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Is the Hospitality Industry More Likely to Reprice Stock Options?

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ABSTRACT

Hospitality companies are known to be sensitive to the economy and movements in the market. When overall performance of the company is poor because of a market wide fall, hospitality managers should not be panelized for the decrease in the stock price. In such cases, it is acceptable to reprice the stock option to realign the incentives and to minimize the agency problem. This paper examines whether repricing of hospitality firms are more likely to reprice options after a stock price decrease that is accompanied by a market wide fall. Although the overall results are consistent with prior literature, the hypothesis is marginally supported.

1. Introduction

Repricing refers to setting a new, lower exercise price for stock options readily available, because the stock price has fallen since the original award. More specifically, repricing makes sure that the executive gets paid and continue to increase their personal wealth no matter what happens to the market price of company's stock which eliminates a lot of risk for the executives. Although the repricing of stock options is not a very common phenomenon, when it happens it attracts a lot of attention from the press and professionals. Companies usually reprice to restore the power of managers' option based incentives when the company stock price decreases significantly due to the market wide fall or poor industry performance (Chen, 2004; Chance at al., 2000). Repricing of stock options is criticized in general because it is seen as a mechanism to reward the managers for poor performance.

This study examines the repricing issue in the hospitality industry. The hospitality industry sets itself apart from other industries in that it is very sensitive to the economy, and it is intensely leveraged. Hotel establishments also have real estate components attached, which makes them capital intensive. They operate in extremely competitive markets and are considered to be high risk/high reward investments (PriceWaterhouseCoopers, Global Hospitality and Leisure Services, 2002).

Repricing issue has never been explored for the hospitality firms although the performance of this specific industry is very dependent on the market movements. Mostly related to the hospitality industry, Rogers (2003) examined the repricing events of casino companies between 1993 and 1998. He concluded that repricing helps casino firms to decrease excessive risk taking incentives of executives. Hospitality Sales & Marketing Association International's (HSMAI) announced the "Top 10 Issues of Concern" facing sales and marketing executives and staff with the number one issue being the current economic situation (Khan, 2004). This information was gathered from a survey that was sent to 7,000 members of HSMAI. Many articles in the press draw attention to the hotel and restaurant industry's sensitivity on economic developments. The main theme of these articles is that strong economy helps hotels enjoy robust health and good profits and it is time to invest in lodging. However, weak economy pulls the stock prices down significantly (for example, *The Washington Post* (March 2, 1997), *Wall Street Journal* (August 18, 1999), *Chicago Tribune* (January 20, 2000), *Hotel and Motel Management* (January 15, 2001)). The intuition behind the arguments of the press and industry professionals is that, in an economic downturn, people would be less likely to travel and spend their money on travel related expenses such as staying in a hotel and participating travel related activities. In addition, dining out is among the first things that people consider cutting down when they need to save. Even amount of corporate travel decreases when the economy is not in a good state. On the contrary, people do not mind spending their money on staying in hotels and dining out in the times of robust economy. These economic movements and their consequences are obviously not in the control of the management.

Overall performance of the company may go down just because of the market wide fall, which is out of managers' control; and hospitality managers should not be penalized for the decrease in the stock price. Thus, this paper will examine whether the hospitality firms are more likely to reprice options after a stock price decrease that is accompanied by a market wide fall compared to a matched sample of non-hospitality firms.

This paper proceeds in the following format. Background information on stock options and options pricing are presented in Section 2. Section 3 explains the data collection and the related tests. Results of the study are explained in Section 4. Section 5 provides the conclusion.

2. Background information and previous research on stock options and option pricing

2.1 Stock Options

Corporate governance is concerned with the system by which businesses are run. This system includes the executive's responsibility to ensure that the business is appropriately and honestly managed. One of the challenges of powerful corporate governance is to minimize the agency problem (Jensen and Meckling, 1976). According to the agency theory, CEO behavior is mostly unobservable. Given this constraint, an optimal pay contract should be closely linked to company's performance (Miller, 1995;

Akhigbe, Madura and Tucker, 1995; Madura, Martin and Jessel, 1996, Attaway 2000). Offering stock options is one of the ways to decrease agency problem. Other popular mechanisms such as presence of board of directors, threat of takeover also exist to minimize the potential conflict of interests between the shareholders and managers.

Granting stock options to CEOs helps to line up the incentives of the executives with the interests of shareholders (Kerr & Bettis, 1989, Hall & Liebman; 1998). Most U.S. companies award stock options once a year. A compensation committee gives the decisions on the size and timing of the stock option awards. This committee is usually composed of the board of directors. (Finkelstein and Hambrick, 1988). A stock option grants the CEO right to acquire shares at a specific price (exercise price) at a later date. More than 90% of large U.S. companies issue stock options and executive stock options are about 60% of total CEO compensation (Deshmuhk, Howe, Luft; 2002). 10 years is a typical time to expiration on the award date.

After the connection between company's performance and optimal CEO contract has been established, some other studies found positive effect of performance on pay (Sigler and Porterfield, 2001; Core, Holthausen and Larker, 1999; Guay, 1999; Lambert and Larker, 1987; and Joyce, 2001). However, CEO compensation is not always tied to the firm's performance. Sometimes CEOs are getting paid well even though they fail to achieve positive results (Behr, 1997). In good states of the economy, firms can achieve good results without much effort, which eventually results in high pay levels.

2.2 The Repricing Provision

A stock option provision typically changes the exercise price of old options and/or cancels old options and reissues new options following a stock price decrease. Repricing can be often seen as a tool to reward the employees for their poor performance (Chance, Kumar, Todd; 2000). But there is a rational explanation behind repricing the stock option. Some of the incentive effects might be lost to the CEO, which increase the agency problem, after a sharp decrease in the stock price (Dalton and Dalton, 2005). Also, employees should not be penalized because of a decrease in the stock price that is not traceable to their actions. In such a situation, compensation committee can review the situation. Usually, executives also demand their options to be repriced. Considering that around 60% of the CEO compensation is related to the stock options, it is reasonable to believe that CEOs and top-level executives would raise their voices to the board of directors and/or compensation committee for a change in the exercise price of old options. It is up to the board of directors and/or compensation committee to make the ultimate decision given that repricing provision is not a part of the original contract (Corrado, Jordan, Miller, and Stansfield, 2001). According to Dalton and Dalton (2005), offering stock options is necessary to motivate the new top management team. However option repricing does not meet its stated purpose which is aligning the concerns of the top executives with those of shareholders.

Repricing of stock options has been a controversial subject since the early 1990’s. Many articles in the business, professional, and popular press have attacked the practice (For example, *USA Today* (April 29, 1997), *The Wall Street Journal* (October 29, 1997), *The New York Times (*July 15, 1998).) There are two different points of view on repricing. Some claim that repricing is a useful means of restoring incentives and retaining executive talent since the incentives related to the stock options will lose their meaning with a deep decline in the stock price. Some others believe that repricing stock options is solely rewarding the employees for their poor performance. Thus the companies should stay away from using repricing provision. Shareholders and institutional investors are among the opponents to the repricing provision while managers and executives obviously support it.

The academic research on repricing in general concentrates on the characteristics of the repricing firms. Gilson and Vetsuypens (1993) found that the repricing firms significantly underperformed the market for six years until the repricing date. Saly (1994) stated that option grants increased significantly after the market crash. However the increase in the option grants is greater for those firms whose stock fell by the largest percentage. Brenner et al. (2000) showed that the likelihood of repricing is more for smaller firms and for firms with poor performance. Chance at al. (2000) stated that the repricing firms have greater agency problems, they are smaller in size and they have insider-dominated boards. Chidambaran and Prabhala (2003) found that the firms that choose to reprice are younger and more likely to have smaller boards. Chen (2004) provided evidence that firms with less stockholder control are more likely to maintain reprice flexibility. Callaghan et al. (2004) examined the timing of option repricing and reported that repricings are timed to coincide with the release of good news or bad news about the company. For example, managers who expect favorable earning reports, reprice before the announcement. Similarly, the managers who anticipate unfavorable earning reports reprice after the announcement. In addition, Callaghan et al. (2004) calculated that repricings boosted executives' pay by an average of nearly $500,000 each. Evidently, taking advantage of the company information systematically helps the executives to increase their personal wealth.

New accounting treatment came into effect on December 15, 1998. As a part of Financial Accounting Standards Board (FASB) interpretation No. 44, companies are required to expense to earnings any consequent stock price approval above the new exercise price.

2.3 Research Purpose

The purpose of this study is to investigate whether hospitality firms are more likely to reprice options after a stock price decrease that is accompanied by a market wide fall.

2.4 Research Hypothesis

Given that hospitality industry is considered to be very sensitive to the economy, it can be argued that when economy turns, hotels and restaurants do poorly in general. However, this is not executives' fault so s/he should not be punished (e.g. in terms of lower rate of increase in her/his compensation in the following period). Given this condition, the following hypothesis has been developed: Hospitality companies are more likely to reprice options after a stock price decrease that is accompanied by a market wide fall compared to a control sample of non-hospitality companies that are matched on size and stock price decrease.

3. The data and methods

Firm level data was collected from Compustat database for the years from 1993 to 2003. Hospitality sample includes hotel companies (SIC 7011) and restaurant companies (SIC 5812). It is required that all firms in the sample are covered in CRSP and Compustat databases.

To obtain repricing of stock options, 2003 proxy statements in U.S. Security Exchange Commission (SEC) database were examined. In 1993, SEC started to require the firms to provide any kind of repricing information in their proxy statements. Proxy statements are designed to give a voting shareholder all the information necessary to make an informed decision. According to the SEC, if a firm reprices in 2002, it must provide a ten-year history detailing any previous repricings for at least the CEO and four highest paid executives (Chance et al., 2000). However, checking one proxy statement in 2003 was not enough to collect the information of any instances where companies decided to reprice executive stock options. Chance at al. (2000) reported that about one-third of the firms in their sample did not mentioned repricing in their proxy statements in spite of SEC regulation. Taking this into consideration, two other databases (LexisNexis and Mergent Online) were employed to identify the firms with repricing policies.

Keyword research was used to identify the option repricing information between 1993 and 2003. Keyword research involves rational combinations of terms related to repricing such as “eliminate”, “prohibit”, “restrict”, and “authority” with terms such as “reprice”, “lower”, “cancel”, “reset” (Chen, 2004). Since numerous combinations have been used to retrieve repricing related information, it is likely that all the references and news related to repricing have been attained.

After examining more than 130 firms in hotel and restaurant sector, 14 companies and 15 repricing events were obtained. Only one restaurant company (Good Times Restaurants) has two repricings, all the others have just one repricing. Among the hospitality companies with repricing policies included in this study, 2 are hotel companies and 13 are restaurant companies. The hotel companies that repriced are Sholodge and Interstate Hotels and Resorts. The restaurant companies that repriced are Ark Restaurants, Buffets Inc., Checkers Drive-in Restaurants, Denny's, Good Times Restaurants, Landrys Restaurants, Lone Star Steakhouse Saloon, Meritage Hospitality Group, New World Restaurant Group, Roadhouse Grill, Shells Seafood Restaurants, Shoney's, Repricings took place between years 1995 and 2001.

It appears that 9 repricing occurred before December 15, 1998, all others occurred after this date. On December 15, 1998, new accounting treatment for priced options (FASB Interpretation No. 44) came into effect. It can be argued that after this provision came into effect, companies would be even more careful when they are making repricing decisions as it may end up affecting companies' earnings significantly. Some hospitality companies included the explanation in their proxy statements that their earnings can get affected to a serious extent from the repricing provision as a reason not to reprice the stock options (such as Applebees and Darden). Note that most number of pricing (5 repricings) occurred in 1997 for hospitality companies in the time frame between 1993 and 2003. Year 1997 was used to test the hypothesis of this study.

3.1 Matched sample

A control sample of firms that are similar in size and in prior year's stock return were constructed for the year 1997. I excluded financial firms (SIC 6000-6999) and utilities (SIC 4900- 4949). Firm sales are taken as a proxy for size. To be included in the sample, a firm's sales should be within 70-130% range of hospitality companies' sales. Among those selected firms, firms with closest prior stock return to the hospitality company's stock return in the sample were selected for matched sample. Data for matched sample was also collected from CRSP and Compustat databases. In the sample set, there were 103 hospitality and 103 non-hospitality companies. Among the hospitality companies, 5 of them repriced stock options in 1997. Among the non-hospitality companies, 2 of them repriced stock options in 1997.

3.2 Research Model

To test the hypothesis that hospitality companies are more likely to reprice options after a stock price decrease that is accompanied by a market wide fall compared to a control sample of companies that are matched on size and stock price decrease, the model below is tested using logistic analysis:

Likelihood of Repricing = $\beta_0 + \beta_1$PSF + β_2SIZE + β_3LEV + β_4DUM

Repricing = Repricing is 1 if the company repriced in 1997 and 0 otherwise.

Prior Stock Performance (PSF) = For the companies that repriced in 1997, prior stock performance is prior year's stock return. For those that did not reprice, lowest 1-year return during year 1997 is measured as prior stock performance.

Firm size and firm leverage are used as control variables.

Firm Size (SIZE) = Prior literature shows that small firms are more likely to reprice (Chidambaran and Prabhala, 2003). Natural logarithm of 1997 sales is taken as a proxy for the firm size.

Leverage (LEV) = Total debt / Total shareholders' equity in 1997.

Hospitality Dummy (DUM) = Hospitality dummy is 1 for hospitality companies and 0 otherwise.

4. Results

4.1 Performance of the stock around the repricing event

Event study approach has been employed to examine whether the market reacts in any way to the public announcement of hospitality firms' repricing. Percentage abnormal returns and corresponding t-statistics for 14 repricing events are shown in Table 1 for a window of ± 5 days around the proxy filing date. Date 0 is the filing date. Data for one company could not be obtained from CRSP database. Abnormal return is the company return in excess of market return. Both value and equal weighted CRSP NYSE-AMEX-NASDAQ indexes were used for the market factor.

[Insert Table 1 here]

It appears that there is no significant market reaction to the public announcement of repricing except 4 days after the announcement using abnormal return on equal-weighted index and 1 day before the announcement using both value-weighted and equal-weighted indexes. T-statistics even for the significant days are barely statistically significant at 0.05 level (t-statistics are just above 2.00). This implies that the investors may not be monitoring proxy filings carefully. In addition, proxy statements are very technically written. It may be the case that the investors do not spend the time to go over the details of this technical report. Also note that the major press covered only 3 repricings out of 15 events. So investors did not have the chance to read all the repricings in the news. Alternatively, it is possible that the market does not observe repricing events in the hospitality industry as important information about the future performance of the firm.

4.2 Descriptive Statistics

Table 2 contains descriptive statistics of the companies that repriced in 1997 2 years prior to and 2 years after the event.

[Insert Table 2 here]

Market capitalization decreases from 1995 to 1996 which implies that the stock prices of these companies have been decreasing for while and the decrease does not stop on the repricing year and continues through 1999. Earnings per share, which is calculated by dividing company's profit by its number of outstanding shares is negative in years between 1995 and 1999 with a decreasing trend every year. Return on equity ratio indicates that repriced companies have been performing poorly. The level of leverage used by these companies also keeps on increasing and it seems that the repriced firms keep on increasing their debt levels. Sales show an increasing trend in general.

Table 3 illustrates the comparison of repriced and non-repriced companies in terms of firm size, performance measures, leverage and stock returns for the event year (1997).

[Insert Table 3 here]

Market capitalization rate, which is measured multiplying closing stock price in 1997 by the number of shares outstanding in 1997, is statistically significant. T-statistics of –3.081 and the mean values of repriced versus non-repriced companies imply that size of the repricing firms are significantly smaller than the non-repricing companies. It can be argued that size effect is related to the information and data availability about the small firms. For example, small firms might be less known firms and it might be easier to reprice stock options for these firms compared to the big firms with large number of shareholders. This finding is also consistent with the previous research (Brenner et al, 2001; Chance et al., 2000). Stock price return is significantly less for repriced companies during 1997. Examining the mean values, repriced companies have an average return of -32.25% whereas the non-repriced companies have an average return of 5%. Dividend per share is on average $0.00 for the repriced companies and $0.20 for non-repriced companies. T-statistics for this variable is also statistically significant. All other variables on Table 3 are not significant. Performance measures such as earnings per share and profit margin are lower for repriced companies compared to non-repriced companies in 1997. However, the difference is not significant. It is apparent but not surprising that repriced companies' financial performance is considerably lower than those of non-repriced companies. The explanation is very simple and intuitive. Stock options may have become "under the water" or "out of the money" as the stock prices decrease, and it is more likely that repriced companies' stock price also decreased along with their stock returns and dividends per share. Thus, it makes more sense to restore value to underwater options, which are virtually worthless, by setting a new exercise price for the stock options. On the other hand, leverage ratio does not seem to differentiate repriced and non-repriced companies.

To identify whether the repricings were indeed following a market wide fall, the return on market during 1997 was observed. I used CRSP NYSE-AMEX-NASDAQ indexes as a proxy.

[Insert Graph 1 here]

As it is illustrated in Graph 1, occurrence of market wide decreases is during March, August and October in 1997. Referring to the repricing dates of hospitality companies in 1997, it seems that repricings took place in months of February, April, May, July and December. It seems that not all the repricings follow the market wide fall. This provides some evidence that the executives of hospitality companies might be indeed being awarded for their poor performance.

4.3 Who is more likely to reprice?

Logistic regression estimates the probability of repricing event occurring in year 1997 given the above independent variables. The results of the analysis are presented in Table 4.

[Insert Table 4 here]

Pseudo R-squares for the model are 0.082 for Cox & Snell R-square and 0.310 for Nagelkerke R-square. Only statistically significant variable is the prior stock performance and all other variables included in the analysis are not significant. Exp(B) in the table above denotes the odds ratio. The coefficients in logistic regression are in terms of the log odds, that is, the coefficient 0.049 implies that a one-unit change in prior stock performance results in a 0.049 unit change in the log of the odds. The fact that only 5 hospitality companies repriced in 1997 and only 2 non-hospitality companies in the matched sample repriced may have some influence on this insignificant result of size, leverage and hospitality industry dummy variables. In the light of the regression analysis, hypothesis that the hospitality companies are more likely to reprice options after a stock price decrease that is accompanied by a market wide fall is rejected.

5. Research Limitations

This study can be considered as a preliminary investigation into repricing of stock options in the hospitality industry. The empirical analysis for the most parts of this paper was done for year 1997. It could provide more insight if this study was done considering a longer time frame. Corporate governance the system by which organizations are directed and controlled. In a corporate system, boards of directors are responsible for the governance of their organization. In this respect, this paper is further limited by not including other factors that may affect the repricing decision in a company such as the size of the board, the presence and/or influence of the CEO on the board of directors, and level of stockholder control.

6. Conclusions

This industry specific study builds on the previous literature regarding repricing of stock options and makes a contribution to the existing hospitality management and repricing literature. Furthermore it attempts to explain the occurrence of repricing for the hospitality companies given the industry's specific characteristics. The motivation of the study is based on hospitality industry's sensitivity to the market and to the economic movements. When the stock price decreases as a result of market wide or industry wide fall, the hospitality managers should not be punished in terms of lower compensation. Since the executive pay contracts are highly dependent to the stock options, a sharp decrease in the stock price significantly affect their compensation.

There was marginal support for the hypothesis that, the hospitality companies are more likely to reprice options after a stock price decrease that is accompanied by a market wide fall compared to a control sample of companies that are matched on size and stock price decrease. Examining 5 days before and 5 days after 14 repricing events, there was not any sign of reaction to the public announcement of the events. The fact that only 3 of the 15 repricing events are covered in the press and technical nature of the proxy statements might have an effect on this. When the financial characteristics of the repricing companies in 1997 are observed 2 years prior to and 2 years after the event year, it appears that these firms continue to perform poorly after the event year. Comparison of the companies that choose to reprice in 1997 and those who did not choose to reprice indicate that repricing firms are significantly smaller in size (in terms of market capitalization), and have lower stock price return, dividends per share.

Overall, this paper makes an attempt to explain the repricing events in the hospitality industry. Although I found support that firms reprice after a significant stock price decrease, there is not enough evidence to support that the hospitality companies are more likely to reprice after a sharp stock price decrease. The research suggests the need for more studies on repricing of stock options in the hospitality industry.

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Table 1: Percentage Abnormal Returns and Corresponding t-statistics for 14 Repriced Firms 5 Days Before and 5 Days After the Announcement Date

Day 0 is the filing date. The CRSP NYSE-AMEX-NASDAQ index is used for market factor.

Relative day	Value-weighted index		Equal-weighted index	
	Percentage abnormal return	t-statistic	Percentage abnormal return	t-statistic
-5	0.026	1.457	0.023	1.288
-4	0.008	0.591	-0.023	0.490
-3	-0.001	-0.075	-0.036	-0.199
-2	-0.005	-0.349	-0.035	-0.201
-1	0.050	-2.455	-0.051	-2.499
0	0.006	0.457	0.060	0.542
1	0.030	1.669	0.027	1.506
2	0.014	1.803	-0.005	1.419
3	-0.005	-0.649	-0.009	-1.131
4	-0.020	-1.902	-0.020	-2.040
5	0.032	1.482	0.028	1.284

Table 2: Descriptive Statistics for 7 Repriced Firms in 1997

Selected measures of performance and leverage from annual accounting data 2 years prior to and 2 years after event year are presented. Year 1997 is the repricing year. The mean and standard deviation are presented. Data are obtained from Compustat.

	1995		1996		1997		1998		1999	
	Mean	St. Dev	Mean	St. Dev	Mean	St. Dev	Mean	St. Dev	Mean	St. Dev
EPS	-0.53	1.31	-1.22	2.82	-1.14	2.40	-0.50	1.12	-0.01	0.73
ROA (%)	-4.52	13.58	-10.60	17.11	-13.63	21.53	-8.61	13.24	-2.24	9.62
MC ($MM)	310.03	161.45	229.48	207.88	196.10	237.29	139.04	191.61	130.34	146.25
LEV (%)	31.67	300.17	45.90	201.24	54.27	156.88	62.27	288.74	167.83	326.74
SAL ($MM)	297.99	372.45	362.47	403.12	393.41	449.47	401.66	432.35	396.77	404.33

EPS=Earnings per share, ROA=Return on Assets, ROE=Return on Equity, MC=Market Cap, LEV=Leverage, SAL=Sales

N=7

$MM = Millions of dollars

Table 3: Descriptive Statistics for Repriced and Non-Repriced firms in 1997

Selected measures of performance and leverage from annual accounting data is presented for year 1997. Mean comparisons and t-statistics are provided. Data are obtained from Compustat files.

	Repriced	Non-Repriced	t-statistics
Sales ($MM)	393.41	710.10	-1.437
Earnings per Share	-1.14	0.36	-1.619
Dividends per Share	0.00	0.20	-6.339
Profit Margin (%)	-10.68	-4.14	-0.905
Stock Price Return (%)	-32.25	0.05	-2.968
Market Capitalization ($MM)	196.10	909.57	-3.081
Leverage (%)	54.27	52.60	0.160

$MM = Millions of dollars

Reprice Companies: N = 7

Non-Reprice Companies: N = 199

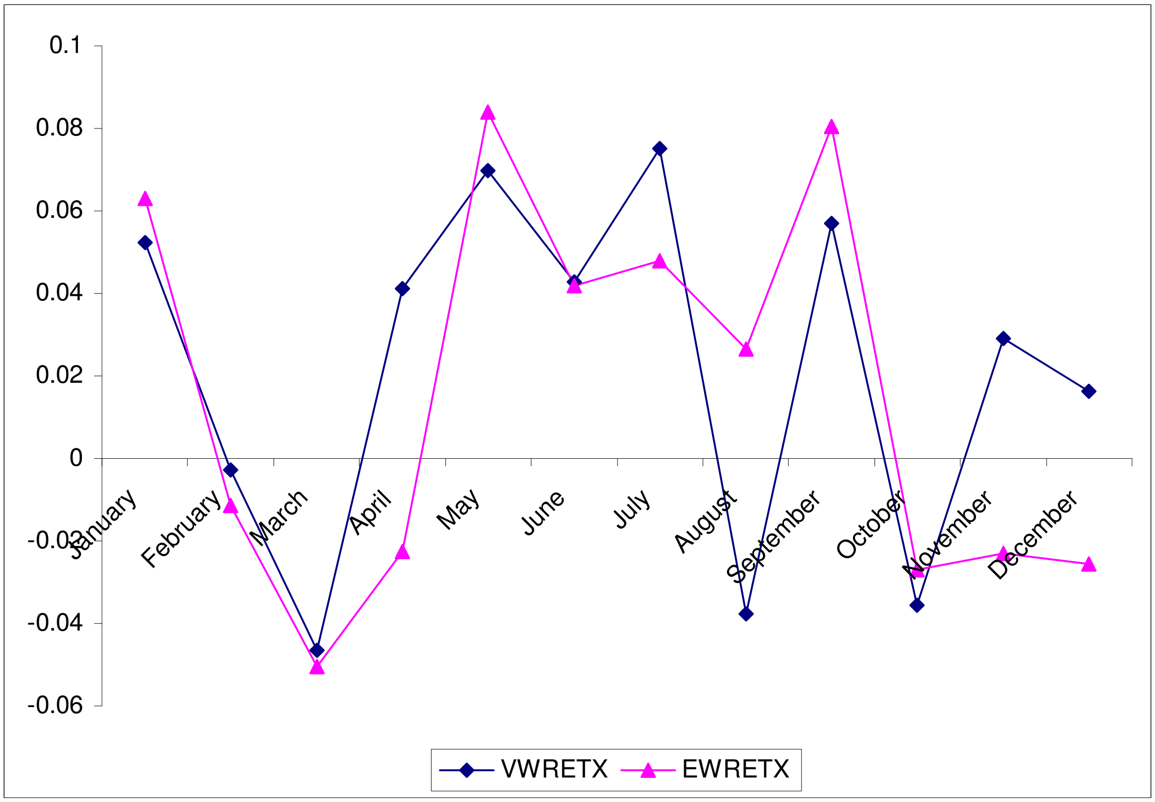
Table 4: Logistic Analysis

Logistic analysis output is presented. Dependent variable is repricing. Repricing is 1 if the company repriced in 1997 and 0 otherwise. Independent variables are PSF, SIZE, LEV and DUM. (PSF) = For the companies that repriced in 1997, prior stock performance is prior year's stock return. For those that did not reprice, lowest 1-year return during year 1997 is measured as prior stock performance. (SIZE) = Natural logarithm of 1997 sales is taken as a proxy for the firm size. (LEV) = Total debt / Total shareholders' equity in 1997. (DUM) = Hospitality dummy is 1 for hospitality companies and 0 otherwise.

	Coefficient	Wald	Sig.	Exp(B)
PSP	-3.016	4.552	0.033*	0.049
SIZE	-0.474	0.930	0.260	0.623
LEV	-1.114	0.079	2.081	0.892
DUM	0.001	0.100	0.067	0.969
Constant	-4.468	20.259	0.000*	0.011

* significant at 0.05 level

Graph 1: Monthly Returns on NYSE-AMEX-NASDAQ Indexes in 1997



VWRETX: Value weighted CRSP NYSE-AMEX-NASDAQ indexes
EWRETX: Equal weighted CRSP NYSE-AMEX-NASDAQ indexes