Pearl Meyer

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One Small Change for a More Durable Biotech Equity Pool

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After a multi-year bull run in biotech, the sector has experienced a new protracted down market driven by the higher cost of capital, changes in investor risk appetite, and general negative sentiment. Given this environment, many biotechs have had to make the difficult decision to reduce their workforce to extend their cash runway. The need to conserve cash further limits employers' tools to adequately motivate and retain critical talent to move the business forward. To compound things even further, many biotechs have a significant portion of outstanding equity in the form of underwater stock options. These options now lack motivational or retentive power, and also create a drag on the available pool to grant new equity.

All of these factors lead to the need for a more durable equity pool that can better serve the needs of the company as it progresses toward achieving its mission.

So how can we make a more durable equity pool?

We should begin with a recognition that the current design of employee stock options hasn't changed much over the last 30 years. At the same time, almost everything else about executive compensation has changed—in some cases dramatically. In most companies offering equity incentives, employees receive stock options with a 10-year term to exercise and a four-year vesting schedule. Generally speaking, these awards will remain outstanding until either the employee exercises the option, leaves the company, or the company is acquired. Experience and data suggest that employees will exercise their in-the-money options well before the 10-year term ends.

What we are currently experiencing is that most life sciences companies that granted options over the last 10 years now have "underwater" awards, meaning the options have a much higher strike price than the stock's current trading price, rendering them valueless in terms of retentive or motivational value. They also represent a drag on a company's available equity pool as they are outstanding but not able to be exercised.

A recent analysis showed that among biopharmaceutical companies with less than $2B in market value, 77% had a majority of their outstanding stock options underwater as of the fiscal year end. The median level of "out-of-the-moneyness" among this group of companies was 70%, meaning that the strike price on the option was 70% higher than the current price of the company's stock. With this level of disconnect, many of these awards not only lack any motivational or retentive power, they are actually demotivational.

We have seen many companies explore, and some execute, stock option repricings or exchanges during this time, which is an attempt to repurpose equity that has not achieved its objectives. These programs either change the exercise price for the option holder (repricing) or allow the holder to exchange their underwater options for new options or other equity awards. This approach is not usually easy, as many companies require shareholder approval for these actions, and they can be particularly costly and burdensome to implement.

A more innovative way to accomplish the elimination of underwater options may be to add an auto-forfeit feature into any new stock option awards. This is a provision in the award agreement that will bring significantly underwater options back into the pool for reuse. The option holder loses the ability to exercise as the grant would be forfeited; however, the likelihood that they would actually exercise the options is quite low when these awards hold no value.

How does this work?

There are a variety of ways that an auto-forfeiture provision can be structured. In its simplest form, the agreement could stipulate that on, for example, the fifth anniversary of the grant date, and each anniversary thereafter until the term is reached, if the price of the company's stock is more than 50% lower than the exercise price, the option is automatically forfeited and returned back to the equity pool. Companies can tailor aspects of this to their specific needs, including how deeply underwater the option needs to be, the measurement period, the method for measuring the stock price, and so on. Another example of customization, as well as simplification, is to have one measurement period for all options granted in a given year which reduces administrative burden.

Should you consider it?

Unfortunately, this kind of provision can't be implemented retroactively, so the decision is more about planning for the future and avoiding history repeating itself. The following high-level steps are helpful if your company has interest in exploring this concept.

1. Seek legal counsel on the feasibility of this approach, including, but not limited to, checking your stock plan(s) to ensure that forfeited stock options return back to the available pool for reissuance.
2. Seek advice from the finance group (or outside equity valuation experts) on the valuation of stock options with these provisions to ensure they are able to implement this structure on the accounting side. It is likely accounting will require a more sophisticated option valuation methodology than the standard Black-Scholes option pricing model that many companies use.
3. Assess the impact based on the go-forward compensation program, including but not limited to, how significant the option grants are as a percentage of the overall equity grants made, the likelihood of grants being materially underwater in the future, etc.
4. Socialize this concept and the analysis with the appropriate senior leaders in the company, and if aligned, the compensation committee of the board.
5. Establish the language to use in future award agreements, as well as processes and protocols to ensure that the grants do not run afoul of any accounting or legal rules.
6. Develop language for plan participants that explains the new provision, including its benefits to the company and benefits to the plan participant.

Why the benefits can be worth the effort

I imagine that many companies currently dealing with a constrained equity pool wish they had this feature in place for stock option grants made during the last five to 10 years. Unfortunately, it isn't practical to make this change retrospectively, but doing so prospectively can help the company manage challenging times in the future with limited drawbacks for companies and employees.

About the Author

Terry Newth is a managing director at Pearl Meyer. He consults on the design, development, and assessment of executive compensation programs that support each organization's business objectives, long term business strategy, and organizational culture. His clients range from Fortune 500 organizations to pre-IPOs to private and family-owned companies in a wide range of industries. Terry's areas of expertise include pay strategy and philosophy development, market-based pay studies, incentive plan design, severance and CIC arrangements, outside director pay, transaction-related compensation, CD&A and supporting table disclosures, corporate governance, and share plan authorizations.

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