

More on Using Options for Remunerating Non-executive Directors

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INTRODUCTION

A Chairman of a leading ASX listed company raised several points when commenting on GRG Remuneration Insight 46 Share Ownership for Non-executive Directors. The Chairman supported the need for a re-examination of the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations (ASX Principles & Recommendations). He also indicated that for the granting of options to NEDs to be accepted by shareholders improvements in the communication of the valuation of options would be required. This was particularly so given the difference in values produced for options granted by established and start-up (including exploration and biotechnology) companies. This GRG Remuneration Insight discusses these aspects and a possible way forward.

VALUING OPTIONS

As a starting point we have calculated the value of options for two hypothetical companies using the assumptions shown below.

Assumptions	Established Company with Substantial Market Capitalisation (say \$1 billion)	Start-Up Company with Small Market Capitalisation (say \$50 million)
Share Price		\$1.00
Exercise Price		\$1.00
Risk Free Interest Rate		3.5%
Term of the Option		5 years
Dividends p.a.	\$0.05	\$0
Volatility	40%	60%

The values of the options calculated using the Black-Scholes Option Valuation Model are:

Established Company	Start-Up Company
\$0.23	\$0.54

A simple explanation of the Black-Scholes Option Valuation Model follows:

- For a company that does not pay dividends the option value is basically the difference between the present value of the exercise price (calculated by adjusting the exercise price using the term of the option and the risk free interest rate) and the share price at the time the option is granted.

- An adjustment is made to take account of volatility. Higher volatility translates to higher option values and vice versa.
- A further adjustment is then made for companies that pay dividends with the value of the option being reduced by approximately the present value of dividends over the term of the option.

The resulting values are intuitive as it would generally be expected that an option over a share in a start-up company would have a greater value than an option over a share in a large established company. It should also be noted that the ASX Principles & Recommendations were first released in 2003. In July 2004 the Australian Accounting Standards Board released AASB 2 which dealt with valuing and reporting share-based payments. Since then various stakeholders have become familiar with approaches used to value rights and options for key management personnel (KMP) remuneration purposes. Thus, any concern that may have existed about the valuation of options for NEDs when the ASX Principles & Recommendations were first released should have evaporated by now.

CONCERNS WITH OPTION VALUES

Where concern can arise in relation to the valuation of options over shares in start-up companies is when the option value does not reflect the potential benefit that may arise from the option. There have been a minority of cases where option holders have realised benefits many times the company's share price at the time the options were granted. These need to be put into perspective by considering the majority of cases where option holders have realised nil or minimal benefit from options. In both types of situations the valuations of the options were probably reasonable. However, history has shown that in the minority of cases the shares were undervalued given their subsequent success and this undervaluation led to the options being undervalued. It is perhaps too much to ask an option valuer to forecast future company share price movements more accurately than the market.

To the writers knowledge all option valuation models take the current share price as a starting point for the valuation process. This is because the option is a right to acquire a share and therefore the value of an option must be a function of the share price. The share price, of course, reflects the market view of the value of the company at a point in time.

Another aspect where concern may arise in relation to the valuation of options is that the probability of the options being of any value in the future is not a factor in the Black-Scholes formula. An option over a share in an established company may be seen as having a high probability of delivering value to the option holder. An option over a share in a start-up company may be seen as having little probability of providing value to the option holder. These probability considerations may lead to a view that options over shares in established companies have higher values than those shown above and options over shares in start-up companies have values lower than those shown above. Thus, shareholders in established companies may be sceptical about the value of options over shares in their companies granted to KMP and KMP in start-up companies may feel sceptical about the value of options they have been granted.

PROJECTED BENEFIT ALTERNATIVE

There is a method of option valuation that was used for executive remuneration purposes but has fallen out of favour compared to the more sophisticated but less easily understood option valuation models such as the Black-Scholes, Binomial and Monte Carlo models. This model is called the Projected Benefit Model. It starts with the current share price (it shares this starting point with the other option valuation models) which is projected forward at a growth rate selected having regard to the company's prospects. The exercise price is then deducted from the projected share price to calculate the potential future benefit. The future benefit is then discounted to determine its present value which is the value of the option.

An example follows: Current share price of \$1.00 projected forward at a growth rate of 12% compound for say 5 years equals \$1.76. If the exercise price is \$1.00 then the projected benefit is \$0.76. Using an interest rate of 4% the present value of the \$0.76 in 5 years time is \$0.65. In applying this method the time period used is usually the maximum term of the option. At around 20% pa compound growth and using a discount interest rate of 4% the present value of the option would be approximately equal to the current share price of \$1.00. At higher growth rates the value of the

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option would exceed the current share price. Other option valuation models produce option values that are lower than the current share price. Logic would suggest that the value of an option over a share would be less than the share price. Why buy an option instead of a share when the share can be acquired for a lesser outlay? Also there is no additional payment obligation when a share is acquired but an option carries an obligation to pay the exercise price if a share is to be acquired by exercising the option.

Nevertheless, the Projected Benefit Valuation Model can be useful when communicating the potential benefit from options and when seeking to explain a valuation to shareholders and other stakeholders. Following are two examples using the Projected Benefit valuation Model that have been structured to deliver values similar to the values calculated above using the Black-Scholes Option Valuation Model.

Assumptions	Established Company with Substantial Market Capitalisation (say \$1 billion)	Start-Up Company with Small Market Capitalisation (say \$50 million)
Share Price	\$1.00	
Exercise Price	\$1.00	
Risk Free Interest Rate	3.5%	
Term of the Option	5 years	
Dividends p.a.	Not relevant except to extent recognised in projected growth rate.	
Projected Growth Rate	5%	10.5%

The values of the options calculated using the Projected Benefit Valuation Model are:

Established Company	Start-Up Company
\$0.23	\$0.55

When communicating with shareholders it may be useful to show the variance between the target benefit value (future option value) and the benefit that may be realised at various future share price outcomes.

Future Share Price	Share Price Growth Over Term of Option	Established Company	Start-up Company
		Benefit Compared to Future Target Benefit Value of \$0.27 ($\0.23×1.035^5)	Benefit Compared to Future Target Benefit Value of \$0.65 ($\0.55×1.035^5)
\$1.00	0%	\$0.27 loss	\$0.65 loss
\$1.10	10%	\$0.17 loss	\$0.55 loss
\$1.20	20%	\$0.07 loss	\$0.45 loss
\$1.27	27%	Break-even	\$0.35 loss
\$1.40	40%	\$0.13 gain	\$0.25 loss
\$1.50	50%	\$0.23 gain	\$0.15 loss
\$1.60	60%	\$0.23 gain	\$0.05 loss
\$1.65	65%	\$0.23 gain	Break-even
\$1.70	70%	\$0.23 gain	\$0.05 gain
\$1.80	80%	\$0.23 gain	\$0.15 gain
\$1.90	90%	\$0.23 gain	\$0.25 gain
\$2.00	100%	\$0.23 gain	\$0.35 gain

The foregoing table shows that there is a strong alignment of director and shareholder interests by clearly indicating that directors will receive:

- no benefit if the share price does not increase,
- less than the target benefit if the share price target is not achieved,
- exactly the target benefit if the share price target is achieved, and
- more than the target benefit if the share price target is exceeded.

Thus, directors would be penalised if the share price target is not achieved and rewarded if the share price target is exceeded. These are outcomes that should be supported by shareholders.

ALL COMPANIES CAN USE OPTIONS AS PART OF NED REMUNERATION

It needs to be kept in mind that the ASX Principles & Recommendations are based on an “if not why not” approach. Thus, if any ASX listed company wishes to do so it can grant options to NEDs as part of their remuneration provided that the rationale for granting the options is explained in the company’s Remuneration Report. In these circumstances the ASX Principles & Recommendations would be fully complied with.

GRG is of the view that options have a role in NED remuneration provided that:

- the values of option grants are not excessive,
- the total number of options granted to individual NEDs do not impair their independence,
- option vesting conditions, if any, do not contain performance conditions applicable to executive LTI plans, and
- the vesting conditions, if any, do not restrain healthy refreshment of the composition of boards.

If boards of ASX listed companies are of a similar view then they should embrace the use of options as an element of NED remuneration.

Key Management Personnel Remuneration Advice

GRG is a specialist advisor on remuneration for key management personnel (KMP) i.e. non-executive directors, executive directors and other top executives, meaning that we are truly independent.

To facilitate its advisory function GRG maintains Australia’s largest KMP remuneration database with over 1,000 companies and over 6,000 incumbents. The analysis this allows keeps GRG up to date with current trends and developments and enables us to produce specialist benchmarking as well as broad remuneration guides.

The increased focus being placed on KMP remuneration makes it more important than ever for Boards to be satisfied that they are adopting practices that are consistent with market practice and appropriate to their company’s circumstances, and to communicate remuneration decisions clearly and effectively.

If you would like an independent review of the market competitiveness of your company’s remuneration practices for KMP then GRG will be pleased to assist. We can also assist in communication strategies, drafting of Remuneration Report disclosures, resolutions related to remuneration, incentive plan rules and engaging with stakeholders to manage strike risks. Please call Denis Godfrey, James Bourchier or Mike Carroll on (02) 8923 5700 or Nicholas Jackson on (03) 9607 1318 for further information.