

GEN PROBE INC  
Form DEFA14A  
May 28, 2003

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GEN-PROBE INCORPORATED  
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[GEN-PROBE INCORPORATED LETTERHEAD]

May 27, 2003

**To Institutional Shareholders of Gen-Probe Incorporated:**

On May 15, 2003, Gen-Probe issued an amendment to its proxy and to the proposed 2003 Incentive Award Plan in response to shareholder comments on the original Plan. The amendment reduced the number of shares to be reserved under the Plan from 3.75 million to 2.5 million. ISS subsequent proxy alert concluded: The total cost of the company's plans of 12.11 percent is within the allowable cap for this company of 19.87 percent. A copy of the ISS analysis is enclosed.

Despite the significant reduction in the size of the Plan and ISS' reiteration of its prior endorsement of the original Plan, we have continued to receive a number of comments on the revised Plan. In response to one such communication from Herbert Denton of Providence Capital, I outlined the circumstances specific to Gen-Probe that have guided our decisions on the 2003 Plan. A copy of my letter is enclosed for your review and consideration.

The enclosed letter also clarifies Gen-Probe's intention with respect to areas where the Plan, on its face, gives us a great deal of latitude. For example, I do not intend to recommend that any individual receive a grant of more than 100,000 options in any calendar year. Also, I will not recommend that the vesting period for any grant be less than three years.

The 2003 Plan is essential to Gen-Probe's ability to recruit, retain, and motivate directors, officers, and key employees. I will try to contact you on Wednesday, May 28, 2003 to discuss the Plan and any concerns that you may have about it.

Sincerely,

Henry L. Nordhoff  
Chairman, Chief Executive Officer and President

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**NOTE:**

ISS is updating its analysis for Gen-Probe, Inc. dated May 14, 2003 with respect to Item 2 (Approve Omnibus Stock Plan). The company filed an amended supplemental to 2003 Incentive Award Plan, reducing the total number of shares reserved under the plan from 3,750,000 to 2,500,000 at the company's board meeting on May 13, 2003. We had originally recommended shareholders to vote FOR this proposal and since this is a reduction in total shares reserved, our vote recommendation is unchanged. The new plan cost calculations are detailed below.

**PROPOSALS**

**Item 2: Approve Omnibus Stock Plan**

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This proposal reserves 2,500,000 shares under the **2003 Incentive Award Plan**. A description and analysis of the plan follows:

### Plan Features

<i>Participation:</i>	All employees, non employee directors, and consultants
<i>Expiration:</i>	March 3, 2013
<i>Administration:</i>	Compensation Committee. Gerald Laubach (IO), Brian McNamee (IO), and Armin Kessler (IO)
<i>Award Type (Exercise Price):</i>	ISOs (100%), NSOs (100%), SARs and restricted stock
<i>Award Limits:</i>	No more than 20 percent shares of restricted stock may be granted.
<i>Payment:</i>	Cash, check, broker notes, or stock. The plan does not provide for company loans to participants.
<i>Terms &amp; Vesting:</i>	All stock options must be exercised within ten years from the date of grant.
<i>Change-in-Control:</i>	The plan includes change-in-control provisions.
<i>Repricing:</i>	No express repricing policy was found.

### Historic Grant Patterns

	Shares Issued(all plans)	Percentage of shares outstanding
Current year grants	809,499	3.40%
Prior year grants	655,303	2.75%
Grants two years ago	1,357,510	5.70%
Total grants	2,822,312	11.86%

Named officer grants (one year) = 420,182

Grants to named officers / Current year grants = 51.91%

### Cost-Based Analysis Discussion

The plan has two costs to shareholders: shareholder value transfer (SVT), which is the dollar cost to the company as participants exercise awards at fixed prices below the current market price; and voting power dilution (VPD), or the relative reduction in shareholders' voting rights. By examining the cost of a new plan or amendment in conjunction with shares available for grant under all continuing plans and granted but unexercised shares, a comprehensive assessment of the company's total compensation program can be made. SVT is calculated using a binomial model: an estimated dollar value for each award is determined by factoring in the number of shares reserved, the exercise price, the award term, the vesting parameters, and any performance criteria. SVT is expressed as a percentage of market value. VPD is expressed as a percentage of fully diluted shares outstanding.

Current stock price:	\$36.33	Shares outstanding:	23,799,945
200-day avg.:	\$21.08	Warrants and convertibles:	0
Market value:	\$501,726,641	Share allocation from plans:	5,113,975
		Fully diluted shares:	28,913,920

**Shareholder Value Transfer**

	Share Allocation		Average Award Value		SVT (\$)	SVT (as % of market value)
A:	2,500,000	x	\$ 12.64	=	\$ 31,595,000	6.30%
B:	274,927	x	\$ 11.84	=	\$ 3,255,136	0.65%
C:	2,339,048	x	\$ 10.44	=	\$ 24,419,661	4.87%
Total:	5,113,975				\$ 59,269,797	11.82%

A = Shares reserved for plan/amendment; B = shares available for grant, all plans; C = granted but unexercised.

**Voting Power Dilution**

	Share Allocation	Voting Power Dilution (fully diluted basis)
Reserved for this proposal	2,500,000	8.65%
Under existing plans available to grant	274,927	0.95%
granted but unexercised	2,339,048	8.09%
Total	5,113,975	17.69%

These two costs are combined by assigning a 95-percent weighting to the SVT and a five-percent weighting to VPD as follows:  $(11.82\% \times 95\%) + (17.69\% \times 5\%) = 12.11\%$

**Comparing the Cost to a Benchmark**

The total cost of the company's plans is compared to an allowable cap. The allowable caps are industry-specific, market cap-based, and pegged to the average amount paid by companies performing in the top quartile of their peer groupings. Industry classifications are established using standard industry code (SIC) groups. Using historic data tracked by ISS of the amount of SVT authorized for issue at each company ranked in the top quartile of its industry, a benchmark pay level is established for each industry.

A cap equation is formulated for each industry by identifying those variables having the most significant impact on SVT. Regression analysis tests are run on the following variables: sales growth, earnings growth, return on equity, return on assets, debt-to-equity ratios, market capitalization, total shareholder returns, and cash compensation. Benchmark SVT levels for each industry are adjusted upward or downward by entering company-specific performance, size, and cash compensation data into the industry-specific cap equations.

SIC	Company-Specific Cap	Cost
8731	19.87%	12.11%

Following is a list of features that impacted the SVT estimates. Features noted with a (+) decreased the plan's cost, while features noted with a (-) increased the plan's cost:

(+) Limits were placed on grants of restricted stock. Such awards are more costly than stock options with an exercise price equal to 100 percent on the date of grant.

(+) Term limits are placed on NSOs. Such awards have a lower time value than options with an unlimited term.

(-) Vesting provisions for each grant are at the discretion of the plan administrators. Shares could be exercisable immediately.

Note that the following plan details were not factored into the SVT analysis:

The administering committee includes independent outside directors only.

Plan participation extends to nonemployees.

Company loans may not be provided for payment of the exercise price.

**Vote Recommendation**

The total cost of the company's plans of 12.11 percent is within the allowable cap for this company of 19.87 percent.

Vote FOR Item 2.



[GEN-PROBE INCORPORATED LETTERHEAD]

May 26, 2003

By Facsimile (212) 888-3203

Mr. Herbert A. Denton  
President  
Providence Capital, Inc.  
730 Fifth Avenue  
New York, New York 10019

Dear Mr. Denton:

Your letter of May 21, 2003 addresses certain issues surrounding Gen-Probe's proposed 2003 Incentive Award Plan. While I appreciate the time and effort that you and your fellow shareholders have spent in discussions and in conveying your views on the pending proxy proposals, I feel your suggestions do not adequately reflect the circumstances specific to Gen-Probe that have guided our decisions on the matters in question. I hope this letter will provide additional clarity concerning the size of the 2003 Plan and explain other areas where we differ, as well as describe the company's intentions in areas where the Plan provides wide latitude.

**Our Efforts to Design a Fair and Reasonable Incentive Award Plan**

When we first began to design the 2003 Plan, we recognized that we faced a unique challenge. We were confronted with a number of issues concerning how to design Gen-Probe's first real stock incentive program, including: the question of how to shape a plan for a long-established, successful biotech company that was far out of step with its peer group with regard to incentive compensation; how to address low employee morale resulting from the perceived inequities of an existing plan that had been based on a pre-market, estimated share value that proved to be unrealistically high, and had been further distorted by the exigencies of the spin-off from Chugai; and how to properly reflect turbulent and changing investor and regulatory attitudes toward stock options. (Note that the 2003 plan was being developed during a period when, despite the excellent performance of the company and its share price subsequent to the spin-off, the exercise prices for existing grants were below the share price.)

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Mr. Herbert A. Denton  
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In light of these circumstances, we contacted Institutional Shareholder Services and asked ISS to advise us with respect to reasonable terms for a 2003 incentive plan. We consider ISS to be the leading advocate of institutional shareholder interests and, therefore, an excellent source for fair, reliable, and independent advice concerning the plan terms. We understood that ISS would view any plan from the perspective of institutional interests and were unable to identify any other consultant that would be more credible, independent, and experienced than ISS. We were also advised by the leading compensation consulting firm of Clark/Bardes, which agreed with this approach.

In February 2003, ISS concluded that a reasonable 2003 Plan could reserve up to 4.9 million additional shares, if non-option awards were restricted to 20% of total awards. ISS also reviewed the other terms of the draft plan and did not suggest any revision to those terms.

The Compensation Committee concluded that we would seek significantly less than the 4.9 million shares determined by ISS to be reasonable, and originally proposed that the 2003 Plan include 3.75 million shares. ISS proxy department, independent from its consulting arm, subsequently endorsed the original plan for 3.75 million shares.

After considering the response of certain shareholders to the Plan as originally proposed, we further reduced the size of the Plan to 2.5 million shares. The revised Plan now includes approximately one-half the number of shares determined by ISS in February 2003 to be reasonable. The Board believes the 2003 Plan, as amended to include 2.5 million shares, is responsive to shareholder concerns about stock incentive plans and is fair and reasonable.

As I have detailed above, we felt that an appropriate incentive plan for post spin-off Gen-Probe had to address some unique problems. We solicited expert advice, and were guided by it. We now recognize that we would have benefited from dialogue with major shareholders before finalizing such an important proposal. In the future we will seek such a dialogue.

#### **Relationship of Number of Options and Exercise Price**

Your letter states that Gen-Probe employees have enjoyed \$21 million incremental value in connection with their existing options over the past eight months, and suggests that the tolerable overhang should be determined with respect to such accrued value. First, your statement disregards the fact that most of the value to which you refer is in vested options and cannot fairly be considered as existing gain. Furthermore, this incremental value only accrued during May 2003, when the share price increased from the mid-20 s to the high 30 s. Since the spin-off, shareholders have enjoyed **\$615 million** in incremental value, created by the efforts of Gen-Probe s management and employees.

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On September 16, 2002, the first day of regular way trading following the spin-off, Gen-Probe stock closed at \$13.79. The stock traded within a narrow range for many weeks. On March 3, 2003, when the Board approved the 2003 Plan, Gen-Probe shares closed at \$23.90. At that time, only an insignificant number of options, granted to employees hired *after* the spin-off, were in the money. On March 3, the share price did not exceed the exercise price for any options granted to management, although Gen-Probe's market capitalization had increased by \$240 million, or 73%, since the spin-off.

Employees did not participate in any significant way in the increased value of the company until *after* the shares began to trade above the two primary exercise prices of \$24.58 and \$27.31. In other words, shareholder value increased by approximately \$260 million before employees began to participate in the increased market value *at all*. Shareholders experienced no dilution, while enjoying a 75% return.

Gen-Probe shares closed on May 23, 2003 at \$39.66. In only eight months since the spin-off, shareholder value has increased 288% from the closing price on the first day of trading. Employees have only recently shared in this appreciation, and their vested portion of the increased value is disproportionately small compared to the gains enjoyed by shareholders.

### **CEO Compensation**

Your comments with respect to my own compensation place me in an awkward position. However, in fairness to the Board and to myself, I will briefly respond.

While I was not an original founder of Gen-Probe, for the past nine years I have led the effort to significantly expand the company's business beyond a limited product line focusing on non-amplified tests for sexually transmitted diseases. We have developed significant new amplified diagnostic assays, undertaken the Herculean task of developing the revolutionary automated *TIGRIS* instrument, built a state-of-the-art CBER-approved manufacturing facility for highly-regulated blood screening assays, and formed a joint venture with Chiron to obtain access to essential intellectual property and the blood screening marketplace. A great portion of the current value of the company was created after I joined Gen-Probe in July 1994.

In 1996, Chugai and Gen-Probe management initiated discussions of a partial IPO of Gen-Probe stock and implementation of a stock option program. Due to various timing constraints related to Gen-Probe's product pipeline, stock market conditions, and Chugai's unfamiliarity with options and public offerings, a stock option plan was not adopted until August 2000. In light of all of the circumstances discussed above, and my contributions to the growth of the company from 1994 on, the prior Chugai-controlled Board of Directors determined that it would make a one-time grant to me of a significant number of options in June 2002. The Chugai-controlled Board also made this award in order to provide incentive in connection with my involvement in critical and complex

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activities related to Gen-Probe's spin-off and the start of our new existence as an independent public company. Significantly, when Gen-Probe went public on September 16, 2002 and traded in the \$13-\$14 range, I held options with exercise prices of \$24.58 and \$27.31.

You have expressed concern that grants of a large number of options may encourage management to inappropriately focus on the short term. Under my stewardship, we have positioned Gen-Probe well for long term growth, with a pipeline of new products and programs that will deliver significant additional revenue. There is very little basis for concern that Gen-Probe's existing option structure will lead to a short-term focus.

#### **Board of Director Compensation**

Gen-Probe is a small, dynamic company with the potential for significant future growth. We need a Board of Directors that can provide active guidance and take a real role in directing the company's efforts. We have assembled an exceptional group of directors, who have outstanding experience, judgment, and commitment to the future of the company.

Gen-Probe needs our directors' hands-on commitment to the business and their wise guidance. Since Gen-Probe became an independent public company, we have made constant demands on the directors' time and they have responded brilliantly. Recent changes in the legal and regulatory environment also require that our directors devote significant time to their duties. After many directors commented on the time commitment that their service was requiring, the Compensation Committee obtained the advice and recommendation of an independent consultant, Clark/Bardes.

The Committee was advised that many companies were in the process of increasing director compensation in response to the new burdens and risks imposed by Sarbanes-Oxley. The amount of director compensation ultimately recommended by the Committee was determined based on Clark/Bardes' advice. All of the considerations discussed here, and particularly the consultant's advice, were pivotal to Committee's decision to set director compensation at the current level, which is appropriate.

At the suggestion of Dr. Laubach, a current member of the Gen-Probe board and the former long-serving president of Pfizer, we reviewed Pfizer's 2003 proxy and determined that your comments with respect to compensation of the Pfizer board are not accurate. Pfizer's cash compensation to directors is in excess of \$60,000 annually and their total compensation is significantly more due to various incentive unit awards. However, I do not believe that a large, established company such as Pfizer provides a relevant comparison in light of the *greater* demands that we place on the Gen-Probe Board to direct this dynamic and evolving organization.

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**Conclusion**

Shareholders are now enjoying the benefits of the hard work, creativity, and dedication of Gen-Probe's employees over many years. Gen-Probe cannot recruit, retain, and reward the best and brightest without stock options. Efforts to maximize shareholder interests in the short term by imposing severe limits on stock options will cripple our efforts to build shareholder value over the long term.

We appreciate the time and effort that you have devoted to providing us with your views and we have sought to be responsive where we found the suggestions or criticism to be well founded. The Board has the fiduciary responsibility to exercise its independent business judgment in connection with these matters and must consider the best interests of all shareholders. We believe a 2003 Plan authorizing 2.5 million shares is fair and responds to the comments that were clearly and effectively expressed to me at the luncheon in New York on May 6.

I do not intend to recommend that any individual receive a grant of more than 100,000 options in any calendar year. Although not written into the Plan, I will not recommend that the vesting period for any grant be less than three years. I intend to recommend that we reserve a portion of the Plan for issuance as specific performance incentives and/or rewards throughout all levels of the company, based on the individual's ability to contribute to specific projects and our continued growth. The final decision on all of these matters is, of course, the Board's.

Your May 21, 2003 letter does not identify any of the institutional investors who attended your May 20 meeting, nor does it identify the other investors who share your views but were unable to attend the meeting. Therefore, I am unable to communicate with them directly. As you requested, I have distributed your letter to all members of the Gen-Probe Board of Directors. I ask that you reciprocate, and distribute my letter to the shareholders referred to in the second paragraph of your letter, so that they can consider the facts and perspectives set forth here.

Sincerely,

Henry L. Nordhoff  
Chairman, Chief Executive Officer and President

cc: The Board of Directors