Long term incentives
by John Egan

Equity based long term incentive plans, while not universally permeating the reward of an entire workforce, have a critical place in executive remuneration. Over the past three decades equity based long term incentive plans have played an increasingly important role in the reward of senior executives in creating shareholder wealth. The plans have taken varying forms over that period from those which involve the issuance of partly paid shares paid to 1 cent to those involving the provision of loans to enable executives and employees to acquire shares in their employer, those loans generally being non-recourse, to option plans, performance shares or rights plans and in a limited number of cases the issuance of restricted shares.

In the majority of settings the benefits arising under these plans were subject to employee service for a period of time, initially in the order of five years and in the current and contemporary environment typically three years. In the last two decades there has been an increased incidence of the incorporation of performance hurdles in these plans whereby employee entitlements are dependent upon growth in shareholder value, company earnings and/or related financial benefit to shareholders.

The emergence of performance hurdles
In the late 90s total shareholder return and share price growth were the dominant performance hurdles. Earnings per share was embraced by only five companies in the top 100 at that stage, with varying measures of profit being adopted by one in twenty-five companies. Board discretion or no hurdle at all applied in approximately 30% of organisations.

This was the beginning of the era when institutional investors were focusing on the need for performance hurdles as more critical than relying on Board discretion to determine whether or not executives benefited from equity grants made as part of their total remuneration arrangements.

Increasingly, long-term equity-based incentive plans have required either fixed rates of growth in return or relative or absolute growth in total shareholder return, where performance equivalent to a market index represents a threshold and superior performance at the base of the top quartile of the market is the position at which all equity would vest.

A decade on, while Boards reserve the right to exercise discretion, performance hurdles among Australia’s leading companies are universal. Share price growth as a reference point has diminished in importance, with earnings per share growth and total shareholder return being the dominant performance hurdle considerations. In the second half of the current decade an increasing number of long term incentive plans adopted more than one performance hurdle, dividing grants into two or more tranches, each tranche subject to a different performance hurdle. In the 80s the vesting period was typically five years, as the 90s progressed the minimum vesting period was typically three years.
With increasing demand for performance hurdles to be met, in the mid 90s a significant proportion of companies reduced their minimum vesting period from four or five years to three years and introduced retesting as a provision if rigorous and demanding performance hurdles were not met by the initial vesting date. This has recently been opposed by a number of institutional investors, the Australian Shareholders’ Association and proxy advisers. In our assessment this has arisen primarily from the fact that the frequency of grants in the 80s and early 90s was every two or three years and not annual, as has become more common practice in the second half of the current decade.

Egan Associates do not endorse the opposition to retesting as executives only benefit from achieving cumulative performance hurdles approved by shareholders, retesting is for a limited period and a benefit will only arise to the participating executive if shareholder-approved performance hurdles are met on a cumulative basis. We also observe that the performance criteria can change from year to year, as have the performance requirements, particularly those requiring the meeting of high levels of relative total shareholder return, which in recent years (prior to the global financial crisis and its effect on capital markets) to achieve a median result have in many instances required a cumulative annual rate of return exceeding 20%.

**Share valuation for equity plans**

It can be demonstrated that there are serious flaws in the application of share valuation methods currently being applied. Review of this is very welcome. A serious flaw in the regulation of share plan administration is in the provisions in regard to valuation and recording of plans under the Accounting Standards. We support the review of the valuation methods to be used to establish the value of the granted benefit. While-ever there are two or even three methods of valuation being recommended or required for different purposes in commercial activities there will be potential problems and injustices.

Valuations may be as provided by the taxation legislation, or as required by the various disclosure provisions of the local and international accounting standards. This requirement is clearly a regulated aspect of disclosure and in accounting for equity grants in a company’s annual accounts.

We also believe that the valuation provisions adopted by accounting standards (typically AASB 2) are inappropriate as a foundation for determining grants under employee share, option and rights plans. The valuation of grants under employee share, option and rights plans have led to significant distortions in the allocation of employee benefits under these plans and bear little relationship to future earned income which is the primary interest of both Governments, boards, shareholders and employees.

Prior to the introduction of the accounting standard AASB 2 the value proposition for the determination of allocated securities under a long term incentive plan was typically an estimate of future share price growth. This was aligned to a company’s three year business plan outlook. The charts in the following several pages highlight the impact of various allocation scenarios over different three year periods and the impact of holding the July 2005 allocation until June 2009.

The first explores the three year period from 1 July 2002 to 30 June 2005 for the ASX top 100 companies at the time. The benefit reported is predicated on achieving a relative total shareholder return (TSR) having regard to the ASX 100 Accumulation Index with proportional vesting for performance levels from the median to the 75th percentile.

The histograms reveal the value of the benefit arising from the allocation of options adopting a future value allocation, a standard Black-Scholes allocation and a 20% discount to the Black-Scholes allocation. The values represent the share price growth over the period which can be compared with the allocation value ($100,000 at the time of grant). The average benefit obtained by the executives in those companies meeting the TSR hurdle was $361,806 by Black Scholes, $452,258 by discounted Black Scholes, and $202,591 by future value methodology.

The second chart, adopting a similar total shareholder return performance hurdle, highlights benefits arising using similar allocation methods in the period 1 January 2004 to 31 December 2006 for the constituents of the ASX 100. The average benefit obtained by the executives in those companies meeting the TSR hurdle was $588,108 by Black Scholes, $735,135 by discounted Black Scholes, $349,441 by future value methodology.
S&P/ASX 100 Constituents
1 July 2002 - 30 June 2005
Nominal realised benefit arising from the allocation of $100,000 by way of a share option adopting either a Black Scholes, discounted Black Scholes, or a future value methodology.
Hurdle: Pro-rata vesting between Median & 75th Percentile after a 3-year performance period

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Companies who fail to meet the hurdle are not shown.

S&P/ASX 100 Constituents
1 January 2004 - 31 December 2006
Nominal realised benefit arising from the allocation of $100,000 by way of a share option adopting either a Black Scholes, discounted Black Scholes, or a future value methodology.
Hurdle: Pro-rata vesting between Median & 75th Percentile after a 3-year performance period

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Companies who fail to meet the hurdle are not shown.
The first chart below applies a similar methodology for the period 1 July 2005 to 30 June 2008 for the constituents of the ASX 100. The average benefit obtained by the executives in those companies meeting the TSR hurdle was $727,941 by Black Scholes, $909,926 by discounted Black Scholes, $794,615 by future value.

Our research reveals quite variable values to participants over each three year cycle. Where securities which vested in June 2008 were retained until 30 June 2009, the current 'in the money' value of options using the standard Black-Scholes valuation was $340,529, using the discounted Black-Scholes $425,661 and the future value allocation $365,769. It will be noted this represents a substantial decline on the value at the date of vesting (second chart below).
Given the nature of the nominated performance hurdle (relative total shareholder return) a significant number of employees (nominally 50%) did not benefit under the theoretical grant as their company’s performance did not meet the hurdle rate of return. This arose in many circumstances where there was a significant increase in the company’s share price – further, due to the nature of the TSR hurdle (the most common) less than 30% of companies met the stretch element of the hurdle. The figures reported above represent the realised value in accordance with each company’s relative performance.

If there were an expectation that the valuation methodology adopted by Accounting Standard AASB 2 were to represent a reliable estimate of future value of securities obtained by employees under an equity based incentive plan, our results in the review of the application of a widely adopted performance hurdle and the adoption of three different approaches to valuing securities at the time of grant indicates a somewhat unsettling relationship between value ascribed and value realised.

In adopting a simplified performance hurdle of relative total shareholder return, 50% of participants would receive no benefit. Of those who do benefit the benefit is generally substantially above that expensed and purported to reflect an indicative remuneration value. Equally, for those companies whose participants fail to benefit using relative total shareholder return as the performance hurdle there is no relief in recovering the amortised expense of the issue of those securities.

Our basic research, reveals that the adoption of Accounting Standards for the purpose of providing shareholders with a meaningful appreciation of value of securities issued to executives is significantly flawed.

As the data reveals in the charts above, taxing a potential income benefit at the date of grant based on an existing valuation regime is at considerable variance to a mark to market outcome at the time of vesting. The illustration does not incorporate widespread market practice of smoothing returns or providing for retesting which we have endorsed based on our long experience, nor does it illustrate outcomes adopting different hurdles such as earnings per share growth or other measures.

**Valuation variance and allocation policy**

In compliance with Accounting Standards and the requirement to expense equity grants under long term incentive plans, companies will often seek a path which optimally mitigates the long term impact on their P&L, particularly as the issuance of securities, unless they are purchased on market, are a balance sheet item, not a P&L item, despite the involvement of international accounting bodies in resolving this foreshadowed governance challenge.

Arising from this juxtaposition of valuation and impact on the P&L, many organisations, with advice, have discounted a straight Black-Scholes valuation to account for exogenous factors, including the meeting of performance hurdles demanded by investors. The two critical drivers of value are volatility and the life of the equity instrument under the long term incentive plan. Many companies would value the security over the period until vesting, others over the life of the security.

In the 2005/2007 period, volatility of the leading indexes would have been in the order of 20% to 25%. Many companies are now experiencing volatility in the order of 60%, though might argue in a look forward context that their volatility for the purpose of determining expensing to the P&L should be reduced to 25% which will have a dramatic impact on the value of instruments issued and the appeal or otherwise in the current market of a share right compared to an option.

The illustration below sets out valuation variance without discount by varying the nominal vesting for an option or share right attached to a current share priced at $5 from three years to five years to seven years and its volatility from 20% to 60%. The graphic illustrations highlight the cross-over implications in respect of the choice of instrument under the long term incentive plan adopting various share price growth assumptions for the period ahead. These graphs also highlight a series of interesting dilemmas in relation to the disclosed intent of grants under long term incentive plans and probable outcomes in line with an organisation’s business strategies and plans.
The graphs above indicate the total value of the option or right over a twelve month period.

The graphs above indicate the total value of the option or right over a twelve month period. The value of options and share rights have been determined using a Black-Scholes Valuation methodology - assuming a share price at the time of grant of $5, the exercise price of an option at $5 and the exercise price for a share right at zero, volatility is assumed to be 20% or 60%, dividend yield and risk free rate are assumed to be 5%, and a 3-year term for both options and rights. Volatility has a direct relationship with the price of the option, such that the higher the volatility, the higher the value of the option.
Choice of performance measures and hurdle structure

While the above illustrates the equity allocation challenges for a company reporting a remuneration intent in its Directors’ Report, the following information portrays the further issue of accurate and transparent reporting of outcomes on the one hand and the level of performance required to meet hurdles, predominantly imposed after pressure from institutional fund managers and proxy advisers.

Prior to the current decade of the mandatory stretch hurdle, boards and shareholders appeared at ease with year on year 10% growth in shareholder returns, with 15% seen as exemplary. Risk mitigation was an underlying consideration, while growth was seen as key to sustainability. The table and graphs below highlight the level of return required to meet a nominated index’s long term total shareholder return over five and ten years for the ASX 50, ASX 100, ASX 200 and ASX 300 indices, as well as the performance gap between the median and 75th percentile for the ASX 200 over varying periods.
S&P/ASX 200 Index, Median & 75th Percentile of the S&P/ASX 200 Index
Total Shareholders' Return Performance
1 January 2008 - 31 December 2008

S&P/ASX 200 Index, Median & 75th Percentile of the S&P/ASX 200 Index
Total Shareholders' Return Performance
1 January 2008 - 30 June 2009

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Source: Thomson Financial Datastream. Values are rebased to 100 on 1 January 2008.
The lottery effect of the market and the probability of performance hurdles being met has not engendered wise planning or an appropriate forensic engagement or understanding by boards in relation to equity outcomes and the embedded risk in those outcomes. Solid performance in many instances has delivered no value to executives because their industry sector or circumstance under-performed the balance of the market.

Given that underlying risk has been recognised globally as a core problem with executive remuneration, one observation may well be that shareholders’ or their representatives’ demands for significant year on year compound growth in total shareholder return exceeding a median and achieving a 75th percentile has in fact been a core ingredient in sponsoring management taking increased risk in order to achieve returns demanded.

There has also been regular discussion in relation to the appropriateness of total shareholder return as a measure of company performance, particularly for the majority of executives participating in these plans. On the other hand, proxy advisers have criticised absolute earnings per share growth hurdles because they have almost universally been met.

It would be our assessment that the current structures of performance hurdles for long term incentive plans are not working for either shareholders or executives. Sound performance, particularly having regard to underlying risk, by management teams in many instances has not been rewarded, whereas in others the endless pursuit of growth associated with significant increases in debt in recent years delivered substantial out-performance, though in the current challenging period the price of debt funding has increased and the assets acquired in a bull market are being revalued in the current economic downturn.

It is not clear to many shareholders, particularly those investing in funds, whether the performance requirements considered appropriate by institutions managing monies primarily on behalf of superannuants, led to significant performance payments to the executives of those institutions.

These matters are not disclosed, but in our view as part of the global improvement of transparency in governance should be disclosed so that fund managers who receive performance fees should have the details of their executive incentive structures disclosed. In this context it is our understanding that there is no universal reward strategy for funds managers. Some would be rewarded on the achievement of an absolute return, others would have regard to their funds’ relative performance with institutions adopting comparable investment philosophies or of a comparable scale, others a combination of the two.

A challenging issue for directors of the major institutional fund managers, one which has existed for some time, is whether bonuses should be paid to investment specialists where they out-perform a market, though lose money. Similar questions have validity in relation to executive earnings under long term incentive plans where the company may have out-performed the market, though during the period of the long term incentive plan the value of shareholders’ investments have declined. This represents a governance challenge for board Remuneration Committees.

The philosophical intent of a long term incentive is to reward sustainability of performance at levels acceptable to boards and shareholders. The philosophical imperative of an annual bonus or incentive plan is to reward management for delivering on the business plan and budget of that year and key strategic and operational objectives agreed by the board as aligned to both the business’s sustainability, near term growth and prosperity. Under annual incentive plans key drivers are weighted between financial, strategic and operational objectives, with reward triggered on the basis of the extent to which management achieve or over-achieve targets or objectives established.

A further issue in relation to the lottery effect and the claimed remuneration intent of securities allocated under equity plans is whether in fact all securities offered under these plans should be conditional securities with no automatic right for those securities to vest irrespective of performance accomplishments. In this context if a fully effective performance is intended to deliver 50% of an executive’s fixed annual remuneration, then should the number of rights or options capable of vesting be aligned with that remuneration intent or should the executive in the immediate past bull market environment for an adequate performance be entitled to receive three or four times the remuneration intent, simply as a result of a rising market? Should there be a cap on remuneration outcomes associated with the original reward intent such that achieving a market average or 50th percentile performance, or indeed a budgeted or planned performance, would deliver the outcome expected, with a superior performance delivering twice that outcome and an exemplary performance say three times that outcome?

Awards would therefore be conditional and benefits would be allocated to executives in accordance with a discipline embracing the construct of reasonable reward, though not one which has the lottery effect of relative total shareholder return or one which pursues rapid growth without due regard to risk and sustainability of acceptable returns to shareholders. This might relate to a construct of reward for the future.

A question arises as to how this links in with good governance. The construct clearly needs further development. It will require careful consideration in relation to tax, though if awards are conditional this should be less evident. Boards would be required to indicate what they expect to deliver to executives who achieve specific outcomes. Outcomes might be required to be sustainable over extended periods and issues in relation to shareholders’ rights to trade and their flexibility should be considered quite separate from those of executives who are receiving remuneration arising from their employment, not a return arising from their investment other than the extent to which executives may be required to invest their earnings in shares during their period of employment.
Given the challenges associated with the performance hurdles now demanded by shareholders, primarily represented by institutional investors and proxy advisers, it may well be in the shareholder’s interest and the executive’s interest for awards of equity, whether options or rights, to be delivered as conditional awards aligned to a company’s annual performance and an executive’s contribution to that performance, those securities vesting over a three to five year period subject to the continuing employment of the executive, with gateways reflecting sustainability of a company’s earnings and sustainability of an executive’s performance at a level which reflects their continuing effectiveness.

It is acknowledged that this approach would also have challenges and place significant pressure on CEOs and boards in relation to the integrity of establishing sustainable performance gateways and assessing the ongoing effectiveness of an executive’s performance. One would assume in this context in respect of executives that if their performance was not at the effective level they would be terminated and forfeit the potential benefit arising from their past participation.

**Expensing of grants to profit and loss account**

We do not support the current requirement to expense the issue of equity to employees to a company’s profit and loss account. The issue of equity is normally a diminution of the shareholders’ proportion of ownership in the company. It is not an opportunity foregone to receive funds for those shares as the company on the employees’ behalf are not in the vast majority of cases purchasers in the market for the shares. Where shares are purchased on market to meet obligations under employee equity based plans they need to be expensed as they represent a cash cost in meeting obligations under an employee incentive plan.

**Vesting and exercise**

When a performance hurdle is satisfied, the share right, option or share is said to vest in the participant. Vesting means that the participant cannot be divested of their equity entitlement. However, there are at least three kinds of circumstance possible at this stage:

- the participant may receive the shares unencumbered, or be able immediately to sell the shares or rights;
- the participant may be required under the rules of the plan or the grant to hold the equity for a further period before dealing with it (exercise or sale) is allowed; or
- an executive may have limited windows in which to trade under the company’s governance protocols and share trading rules.

When decisions are being made on the timing of the imposition of tax on grants, the access to funds to pay the tax where securities are restricted from dealing must be addressed. There are often further complications with equity rights in multinationals and private companies.

**Concluding observations**

Egan Associates are of the view that the wide use of accounting standards for the purpose of valuing equity grants to executives has no merit. The practice of adjusting the allocation value of the award to reflect the probability of risk of forfeiture or failure is in no way aligned to the disclosed intent of an equity-based long-term incentive plan.

The insistence by major shareholder groups, proxy advisers and institutional investors that demanding performance hurdles, principally relative total shareholder return, be adopted has led to an increasing focus on pursuing growth, often with inadequate attention being given to the underlying risk associated with these initiatives.

Traditionally and appropriately, executive participation in long-term incentive plans has been designed primarily to align their interests with the sustainability of enterprise value for the benefit of shareholders. Meeting relative performance hurdles over a decade or more of bull market conditions, in our judgement, has placed undue pressure on company boards and executives to grow their enterprises at a rapid rate beyond measures considered to be reasonable and sustainable. In this context from a shareholder viewpoint, many being superannuants, steady rates of return in the range of 10% to 15% were considered admirable and today would be highly regarded. In contrast, the graph Average 1 year Annualised Return Index Growth for 1992 to 2008 in the section on **Choice of performance measures and hurdle structure** above reveals the return requirements to meet the share price index over the past five and ten years for the ASX 50, 100, 200 and 300.

General indexes are meaningless in the majority of instances as companies’ true prosperity is reflective of their industry sector, their positioning in a life cycle in relation to growth and their business sustainability.