Share Option Neutral Adjustments

by Nick Stevens, Robert Muriel and George Speyer

1. Share options are usually given to managers as an incentive to reward good performance. They are a flawed reward. They carry no penalty for bad performance. They represent a real, but until very recently a not properly accounted for, cost to shareholders. They provide a reward that may not relate to managerial performance since many other factors can influence share prices and thus the option value.

2. One such factor is when changes are made to a company's capital structure. The Inland Revenue (IR) in respect of tax exempt approved share schemes and the Association of British Insurers (ABI) both recognise in their guidelines that share option schemes need adjusting when a company's capital structure is changed. According to the IR, the general principle in making adjustments is that 'the value of the share option reflects what it would have been had the new …(capital)…. structure been in place when the options were first granted'. This principle of a neutral adjustment is often not being followed in the current practices of British Companies. IR & ABI's guidelines now seem to allow the capital structure of companies to be changed in ways that enhance the value of share options to the detriment of other shareholders.

3. A share gives its owner a certain proportion of the company's distributed profits depending on what number of share have been issued. A share option allows the holder subject to conditions, to buy a share at a fixed price sometime in the future. A share option can only have value if the future share price rises above the option exercise price.

4. Changes in the company structure can influence the future share price in two ways by altering:
   i The proportion of a company's distributed profits, future shares are due to receive, and/or
   ii The assets the company uses to earn future profits.

5. The prime example of the first influence is the issuing of bonus shares. A neutral adjustment of share options after a bonus issue must give the option holder upon their exercise; the same proportionate claim over the company's distributed profits as they had before. Thus following a one for one bonus share issue, a properly adjusted share option will on its exercise, yield two shares when only one would have been purchased before. This is current practice.

6. The second influence is present when returning capital to shareholders without otherwise changing the capital structure. Returning capital devalues what had been on offer to option holders. To leave the value of share options unchanged, the option price needs to be reduced to allow for what was returned.

7. Both influences are present when a company returns capital with a share consolidation, buys shares for cancellation or issues new shares for cash or assets. The issue of shares, the consolidation of shares, the cancellation of shares affects the proportion of a company's distributed profits shares thereon receive. The company's assets are changed, by returning capital to shareholders, buying existing shares or selling new shares. In all cases one influence is pushing up the share price whilst the other pulls it back.

8. These countervailing influences are rarely equivalent, which is why many of today's practices in adjusting share options are not neutral but enhancing their value. By assumption there is one exception. Where a new share is issued at the full market price, it may be reasonable to accept that a company will invest the proceeds as well as it did in the past. This would result in earnings per share, dividend per share and market share price being unchanged causing no need for share option adjustments.

9. Except when companies merge, the sale of newly issued shares is generally at a discounted price. Current practice treats rights issues as if they were the purchase of new shares at the full market price (requiring no adjustment to the share options) plus a bonus share issue equivalent to the discount. (For a proof of this see accompanying paper Executive Share Option Adjustments.) This forgets that the discount is given as an inducement to shareholders to subscribe and to save the company underwriting costs. Option holders are like non-subscribing shareholders. The compensation the latter receives for the dilution of their interest after a right's issue, is to get whatever the market is prepared to pay for their rights allocation less the shareholders' right's subscription price. In cases where the rights issue is not tradeable, they do not even get that. Why should option holders get anything more?

10. Following a return of capital to shareholders, it is common practice to reduce the company's shares by the same percentage as the equity capital return to keep up the share price. For example, when Mitchells and Butlers returned capital by paying a 29% 'special dividend' they reduced the number of shares by 29%or 5/17ths. Because share options are not affected, option holders become entitled upon their exercise to a higher proportion of the company's distributed profits (17/12 = 1·417 in Mitchells & Butlers case) than before the share consolidation.

11. This is not a neutral adjustment. By expending capital the Company disposes of the least wanted assets making the smallest contribution to the company's profits. So when holders exercise their options after the share consolidation, they get the right to an increased share of the earnings from the remaining more profitable assets. This is enhancing the value of share options and it comes at the expense of other shareholders. It is sometimes argued that this is only fair because with out share consolidation, the share price would fall, reflecting the capital that had been returned. But the enhancing adjustment is being made to ensure not only that there is no fall in share price but that there is a rise in the share-option's potential for future dividends.

12. The effect of buying shares and cancelling them is the same as returning capital and consolidating the share capital except that the capital return goes only to outright share sellers receiving a higher price as a result of the Company's market operations. Following buybacks the share price can be expected to rise compared to what otherwise would have happened. (See US evidence below[*]). Because share-options are not being adjusted, their value is being enhanced for the reasons described above. A neutral adjustment would in cases of buybacks and capital return, allow the option price to be abated (by the return per share the company was effecting) and a consolidation of the options in line with the share consolidation/buyback percentage.

13. The underlying principles of a neutral adjustment are the same in all cases:
    - The option holder gets no more than like for like. The rights adjustment should be based on the compensation given to a non-subscribing rights shareholder for the dilution of their interest.
    - Just as the number of share-options is adjusted upwards when there is a share bonus issue, the number ought to be adjusted downwards when shares are bought back or consolidated.
    - When capital is returned to shareholders, the adjustment must be by option price abatement.

14. There are only a few occasions when capital is returned to shareholders without a share consolidation. Companies are usually seeking to gear up their capital whether by buyback or capital return. This is a widespread company activity with shareholders being routinely asked for buyback permission. Except for the issue of bonus shares, IR's general principle is being honoured more in the breach. ABI has been invited to give the underlying principles of their guidelines but have yet to describe them. The failure to ensure neutral adjustments is probably encouraging companies into share consolidations and buybacks for the private advantage of option holders.

[*]. William McNally examined 702 repurchase announcements in the US [See Open Market Stock Repurchase Signal~~l~~ing published in Financial Management Summer 1999] and found that the proposed mean purchase of 6.93% of these Companies' equity raised the share price on average by about 2.5% immediately after the announcement.

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