



## TenStep Supplemental Paper

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### Retention Management with ESOPs

Research has proved that ESOPs are the best compensation mechanism available and ensure long-term success to the employees. ESOPs aim to link pay with performance. This ensures that executives gain when the company profits and suffer when it struggles. Critics claim that it's not enough to reward good results - there should be a penalty for poor performances. They also claim that options have unlimited upside, under the assumption that options have no value when issued.

#### Stock options take many forms

- **Fixed Value Plans.** These provide stock options in the form of a series of annual grants with a value that is held constant or maintained at a fixed proportion of total compensation.

For example, an executive is granted one million dollars worth of options each year for four years or is given a grant equal to 1.2 times his salary each year for four years. This means even if the stock price falls, there's no cause for alarm because the grant ensures his stake. The flip side - it creates the weakest incentives for value creation.

- **Fixed Number Plans.** Stock options come in the form of a series of annual grants of a fixed number of options. While this creates higher-powered incentives than fixed value plans, it also reduces retention risks.
- **Megagrant.** These are large, up-front grants in lieu of annual grants. The exercise price and the number of options are fixed when issued. For example, an executive is granted 100,000 at the money options this year and none in the next three years.

These ESOP's create the most high-powered incentives for value creation. But, they exacerbate retention risk, and in case of falling prices, executives may quit.

While options have done a great deal to get executives to think and act like owners, not all ESOP's are created equal. Only a clear understanding of how options work will help corporations to ensure that their options program is accomplishing its goals. If distributed in the wrong way, ESOPs can do more harm than good.