

A Tale of Two Companies

A Fable About Long Term Incentive Programs

Once upon a time, actually in 2005, there were two head to head competitors in the medical instruments industry named MediStuff and SurgiSys. Since this is a fable, we will pretend they are mirror images of each other, with one exception: the decision they made in 2005 regarding their long term incentive programs.

Up until then, both companies issued stock options to executives, managers and professional employees. Both companies believed that employee stock options aligned the interest of employees and shareholders, and provided an outstanding vehicle for attracting, retaining, and motivating key employees.

In 2005, however, the companies took a different path. As mandatory expensing of options loomed on the horizon, and shareholder advocacy groups lobbied for reduced option overhang, SurgiSys decided to replace their option program with restricted stock awards. Following the custom of the day, they issued one share of restricted stock for every three and half options they had formerly issued. MediStuff, on the other hand, believed that options were fundamental to their ownership culture, and in the long term would be far more effective at attracting, retaining, and motivating the key employees who were critical to the company's future. They launched a program to educate their shareholders on these benefits, and successfully convinced them to approve an new employee stock option program. But, they did something more, and that was to comprehensively educate their employees on these often misunderstood financial instruments.

The MediStuff education program provided each employee with a comprehensive report of their company stock and option holdings, and a workshop that helped them to understand the many concepts embodied in the report. Following are some of the concepts illustrated in the personalized report and explained in the workshops:

- **Their Forfeit Value®** - the value they would leave behind if they were to terminate their employment.
- **Their option leverage** – the increase in the value of their option holdings resulting from a 20% stock price increases
- **Their Insight Ratio** – a metric that helps employees determine when to exercise their options
- The role their company stock and options play in the achievement of **long term financial goals**.

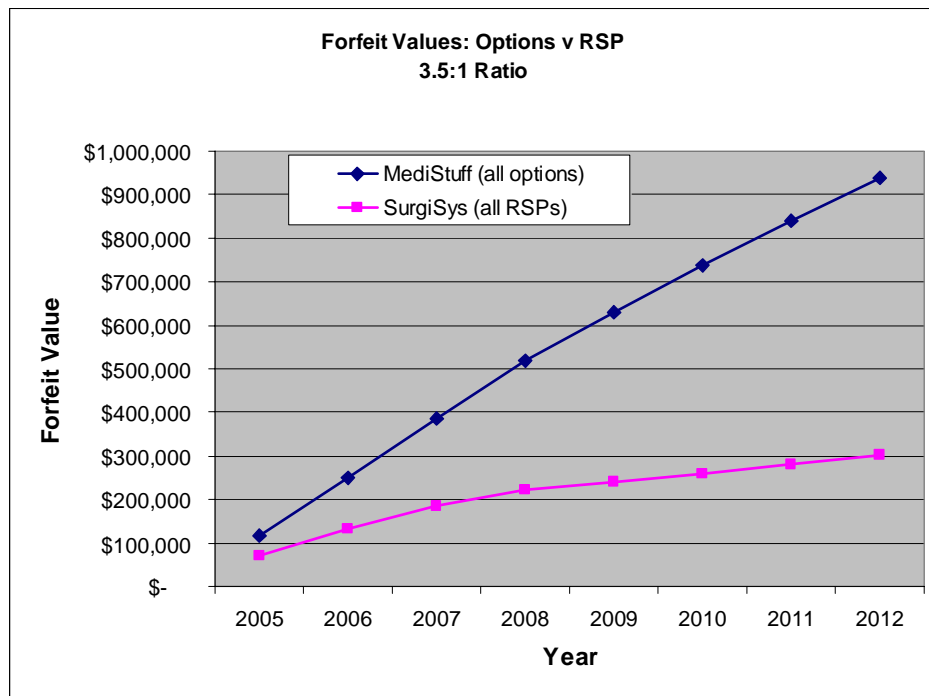
Within a few months of an employee receiving their first option grant, he or she went through the program to ensure that they fully understood the importance of the company's success to their financial future, and their

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importance to the success of the company. These programs were always introduced by the CEO or another senior officer of the company as the training offered a unique opportunity to establish linkage between the employee's contributions and the growth of the company's value. The executive introducing the program would always communicate the company's vision of growth and greatness. You see, MediStuff had a strong belief that great companies are built by employees who feel like owners and are excited by the opportunity to make a difference in the world.

Through the wonder of time travel, we now fast forward our fable to the year 2012. During the summer of that year, the Vice President of Research for SurgiSys and the Western Regional Director of Sales for MediStuff met at an industry sponsored golf match. They subsequently decided to start up a new medical instruments company based on pico-robotics that they named MedBotics. After raising \$35 million in venture capital, they set about recruiting their team. These entrepreneurs wanted to establish an ownership culture where employee buy-in would encourage innovation and dedication to their cause. They naturally decided to target the best and the brightest from their former employers, and attract them with generous option packages.

The chart below illustrates the Forfeit Value® over time for a MediStuff employee who received options and a SurgiSys employee who received restricted stock at the 3.5 ratio mentioned above.



Assumptions:

1. The MediStuff employee received option grants on 4,000 shares each year, while the SurgiSys employee received 1144 shares of restricted stock each year (3.5 to 1 ratio).

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2. In both cases, the grants vested at 25% per year beginning the year following the grant.
3. The MediStuff options expire 10 years from date of grant.
4. For both companies the stock price was \$57 per share in 2005, growing by 8% per year through 2012.

Note that by 2012, the Forfeit Value® for the MediStuff employee with options is three times greater than the Forfeit Value® for the SurgiSys employee who received restricted stock over the same period. Forfeit Value® is defined as the theoretical value an employee loses when they leave their company. This difference exists because options typically have significant value even after they vest (time value) as long as the employee stays with the company. Whereas once stock vests, the employee realizes the full value even if they terminate their employment.

Whereas fables typically have a moral, we will instead leave the reader with following questions:

1. Which company is most vulnerable to being raided by MedBotics?
2. Is it likely that SurgiSys foresaw this scenario when they decided to switch from options to restricted shares?
3. How important is on-going education to realization of the full impact of the Forfeit Value®
4. What would be required for SurgiSys to mitigate the Forfeit Value® differential that exists by 2012?
5. Which equity compensation program is likely to be most motivational to the employee? Why?