

Management Briefing

Long Term Incentives

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Background

For the purposes of this paper we have defined a long-term incentive (LTI) as:

Any reward mechanism that provides for performance-contingent reward to be granted over at least a three year timeframe.

LTI schemes include the following two categories of plans:

1. Share based arrangements:

- ◆ These can be approved or unapproved
- ◆ They can be options or contingent share grants
- ◆ They also include share allocation linked to a deferral from an annual bonus scheme

2. Cash based arrangements:

- ◆ These might mimic share-based schemes, for example Phantom Share Plans
- ◆ They may also include future cash payments linked to a deferral from an annual bonus scheme

Why do businesses introduce LTIs?

The traditional objectives businesses seek to meet by introducing a LTI are to:

- ◆ Align the interest of top management with those of the shareholder
- ◆ Support the attraction, retention and motivation of top talent.

Increased focus on LTIs has been driven primarily by recent economic events, which in turn have led to new codes of practice published by the Financial Reporting Council (June 2010) and the Financial Services Authority (January 2010). In addition, the Commission of the European Communities has published a draft recommendation on remuneration for directors and a second draft recommendation that sets out specific requirements relating to the financial sector. The general thrust of these various initiatives is that:

- ◆ executive pay arrangements should be more transparent
- ◆ there should be increased focus on managing risk
- ◆ more of the total reward package should take the form of a LTI.

While these codes and recommendations do not specifically apply to every business or business type, they do provide a strong indication of best practice that is worthy of consideration in all LTI scheme design.

Which type of LTI is right for a particular business?

This depends largely on the interplay of a number of factors which include:

- ◆ The size of the business
- ◆ Whether it is a private or public company
- ◆ The type of business e.g. FSA regulated
- ◆ The objectives of the shareholders (share value, dividend income, exit strategy, etc).

Some examples of how different types of scheme might suit different types of business are:

Type of Business	Possible Scheme Type
◆ Small entrepreneurial	◆ Enterprise Management Incentive
◆ Privately owned / family business	◆ Phantom Share Plan
◆ Large corporate	◆ Deferred annual bonus plus share-based LTI

What are the features of the main LTI schemes?

Share-based arrangements

Option schemes

Option schemes provide the participant with the opportunity to buy shares at a future date based on a price agreed when the offer is made. The right to exercise the option may be based on the achievement of agreed performance conditions either related to the return to shareholders or the performance of the business.

The participant must find the capital for the share purchase and receives the benefit of any intervening increase in share price. If the shares have not increased in price there is not normally any obligation on the participant to exercise their option. Share option schemes therefore provide an upside value for the participant but unlike "real" shareholders there is less exposure to falls in share price until after the option is exercised.

Option schemes may be approved by HMRC or unapproved. In general, approved schemes have beneficial tax treatment but are less flexible because the design needs to meet the appropriate rules.

Performance contingent plans

The most commonly occurring performance contingent share plan is what is known as a Performance Share Plan. In this type of scheme shares are nominally allocated to participants based on the share value being a multiple of base salary. These shares transfer into the ownership of the participant after an agreed time period (typically three years) and subject to certain performance conditions (for example, total shareholder return relative to an agreed peer group).

Deferred bonus schemes

In a share-based deferred bonus scheme the value of the bonus that is deferred is converted into shares. In voluntary deferral schemes the employer might add matching shares to make deferral more attractive to the employee. In compulsory deferral schemes there are usually further performance requirements set that determine whether the shares are subsequently released to the participants.

Cash-based arrangements

Phantom share schemes

These mimic some of the features of share-based schemes and tend to be used where real shares are not available. This might be because the employer is not a company limited by shares or because there are shareholder concerns about equity dilution.

Phantom plans are usually based on one of two approaches:

- ◆ A stock appreciation plan is a LTI where the value of the plan tracks changes in the price of the underlying shares. Where shares are not listed a formula is devised to represent the share price which may include reference to performance against a peer group of companies.
- ◆ A performance-driven plan is where a balanced scorecard is used to revalue units of phantom stock. Typically these plans focus not just on the financial metrics but also underlying performance indicators that are believed to affect the long-term financial success of the business. Examples include customer satisfaction, employee satisfaction and corporate social responsibility results.

Phantom schemes are flexible within the constraints of accounting regulations and company law because they are unapproved. In effect they are long-term cash bonus plans that are paid through payroll. Typically plan measurement periods are between three and five years, with some schemes providing incentives for participants to hold their "shares" for longer.

Deferred bonus schemes

Cash-based deferral plans operate in a similar way to share-based deferral plans. Deferred bonus might be managed under the Phantom Stock Plan or might be subject to performance criteria that determine the extent to which the bonus is released.

How do I introduce a LTI scheme?

There are a number of steps that need to be completed:

- ◆ Clarify the objectives that the scheme needs to satisfy, for example the balance between rewarding performance and driving the right behaviours.
- ◆ Determine what type of scheme will be the most appropriate based on the type and size of business.
- ◆ Review the employment contract of the potential participants and identify the potential impact of introducing a LTI, for example the total value of the package payable if an employee leaves the organisation.
- ◆ Develop the scheme and model against various scenarios to create an understanding of the risk to return balance.
- ◆ Engage key stakeholders and ensure the scheme meets the appropriate regulatory requirement or best practice guidelines as necessary.
- ◆ Develop communication and administration methods appropriate to the scheme and the business.
- ◆ Launch and continually review to ensure the scheme is meeting its objectives and is compliant with any requirements.

To discuss your needs and to get a better understanding of how PAYdata can help you develop the right LTI for your business please contact Paul Hajduk on 01733 364070.

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