GRG Remuneration Review

Is It Time to Reconsider the Use of Options as Executive Long Term Incentives?

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INTRODUCTION

Now that the hysteria surrounding options has dissipated it is perhaps timely to review which executive equity based long term incentive plans are most appropriate to company circumstances. Separate papers will be prepared on specific aspects such as performance hurdles, allocations, taxation implications and accounting charges. This paper focuses on identifying the main alternatives in terms of plan types. It then goes on to discuss when each plan may be the most appropriate plan to use and why.

KEY POINTS

- Market practice indicates that share rights are the dominant form of executive long term incentive plan in Australia.
- With the exception of groups with stapled securities, which use loan or cash based plans, the circumstances of companies, in particular their business plans and strategies, do not seem to have been taken into account when selecting the plan type to be used.
- The dominant form of plan is based on share rights rather than options which were previously the most frequently used.
- The change from options to rights was driven by factors unrelated to the effectiveness of rights or options in terms of meeting the objectives of LTI plans. Such objectives being to drive performance and retain key executives.
- Analysis of the relative benefit opportunities for executives indicates that companies seeking superior returns to shareholders through share price growth would be better served with an option plan than a rights plan.
- Given the foregoing it may be timely for Boards to reconsider the use of rights and possibly change to options.

GRG **Remuneration Reviews** are articles to assist directors and senior executives who have responsibilities in relation to Board and senior executive remuneration and other human resources issues. Their role varies between articles with some aimed at stimulating critical thinking, others updating information and others simply acting as a reminder of principles and approaches where awareness may need to be heightened.

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ROLES OF LTI PLANS

There are two main roles to be filled by long term incentive (LTI) plans. These are:

- incentive to grow the value of the business by providing executives with a share of the value growth they help to generate, and
- retention of executives so as to maintain a stable top management team.

It was the first of these roles that led to the widespread use of options in LTI plans. They only produce benefits for executives when the value of the business increases and therefore provide a strong alignment with shareholder interests.

Other factors such as dilution may have an impact on plan type selection. However, the role of the plan should drive plan type selection.

MARKET PRACTICE

The following table summarises the results of a recent analysis of a group of 56 of the top 100 companies listed on the Australian Stock Exchange. Overseas companies, investment companies and others where their practices were not clear were excluded. The terms “rights” and “options” are explained later in this article.

PLAN TYPE	% OF COMPANIES
Rights	57%
Rights & Options	11%
Options	9%
Cash Based	4%
Loan Based	16%
Other	3%
Total	100%

The dominance of rights has been driven by concerns about options following notorious options linked behaviour of a few overseas executives and the previous absence of an accounting charge for options. However, the current environment is different with annual grants, performance based vesting, accounting charges for share-based payments and increased emphasis on auditing and accurate financial reporting.

PLAN TYPES

Options and Rights Plans

As indicated by the previous market data, there are two main plan types that are commonly in use in Australia today. These two plan types are rights plans and option plans. They are described below.

Plan Type	Other Names for Same or Similar Plans	Description of Plan
Options	▪ Share Option ▪ Market exercise price options	• Options are granted to executives. • Exercise price of the options is equal to the <u>market</u> share price when the options are granted. • The term of the options is between 5 and 10 years. If not exercised by the end of their term then they lapse. • Executives should elect to be taxed on the value of options in the year they are received so as to commence qualification for the 50% capital gains tax (CGT) concession. This has cash outflow implications for executives. • Options vest (become exercisable) when vesting conditions have been fulfilled. Exercise requires payment of the exercise price which generally necessitates sale of shares which also triggers a tax liability and sale of more shares. • On termination of employment some unvested options may vest and then all vested options need to be exercised within specific periods or they lapse. • Takeovers generally trigger vesting of options.
Rights	▪ Performance Shares ▪ Share Rights ▪ Performance Rights ▪ Zero exercise price options	• Rights are granted to executives. • Exercise price of the rights is <u>zero</u>. • The term of the rights is between 5 and 10 years. If not exercised by the end of their term then they lapse. • Rights vest (become exercisable) when vesting conditions have been fulfilled. • Executives would not elect to be taxed in the year when the rights are received as tax would be paid on the full value of the shares. Not electing allows deferral of tax. • Exercise occurs as soon as the rights vest thereby converting them into shares. No exercise price or tax needs to be paid at exercise and therefore there is no pressure to sell shares. • On termination of employment some unvested rights may vest and then all vested rights need to be exercised within specific periods or they lapse. • Takeovers generally trigger vesting of rights.

COMPARISON OF PLANS

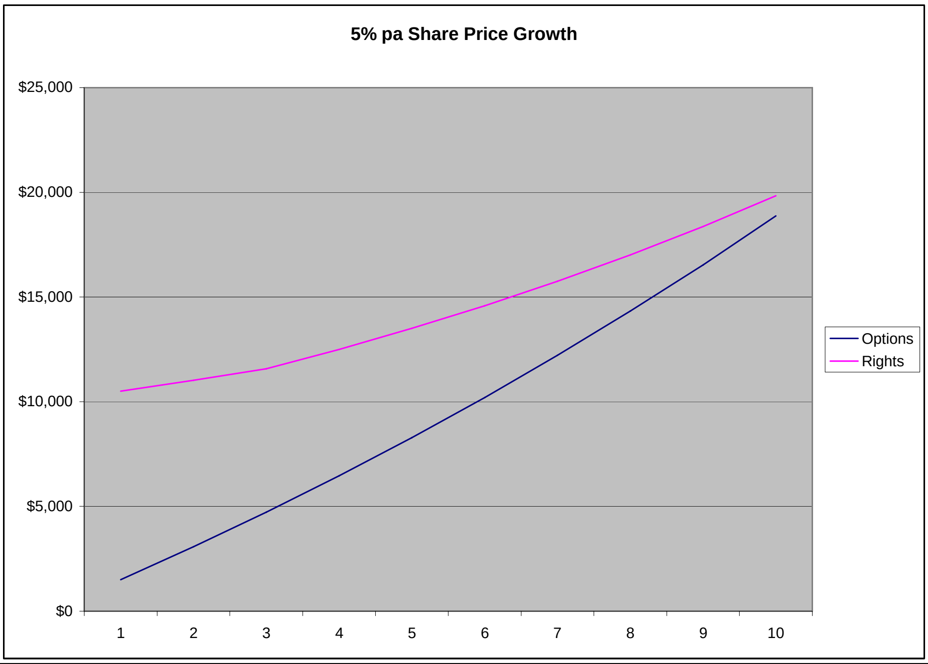
A critical aspect when comparing LTI plans is the potential benefit for executives and therefore the likely incentive and retention impacts.

In order to compare options and rights we have used the following assumptions and then graphed the resultant gross benefit produced under each plan.

Assumptions:

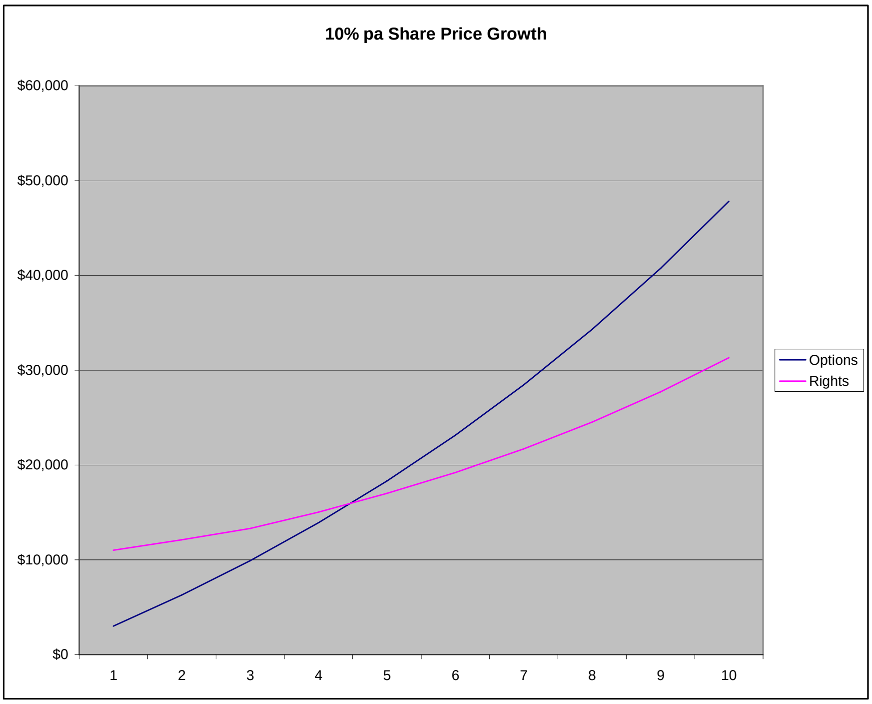
1. Grants of rights over $10,000 of shares and options over $30,000 of shares. This is based on each right being equivalent to three options. Thus, the cost to the company would be about the same irrespective of whether options or rights are used.
2. All options and rights vest.
3. The term for both options and rights is 10 years.
4. Rates of growth in share price vary between the illustrations with 5%, 10% and 15% pa compound being used.
5. Dividends on rights have been brought to account after year 3 at an after tax yield of 3%.
6. That options may qualify for the 50% CGT concession has not been brought to account

The graphs show the accumulating gross benefit.



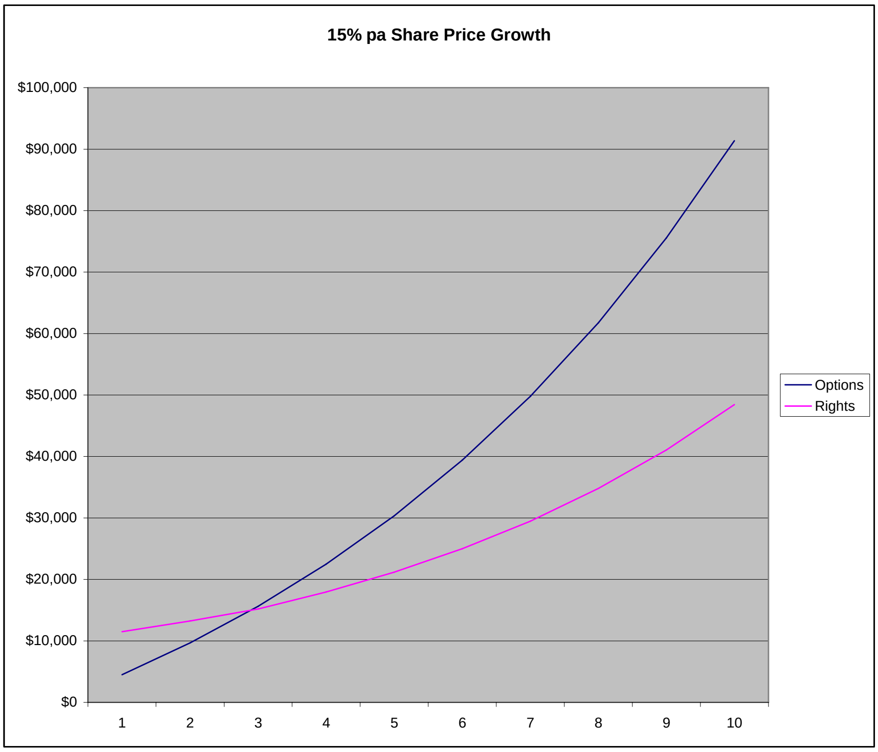
Plan Type	Years at 5% pa Compound Growth in Share Price									
	1	2	3	4	5	6	7	8	9	10
Options	$1,500	$3,075	$4,729	$6,465	$8,288	$10,203	$12,213	$14,324	$16,540	$18,867
Rights	$10,500	$11,025	$11,576	$12,502	$13,503	$14,583	$15,749	$17,009	$18,370	$19,840
Net Divs on Rights				$347	$375	$405	$437	$472	$510	$551

At 5% pa compound share price growth, rights out perform options over the whole 10 year period.



Plan Type	Years at 10% pa Compound Growth in Share Price									
	1	2	3	4	5	6	7	8	9	10
Options	$3,000	$6,300	$9,930	$13,923	$18,315	$23,147	$28,462	$34,308	$40,738	$47,812
Rights	$11,000	$12,100	$13,310	$15,040	$16,996	$19,205	$21,702	$24,523	$27,711	$31,313
Net Divs on Rights				$399	$451	$510	$576	$651	$736	$831

At 10% pa compound share price growth, rights provide greater benefits during the first 4 years but options provide greater benefits from the 5th year onwards.



Plan Type	Years at 15% pa Compound Growth in Share Price									
	1	2	3	4	5	6	7	8	9	10
Options	$4,500	$9,675	$15,626	$22,470	$30,341	$39,392	$49,801	$61,771	$75,536	$91,367
Rights	$11,500	$13,225	$15,209	$17,946	$21,177	$24,988	$29,486	$34,794	$41,057	$48,447
Net Divs on Rights				$456	$538	$635	$750	$885	$1,044	$1,232

At 15% pa compound share price growth, rights provide greater benefits during the first 2 years only and options provide greater benefits thereafter.

OVERVIEW OF COMPANY CIRCUMSTANCES

As a guide the following table presents a range of share price growth scenarios and then suggests which plan may be most appropriate to those circumstances.

Share Price Growth Expectations	LTI Plan Most Likely to Be Appropriate	Comments
>10% pa	Options	Companies pursuing superior share price growth would expect to meet performance hurdles. Therefore both performance and retention would be well serviced via options.
>7% & <10%	Options or Rights	Either plan will produce similar benefits for employees over the medium term. Rights may be more appropriate if retention needs emphasis. Options may be more appropriate is performanve needs more emphasis.
>0% & <7%	Rights	Companies expecting modest share price growth possibly operating mature businesses.
</=0%	Cash Based Plan	Companies with particular issues that may mean that high quality management contribution may reduce expected loss of shareholder value.
Stapled Securities	Loan Plan or Cash Based Plan	Taxation and other considerations lead to use of cash or loan based LTI plans.

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GRG Contacts

GRG is well positioned to assist boards in reviewing their company's remuneration strategies, incentive plans and employment contract terms. Many of the top Australian listed companies are among our growing number of clients.

GRG maintains data bases on director and executive remuneration. We will be capturing all the aspects required to be covered in Remuneration Reports and therefore will provide an authoritative source of advice in relation to market practices and emerging trends.

Please feel free to call any of the following consultants.

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More information on GRG may be obtained from our website: www.godfreyremuneration.com