

Report *Dynamo* 41

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Stock Option Plans - I

In our last Report, we looked at some of the reasons why the trend towards variable pay is grabbing an increasing portion of executive compensation packages, and described the various different pay methods. Among them, stock option plans have shown the most unprecedented growth over the last twenty years and far outpaced the other systems. In the mid-sixties, the average unit value of these plans was approximately US\$ 16 thousand. At the close of the nineties, US CEOs were paid, on average, US\$ 9 million in stock options. This growth was

most apparent in the nineties when, for example, the total stock options granted in S&P 500 companies soared from US\$11 billion in 1992 to US\$119 billion in 2000. Moreover, hundreds of companies began granting stock options not only to their CEOs but also to most employees. It is estimated that, in 2000, between seven and ten million employees in the US had stock option plans.

As stock market launched its descent in 1999 and corporate scandals started to surge, stock options programs began to lose their

appeal. Enron, WorldCom, Global Crossing, among other companies, presented their investors with a peculiar prospect: rich executives *cum* poor shareholders. Stock option programs moved from being the heroes of incentives to efficiency to villains of inciting rashness, along the rocky road of "infectious greed". This new perception led to an interesting reaction in July 2003, when Microsoft, the model of corporate growth, and fertile ground for proliferation of options, announced that these would be fully substituted by restricted shares.

Natura facit saltus

The IPO of Natura Cosméticos was a success to which we were proud to be a part of. Although we were surprised, as were all other investors, by the fact that we got a much smaller stake than we had hoped for, the general feeling is extremely positive. At this point, we shall restrict our comments to the IPO transaction and its repercussion on our capital markets. We shall leave our examination of Natura's operational performance to a future occasion, including its growth drivers, which we find solid and interesting.

Our work on active equity management has taken us to the front of issues involving the viability of the Brazilian capital market. Surrounding this theme, there have been many discussions about the role of institutional environment, the specific laws and regulations, the alternatives for tackling the chronic lack of long term financing mechanisms, the barely existent culture of 'public company' entrepreneurship, the high cost of financial transactions, etc. More recently, after the maturing of some of these discussions and monitoring the comparative experiences in other markets, we began to encourage entrepreneurs from a wide variety of sectors of activities and business size to test the capital market as a competitive source of financing for their projects. We always point out that a sound business, conducted by competent and trustworthy individuals, in a transparent environment, with fair corporate arrangements,

can find financing at a competitive capital cost. But we lacked practical examples of success in this area. Now we have Natura.

According to the banks that led the transaction, the demand for Natura shares was ten times greater than the offer, and the price was set in the upper half of the suggested range. The implicit multiples were 7,9x EV/Ebitda and 10,7x P/E, according to the projections of the same banks for 2004, which represents a substantial premium over the Ibovespa. Natura shares opened 9.5% above the offer price, and was the most liquid stock on that day in the Bovespa (R\$ 160 million). Since then, the shares have reached R\$ 47,00, or 29% above the IPO price, with an average daily liquidity of R\$ 12 million.

This successful offering has beaten the stigma of secondary sales done by the controlling shareholder where the market would traditionally impose a higher discount for information asymmetry between buyers and sellers. In this case, the reason for the sale of the secondary shares became clear and buyers regarded the offer as an opportunity to be party to an interesting story, without the fear that they were simply providing a partial "exit" for the controlling shareholders.

The amounts involved in the operation make for an interesting exercise: the volume of funds obtained in the public offer was almost R\$680 million, before the green shoe allotment. If we were to imagine a project levered at the ratio of one-third, equity, and two-thirds, debt,

the transaction could have represented the financial feasibility of a US\$650 million project. If we assume further that the real demand was not ten, but five times the offer (as bid offers are usually artificially inflated), *voilà!*, our mental gym would reveal the potential availability of more than US\$ 3 billion for investments. There are very few companies in our market whose growth needs would not be more than satisfied with such a budget.

The cosmetics sector has experienced a quite remarkable momentum, geared by changes in consumption patterns and by alterations in global demographic profiles. There will always be those who interpret the success of the offering as a reflection of this favorable external environment, and justifying the success of the Natura offer with the much higher multiples of its international peers.

But the fact is that, after Natura's IPO, new deals are on the way. Perhaps this was the missing incentive to provoke the more skeptical entrepreneurs and bankers to believe in the equity market as a competitive financing source. Natura still has a long way to go as a public company, but there is clear evidence that this deal already represents a quality leap in the development of our capital markets. Says the old Latin principle, "Natura does not progress in leaps". With due deference to the ancients, in this case, *Natura facit saltus*. Naturally.

The idea now is to analyze this rise and fall of stock option plans. The topic is now an inherent part of the daily life of US economic and political news, as it affects companies' cash flows and citizen/shareholder's pockets. At the same time, it also involves calculations that are quite complex. The June 2001 edition of *Fortune* announced that Apple's CEO, Steve Jobs, received an options package worth US\$ 872 million. In his defense, the executive claimed that the real value of his options was zero. A mathematical pricing method at the time reached a market value of US\$ 170 million for this package. Herein lie the allure and the peril of stock option plans. It is very rare for a financial concept to be so widespread among people while, at the same time, being subject to such a huge discrepancy of valuations. That is why it is a difficult theme and why we became interested in writing about it.

Thus, we decided to split this task into two further Reports. In the present one, we describe the chief concepts of a stock option plan. We also analyze the status of this type of compensation in light of the idiosyncrasies of our (Brazilian) capital markets and suggest a few features for the design of new plans. In our next Report, we shall return to the context of the US market and analyze why these options packages acquired less than ideal formats and proportions, in order to understand the characteristics and the problems intrinsic to this method of compensation.

Concepts

Stock option plans are a set of general rules implemented via individual agreements whereby the company grants an employee the right to acquire some of its shares under specific pre-established conditions. Despite varying in format and system, as a general rule, the aim is to achieve a common objective of attracting and retaining qualified professionals, assuring these individuals a portion of the profits they helped to build, and aligning their interests with those of the shareholders. The agreement defines the grant periods, the eligible employees, the amount of underlying shares, in addition to the conditions for exercising and paying for these shares. As a rule, a Compensation Committee, usually comprised of members of the Board of Directors, is set up to manage these plans.

Under Brazilian corporate law, stock option plans need a specific provision in the company's by-laws. The general plan must then be submitted to shareholder's approval in a General Meeting. After that, the Board of Directors is empowered to grant the options, and the Compensation Committee is in charge of the allocation among the beneficiaries. The company then grants each nominee the right to buy the number of shares allocated to him/her, at a given price, over the time in which the plan is in force. This is called the option exer-

cise price, which is defined at the time the options are granted. Usually, this price is equivalent to the average of recent market quotations.

The company's expectation is that the efforts of its executives and staff will result in increased market prices for its shares. In this event, at the time the options are exercised, the beneficiary will purchase the shares at a price below the then prevailing market price, thus receiving a premium for his/her contribution to the company's success. Let us take a highly simplified example: let us imagine that an executive, qualified to take part in the program, receives a grant of 1,000 shares at R\$10 per share, the market price at the time. At the end of the vesting period, the executive will be able to exercise his/her right. If the market price on that date is R\$30 per share, he/she may acquire the shares from the company at the exercise price and immediately thereafter sell them in the market. This represents a gain of R\$20 per share or total gain of R\$20,000.

The nomenclature of stock option plans involves many diverse definitions. If the exerci-

port. For now, let's limit ourselves to examining the definitions.

Repricing is the mechanism whereby exercise prices are adjusted downwards to follow substantial declines in market prices. The idea is to ensure that the options become more *in-the-money* or, at least, less *underwater*. When the exercise price is adjusted based on an economic or performance index, this is known as an *indexed option*. As a rule, exercise prices are not usually adjusted for dividend distribution. In other words, dividend payments tend to render options more *out-of-the-money* (or less *in-the-money*), since the market price is normally adjusted down but not the exercise price. Plans are subject to *vesting rules*, which define the minimum period after which options may be exercised and the shares can be sold at the marketplace. A vesting period may fall due on a single occasion or, equally, may be scaled over a period of years, depending on goals achieved or a combination of the above alternatives. Periods of less than a year also occur, but rarely, since it is more usual for US companies to apply the 25% equal annual vesting method over a four-year period. At the close of the vesting period, the employee who exercises his/her option becomes a company shareholder, with all the rights inherent to this asset. The total option life is generally ten years. Options may be exercised in cash, using company loans as funding, through swaps of shares received in prior grants, with the profits obtained on exercising the options in question, or via stocks appreciation rights, under hybrid plans. Some plans offer additional

incentives encouraging employees to retain their shares for as long as possible.

For the companies, the aim of stock option plans is to retain and motivate key staff, by offering them a participation on the success of the corporation. They create a corporate culture of "ownership", and motivate and reward long-term efforts while, at the same time, avoiding fixed costs and postponing expenses. Conceptually, if the price of the share is the best measure of corporate success (which it unquestionably is for the shareholders), then the transformation of employees into shareholders should be the ideal method for linking compensation to performance. It would be even more interesting to successfully align these interests without an immediate cash disbursement. Thus, the appeal of stock option packages is to attain the specific target objectives of compensation mechanisms, to attract, motivate, and retain highly qualified staff, with the further ability to: i) minimize agency costs by aligning company interests; ii) incorporate market opinion as a performance judgment criterion; and iii) institute an alternative source of capital to finance expenses on compensation during corporate growth.

It is a long way from the concept to the results. The route of stock option plans in US

Dynamo Cougar x Ibovespa x FGV-100 *Performance up to march/2004 (in R\$)*

Period	Dynamo Cougar	FGV-100	Ibovespa
60 months	483,94%	451,90%	103,37%
36 months	138,02%	159,56%	56,24%
24 months	107,11%	129,31%	65,17%
12 months	68,55%	108,03%	95,60%
3 months	5,37%	3,04%	-0,74%
NAV/Share on 31/mar/2004 = 60,219273595			

se price is the same as market price, the option is deemed to have been granted *at-the-money*. If the exercise price is greater or less than market price, the option will have been granted *in-the-money* or *out-of-the-money*, respectively. Throughout the duration of the plan, if the market price drops below the exercise price, the options become *underwater*, i.e., they have no value to their holders. The *intrinsic value* of the option is the difference between market and exercise price. Accordingly, options with a positive intrinsic value are *in-the-money*. *Fair value* is that shown by an option pricing model based on market criteria, such as Black-Scholes (BS). The mathematical option price calculation via BS is one of the most complex and useful formulas in finance, and was devised by Fisher Black and Myron Scholes, who were awarded the Nobel Economics Prize for this work. Option value is defined as being a function of: (i) the price of the underlying stock, (ii) the maturity of the options, (iii) the exercise price, (iv) the interest rate, and (v) the volatility of the underlying stock, where the mathematical relationship between the stock price and the option value derive from an exponential function. This feature represents significant implications in stock option package incentives. But this will be discussed in the next Re-

companies suffered important deviations, losing momentum in compensation packages, to the point where it began to be associated with bad corporate governance policy. We would need considerably more space to retrace this meandering path. Thereupon, we left this task for our next Report. For the moment, it should suffice to convey the insight that, in the US model, the process for establishing stock option plans reveals a latent conflict: the CEO is the subject and the object of the agreement, since it is he/she who controls the Board of Directors, which is responsible for shaping and deciding on the CEO's own compensation package.

In Brazil

Pay packages linked to stock performance are still relatively uncommon in our corporate culture. While the US market is concerned with controlling the obesity of its stock option plans, here, we still lack the calories essential to align interests via the capital market.

A characteristic of our market is the defined control of the ownership of capital. It is the controlling shareholders themselves who contract managers and are responsible for shaping their compensation packages. As such, in Brazil, the relationship is inverse: it is not the executives who manipulate the Boards, but the board members who control management. If the cost of stock option compensation is the dilution of shareholders, board members elected by them will tend to be diligent in this method of contracting. We live in an environment where opportunities for abuses such as the ones that occurred in the U.S. recently are significantly fewer¹, the exception being when the controlling shareholders hold the majority of management positions. In this situation, controlling shareholders will have incentives for the appropriation of private benefits², and these incentives will be as big as smaller is their economic interest in the company.

We have written before about the potential for a misalignment of interests that could arise from the combination of concentrated ownership and the existence of preferred shares without tag along rights in Brazilian capital market. This could stimulate management to exclusively maximize control premium, condemning shares outside the majority block to oblivion (see Dynamo Reports n. 25 and 26). Accordingly, stock option plans can be an important reassurance for minority shareholders, signaling that senior management is really interested in the performance of company's shares (assuming that the program involves the shares of the same kind as those held by the outside investors). Consequently, compensation plans linked to stock performance are welcomed. Here, we would dare to recommend some features for a stock option program adapted to our market environment³:

Our Performance

Dynamo Cougar's shares rose 5.4% during the first quarter of 2004, which compares with 1.2% for the IBX and an actual fall of 0.7% for the Ibovespa. Since inception on September 1993, the compounded annual return was 32.6%^{pa} in US dollars and 31.2%^{pa} if measured in relation to the inflation index, IGP-M. Comparable figures for the Ibovespa are 9.5%^{pa} in US dollars and 8.4%^{pa} in IGP-M.

Most of the optimism for 2004 faded as the first quarter progressed. After a good start for the year, where most indices went up nicely, expectations were reversed and the Ibovespa index closed the quarter with a negative return.

Although we benefited from the environment of positive expectations, our portfolio continued to reflect our more cautious perception about the fundamentals required for a sustained phase of GDP growth. We continued to have exposure to exporting companies, where we could identify long-term comparative advantages and that were not significantly dependent on the impact of domestic income levels. In this context, we kept a high percentage of the portfolio in companies whose revenue dynamics are mainly dictated by foreign market. Thus, VCP became our top position.

Another highlight for the quarter was Ambev ON. After the announced "merger" with

Interbrew, Ambev's non-controlling common shareholders will be granted their lawful tag along rights and, as such, will be entitled to receive the equivalent of 13.74 Interbrew shares for every 1,000 Ambev shares. Accordingly, until the final tender for the ON shares is made, they will be traded as proxies for Interbrew. In other words, the value of Ambev common shares can be interpreted as being a function of the price of Interbrew's shares in Europe, the Euro/Real exchange rate and the probability attributed to the closing of this transaction.

With the announcement of this transaction, common shares of Ambev went up significantly. Even so, they still traded at a large discount in relation to the parity given by the tender to be made by Interbrew. As such, in view of this high discount and the low probability we ascribe to the deal not occurring, we kept our position in Ambev's common shares.

The prospects for the economy during the remainder of 2004 remain unclear. At present, there are many positive and many negative points. Despite this low visibility, we are optimistic about the market for IPO's in Brazil. There should be more IPO's in 2004 than the sum of all of those from 2000 to 2003. For this very reason, we dedicate a portion of this Report to the first of such offers, Natura.

- i) The underlying shares must be identical to those held by non-controlling shareholders: For example, there will be no alignment of interests for shareholders holding preferred shares if the executives have their plans based on common shares.
- ii) Options should be adjusted to dividends: For the shareholder, what matters is the total return of the stock and not just its appreciation. If options are not adjusted for the payment of dividends, this will represent an incentive for the executives to retain profits, which frequently results in lesser returns for the shareholders;
- iii) Options should be indexed: The index can be based on the performance of the overall market or the specific sector as measured simply by an average return of a basket of shares as opposed to a liquidity-based index such as the most popular ones in Brazil. Extra-good returns could even be removed from the base to ensure that the comparison applies only to mediocre performances. Alternatively, a minimum indexation linked some basic interest rate within the concept of risk-free rate, could be used to reflect the opportunity cost of capital and to prevent the executives being compensated when the shareholders are subject to a negative return.
- iv) Prohibition of repricing: At this initial stage, the options are unlikely to represent a significant portion of Brazilian executives' total compensation. But, when this is the case, if the shares drop to a region where the incentives to retain staff become weak, a new exercise price could even be considered, but the number of shares must be adjusted downwards, taking into consideration considering the market value of the previous grant.
- v) Establish and disclose the dates for granting packages, in order to prevent "gaming" problems: The aim here is to restrict management's opportunities to manipulate the timing of relevant information based on the proximity of the grants dates.
- vi) Establish a vesting period of at least five years.
- vii) Make it compulsory for the profit, or at least part of it, on the exercise of existing options, to be converted into the purchase of new shares, which sale would be restricted for a

(1) Nevertheless, the Regulatory Authorities were diligent in establishing that stock option plan deviations are deemed to be a category of abuse of the power to control, where their practitioners incur the penalties applicable to grave infractions (CVM Instruction. 323 Art. 1, Item XI).

(2) This type of behavior is also known as tunneling, and was discussed in Dynamo Letters 25, 26, and 33.

(3) The greater part of this list is borrowed from Crystal, G. *The Perfect Stock Option Plan* prepared for The California State Teachers' Retirement System, 2003.

specific period: The idea here is to prevent short term gains based on the volatility of the markets and also to stimulate a long-term bias.

- viii) Establish a rule stating that, three years prior to retirement, executives become ineligible to participate in stock option plans: This should prevent risky and/or short-term focused managerial decisions, particularly if these executive's options are seriously underwater.
- ix) The option life should not be extended beyond three years after an executive's retirement.

Another important aspect is that the stock option packages must be approved in a General Meeting by all the shareholders, including the ones holding preferred shares. This is because the dilution of total capital arising from the issue of new shares affects all classes of shares equally.

Lastly, the slow beginning of the use of stock option plans in Brazil explains the fact that the debate on the labor, tax, and accounting implications involved is much more infrequent here. On these aspects, it is worth noting that: i) the predominant legal interpretation is that a stock option plan is a business agreement based on corporate legislation, and should not be confused with labor-related obligations, since the option is merely the expectation of a right and not a benefit that becomes automatically incorporated into the employee's entitlements; ii) as yet, we do not even have specific tax legislation on the matter; and iii) the CVM's technical department believes that companies should account for the granting of options as an expense, but have not expressly manifested themselves on the matter (*Ofício-Circular CVM/SNC/SEP No. 01/2004*). Meanwhile, companies must observe the minimum requirements for disclosure in the 'notes to the consolidated financial statements', required by *Deliberação CVM No. 37*.

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Given the evidence that we lack instruments for alignment of interests based on capital markets, compensation mechanisms based on the performance of stocks should be promoted and encouraged. In this respect, stock option packages are very timely, given their proven efficiency in creating an "owner's attitude" among executives and employees. Moreover, in Brazil, a combination of concentrated capital ownership and corporate culture makes our environment much less vulnerable to the distortions observed abroad. In our next Report, we shall examine the experiences of large US corporations. This will serve as a subsidy for the analysis of an improvement in the model: we believe the issue of restricted shares could represent an interesting alternative for market compensation.

Rio de Janeiro, June 19th, 2004.

Dynamo Cougar x Ibovespa x FGV-100 (in US\$ dollars)

Period	DYNAMO COUGAR*			FGV-100**			IBOVESPA***		
	Quarter	Year to Date	Since 01/09/93	Quarter	Year to Date	Since 01/09/93	Quarter	Year to Date	Since 01/09/93
1993	-	38,78	38,78	-	9,07	9,07	-	11,12	11,12
1994	-	245,55	379,54	-	165,25	189,30	-	58,59	76,22
1995	-	-3,62	362,20	-	-35,06	87,87	-	-13,48	52,47
1996	-	53,56	609,75	-	6,62	100,30	-	53,19	133,57
1997	-	-6,20	565,50	-	-4,10	92,00	-	34,40	213,80
1998	-	-19,14	438,13	-	-31,49	31,54	-	-38,4	93,27
1999	-	104,64	1001,24	-	116,46	184,73	-	69,49	227,58
2000	-	3,02	1034,53	-7,69	-2,63	177,23	-10,45	-18,08	168,33
1 st Quar/01	-0,98	-0,98	1023,40	-10,06	-10,06	149,33	-16,00	-16,00	125,39
2 nd Quar/01	-6,15	-7,07	954,28	-1,76	-11,64	144,95	-3,73	-19,14	116,97
3 rd Quar/01	-27,25	-32,40	666,97	-33,81	-41,52	62,12	-36,93	-49,00	36,84
4 th Quar/01	38,52	-6,36	962,40	55,88	-8,84	152,71	49,07	-23,98	103,99
1 st Quar/02	13,05	13,05	1101,05	3,89	3,89	162,55	-2,76	-2,76	98,35
2 nd Quar/02	-19,15	-8,60	871,04	-22,45	-19,43	103,60	-31,62	-33,51	35,63
3 rd Quar/02	-22,31	-28,99	654,37	-31,78	-45,04	38,90	-44,17	-62,88	-24,28
4 th Quar/02	29,76	-7,86	878,90	38,00	-24,15	91,67	45,43	-46,01	10,12
1 st Quar/03	4,47	4,47	922,65	4,63	4,63	100,55	5,39	5,39	16,06
2 nd Quar/03	27,29	32,98	1201,73	38,16	44,55	177,07	34,33	41,58	55,91
3 rd Quar/03	19,37	58,73	1453,83	24,72	80,29	245,56	22,34	73,20	90,74
4 th Quar/03	22,18	93,94	1798,51	35,98	145,16	369,91	39,17	141,04	165,44
1 st Quar/04	4,67	4,67	1887,16	2,35	2,35	380,16	-1,40	-1,40	161,72
Average Net Asset Value for Dynamo Cougar (Last 36 months): R\$ 168.769.038,73									

(*) The Dynamo Cougar Fund figures are audited by KPMG and returns net of all costs and fees, except for Adjustment of Performance Fee, if due.

(**) Index that includes 100 companies, but excludes banks and state-owned companies. (***) Ibovespa average.

Please visit our website if you would like to compare the performance of Dynamo funds to other indices.

For any further information,
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