

Determining When to Exercise Stock Options

The most common question I am asked by executives is "when is the best time to exercise my stock options." This question alone brings many different scenarios and questions into play. Is exercising the most effective strategy for minimizing taxes? What if I sell and the stock keeps going up? Do I have too much exposure to company stock?

Executives that receive options as part of their compensation are truly in a win/win situation. They can't lose any of their own money and they have no out-of-pocket costs for the options they're granted. They can only make money. Another advantage of options is the inherent leverage they have. In other words, a small change on one side produces a larger change on the other. This inherent leverage is why option values go up substantially when the stock price goes up and with the recent decline in stock prices, option values have dropped significantly more than the underlying stock.

One method to determine if it may be a good time to exercise an option is referred to as the "Profit Percentage." The profit percentage of an option is the dollar amount of the profit/share from exercising the option divided by the value of the stock/share.

As illustrated in the chart below, a stock with a low exercise price relative to the current stock price will have a high profit percentage. The higher the profit percentage the more attractive the option is for exercising.

Grant Date	# of Shares	Exercise Price	Current Stock Price	Profit Percentage
8-20-2004	4,000	16	48	67%
8-20-2005	5,000	22	48	54%
8-20-2006	4,000	30	48	38%
8-20-2007	6,000	44	48	8%
8-20-2008	5,000	34	48	29%

An option with a 60% profit percentage may be ripe for harvesting even with four or five years before expiration. When the profit percentage of an option reaches 90% or more, the remaining time value of the option becomes insignificant regardless of when the option expires.

On the other hand, an option with less than 20% profit percentage may be better left unexercised with only a few years until expiration.

The profit percentage is only one of several methods used to determine when to exercise an option. There are many other considerations that are unique to each individual in determining when to exercise. Some of these considerations would include the expiration date of the options, the tax bracket of the executive, and how much other stock and options are owned (i.e., concentration risk, job security, financial goals, etc.)