

Point of View

Share and Share Alike: Employee Share Plans

How relevant are employee share plans in today's turbulent market? Sabrina Rabbani and Alan Jackson examine types of plans, their design features and benefits.

In the current environment it is easy to dismiss the relevance and value of employee share acquisition plans or equity-based incentive plans. With annual market declines of 30% or more for the majority of ASX listed companies and significantly more among some sectors, employee share accumulation plan balances have dropped considerably.

All or part of the unvested option awards may be “underwater” and performance share plans may vest at prices lower than the award price. Add to that the general discomfort of participants with the types of performance hurdles used for option and share plans, it's no surprise many consider their equity incentives to be disconnected from their contribution and “more of a lottery”.

There is a challenge for human resource professionals to ensure an employees' performance assessment is not clouded by recent events, and is based on ongoing performance and potential. A similar challenge exists where share plans must be evaluated using their long term benefits.

Prevalence of Employee Share Schemes

The popular view is that giving employees the opportunity to have a stake in the company provides a direct link between corporate and individual performance and is one of the best ways to get across a corporate message, to provide tangible benefits and build commitment.

Share schemes as a benefit have become more prevalent over the last twenty-five years in Australia. Equity based incentives and/or share acquisition schemes that provide all permanent employees the opportunity to become a shareholder in their company are prevalent among virtually all ASX100.

However across the broader community, the availability of share ownership schemes and employee participation rates in these schemes are lagging when compared to other industrialised nations. A policy initiative seminar jointly conducted in July 2008, by Australian Employee Ownership Association, Australian Fabian Society and the Australian Private Equity & Venture Capital concluded the percentage of owners in the work force in the UK and the US is twice that of Australia, where it is currently around 6%.

Excluding the negative influence of recent market declines, the biggest barriers to increasing employee participation would appear to be the complexity and cost of developing an appropriate equity plan that is in compliance with the relevant regulatory, taxation and accounting requirements. The administration and operation of equity based plans is more onerous and costly for unlisted companies than for listed companies, due to different disclosure requirements in regards to reporting and prospectus issuance. Additional reasons unlisted companies deciding equity plans for employees aren't worth the effort include:

- **Business valuation**—Professional external valuations can be expensive. Are the private owners willing to disclose the financial details required for a transparent internal valuation? Independent valuations are likely to be more frequent among companies with a diverse shareholding, perhaps involving private equity funds or where there is a planned liquidity event such as an IPO.
- **Liquidity of awards**—the management of sale and any forfeiture of employee shareholdings are more cumbersome. Assuming there are buyers and sellers how will the “price” be determined?

- **Dilution**—Are the shareholders e.g. founders or family owners willing to share in outright ownership?

Having considered how the ownership demographics of the company can influence the presence and extent of share ownership and equity based incentive plans, we turn to a view of the types of plans and how they might be utilised in listed and unlisted companies.

Types of Equity Based Plans and “Replicators”

There are several vehicles available for a company with an equity based capital structure, listed or unlisted on the local stock exchange to implement a broad based employee share ownership scheme or share based incentive plans aligned to performance. The commonly used equity based plans can be categorised as:

- **Share acquisition plans** that are broadly offered to all permanent employees across the company and its subsidiaries. These broadly include:
 - Employee Share Acquisition Plans, where employees salary sacrifice to purchase shares with support from tax concessions. A trustee, who holds the shares until the participant leaves the employment, usually runs the plan. Shares acquired and deferred can be held in the plan for up to 10 years.
 - Employee Award Plans provide for the free grant to employees (excluding executives) of parcels of shares up to a value of \$1,000 designed to attract the tax concession for such plans (certain requirements for concession such as > 75% of permanent employees must be invited to participate). The plan may be subject to a series of pre-grant company performance hurdles.

- **Contingent plans** where awards are contingent upon the achievement of performance hurdles and/or upon continued employment. The description of each type of plan under this category is shown in table 1.

A further category can be considered where a company seeks to provide equity or ownership alignment in a way that does not dilute existing shareholders or change the balance of shareholder interests. In a listed company these *phantom* or *replicator share* or *options plans* will track the value of the company's share price but will deliver a cash benefit vesting rather than equity. In private companies the options can be replaced by Value Appreciation Units and share plans replaced by Full Value Units.

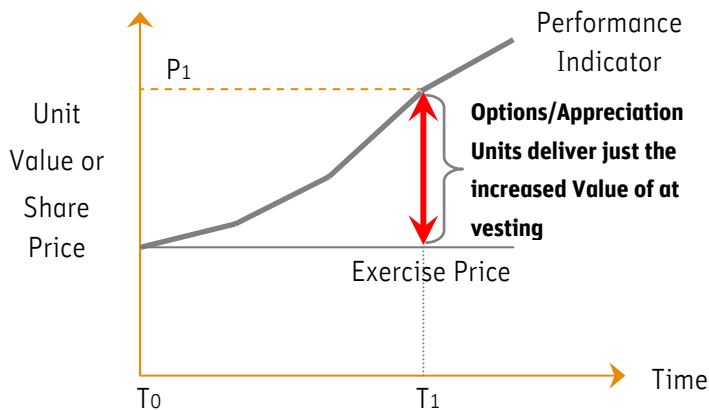
Table 1 Vehicle	Objectives					Constraints		
	Drive Long-Term Behaviour	Tie to Ownership	Market Competitive/Prevalent	Drives Retention	Clear "Line-of-Sight"	Dilution Expense	Cash Expense	Shareholder Reaction
<u>Options</u> : Provides the right but not the obligation for participants to buy a parcel of shares in the future at a price fixed at the date of the grant contingent upon tenure. Performance options are contingent upon tenure and performance.		++	++ <i>(trending lower)</i>	+	-	-	++	+
<u>Restricted Shares</u> : Shares are allocated to a Participant under plan arrangements intended to satisfy the exemption conditions under Division 13A of the Income Tax Assessment Act and will be subject to forfeiture if the participant ceases to be employed by the company before the end of the vesting period, - typically 3 years after the date of allocation. During this period the shares cannot be traded or mortgaged.	+	++	+	++	-	+	++	-
<u>Performance Shares</u> : Similar to restricted shares but subject to the achievement of performance criteria established and communicated at the date of allocation. Typically, shares are issued or acquired on market, placed in trust and vest depending on when and if performance hurdles and tenure conditions are achieved. No consideration is required from employees for the grant of restricted or performance shares.	++	+	- <i>(trending higher)</i>	+	+	+	++	++
<u>Performance Rights</u> : Provides the participant a right (subject to performance hurdle) to acquire shares in the company at a time in the future. In some companies plans can be flexible enabling rights to be issued with or without an exercise price. Such "omnibus" type plans provide the Board the discretion to issue rights that provide similar benefits to options, restricted shares and/or performance shares.	+	+	+	+	+	+	+	-
<u>Cash Based and Replicator Plans</u> : Can comprise of "Phantom Shares" replicating shares or "Share Appreciation Rights" replicating an option, each delivering the value in the form of shares or cash, with or without a performance hurdle. Work most effectively when tracking a market based share price. Can also be aligned to an annual valuation of the company's equity or other method to determine a value for the company.	+	- <i>(require high transparency and effective communication)</i>	- <i>(trending higher)</i>	+	+ with hurdle - without hurdle	++	-	++

++ Most Favorable; + Favorable; - Least Favorable

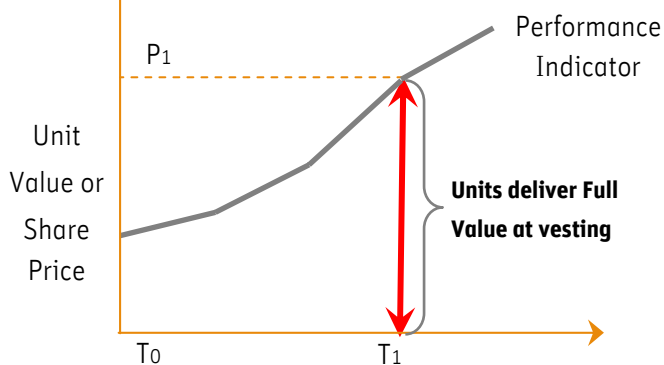
Note: Assuming consistent valuation methodology, accounting expense will be comparable between vehicles.

In the diagrams below we show how a full value share or unit provides a different benefit compared to Option or “Option like” appreciation value units.

“Option like” Appreciation Value



“Share Like” Entire Value Units



Main Characteristics:

- Employees receive the “appreciation” between price at exercise date (T1) and exercise price ¹at grant date (T0).

¹ The authors are not qualified financial planners and we recognise that our assumptions and approach are simplistic. Our sole objective is to illustrate the power of compounding to discourage short term market movements from influencing perceptions of the effectiveness of employee share plans. We recognise that there are a number of tax, financial and regulatory complexities that have not been taken into account. We further acknowledge that the relevance of our examples will also depend upon where the reader is on the career timelines

- When price (P1) is under the exercise price, the unit is technically worthless, or “under water”.
- Company and participants aligned to growth in value occurring over the performance/ vesting period.
- With “Share Like” units, employees receive the “entire fair value” of a full value unit or share at exercise date (T1).
- If there are no accompanying performance hurdles the only risk to LTI participants is in the value of the units.
- There is no “exercise price”, which means a unit always has positive value to plan participant.

Fewer full value units/shares than options or value appreciation units are required to deliver the same remuneration intent (indicatively 3 -4 options or appreciation units for 1 full value unit or share).

This two part article will conclude next month with some examples of how to deal with negative perceptions of share plans amongst employees in the current climate.

Employee Shares Schemes and the Current Climate

The following provides illustrative examples of how a long term perspective might be used to counter the negative perceptions arising in the context of the significant share market declines. On the basis of “buy low sell high” now might be the time to review the potential of future gains from commencing or continuing participation in employee share plans.

Share Acquisition Plans

Let's assume an employee had been awarded, or salary sacrificed annually, \$1000 worth of company's shares at market share price around January 1 each year, commencing from January 2003. Further assume that the company's total return to shareholders and the share price at acquisition tracks the ASX200 Accumulation index.

From January 2003 to date, the six contributions would total \$6,000. With a share price aligned to the accumulation index the value of the shares in January would have been approximately \$7,350 but by mid February 2008 would have declined to approximately \$6,640. By contrast \$1,000 invested each year at 5% (excluding tax considerations) would then have a value of \$8,142.

If the employee in this example were to continue with the annual \$1,000 acquisition for 10 years with market appreciated at an annual rate of 10% from the lows of February 2009, the accumulated value would approximate \$13,400 in January 2013, compared to the money in the bank value of \$13,207.

If the market and the company's share price saw an accelerated recovery from late 2009 and delivered annualised returns of 20% per year for the next 4 years, from February 2009 to 2013, the accumulated value would approximate \$19,600 in January 2013 compared to money in the bank of \$13,207.

Contingent Plans

A recent survey by Hewitt sought to assess the impact of the global economic downturn on executive pay and long term incentive programs in Australia and the Asia Pacific Region. The findings of the survey in relation to equity based incentive plans can be summarised as follows:

- Options continue to be a popular form of long term incentive (LTI), though Australian listed companies favour “full value” vehicles, as they are less dilutive and have greater perceived value.
- Around 75% of the respondents indicated that some action is expected to be taken regarding the delivery of long-term incentives in 2009.
- For those organisations who plan to modify their LTI plans, about a third of them plan to deliver lower long term incentive amounts than last year due to the decline in share price.
- Organisations experiencing a 50% decline in stock value or greater, are taking more action when compared to others in the survey sample. Approximately 40% of this group indicate they will deliver lower equity compensation than last year due to stock price decline, while another third reported they are expected to modify vesting or exercise conditions.
- Approximately 29% of the participants note that more than 75% of their outstanding stock options are “underwater”. However the vast majority of respondents (84%) are choosing to let them run their course as opposed to considering other alternatives.

- More than half of the participants reported an expected reduction in equity based incentive plan eligibility, of which the majority reported that the economic value sacrificed would only be partially replaced.

Given the current downturn and company responses in regards to their long term incentive plan, how does the situation vary between different types of vehicles? The table below illustrates the potential reward outcomes between shares and options. Let's assume:

- An award of options having a value of \$10,000 and an award of performance shares or rights having a value of \$10,000.
- All performance hurdles are met.
- Shares and options vest at the end of a 3 year performance period.
- In economic value terms, 1 performance share equals 3 share options.
- A share price of \$10 at the time of grant: suggests an award of 1,000 shares and 3,000 options.

	Award Size	Annualised Share Price Growth					
		-10%	5%	10%	15%	20%	30%
Options	3,000	\$0	\$4,729	\$9,930	\$15,626	\$21,840	\$35,910
Shares	1,000	\$7,290	\$11,576	\$13,310	\$15,209	\$17,280	\$21,970

In this example an annualised share price growth of approximately 15% is required over the 3 year performance period before an option plan delivers a higher value than a share plan. If the view was that the company's low share price offered a "recovery play" and annualised appreciation potential above 15% per annum, options would provide the better leverage and reward outcomes. By contrast, performance shares cannot go "underwater" and if hurdles are met will always have a value.

Conclusion

While the current market turmoil will likely give rise to lower levels of participation in employee share plans, shifting away from an "ownership culture" may address some immediate concerns but may influence long term employee engagement.

For a number of companies this may be an appropriate time to review changes to the design and operation of equity based incentive arrangements, the appropriateness of existing performance hurdles to current business circumstances and the scope of participation. Other questions to be asked at the time of review could also include:

- Is the purpose of the plan: to promote employee ownership or offered as a core component of the participants' remuneration arrangements aligned to their impact on the success of the company?
- Are both employee and management groups sufficiently knowledgeable about share schemes: how much educational support and disclosure will they require? How does the plan design and communication

resonate with the demographics of the employee population? If the overwhelming perspective is short term and cash oriented, or if in a privately held company there is a lack of transparency around the financials, is the share plan worth the effort?

- Is the equity based incentive plan constructed to align career oriented employee participants with the interests of long term investors (as opposed to those with a short term, trading perspective)?
- Will the company's board of directors and shareholders approve intended changes the plan design and performance criteria? Will there be any resistance? Why and how will that resistance be handled?
- What is the most appropriate long-term incentive vehicle in the current environment? Options, restricted shares and/or performance shares/rights?
- Is there a view that share market volatility has disconnected the share price from the underlying value of the company? In certain circumstances might the most appropriate long term incentive program be a cash based reward aligned to major milestones and/or to financial criteria, other than share price or a unit value methodology that serves as a surrogate for a share price?

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