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Glub, glub, glub: 40% of options are underwater

Stock drops pound Fortune 500, with options at 1 in 10 big companies essentially worthless. Comp experts see wave of calls for repricings.

By Mark Bruno
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The plan was simple earlier this year at most large companies where top brass and rank-and-filers found themselves holding worthless stock options: Wait and hope investors send prices back up.

Now it may be time for Plan B. Stock options are currently underwater at nearly 40% of Fortune 500 companies, compared with about one-third that had worthless options during the first quarter, according to data compiled for *Financial Week* by compensation consultants Steven Hall & Partners.

And many of those options are well into the abyss: One in every 10 companies now has options that are more than 50% underwater.

Compensation consultants say an increasing number of companies are considering dealing with their now-worthless options, either by repricing them or exchanging them for newly issued restricted stock.

“Over the last several weeks, we've fielded a number of calls from companies about their underwater options,” said Brett Harsen, vice president at Radford, a compensation research and consulting firm. “They want to know what their choices are, and what it will take to find a solution.”

While devising a plan that flies with shareholders—themselves reeling from huge stock losses—won't be easy, some experts say companies have little choice but to try. After all, more companies are watching their stock options sink deeper and deeper, making the chances for getting back “in the money” seem even more bleak than they did just a few months ago.

“From a morale standpoint, and an employee retention standpoint, this has become a serious issue for many companies where options don't appear as if they'll emerge anytime soon,” said Pearl Meyer, senior managing director at Steven Hall. “In some ways, they have lost the value of using company stock as a motivator for current workers.”

The underwater issue is relatively industry-specific and is largely affecting the companies that have been hardest hit by the credit crunch and economic downturn, companies, Ms. Meyer added, that have the greatest need to keep their most talented workers.

Not surprisingly, the corporations whose options are the most deeply underwater—which occurs when a company's stock price dips below the exercise price of an option—are largely financial firms, although automakers, retailers and tech companies also account for a significant portion.

Five of the 10 most underwater companies are financial services firms, and that group would have been larger if Bear Stearns and Countrywide Financial—the two most underwater financials in the first quarter—were still operating independently.

Their departure from the Fortune 500 leaves Freddie Mac as the company with the most deeply underwater options—roughly 90% below its weighted average exercise price on Aug. 15, when its stock was trading at $5.85 a share. The mortgage lender's shares have lost almost 90% of their value since the end of the first quarter. Its sister government-sponsored entity, Fannie Mae, and giant savings and loan Washington Mutual aren't far behind, as both now have options that are 89% underwater.

Spokesmen for the three firms could not offer any details on how, or if, they will attempt to address their option pricing dilemmas.

Some companies with options deeply underwater may consider repricing them at a lower exercise price. This can be a tricky undertaking, given that it now requires the approval of shareholders. Yet that isn't deterring at least one firm, Palo Alto, Calif., technology company VMware, from seeking shareholder approval to reprice options.

In a July 17 letter to employees, VMware CEO Paul Maritz revealed that the company's board had approved a proposal to allow workers to ex-change out-of-the-money options for new options. During VMware's second-quarter earnings conference call, Mr. Maritz said the proposal “obviously went a long way to addressing concern” about morale and retention. VMware is holding a special shareholder meeting to approve the exchange on Sept. 9, confirmed spokeswoman Mary Ann Gallo.

An alternative to trading in underwater options for options with new exercise prices is to swap them for restricted stock, Mr. Harsen said. This can restore the alignment of interests between workers and investors, which could help corporations get the green light from shareholders, particularly if a company's stock has performed poorly for a prolonged period of time.

“There's a lot of talk about this right now,” said Ira Kay, global director of compensation consulting at Watson Wyatt. “It's a bear market, and if you reprice the options now, there's still a chance they could go underwater at some point in the future. Employees want something that has some value.”

Mr. Kay predicts that a “few dozen” large companies might swap underwater options for restricted stock over the next 12 months.

But deeply underwater companies may not want to wait too much longer, noted Chuck Eldridge, managing director at executive search firm Korn Ferry. “If you jump ship to a competitor, you can pick up new options that have lower prices and more upside,” he said. “If your company isn't doing anything about underwater options, you can do your own exchange.”

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