

# From Bull to Bear: Equity Based Incentives in Turbulent Times



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Discipline of Work & Organisational Studies

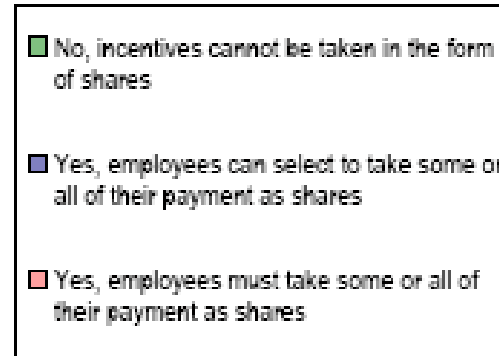
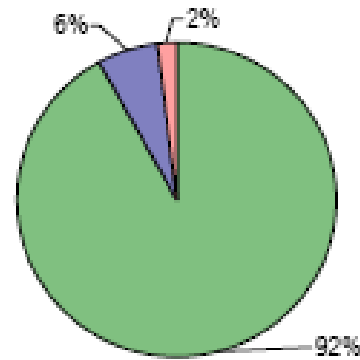
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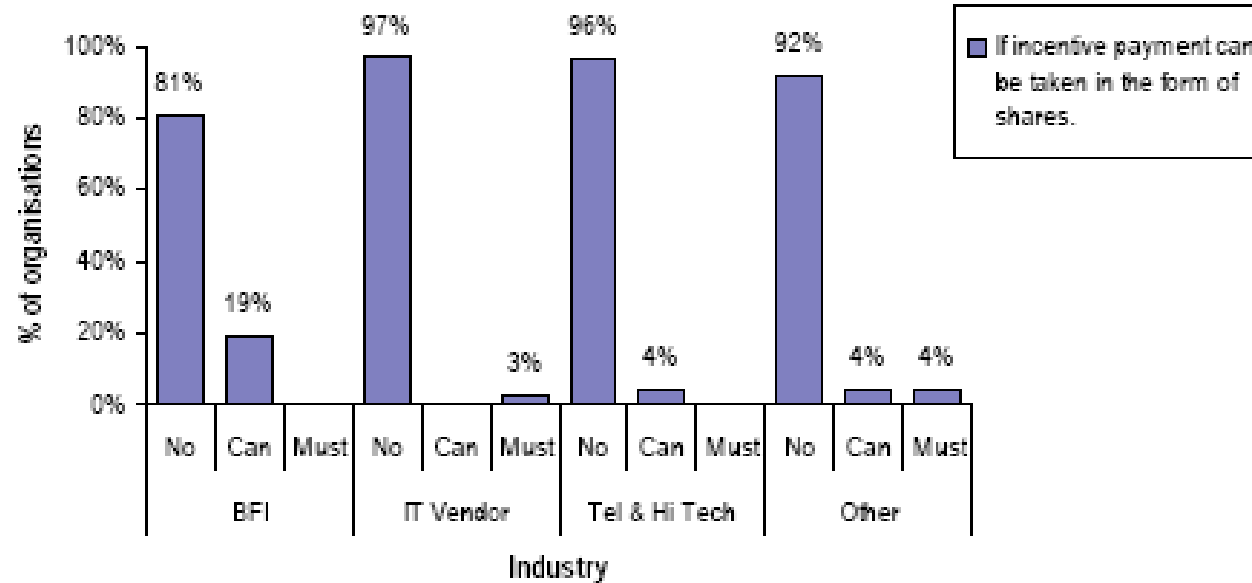
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# Equity-based Incentive Payment – Australia, 2006 (Csi Survey)



## Industry



## Performance-Related Reward Plan Types

Who (=performance entity/unit) & When (=time-frame for payout)?	How? (=behaviour)	How Much? (=results)
<b>Individual</b>	<ul style="list-style-type: none"> <li>• Merit raises/increments</li> <li>• Merit bonuses</li> </ul>	<ul style="list-style-type: none"> <li>• Piece rates</li> <li>• Sales commissions</li> <li>• Goal-based bonuses</li> <li>• Discretionary bonuses/cash recognition</li> <li>• Individual non-cash recognition</li> </ul>
<b>Large group short term incentives (STIs)</b>		<ul style="list-style-type: none"> <li>• Profit-sharing</li> <li>• Gainsharing</li> <li>• Goalsharing</li> </ul>
<b>Small Group STIs</b>		<ul style="list-style-type: none"> <li>• Team incentives</li> <li>• Team non-cash recognition</li> </ul>
<b>Organisation-wide long term incentives (LTIs)</b>		<ul style="list-style-type: none"> <li>• Share bonus plans</li> <li>• Share purchase plans</li> <li>• Share option plans</li> <li>• Share appreciation and other rights plans</li> </ul>

## Employee Share Plan Incidence & Types in Australia

- ❑ Almost 60% of all adult Australians own some company shares (either directly or via superannuation funds).
- ❑ But only 6% of Australian employees hold shares in the firm that employs them, compared to 30%+ in the US and EU.
- ❑ Only 4% of Australian firms have a broad-based plan covering at least 75% of employees
- ❑ Plan incidence highest in manufacturing (22%) finance & insurance (19%), & communication services (15%).
- ❑ Highest incidence in large listed companies; much lower unlisted companies (cf. USA).
- ❑ Proportion is higher amongst managers (12.6%) than non-managers (5.2%)
- ❑ Types of share plans for non-managerial employees in Canadian & Australian firms, c.2000:



<b>% of firms using:</b>	<b>Canada</b>	<b>Australia</b>
Share bonus plans	4	6
<b>Share purchase plans</b>	<b>21</b>	<b>21</b>
Share option plans	10	3

Source: Long & Shields (2005)

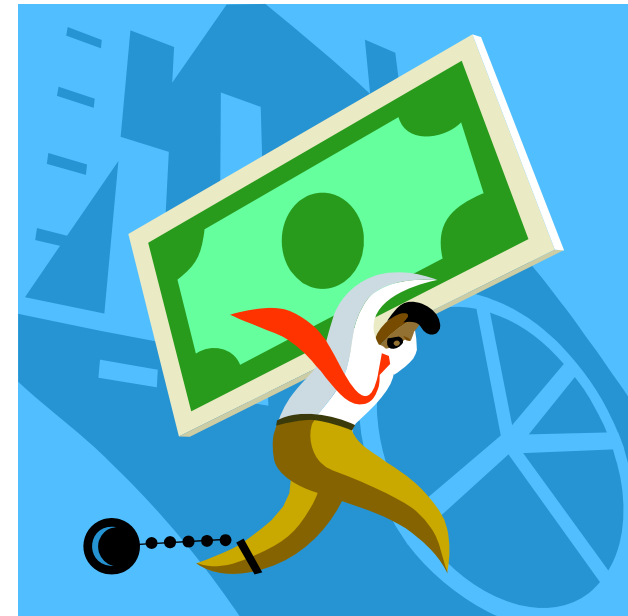
## Share Bonus (or Grant) Plans



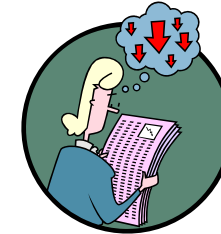
- Shares fully paid for by company
- Frequently in lieu of additional cash remuneration (e.g. deferred profitsharing)
- May be rolled into retirement fund/trust
- Employee receives regular dividends, typically fully-franked (i.e. tax-paid)
- Vested shares carry full shareholder voting rights
- May be 'restricted':
  - Non-vest/holding period (= 'golden handcuff')
  - Performance hurdle/s
  - Forfeiture
- Tax advantages depending on tax law

## Share Purchase Plans

- ❑ Employee pays for shares in part or full (and remains liable for purchase amount irrespective of subsequent movements in share price)
- ❑ Purchase price is typically discounted (i.e. price is set below prevailing market rate)
- ❑ Purchase facilitated by low-interest or interest-free loan to each employee (FBT exempt to employer in Australia).
- ❑ Loan principal and any interest owing commonly repaid by means of pay deductions or firm-operated savings/salary sacrifice plan and/or from dividend entitlements
- ❑ Shares held in trust during purchase period, with ownership vesting progressively as purchase is paid off
- ❑ Employee liable for income tax on dividends received.



## Share Bonus & Purchase Plans



### ADVANTAGES:

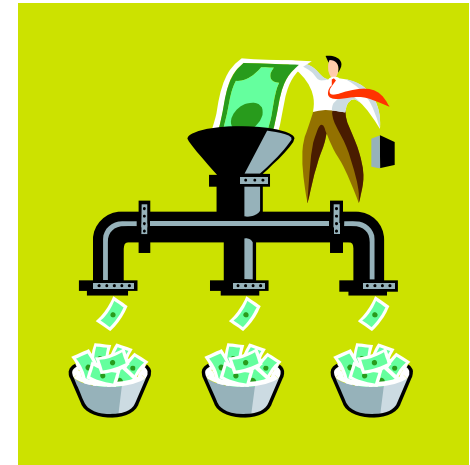
- ✓ Long-term effect compared to cash.
- ✓ Encourage an 'ownership' mentality.
- ✓ Encourage long-term commitment and membership behaviour.
- ✓ Support high involvement management style.
- ✓ Share purchase by employees can be a source of additional capital.
- ✓ Share ownership by employees can prevent competitor takeover & ensure ownership succession.
- ✓ Tax advantages.
- ✓ Can be used to confer equity to employees in firms that do not issue traded shares.
- ✓ Break on executive excess.

### DISADVANTAGES:

- ✗ Financial rewards (share price and dividends) linked only loosely to employee effort and performance (= low 'line of sight').
- ✗ Employee dissatisfaction and demotivation if the company share price falls or stagnates.
- ✗ Share purchase plans expose employees to considerable financial risk and loss of equity.
- ✗ Requires 'open book' management, which may expose management to greater scrutiny.
- ✗ May need to change management system to make it more participative and open.
- ✗ Can be costly to administer.
- ✗ Using of profitsharing as allocation mechanism further reduces line of sight.

## Problems with Using Profitsharing to allocate Equity

- ⊗ The 'line of sight' between individual performance and reward is likely to be weak because profitability is influenced by many non-controllable variables.
- ⊗ 1/N problem
- ⊗ A run of low profitability can cause significant employee dissatisfaction and actually compound the firm's troubles.
- ⊗ Equal allocation can cause 'free-loading'/'social loafing'.



# Employee Share Option Plans

## ***Fixed Price Option Plans:***

- Previously confined to executives; now commonly available to managers and professionals.
- Employees granted an entitlement to purchase a specified number of restricted shares in the company at a specified ('strike') price at a specified future 'exercise' date (typically the third, fourth or fifth anniversary of the option grant date).
- No ownership until option to buy is exercised.
- Strike price is typically the share price prevailing at the time the option is granted.
- Many option plans now have a 'performance hurdle' requirement.



## Employee Share Option Plans

### ADVANTAGES:

- ☑ No up-front costs to the employee (though firm must now expense against profit).
- ☑ No absolute 'down-side' risk to employees
- ☑ Allows employees to defer liability for capital gains and income tax.
- ☑ Substitute for cash in start-ups (e.g. 1990s IT firms; Amazon)
- ☑ In bear market (low/zero strike price) may have strong appeal to committed employees ('golden handcuff')

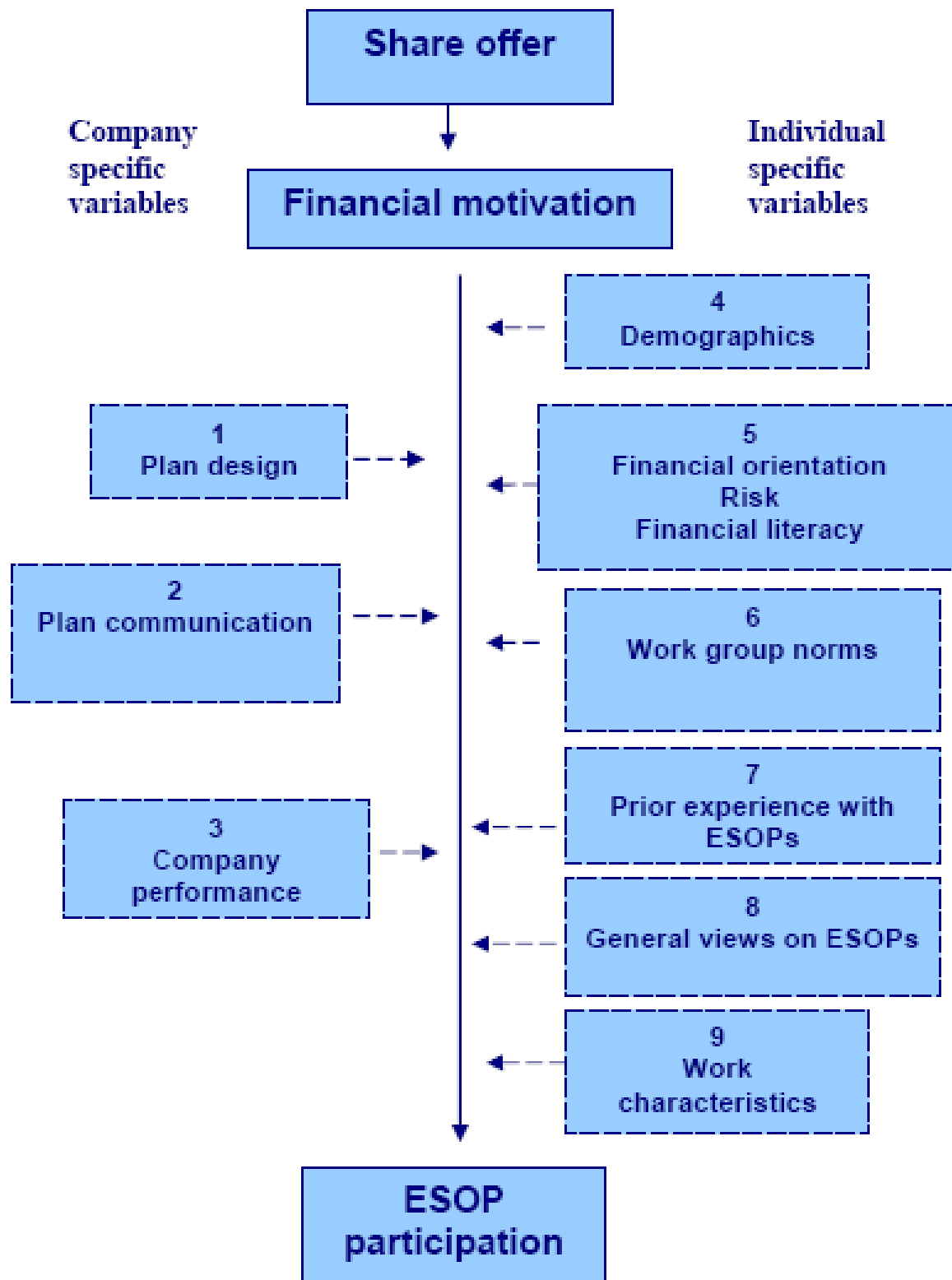


### DISADVANTAGES:

- ☒ Can encourage speculative behaviour; ownership may be transient
- ☒ Dilution
- ☒ New option grants are a 'cost' to the organisation and should be 'expensed' against revenue
- ☒ Fair-weather option only?

# Why Do/Don't Employees Participate In ESOPs?

(Brown et al, CCLSR, MUP, 2008)



## Requirements for ESOP Effectiveness

- ☑ Extensive communication about the nature of the plan and company finances.
- ☑ A high level of employee eligibility.
- ☑ A high proportion of employees who actually own shares.
- ☑ Eligibility for new hires as well as existing employees.
- ☑ Employees owning a high proportion of overall company equity (but the 5% barrier under the ITAA).
- ☑ Participative development of the ESOP itself.
- ☑ Accompanied by a meaningful employee involvement program.
- ☑ Favourable economic climate and share market.
- ☑ Limited employee exposure to downside risk/loss; problematic in high volatility industries.
- ☑ Comparable/equitable and transparent executive LTIs, with no hurdle retesting – i.e. one set of rules for all.



## Recent Innovations in Executive LTI Plans

### Performance Shares/ZEPOs

- Zero exercise price options (or ZEPO) plans allow the executive to take up shares at no cost but only on condition of a performance hurdle being satisfied over a designated performance period.
- Since fewer ZEPOs will be needed to deliver a level of reward comparable to that of a fixed price option plan, there is less potential for dilution, especially when shares themselves are market purchased rather than new issue.
- Do not encourage speculative behaviour.

### Share Rights Plans

- Non-compulsory share purchase plans, with option-like characteristics.
- Gives the holder the right, but not the obligation, to buy shares in the company.
- The purchase price is typically the market price at the date of grant.
- Some emulate direct grant and ZEPO plans by allowing shares to be acquired without payment but such plans generally involve performance hurdles.

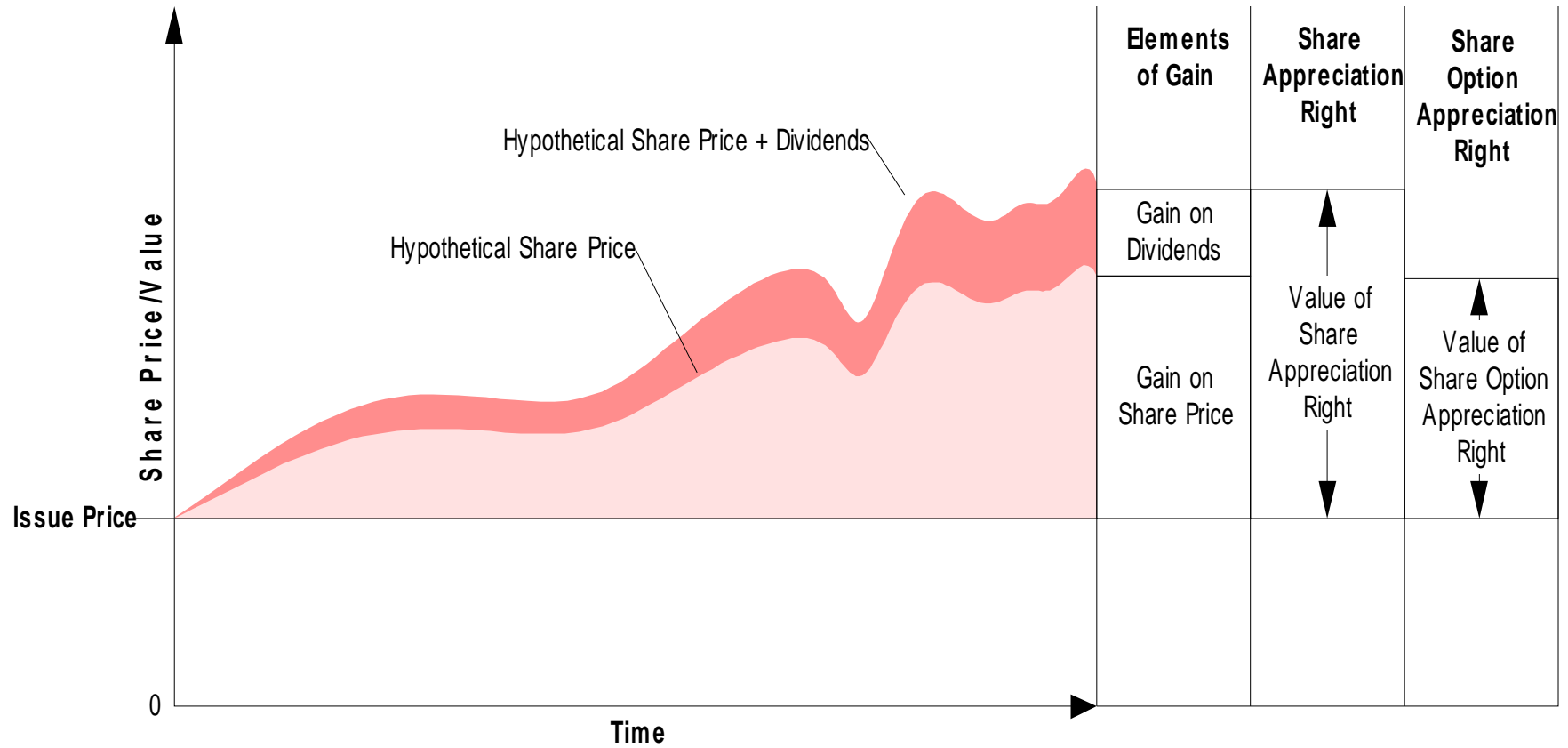
## Replicator Plans

- Share-like but cash-based
- Avoid dilution but are a direct expense
- Performance units/ share warrants/phantom share plans

## Share Appreciation Rights

- Take account of dividend earnings as well as share price appreciation
- No requirement to acquire shares.
- Often granted as a companion to share options in order to cover the holder for CGT liability arising from gain on exercise of an option.

# Share Appreciation Rights vs Options



## Executive LTI Plan Types and Hurdles, Australia, 2004

LTI Plan Type:	Percentage of Companies
Restricted shares or ZEPOs	57%
Options	45%
Share purchase loan plan	9%
Cash plan	4%
More than one LTI plan	23%
No LTI plan	11%

LTI Hurdles for:	Share Plans	Option Plans
Total shareholder return (TSR)	64%	64%
Earnings per share (EPS)	-	4.5%
Dual hurdle (TSR & EPS <sup>1</sup> )	11%	4.5%
No Hurdle	25%	27%

1. Dual hurdles may be 'either/or' or 50/50.

Source: Neuhold & HayGroup, 2005.

## Executive Reward Trends and Temptations in Hard Times

- 💣 STI equalisation plans
- 💣 Profit-sharing to goal-sharing
- 💣 Flight to cash
- 💣 Retreat to executive-only equity plans (but distributive justice an issue)
- 💣 80/20 rule (Juran) – incentive eligibility only for ‘key contributors’ – but performance is system-driven (Deming; Pfeffer).
- 💣 Re-pricing ‘out-of-the-money’ options
- 💣 Retesting of hurdles
- 💣 Relative hurdles (execs) vs absolute hurdles (shareholders)
- 💣 Longer vesting periods for equity LTIs.
- 💣 Rise and rise of the ZEPO.
- 💣 Legislated exec rem cap in taxpayer supported firms
- 💣 Binding (?) vote on all top exec rem packages of \$1m plus.

