

# GRG Remuneration Insight 118

## Demergers & Long Term Variable Remuneration

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### Introduction

Boards are often finding themselves under pressure, with no obvious choices or guidance under their equity plans, when a change of control, demerger or major return of capital occurs. This is because the Plan Rules that govern long term variable remuneration (LTVR) plans rarely include specific rules covering demerger or return of capital situations. Rules that cover change-of-control or capital reconstructions are usually not much short of useless when boards are faced with the reality of managing competing stakeholder pressures. Rarely is a distinction made between a change of control resulting in a delisting, when the result will be no market for employee equity, as distinct from a case where the Company remains listed. Similarly, rules that deal with cessation of employment (usually relevant for employees of the demerged entity and those who become redundant as a result of the demerger) generally do not adequately deal with demerger triggered cessations of employment. This GRG Remuneration Insight seeks to identify various demerger situations and possible approaches for consideration by boards. GRG has previously published, and will continue to publish, Remuneration Insights on other cases such as change of control.

### Demerger Situations

Demergers can fall into different categories. For ease of reference the current company is referred to as the Origin Company (including after the demerger) and the new company established to hold the business assets being demerged is referred to as the Separated Company even though it may remain a subsidiary of the Origin Company. The various situations that can apply to demergers where the Origin Company splits off part of its business assets into a Separated Company are:

1. **Situation 1:** Origin Company retains ownership of Separated Company shares (none sold) but additional shares may be issued to other shareholders as an initial public offering (IPO) of Separated Company shares, to raise capital to reduce debt and/or fund future growth of Separated Company's business. Origin Company's shareholding exceeds 50% of Separated Company's issued shares.
2. **Situation 2:** Origin Company sells all of its shares in Separated Company and retains the sale proceeds.
3. **Situation 3:** Origin Company shareholders are provided with shares in Separated Company in proportion to their shareholdings in Origin Company. Thus, shareholders continue to own the businesses of Origin Company and Separated Company but via separate shareholdings (Origin Company shares and Separated Company shares) instead of a single holding (previously Origin Company shares only).
4. **Situation 4:** Origin Company sells all of its shares in Separated Company and distributes the sale proceeds to Origin Company shareholders as a major return of capital.

Of course, hybrid situations could emerge but for purposes of this Insight the distinct alternatives presented above are discussed.

## Principles

Before suggesting possible approaches to determining outcomes for LTVR participants when a demerger occurs, it may be helpful to first consider some basic principles that should inform such decisions. These principles include:

1. Two classes of company circumstances need to be recognised:
  - a) After the demerger, Origin Company's operational scale and value are not negatively effected, because Separated Company remains part of the Origin Company Group or the sale proceeds are retained by the Origin Company. The Origin Company is simply managing its business and assets to maximise value for shareholders and Separated Company employees remain employed by the Origin Company group (no termination event), and
  - b) After the demerger, the Origin Company's operational scale and value are significantly impacted due to Separated Company no longer being part of the business, its strategy or long term planning, and Separated Company employees are no longer employed by the Origin Company group (a termination has occurred).
1. Three groups of LTVR participants need to be recognised:
  - a) Origin Company continuing employees, who may be subject to very much the same, or a very different business environment following the demerger (depending on whether a) or b) above applies),
  - b) Origin Company employees that become Separated Company employees as a result of the demerger, who are likely to have a very different focus than was the case prior to the demerger regardless of whether a) or b) applies, and who may or may not be employees of the Origin Company group after the demerger (depending on whether a) or b) applies), and
  - c) Origin Company employees who become redundant due to the demerger.
2. Employees in all three groups should, as far as possible be treated similarly and fairly given the circumstances relevant to them. Given that the demerger is not a choice of the employees it would seem to be inappropriate for one group of LTVR participants to be treated better or worse than another group in respect of LTVR grants made prior to the demerger. The principle should be for all classes of participants to be neither advantaged nor disadvantaged, to the extent possible.
3. If employees cease to be employees of Origin Company because they become redundant due to the demerger or remain with Separated Company when it ceases to be a subsidiary of Origin Company, they need to be treated fairly as the cessation of employment was not their choice.
4. LTVR grants after the demerger would be made by Origin Company to its employees and separately by Separated Company to its employees, with the possible exception of when Separated Company simply becomes a subsidiary of Origin Company, in which case Origin Company may continue to make future grants to employees of both Origin Company and Separated Company, as if nothing had changed.
5. Ideally, vesting of previous LTVR grants should not be changed or impacted i.e. the vesting conditions including the measurement periods should remain on-foot, such as when Separated Company simply becomes a subsidiary of Origin Company and there are no triggers to make adjustments due to terminations or significantly changed business circumstances.
6. When a demerger occurs and Separated Company does not remain part of the Origin Company Group, the value of Separated Company no longer contributes to the value or operational scale of the Origin Company e.g. when shares in the Separated Company are provided to Origin Company shareholders and when the Origin Company distributes the capital raised from the sale to Origin Company shareholders. In these circumstances, allowing any employees to continue to hold LTVR grants in respect of Origin Company will generally not be a fair

alternative. This is because the value of Origin Company and its shares may be substantially reduced and its potential for future growth may have changed.

7. If the demerger is seen as triggering an early truncation of the LTVR plan because the expectations that were in place when the LTVR terms were set are no longer relevant to either Origin Company or Separated Company, then pro-rata service forfeiture of prior grants should only affect grants made as part of the remuneration package for the year in which the demerger occurs. Such forfeiture should be in the proportion that the post-demerger remainder of the year represents of a full year. This is consistent with the principle that LTVR is remuneration for the year in which it is granted, when it is granted every year (despite longer term outcome assessment).
8. For prior LTVR grants with measurement periods that are close to completion at the time of the demerger, and performance relative to the vesting conditions can be reasonably extrapolated to the end of the measurement period then the vesting should be applied having regard to such extrapolated performance. Subject to point 7 above, vesting would be based on performance with no pro-rata adjustment for the portion of the measurement period not served.
9. For prior LTVR grants with measurement periods that are not close to completion at the time of the demerger, it will generally not be possible to extrapolate performance relative to the vesting conditions to the end of the measurement period. This could also apply to metrics such as Earnings Per Share growth if interim NPAT cannot be calculated. In these cases, it may be appropriate for the board to exercise discretion and vest prior LTVR grants at the target level. Stretch would seem to be excessive and threshold, inadequate, assuming target is intended to deliver remuneration appropriate to meeting expectations (i.e. not a stretch or easy hurdle). This determination may be more complex than it may appear. This is because, some companies do not make it clear as to what is the target or expected level of performance and reward (vesting scale may specify a threshold and a stretch but no target) and some companies make grants at the target level only irrespective of the vesting scale applied.

## Conclusions

Reference should be made to the Appendix to this Insight for a summary of the demerger situations, employee groups and recommended possible approaches to the treatment of prior year LTVR grants.

Demerger situations are not all the same and may require different approaches to prior grants of LTVR. Also, there are various employee circumstances that need to be considered along with fairness in the treatment of these employee circumstance groups. Measurement challenges often require board discretion which can be problematic, or ideally a default level of award to be specified in rules.

This is a complex area where LTVR Plan Rules need to be amended so as to allow different approaches to be applied to continuing and former employees as determined by the board. Board discretion will generally leave the board struggling to find the right outcome under competing pressures from employees, governance commentators, and buyers of the demerged entity.

## Appendix - Impact on LTVR

Situation Following Demerger	Origin Company Continuing Employees	Separated Company Continuing Employees	Redundant Employees	Comments
<p><b>Origin Company retains &gt;50% ownership of Shares in the Separated Company or</b>  <b>Origin Company retains the proceeds from the sale of the Separated Company.</b></p>	<p>No change needed.</p>	<p>If employee can retain rights or options post the demerger when the employee will have ceased to be an employee of the Origin Company without facing tax on the value of unvested rights or options, then there would be no need for any change to LTVR.</p>		<p>If the demerger results in materially different future business objectives then there may be a need to adjust the vesting conditions to make them more relevant going forward. The extent to which this should be considered may be influenced by the length of the remaining portion of the measurement period at the date of the demerger.</p>
<p><b>Origin Company sell shares in the Separated Company and distributes the funds realised to shareholders or</b>  <b>Origin Company distributes shares in the Separated Company to Origin Company shareholders in proportion to their shareholdings in the Origin Company.</b></p>	<p>The value of rights and options held at the date of the demerger may be substantially reduced when the Company makes the distribution to shareholders in cash or shares. This leads to a need to restore value by either bringing forward vesting so that rights and options may be converted into shares which will participate in the distribution or granting additional rights or options. To achieve consistency of treatment of ongoing and former employees the early vesting approach would seem to be most relevant. In addition to restoring value there will also be a need to review the vesting conditions as the future potential for total shareholder returns may be diminished and financial objectives may have changed materially. The remaining uncompleted portion of measurement periods may also need to be considered when reviewing vesting conditions.</p>	<p>Restoring value via early vesting of rights or options appears to be the most relevant alternative as granting additional rights or options to employees who have or are about to cease to be employees would generally not be well regarded by shareholders.</p>		<p>When considering bringing forward the vesting date, consideration needs to be given to the extent to which outcomes may be confidently determined prior to the end of the measurement period (including pro-rata). This may be affected by the length of the remainder of the measurement period at the date of the demerger. If a prediction can be made with confidence, then it could be applied to determine the extent of vesting. However, if the outcome cannot be predicted with confidence then it may be prudent to apply the target level of vesting - threshold vesting may be too low and stretch vesting may be too high.</p>