

# Executive Stock Option Contract Increases Firm Value and Performance: A Case Study on Starbucks Company

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## Abstract

A diversified stock option plan design plays a crucial role in the effectiveness of option contracts management and elimination of the free-rider problem. The aim of this study is to examine how a company can be used stock options in risk management and solving the agency problem rewarding employees and managers. The stock options plans offered by Starbucks engage all employees and executives into the ownership providing appropriate motivation and incentive and solving the agency problem. However, the study found that, this could also trigger more risk taking on the part of the top managers.

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**Index terms**— contracts management and elimination of the free-rider problem.

## 1 Introduction

The aim of this study is to assess the use of stock options contracts in risk management. Stock options are derivative instruments that provide a right to the holder to purchase the stock of the company, which is used as the underlying asset. This opportunity to purchase stocks is provided in return for a premium or as a compensation for work. Yet, there is no obligation that the options have to be exercised. The desire of firms to manage financial and other risks effectively and thus maximise shareholders' wealth encourages the use of equity incentives in various forms including stock options. By using stock options, the company can reduce its risk by keeping managers interested in maintaining high value of the company and good performance (Core, Guay and Larcker, 2003). Moreover, if the company is involved in stock trading and purchases of shares of other companies, stock options can be used as hedging instruments to protect against the downside risk.

With the rapid growth of the markets in the 1990s, many companies adopted employee stock options at all levels of their organisations without any specific attention to the stock option plans design. This illustrates the expansion of the use of stock options not only in risk management and trading but also as a reward system (Brandes, Dharwadkar, and Lemesis, 2003). While the shareholders expect to negate risk aversion among managers, managers with large stock holdings appear to undertake risk-reducing actions (May, 1995). That points to the direct correlation between the effectiveness of compensation plans and overall company performance. The direct relation between the use of stock options and risk taking has been empirically proven (Rajgopal and Shevlin, 2002).

The main objective of this paper is to discuss the general use of stock option contracts in risk management of companies. This is done by reviewing the literature on how options influence executives' risk taking and conducting a case study of Starbucks Corporation.

In the first, theoretical, part of the paper the literature concerning the general use of stock options, how they work and how they impact risk and risk management is reviewed. In the second part of the paper the application of the stock options at Starbucks Corporation is assessed using the information provided by the company in its annual reports (Starbucks Corporation, 2013).

## 2 II.

### 3 Literature Review

There is a variety of stock options available for companies and investors. They include American options, European options, barrier options, Asian options, and other exotic options. There are also stock options as a form of employee and management compensation. There is a put option and a call option. The former entitles the holder to sell underlying shares whereas call options give the right to buy shares.

In terms of non-cash compensation, stock option can be defined as a right to purchase shares of the corporation "at or below the market price at the time the option is granted for a specified period of years" (Downes and Goodman, 2010, p. 708) in quantities that are indicated in the stock option contract. Important grant details of the stock option agreement include exercise price per share, vesting commencement date, and expiration date (Kolb, 2012). Exercise price, also referred to as the strike price, is the price at which the holder of an option can buy the underlying asset, namely stocks of the company. Vesting period is the period of time between the date when the option was granted and the time the options can be owned and exercised. An exercise price remains fixed and can be exercised no earlier than the vesting date and no later than the expiration date. However, European options do not allow for an earlier exercise. There is a fixed date (Oyer and Schaefer, 2002).

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## 5 C

The cash profit is usually gained with the exercise of the stock options and the sale of the stock, otherwise the option is not exercised and investor incurs a loss equal to the premium paid (Heath, Huddart and Lang, 1999).

In the context of the stock options used by companies as a form of managing the risk taken by employees and managers, Olagues and Summa (2010) suggest that maximisation of the long-term potential value can be reached through avoiding exercise, because exercising long before the expiration date leads to forfeiture of the time premium, which is often quite big, especially if the stock is volatile. Not to mention that any intrinsic value of the options becomes subject to taxation.

Companies widely use employee stock options as a part of compensation package to retain and encourage executives to act in the shareholders' interests and link this form of compensation to valuebuilding performance. Such options serve as one of the risk management tools in companies (Marin, 2008).

Stock options provide incentives to top managers to influence the value of the firm by taking actions to increase the stock value which is of benefit to other shareholders (Kolb and Overdahl, 2010). Those actions would be risk-taking actions since option value increases with volatility. This argument is consistent with the Agency theory proposed by Jensen and Meckling (1976) who show that stock options spur risk-taking by managers. Gormley, Matsa and Milbourn (2013) also agree that stock options provided by the company increase risk taking by company managers. However Carpenter (2000) says that stock options will not necessarily lead to greater risk by explaining that risk-averse managers who own more options and thus being more exposed may choose a rather safer strategy. Ross (2004, p. 224) points that the relationship between the use of stock options and risk taking by managers depends on the manager's utility function by saying that "It is routine for commentators to argue that call options increase the manager's willingness to take risk. We now know, though, that this also depends on the wealth effect of the options" (Ross, 2004, p.224). Kadan and Swinkels (2006) with their empirical research results complement Ross and Carpenter's findings on the statement that the changes in the distribution of stock options within a company do not necessarily impact in the obvious direction in the presence of a risk-averse leader. In other words, higher effort impelled by more options does not always provide significant changes in volatility of the stock price (Hall, 2003).

Risk-averse executives seek to diversify their personal portfolios, so they are prone for premature exercise and partly because of that they might place a lower value on stock options than the potential cost to shareholders (Gillan, 2001). In this case, compensation costs to shareholders more than its perceived value to employees, making its appropriateness at least questionable (Lazear, 2002).

## 6 III.

### 7 Case Study

Companies can use options for hedging purposes and this is one part of risk management. However, firms can also use stock options as a form of compensation. When use for hedging purposes, call options provide the right to purchase a particular amount of stocks. The price and a period of time of such purchase are predetermined. An option holder does not have an obligation to buy the security and this is the major difference of options from futures and forward contracts. Still, an option holder pays option premium and therefore need to evaluate whether the benefits of an option hedge are worth this premium (Madura, 2011). Put options provide the buyers of the option with the right to sell a particular amount of securities at a predetermined price and within a predetermined period. Similarly to the call option the put option contract is the right but not the obligation for

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the holder of the option. Normally the buyer of the call option expects the increase of the price of the underlying security in future. In this case if the exercise price of an option is lower than the market price, option holder has an opportunity to buy the security at the price that is below market price. On the other hand, the holder of the put option expects the decrease of the security price in future. Thus he seeks for an opportunity to sell the security at a price that is higher than market price (Roberts, 2006).

One of the disadvantages of options hedging is the fact that the cost of hedging is not known at the time of purchase of the options. It becomes known only when the payables are due. Therefore option holders need to assess what would be the cost of hedging under different circumstances. The cost of hedging consists of the security price and the premium that is paid for the option (Madura, 2011). The disadvantages of options hedging include the facts that premium payment is required for holding the options. The premium normally includes two components. The first one is the intrinsic value which represents the amount by which the exercise price exceeds the current price of the futures market. The second one is the time value. It represents the amount that is required by the option seller to compensate for the risk that he bears in the course of the life of the contract. Besides only a fixed quantity of securities is available. Nevertheless the major advantage of options hedging is the right to cancel the commitment. This provided greater flexibility to the option holder (Anderson et al., 2012).

Starbucks Corporation uses stock options mainly to reward employees and thus manage the agency problem in the company. The company's stock The stock options plans offered by Starbucks engage all employees and executives into the ownership providing appropriate motivation and incentive and solving the agency problem. However, as it was noted in literature review, this could also trigger more risk taking on the part of the top managers.

IV.

## 8 Conclusion

In conclusions, stock options have been widely used in companies with a purpose of risk management and solving the agency problem rewarding employees and managers. If applied properly, the use of stock options can potentially enhance the firm value and overall performance. A diversified stock option plan design plays a crucial role in the effectiveness of option contracts management and elimination of the free-rider problem. It is important to differentiate between stockbased compensation packages according to the position levels to reach the effective ownership engagement of lower level employees and interest alignment between shareholders and executives. Executive stock option compensation and incentives plans must balance in cost and volumes in order to encourage a proper amount of risk taking actions yet avoid inadequate overdose of options. At last, it would be fair to mention that in today's human capital oriented corporate structures, when more companies treat all employees as their key talents and develop benefit schemes accordingly, it is essential to not just design an effective compensation plan but also complement it with a truly committed ownership culture inside the company, as can be seen in the Starbucks' case study. <sup>1 2</sup>

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