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A quarterly discussion of innovation, entrepreneurship, and corporate transformation

When Employee Stock Options Sink

by Mary Ellen Carter and Luann J. Lynch

For many young, fast-growing companies, employee stock options can be an invaluable compensation tool. Of course, options are a more powerful incentive when the company's stock price climbs above the options' exercise price. So, what happens when the stock price falls? What can companies do about so-called "underwater" options before their best employees jump ship?

For the past five years, we have been researching companies' strategies for dealing with underwater stock options and the motives behind those strategies. Along the way, we have shed some light on a topic that is as complicated as it is controversial. A particular focus of our research has been the practice of repricing underwater options, but before we examine the ins and outs of repricing, let's consider the various ways companies can respond to underwater options.

When employee stock options lose their incentive effects, companies can increase cash compensation, grant additional options, grant restricted stock, reprice the options, or offer what are known as 6 and 1 option exchanges (more on these later). Of the companies we studied that had underwater options in 2000, more than 80 percent did something to alter compensation. Institutional investors and others argue that companies that attempt to increase compensation in the face of sinking stock options are unjustifiably transferring wealth from shareholders to employees. Why, they ask, should employees be rewarded when their company's stock price falls? Many managers, however, claim that they are motivated not by self-interest but by the need to retain talented people, restore performance-based incentives, and insulate employees from industry-wide or market-wide factors beyond their control. Indeed, in our research into what drives companies to respond to underwater options, we found that the desire to amass more wealth does not seem to be a primary driver and that companies are trying to retain executives and restore incentives to the options portfolio.

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Diversity That Matters

by Martin N. Davidson

Listen to what the CEO of a U.S. manufacturing company has to say about the results of his firm's diversity initiatives:

"We got really excited about increasing diversity in our company, not only because it was the right thing to do, but because it would make our business better. We made a huge effort to recruit women and minorities, and then we hit a snag. The recruits we brought in either couldn't cut it or left. The more we made a push, the more our existing workforce pushed back—our people got angry about the special treatment toward the women and minorities. Now, ten years later, it feels like we've been spinning our wheels in mud. We do all the things that they say are

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All M&A Is Local

by Robert F. Bruner

Here we go again. The recent announcements of megamergers signal a return to our favorite business sport: handicapping potential buyers and targets. But approaching this like most bettors at the track is fruitless. In the high-stakes game of ever shifting competitive landscapes, only a clear view of the underlying drivers of mergers and acquisitions can yield intelligent guesses about who'll buy, who'll be sold, and the timing of either. Scholars have studied the drivers for years and by now have produced some insights that can help the handicapper.

One popular explanation, fed by findings that M&A waves coincide with stock market booms, is that M&A happens for behavioral reasons such as ego or irrationality. This view has led some scholars to hypothesize that M&A activity is an outgrowth of the wider market mania. Others infer that executives could be rationally exploiting irrational investors: inflated share values create an attractive currency with which to get big. A third hypothesis is that executives know how difficult it is to create value through M&A but continue to do deals out of sheer hubris. All of these arguments fit into a broader wave of studies confirming behavioral influences on investment decisions. These studies are probably on to something, but to believe that hubris or irrationality tells the whole story about M&A activity doesn't help the handicapper or the decision maker think about what might be just around the corner.

We can gain more traction by viewing M&A as an instrument of corporate transformation, a response by executives to a turbulent environment. This view does not disregard the behavioral influences on M&A activity that other researchers have exposed, but it points to other drivers as well and, overall, presents a more complex picture. For instance, buoyant stock markets tend to coincide with episodes of industrial change; thus, turbulent conditions rather than the stock market might prompt M&A activity. And instead of simply blaming high-profile failures on hubris and leaving it at that, those who consider the forces of turbulence ask how the firms would have performed absent the merger. DaimlerChrysler and AOL/Time

Warner are certainly the poster children of the hubris view, but does anyone really believe that Chrysler's or AOL's shareholders and employees would be *better off* today had those companies walked away from negotiations with their partners? When they announced their deals, both firms faced the onset of "perfect storms" in their industries. An understanding of such turbulence gives a richer outlook on any merger.

The turbulence view has long been explored by researchers and practitioners. In 1942, Joseph Schumpeter described the business economy as characterized by ceaseless and self-generated change arising from turbulence in the firm's environment. He argued that canny entrepreneurs and managers seize the opportunity created by this turbulence to make a profit—M&A is one way to do that. More recently, Bruce Wasserstein, the dean of M&A advisers, cited five forces that drive the merger process: regulatory and political reform, technological change, fluctuations in financial markets, the role of leadership, and the tension between scale and focus.

Various scholars offer evidence consistent with the view that strategic turbulence is the real driver of M&A activity. Consider these examples:

- In their study of the 1980s merger wave, Mark Mitchell and Harold Mulherin found that industries with the greatest amount of takeover activity were those that experienced fundamental economic shocks like deregulation, technological innovation, demographic shifts, and input price shocks. They pointed to M&A activity in banking and broadcasting driven by deregulation, textiles by liberalized trade policy, energy by petroleum price changes, and food processing by a demographic shift and low population growth.
- Naomi Lamoreaux studied the M&A wave of 1894 to 1904, when more than 1,800 firms disappeared into the formation of 93 "trusts." She found that most M&A activity occurred within industries characterized by capital-intensive, mass-production manufacturing processes in which new firms introduced new and devastating technology. The M&A of this period removed older and less efficient players from these industries.
- Similarly, Boyan Jovanovic and Peter Rousseau studied the waves of 1890 to 1930 and 1971 to 2001 and concluded that the former was significantly associated with the diffusion of electricity and the internal combustion engine and the latter with the rise of information technology.
- Michael Jensen has argued that restructuring in the 1980s was stimulated by innovation in organizational design, such as the retailing model introduced by Wal-Mart and wholesale clubs. He has also pointed to the creation of new markets and trading systems (such as in high-yield debt) that stimulated the wave of hostile takeovers and leveraged buyouts.

The turbulence view of M&A activity has at least five implications for business practitioners.

1. All M&A is local. Tip O'Neil, former Speaker of the House, helped newcomers to Washington understand the behavior of politicians with the phrase, "All politics is local." By this he meant that the mind-set of the successful politician begins with his or her constituency, not with supposed mood swings at the national level. Thus it is with understanding M&A. Pay attention to economic turbulence, the form it takes, how and which firms it affects, and who exploits it.

2. The sources of turbulence reveal more than the results. Observers tend to focus on M&A deals, rather than their drivers. The turbulence view encourages us to look upstream to the profound forces at work in a particular industrial market. Almost certainly, the drivers will vary from one industry to the next.

3. Flexibility is key. The forces behind M&A activity are most devastating when least expected. Just when you have the dance steps memorized, the music changes. Cultivate the ability to envision several scenarios and hedge accordingly rather than bet the ranch on your favorite view of the future.

4. Change leaders are likely to be those with the most at stake, either because of threat or opportunity. NationsBank changed the rules of M&A in interstate banking, led in no small part by a fear of being surrounded by larger players first in North Carolina, then the Southeast, and, finally, nationally. Change

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The Repricing Decision

Of all the strategies for dealing with underwater options, repricing may be the most controversial and complex. Some firms prohibit stock option repricing or require shareholder approval, but frequently, all that's necessary is a go-ahead from the board. The decision to reprice—either to lower the exercise price of options or to cancel previously granted options and reissue them at a lower exercise price—must be undertaken with great caution, not only because of accounting and logistical issues but also because repricing is controversial, and controversy itself can impose costs.

Like those who question the appropriateness of altering compensation in any way when options sink, repricing opponents argue that lowering the exercise price of options that were meant to inspire great performance actually rewards poor performance. In our study of repricing activity in 1998, we found that repricing was driven not by poor industry performance but poor firm performance. This finding, which suggests that repricing was not undertaken solely to shield employees from fluctuations in a troubled industry, appears to support the claims of those who oppose the practice. However, we also found that young companies and those in high-tech industries are more likely than others to reprice employee stock options. In such competitive labor markets, talented employees in poorly performing firms may be tempted by offers from better-performing competitors whose options are above water. Repricing, then, may indeed be an attempt to keep employees from abandoning ship.

Given the controversy around repricing and our evidence suggesting that concerns about retention drive the practice, we went on to examine whether the strategy actually helps keep employees on board. In our study of the effect of repricing on employee turnover, we found little evidence of a relationship between repricing and lower *executive* turnover. Perhaps underwater options make less of a dent in the overall wealth of executives, who then may be less motivated to leave when stock options lose their value. We did find evidence, though, that repricing the stock options of *nonexecutive* employees may help reduce turnover at that level. Repricing, then, may still seem like a valuable tool for dealing with the underwater options of the general employee population in spite of the criticisms of some observers. A company with underwater options might very well weigh the potential reputation cost of doing something controversial against the cost of employee turnover and decide that repricing is the less costly alternative. But there are other factors to weigh and other potential costs to consider.

Accounting for the Repricing of Employee Stock Options

Until 1998, stock option repricings were treated under accounting guidelines as traditional "fixed" options, which meant that companies repricing employee stock options did not have to record an expense. On December 4, 1998, the Financial Accounting Standards Board (FASB) announced that starting on December 15 of that year, companies would have to account for stock option repricings using the "variable method," which requires companies to record as an expense an amount related to the difference between the exercise price of repriced options and the market price of the underlying stock in each future period that the options are unexercised. The accounting change would have no effect on cash flows, but the expense would show up on the income statements scrutinized by Wall Street analysts and investors.

In our study of repricing activity around the time of the FASB's announcement, we saw a marked increase in repricing from December 4 through December 15—the last chance to reprice without having to record an expense—and a decrease after the new rule went into effect. Most likely to reprice during this 12-day window were firms who would have been penalized by the stock market for this charge to earnings. The non-accounting costs of repricing, such as those associated with the controversy surrounding the practice, did deter some firms from repricing during the December window. But we found that for most companies, the financial reporting costs outweighed the other considerations. Many companies clearly thought that if they had to record an expense, their earnings would not live up to analysts' expectations, and many found themselves needing other ways to deal with sinking employee stock options.

The 6 and 1 Approach

All new rules give rise to creative ways of getting around them. The FASB's clarification of the accounting procedures for option repricings states that repricings include not only the lowering of the exercise price of an option but also the cancellation of existing options and the

granting of new ones within a six-month period. Thus was born the 6 and 1 option exchange: the canceling of existing options and the commitment to grant new ones six months and one day later. Clearly, this is a strategy for avoiding the expense associated with traditional repricings, but it comes with its own potential costs. As with the decision to reprice at all, the decision of how to reprice must be weighed carefully.

6 and 1 option exchanges are not a perfect substitute for traditional repricing because of two risks. First, such option exchanges give managers an incentive to take actions to decrease the company's stock price during the six-month window between the cancellation of the old options and the granting of new ones. Because the exercise price of most options is set to the market price on the grant date, a decline in the stock price during the six-month period results in a lower exercise price on the replacement options and thus a higher potential gain when those options are exercised. Companies that choose the 6 and 1 exchange therefore face the risk that managers may attempt to lower the company's stock price. The second risk is that 6 and 1 exchanges subject the option holder to the risk of stock price increases during the six-month window, which result in a higher exercise price on the replacement options and thus a lower potential gain when the options are exercised. If the stock price goes up before the replacement options are granted, the option holder may regret not having repriced in the traditional manner.

Companies trying to decide between a traditional repricing and a 6 and 1 exchange face a trade-off. Which is more important, avoiding the financial reporting cost of repricing or the potential costs of a 6 and 1 option exchange? Here are some questions that can help managers answer that question.

How strong is the company's governance? Many people expect companies with strong governance to go with the traditional approach, in spite of the less favorable accounting treatment, in order to avoid the potential conflicts of interest associated with a 6 and 1 option exchange. But it may be that better-governed companies are the ones that can withstand close scrutiny, and their governance structures may help deter self-interested actions by managers during the six-month window. To date, we have found no widespread evidence of deliberate attempts by managers in firms offering 6 and 1 exchanges to lower the stock price during the six-month window.

How important is the financial reporting cost? If managers are concerned about having to record an expense and missing earnings targets, the 6 and 1 option exchange, despite the risks, may make more sense than a traditional repricing. Indeed, about 85 percent of the companies offering 6 and 1 exchanges that we have studied so far cite their desire to avoid an expense as the reason for not repricing traditionally.

What might happen to the company's stock price in the coming months? If managers expect the company's stock price to fall, they'll find it difficult to keep options above water by taking the traditional approach. But if they expect the stock price to rise, they may choose a traditional repricing so that the new exercise price is set before the stock price increases. We have noticed that firms with more insider-selling activity in the six months before the repricing decision seem to choose a 6 and 1 option exchange instead of a traditional repricing. This may suggest that managers who are bearish about their firm's stock, and thus are selling it, take their expectations into account.

The decision to reprice options is a matter of assessing trade-offs, and the same is true for the choice between traditional repricings and the 6 and 1 exchange. Indeed, all responses to underwater options must be weighed carefully. Of course, there's one alternative we've not yet discussed: doing nothing, a strategy followed by about 20 percent of the companies in our sample. A company that makes no attempt to adjust employees' compensation when options go underwater certainly can't be accused of letting executive conflicts of interest run the show. But perhaps it can be accused of a different kind of recklessness: not fighting to hang on to the best people in the industry.

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Diversity That Matters

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best practices, but we haven't made much progress, and I don't know what to do next."

This CEO's frustration sounds a familiar theme. Few organizations are successful in cultivating the workforce diversity they want, and even fewer know what to *do* with the diversity they achieve. One year ago in the *Batten Briefings,* I wrote about business leaders who have realized that instead of treating diversity as yet another item on HR's to-do list, they can approach it as a source of competitive advantage across the enterprise. In other words, instead of managing diversity, they can leverage it, using individuals' distinctive traits and abilities to transform the organization.

This shift is crucial for achieving and sustaining a diverse workforce, but it is predicated on a more fundamental shift: before managers can learn to leverage diversity, they must examine how they make sense of it. What is diversity? What constitutes a meaningful difference? How can we learn about differences and incorporate them into our organizations? We all think of race, ethnicity, and gender as the crucial categories. But what about someone's distinctive approach to generating ideas or someone else's years of experience in another industry, which inform her perspective on business processes? Companies that successfully leverage difference think in a broad, perhaps even idiosyncratic way about the sources of diversity and how differences of many kinds can enrich the workplace and shape strategy. In particular, they avoid three critical mistakes.

Mistake 1: Not Identifying Crucial Differences

Managers are often so focused on the differences they think they should attend to that they fail to see those that truly matter to the company. The leaders of a high-tech firm, for example, decided they needed to make inroads in hiring and retaining African Americans because that was what competitors were doing. This goal obscured the fact that the company was losing critical engineers, who happened to be Asian and Asian American, at an alarming rate. Instead of focusing on the diversity issue that was relevant to the business—an issue that was right under their noses—the company's leaders chose to follow their rivals.

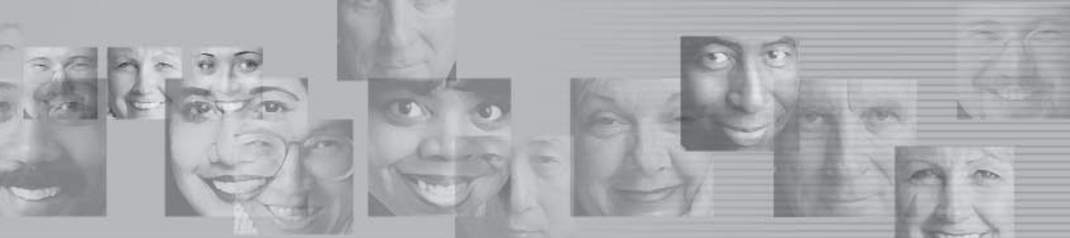
The leaders of that company were unable to recognize a critical difference, but sometimes leaders and key change agents are unable literally to see relevant differences. A casual observer can see the color of someone's skin but cannot easily observe how that person solves problems, parses time, or deals with ambiguity. Yet these distinctive capabilities and traits can define outstanding performance. The key is to adopt the attitude that any characteristic could be strategically important. Instead of focusing on similarities, successful leaders focus on strategic differences. A variety of tools—the Myers-Briggs Type Indicator is one example—can help reveal characteristics that are hard to detect.

Mistake 2: Being Uninformed About Important Differences

Even if managers can see relevant differences, they may not know what those differences mean. Such a lack of understanding can derail not only diversity efforts but also performance. Consider a retail firm that, because it had a large Hispanic customer base, sought out and hired candidates who identified themselves as Hispanic or had Hispanic surnames. After several quarters of poor sales performance, managers realized their mistake: the Hispanic market was multiracial, multinational, and multilingual, but they had been hiring predominantly white, highly assimilated Hispanics, many of whom spoke only English.

This is a dramatic example of leaders and organizations failing to understand the nature of the differences they identify as important. Often, differences are given labels: gay, female, disabled. These labels are shorthand; they can help an organization measure its progress in increasing the representation of various categories. The problem comes when managers make no attempt to gather data about the labeled difference and to understand *how* and *why* it matters to the business.

Companies can realize greater returns from their diversity initiatives through continual education and cultivating a stance of inquisitiveness. When a person walks up to me, I may be able to notice only that the person is female and of Asian descent. When I begin to talk with her, I may be able to discern by her accent whether she is Asian American or Asian. By asking questions, I may be able to confirm or disconfirm my assumptions about her cultural heritage. By listening to her story, I may learn other things—that she is an investment banker, that she is married with two children, that her oldest daughter is gay, that she is politically conservative. All of these facts help me build a more sophisticated model of what



it might mean to be an Asian woman and what it means to be this particular woman. And if I want to learn more, I can turn to various sources, such as books and magazines, films, and other cultural artifacts. Having such knowledge diminishes the likelihood that attempts to leverage an important difference will go awry.

Mistake 3: Not Allowing Important Differences to Transform the Organization

Though identifying and learning about differences are significant steps in shifting the way we think about diversity, they don't map the entire journey to leveraging it effectively. Firms that only see and understand difference won't necessarily know how to accommodate the kinds of differences that may be emerging as strategically important. Consider a southeastern U.S. manufacturing company that had a strong business rationale for growing a European customer base. The company learned about doing business in France, Germany, and the U.K. and hired skilled European employees. But after only 14 months, the best new employees had cycled out of the organization, and the company was scrambling to replace them.

People who do not fit an organization's norm may leave for many reasons, but all of those reasons are grounded in the company's inability to be transformed by their presence. The manufacturing company wanted to do business in Europe, but the employees who could help the organization achieve that goal felt alienated and excluded. For example, the Europeans were often appraised as competent but not fitting into the culture well enough to receive the most desirable promotions. And they were rarely invited to informal social events.

In order to leverage an important difference, organizations must be willing to be transformed in both culture and business practices by that difference. If doing business in Europe is truly important, then the manufacturer could accommodate multiple languages in the workplace. It could modify its practice of requiring all senior managers to relocate to western North Carolina. By rethinking the business based on the espoused new strategy, the company would be more successful in retaining its new European contingent. Only when such change is cultivated can the difference be brought to life in the business. Only then is the difference being valued.

Organizations that leverage difference are practiced at identifying the most important differences, learning about those differences, and incorporating them into their culture and practices. These companies also understand that true diversity comes from more than the categories that are easiest to identify. Once managers start to think about difference more broadly and more strategically, they can increase diversity both by reaching outside the organization and by looking more carefully within. Isn't it quite possible that all sorts of differences exist in an organization, waiting to be seen and valued?

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All M&A Is Local

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leaders are often created by circumstance rather than choice. As Hugh McColl, CEO of NationsBank, told me in a case interview, "Our goal was to survive, to have control over our own destiny, and to be prosperous."

5. Targets are likely to be those that have lost the strategic initiative in the face of change. Strong players deal better with turbulence than weak players. Keep an eye on the relative financial and operational health, competitive position, and organizational strength of firms in the industry.

Our understanding of what drives waves of M&A continues to evolve. The behavioral view offers provocative insights and certainly makes interesting reading in newspapers. The thoughtful practitioner, however, should follow the turbulence to learn more. Perhaps the most important insight of the turbulence view is that broad-brush speculation about M&A activity around the globe doesn't have much practical content. The best insights about the drivers of M&A are to be found industry by industry. It is through focusing on industry-level M&A activity that we can make more meaningful assessments of the larger movements.

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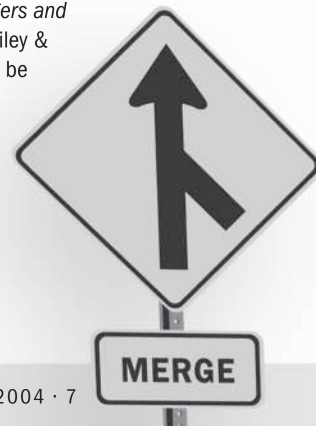

Retooling Business Paradigms

by Pedro Medina

In 1989, after 13 years of education in the United States, I returned to Colombia to work for Propilco, a Colombian petrochemical company. My challenge was to find markets for the polypropylene that Propilco would produce in its new plant in Cartagena. My team and I opened up 26 export markets, but it soon became clear that the best strategy was to increase domestic sales. In attempting to switch current and potential local customers to this product, I ran head-on into the region's rigid business paradigms. I recall a bottle manufacturer who asked, "Who will *guarantee* that if I retool my factory to make polypropylene bottles I will be able to sell them?" Although the potential upside of retooling was high—polypropylene is superior to other plastics in price and performance—he was paralyzed by the risk and never retooled. Three years later, he went bankrupt after those who did retool ate his share of the market.

Asking that manufacturer to retool his factory and business model was really asking him to retool his mental framework. I encountered this not only at Propilco but also when I introduced McDonald's to Colombia and began developing local suppliers. Even though they had the capital to invest and the franchise was experiencing tremendous success in Colombia—my team and I opened ten restaurants the first year—these suppliers felt insecure about jumping into an entrepreneurial venture.

In them and in the bottle manufacturer, I recognize three paradigms that guide the beliefs and behavior of most Colombian businesspeople. First is the attitude that you must not put all your eggs in one basket, that you must ensure stability by not making big bets. This aversion to risk means that the people who become business leaders are not those with the most innovative ideas but those who have played it safe—who have not failed. Second is the belief that you can take care of situations as they come along and that detailed planning is not a strategic necessity, an attitude expressed in the phrase "sobre la marcha." Third is a persistent sense of scarcity despite the incredible resources and potential that define Colombia. People aren't in the habit of assuming that opportunities are all around them, and therefore they can't recognize and seize them. Together, these paradigms generate low levels of trust, self-confidence, and, ultimately, innovation.

At McDonald's, we were able to overcome these paradigms because we understood them deeply and had encountered alternative frameworks in other cultures. We acknowledged our suppliers' concerns about risk by conducting pilot tests of our business model and outlining clearly the rules and expectations for partnerships. We addressed small breaches by suppliers early on, and we penalized them for repeated infractions by revoking privileges, such as the opportunity to develop a new product or market. We addressed potential suppliers' wariness and low self-confidence by touting local success stories. Our lettuce supplier, for example, began serving McDonald's restaurants in Venezuela and thus provided a compelling example of the potency of local partnerships and the abundance of business opportunities. By joining hands with a state-of-the-art distribution network, this supplier disproved those who believe in the scarcity of resources throughout the region.

In spite of the challenges, my desire to be a catalyst in this country does not falter. Colombia and all of Latin America are overflowing with opportunity for entrepreneurs who first take the time to understand the risk-averse business paradigms at work in the region and then patiently and persistently dismantle them, one by one.

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