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THOUGHT CONTAGIONS

Microsoft's Options Reboot

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Ending option grants could be the prelude to paying out Microsoft's $46 billion hoard.

Microsoft's announcement after the close yesterday that it will discontinue granting employee stock options -- and instead, grant restricted stock -- may be preparatory to a major long-term shift toward less cash-retention and more dividends. In its most extreme form, Microsoft may now elect to pay out some or all of its $46 billion cash hoard as a special dividend. There is no reason policy changes in the same direction should not also occur at other cash-rich technology companies such as **Cisco** and **Dell**.

Nothing in this should be seen as revealing anything new about the maturation of today's technology giants. Such maturation has been obvious for a long time, and is part of the normal rapid life-cycle of technology companies. And it certainly isn't a move against "infectious greed" by a "good citizen" corporation, as some press reports have suggested. Instead, it is a rational response by a mature company to changes in tax policy, intended to serve the interests of its investors and employees. We noted that Microsoft took its first small step toward this response only ten days after **President Bush** announced last January his intention to eliminate the double taxation of dividend income (see "Microsoft's 'Starter Dividend'" January 17, 2003)

As we pointed out when the dividend tax cut was signed into law, its final enacted form made if possible for companies to pay out cash accumulated over years on the same tax-advantaged basis as they could pay out current earnings (see "Aftermath of a Tax Cut Miracle" May 27, 2003). With top marginal dividend tax rates cut by more than half, companies lost much of their reason for hoarding cash and investing it on behalf of shareholders, rather than paying it out and letting shareholders invest it themselves. But we noted that the presence of large numbers of outstanding stock options in the hands of employees would make paying dividends difficult for technology companies -- dividend payments reduce the ex-dividend price of a company's stock to the detriment of option holders.

In the future, employees holding restricted stock will not be harmed by dividend payments. But today Microsoft has *lots* of option holders who would indeed be harmed. Based on data from the company's most recent 10k, Microsoft had options on 1.6 billion shares outstanding. At today's stock price they have an aggregate Black-Scholes value of $18.7 billion, and the in-the-money ones have an aggregate exercise value of $9.1 billion. If Microsoft were to pay out its $46 billion cash hoard as a special dividend, the Black Scholes value of the options would be reduced by $4.7 billion, and their exercise value would be reduced by $2.1 billion.

This problem could be ameliorated by Microsoft's plan to retain an investment bank to offer to buy outstanding options from option holders. Employees may be disappointed when they find that the offer price has been reduced from today's Black-Scholes value to reflect the probability of regular and special dividend payments in the future (press reports this morning suggest the price would be even lower than that). But they may feel compensated by being bought out of deep out-of-the-money options that they probably had mentally written off as worthless.

Outstanding out-of-the-money options, when discounted for worst-case dividend policies, would still have a value of $6.1 billion.

To hedge the exposure of owning options on up to 1.6 billion shares of Microsoft, the investment bank would have to short 1.1 billion shares, with a market value of $31.2 billion. The hedge would have to be adjusted almost continuously, shorting more whenever the stock price increased, and covering whenever the stock price fell. From today's price, if the stock went up 1 point the bank would sell short an additional 17 million shares; if the stock went down 1 point it would buy 19 million shares.

Without more details it is difficult to know what impact all this will have on reported earnings. Microsoft has announced that it intends to begin to record options expense on its income statement in fiscal 2004 -- but without issuing any new options, that alone shouldn't be very significant for very long. That said, the value of the new restricted stock grants would have to be reported as a compensation expense, and as a first approximation, we could guess that it will track historical options expense. Based on Microsoft's disclosures under FAS 123's fair-value regime, options expense has averaged about 15% of pre-tax income since 1995. That will make an important optical difference in reported earnings -- but the difference is, indeed, just optical: it has been disclosed all along.

But how will employees feel about getting restricted stock with a value equal to the Black Scholes value of the options they would have otherwise received? It's an interesting set of trade-offs. A grant of 1,000 options has a Black Scholes value of $11,772. A restricted stock grant of the same value would be 425 shares -- that gives the employee less than half the upside of the options. Functionally, it would be even less because the employee would have to pay ordinary income taxes on the restricted stock as soon as it vested -- options don't give rise to income tax until they are exercised. On the other side of the trade-off, with options the employee loses everything if they expire below their strike-price -- stock will always be worth *something* as long as the company exists.

If the balance of trade-offs seems tilted against restricted stock, Microsoft may choose to make grants in excess of the Black Scholes value of options that would have otherwise been granted. This would be consistent what we have pointed out before -- that the true economic expense of Microsoft's options issuance has been far greater than the Black-Scholes value (see "Stock Options Expense: The Big Truth" May 15, 2002). Based on a more accurate, complete and objective valuation measure -- Microsoft's tax deduction based on the intrinsic value of options exercised -- options expense has averaged about 70% of pre-tax income.

It is highly doubtful that Microsoft would dare to grant *that* much restricted stock, since its expense would have to be recorded in the income statement (when it was in the form of option exercises, it was neither recorded in the income statement nor fully disclosed in the notes). But it is entirely possible that the recorded expense may be greater than the 15% of pre-tax income than investors have been accustomed to, on average, from Microsoft's longstanding options program. And if it that happens, investors may well not object too loudly -- thanks to the reduction of dividend taxes. The tax cut creates a surplus -- the government's former take -- that can be divided among investors and employees. One way employees can get their share of the surplus is through liberal restricted stock grants.

While there is still much that is unknown, it's of fundamental importance to realize that this is the leading edge of a wave of restructuring set in motion by President Bush's dividend tax cuts. An economy that has for too long had to adapt to disappointment and catastrophe now has the chance to seize a substantive opportunity. TM