GRG Remuneration Review

Determining the Size of LTI Grants

Remuneration Review No. 5

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INTRODUCTION

Recent consulting assignments have indicated that some directors have found the accounting standard for Share-based Payment (AASB 2) to be complex and are finding it difficult to translate long term incentive (LTI) values disclosed in Remuneration Reports into competitive grants of options, rights or restricted shares. This paper briefly covers AASB 2 and then provides a method of calculating the number of equity units to be offered to give effect to a LTI of a specified annual value.

LTI AN ESSENTIAL REMUNERATION COMPONENT

Institutional investors generally see a strong need for executives to have exposure to a significant amount of equity in the company for which they work. This view is soundly based on wanting executive interests to be strongly aligned with those of shareholders, providing incentive to secure sustainable improvements in company performance and helping maintain/retain a stable team of top executives.

It has been reported in the Press that some executives have expressed a preference for more short term incentive (STI) cash payments rather than LTI grants of equity units. Their view is understandable given that they have input to the goals on which STI performance is measured and the goals may be reset each year. However, it is not a view that should necessarily be followed by Boards which are representing shareholder interests. Equity based LTI plans remain more cost effective than cash based LTI plans, clearly align executive and shareholder interests and have a strong retention impact.

Remuneration Report disclosure requirements expect LTIs to be provided to executives and for the value of the LTI to be appropriately weighted compared to Base Package and STI. Unless there are sound reasons for reducing the LTI component it should not be reduced.

Top executive remuneration in Australia has shown strong increases in Base Packages over recent years. This has been driven by the resources boom and shortages of proven executive talent. Nevertheless, it is perhaps time to consider changing the packaging of remuneration increases from being additions to the Base Packages with consequential increases in STI and LTI when they are expressed as percentages of Base packages, to increases in the LTI component only. Higher grants of equity units as LTIs will increase the exposure of executives to company share price and dividend policy and produce remuneration packages which have a higher incentive component as would generally be preferred by institutional investors. At the same time it will help moderate the rate of remuneration increases as there will be no flow on impacts as occurs with Base Package increases.

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THREE MAIN TYPES OF EQUITY UNITS

In Australia the dominant form of equity units offered to executives as LTIs are options, rights and restricted shares. Each is briefly described below.

Type of Equity Unit	Descriptions
Options	These are rights to acquire shares in the future within a specified time frame at a specified price (usually the share price when the option is granted) possibly after specified vesting conditions have been satisfied. Dividends do not accrue to option holders.
Rights	These are options but with the exercise price set at nil. Dividends do not accrue to right holders until after they vest and are converted into shares.
Restricted Shares	These are shares which typically vest after specified vesting conditions have been satisfied. Dividends accrue on the same basis as applies to other shares of the same class in the company.

Rights plans are the most frequently used plan type followed by options. There is an emerging practice of combination grants of rights and options. Share purchase loan plans are occasionally used and when they are non-recourse loans, they are valued for accounting charge purposes as if they were options.

Particularly with rights and options a typical vesting scale is as follows.

Company's Total Shareholder Return (TSR) Ranking Relative to Peer Group Companies' TSRs at the End of the 3 Year Measurement Period	% of Rights or Options to Vest
<P50	0%
P50	50%
>P50 & < P75	>50% to <100%
P75 and above	100%

It has become standard practice in Australia for grants to be made each year. Therefore, this paper focuses on annual grants.

AASB 2 VALUATION OF EQUITY UNITS

The value of equity units to be disclosed as part of executive and director remuneration in the Remuneration Report needs to be determined in accordance with AASB 2 as indicated in the Australian Securities and Investments Commission (ASIC) Practice Note 68.

AASB 2 deals with the accounting charge to be recognised as an expense in company profit and loss accounts. To illustrate the operation of AASB 2 we have taken grants of options, rights and restricted shares of equivalent value. The grants are made half way through a financial year and the vesting period is 3 years, thus the accounting charge which must be spread over the vesting period, is reflected in 4 years' accounts. The values are based on a share with a market value of $10.00 which carries entitlement to $0.50 of dividends pa. Other assumptions in the option valuation were: exercise price of $10.00, term of 5 years, risk free interest rate of 6% and 30% volatility. Using a Black-Scholes model the option was valued at $2.00. The restricted share value was $10.00 and the right value was $8.50 being the share price less 3 years of dividends.

The amount to be recognised as an expense is influenced by whether or not a market vesting condition is attached to the equity units. A market condition is one that is "related to the market price of the entity's equity instruments, such as attaining a specified share price or … or achieving a specified target that is based on the market price of the entity's equity instruments relative to an index of market prices of equity instruments of other entities" (AASB 2 Appendix A Defined Terms). When a market vesting condition applies the equity unit value needs to take account of the vesting condition. In Example A the equity unit value has been taken as 50% of the basic/full unit value when market vesting conditions apply. The value of all the equity units is then amortised evenly over the vesting period irrespective of how many of the equity units actually vest provided that the executive remains employed for the full vesting period. This is shown in the green shaded areas of Example A.

When market vesting conditions do not apply the total accounting cost recognised over the vesting period must equal the basic/full value of the equity units that vest. During the vesting period at financial year ends, estimates need to be made of the expected vesting. The accounting charge is then adjusted to reflect the latest estimate so that the cumulative charge up to the end of that financial year reflects the latest estimate. In Example A the accounting charge varies in response to changing estimates and in the last year produces a negative charge as less equity units vested than was estimated earlier.

It should also be noted that in Example A the numbers of options, rights and restricted shares have been varied to reflect the relative basic/full values of options, rights and restricted shares.

<u>Example A</u>

		No. of Equity Units Granted	Basic Value per Equity Unit	Equity Unit Value for Accounting Charge Purposes	Amortised Value for Year in Vesting Period				Total Accounting Charge
Best Estimate of Likely Vesting During Vesting Period or Actual Vesting At End of Vesting Period				50%	50%	70%	70%	50%	
Options	Not Market Vesting Conditions	180,000	$2.00	$2.00	$30,000	$96,000	$84,000	-$30,000	$180,000
	Market Vesting Condition	180,000	$2.00	$1.00	$30,000	$60,000	$60,000	$30,000	$180,000
Rights	Not Market Vesting Conditions	42,353	$8.50	$8.50	$30,000	$96,000	$84,000	-$30,000	$180,000
	Market Vesting Condition	42,353	$8.50	$4.25	$30,000	$60,000	$60,000	$30,000	$180,000
Restricted Shares	Not Market Vesting Conditions	36,000	$10.00	$10.00	$30,000	$96,000	$84,000	-$30,000	$180,000
	Market Vesting Condition	36,000	$10.00	$5.00	$30,000	$60,000	$60,000	$30,000	$180,000

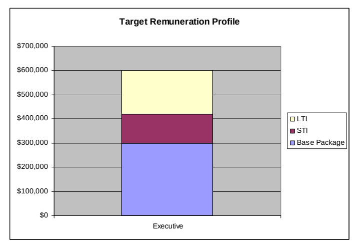
The principle behind AASB 2 is that share-based payments to employees are remuneration for work performed over a period being the vesting period. Thus, the values attributed to equity units are seen as the values of the remuneration payments which are considered to be similar to salary, benefits and cash incentives. Hence, when executive remuneration is disclosed the share-based payments are disclosed along side of and are added to other remuneration components to calculate the total remuneration paid during the relevant year.

DETERMINING THE ANNUAL LTI VALUE

There are several approaches that may be used to determine the annual value of LTI as a component of remuneration. The main alternatives and comments on each are provided in the following table.

Approach	Commentary
Judgement	This approach involves the Board in relation to the Managing Director and Direct Reports as well as the Managing Director in relation to other participants making judgements as to what represent reasonable values of LTI grant for various roles. Such judgements would be made taking into account a range of factors possibly including the following: previous grants made to the executive, individual performance, criticality to future company success, remuneration quantum, level in the organisation and expected impact of the grant in relation to retention and incentive. This approach tends to view LTI as not so much a part of remuneration but as an additional condition of employment.

<table>
<tr><th>Approach</th><th>Commentary</th></tr>
<tr><td>Market LTI Practice Assessment</td><td>Under this approach each of the three major remuneration components is treated as a separate and distinct element. Base Packages are benchmarked against Base Packages and a market positioning is selected to ensure competitiveness in relation to that component. Similarly, short term incentives (STIs) are benchmarked against STIs and a market positioning is selected to ensure competitiveness in relation to that component. LTIs are benchmarked against LTIs and a market positioning is selected to ensure competitiveness in relation to that component.</td></tr>
<tr><td>LTI as Part of Remuneration Profile</td><td>Under this approach it is usual for market positions to be selected for two anchor point being Base Package e.g. P50 i.e. 50th percentile, and Total Remuneration Package (TRP) e.g. P75 i.e. 75th percentile. Then the gap between the Base Package and the TRP is bridged with a combination of STI and LTI. The weighting of STI and LTI should be determined by reference to amongst other factors the time frame of the planning horizon applicable to the role. A remuneration profile is then determined for target performance with value attributed to each component of remuneration. Example B follows showing a possible remuneration profiles for an executive.

<u>Example B</u>
<table>
<tr><td>
<table>
<tr><td>Base Package</td><td>$300,000</td></tr>
<tr><td>STI</td><td>$120,000</td></tr>
<tr><td>LTI</td><td>$180,000</td></tr>
<tr><td>TRP</td><td>$600,000</td></tr>
</table>
NB: The STI may have a stretch payout opportunity up to double the target or more, if appropriate to the role and the business circumstances.
</td><td>
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Under each of these alternatives the outcome should be an annual value for the LTI such a $180,000 a shown in Example B.

CONVERTING THE LTI VALUE INTO A NUMBER OF EQUITY UNITS

In order to convert the annual LTI value into a grant of equity units the same principles may be applied to options, rights or restricted shares. The number to be granted may be simply calculated by applying the following formula.

No. of Equity Units	**=**	**Annual LTI Value ÷ Adjusted Value of Equity Unit**

Determining the adjusted value of an equity unit should take account of the factors that are reflected in the valuation of equity units when determining accounting charges. The two main factors that are reflected in the accounting charges are:

- the vesting condition, and
- the time in the vesting period.

A typical vesting scale as indicated earlier in relation to total shareholder return (TSR) is for nil vesting below the P50, 50% vesting at the P50 (half of the TSR scores are below the company's

TSR score), 100% vesting at or above the P75 (three-quarters of the TSR scores are below the company's TSR score) and pro-rata vesting between P50 and P75. The average vesting percentage in a group to which this typical scale is applied would be 44% (NB: approx. 50% have nil vesting, 25% have 100% vesting and 25% have been 50% and 100% vesting, thus if there were 4 scores 2 would have 0% vesting, 1 would have 75% vesting and 1 would have 100% vesting. Total vesting would be 175% divided by 4 scores producing an average of 44%). Of course, different vesting scales would give rise to different average vesting percentages.

In this regard it should be noted that at the beginning of the measurement period investors would price the shares so that any expected out performance would be built into the share price. Thus, from a TSR point of view each company should be in a similar position in terms of opportunity to generate returns for shareholders. Accordingly, possible biases in the relative opportunity of comparator companies to generate higher or lower TSRs should have been largely neutralised through the functioning of the securities market with the outcome being that the average vesting should be a sound approximation of the probability of vesting.

The other factor which should be considered is turnover of executives. If grants of equity units are being made to a significant group of executives then it may be expected that some equity units will lapse because executives leave the company. With executive turnover rates of 10% or more on average pa the turnover aspect can have a significant impact. For example 10% pa for 3 years can reduce the vesting percentage from 100% to 73% (100% x 90% x 90% x 90% = 73%).

To combine the vesting scale and the vesting period involves multiplying the two vesting percentages e.g. 44% x 73% = 32%.

In many cases where the executive is senior and termination is likely to be planned with equity grants close to the termination date recognising the impending termination it may be argued that the adjustment for service in not valid or should be minimal. Thus, GRG tends to focus mainly on the vesting scale rather then vesting period.

For example, if an executive had a LTI value of $180,000 and the adjusted equity unit value were $1.00 for options, $4.25 for rights and $5.00 for restricted shares after allowing for a estimated 50% vesting then the number of equity units to be granted would be as follows.

Type of Equity Unit	LTI Value	Adjusted Equity Unit Value	Number of Equity Units to be Granted
Options	$180,000	$1.00	180,000
Rights	$180,000	$4.25	42,353
Restricted Shares	$180,000	$5.00	36,000

This approach to calculating the number of equity units to be allocated should result in the accounting charge and the LTI value being approximately the same when market vesting conditions apply. Of course the accounting charge when a non-market vesting conditions is used is unlikely to be the same as the LTI value as the actual vesting percentage is unlikely to exactly equal the vesting percentage estimated when the equity units were granted.

The value ultimately realised by the executive will vary depending upon performance and share price movement. Using restricted shares from the previous example, 18,000 would vest at P50 TSR performance providing a benefit of $180,000 being the LTI value if the share price had not moved or up to $360,000 if P75 or better TSR performance is achieved. Thus, the approach proposed for calculating the number of equity units ensures that there is a range of potential outcomes including a stretch performance outcome. Of course if the share price increases then the value of the benefit received by the executive will be higher than that used at the grant date, thereby providing another component of incentive.

CONCLUSIONS

The foregoing comments may be re-expressed and concluded as follows.

1. By having a properly structured remuneration strategy each company will be able to establish executive remuneration profiles which are market competitive and structured to reflect the stratum in which the executive is operating as well as the company's business circumstances.
2. The quantum of the LTI will be established as part of the remuneration profiles.
3. Conversion of the LTI quantum into an annual grant of a number of equity units is a simple calculation once the value of the equity units has been determined taking into account the vesting conditions.
4. The valuation of the equity units should be consistent with the valuation of equity units for AASB 2 share-based payment accounting charge purposes. This valuation approach is used to value LTI component for disclosure of remuneration package in Remuneration Reports.

An understanding of the foregoing will assist directors when considering proposed allocations of equity units and executives when determining proposals for the numbers of equity units to be offered to executives.

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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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