

UNIVERSITY OF ROCHESTER

William E. Simon Graduate School of Business Administration

Finance 411
Investments

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Quiz # 4: May 7, 1997

1. (10 points)

A large part of George Fisher's compensation when he came to Kodak as CEO involved slightly out-of-the-money stock options in Kodak stock. He received options for 750,000 shares of Kodak stock at an exercise price of about \$58 and an expiration date ten years into the future at a time when the stock price was about \$55.

(a) One view of this arrangement is that it was costless to Kodak shareholders since the options would only become valuable if Kodak's stock price rose above \$58. Do you agree with that assessment? **Why or why not?**

(b) Suppose you had to estimate the value of the option package (e.g., to include in Kodak's annual report to shareholders). How would you determine the value of Fisher's options? **Be as specific as possible.**

(c) The usual motivation for giving high-level executives stock options as an important part of their compensation is that it aligns their incentives with those of the shareholders (i.e., they worry about making the stock price go up). From the perspective of portfolio theory, do these stock options cause any problems for Mr. Fisher? ***What are they?***

(d) Given that Mr. Fisher is forced to hold a large position in Kodak stock (through his option compensation), how do you think he might adjust his view of the risks facing Kodak when evaluating capital budgeting projects? Is this different from the approach that you learned about in FIN 402? ***Why or why not?***