

Why 'Vanilla' Won't Cut It

Design Principles for LTI Plans in Publicly Listed Companies



By Jamie Anderson

Too Much Use of the Cookie Cutter!

Over recent years we have witnessed a growing trend in the design of long term incentive plans, fuelled by consultants all too willing to leverage the vociferous position of influential stakeholder groups for maximum gain. At Mastertek we've challenged the conventional thinking, tested the principals underpinning these 'vanilla flavoured' equity plans, and developed an approach to the design of new programs that truly drives return on investment and successful business outcomes.

This paper highlights some of the factors contributing to the trend towards duplicate plan design, reviews some of the statistics and shares the principles we have established for effective plan design.

Expensing, Disclosure & Shareholder Institutions

There are a number of reasons why long term incentive plans developed in publicly listed companies are tending become common in their design, for example:

- ✓ IFRS2 and AASB2 accounting requirements, implemented from 2005, introduced mandatory expensing of equity-based rewards
- ✓ Disclosure requirements mean companies need to explain the mechanics of LTI plans and demonstrate the link between executive remuneration and company performance
- ✓ The introduction of the non-binding shareholder vote from 2004 has led to an increase in shareholder awareness and influence on plan designs

The influence of shareholder institutions in particular should not be underestimated. A February 2007 paper issued by the Australian Shareholders Association (Position Paper No. 2 – Executive Equity Plan Guidelines, issued jointly by the AICD, AEOA, ASA) set out a number of principles and guidelines that Boards were asked to adhere to when designing plans and seeking shareholder approval. Amongst other recommendations contained in the paper, it was suggested that executive rewards "should generally be consistent with equity plans for companies of similar size, industry and complexity".

The recommendations also touch on the type and nature of performance hurdles, paying particular attention to the fact that measures should be based on "comparing a company's performance with similar companies within a sector or industry over a certain period of time exceeding three years". The paper goes on to note that it is ASA policy to vote against any plan proposing vesting for a period of less than 3 years.

Trends in Publicly Listed Companies

Given the influences discussed above it is no surprise that, as statistics show, LTI plans implemented by publicly listed companies in recent years have adopted a similar set of measures and parameters.

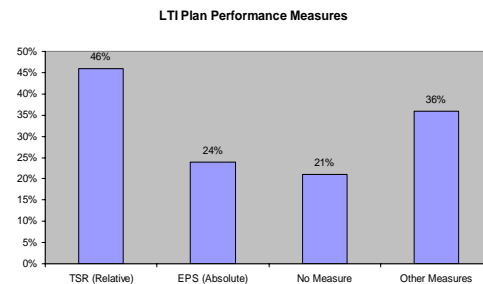
A 2008 study by Mercer highlighted the resolute use of performance based share plans in Australia (84% of those surveyed used full value performance-vested share plans), owing to preferential account treatment as well as the obvious link to executive performance.

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More interesting however is the convergence towards the use of a very narrow range of performance measures and the almost unvarying use of the 3 year performance period. In reviewing these performance measures we begin to question whether the plans have been designed to suit the companies and their strategic objectives or to suit the institutional shareholder groups who vote on their acceptance.



Taken from Ernst & Young's 2007 Executive & Board Remuneration Report covering the ASX Top 200 Companies.

The selection of appropriate performance measures is critical to the return on investment of any incentive plan. The success of the plan in focussing participants' efforts on activities that will drive business performance hinges on a number of factors (including the ability of the participant to affect the outcome) that may be diluted when selecting from a generic list of 'pre-accepted' measures.

Executive remuneration can at times involve a degree of tension between the interests of a company's executives and its shareholders and when designed well an LTI plan can be an effective vehicle for aligning the interests of the two groups. A combination of internal and external performance measures (such as EBIT and TSR compared to an appropriate industry benchmark) can help to balance the delivery of shareholder value alongside key performance indicators over which the participants have a higher degree of influence.

Design Principles for Strategic Alignment

In honing our approach to developing long term incentive plans we have learned that failing to engage and address stakeholder issues from the start invariably results in lengthy delays to implementation when shareholders are unable to commit to performance measures, value and quantum. Similarly, plan design should be inherently aligned to the business strategy in order to drive return on investment and help to ensure the buy-in of the Board and Remuneration Committee.

✓ Align with Business Strategy

- Select performance measures that are indicative of successful delivery of the business plan and drive return on investment for shareholders
- Clearly establish the objectives of the plan out the outset – "What are we trying to achieve here?" – to act as a reference throughout the design and testing phases
- Ensure participants can affect the outcome, and consider including individual level participation, or indeed vesting, criteria
- A graduated vesting scale reinforces the link between performance and reward

✓ Address the Shareholder Issues

- Build in an element of Board discretion over vesting and settlement wherever possible to retain control, while still ensuring that the plan design provides reasonable certainty for participants in terms of the outcome
- Good Leaver/Bad Leaver provisions relating to participants exiting the business can also help to protect shareholder interests
- Establish effective lines of communication with major shareholders, including both institutional and private groups, and ensure that any new plans are tested before taking to the vote

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Making Strategy Work

Mastertek's mission is to help our client organisations make business strategy work with a specific focus on people. We believe that every program we create should align the focus of the client organisation's employees with activities that will help to deliver specific business outcomes and ensure that strategies developed to realise particular aspirations really work.

We have worked extensively in the area of incentive plan design and development with a diverse range of clients across multiple sectors.