

Plan Design Issues

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Corey Rosen

National Center for Employee Ownership

www.nceo.org

Broad-Based or Not?

- ◆ Accounting and shareholder approval rules will pressure companies to reduce grants.
- ◆ So shouldn't grants focus on those who can really make the most difference?
- ◆ "Line-of-sight" argument suggests management should get awards.
- ◆ Data show something else entirely.

Broad-Based Equity and Corporate Performance

- ◆ Data from Joseph Blasi, Douglas Kruse, and Aaron Bernstein, *In the Company of Owners* (Basic Books, 2003).
- ◆ In plans that provide options to most or all employees, productivity grows 17% in a three-year post plan period compared to what would have otherwise have been expected.
- ◆ Net return on assets grows 2.3 percent per year faster.

More Blasi/Kruse Data

Looking at all the studies on all forms of broad equity sharing, companies following this model showed:

- ◆ Productivity gains of four percent, compared to firms that do not adopt such practices
- ◆ Total shareholder returns 2 percent greater
- ◆ Profit levels – as measured by return on assets, return on equity, and profit margins—about 14% higher

The Wharton Study

- ◆ 159 “new economy” companies studied in 2001 by David Larcker, Christopher Ittner, and Richard Lambert.
- ◆ Larger than usual grants to CEOs and other top executives do not affect stock prices up or down.
- ◆ Larger than usual grants to managers, individual contributors (high performing non-management employees), and technical employees results in better performance.

Sesil/Krumova Study

- ◆ Rutgers and NYU professors looked at companies with broad options in 1995-1997 and 2002-2002, capturing up and down markets.
- ◆ Options increase productivity 20% to 33% in the first period (varies with company size), and companies kept this advantage in the second period, except for a slight decline (to a still elevated level) in smaller companies.
- ◆ Broad options clearly work, they conclude, in up and down markets; moreover, size is not clearly related to how well they work.

A Necessity for High-Tech

There's not been a single successful company in the history of high-tech in the last two decades that has done that without broad-based stock option plans. When I originally heard about that in school, I would have called it socialism, when in fact it is the ultimate form of capitalism. It is a very effective way to align interests.

John Chambers, CEO, Cisco Systems, *San Francisco Chronicle*, 2/29/04

But Not Just for High-Tech

Thirty-seven of the 84 companies that have stock that are included in the *Fortune* 100 Best Companies to Work For list offer either broad-based stock options, ESOPs, or other broad based ownership plans other than ESPPs to their employees

Even Your Latte Needs Options

We believed very early on that people's interaction with the Starbucks experience was going to determine the success of the brand. The culture and values of how we related to our customers, which is reflected in how the company relates to our employees, would determine our success. And we thought the best way to have those kinds of universal values was to build around company-owned stores and then to provide stock options to every employee, to give them a financial and psychological stake in the company...As a result, Starbucks has the lowest employee turnover of any food and beverage company.

Howard Schultz, CEO of Starbucks, quoted in Entrepreneur, Nov. 2003.

Just Executive Plans

- ◆ Blasi, Kruse and Bernstein reviewed all the data and concluded that concentrated ownership in the top five executives actually leads to a decline in shareholder returns.
- ◆ Review of 84 studies through 2000 by Encyclopedia of Corporate Governance indicated 56 found increasing executive equity compensation was unrelated or negatively related with subsequent performance gains, 22 found a positive one, and 16 found a mixed relationship.

More on Just Executive Plans

- ◆ 2003 review of 229 studies by Robert Grams for *WorldatWork*
- ◆ Company stock price performance associated with (but not necessarily caused by) higher actual ownership by executives
- ◆ Performance is unrelated or negatively related to options and other awards that represent compensation through ownership.

Do Employees Value Options?

- ◆ Survey of 1,105 stock optionees by Sibson Consulting in 2000 and 2003 found they do, with no significant change in attitudes from 2000 to 2003 despite the drop in stock prices.
- ◆ 75% say options send a message that everyone is an owner, 38% say they work harder because of options, and 53% say they are more loyal to the company.
- ◆ Options are the most cost-effective way to lure an employee to a new job.

40% is a Big Number

- ◆ About 40% of employees say ownership makes them work harder. Is that good or bad?
- ◆ Many employees already work as hard as they can; they are just that way; others are just impossible to motivate.
- ◆ Getting 4 out of 10 people in a company to work harder is actually an impressive achievement, especially since no one reports working less hard because of ownership.

Do Broad Option Grants Affect Share Prices?

- ◆ 2003 study by Eric Hager at the Univ. of British Columbia finds that announcement of actual grants of options to most employees results in a positive market reaction in the Canada and in the U.S. (when grants are for more than 1% of equity).
- ◆ Price increased from about 1% to 4% on announcement date.
- ◆ 2003 study by Watson Wyatt finds that a 1% increase in the percentage of options granted broadly leads to nearly a 1% increase in total market capitalization.

Will Expensing Affect Share Prices?

- ◆ 2003 NCEO survey of graduate professors of finance showed that 31 of 37 think it will have no substantial impact.
- ◆ 2002 Towers Perrin study of companies that voluntarily expensed options showed no significant market reaction to earnings announcements reflecting options.

And the Clincher

- ◆ 2003 Ernst & Young study by Ashish Garg and William Wilson
- ◆ Looked at 140 companies voluntarily expensing options.
- ◆ Stock prices did not significantly change in reaction to their expensing; in fact, there is some evidence that companies with a larger bottom line impact from expensing saw their prices go up, not down.

So What Are Companies Going to Do?

- ◆ Several studies indicate about 40% to 50% will eliminate broad-based options and/or ESPPs, generally not replacing them with anything else.
- ◆ Just 3% will change executive plans

Can They Sustain That?

- ◆ Demographers predict significant shortages of skilled labor and, in some sectors, any workers as the population ages, has more immigrants (in some countries), and the need for educated employees grows.
- ◆ So if your competitor still has broad equity (half will, after all), can you really keep equity limited?

What Will Employees Think?

- ◆ Are you kidding? For years you told us you wanted us to think like, act like, and actually be owners. We were, you said, your most important asset.
- ◆ But now you say, “sorry, actually executives are our most important asset, and we want them the already often scandalous gap between their pay and yours to grow. Now go out there and do a great job!

What Will Shareholders Think?

- ◆ The accounting and shareholder reform efforts that are driving these changes were not about equity for non-management employees; they were about excessive grants to executives.
- ◆ Companies with broad options perform better, and the market apparently knows it.

So What Are these Changes About?

- ◆ It's hard not to conclude they are about one thing: greed.
- ◆ The perception of the heroic CEO who virtually alone makes a company great or mediocre has seriously distorted compensation systems. It's not fair, it's not responsible, and it's not good for shareholders. It's just greedy.

Do Cost/Benefit Analysis

- ◆ Companies spend millions or billions on equity plans—and nothing on analyzing whether they provide a fair return
- ◆ Analyze turnover rates/costs versus improvements in turnover from equity awards
- ◆ Analyze improvements in productivity relative to industry after start of awards
- ◆ Break down by position

You Don't Have to Do This

- ◆ Compensation and equity plan consultants need to take a stronger stance. Most seem to agree about the data; too many seem to fear the consequences of being honest about it.
- ◆ Companies need to rethink equity in terms not just of how top execs gets paid relative to other (overpaid) top execs, but what it internally equitable in the company.

For More Details

NCEO Issue Brief: The Future of Broad-Based Stock Options

<http://www.nceo.org/pubs/futurebroad.html>