

# Don't Sell Your Business Short

Driving Long Term Returns Through Equity Based Incentive Plans

## A Return to Profit as Basis for Valuation

In recent years we've seen a bull market in Australia and coupled with strong economic growth the news has invariably be good for business. Well managed privately held companies have been able to achieve strong growth and investors have been happy to value prospective targets on a multiple of revenue rather than the more traditional profit based approach.

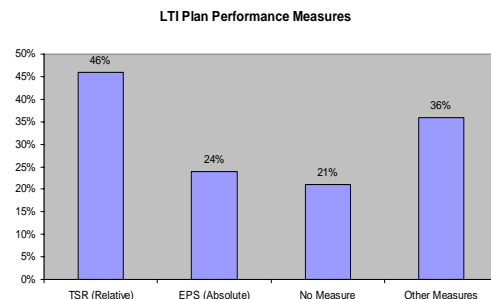
The recent global economic crisis however has begun to hit home in real terms. Those same suitors who six months ago might have been happy to pay up to 5 or 6 times revenue to acquire a new asset will now have revised their valuations to something more like 1½ times profit – meaning a considerable drop in return on investment for the enterprising baby boomers who have been toiling away for twenty years to grow these businesses.

This paper considers how a well designed, implemented and managed long term incentive plan can enable owners to continue to drive business growth and achieve an on-going return on investment through a retained shareholding and in doing ensure that they don't have to sell the business short in order to scale back day-to-day involvement and move towards that retirement dream.

## Listed Companies Have It Easy!

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

Furthermore, there has been a convergence towards the use of a very narrow range of performance measures and an 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

There are a number of reasons why long term incentive plans developed in publicly listed companies have 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

There has been no such trend in the private equity sector for the simple reason that objectives and aspirations are vastly divergent. Creating and implementing an LTI plan is a lot more complicated than satisfying a shareholder group that have already 'mailed in' their requirements<sup>1</sup>.

<sup>1</sup> A 2007 paper, "Position Paper No. 2 – Executive Equity Plan Guidelines", issued jointly by the AICD, AEOA, ASA offers a set of principles that company Boards are asked to adhere to when designing LTI plans and seeking shareholder approval.

## The Emotional Journey

In a privately held company, emotional factors add to the traditional design considerations – particularly when dealing with long term incentive plans in which owners consider the implications of sharing equity with their employees. This is particularly true of family run organisations or those still owned by the original or founding shareholders. On numerous occasions over the years Mastertek's consultants have travelled an 'emotional journey' with business owners when developing what has ultimately turned out to be a highly customised long term incentive plan. This journey tends to include a similar set of emotional 'phases':

- ✓ **Certainty or "Clarity of mind"** – typified by the statement, "We know we want an LTI plan and have a fairly good idea what it should look like, but just need your help setting it up". This is often where the engagement commences and almost always proves to be a 'false start'.
- ✓ **Uncertainty or "Questioning the outcome"** – as options for plan design are tabled, owners often begin to question whether they really want to dilute their equity holding and the implications of sharing equity with employees
- ✓ **Cost or "How much do we need to offer?"** – in our experience, owners of private companies need greater reassurance that the plan is affordable and struggle with the issue of "how much do we need to give"
- ✓ **Performance measures or "Covering all bases"** – owners can often find it difficult to select the appropriate performance measures for an LTI and often end up trying to cover every aspect of performance. The risk here is that the plan loses the attention and the "buy-in" of participants and ceases to be an effective incentive
- ✓ **Valuing equity or "What are we worth?"** – sharing real (or even phantom) equity with employees necessitates some form of valuation of the business which may never have been undertaken before. Mastertek generally recommend a simple formula that is defensible and repeatable for this purpose; it doesn't need to be a reflection of what an investor buying in to the business might pay for the shares

## The Golden Rules

In honing our approach to developing long term incentive plans for privately held companies we have learned that failing to address the emotional issues from the start invariably results in lengthy delays to implementation when stakeholders are unable to commit to performance measures, value and quantum.

We believe that by applying these principles well owners can put in place effective long term incentive strategies that enable a phased approach to dilution of equity whilst at the same time driving future growth and ensuring a return on investment of shareholders.

### ✓ Address the Emotional Issues

- Build in an element of owner/Board discretion over vesting and settlement wherever possible to retain control, while still ensuring that the plan design provides certainty for participants in terms of the outcome
- Good Leaver/Bad Leaver provisions relating to shareholders exiting the business can also help to ensure ownership is devolved appropriately

### ✓ Align with Business Strategy

- Select performance measures that are indicative of successful delivery of the business plan and drive return on investment for shareholders
- Ensure participants can affect the outcome, and consider including individual level participation, or indeed vesting, criteria

✓ **Address the Emotional Issues**

- Establish a mechanism for internal trading of shares once restrictions placed on the shares end
- 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

✓ **Align with Business Strategy**

- A graduated vesting scale reinforces the link between performance and reward

**Making Strategy Work**

Mastertek’s consulting practice is built on the premise of making strategy work through 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.