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Cisco and EMC: Crystal, You Can't Value Options!: Graef Crystal

Nov. 5 (Bloomberg) -- In many companies where executive stock options have gone under water, chief executive officers act as though what occurred was some sort of natural disaster, an event that certainly was not their responsibility or that of their top management team.

That was the reaction to my Aug. 13 article entitled, "U.S. CEO Pay Averages \$12M Annually: Jobs No. 1." No sooner had it been transmitted than the phone started ringing and the e-mail deluge began.

First, I heard from the spokeswoman for John Chambers, CEO of Cisco Systems Inc. Then, it was the spokesman for Joseph Tucci, CEO of EMC Corp. There was no call or e-mail from a spokesman for Apple Computer Inc., though I did hear from perhaps 20 of Steve Jobs' groupies.

They all had the same complaint:

"You, Crystal, calculated the value as of the date of the grant of the executive's stock options using the Black-Scholes option pricing model. You failed to note that those options are now way under water. So how dare you attribute huge amounts of compensation to a CEO who, at least at the moment, hasn't received a nickel and whose company's stock price will have to appreciate wildly just to get the options back into the money?"

My Defense

I stoutly defend valuing a stock option at the time of its grant. That figure represents the implicit compensation that a board of directors intends to give an executive. It's irrelevant if the CEO subsequently hits the ball over the fence, and makes far more from his options than the Black-Scholes model ever said he would. And it doesn't matter if those options go under water and he makes nothing. It's the intention that counts.

Think of it this way: If a CEO gets a \$1 million bonus, then heads to Las Vegas and blows it all on slot machines, should a board of directors argue that they really gave him nothing? Funny, because the company's pretax earnings have been reduced by \$1 million, and that much seems to be missing from the company's bank balance.

That slot machine analogy is flawed, for there you have pure luck operating. If a company's stock price drops, is that just bad for the CEO? Or is it an indication of his ineptness?

It's nothing short of amazing that when a stock soars, the first person to take full credit for the triumph is the CEO -- the same CEO who earlier was casting blame in every direction except his own when his stock price was slumping.

Looking at 239 CEOs

To get a handle on just how far under water options now are, I looked at 239 CEOs running U.S. companies with 2002 net sales of at least \$5 billion. (Data for this analysis were furnished by Equilar Inc., an independent provider of executive pay information.)

For each CEO, I examined all stock option grants made in the company's 2000 fiscal year. It was in early 2000 that the market began its decline.

The median CEO received options in that year with an estimated value at grant of \$3 million. The average was \$10.1 million, demonstrating the extreme skewness of option grants.

By last Thursday's close, the median CEO's options contained a paper profit of only \$393,000, while the average CEO's options were under water by \$1.9 million.

44 Percent Under Water

Had I chosen to measure what happened earlier than last Thursday, the plunge in option values would have been far greater. Since Oct. 9, 2002, when the Standard & Poor's 500 Index closed at a low of 776.76, the index, through last Thursday, increased 34.8 percent. That market surge accounts for just 44 percent of the options granted in 2000 to the 239 CEOs currently being under water.

And even for that 44 percent it needs to be remembered that they still have about seven years to go before they expire. A lot can happen in that time, and many of those options can be expected to finish in the money.

The first table below shows the 15 CEOs out of the 239 whose option grants in 2000 are most under water. Paper profits (actually paper losses) in these options are measured by multiplying the number of shares in the grant by the amount by which the closing price last Thursday was higher (or lower) than the option's strike price.

The second table lists the 15 CEOs whose options show the highest paper profits. For this group, an average Black-Scholes value at grant of \$18 million has morphed into a current paper profit of \$43 million.

Indexed Options

There's a case to be made for a CEO taking credit for a rise in his company's stock price -- even though that increase may fall short of the increase in the overall stock market. The flip side of that is the CEO must then take the blame for any decrease in his company's stock price, even though the decline may be less severe than the decrease in the overall market.

Alternatively, companies could switch to indexed options, which allow the strike price to move up and down according to a major index or the stock prices of a group of peer companies. Virtually no CEO likes that idea since performing at the middle of the pack or finishing in a even lower position gets you nothing. You have to outperform the market, and then by a substantial margin, to become seriously rich.

Jobs Rewarded

One final point involving Steve Jobs. I have shown his 2000 option grant which covered 20 million shares as being \$410 million under water as of last Thursday. Before any reader decides to book Carnegie Hall for a benefit performance for poor old Steve, consider that last March he turned in that option, as well as another under-water option covering 7.5 million more shares, and in return received five million free shares. They were worth about \$75 million when awarded. Their current value is about \$115 million.

So Jobs has been rewarded for delivering a current stock price that's just a bit more than half what it was in 2000 when he received his 20 million-share option. Jobs is doing quite nicely, thank you very much. And maybe now I'll hear from an Apple spokesman.

15 CEOs with the most under-water options:

Company	Executive	Original Option Present Value (millions)	Paper Profit As of 10/30/03 (millions)
Apple Computer	Steven Jobs	\$486	-\$410
SPX	John Blystone	\$73	-\$163

Cisco Systems	John Chambers	\$103	-\$135
Safeway	Steven Burd	\$50	-\$66
Citigroup	Sanford Weill *	\$215	-\$51
EMC Corp.	Joseph Tucci	\$30	-\$46
Circuit City Stores	Alan McCollough	\$35	-\$42
Hewlett Packard	Carleton Fiorina	\$31	-\$41
Sun Microsystems	Scott McNealy	\$21	-\$36
J P Morgan Chase	William Harrison	\$40	-\$35
Time Warner	Richard Parsons	\$17	-\$28
Delta Air Lines	Leo Mullin	\$15	-\$26
Morgan Stanley	Philip Purcell	\$29	-\$23
Verizon Commun.	Ivan Seidenberg	\$16	-\$21
Nextel Commun.	Timothy Donahue	\$17	-\$19

* Stepped down as
CEO on Sept. 30

15 CEOs with the largest paper profits:

Company	Executive	Original Option Present Value (millions)	Paper Profit As of 10/30/03 (millions)
Oracle	Lawrence Ellison	\$148	\$213
Caremark Rx	Edwin Crawford	\$11	\$79
UnitedHealth Group	William McGuire	\$8	\$51
Bank One	James Dimon	\$20	\$46
Cardinal Health	Robert Walter	\$19	\$40
Aetna	John Rowe	\$13	\$32
Lehman Brothers Holdings	Richard Fuld	\$10	\$31
Wellpoint Health Net	Leonard Schaeffer	\$9	\$28
J C Penney	Allen Questrom	\$6	\$28
KB HOME	Bruce Karatz	\$6	\$22
Lockheed Martin	Vance Coffman	\$2	\$17
Yum Brands	David Novak	\$6	\$15
Wells Fargo	Richard Kovacevich	\$7	\$14
General Dynamics	Nicholas Chabraja	\$3	\$13
AdvancePCS	David Halbert	\$2	\$12

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