Silver Lining to Tech Stock Clouds?

Companies that lavish stock options on employees mull share buybacks when markets collapse.

By Brandt Johnson

Dell Computer does it. So do Adobe Systems and Microsoft Corp. But Nortel Networks can’t quite do it and hosts of dot.com start-ups only wish they could.

We’re talking about stock buybacks by technology companies. Their treasurers are acutely aware that the reservoirs of stock options awarded to corporate employees can not just dilute, but swamp, existing shareholders if the options are exercised willy-nilly. One way of diminishing the impact is to lower outstanding float by purchasing shares in the public markets. And with the recent swoon in technology stock prices, many treasurers say there has never been a better time to execute buyback programs.

Option-related shareholder dilution is “one of the biggest issues we face,” says Brent Callinicos, the newly appointed treasurer of Microsoft. The software giant has repurchased 764 million shares in the open market and granted employees 1.1 billion shares in various programs since it launched its first buyback plan in 1990. Callinicos says the company’s stock is now at “the best levels we’ve seen in 12 months at which to buy shares.”

Star-crossed Microsoft, unfortunately, has not been able to exploit its beaten-down stock price thanks to its pooling-of-interest purchase of Visio Corp. last January. (A pooling, under accounting rules, requires buyback programs to be suspended “in perpetuity” so that they do not counter the pooling effect. However, tax attorneys say companies can argue that programs can be reinstated after a minimum of six months, meaning Microsoft could come back with a program in mid-summer.)

The Redmond, Wash., company, meanwhile, is missing a bittersweet opportunity since its stock price had plummeted more than 44% between the beginning of the year and April 24, when this article was
being prepared. Nevertheless, Microsoft upped the dilution ante by announcing an eye-popping plan on April 25 to give employees options to buy about 70 million more company shares at $66.25 per share (their closing price on April 24 and well below Microsoft’s 52-week high of $119.937.) As of the end of last year, employees were sitting on 692 million unexercised options.

Combined with existing options, the shares that employees could exercise represent about 16% of Microsoft’s 5.24 billion common shares outstanding—not nearly as high as many dot.com companies but significant considering the company’s float.

Microsoft’s senior executives indicated that they launched the new option plan to calm employees’ jittery nerves. For the first time in its stunningly successful history, the company is battling internally to boost morale that has been shaken by the recent antitrust ruling against the company and government recommendations that a judge break Microsoft into two separate companies. Furthermore, the steep decline in Microsoft stock has created discontent throughout the company, as employees realize that many of their once valuable options are worthless for the time being because their exercise price is higher than the underlying shares’ market price.

The new program aims to “make a very strong statement to employees that this is the place to be for the long term,” Microsoft CFO John Connors told The Wall Street Journal.

Microsoft officials did not return calls for comment about the potential dilutive effects of the new option program.

Adobe’s Plan
Adobe Systems is adept at opportunistically retiring shares to offset its options grants. The San Jose, Calif.-based software company has had repurchase plan for more than eight years, and has been especially active during the recent market slide, says Barbara Hill, Adobe’s vice president and treasurer.

“We have been very successful … in stemming dilution and buying back our stock when the market has undervalued it,” Hill says. The program also has been a tonic. Adobe’s first-quarter earnings per share this year soared more than 36% from the year-earlier period, a span that closely coincided with a 5-million-share repurchase program launched in April 1999. As of December 1999, Adobe had more than 19 million options outstanding at a weighted average exercise price of around $37. Its stock closed at $104.75 on April 25, compared with its 52-week high of $125.

Other seasoned tech companies, as well as numerous “old economy” companies, have similar programs for disciplined buybacks. (Equity analysts generally approve of buybacks as a more efficient use of excess cash to reward shareholders than paying tax-laden dividends.) However, the buyback opportunity is not available to all publicly held tech companies. The great bulk of young dot.com companies do not
have cash—or the borrowing capacity—to buy back stock, particularly at the stratospheric levels at which many have been trading over the past two years. But even some option-heavy companies with loads of cash find it hard to launch programs when their shares are trading at what they apparently believe are inflated values.

At a recent treasurers’ conference, Joseph Coneybeare, a senior manager in corporate finance at Nortel Networks, buttonholed Pepsi Cola’s Matthew McKenna for advice on buybacks. The Pepsi treasurer had just made a presentation on the strong focus he keeps on the company’s ongoing repurchase programs.

“How can a technology company whose shares are trading at a big multiple [to its peer group] do this?” Coneybeare asked. McKenna, whose company’s stock price had been in a prolonged slump, had no answer.

Nortel, which on April 25 reported an unexpectedly high 80% jump in first-quarter revenues, had suffered a 25% dip in its share price over the two weeks ending on April 24. Even that did not stimulate the Canadian company to buy back shares.

“High multiples remain an issue,” Coneybeare said, noting that even at their nadir this year, Nortel shares were 400% to 500% more expensive than during its last buyback program in 1996/1997. He also cited “other factors” behind Nortel’s buyback reluctance. To be sure, the Brampton, Ontario, network systems company has more than $2 billion of cash on its balance sheet that could easily finance share repurchases. Meanwhile, like other longtime tech beneficiaries of the market boom, it has been using its high-priced shares for other purposes. “We find stock to be the best way to finance most of our acquisitions,” Coneybeare said. Indeed, the company recently announced acquisitions of two new technology companies for about $6.5 billion of stock.

The “I Love Lucy” Effect

While Nortel is making a conscious choice to avoid buybacks, most dot.coms could not initiate one even if they wanted to.

Buyback programs “tend to be a good idea for the more mature [tech] companies, the ones that have cash flow, that are more certain about what the future holds,” says Rick Escherich, head of mergers and acquisition research at J.P. Morgan Securities. Younger tech companies, on the other hand, have to spend whatever cash they have on business development.

Others are more severe about dot.com strategies, saying that the options these companies lavishly grant could destroy many of them (if the market doesn’t do it to them first).

“They are almost structurally doomed to failure,” observes Patrick McGurn, director of corporate programs at Institutional Shareholder Services in Rockville, Md. “Many of the [dot.coms] have no earnings to start with, and with every option they grant, the hole gets deeper.
For a while, that treadmill can run at a comfortable pace, but then, if
the speed continues to increase, you kind of use the visual picture of
Lucille Ball with the candy coming fast off the factory conveyor belt.
… The conveyor belt just gets ahead of you.”

Of course, some companies have factored their options programs into
their exit strategies. Most have change-of-control clauses that
accelerate the vesting of the options on purchase date and/or cash out
the holders. The old options also may be converted into those of an
acquiring company’s shares.

“Overhyped”
Despite treasurers’ and shareholders’ focus on dilution, some
partisans of the Silicon Valley way of life dismiss their concerns. The
issue is “overhyped,” says Matt Ward, chief executive officer of
WestWard Pay Strategies, an executive compensation consulting firm
in San Francisco. He encourages these firms to continue their option
grants and initiate buybacks when market declines present “a great
bargain.”

Morgan’s Escherich, for his part, says that not all options will translate
into stock purchases. His explanation, however, may be cold comfort
to option-granting companies.

“If the stocks don’t do well, those shares are not going to show up,”
he says, explaining that they will be out-of-the money. And though
Escherich advocates share repurchases for companies that can afford
them, he cautions that issuers should continually explore other outlets if
they have available cash to enhance shareholder value—including
outside investments and the repayment of debt.

Buybacks in the open market are not the only way to combat dilution,
of course. For large companies, “the buyback program by itself isn’t
really enough anymore,” Callinicos says. He notes that Microsoft has
for years sold put warrants to investors, guaranteeing that the
company would purchase shares back at a fixed price if they fell
below a certain range. Since the stock had always risen, Microsoft
built a considerable pile of premium income that it used to finance
more buybacks.

Adobe Systems and many other firms use similar strategies. “We have
developed an option strategy that does not rely on going into the open
market exclusively,” says Hill. “Rather, we set up our repurchases for
future quarters through an option program that we execute when
prices are at lower levels.” She adds that options “monetize the
volatility and take advantage of it to ‘fund’ your program.”

Callinicos notes that buybacks offer some compelling tax advantages.
The difference between the strike price of an exercised option (say
$20) and the actual market price (say $100) is tax-deductible, he
notes. Assuming a 35% marginal tax rate, the tax deduction is worth
$28 an option (0.35x$80). Microsoft uses the hundreds of millions of
dollars a year it receives from option exercises (and related tax
savings) to buy back more shares. “What we spend is that money,
and we have a formula for that,” the treasurer says. “And then, whether we do anything beyond that, that’s really opportunistic.”

When markets do create buyback opportunities, treasury staffs are quickly called into action. Companies that have announced buyback programs in advance and filed their plans with regulators can move within days to pounce on low prices, says Morgan’s Escherich. (If buyback plans have not been filed with regulators, a treasurer at a technology company says, there could be a delay of several weeks before the buying can begin.)

Treasury departments that can make opportunistic buys need plenty of planning—good relationships with investment banks must be in place, for example—and lots of adrenaline.

“It is quite hectic for the individuals who are managing high-tech repurchase programs on the days when the market takes a huge dive,” says Adobe Systems’ Hill. “We are all trying to get in touch with our contacts at the banks to get into the market at the same moment. Managing a stock repurchase program to take advantage of the dips requires daily attention to the market, the economy, etc. Thank goodness for blackout periods—you get a little respite.”

Whatever the circumstances, it’s certain that Adobe, Microsoft and their cash-rich tech brethren will continue to operate buyback programs, if only because of their pay structures. “We’re never going to have cash-driven compensation models,” Callinicos explains.

A Light Unto the Tech World

Some high-tech companies are better at managing dilution than others. Dell Computer Corp. has a generous stock option program and excellent dilution-fighting programs, admirers say. “Dell is the standard by which we measure ourselves,” declares Microsoft Treasurer Brent Callinicos. “It is a poster child for combatting dilution.”

Dell launched its first repurchase plan in early 1996, and it has subsequently repurchased shares every quarter. “It’s largely to provide the shares required for our employee compensation programs,” points out T.R. Reid, senior spokesman at the Round Rock, Tex., computer giant. The company had 320 million options outstanding at a weighted average price of $11.39 at the end of January. (Its market price in late April stood at about $50 a share.)

Dell repurchased 7 million shares in its fourth quarter, which ended on January 28, 2000, using some of its $835 million of free cash. Indeed, the company’s strong cash position is the key to its buyback consistency,

Reid says. —BJ
Buybacks in a Bullish Year

Number of Announced Programs in 1999—116 (from separate companies)

Announced Programs from High-tech Firms in 1999—14

$ Value of Announced Programs in 1999 —$500 million-plus per program

Source: Thomson Financial Securities Data

Financing Buybacks

An alternative to cash as a funding source for repurchases is debt. However, the option of borrowing to finance buybacks is usually unrealistic for young tech companies and some e-businesses. Their debt coverage capacity is unlikely to warm the hearts of lenders, and interest rates—if financing could be obtained—would be prohibitively high.

Noting dot.coms’ extensive use of employee options, one institutional investor advocate says that high-tech companies without profits may find the financing question moot since they will never be able to buy back enough shares.

Brent Callinicos, treasurer of Microsoft, says that borrowing to fund repurchases “absolutely makes sense” when interest rates are reasonable and stock prices are low. “Unfortunately, it’s unlikely that you ever end up with the ideal mix of extremely low interest rates and very cheap stock prices,” he notes. “But, it is entirely possible that there is a quantitative trade-off that is worthwhile from that standpoint.”

At Adobe Systems, Treasurer Barbara Hill gives a no-nonsense response to the question of whether it makes sense to borrow to fund stock repurchases. “If it adds shareholder value, then it makes sense.” “The handwriting’s on the wall,” says Patrick McGurn, director of corporate programs at Institutional Shareholder Services in Rockville, Md. “If they are not at the point of no return, they are getting pretty close to it.” —BJ