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HOW OPTIONS AFFECT THE WAY WE LOOK AT COMPANIES

In financial markets today, there is an ongoing debate about the pros and cons of stock options – principally around incentivising executives with them. In addition, South Africa is experiencing a massive issuance of options relating to the facilitation of black empowerment transactions.

We think it is pertinent to share with you our views on this subject, and specifically on how it influences our valuation of companies.

The debate hinges on the following questions:

1. Are options a cost to a companies owners (i.e. shareholders)?
2. If so, is this cost quantifiable?
3. If it is quantifiable, how should it be accounted for?
4. Are options an appropriate tool for incentivising management?

(As an aside, the "opponents" in this debate can generally be classed into two broad groups: company management and investors. I'll leave it to you to decide which party is on which side of this particular argument!)

Let's discuss each point separately.

The answer to the first point is quite obvious: options represent a cost, and sometimes quite a significant one to the owners of a company. Let there be no doubt about this point. The share price reflects the discounted value of the "per share" cash flows of a business. When options are exercised, the number of shares increases, and the "per share" value of the discounted stream of cash flows is reduced. This decline is the cost to the owners of the business. It is that simple.

Point one is actually a moot point, as even the most ardent opponent of proper accounting for stock options will concede that there is a cost. Where they most vehemently argue against proper accounting is when it comes to putting a value on this cost. Please note: these are very smart people, who regularly enter into very intricate contracts on behalf of their companies, who now claim they cannot put a value on options! These same people regularly sign off on company accounts that include all sorts of estimates – estimates on the provisioning for bad debt, estimates on the depreciation of fixed assets etc, etc. To argue that they cannot put an exact value on options, and therefore do not have to account for them, is a laughable argument, to say the least.

The accounting treatment argument is another interesting one. In effect, the opponents are saying that no accounting standards exist for options accounting, and they are therefore not willing to account for them! Again, these are the same people who present all sorts of arbitrary accounting concepts in their results, for which no accounting standards exist. Numbers like core headline earnings, adjusted core headline earnings, pro-forma earnings and so on have no standing in the accounting environment, yet are widely used in an effort to present investors with an earnings number that represents managements opinion, rather than economic reality. That is like Ernie Els only counting the holes he birdied when he fills in his scorecard. It looks good, but in terms of determining who the best golfer is, it has no value.

Management argues that investors do not like companies with volatile earnings, and should not be exposed to the cold hard reality of capitalism: that it is a very volatile environment. We object strongly to this paternalistic attitude, and note that companies with apparently very smooth earnings streams tend to come unstuck in a big way, every now and then. In fact, in doing our valuation work, we look at companies with such unnatural smooth earnings streams very suspiciously. What this means in practice, is that we use a somewhat higher discount rate to value the company's cash flows – which results in a somewhat lower valuation. We would contend that this is the only rational way to deal with a company whose management insists on presenting what they want the world to see, and not how things really are!

In addition, despite the lack of accounting rules, a number of highly respected companies in the US have started to account for options. We think this is highly commendable. After all, accounting for a cost explicitly, forces management to think about it, and take actions to get the best "bang" for the owners "buck". Our view is simply this: it does not really matter how exactly one accounts for options, as long as it is done consistently, and as long as the accounting treatment reflects economic reality as closely as possible.

Finally, it is our view that options are a wholly inappropriate way to incentivise management. Options bestow the holder with a significant one way bet – he or she makes a lot of money if things go well, but lose nothing if things go wrong. They simply walk away. This effectively incentivises management to take big risks with a company – heads they win, tails you lose. Furthermore, most options are simply tied to the share price of the company, and increase in value, just because the share price happens to be going up. This rising share price could be because of any of a host of factors, outside of management's control –for which they should not be rewarded!

A proper incentive scheme would align the interests of management with those of the owners (both on the up and on the down) and force management to take longer term views, in order to maximise the long term value of the business.

Let us be very clear here – we have no problem in paying the management of the companies (in which we invest our clients' funds) a lot of money, if they are clearly adding commensurate value. (It must be said however, that such managers are very rare and mostly unsung – they are generally not the ones gracing the covers of magazines!) Incentive structures that offer large rewards to managers that perform outstandingly well are thus actually quite desirable. However, just as these managers have a right to enjoy the upside, they should be exposed to the downside, if they perform poorly. Options-based incentive schemes do not have this characteristic.

We have tended to focus on options used as executive compensation tools. A lot of BEE transactions these days are also options based. Again, the reasons given for not properly accounting for these deals are very similar to the ones used above. And again, we would use similar arguments to counter the proponents of misleading accounting, with one small change: we view the BEE transactions as something akin to capex on projects that protect the existing business, as well as potentially adding future growth.

As opposed to the options used as executive compensation, which should be accounted for as a cost of doing business, the options issued in BEE transactions should be accounted for as capex. But they should still be accounted for!

In summary, when valuing companies for potential inclusion in our clients' portfolios, we discern between two types of companies. The first type is those that reflect economic reality in their accounts, practice full disclosure, and have management teams that are incentivised to maximise returns to the owners of the business, not themselves. The second broad group thinks that investors are naïve, and cannot be trusted with reality. They smooth earnings, do not account for options properly, and generally do not have management teams whose interests are aligned with those of the owners.

Needless to say, at RE:CM we place a much higher value on the shares of the first type of company. With the second type of company, we are much more conservative, and use higher discount rates in valuing their cash flows. One just doesn't know what else will crawl out of the woodwork, if management cannot even be trusted to account properly for their own incentive scheme!

Furthermore, our proxy voting guidelines are clear on this issue: we will advise our clients to vote against any form of options issuance, if the issuing company refuses to account for them properly, and with immediate effect.

Piet Viljoen, April 2004 Market Comment