GRG Remuneration Insight 73

Valuing Rights

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Introduction

During the course of benchmarking the market competitiveness of total remuneration packages and reviewing equity based remuneration plans for key management personnel (KMP) roles, we have observed a lack of clarity and consistency in the way that rights (share and indeterminate) are valued. This GRG Remuneration Insight discusses some of the approaches used and the need to distinguish between accounting values used for reporting and values used to determine the number of rights to be granted to participants in equity remuneration plans.

Equity Remuneration Plans

For the purposes of this GRG Remuneration Insight the term "equity remuneration plans" is referring to plans that use shares, rights, options and other forms of equity for the purpose of remunerating KMP. For senior executives they mainly take the form of long term incentive (LTI) plans, retention plans, deferred short term incentive (STI) and salary sacrifice plans. For non-executive directors (NEDs) they mainly take the form of fee sacrifice plans whether elective or compulsory.

While both salary and fee sacrifice plans fell out of use after the 2009 amendments to the employee share scheme (ESS) taxing provisions it is anticipated that their use will strongly re-emerge when the imminent amendments to the ESS taxing provisions come into effect on 1 July 2015 and reverse much of the 2009 changes.

Rights Being Valued

While various types of equity units may be used for equity remuneration plans this GRG Remuneration Insight is focussing on rights. This is because the valuation of rights is less complex than the valuation of options and rights are the form of equity unit most frequently used in LTI plans. Option valuation models are used for both options and loan funded share plans with limited/non-recourse loans. The principles discussed in this GRG Remuneration Insight in relation to valuing rights also apply to valuing options.

A right may be a right to (upon exercise) a share, to the value of a share in cash (a derivative or phantom right) or to a mix of cash and shares (indeterminate rights). Rights used for retention or LTI plans usually cannot be exercised and converted into shares until they vest which will be after service and/or performance conditions are satisfied. For LTI grants of rights the typical measurement period is 3 years and therefore the rights cannot be exercised until the 3 year measurement period is completed and vesting determined. Rights used for STI deferral or salary/fee sacrifice purposes may have limited or no defined periods in which exercise of the rights is restricted.

Basic Value of Right (no performance based vesting conditions)

In the case of rights used for salary/fee sacrifice or deferred STI purposes it is unlikely that there would be any vesting period for grants made on or after 1 July 2015. There may be a short period after grant before the rights may be exercised. For companies that pay dividends it is in the interests of right holders to exercise rights as soon as possible so that they will qualify for dividends as shareholders. For right holders in companies that do not declare dividends there will be less urgency to exercise rights but the right holders may still prefer to exercise rights as soon as possible so as to be able to access all the entitlements of shareholders including the ability to vote at general meetings.

From a valuation point of view the main difference between a grant of rights and a grant of shares is that right holders will not receive dividends for a period between grant and exercise of the right. If a company does not declare dividends then the value of a right and the value of a share will be the same.

Ignoring complexities around projecting future dividends and calculating their present value, the value of a right will be less than the value of a share by the amount of dividends that will not be received during the period between grant and exercise of the right. For example, if a share has a value of $10.00, attracts an annual dividend of $0.40 and the right is not exercisable for 3 years then the value of the right would be $8.80, calculated as $10.00 less $1.20 (i.e. 3 x $0.40).

To validate the foregoing approach GRG applied the Black-Scholes Option Pricing Model to value a right. In the model the exercise price used was a small fraction of a cent as nil would have produced an "error" result (mathematically it is not possible

to multiply by zero). Irrespective of assumptions used for the term of the option, volatility or risk free rate the resulting value of the right was $8.80. Thus, the intuitive approach also turns out to produce a reasonable valuation for rights that accords with accepted accounting approaches, *prior* to consideration of any vesting conditions. It is the accounting treatment of vesting conditions that often creates a disconnect with intended remuneration or policy because the assumptions used are not directly aligned to vesting scales.

Accounting Values

No Market Vesting Conditions

AASB 2 Share-based Payment provides in paragraph 19 that

> *"Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date."*

Thus, when valuing rights (options with a zero exercise price) that have no vesting conditions, or have service only vesting conditions or have only non-market vesting conditions the value of the rights shall not take account of those factors. In these circumstances the value of the right should be equal to the value calculated in the previous section irrespective of which of the well-recognised valuation methods is used.

Market Vesting Conditions

When market vesting conditions (those related to the price of the company's shares) are attached to rights the value of the right needs to take into account those market vesting conditions. The method for taking them into account is not specified in the accounting standard. Thus, it is up to the valuer to determine how to take them into account. Such factors would, of course, lead to a lower value than if no conditions were attached to the rights. Typically a probability of vesting factor is applied of between 40% and 60%, depending on the hurdles.

Face Value Method

The face value method treats the value of a right as equal to the value of a share. This method is correct if the rights are fully vested at the date of grant and may be exercised at any time. However, when rights cannot be exercised immediately due to either vesting conditions or exercise restrictions the value of a right will be less than the value of a share, as discussed above.

Value for Determining Numbers of Rights to be Granted

When determining the value of a right to be used to calculate the number of rights to be granted an additional factor needs to be considered and that is tax deductibility. Most forms of remuneration qualify as a tax deduction for the company. This will also be the case in relation to rights when contributions to an employee share trust are used to fund the value of shares to be provided on exercise of rights. However, it will not be the case when the company transfers and receives no cash in return for a new issue of shares upon exercise of a right (such as is typically the case when a company's practice is to issue a share directly to a participant upon exercise of a right, instead of using a trust).

That accounting values of rights do not qualify as a tax deduction is not relevant for accounting purposes but is very important for KMP remuneration purposes. If it is ignored then grants may be excessive and have a larger impact on company profitability than expected. If the company will not receive a tax deduction in relation to rights that are granted then the value of the rights needs to be adjusted by a gross-up factor. While the company tax rate remains at 30% the gross-up factor is a multiplier of approximately 1.43.

Given that AASB2 is inconsistent in the treatment of vesting conditions (some conditions reduce the value of rights and others do not even if of similar difficulty) and that there is no generally accepted method for calculating the discounting impact of various vesting conditions, it is GRG's view that such conditions should not be taken into account in valuing rights. Vesting conditions should, however, be taken into account on a consistent basis in calculating the number of rights to be granted.

The next Remuneration Insight focuses on an explanation of the only correct method that GRG has identified to deliver the intended remuneration value when target performance is achieved, based on a remuneration policy or intended remuneration mix that is focussed upon target/expected performance (when target/expected performance is challenging but achievable). Remuneration planning and policies should focus on target performance and reward and expectations, rather than maximum. Since maximum performance and reward is rarely achieved, benchmarking, planning and communicating remuneration in these terms is imprecise and misleading to the Board, to participants in equity based remuneration plans and to shareholders, undermining the link between performance and reward.