GRG Remuneration Insight 138

Universal LTI Grant Calculation Formula

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INTRODUCTION

In the market various approaches are applied to calculate the number of equity instruments (rights, options etc.) to be granted as a long term incentive (LTI). Unfortunately, many of these approaches are flawed and result in inappropriate numbers of equity instruments being granted. To address this issue Godfrey Remuneration Group (GRG) has developed a universal formula for calculating the numbers of equity instruments to be granted for LTI and other purposes. This GRG Insight presents the formula and discusses its application.

It should be noted that the formula is based on a Target LTI% which may be determined by the difference between the targeted total remuneration package for expected performance and the company's market positioning policy for Fixed Pay. The Target LTI% may be determined from market remuneration practice data for executive key management personnel (KMP) roles published in GRG KMP Remuneration Guides – see https://www.grg.consulting/remuneration-data/grg-remuneration-guides/ .

THE UNIVERSAL FORMULA

The universal formula for granting equity instruments is as follows:

Grant Number = Stretch Award Value ÷ Instrument Value

Where

Stretch Award Value = Fixed Pay x Target LTI % ÷ Target Vesting %

Instrument Value = Value of Rights, Options etc ignoring the impact of vesting conditions

Proxy Advisors prefer share price/face value for rights, but this is technically incorrect and inconsistent with their acceptance of the value of options.

REMUNERATION CONTEXT FOR FORMULA

Total Remuneration Package

The total remuneration package (TRP) for senior executives is typically composed of three elements: Fixed Pay, short term incentive (STI) and long term incentive (LTI). Fixed Pay is often set by reference to the median/P50/50th percentile of market practice for Fixed Pay. When adding STI and LTI to Fixed Pay boards need to be conscious of where the TRPs will fall when various levels of performance are achieved. In this regard it should be noted that most STI and LTI plans have three anchor levels of performance being:

- **Target**: which should represent the outcome expected when fully competent performance is delivered,
- **Threshold:** which should represent a near miss of Target and be an outcome when acceptable but below expected performance is delivered, and

- **Stretch:** which should represent an outstanding level of performance rarely expected to be achieved.

While outcomes may vary from year to year it would generally be expected that outcomes would cluster around the Target over time. Accordingly, Target is the most relevant potential outcome when a company is considering where in the market it wishes to aim its TRP practices. Often selected market positionings for Target TRP are P50, P62.5 and P75. By focusing on Target, a company can budget for expected costs but incur lower costs when Targets are not achieved or higher costs when company performance is exceeded. In addition, communicating Target as the expected outcome has significant advantages compared to communications to executive which focus on Threshold or Stretch. In this regard it should be noted that Threshold is rarely communicated to executives as the expected outcome, but Stretch is sometimes communicated to executives and as a result becomes the expected outcome. When Stretch is communicated it generally leads to executives becoming dissatisfied as their expectations are linked to outcomes that should be rarely, if ever, achieved. Stretch by its nature should be achieved around once every 10 years (≤10% probability), leaving executives disappointed with their incentive rewards in 9 out of 10 years.

From budgeting, accounting, communications and remuneration management perspectives, it is clear that TRP benchmarking and communications should be focussed on Target outcomes rather than any other possible outcomes. These are reasons for the granting formula to also focus on Target award opportunities.

LTI Vesting Scale Considerations

Most STI and LTI plans use performance and/or service metrics to assess the level of award for STI and the amount of vesting for LTI.

To illustrate the flexibility of the universal grant calculation formula several different vesting scale examples are used in the models shown in the Appendix. In each case the Fixed Pay is $300,000 and the Target LTI percentage is 40%. With a share price of $10.00 and nil dividends, the value of a Right is $10.00 (as per Black-Scholes models, or any other broadly accepted method, ignoring vesting conditions, noting that AASB2 valuations are not relevant). The Target number of Rights is 12,000 ($300,000 x 40% ÷ $10.00). Because the Stretch level of vesting is typically 200% of the Target level of vesting (most vesting scales show 50% vesting at Target and 100% vesting at Stretch making Stretch 2x Target, it is not possible to vest more than 100% of a tranche) it has become common practice for Stretch grants to be set at double the Target Level irrespective of the type of vesting condition (scaled or binary) or the scale used for scaled vesting. In some cases, the Stretch level is determined without reference to the type of vesting conditions to be applied or to the vesting scale to be subsequently applied e.g. when stretch levels of LTI are benchmarked instead of Target.

The Stretch level of the LTI award opportunity is important because grants of rights and options are made at the Stretch level and the level of vesting is then determined by reference to the extent to which vesting conditions are satisfied. The practice of granting at the Stretch level has been influenced by:

- the need for prior shareholder approval of grants to directors,
- a preference for grants to all participants to be made at the same time to minimise administration costs, and
- that the value of the rights/options to be expensed will usually be least when grants are made at the earliest possible time (assuming that the share price increases).

In the universal granting formula, the Stretch Award Value is calculated by reference to the Target LTI value so as to ensure that different vesting conditions and vesting scales are properly brought to account and that the same number of rights/options vest when Target Performance is achieved. This approach recognises that the Stretch Award Value for each tranche of LTI needs to be independently calculated and is not an independently defined element of the grant calculation formula. Where approaches are used that do not recognise the difference between scaled vesting and binary vesting, such as milestones which are either achieved or not achieved, illogical outcomes will arise, particularly with regards to intended weightings (often scaled metrics will end up with a much lower weighting than intended).

See Appendix for Examples, where the Target level of vesting for grants of rights is 12,000 (calculated as indicated above) yet the stretch level is a different number in each case ranging from 12,000 to 24,000 to 36,000.

Multiple Tranche Considerations

With LTI grants of rights, options etc, it is common practice for the grant to be divided into tranches with different vesting conditions. To recognise the different vesting conditions and vesting scales it is necessary to modify the universal grant formula such that it is being applied to each tranche separately. This is done by adding a tranche weighting to the formula as follows:

Grant Number = Stretch Award Value ÷ Instrument Value x Tranche Weighting

This approach is very different to calculating a Stretch level grant and then dividing it into tranches. This approach only works when each tranche has the same Target vesting %. If a grant were composed of 3 tranches as per the example in the Appendix (3 different Target vesting %s) and each were to have an LTI weighting of one-third then the three tranches would be as follows:

Tranche with Vesting Condition	Number of Rights to Grant
ATSR	8,000 (24,000 x 33.3%)
EBITDA	12,000 (36,000 x 33.3%)
Service	4,000 (12,000 x 33.3%)

DEFERRED STI AWARDS

Standard STI Plans

For some years, it has been common practice for a part of the STI award to be deferred into equity mainly in the form of rights. Such rights were initially subject to service vesting conditions so as to qualify for tax deferral. However, following changes to the taxation laws current best practice is for deferred STI awards to be fully vested at grant but for exercise and/or disposal restrictions to be applied to ensure that the rights are held for a period of time of at least 1 to 2 years following grant, and to enable clawback.

When converting deferred STI awards into grants of rights, the universal grant calculation formula may be applied but, of course, with the Target vesting % of 100%.

Single Incentive Plans

When a single incentive plan is used instead of a combination of STI and LTI plans it is common practice for part of the award to be provided:

a) in rights on the same basis as standard STI deferral, and

b) in rights with vesting conditions typically used in LTI plans.

In relation to a) above, the same approach as outlined above for standard STI plans should be applied. However, in relation to b) above, the same approach as discussed in the section dealing with LTI Awards should be applied.

Looking at a) and b) from a value perspective it is clear that vested rights over say $50,000 of shares will have much more value than contingent rights over $50,000 of shares where vesting is subject to onerous performance vesting conditions. Using the Target vesting % as the divisor is a convenient way of addressing the vesting conditions without the need to have the rights independently valued and will, in most cases, produce a similar result.

Appendix Examples

Common Vesting Scale

Total Shareholder Return (as CAGR) as a Vesting Condition for an LTI Plan				
Performance Level	**Standard of Performance**	**Award**	**Number of Granted Rights to Vest**	**Vesting Rights as % of Total Grant**
Stretch/Maximum	15%	200% of Target Award	24,000	100%
Target (Planned)	10%	100% of Target Award	12,000	50%
Threshold	8% of Budget	50% of Target Award	6,000	25%
Below Threshold	Below 8% of Budget	Nil	0	0%

Leveraged Vesting Scale

EBITDA as Vesting Condition for an LTI Plan				
Performance Level	**Standard of Performance**	**Award**	**Number of Granted Rights to Vest**	**Vesting Rights as % of Total Grant**
Stretch/Maximum	400% of Budget	300% of Target Award	36,000	100%
Target (Planned)	Budget	100% of Target Award	12,000	33.3%
Threshold	80% of Budget	50% of Target Award	6,000	17.7%
Below Threshold	Below 80% of Budget	Nil	0	0%

Binary Vesting Scale

Service Vesting Condition for an LTI Plan				
Performance Level	**Standard of Performance**	**Award**	**Number of Granted Rights to Vest**	**Vesting Rights as % of Total Grant**
Stretch/Maximum	Served > Specified period	100% of Target Award	12,000	100%
Target (Planned)	Served the Specified Period	100% of Target Award	12,000	100%
Below Target	Below 80% of Budget	Nil	0	0%

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	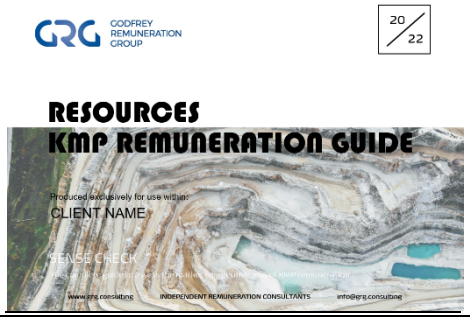	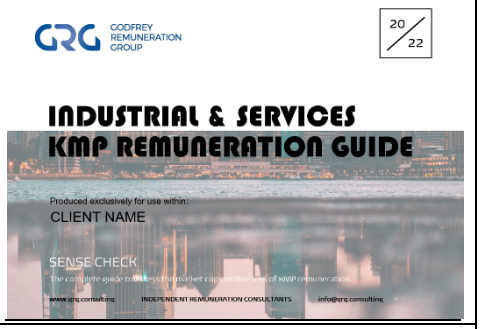
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Data typically presented includes:

- Median, 25th and 75th percentile statistics,
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- Sample sizes.

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