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Right-Sizing Stock Option Grants at High-Growth, High-Volatility Biotech Firms

High-growth biotech companies can benefit greatly from alternative methods for right-sizing employee stock option grants, but no method is free from potential drawbacks.

Compensation professionals at high-growth life sciences companies with unpredictable stock prices often face difficult decisions when it comes to evaluating the size of employee stock option grants. They need to find the best way to right-size option awards so that grants don't far exceed market benchmarks, while still enabling employees to be appropriately rewarded and reap the benefits of contributing to a highly successful company.

It's a dilemma we see at many of our biotech clients, and the struggle has only grown more severe over the past several years as company valuations in the industry soar. What's more, recent market corrections have not really eased concerns around this issue, as the market continues to oscillate with high levels of volatility. Biotech companies are heavily reliant on stock options and many companies have stock prices that are rising at an exponential rate given the premium the market is placing on new technologies that aim to improve patient lives. For life sciences companies, this is an acute concern as the results of drug trials and FDA approvals can make or break years of research and development— as well as invite swift and massive reactions from investors.

Given these factors, one approach that can be effective, under the right circumstances, for balancing employee rewards with investor interests is to develop stock option grant guidelines based on the annual percentage of ownership given to employees, otherwise known as *annual opportunity*. The annual opportunity approach is not a long-term solution, and determining grant sizes in this somewhat unconventional manner can create a few specific drawbacks. Yet, for companies experiencing exponential growth rates, more conventional means for setting grant guidelines can quickly become untenable.

Traditional vs. Annual Opportunity Approaches

Before we go into more detail about how to implement an annual opportunity approach, let's first discuss traditional approaches for calculating the size of stock option awards. There are several common methodologies in use today. Younger companies tend to grant options based on a fixed number of shares (e.g., an employee receives 5,000 shares annually based on a $7 strike price— the total value of which can change depending upon the current stock price). This approach is straight-forward to communicate to employees and is easy to implement.

As a company matures, it often transitions to a value-based approach for determining the size of stock option grants. This method is beneficial for companies that have more predictable stock valuations and generally orient

employees toward a “total compensation” view. In this model, the focus is on value transfer to employees, not the fact that the number of shares received each year may be declining. However, if a company’s stock price is rising rapidly, new option grants can quickly become demotivating.

That may sound counterintuitive at first, but consider this example. If an employee is eligible for $50,000 in stock option grants each year and the stock price climbs from $20/per share to $50/per share, the number of options granted would then fall from 5,000 to 2,000, assuming a Black-Scholes value of 50% of face value. From the employee’s perspective, it might seem unfair to see the number options they receive fall by more than half, while the strike price of those options has more than doubled. This is especially true if the change is rapid in volatile markets. Those high-priced options could quickly be well underwater.

With this said, a value-based approach works very well for a large number of our clients and we often recommend this model. It’s just important to consider the context in which you operate. If your stock price is fairly predictable and less volatile, a value-based approach is a great long-term solution.

However, in a high-growth scenario, the annual opportunity approach mentioned earlier may be more appropriate. At Radford, we define ‘annual opportunity’ as the number of annual stock option equivalents granted to an employee expressed as a percent of basic total shares outstanding. Public company executives and pre-IPO companies will be familiar with this measurement. Public companies evaluate this metric as part of their annual dilution or burn rate practices and pre-IPO companies orient around percent ownership given their financing twists and turns and the broader market valuation changes they are subject to. There is a key difference, though: pre-IPO ownership looks at total holdings, whereas an annual opportunity approach isolates awards made in the last grant cycle. This allows each stock option award to be calculated with more precision.

So how does annual opportunity work? The following example describes how the method can be implemented:

Sample Illustration of Annual Opportunity vs. Value-Based Approach

Alpha Company has 15 million basic total shares outstanding and grants 20,000 options to an employee. This translates to an annual opportunity of 0.133% of the company. Regardless of whether the company is trading at $20/share or $50/share, the percent of company stays constant; however, the value changes dramatically. If the stock is trading at $20/per share, the grant would be valued at $200,000. At a $50/per share stock price, that same award would swell to $500,000 (assuming a Black-Scholes value of 50% of face value in both instances).

Conversely, Beta Company targets annual grants at $200,000 in value and also has 15 million basic shares outstanding. At a stock price of $20/share, that would require a grant of 20,000 options, or 0.133% ownership— the same as Alpha Company. However, at a $50/per share stock price, the value approach would call for the number of options to reduce to 8,000 options, or 0.053% ownership.

This example highlights both the benefit and drawback of this methodology. Is it better to provide the same number of shares and report values that are 2.5x higher than the prior year? Or is it better to reduce the number of shares awarded by 60% to maintain a constant value?

The annual opportunity approach— also called annual grant as percent of the company— works well for all employees of companies with unpredictable or volatile stock prices because it is considerate of appropriate total employee annual dilution rates and does not over-react to short-term or extreme changes in value. However, the approach is not without flaws, which we describe below. It is because of these drawbacks that many of our high-growth biotech clients only partially embrace the annual opportunity approach. Ultimately, the decision comes down to each company's risk profile, workforce composition and investor base.

Challenges with the Annual Opportunity Approach

The annual opportunity approach may seem like a perfect solution for companies that are challenged in delivering consistent long-term equity incentive grants to their employees because of high stock price volatility. However, it's important to note that it's also a non-standard methodology for determining and communicating equity awards. As with any non-standard approach to compensation, unique challenges will follow.

The primary hurdle is effectively explaining the approach to employees and what it means for their total direct compensation package. But secondary to that, will be the challenge of communicating to investors and proxy advisors the reasons behind the decision to stray from standard (and universally accepted) accounting methodologies. Institutional Shareholder Services (ISS) and Glass Lewis, the predominant proxy advisory firms in the United States, tend to scrutinize methodologies for calculating equity compensation that could result in large sums, which may exceed the target pay position for specific job levels. That could also create target benchmarking problems and overstate reported values over time if companies set awards using a non-standard framework.

Organizations may also find that not all of their peers use this approach, and, therefore, incentive payouts could exceed their peer benchmarks. Overall, fairness and optics must be considered, often in conjunction with understanding the impact of using more traditional methodologies like Black-Scholes— which arguably is also flawed but in different ways.

Adopting a Blended View

Several biotech companies have begun using a blend of value-based and annual opportunity approaches to determine the size of stock grants in a more nuanced fashion. This hybrid approach balances traditional option valuation methodologies against the potential for volatile stock price swings by not over-reacting to short-term valuation changes.

Another method that circumvents the entire stock option valuation debate is to abandon options all together, or to limit to the use of options to key employees and executives. Life sciences companies haven't embraced alternative equity vehicles— such as restricted stock or restricted stock units (RSUs)— nearly as much as technology companies, but a migration is still taking place. Our research finds life sciences companies have gone from being nearly 100% option-centric in their equity awards in 2003 to a little over 75% option centric in 2013 (see our article *Restricted Stock Units (RSUs) Are Everywhere, But Are They Right For You?* for more information). Any time a company considers switching to a different equity vehicle, human resources, compensation professionals and the board of directors should consider factors such as the available equity pool, expected hiring plans, dilution constraints, tax implications, and expected future stock performance.

Next Steps

Determining stock option grants based on targeting a percentage of ownership for each job level makes sense in certain situations, particularly in the current environment biotech companies are operating in, but it shouldn't be viewed as a permanent solution. High-growth companies will eventually stabilize, at which point they should consider switching to a value-based approach for calculating the size of stock option awards. Stock prices for biotech companies tend to stabilize once the company begins commercial operations, or forms a partnership with a larger pharmaceutical company, which is increasingly common. Once either of these milestones is reached, any company using an annual opportunity approach should revisit its methodology with input from the compensation committee, senior human resources leaders and compensation professionals.

In the meantime, while the good times continue to roll for many young biotech companies, it's prudent to explore alternative methods to determining equity grant sizes that both motivate employees by allowing them to prosper from the company's own success but don't amount to totals that far exceed benchmarks for that position—as doing so risks internal pay equity issues and soliciting criticism from investors and proxy advisors.

Like many things in life, balance is the key. Each long-term incentive methodology in-and-of-itself is problematic, so it's good practice to consider multiple approaches, the merits of each, and what is most applicable to your unique business situation.

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