer be the case, especially for large caps.

Currently, the CBOE Volatility Index (VIX) is at near record lows, risk-free interest rates have remained well below historic averages and dividend yields have steadily increased, all of which in turn drive Black-Scholes values downward. This decline in option values also seems counter-intuitive in a strong bull market.

Lower valuations require substantially more options in order to deliver the same grant-date value. This may cause affordability concerns relative to dilution and the impact on share pool burn rate. More options also provide the executive with greater leverage if the stock price goes up. Companies should consider these factors carefully when deciding how best to utilize stock options as an executive compensation vehicle.

Historical Movement of Key Black-Scholes Value Drivers Across Industries

The charts below illustrate 15-year historical trends in volatility and dividend yield for the S&P 500. Volatility is measured over five years to align with accounting conventions. Volatility and risk-free rates trending downward and dividend yields trending upward all work to drive Black-Scholes values lower.



Impact on Valuations of Stock Options

Meridian conducted a study capturing accounting values of CEO option grants disclosed in the recent proxy statements of Fortune 100 ("F100") companies. As illustrated below, just over the past three years, we have seen significant a downward trend in option values.

Measurement	2017	2016	2015
Number of F100 CEO Stock Option Grants	65	60	60
Average Accounting Value (as a % of Face Value)	19.1%	21.8%	23.6%
Prevalence of Accounting Values Less Than:			
▪ 20% of Face Value	59%	40%	33%
▪ 15% of Face Value	26%	22%	15%
▪ 10% of Face Value	12%	2%	3%

Compensation Philosophy Considerations

Boards may want to consider implementing a "floor" on the Black-Scholes value used to size stock option grants. This would still allow executives to enjoy some benefit of a levered position without creating significant dilution concerns.

Large cap companies should also review their implied volatility (generally two to three years in most cases). If the implied volatility is significantly different than the historical volatility and is more indicative of future stock price movement, the company may want to assign a somewhat higher weighting to implied volatility when determining the expected volatility assumption.

Concluding Thought

For many years, the idea that options were worth one-third of a full-value share of stock held true, but in a world of historic low stock price volatilities and risk-free rates along with increasing dividend yields, it may be time to develop a new rule of thumb.

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