The VIEW from BURGUNDY

AUGUST 1998

STEALING A FORTUNE

From undervalued jurisdictions, we turned our eye to a subject that was becoming more and more dangerous and outrageous – the stock options binge that America was on in the 1990s. Due to a loophole in U.S. accounting standards, stock options could be granted in vast profusion without accounting for them. Managements took advantage of this loophole and granted themselves enormous options packages that enriched them beyond any reasonable concept of renumeration for their services. Very often, those who received these packages did not in fact do a very good job for shareholders. It now appears that many of these same managers, not content with options packages in the tens and even hundreds of millions of dollars, stacked the deck by backdating them so they were assured of extra value. Their greed was boundless.

We looked at the behavioural and financial aspects for executive stock options and strongly opposed their use in any form, at least until they were completely accounted for. Yet it took the expensive and sleazy scandals at Enron and WorldCom to show just how dysfunctional options were as a means of incentivising and compensating management. And it was 2003 before expensing of options became mandatory.

Richard Rooney, 2007

IT IS NOT TOO MUCH OF A STRETCH to say that the biggest change in management behaviour over the past 20 years has been the transformation of senior managers from stewards of businesses into shareholders and option-holders of those businesses. Under the stewardship approach, the management took sort of a "father knows best" attitude to the shareholders and their interests. In a market where control of companies tended not to change hands through takeover bids, they attempted to hand down to the next generation of managers an intact corporate culture, a strong balance sheet and a business much the same as the one they inherited. Title, prestige, job security and association with the company name were more important than monetary compensation, which was adequate, but by no means excessive. Shareholders were treated politely but not taken seriously. Longtime shareholders of the Canadian banks will recognize this style of management.

From our standpoint, those were not the good old days. While the stewardship approach to managing a public corporation tended to be safe and ethical, it was extremely risk averse and often led to inefficient use of the shareholders' resources. We have always believed in the power of capable management in a good business, under proper incentives, to generate excellent returns. And the best possible incentive is for management to own part of the company along with us. But we have major concerns with the way management is acquiring its shares.

It used to be said, "You can win a fortune, and you can inherit a fortune, and you can steal a fortune, but you can't earn a fortune." Nowadays, American managers can expect to retire with enormous wealth as a result of the options plans that can earn them hundreds of millions of dollars in their careers. Executives like Sandy Weill of Travelers and Michael

Eisner of Disney will be among the richest people in America when they retire. Thousands of others will be wealthy beyond most people's wildest dreams of avarice. The vast majority of this wealth has been generated by Employee Stock Option (ESO) plans. Our question is this: Is the old saying true? Or do ESOs permit managers to earn their fortunes at nobody else's expense?

The raw numbers are staggering. Managers of the 350 largest U.S. companies realized over $1 billion in options gains in 1997. Gains from vested, but unexercised options in those companies exceed $7 billion. Over the past five years, the total value of all options they have issued is over $45 billion, increasing 500% over that period. The 200 top American companies now have reserved 13.2% of total shares outstanding on average for options issuance, double the proportion in 1989.

In this issue of *The View*, we will look at the nature and history of options. We will then use an illustrative example to assess ESOs as a long-term incentive system. Finally, we will summarize our beliefs about options and where we, as long-term shareholders, should go from here.

The Nature of the Beast

An option is the right, but not the obligation, to buy a share of stock at a fixed price sometime in the future. Exchange-traded options are usually based around the current market price of the underlying stock, and have terms of weeks or months. Employee Stock Options, by contrast, often have terms of 10 years. After some period, ESOs "vest" and become the property of the option holder.

Exchange-traded options are very risky derivative securities that will expire worthless at the end of their term if the market price of the shares stays below the strike price of the option. So too will ESOs. The problem is that the long terms of ESOs, coupled with the habit of issuing them at current market prices, makes it highly improbable that the ESO holder will suffer the common fate of the exchange-traded option holder and be left with a worthless piece of paper.

Think about it. In the past 75 years, there have been exactly two 10-year periods in which the return on large-capitalization U.S. companies has been negative. Those decades were January 1, 1929 to December 31, 1938, and January 1, 1930 to December 31, 1939. Given enough time, the stock market can recover from lost wars, depressions, oil shocks and just about everything else that can be thrown at it. And while the fates of individual corporations are obviously far more various than the gross statistics suggest, it is safe to say that a 10-year option on an established, publicly traded corporation is a pretty good bet. In a great bull market, it's a no-brainer.

So how did Employee Stock Options take over corporate America in the past 15 years? Well, ESOs are by no means useless. In cases where there is substantial risk and a lack of cash, like start-ups and leveraged buyouts, they are a superb way of motivating and empowering management. A good case can be made that America's technology sector, the envy of the world, was built on a foundation of stock options. Thousands of techies accepted derisory salaries and worked insane hours to launch their companies in return for a piece of the action. Many made and lost several fortunes this way.

The corporate raiders of the 1980s usually found themselves with highly leveraged businesses where the margin of safety was thin and good managers were necessary to keep the business on the rails. They found that the best way to attract this management talent was to offer them lots of options. Options grants of millions of shares of stock to single individuals were pioneered by the Carl Icahns, Ron Perelmans, KKRs and Wasserstein Perellas of the 1980s.

As the great bull market roared on and on, more and more corporate executives got on the options bandwagon. Interestingly, the last time the stock markets were very sloppy for a prolonged length of time – in the 1970s – executives wanted cash, cash and nothing but cash. But with options fortunes being made all around them, more and more companies initiated ESO schemes. ESOs began to be adopted by large, established companies with little risk of bankruptcy and no shortage of cash. What was in it for these companies, that they adopted ESO plans so enthusiastically?

The ultimate attraction was that options gave managers a chance to get rich without the shareholders being any the wiser.

Now, accounting issues are real eye-glazers. Prolonged thought on the subject of options accounting leads only to the sincere wish that someone had written one of those "Options for Dummies" books on the subject. But this is the central issue here, so we beg your indulgent attention.

If a payment is made out of a company's bank account, it is eventually expensed through the income statement, with very few exceptions. But options are not a cash outlay of the company. They are issued out of the liability side of the balance sheet, from shareholders' equity. Normally, the issue of shares results in cash or other assets being acquired by the company for the benefit of all shareholders; in this case, the cash from the sale of stock is pocketed by management. In effect, the company grants the employee the right to do a share issue with the proceeds going to the option holder rather than the company.

It is this rather peculiar nature of options that has prevented the accountants from coming up with a sensible way to account for them. They have ducked the issue completely in Canada, unlike in the U.S. where some attempt has been made to relate options to corporate income. In Canada, the existence of the options is disclosed in a note to the audited financial statements. And that's it. The only way the shareholder sees the impact of options is as one of those phantom dilutive factors in calculating earnings per share.

A Free Lunch

Why should we care? Well, as shareholders, we are entitled to whatever is left of a company after everyone else takes their share. We have the right to the residual value of the company, and if it is managed right, that residual value increases over time. Think of a corporate income statement as a line-up in the cafeteria. Our customers provide the food. First in line to eat are our line employees and suppliers. Then our staff employees, managers, accountants and lawyers. Then our bankers and bondholders. Then the government takes its share. Finally, our preferred shareholders take some. And whatever is left, theoretically, is ours. Options give managers the chance to go through the line at the cafeteria twice. First, they go through as employees, collecting their salaries and cash bonuses. Then, they have the right to go through a second time as shareholders. In practice, they usually sell that right to others, but since they don't have to have their ticket punched for the second trip, it's a free lunch for the option holders.

This is the really objectionable thing about options accounting, or rather the lack of it, in Canada. That right to line up for a second time in the cafeteria is clearly a valuable thing. And it is, equally clearly, a key part of management compensation. Yet it will never show up in compensation expense. So arguably, corporate earnings are overstated by the amount of options gains.

What would happen if those gains were charged against income, as they clearly should be, as part of compensation expense? Well, in our example, management would now make only one trip through the cafeteria line-up. But they would take a great deal of food. And the vital residual, net income, would be severely reduced as a result. The extent of that reduction is a controversial topic that is outside the scope of our discussion, but the existence of any overstatement of earnings is a matter of grave concern.

When the Financial Accounting Standards Board (FASB) in the U.S. attempted to make companies expense a portion of their options a few years ago, they were roundly denounced as saboteurs who were trying to destroy America's great enterprise culture, and (even worse) make the stock market go down. No question of propriety of reporting or honest disclosure; just (literally) vested interests preventing their ox from being gored. And since the constituency for honest accounting and disclosure is minuscule compared to the hordes who have options, the FASB beat a hasty retreat. They salvaged something, however, since U.S. companies must now disclose the value of the options granted as calculated by the Black-Scholes method. So at least some attempt has been made in the U.S. to place a value on the options that have been granted to the managements of companies with ESO plans. The Canadian Institute of Chartered Accountants (CICA), dedicated to a quiet life, has made no such attempt.

So that is the accounting controversy in a nutshell. Options do not affect the bottom line on which managements' performance is measured, so they employ them aggressively. That alone would be sufficient grounds for objection, since accountability is the single most important issue for long-term investors. But beyond that issue, we object to options issuance because options cause managers to behave in ways that are not in their shareholders' best interests. So what is the difference between an owner-manager and a manager with options? The following simplified little parable should make that distinction plain.

A Tale of Two Companies

Two directors' meetings are held in August 1988 by companies in similar businesses. One is a Board meeting of Excellent Corporation, the other of Subpar Corporation. The subject is long-term incentives for top management. Excellent Corp. and Subpar Corp. (all names have been carefully chosen to conceal any bias Burgundy may have) have decided that Mr. Topnotch and Mr. Hohum – their respective newly hired CEOs – should receive long-term incentives tied to the company's stock price. Excellent Corp.'s Board has carefully thought through an approach that it believes will lead to the most shareholder-friendly behaviour by its CEO over the long term. Subpar Corp.'s Board has adopted a standard Employee Stock Option plan. Both Boards have decided that the amount of long-term incentive bonus should be about 500% of salary, which in this case is about $2.5 million. The stocks of both companies are trading at $10 per share.

Subpar Corp. will grant Hohum a 10-year option to buy 250,000 shares of Subpar at $10 per share. The options will vest after five years, after which Hohum may exercise his options at any time.

Excellent Corp. grants Topnotch a $2.5 million bonus contingent on his using the after-tax amount to buy shares in Excellent Corp. in the stock market. With the after-tax proceeds of his bonus, he purchases 125,000 shares of Excellent Corp. His stock will also vest after five years, after which he may sell his stock at any time.

Topnotch buys his stock in the market, as all other shareholders must. When the time comes, Hohum's stock from his options exercise will be issued at a fixed price from treasury, a privilege granted to no other shareholder.

Topnotch's bonus is incorporated into the compensation expense of Excellent Corp. in its reporting to shareholders. The existence and terms of Hohum's ESOs are disclosed in a note to Subpar Corp.'s financial statements. Excellent Corp. has accounted fully and honestly for a valuable asset that has been acquired by an employee. The ESO granted to Hohum will never be charged against SubparCorp.'s earnings.

Excellent Corp. gets a tax deduction for the bonus it has paid to Topnotch. Subpar Corp. receives no tax deduction for the ESOs that Hohum has received.

The taxation issue is also important when looking at the position of the two recipients. Topnotch's benefit was front-end loaded for tax purposes – he paid his taxes but now owns his stock outright. He will be able to enjoy the tax-free compounding from holding the stock for the long term. He only faces the dire prospect of further taxes payable if he sells the stock. He is in exactly the same position as any other long-term shareholder. By contrast, Hohum's benefit is back-end loaded. He faces a stiff tax bill when he exercises his option and buys the stock.

Topnotch knows exactly what his incentive is worth on a given trading day. Hohum really has no idea of the value of his ESO.

Fast Forward – Autumn 1992

For our two companies, it has been a long four years. A sluggish economy, high interest rates and structural adjustments relating to the NAFTA agreement have all had a depressing effect on Canadian equities. They have been very challenging years for both Excellent Corp. and Subpar Corp. Topnotch has taken charge of his business, divesting non-core assets, reducing costs, and focusing his managers on return on capital, but the company is not yet showing consistent improvement. Hohum, despairing of Canada's weak economy and wanting to play in the big leagues, has opened a large operation in the U.S. and is losing money hand over fist. But the market is not discriminating between the two companies, and both stocks are now trading at $7 per share.

Topnotch shares the unhappiness of his fellow Excellent Corp. shareholders, since his investment has declined by $375,000 over the period since his share purchase. He feels their pain.

Hohum, on the other hand, has no downside in his ESOs. But as long as they are "out of the money" below $10, they have no value to him whatsoever. He has raised with his directors the possibility of repricing his options to reflect "current realities," as he puts it. The directors of Subpar Corp., a sympathetic bunch, agree to do so, and the shareholders, as they usually (and incredibly) do, approve the repricing.

This is an economic absurdity, of course. If a manager is held responsible for the appreciation of a stock, which is the inherent idea of using stock as a long-term incentive, then he must be responsible for the depreciation as well. So assigning a benefit like a repricing to that manager is ridiculous. Repricing options is abusive, arbitrary and offensive to any conception of common sense or fair play.

Fast Forward II – Autumn 1993

What a difference a year makes! The Canadian market has been on wheels since late 1992 and now, at the Board meetings in autumn 1993, both Excellent Corp.'s and Subpar Corp.'s share prices have rebounded to $15 in a rather indiscriminate rally.

Hohum has decided to exercise his options. He therefore buys 250,000 shares of Subpar Corp. from treasury, and immediately sells them. He has income of $2 million from his exercise and therefore owes Revenue Canada a large sum of money. (Incidentally, the options repricing of 1992 has given him a windfall profit of $750,000.) This big tax bill forces him to sell a good part of his position, and it seems odd that an incentive plan should force a manager to sell stock in his company. But why does he sell all of his stock?

Based on a sample of observations by people with experience in the corporate compensation area, option holders treat their options earnings like lottery ticket winnings. And if you offer a lottery winner the choice between cash and anything else, he will always choose cash. Unless there is a specific rule in the ESO plan requiring the employee to continue to hold a portion of the stock purchased on the exercise of options, managers will always tend to cash out.

Just check the insider trading listings in the newspaper. From *The Financial Post* of August 19, 1998: "Trizec Hahn Corporation – Andrew Blair, officer, exercised 70,000 options at $18.25 each and sold the same number of subordinate voting shares at $34 each to hold none. He still holds 260,000 options. Richard Steets, officer, exercised 30,000 options at $17.24 each and sold the same number of subordinated voting shares at $34.10 to $34.20 each to hold none. He still holds 370,000 options."[†] These gentlemen have done nothing wrong; they are acting the way option holders usually act.

The value of Hohum's option granted in 1988 is now known. A sensible accounting treatment would be to charge the $2 million gain from the options exercise to 1993 compensation expense. But that will not happen because it is not required by the CICA.

Note how Hohum was able to turn the volatility of Subpar Corp.'s stock price to his own advantage through the options repricing. Volatility to a long-term shareholder is a negative; to an option holder it is a huge advantage, and not only through repricing. The more frequently options are granted, the more useful volatility will be to the option holders, since they can influence the amount of options granted in a given year as well. Our example is deliberately oversimplified since most options plans grant options on an annual basis.

Topnotch is now sitting on an unrealized capital gain of $625,000. He is unlikely to sell his stock and pay more taxes, especially since he is able to see all the good things happening at Excellent Corp. His stock is vested so he now owns his stock outright.

Although the Board of Excellent Corp approves of the moves that Topnotch has taken, those measures are only beginning to bear fruit. The Board decides that based on his return on capital performance, Topnotch should be granted a bonus large enough to purchase 50,000 more shares of Excellent Corp. Note that because Topnotch's incentive is fully accounted for, it affects the return on capital of his company. So the more he takes, the less likely he is to make his return targets, and the less his short-term bonuses are likely to be. That is the real importance of accounting properly for these things – they tend to be self-regulating to some degree.

Hohum's directors decide to "reload the options plan" since with no options outstanding, Hohum has no incentive whatsoever. His performance is deemed satisfactory, though nobody is able to recall a specific accomplishment. They renew the previous plan at 500% of salary, which is again an issue of 250,000 shares of Subpar Corp. at $15, over 10 years, vesting in five years. Because options do not affect the cash position or reported earnings of the company, Boards of Directors do not seem to consider themselves to be spending real money. They therefore reload options plans without much thought. And Hohum has an incentive to get as large a grant as he possibly can through the options plan, since it doesn't affect his profit performance.

Fast Forward III – Autumn 1996

The Canadian stock market has continued to motor on, and business conditions have improved mightily over the last three years. Earnings have improved dramatically, and with them, returns on equity. With a bit of a following wind, Excellent Corp. has opened up a decided lead over Subpar Corp. in terms of corporate performance. While Subpar Corp.'s stock price has increased by 8% per year over the 1993-1996 period to $19, Excellent Corp.'s share price has reached $29, a 25% annual appreciation rate. Both companies now have a cash surplus.

There are three potential uses for a cash surplus. Management can invest in any business opportunities it sees that could earn a return greater than that of the company's base business. Otherwise, if no such opportunities are available, it can buy back its own stock, or return cash to shareholders through a special dividend.

Hohum has taken a lot of heat for his U.S. operation that continues to destroy shareholder value. He therefore rules out an acquisition. So his choice is between a special dividend and a share buyback. It's really no choice at all. Option holders receive no benefit whatsoever from a special dividend, since unlike shareholders, they receive no income from the option. Quite the contrary, since a dividend reduces the share price by the amount of the dividend, at least in the short term, and share price is all that option holders care about. So all the other holders of vested but unexercised options at Subpar Corp., who probably include Hohum's senior managers and even his directors, will be lobbying for a share buyback rather than a dividend. Hohum announces a share buyback.

Stock buybacks, properly used, are a tremendous way to return value to shareholders. If a company's stock is inexpensive, a share buyback can materially increase per share values, soak up excess supply of stock in the market and support share prices to some degree. But at some price, a share buyback becomes subject to the law of diminishing returns, if it is viewed as only one of several different investment alternatives for the company. Executives with a lot of stock options do not consider alternatives, however, because they have a direct interest in supporting the stock price. And since options are issued at current prices on an ongoing basis, stock buybacks by companies with large options programs tend to be done at almost any price.

Topnotch, by contrast, carefully weighs the alternatives. Excellent Corp. is now humming along at a very high rate of return on shareholders' equity, so he cannot find a direct investment that will not dilute the rate of return on his 175,000 shares of Excellent Corp. He too is faced with the choice between a share buyback and a special dividend. He will make his choice based on considerations of his shareholders. If he deems the stock price to be cheap enough, then the share buyback may increase per share values, and he will go that route. If the stock price is expensive, or if many of his shareholders hold Excellent Corp. stock for income purposes, he may elect to pay a special dividend. In all cases, he is thinking like a shareholder because he is a shareholder.

Fast Forward IV – Today

It's vesting day again for our managers. The fortunes of our two companies have diverged markedly. Excellent Corp. has gone from strength to strength, continuing to compound at 25% annual rates. The stock has now reached $45, meaning that under Topnotch's leadership, the 10-year compound return from holding the stock has been 16.2%. Topnotch's personal position is now worth almost $8 million, a very considerable fortune. Even more important, almost $6 million of that amount is unrealized capital gain. Selling the stock would be very painful for Topnotch to contemplate. It is safe to say that his interests are aligned with those of the long-term shareholders.

Hohum's shareholders and directors are becoming rebellious. His continued refusal to cut his shareholders' losses in the U.S. has led to poor performance. His stock has continued to increase at about 8% per year, despite the obvious value that he could unlock if he discontinued his U.S. adventure. The stock price has struggled up to $22 on the basis of earnings that have somehow managed to show modest growth despite the U.S. losses. Hohum exercises his options and sells all the stock at $22, leaving him a net after-tax gain of almost $2 million.

Hohum has no stake in Subpar Corp. He does have independent means as a result of the generous options program. During his decade-long tenure as CEO of Subpar Corp., the compound rate of return on the stock has been 8.2%, less even than the uninspiring 10.5% return on the TSE 300 Index over that period. Hohum, of course, has done much better than his shareholders due to his options repricing and the superb timing of his options exercise. Subpar Corp. shareholders have received very poor value for money; all they have done is to enrich a mediocrity.

The Moral of the Story

The differences between option holders and shareholder managers are:

1. The shareholder managers account fully for the expenses of their firms, so their return targets will include the full costs of their own compensation. The option holders are not accountable, in several senses of the word.
2. The shareholder managers pay their taxes up front, and are able to benefit from long-term tax-free compounding on their stock positions. The option holders pay their taxes when they exercise their options, and must usually sell at least part of their position to pay those taxes. In practice, they will usually sell the whole position.
3. Shareholder managers have the same downside as other shareholders. Option holders cannot lose money on their options. The worst they can do is not make money.
4. Option holders can reprice their options to benefit from share price volatility. Shareholders are stuck with the original deal they made when they purchased the stock.
5. Option holders can influence the timing and amount of options issued in order to benefit from share price volatility.
6. Option holders will never distribute cash through dividends if they can do a stock buyback, regardless of valuation. Shareholder managers will examine the situation based on expected returns to all shareholders.
7. The motivational aspect of options only lasts until they are exercised, after which the plan must be reloaded. Shareholder managers must stick with their stock through thick and thin. As the stock becomes more and more valuable, the motivational value increases and builds over time.
8. Option holders can, and usually do, build substantial wealth independent of the option-granting firm. Shareholder managers have their wealth in the firm, literally. Options often encourage medium-term turnover of personnel; we believe that shareholder ownership reduces turnover.
9. Shareholder managers buy their stock in the market just like other shareholders; option holders have preferential access to the corporate treasury.

In each and every case, options cause managers to behave in ways that are not aligned with the interests of long-term shareholders and that are detrimental to those interests.

Make Them Owners!

In Canada, over half of our public companies are controlled by individuals, families or other corporations. While it is difficult to portray that statistic as a big boon to the Canadian market, it has at least prevented the wholesale looting of companies by management, which has occurred in the U.S., because people with control blocks are usually careful about share issuance. For a measure of the kind of nonsense going on in America today, multiply the above options grants for Topnotch and Hohum by a factor of 10 or 20.

Canadian companies have generally been less aggressive about options issuance than their U.S.

counterparts. The great majority of companies here have options plans, but they rarely reserve more than 10% of the total shares outstanding for a given company. That means there are still billions of dollars worth of options outstanding and, given the very modest accomplishments of Canadian companies in the domain of return on capital, that is far more than the vast majority of these managers deserve.

What can stop the options gravy train? Well, the only reason for the existence and popularity of stock options is the fact that they are not accounted for. In the U.S., there is no reason why they should not be charged against net income as compensation expense, since even the Internal Revenue Service recognizes options as a deductible expense for tax purposes. In Canada, the taxation authorities connive at the deception involved in options issuance by not allowing a deduction for options. They just appear magically as a big increase in income to the option holder, with no recognition that the companies involved have given up something of value. And that of course gives the CICA the justification to leave options off corporate income statements on the grounds that they are avoiding an arbitrary non-cash adjustment. (This from the people who gave you deferred tax accounting.)

What are the prospects for a change in accounting for options? The outcry in America against mediocre CEOs retiring as "rich as Croesus" is growing. Many companies are experimenting with options that increase in price over time, or are indexed to the S&P 500. But those experiments are just window dressing. Ultimately, shareholders in the world's most successful and best-regulated stock market will insist on proper disclosure. Winston Churchill once said that the American people could always be relied upon to do the right thing, after exhausting all possible alternatives. He might have added that once the Americans do the right thing, the Canadians will then follow their lead.

We have already seen the tendency when stock prices are weak for managers to try to reprice their options. We predict that when the markets soften, there will be a rash of repricing proposals from managers whose options are only meaningful when they are in the money. Shareholders should reject any and all such attempts, and try to get managers and Boards of Directors back to the drawing board to redesign their long-term incentive systems.

Options do not do what they were intended to do, which is to align the interests of management and shareholders. If the fortunes from options programs are earned, they are earned at other shareholders' expense. We believe that corporate Boards of Directors should put a sunset clause on all existing options plans – except those associated with highly leveraged or startup situations – and replace them with systems of employee ownership based on share purchase. Don't give your managers lottery tickets – make them owners!

Endnotes

†. The Financial Post. August 19, 1998.

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