Employee Stock Options for the Participant

Part III: Management of ESO's

By J. Gregory Vermeychuk, Ph.D., CAIA

In **Part I** and **Part II**, we discussed the basic features of employee stock options and explained how they were awarded and exercised. We also discussed the value embedded in employee stock options. Finally, we presented some examples of the exercise process, including the taxes which become due upon exercise. Here in **Part III**, we will examine some basic strategies for the management of ESO's once they have vested. As in any investment program, there is no single course of action which works for everybody. As the recipient of employee stock options, you must consider your individual situation and future plans in order to make an intelligent choice. Although we will make some generalizations regarding the advantages and disadvantages of individual strategies, there are no guarantees that a given course of action may be suitable for a particular individual. When dealing with employee stock options, thorough due diligence is in order. If you feel uncertain about your ability to make a logical choice, engage qualified professionals to assist you.

To begin, we will assume that our fictional recipient (an employee of ABC Company) has received an award which is based on an example we have used previously:

Date of Award:	January 30, 2013
Size of Award:	1,000 units (call option on 1,000 shares of ABC common stock)
Type of Award:	Non-Qualified Stock Option
Share Price on Award Date:	$40.00
Exercise Price:	$40.00 per share
Vesting Period:	Three years (No exercise is possible before January 31, 2016.)
Contractual Period:	Ten Years (Award expires and becomes worthless on January 30, 2023.)
Type of Vesting:	Cliff (All units vest at the same time)
Exercise Type:	Cashless
Tax Withholding:	Yes
Restrictions on Stock:	None

How should the recipient proceed? To begin, there is nothing which can be done before the vesting date of January 31, 2016. The award is in place, but the recipient cannot exercise or exchange the award for anything of value. The only thing that must be kept in mind is that, if employment of the recipient is terminated at any time before the vesting date, in the majority of cases the award is forfeited. There may be specific awards where this is not the case, but usually, the recipient must remain employed by the granting company during the period from grant to vesting. Let us say that it is now January 31, 2016, our recipient is still employed with ABC, and company shares are trading at $65.00. Our recipient decides to use Strategy No.1.

No.1: Exercise on Vesting and Sell Stock Immediately

This is a viable strategy whenever the shares of the company are trading above their value on the award date. In this case, the award has an ***intrinsic value*** of $25,000. The recipient has a proverbial "bird in the hand" and wants to realize his gains as soon as possible. Since this is a cashless exercise situation, the recipient does not have to come up with $40,000 to purchase the stock upon exercise of his vested option. The cooperating broker engaged by ABC Company will handle this, as well as the sale of the appreciated stock. The $25,000 gross gain will be reduced by the approximately $10,000 of taxes due on the $25,000 intrinsic value (which include FICA, Medicare, and other payroll taxes, in addition to ordinary income tax) leaving a $15,000 from the 1,000 unit award.

Who would employ Strategy No.1? A person who may find this strategy attractive would be someone relatively early in their career with few if any other investments. The advantage is ***diversification***. The cash resulting from an immediate exercise and sale can be channeled by the recipient into investments which are completely unrelated to ABC Company and are therefore not directly exposed to any threats facing the continued prosperity of ABC as an employer. In this case, diversification is gained at the expense of potential additional gains in the price of ABC shares with the passage of time. Of course, shares of ABC may

lose as well as gain, and there is no guarantee that a delay of exercise will be rewarded. One may also choose to employ this strategy to fill an immediate need for cash. If the recipient has other investments, they may be either illiquid or strongly appreciated, thus exposing the sale to capital gains tax.

It is worth mentioning that in no case does it make sense to exercise the options and retain the stock in anticipation of future gains. All taxes on the intrinsic value of an ESO are due when the option is exercised, regardless of whether the stock is held or sold. If the recipient has a strong view that the price of ABC shares will increase in the next year or two, he is much better off waiting to exercise the option and delaying the tax. The gains on the share price can still be realized and the taxes deferred until exercise occurs.

No.2: Exercise Just Before Expiration

Strategy No.2 is the antithesis of strategy No.1. The recipient holds the employee stock options for as long as possible and exercises them just before they expire, given the condition that the options have a positive intrinsic value. On the date of expiration, the value of the option consists only of intrinsic value, or the difference between the current share price and the strike price of the option. By delaying exercise until just before expiration, no intrinsic value is sacrificed. For a typical award such as the one in our examples, the time between vesting and expiration is seven years. Over this period of time, in the absence of company-specific idiosyncratic factors, the price of a share may be expected to increase at a rate which approximates the risk-free interest rate. Thus, if there is no compelling reason to exercise at an earlier date, exercise upon the date of expiration will result in the maximum theoretical gain.

Although behavior such as this is observed for broad market indices, the increase in the value of an index over the intermediate to long term is not monotonic. There are always advances and declines superimposed upon a secular trend. The advances and declines are reflections of ***market volatility***. Due to the effects of correlation, the volatility of a broad index is typically less than the volatilities of the individual components. There is no guarantee whatsoever that delay of exercise will result in an increase in intrinsic value, although, over the long term and over many different issues, this is what happens.

Strategy No.2 may appeal to participants who are well along in their careers, have substantial, well-diversified portfolios, no immediate need for cash proceeds, and who can accept the risk of a secular decline in the share price of their employer. Taxes are incurred at the latest possible time.

In considering this strategy, some consideration must be given to the volatility of the company shares in question. A recipient is more likely to realize a long-term gain at a specific future date with a low-volatility stock than with a higher volatility stock. Even though the higher volatility stock has the potential for larger gains, the realization of a gain at a specific, predetermined time is less likely than with lower volatility shares.

In the event that an employee with vested ESO's terminates their employment before the date of expiration, most company plans stipulate that the former employee must either exercise the vested options within some period of time (typically 90 days) or forfeit their options. Such a provision has the effect of accelerating the expiration of the options, and usually applies if the termination is either voluntary or involuntary.

There is a variation on Strategy No.2 which calls for the exercise of employee stock options after a certain period of time after vesting, but before the date of expiration. No matter what the specified time, the strategy is predicated upon the anticipated growth of intrinsic value as extrinsic or time value declines. Although the decline of time value is a certainty, the growth in intrinsic value depends upon market conditions. Individual stocks experience secular advances and declines which depend upon the business cycle, product life cycles of the issuer, interest rates, and many other factors. All companies are also exposed to idiosyncratic or company-specific influences, which may cause a significant advance or decline as a result of a merger or acquisition, regulatory developments, a natural disaster, a technological development, or any one of a number of unforeseen events. Beyond events which alter the fundamental ability of a firm to generate a stream of earnings, there are also psychological factors which drive the market in individual stocks. No analyst, no matter how disciplined and thorough, has a crystal ball which allows him to predict the future. Holding vested employee stock options until expiration is for those who recognize the risks involved as well as the potential benefits. In some cases, such as a rapidly growing

company with new technology, the benefits may significantly outweigh the risks. For more established companies in mature industries, the ESO recipient should accept the risk only if a loss will not threaten his financial well-being.

No.3: Exercise at a Value Target

The last of the simplified exercise strategies for ESO's involves a value target. After the options vest, the recipient selects a target share price at which he will exercise and sell his shares. If the target price is not achieved before expiration, then the options are exercised just before they expire, to avoid forfeiture. Further, if the options expire out of the money, or ***underwater***, they are worthless and are allowed to expire with no value. The recipient should keep in mind that he will realize approximately 60% of the intrinsic value at exercise, with the rest going to taxes.

When expressed as a multiple of the share price on the award date, the target value is referred to as a ***"suboptimal exercise factor"*** or SOEF. These factors are used in the valuation of ESO awards by some companies who make the assumption that by and large, the recipients of their awards will behave as dictated by Strategy No.3. A typical value target is 2.0x the share price at the award date. In the case discussed previously, the shares of ABC would be trading at $80.00 at some date between the vest date and the expiration date. Upon exercise, a gross gain of $40,000 would be made with a tax liability of $16,000, for a net gain of $24,000.

Selection of the value target will also depend upon the history and outlook for dividends on the company stock. As with Strategy No.2, the user of Strategy No.3 will be able to accept a degree of risk and will have no immediate need for the proceeds of an ESO exercise. Value targets may be set with the use of analysts' recommendations, the participant's own views on the prospects for his employer's share, or on the participant's individual needs and preferences. In any case, the selection of a target value for the exercise of an employee stock option is an inexact pursuit.

Summary

In this paper, we have reviewed three rather simplistic strategies for the management of an ESO award by the recipient and have indicated some of the pros and cons of each. In the final paper of the series, we shall briefly explore some of the steps which can be taken by recipients to extract some of the time value from an unexercised ESO or to limit the risk caused by changing value of an employer's shares over a well-defined span of time. These activities all fit under the broad classification of ***"hedging."***

If you are the recipient of an ESO, you may be expressly prohibited from hedging activities under the terms of your contract. Even if an employment contract or company stock plan does not prohibit hedging, participants in the plan may be strongly discouraged from engaging in such practices. Nonetheless, if there are no obstacles to hedging an ESO award, you may be able to limit the risk of loss of value at the expense of foregoing the possibility of future gains. The basic concepts will be explained in the next paper. Although the concepts are simple, the implementation may be complex. We recommend that anyone contemplating the use of a hedging program engage the services of qualified professionals to offer assistance.

Disclaimer

The foregoing is intended for educational purposes only and is not to be regarded as investment advice. The examples are illustrative and do not represent actual employee stock options. The circumstances of every investor are unique. One should consult with licensed professionals before making any investment decision.

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Montgomery Investment Technology, Inc.
200 Federal Street - Suite 245
Camden, NJ 08103
Tel: 610.688.8111
Fax: 610.688.5084
URL: *www.fintools.com*
Email: *miti@fintools.com*

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