

Calculating LTI Grant Numbers

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Introduction

In “GRG Remuneration Insight 73 – Valuing Rights” various methods for valuing rights were canvassed. A conclusion of that GRG Remuneration Insight was that rights should be valued ignoring vesting conditions. This conclusion had important implications being:

1. The value would be the same as that used for accounting purposes when vesting conditions are not taken into account which applies to all rights that do not have market vesting conditions,
2. By applying that valuation approach all rights are treated equally irrespective of any vesting conditions,
3. Only one adjustment needs to be made to the accounting value for remuneration management purposes and that arises when the company will not obtain a tax deduction in relation to the provision of shares when rights are exercised which should be a rare occurrence (it also usually applies to loan funded share plans), and
4. Vesting conditions, if any, can be dealt with as part of the calculation of the numbers of rights to be granted – this aspect is covered in this GRG Remuneration Insight.

This GRG Remuneration Insight discusses a formula that may be used to calculate the number of rights to be granted to deliver a given remuneration value.

The Formula

The following formula is sufficiently flexible to be able to be used for most grants of rights or options.

$$\text{Number of Equity Units} = \text{Remuneration Value} \times \text{Weighting} \div \text{Equity Unit Value} \div \text{Target Vesting \%}$$

Each of the elements in the formula are discussed below.

Element	Comments
Remuneration Value	This is the target value to be provided in equity. In the case of LTI grants it is usually calculated as Base Package x Target LTI%. Thus, if an executive had a Base Package of \$200,000 and the target LTI was set at 30% then the Remuneration Value would be \$60,000. If it were a salary sacrifice situation then it would be the amount that the executive decided to salary sacrifice for the year. If it were deferred STI then it would be the amount of STI to be deferred.
Weighting	Weightings frequently need to be considered in relation to LTI grants as they are often divided into tranches with different vesting conditions. If say 40% of the LTI were to be subject to an EPS growth vesting condition then the weighting would be 0.4.
Equity Unit Value	In the case of rights, the value would be calculated as discussed in GRG Remuneration Insight 73 - Valuing Rights. In the case of options, it may be the value calculated using Black-Scholes, Binomial, Monte Carlo or other valuation models but excluding consideration of any vesting conditions.

Element	Comments
Target Vesting %	<p>In cases of:</p> <ul style="list-style-type: none"> • salary sacrifice, • STI deferral, • employment/service based vesting conditions, or • other binary vesting conditions (either achieved or not achieved), such as project or milestone goals <p>the Target Vesting % would be 100% (i.e. 1.0).</p> <p>However, when performance vesting conditions are attached they will typically have a vesting scale with a level of vesting aligned to target performance. For example, EPS growth may have threshold, target and stretch performance levels of 6%, 10% and 16% compound annual growth, with 25%, 50% and 100% vesting. 50% (i.e. 0.5) would be the Target Vesting %.</p>

LTI Grant Example

Assumptions

The assumptions used in this example are as follows:

- The executive has a Base Package of \$200,000,
- The Target LTI % for the role is 30%, therefore the **Remuneration Value** is **\$60,000** (30% x \$200,000),
- The LTI grant is to be of performance tested Rights with vesting scales,
- The LTI will be divided into two tranches with **60%** of the LTI subject to relative TSR vesting and **40%** subject to EPS growth vesting,
- The vesting scale for the relative TSR and EPS growth performance conditions are:

Performance Goals	Relative TSR Ranking	% Vesting
Stretch	≥P75	100%
	>P50 & <P75	Pro-rata
Target	P50	50%
<Target	<P50	0%

NB: P75 = 75th percentile and P50 = 50th percentile

NB: In standard relative TSR vesting scales the target is also the threshold. Due to previous activism, threshold levels of award were removed.

Performance Goals	EPS Growth (CAGR)	% Vesting
Stretch	≥16%	100%
	>10% & <16%	Pro-rata
Target	10%	50%
	>6% & <10%	Pro-rata
Threshold	6%	25%
<Threshold	<6%	0%

NB: CAGR = compound annual growth rate

- The measurement period for vesting is **3 years**,
- The share **price is \$10.00** and the annual **dividend is \$0.40**.

Right Value

The value of the rights would be \$8.80 calculated as follows:

$$\begin{aligned}
 \text{Right Value (equity unit value)} &= \text{Share Price} - (\text{Annual Dividend} \times \text{Measurement Period}) \\
 &= \$10.00 - (\$0.40 \times 3) \\
 &= \$10.00 - \$1.20 \\
 &= \mathbf{\$8.80}
 \end{aligned}$$

Number of Rights to be Granted

Applying the formula discussed above the number of Rights to be granted would be 13,636 (8,182 + 5,454) calculated as follows

Number of Rights Subject to Relative TSR Vesting	=	Remuneration Value x Weighting ÷ Equity Unit Value ÷ Target Vesting %
	=	\$60,000 x 60% ÷ \$8.80 ÷ 0.5
		\$36,000 ÷ \$8.80 ÷ 0.5
		4,091 ÷ 0.5
		8,182
Number of Rights Subject to EPS Growth Vesting	=	Remuneration Value x Weighting ÷ Equity Unit Value ÷ Target Vesting %
	=	\$60,000 x 40% ÷ \$8.80 ÷ 0.5
		\$24,000 ÷ \$8.80 ÷ 0.5
		2,727 ÷ 0.5
		5,454

Validation of Number Granted

The following table shows the value of rights that will vest when target performance is achieved, is the intended remuneration value (which is equal to the target LTI value) of \$60,000 (\$200,000 x 30%).

Aspect	Relative TSR Vesting Condition	EPS Growth Vesting Condition	TOTAL
Rights Granted	8,182	5,454	13,636
Target Vesting %	50%	50%	
Number of Rights Vesting at Target Performance	4,091	2,727	6,828
Grant Value of Rights That Vest at Target Performance	\$36,000 (4,091 x \$8.80 rounded)	\$24,000 (2,727 x \$8.80 rounded)	\$60,000
Target LTI Award			\$60,000

Vesting Value Does Not Equal Grant Value

In the foregoing table the value of Rights that vested was based on their grant value. The actual value that arises from vesting will differ from the grant value for the following reasons:

1. During the vesting period the share price may have increased or decreased. To the extent that such changes in the share price are related to company performance, the potential for such changes will have acted as an additional incentive factor as part of the LTI plan. This incentive element is one of the reasons that equity units are used for LTI purposes.
2. At the time of vesting the value of the Right will have changed due to there being no future period when the holder of the Right is denied access to dividends. This is because vested Rights may be exercised and thereby converted into shares which carry full dividend entitlements.

Why Not Use Stretch LTI Values

Stretch values can be used for the Remuneration Value in the foregoing formula provided that:

- a) The Target Vesting % is deleted from the formula, and
- b) The stretch level is set having regard to the vesting scale for the tranche.

However, if stretch levels are set in isolation from the vesting scale at say double the target level then;

- If one tranche has a binary target the use of stretch will result in excessive grants, or
- If the vesting scale for a tranche has a target that is not 50% (related to stretch of double target) then the grant may be too large if target is above 50% vesting or too small if the target is below 50% vesting.

Stakeholder Concerns

When Remuneration Reports and notices of meeting have included formulae for calculating the number of equity units to be granted and these formulae have included a discounted value for equity units there has often been criticism of the approach. The criticism, while not well founded, focuses on executives receiving grants based on equity values that are not reflective of market values (because accounting methods in relation to grants subject to market related vesting conditions call for a discount reflective of the probability of vesting, which is usually around 40%-60%, with 50% being typical). Such criticism has not occurred in cases where our recommended formula has been used as it relies on an undiscounted value of equity units, despite the fact that the outcome is usually similar in terms of grant numbers. Instead adjustments are made to recognise the vesting and remuneration value for performance outcomes which is logical, quantifiable and defensible.

Applying the recommended approach removes the debate around the probability of vesting, which is virtually impossible to quantify accurately or reliably, and instead focusses on the vesting scale, target vesting and intended remuneration outcomes (remuneration value), which may be easily quantified.

However, it should be noted that related to the application of this approach is the calibration of vesting scales each year in the context of internal and external expectations for the performance period, such that the target performance is considered challenging but achievable, with a similar level of difficulty expected at the point of each offer. This requires the Board to consider the performance levels each year so that the target is always appropriate and is not considered either too easily achieved (threshold or lower) or virtually unachievable (stretch or higher).

The face value of a grant of equity units calculated under this approach may appear higher than expected, to an observer that is not aware of the details of LTI plan operation and the calculation process, because of:

- the impact of dividends,
- the fact that the maximum/stretch level of LTI must be granted up-front,
- when target performance is achieved the expectation is usually that 50% of the grant is forfeited,
- the full grant (100%) vesting only occurs when stretch performance is achieved, which (if properly calibrated) should only occur rarely, in exceptional circumstances of truly outstanding performance, and
- if the target vesting % (V) is to deliver the intended target performance remuneration value (T) and the total value of the grant is (G), then the elements have the following relationship:

$$T = V \times G$$

This may also be expressed thusly by re-arranging the formula to determine the grant (G):

$$G = T/V$$

Since 50% vesting at target is the most common approach, the grant (G) may be expressed as:

$$G = T/0.5$$

$$G = 2 \times T$$

Thus the grant is typically double the target number of equity units, so that when 50% is forfeited when target performance is achieved, the target level of reward remains.

For these reasons GRG recommends that the calculation method of the grant and the rationale be transparently explained to stakeholders, as it does produce the correct outcome.