William Blair & Company, L.L.C.

Aligning Management and Shareholder Interests

A white paper that examines the key aspects of executive management and compensation that account for strong long-term investment performance.

Harvey Bundy
312.364.8222
hbundy@williamblair.com

Executive Summary

At the heart of William Blair & Company's investment philosophy is a focus on the long-term viability of the companies in which we invest. Since its inception more than 65 years ago, the firm has recognized that many of the companies able to stand the test of time share common characteristics. One of those vital traits—the alignment of management and shareholder interests—has proved to be a significant determinant in superior long-term performance.

On its own, the alignment of management and shareholder interests does not translate into a solid investment. But well-positioned, financially sound companies whose executives and directors have accumulated wealth through long-term stock ownership have proved profitable investments for our clients.

As long-term growth investors, we are heartened when companies take steps to create this type of significant, real equity ownership, fostering alignment with shareholders. But today such actions remain the exception. Current compensation schemes have been abused or failed outright. In the long term, however, this misconduct could serve to improve management and shareholder alignment, as an era of heightened scrutiny on corporate governance is now upon us.

In this environment, we believe no time is better than the present to share our suggestions on different techniques for structuring management compensation responsibly. We only can hope that the boards will take such actions and recognize what we and our clients have for many years: When management teams accumulate wealth through the long-term appreciation of a meaningful equity stake in their companies, all parties are well served.

ALIGNING MANAGEMENT AND SHAREHOLDER INTERESTS

Many of the companies that prove to be our best-performing long-term investments share a common characteristic: top executives have built wealth through long-term ownership of stock, not through the size of their paychecks or the exercise and subsequent sale of their option grants. Two points are key: management's long-term focus and its real ownership of an interest in the company. When these are achieved, this ownership creates a true alignment of interest between management and shareholders. Consequently, the alignment of interests between management and shareholders has been one of our fundamental stock selection criteria since William McCormick Blair founded William Blair & Company more than 65 years ago.

But how is this alignment of interests measured and accomplished? In another era it was easier—founders of many companies in the small- and midcap space still ran those companies. The founder still held much of his or her initial position. As a result, management was an owner, always had been an owner, and thought like an owner. As long as personal objectives and drive had not changed, investors had some confidence that this founder/owner would continue to do whatever necessary to expand the business. While such individuals still exist (Bill Gates at Microsoft, Tom Golisano at Paychex, and Ed Kaplan at Zebra Technologies, among others), there are not enough around whom to build a portfolio. In today's era of professional management and venture-backed start-ups, the large stockholding entrepreneurial chief executive has become more of a rarity.

Corporate boards and compensation consultants are keenly aware of this problem. The compensation consultant community has created many compensation schemes in an effort to motivate management teams effectively. Almost any proxy statement has a phrase in the report of the compensation committee such as the following: "Management compensation is based upon a combination of salary, bonus, and long-term incentive rewards…" Large and deep option grants are justified based on alignment and retention objectives. But as investors are painfully aware, these compensation plans often have resulted in opportunistic windfalls for management and employees. Alignment is not symmetrical. Option holders benefit from the upside, but do not participate in downside pain. They can cash out and take chips off the table. How many dot.com executives made fortunes on such a strategy, only to see the common stock decline precipitously or become worthless? Their actions may be markedly different from what we would expect of long-term owners of the stock.

In this paper, we analyze this issue from three perspectives. First, we discuss why (or whether) it is important to align the interests of management teams and shareholders. We then examine some of the historical approaches used to accomplish this objective, evaluating their strengths and weaknesses. In this section, we discuss options extensively, including a quick summary of why we believe there exists so much controversy over the issue of option expensing. Lastly, we offer some ideas on approaches toward compensation that we believe would enhance the alignment of management and shareholder interests in the future.

Why Does It Matter? Defining Alignment

Our investing experience suggests that companies with aligned interests are better performers, but this is far from the only criterion we apply in selecting our investments. Proof of this causality is more difficult to come by. First, defining alignment may be more an art than a science. Ownership alone is not enough: it is critical to understand management teams' drives and ambitions. Not every management with a large ownership position has a goal of building the company. And motivation is insufficient if ability is lacking. Second, we tend to recall the occasions on which this alignment has led to stock price outperformance, while we often forget or ignore the times it has not worked. Moreover, it is unlikely that we would recognize when management interests shift. Is Bill Gates still as driven as he was 15 years ago, or has his agenda changed? We would bet on the latter, but we could not determine when such a change had occurred. Lastly, many additional criteria must be met for a company to succeed over the longer term. The company with the most aligned management will not be a good investment if it does not have a market opportunity to pursue, quality goods or services that provide value to customers or clients, and good financial metrics, at the minimum.

Having acknowledged that it is difficult to prove that companies where management and shareholder interests are aligned are superior long-term investments, we point to anecdotal evidence. Naming specific companies where this has worked (Microsoft, Paychex, Cintas, Dell, and Molex, among others) suffers from obvious survivorship bias. However, the huge gains early investors achieved in these companies, often

100 to 1,000 times their investments, cannot be disputed. With these types of gains, it takes only one success to offset multiple failures.

Not all investors care about this criterion—the alignment of management and shareholder interests—and we concede that it is neither necessary nor identical for all investor classes. If we divide investors into admittedly arbitrary classes, it becomes readily apparent that the alignment that works for one class may be counterproductive or unnecessary for another. At the extremes, a day trader would have far different interests than would a long-term growth investor. Likewise, a momentum investor might prefer to have a different set of incentives in place than would a value investor. Can compensation schemes be devised to serve the multiple needs of these diverse classes of owners? Should they be?

At the risk of sounding self-serving, we are convinced that the only investor group that matters is the long-term investor. Is this a responsible statement? Looking only at short versus long term, we believe it is. Our rationale is based on the bedrock of corporate governance—the board of directors. Directors hold the ultimate responsibility for overseeing the success of an enterprise. They have the power to hire and fire executives, who, in turn, manage the business to deliver this success. With the exception of boards dominated by venture capitalists, whose time horizon may be shortened by their need to achieve liquidity, and boards seeking to "fix up" the business so that it could be sold, we are not aware of any board that intentionally has overseen a business with a short-term focus. If boards are focused on the long-term success of the enterprise, then ultimately they are fiduciaries to the interests of long-term owners.

In some cases, a board may be more interested in maintaining the corporation than in expanding it. Growth is not easy to come by for companies such as US Steel or General Motors. Protecting and preserving jobs and capital may be more important objectives. For these companies, aligning management interests with long-term growth is neither practical nor possible. But these boards still should be focused on the long term. Moreover, these companies are not owned by growth investors.

What about momentum investors? Any successful long-term growth company will become a momentum "story" from time to time. An ideal momentum investment would sustain its momentum for a long time. But the key to successful momentum investing is identifying the inflection points before others do. To the extent that proper long-term alignment might cause management teams to accept a temporary slowing to achieve long-term success, a momentum investor might not view such alignment favorably.

We are growth investors focused on the long-term success of quality growth companies. If this is our investment universe, then the management teams of these companies also should be focused on a similar time horizon. Aside from the board's fiduciary responsibility, it seems intuitive that focusing management on the enterprise's long-term performance brings many additional benefits. Management teams are not as likely to reach to make near-term results at the expense of long-term success. Aggressive accounting becomes less appealing. Aggressive accounting usually reflects either an acceleration of revenue or a deferral of expenses into the future. This trade of a dollar of future earnings for a dollar of earnings today has little appeal to the long-term investor. We have found anecdotally that companies with high management ownership often have the most conservative accounting. Examples include Microsoft, where accounting conservatism has led to an SEC admonishment, and Molex.

Would a compensation structure designed to foster long-term stock ownership have resulted in a different set of management actions at Tyco or Enron? We doubt it. Other aspects of culture cannot be overcome by improving management and shareholder alignment. Moreover, executives who try to get away with fraud also are likely to believe they never will be caught. Investors need to employ other ways of detecting fraud or corporate malfeasance. Nonetheless, a management team that makes decisions toward the goal of creating long-term shareholder wealth is likely to be more focused on this goal if its own wealth will be determined by the company's long-term outcome.

Some might argue that there are other constituents for a corporation than the shareholders. Employees, customers, and the community come to mind. Some would question whether aligning the interests of management teams too closely with shareholders would make them less focused on these other stakeholders.

As we discuss in the next section, we believe that significant real equity ownership is the best way to ensure that executives (and directors) have their interests aligned with those of long-term shareholders. But we do not believe that this ownership makes management any less focused on the needs of other stakeholders. Brazenly exploiting

customers or clients will not maximize long-term returns, except in the case of monopoly power. Great companies with strong management ownership (for example, Wal-Mart) often make it an obsession to put the customer first (in the case of Wal-Mart, by giving back cost reductions in the form of lower prices). Likewise, these companies do not ignore their employees. In many cases, employees are not referred to as such—they may be called Partners (Cintas) or Associates (Home Depot), and usually are treated well. Rarely are they represented by a union. We find that a high percentage of the companies on "envy" lists (for example, "100 Best Companies to Work For" and "America's 100 Most Admired Companies") also have made a significant effort to align management and shareholder interests.

Lastly, any management with significant ownership will recognize that the community is crucial to long-term success. Companies mired in environmental issues, or those that have taken advantage of a community in some other way, often are run by teams of professional managers with limited interest in the long term.

There are risks associated with management equity ownership. A management team with too much of its compensation tied to long-term corporate performance may become more risk-averse as the amount it has at risk becomes greater. In a few circumstances, management teams with large ownership stakes have grown reluctant to make new investments that might put the value of their ownership at risk. In these cases, their objective has changed from growth to protection of wealth. It behooves the boards to refocus management on long-term growth and not caretaking.

Overall, we believe that the benefits of aligning management interests with those of long-term investors far outweigh any risks. The risk of overstated earnings or corporate misconduct may be lessened. Shareholders are better off, but other stakeholders also are better served when management's interests are aligned with those of common shareholders. And the relevant shareholders to be focused on are those with a long-term investment horizon. Perhaps most important to our clients, these companies have generated superior long-term investment returns.

Do Current Compensation Plans Achieve This Alignment of Interest?

Option grants, restricted stock grants, bonuses based on everything from a percentage of operating profit to the increase in book value, employment contracts, golden parachutes, pension plans, supplemental pension plans, retirement health benefits, use of corporate assets for personal purposes, loans to executives, and "certain transactions": These and more go into the compensation plans that some of the finest minds in executive compensation and executive search firms can devise. All these compensation schemes for management teams have received board approval. In some cases, we wonder what they were thinking. In others, it was a clear case of quid pro quo. And in others, the board put a great deal of thought into devising a scheme that was fair and appropriately aligned; but even these plans often do not achieve the desired results.

There seems to be widespread agreement that management teams should have some portion of their compensation tied to performance. But how much, in what form, and over what measurement period are questions with markedly different answers. Many plans include three components: salary, a bonus based on short- to intermediate-term performance, and an equity component. How are these determined and what are the consequences?

Salary is relatively straightforward. All executives deserve a take-home paycheck, which should reflect the level of responsibility that their positions carry. We have serious concerns with how salary is determined in some cases, but it does not appear to be a problem in aligning interests with shareholders unless it becomes excessive or too great a determinant of wealth, negating the value of the equity component. Our problem with the way many salaries are formulated comes from the "studies" done by compensation consultants of the salaries among peer companies. This peer information often is used to set management salaries, almost always "at or modestly above the 50th percentile for our peer group." The problem with this approach is mathematical. Since everyone uses it, it assures management of an above-average raise. This is because as the companies below the 50th percentile struggle to catch up, the mean is escalated rapidly.

The second component of compensation is the performance bonus. This bonus is tied to short-term results, typically one year, and is based on achieving predetermined (but often undisclosed) targets. If not excessive, if tied to reasonable targets, and if not paid when performance is poor, this can be an effective tool for holding management accountable for meeting budget. However, in some cases the performance bonus is tied to targets that are too easy (for example, no decrease in book value or 90% of target earnings) or where the figure can become unwarranted (for example, Greentree Financial, where the CEO was paid a percentage of gross profit, one of the most egregious examples). As we discuss later, many companies miss an opportunity to increase management stock ownership by not "paying" part of this bonus in some form of equity.

Equity-based Compensation Plans

The equity-based component of the compensation package is the one that typically becomes exorbitant and runs afoul of shareholder interests. There is widespread belief that management should receive equity-based compensation. This is justified by the twin goals of retention and ensuring that the executives have a stake in a company's long-term success. With this we agree, particularly for top management (although the retention benefit has been undermined by the executive recruitment community through packages that "make whole" an executive who leaves behind significant unvested equity-based compensation).

We would not argue that management with no equity interest will underperform. Prior to the option boom of the 1990s, many top executives worked for only a paycheck and a bonus. This worked well, particularly for privately owned companies where the owners held real control and/or where the board took a strong active role in ensuring management teams were fulfilling their long-term objectives, and paid them for it. But today, equity compensation is an essential component of the total pay package.

At a high level, we like this trend. As stated previously, we believe that management will work to provide the long-term growth that we desire as investors when a company's long-term performance is more important to top executives' wealth than are the paychecks they take home every week. While a complex bonus plan may be able to do this with cash, we believe it is easier and more practically achieved through equity-based compensation. Our concern lies in the way in which this equity incentive has been delivered.

Options have been the medium of choice for equity-based compensation, primarily due to their historical free-lunch status. They are worth something to executives, they give the company a tax benefit, yet they never flow through the income statement, instead resulting in eventual dilution to the share count (before considering the footnote disclosures required by FAS 123 and FAS 148). However, despite protests to the contrary, we would argue that most option grants do not, on their own, do a good job of aligning management teams' and shareholders' long-term interests.

We will cover this issue later, but first we consider an interesting but rarely answered question in the proxy statement: How does the board (or the compensation committee or the CEO for lower-level executives and employees) determine how many options to grant? Curiously, option grants for top executives almost always are round numbers—10,000, 50,000, 200,000, or even 1,000,000 shares in some extreme cases. As we discussed previously, the proxy includes the boilerplate explanation of how salaries are determined (for example, "modestly above the median for our peer group"). Further, bonuses are quantified with hackneyed language about targets based on meeting undisclosed objectives. But language referring to options often is ambiguous and essentially provides for a blank check, as is the case with this excerpt from a representative proxy: "The level of stock options granted generally has been determined consulting with senior management and has been based upon a subjective evaluation as to competitive practices for equity-based compensation." Needless to say, this company grants huge annual options.

The argument that levels of stock options are arbitrary because options are difficult to value holds little water. But even if we accept that flimsy proposition, then why do stock options fail in their stated purpose? First, and most important, option ownership is not equity ownership. Option holders do not vote proxies and do not receive dividends as shareholders do, unless and until they exercise their options. They share asymmetrically in stock price appreciation and declines. Consequently, option holders and shareholders have different interests. Most obvious, when considering where to spend excess corporate cash flow, options holders would prefer repurchase of shares (to benefit sellers, which they eventually will be; we discuss this issue later in this paper) over cash dividends, which are received only by actual shareholders. In fact, dividends are particularly bad for option holders wishing to exercise and sell, as the stock is sure to decline by the amount of the dividend on its ex-dividend date.

Surprisingly, many analysts and investors do not make this differentiation between the form of management ownership. Most Wall Street research reports include a figure for insider ownership. However, in almost every case this figure is lifted from the proxy. And the proxy figure treats exercisable options as if they were owned shares, irrespective of the exercise price. Every proxy statement includes a table showing management and director and 5% ownership. However, except in the rare case where the table contains two columns, one for shares owned and a second for shares issuable upon the exercise of vested options, these two figures are combined, with the full disclosure in a footnote that might read, "Mr. X's beneficial ownership includes 1,000,000 shares issuable upon the exercise of options." With the exception of a long-time employee who has retained shares, this option figure frequently is many times the size of the actual ownership. We can glean some useful information by tracking this table over time.

We consider the following information on the share ownership of the founder of a well-known public company. While it is an interesting, separate question whether large shareholders should receive options (see below), the point here is the changed nature of this executive's (Mr. X) ownership over the five-year period from 1995 to 1999. At the beginning of this period, more than 75% of Mr. X's ownership was outright. While his total reported ownership did not decline much during the next five years (due to generous option grants with rapid vesting), by 1999 half of the ownership was in options, not shares owned outright. In more extreme cases, all or virtually all of the executive's ownership will be in options.

Conversion of "Real" Ownership Into Option Ownership

Year	Shares Owned	Options Exercisable	Total Shares	Shares Sold	Options Granted
1995	11,852,000	3,688,000	15,540,000	2,308,000	1,720,000
1996	9,664,000	4,488,000	14,152,000	1,740,000	2,000,000
1997	7,996,000	5,788,000	13,784,000	1,540,000	1,600,000
1998	7,189,892	5,946,656	13,136,548	2,980,332	2,100,000
1999	7,586,892	7,346,660	14,933,552	643,000	1,600,000

Note: Figures adjusted to reflect two 2-for-1 stock splits

Most executives do not hold as many shares as Mr. X and many executives exercise options well before they expire. The tendency to exercise options well before they expire and the related tendency to sell immediately the shares acquired upon exercise is the other principal reason why option ownership is different from common stock ownership.

It is not easy to determine from the proxy or related SEC filings how many shares an executive has exercised and subsequently sold. However, the nature of the executive's actions is easy to discern in the more extreme examples. When an executive has little real ownership and exercises options close in amount to the total shown as exercisable in the prior-year proxies, it is clear that he or she is exercising early. And a comparison of amounts exercised and amounts sold shows whether he or she is retaining any real ownership.

The following example is calculated from data in the proxy for a distribution company and tracks the option grants, ownership, and shares exercised by the chief financial officer of that company. The column titled "Reported Ownership" shows the figure reported in the proxy. When the adjoining column, "Exercisable Options," is deducted, the actual ownership figure can be computed. Note that this executive acquired significant shares through option exercises between 1997 and 2000, and yet had very little ownership at the end of each reporting year. Also note that the executive exercised all (in 1999) or almost all of the shares that were vested and could be exercised each year and then must have sold the shares, as the executive's remaining ownership was negligible. This becomes more vivid when considering that these options vested very quickly, at a rate of one-third per year.

Lack of Equity Ownership Despite Large Option Grants

Year	Granted	Reported Ownership	Exercisable Options	Shares Owned	Shares Acquired
1996	168,205	132,685	132,685	--	--
1997	50,622	147,870	147,870	--	23,062
1998	90,000	102,145	92,624	9,521	146,368
1999	100,000	31,971	--	31,971	139,497
2000	112,000	166,186	132,500	33,686	25,309
2001	250,000	347,048	315,000	32,048	--

Note: Figures adjusted to reflect stock splits

It is clear that the options granted to this executive did little to make the executive a long-term shareholder in this company. Rather, the executive viewed them as additional compensation. It is difficult to view this form of (very generous) compensation as appropriate in aligning interests with the shareholders. Interestingly, during this same period the two founders of the company, who in 1996 owned 22% of the stock, reduced their outright ownership to only 7.1% by 2001, despite being the beneficiaries of generous stock option grants. Needless to say, we never have viewed this management team as having aligned interests with long-term shareholders.

Why would an executive exercise options early? This causes taxes to become due on any appreciation, so the amount that can be reinvested is significantly less than the intrinsic value of the options. An executive also loses the leverage of the options and the time value of the money. Consequently, an option holder will exercise early only if he or she plans to sell the resultant shares. This indeed is what happens. And it is not difficult to think of reasons why an executive might want to sell shares. Valid reasons include diversification if the intrinsic value of the unexercised options is large relative to the executive's wealth. However, as shareholders, we would prefer that the executive retain this disproportionate ownership in the company. Other, less shareholder-friendly reasons for selling include the concern that the current stock price will not be sustained over the long term, or lack of confidence in the company's long-term outlook.

Consider now the issuance of options to executives who already have significant ownership. There are two schools of thought. Some founders believe that their significant ownership enables them to have enough "skin in the game." While their companies have granted options to employees, in some cases very generously, these executives have never partaken of them. Prominent examples include Bill Gates at Microsoft, Tom Golisano at Paychex, and Dick Farmer at Cintas. At the other extreme are the founders/executives who want their "piece of the action." Their existing ownership does not "pay" them enough, and so they take significant options. Extreme examples include Michael Dell, Steve Jobs, Tom Siebel, and Howard Schultz. No one could argue that these options are issued to align interests or retain management. There is only one function of these options—compensation.

Examining the actions of option recipients, it becomes evident that options first and foremost are a compensation tool. We have no problem with compensating management for a job well done. But if options are compensation, then the method of determining the amount to be granted should be addressed by the board and disclosed in the proxy. And if options are a form of compensation, an investor should not confuse them with true common stock ownership. As a tool for aligning management teams' and shareholders' long-term interests, their role is a distant second.

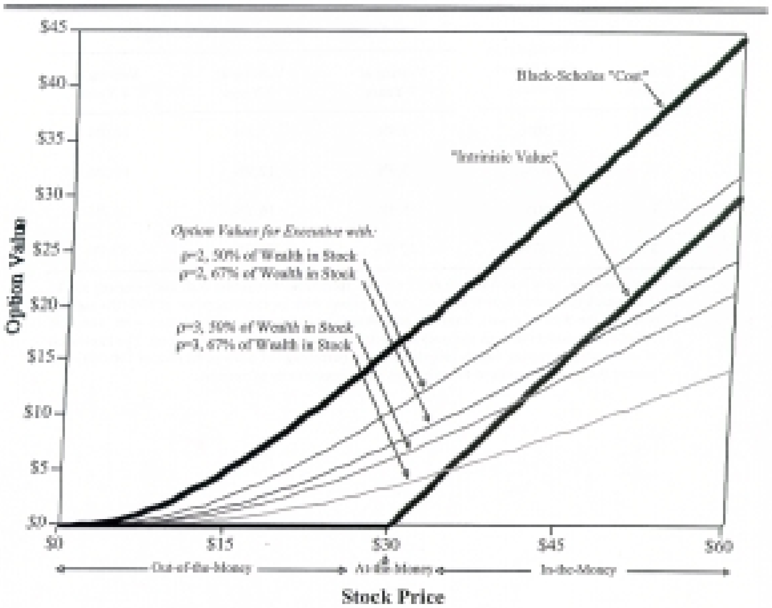
While not relevant to this discussion of aligning the interests of management and shareholders, we cannot end this review of options as compensation without a word on the issue of expensing options. The principal argument against option expensing seems to be that they cannot be valued. However, if the compensation committee cannot value options, the market will. There is nothing preventing a company from selling options in the open market equivalent in terms to what it would issue to an employee. The market price will determine what they are worth, no matter how different they are from exchange-traded options. Coca-Cola used this method to value executive stock options and had no difficulty in receiving bids from two different sources. It may not have liked the results, but the bids were there (and not that different from the Black-Scholes values). Microsoft is using it to solicit bids for out-of-the-money employee options.

It is clear that options can be valued, even options with terms similar to those granted to employees. The reality is that executives do not like the value that is calculated under the Black-Scholes or binomial models. This is because the value employees place on options does not equal the market or model price. Employees are not diversified investors and almost always have a different risk tolerance than the market. Consequently, they place a far lower value on options than the figure calculated under Black-Scholes or any other methodology. This point is made in an excellent paper by Brian J. Hall of Harvard Business School and Kevin J. Murphy of the Marshall School of Business at the University of Southern California, entitled "Stock Options for Undiversified Executives." (Paper provided by National Bureau of Economic Research, Inc. in its series NBER Working Papers, No. 8052.) Messrs. Hall and Murphy have determined that the value of an option to an undiversified executive is determined by the executive's risk aversion, r, and the percentage of wealth represented by company stock (and, of course, by the price of the underlying stock and the option's strike price). This is shown in the following chart for two different levels of wealth concentration and risk aversion. The chart also compares these values with the intrinsic value of the option and the value computed under Black-Scholes (the Black-Scholes "cost").

Executive Value Lines: Option Values for Undiversified Executives

Figure 1

Executive Value Lines: Option Values for Undiversified Executives



Note: Executive values for ten-year options with an exercise price of $30 are estimated using the "certainty equivalence" approach, and are defined as the amount of riskless cash compensation the executive would exchange for the option. Certainty equivalents are estimated numerically assuming that the executive has constant relative risk aversion, $\rho=2$ or $\rho=3$, and assuming (using the Capital Asset Pricing Model, CAPM) that the distribution of stock prices in T=10 years is lognormal with volatility $\sigma = .30$ and expected value $(r_f + \beta(r_m - r_f) - \sigma^2/2)T$, where $\beta = 1$ is the firm's systematic risk, $r_f = 6\%$ is the risk-free rate, and $r_m - r_f = 6.5\%$ is the equity premium.

We do not intend to reproduce the Hall and Murphy paper here. However, we can illustrate several important points from the chart.

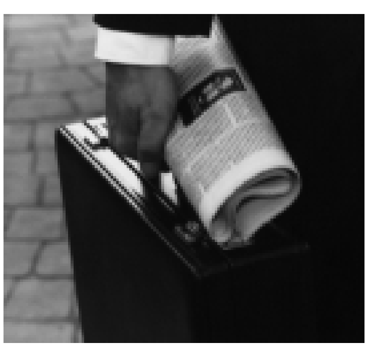
First, the Black-Scholes cost always is higher than the value of the option to the executive. No wonder executives do not think it is a good way to calculate the value. Interestingly, we have noted that executives value "at-the-money" options (at the time of their issuance) at roughly 25% of the then-current stock price, a figure that would fit within the band of expectations calculated by Messrs. Hall and Murphy.

The second interesting observation is that for most executives, the options rapidly become worth less than their intrinsic value as the stock price appreciates. This helps to explain the phenomena of early exercise and sale we observed above.

Therefore, companies are faced with an interesting dilemma. The value of an option granted to executives is easy to calculate. However, if offered a choice between this value of options and a similar amount of cash compensation, the executive almost always would select the cash (tax considerations aside). It is only when the executive is offered a significantly smaller amount of cash (roughly one-half the amount in our observations) that he or she becomes indifferent or prefers the option. Once this difference in value is recognized, the debate on option expensing should be easier to resolve.

Other Forms of Equity Compensation

Recognizing some of the issues discussed above, compensation committees have used a number of other equity-based tools, some of which help to align management interests and some of which work conversely. Perhaps the most outrageous example of the latter is the repricing of options. Such an action magnifies the asymmetrical nature of options versus stock ownership. This practice has all but ceased with the accounting requirement that repriced options be expensed in accordance with FAS 123 in the financials, not just footnoted. However, it has been replaced by programs under which current out-of-the-money options are canceled. Six months and one day later, new replacement options are granted, with the time period selected to avoid the necessity of expensing the options. Again, it is difficult to see how this serves to create long-term equity ownership—it is just another deal for management and employees that is not available to shareholders.



In the middle ground are tools that benefit management but that, arguably, also can make executives act like shareholders. One is the so-called reload feature. Option plans with a reload call for the issuance of immediately exercisable options to any executive who delivers stock to pay for the option exercise price, in an amount equal to the number of shares delivered. In theory, this enables management to maintain the same share ownership. However, the effect is a conversion of share ownership into option ownership, and we already have learned that these are not equivalent.

A second apparently shareholder-friendly feature of some equity-based compensation schemes is acceleration of vesting upon attainment of certain goals, most frequently share price. The argument is that management should be rewarded sooner if the stock price rises, since this movement benefits all shareholders. But consider that accelerated vesting almost always is accompanied by accelerated selling. Therefore, the effect of such a program is to shorten, not lengthen, the period during which management and shareholder interests are at least partially aligned.

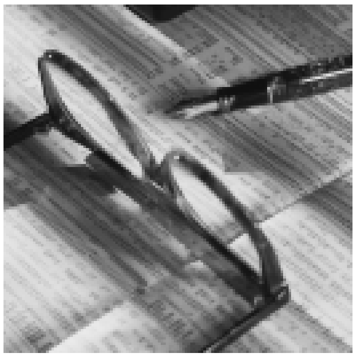
More shareholder-friendly option programs can call for the issuance of premium-priced options (for example, if the stock is selling at $30, the option exercise price may be set at $45). Or the option program may require a certain amount of stock ownership to be eligible for option grants. Options also may be offered as a substitute for cash bonus, usually at some discounted value. We have found that when executives are offered the opportunity to take half of their bonuses in options, with the options usually valued at 25% of the then-current stock price, many will avail themselves of this opportunity.

The ultimate shareholder-friendly equity-based compensation is the grant of restricted stock. In reality a form of option (with a $0 exercise price), restricted stock with an extended vesting period clearly makes an executive a shareholder. Executives collect dividends on restricted stock and can vote it like any other shareholder. However, it is not free to trade until it has vested. Again, the use of accelerated vesting can destroy the effectiveness of this tool.

We end this section with a quote from a letter to shareholders from Richard Farmer, the founder, chairman, and largest shareholder of Cintas Corporation.

"…Our high standards also apply to our use of stock options, one of the most controversial issues in the news today. The fallout from all these revelations has invigorated a crusade against the use of employee stock options. But I believe, if properly structured and properly reported, stock options can be very valuable to shareholders by providing positive incentives for employees, the people who make a business grow and prosper."

"I, for example, am the largest shareholder in this company. I would never provide stock options to my partners (we call our employees 'partners' at Cintas) if I thought they were having a negative effect on me by decreasing the value of my stock. In fact, I feel just the opposite. I'm happy to share ownership in this company with my partners because I'm a firm believer in the power of ownership. Our history has proven that options can be used to enhance shareholder value. While I may own a lower percentage of the company, each share is worth more. I believe that as owners, our partners care more and align their interests more closely with mine and all our shareholders…"



"But some option plans do not accomplish that goal… Cintas options are 10-year options with no vesting in the first five years and 20% vesting per year in the sixth through 10th years. This provides a longer-term perspective. And at Cintas, when partners receive stock through the stock option program, they are strongly encouraged not to sell the shares. If they do sell the stock without management's blessing, they may not receive additional options. We expect our partners who receive stock options to become long-term owners…"

What Might Be Done?

Current compensation practices can be used to align management and shareholder interests, as stated eloquently in Mr. Farmer's letter. We sent a copy of his letter to the chief executive officer of a technology company. His response was, "We can't do that; no one would work for us." Perhaps not today, but we hope the world is moving in this direction.

It is clear to us where to start—with the board of directors. If the board does not have its interests aligned with the long-term shareholders, it is difficult to expect it to hold management to such a standard. Relatively few boards have yet to address this issue.

We believe that board compensation should consist of a blend of cash and equity. The cash component serves the same purpose as the salary component of management compensation—payment for value provided. The equity component's intent is to align interests with those of shareholders. Accordingly, restricted stock is preferable to options for all the reasons discussed above. Moreover, it is easier to value. If options are used, board members should be required to hold any shares acquired upon exercise for five or more years. It is difficult to justify board member sales of any meaningful portion of an equity stake while still a member of the board. This equity ownership will constitute only a small portion of most board members' total wealth, and therefore diversification is not a valid excuse for a sale.

In any event, board equity grants should be subject to the same test of reasonableness applied to management compensation. It is difficult to justify grants with Black-Scholes values in excess of $100,000 for the time spent serving on a board. Yet we can identify many board members who are granted 20,000-50,000 shares annually by companies with stock prices of $25-$50 per share. Even using the low-end figures and a conservative Black-Scholes option valuation of 25% of the stock price yields annual compensation of $125,000 ($25 x 0.25 x 20,000).

Once the board is aligned properly, we can begin to work on management. While not pretending to be compensation consultants, the following list comprises elements we would like responsible corporations to consider in designing compensation plans. We believe that these elements will serve to align management and shareholder interests:

• Two-part bonus plans for achieving short-term goals, with the noncash portion paid in restricted stock.
• Longer vesting periods (5 to 10 years) for options and restricted stock.
• Required stock ownership (as a multiple of salary) to qualify for option or restricted stock grants.
• Equity grants (restricted stock or options) based on a formula designed to give a certain value to the executive, not a certain number of shares.
• Restrictions on executives' ability to exercise options early and sell the shares.
• Increased use of restricted stock in lieu of options.
• Restrictions on the percentage of outstanding shares that can be granted to management in a given year.

There are common elements to all these suggestions. In all cases, we are trying to build long-term equity ownership on the part of management. Management should be well paid for a job well done. If executives become wealthy as a result of the long-term appreciation of their equity ownership, all parties will be well served.

Conclusion

When management teams accumulate wealth through the long-term appreciation of a meaningful equity stake in their companies, shareholders are well served. While by no means the sole prerequisite to superior long-term stock price performance, we have found that this characteristic has been present in many of the companies where our investors have built their wealth—for example, shares in Molex, Paychex, Cintas, Zebra, and CDW have appreciated more than 100 times since they were first included in client portfolios. We will continue to seek out these companies and include them in our portfolios.

When management is not the founder or does not come in with a large ownership stake, the board of directors must take actions to provide management with this alignment of interest. Historical approaches have not worked, and in some cases have been abused by management teams. But responsible boards can take actions to move us closer toward this goal. With an increased focus on corporate governance today, we hope for widespread use of some of the techniques discussed here.

Harvey H. Bundy III, Principal

Harvey Bundy joined William Blair & Company in 1968. He served as the Director of Research and was a member of the Executive Committee from 1988 through 1997. He also was responsible for the selection of names on the firm's bi-monthly Current Better Values List™. His more than 25 years of analytical coverage has included connectors, specialty insurance, insurance brokers, software, and distribution. Together with Rob Lanphier, he is responsible for the management of the investment assets of our SMID clients. He also is a member of the team that manages institutional midcap assets. Education: A.B. Yale University; M.B.A. Amos Tuck School of Business Administration at Dartmouth.

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