

The New Share Plan Metrics

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About the Speaker

Fred Whittlesey is Senior Vice President of Aon Consulting/Radford Surveys. Residing in the Seattle area and based in Radford's San Jose office, Fred provides services to clients across the US and globally. He is an internationally recognized expert in allocating organizational financial capital to their human capital. He consults in executive, sales, and incentive compensation as well as performance management, with particular expertise in equity-based compensation plans. He has worked with publicly-traded and privately-held companies as well as not-for-profit organizations, and has provided expert technical assistance to support complex litigation related to compensation.

Fred has 20 years of experience as a management consultant with firms including Towers Perrin and Mercer. He founded Compensation and Performance Management, Inc. and prior to this was the director of the Western Region Compensation Consulting practice at HRCO. His career also includes the role of Director, Global Compensation for Amazon.com and Director, Compensation/HR Technology for Broadcom Corporation where he pioneered the option exchange/rollover offer program. Fred also performed consulting and research work with the UCLA Institute of Industrial Relations, assessing human resource value and replacement costs in organizations using human resource accounting methods. Fred began his career as a Personnel Research Psychologist with the Navy Personnel Research and Development Center in San Diego where he conducted selection, classification, and attrition studies and developed computer-based research methods.

Fred is co-founder of Global Equity Organization (GEO) as served as a member of GEO's Board of Directors and as Chief Financial officer. He has been a member of the Advisory Board of the National Association of Stock Plan Professionals (NASPP) and currently is a member of their Executive Compensation Task Force. He has authored many articles in leading industry and business publications, and has presented his ideas at compensation conferences around the world. Fred is a course developer and instructor for WorldatWork's certification courses "Accounting and Finance for HR Professionals" and "Executive Compensation" including both classroom and virtual course delivery. He has taught courses in financial aspects of human resources for UCLA Anderson Graduate School of Management and UCLA Extension. Fred is the Immediate Past Chair of Santa Clara University's Certified Equity Professional (CEP) Institute Advisory Board and previously served as the strategic compensation advisor to PayScale.com, an online compensation data service.

Fred received his MBA with honors from UCLA concentrating in human resource management and marketing. He graduated Phi Beta Kappa and Magna Cum Laude from San Diego State University with a BA in industrial/organizational psychology. He also received the Certified Equity Professional (CEP) designation from Santa Clara University and the Certified Compensation Professional (CCP) designation from WorldatWork (formerly the American Compensation Association).



Today's Presentation

"Until recently, the ubiquitous use of stock options made competitive comparisons and evaluations of alternative forms of awards a relatively easy process. Given the rapid and significant changes in plan design – triggered by changes in accounting rules, the corporate governance climate, and emerging "standards" from a variety of constituencies – **the old metrics don't work any more.** Overhang, run rate, Black-Scholes values and other metrics give an inaccurate view of award values, leading to misguided decisions. As companies reconsider the use of stock options and assess alternative forms of share-based awards – SARs, restricted stock and RSUs, and performance shares – and changes in the mix between equity and cash, **the decision process requires a series of assumptions about the "value" and "cost" of each type of award.** This session reveals the emerging metrics and techniques used by leading companies in understanding the value and cost of share-based awards in this new environment."



Today's Presentation




- > The Good Ol' Days (ahhhh....)
- > Complications (ruh roh....)
- > The Metrics-Setters (who are these guys?)
- > What do we (really) want to know?
- > Emerging Metrics (whoo, complicated)
 - >Cost
 - >Pay
 - >Standards
- > Where we'll be in 18 months (ahhhh....)





The Good Ol' Days




- > **Stock Options – grant level**
 - Number of shares
 - Grant value
 - Grant value multiples
 - Black-Scholes (4 key assumptions)
 - NPV of gain (2 assumptions)
 - Percent of outstanding
- > **Stock Options – aggregate**
 - Overhang
 - Net run rate
 - Voting dilution
 - Value transfer

The Good Ol' Days

- > **Stock Options – grant level**

| | | |
|-----------------------------|--------------------|-------|
| a Base salary | \$250,000 | |
| b Number of options | 25,000 | |
| c FMV at grant | \$50.00 | |
| d Grant price | \$50.00 | |
| | | |
| e Grant Value | \$1,250,000 | b * d |
| f Grant Value Multiple | 5.0 | e / a |
| | | |
| g Black-Scholes % | 45% | |
| h Black-Scholes value | \$562,500 | g * e |
| | | |
| j NPV % | 50% | |
| k NPV | \$625,000 | j * e |
| | | |
| l Common shares outstanding | 1,000,000,000 | |
| m Percent of CSO | 0.0025% | b / l |








The Good Ol' Days

> **Stock Options – aggregate level**

| | | | |
|---|-----------------------------------|---------------|--|
| m | Common shares outstanding | 1,000,000,000 | |
| n | Shares available for future grant | 40,000,000 | |
| p | Total shares issued from plan(s) | 120,000,000 | |
| q | Shares issued in 2004 (gross) | 45,000,000 | |
| r | Cancellations in 2004 | 10,000,000 | |




| | | | |
|----------------------------------|-----------------|-------|-----------------|
| s | Issued overhang | 12.0% | p / m |
| t | Total overhang | 16.0% | $(n+p)/m$ |
| u | Net run rate | 3.5% | $(q-r)/m$ |
| grants excluded from denominator | | | |
| v | Issued overhang | 10.7% | $p / (m+p)$ |
| w | Total overhang | 13.8% | $(n+p)/(m+n+p)$ |
| x | Net run rate | 3.4% | $(q-r)/(m+q-r)$ |
| grants included in denominator | | | |

The Good Ol' Days

> **Stock Options – aggregate level**

| | | | |
|----|------------------------------------|-----------------|----------------|
| y | share value transfer (all options) | \$1,012,500,000 | $q * c * g$ |
| z | SVT vs. market cap | 2.03% | $y / (l * c)$ |
| aa | share value transfer (all shares) | \$2,250,000,000 | $q * c$ |
| bb | SVT vs. market cap | 4.50% | $aa / (l * c)$ |




Complications

> FAS123

- Little attention to assumptions
- Apples-to-apples comparisons
- Bad apples – institutionalized as the method


> IFRS2 and FAS123R

- Heightened attention to valuation
- Pressure for "more accurate" (ahem, lower) valuation
- Inability of valuation models to measure non-options properly
- Emergence of incorrect conversion ratios – "1 RSU for 3 options"
 - ✓ But limited practice makes for a limited problem

Complications

- Change in usage metrics
 - Run Rate
 - ✓ Full value grants distort the "cost" measurement
 - ✓ Net run rate doesn't capture use of "recycled shares"
 - Overhang
 - ✓ Technology sector renders 10%/15% norms moot
 - ✓ Number of shares not as important as how they are granted
 - ✓ Large number of underwater options – and constraints on addressing the problem – inflate overhang numbers
 - Plan cost (value transfer)
 - ✓ Plan documents add limits on full-value awards to reduce "cost"

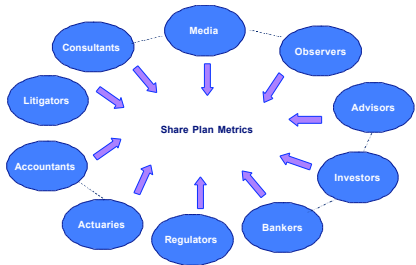



Complications

- Investor and advisor models begin changing the "rules"
 - Inconsistent logic: RS good, DNSO bad
 - Continued focus on individual elements, no TDC focus
- Disclosure
 - US: Many inconsistencies and gaps in reporting requirements
 - Europe: Catching up to US – concepts more than details
- Governance expectations
 - Ownership guidelines change risk profile and arguably reduce risk-adjusted pay level



The Metrics-Setters







What We Really Want to Know

- > How much is this costing the shareholders?

- > How much are we paying these people?

- > How do we know we're doing the right thing?

The Categories of Metrics

Cost



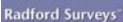
- > Valuation – what it it worth today?
- > Efficiency – what do we get for the accounting expense?
- > Adherence – how much value can we give?

Pay

- > Goals – when will it be worth something?
- > Conversion – how to get from A to B?
- > Projections – what will it be worth then?

Standards




- > Compliance – did we measure and report it properly?
- > Concession – did we address our major stakeholders' criteria?
- > Balance – did we make the right trade-offs of priorities?

Emerging Metrics: Cost

- > Gross Run Rate (3-year average vs. peers) – ISS and RREV
 - Multi-year analysis (3-year average)
 - Mean plus one standard deviation (84th percentile)
 - Relative to GICS peers
 - Adjusted for full value grants

| Characteristics | Annual Stock Price Volatility | Premium |
|----------------------------|-------------------------------|--|
| High annual volatility | 53% or higher | 1 restricted share for 1.5 option shares |
| Moderate annual volatility | 25% - 52% | 1 restricted share for 2.0 option shares |
| Low annual volatility | Less than 25% | 1 restricted share for 4.0 option shares |

Emerging Metrics: Cost

- Expense efficiency
 - Compensation paid vs. expense recognized
 - Requires projection of compensation delivery
 - Requires projection of share price scenarios
 - ✓ Discomfort with price projections
 - ✓ Learning that market-based projections of prices are superior to "black box" assumptions and models
 - Requires analysis of
 - ✓ Company-specific factors
 - ✓ Industry-specific factors
 - ✓ Market-specific factors

Emerging Metrics: Cost

Expense Efficiency

| | | Price at End of Year 4 | | | |
|--|-------------------------------|------------------------|-----------|-----------|-----------|
| | | Current | Below | Target | Exceeds |
| | Price → | \$25.00 | \$26.10 | \$28.20 | \$31.84 |
| Shareholder Value (v. target) | | -42% | -21% | target | 30% |
| Increase in Value (vs. beginning value) | | base | 25% | 72% | 127% |
| Stock Options | Grant | 10,000 | | | |
| | Gain | \$0.00 | \$91,000 | \$182,000 | \$288,400 |
| | Expense | \$110,000 | \$110,000 | \$110,000 | \$110,000 |
| | Compensation to Expense Ratio | 0.00 | 0.81 | 1.62 | 2.33 |
| Restricted Stock/RSU | Grant | 4,210 | | | |
| | Gain | \$105,250 | \$143,561 | \$181,872 | \$218,246 |
| | Expense | \$105,250 | \$105,250 | \$105,250 | \$105,250 |
| | Compensation to Expense Ratio | 1.00 | 1.36 | 1.73 | 2.07 |
| payoff % for illustration only, would depend on financial performance per metric | | | | | |
| Performance Shares* | Grant | 4,210 | 8% | 10% | 120% |
| | Gain | \$0 | \$114,849 | \$181,872 | \$341,010 |
| | Expense** | \$0 | \$88,200 | \$100,250 | \$104,493 |
| | Compensation to Expense Ratio | 0.00 | 1.36 | 1.73 | 2.07 |



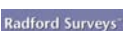
Emerging Metrics: Pay

- Multi-year analysis
 - Addresses lumpy data (Checkerboard PaySM) Issue
 - Converges with 3-year run rate measure
 - Requires assumptions about share price in "off" years
- Grant value vesting
 - Addresses growing variation in vesting schedules
 - Addresses counterintuitive valuation premise that longer vesting is "more valuable"
- Normalized option valuation
 - Gain from returning to peer norm, plus value from that point based on BS
 - Grant values based on normalized value

Emerging Metrics: Pay

Expected Value

| | | Stays at a performance level implying a stock price of: | | | | | |
|-----------------------------|-------------|---|-------------|-----------|-----------|-----------|-----------|
| | | \$25.00 | \$30.00 | \$35.00 | \$40.00 | | |
| Type | # of shares | price | | | | | |
| Option | 10,000 | \$20.00 | \$50,000 | \$100,000 | \$150,000 | \$200,000 | |
| Perf Shares | 2,000 | \$0.00 | \$0 | \$30,000 | \$70,000 | \$160,000 | |
| Percent of award paid: | | | 0% | 40% | 100% | 200% | |
| | | | Payout | \$50,000 | \$130,000 | \$220,000 | \$360,000 |
| | | | Probability | 10% | 40% | 30% | 20% |
| Target Payout | \$220,000 | | | | | | |
| Probabilistic Payout | \$195,000 | | | | | | |
| Financial reporting cost* | \$130,000 | | | | | | |
| Option value as % of Face = | 45% | | | | | | |

Emerging Metrics: Standards

Pay Levels




- > Cumulative compensation vs. multi-year TSR
- > % of MVA given to exec
- > Expected Value (probabilistic value)

Pay Premise

- > Risk-adjusted performance
- > Payments for "failure" vs. "success"

Pay Distribution



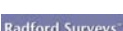
- > Shares granted to "top five" (NEOs) as a percent of all shares granted

Emerging Metrics: Standards





Risk Management

- > Upside surprises
 - Scenario modeling for understanding of upside potential
- > Downside surprises
 - Calculations of payout at termination, change-in-control


Emerging Metrics: Standards



- > Qualitative metrics
 - Corporate governance quotient (ISS)
 - 61 criteria for US companies; 55 for non-US companies
 - ✓ Plan cost
 - ✓ Burn rate
 - ✓ Shareholder approval
 - ✓ Repricing
 - ✓ Director and officer ownership guidelines

Emerging Metrics: Standards





- > **Good and Bad lists – ABI and NAPF**
 - **Good**
 - ✓ Deferred bonus schemes, invested in shares
 - ✓ Share Matching Plans
 - ✓ Performance criteria – details of
 - ✓ Time period – 3 years (ABI) to 5 years (NAPF)
 - ✓ Phased awards
 - ✓ Pay only for performance above peer median



Emerging Metrics: Standards

- > **Good and Bad lists – ABI and NAPF**
 - **Bad**
 - ✓ Performance criterion of EPS growth less than RPI + 3% p.a.
 - ✓ Repricing that doesn't meet criteria
 - ✓ Retesting
 - ✓ Participation in more than one scheme
 - ✓ Acceleration of vesting upon change in control

The Future – Where We'll Be in 18 (?) Months

- First year under FAS123R for all US companies – and second year under IFRS2 - will be coming to close
 - Major valuation method and assumption changes will be in place
 - Markets will have reacted (or not reacted) to changes in reported earnings
 - Companies will have made first one or two rounds of grants under new strategy
 - Interim disclosures (10Q and 8K in the US) will have publicized most executive pay and equity plan changes





The Future – Where We'll Be in 18 (?) Months




- Improved disclosure will accelerate market knowledge of and reaction to changes
 - US requiring increased disclosure
 - Euro approaching US standard
 - Continued increase in publicity of pay
- Unprecedented complexity of pay design will begin to create symptoms
 - New survey models needed
 - New analytical models needed





The Future – Where We'll Be in 18 (?) Months

- Continued proliferation of proxy advisors and complexity of their standards will have diluted the influence of any single perspective
 - Consensus will have developed on which metrics are important
 - Radical fringe perspectives will have lost credibility and been toned down
- Private equity activity will have brought a substantial percentage of market cap private and influence LTI design and performance measurement
 - More concentration of equity grants at senior management level
 - Cash flow focus
 - Timeframe

The Future – Where We'll Be in 18 (?) Months

> And why is that better?

- Reallocation of resources away from tactical to strategic
- Reallocation of resources from lobbying to designing and implementing
- Reduction of conflicting standards and "no-win" plan design
- Boards of Directors with more experience in new plans

Questions and Comments

Questions or comments now?
(hopefully you didn't wait until now)

Questions or comments later?

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