GRG Remuneration Insight 126

Equity Remuneration in Micro Resources Companies

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INTRODUCTION

With effect from 1 July 2015 unlisted companies that qualified as start-ups have been able to access a specific concession under the employee share scheme (ESS) taxing provisions. There is no equivalent concession for ASX listed companies even if they meet most of the criteria to qualify as a start-up. Despite the lack of a specific concession in the ESS taxing provisions, employees and directors of ASX listed Micro Resources Companies can still qualify for tax deferral on Rights and Options provided to them as part of their remuneration packages. While this Insight is focused on Micro Resources Companies, the same provision can also apply to other small ASX listed companies operating in other industry sectors that face similar circumstances during development, such as technology and medical companies investing in research or early product development i.e. restricted cashflow, low or negative profitability and high investment requirements.

MICRO RESOURCES COMPANIES

GRG considers companies with market capitalisations of less than $25 million and operating in the resources sector to be Micro Resources Companies. Such companies are generally explorers that have not yet been successful in finding a resource or have not yet proven the commercial viability of the discovery they have made. In this Insight the focus is on ASX listed Micro Resources Companies as they do not qualify for the specific start-up ESS taxation concession for which many other early development companies often qualify.

WHY USE EQUITY

The reasons that equity is provided as part of remuneration packages for key contributors in early stages include to:

1. Preserve scarce cash resources,
2. Align the interests of key contributors and shareholders,
3. Attract talent that the company couldn't otherwise afford by offering large, leveraged reward opportunities,
4. Help retain key talent, and
5. hare the Company's success with those who have worked to achieve it.

CONSIDERATIONS WHEN USING EQUITY

Rights, Options or Share Appreciation Rights

Generally, shares are not used to provide equity remuneration. This is because there are more onerous conditions that need to be satisfied for grants of shares to qualify for tax deferral compared to Rights, Options and Share Appreciation Rights (SARs). It is therefore important to understand the differences between these instruments.

Rights are entitlements on valid exercise to a share or the value of a share. As Micro Resources Companies generally do not pay dividends there is little material difference for an employee in holding a share or a Right. To sell a share a Right holder must exercise the Right to receive a share and then sell the share.

Options are similar to Rights except that they have an exercise price which is usually set at the market value of a share at about the time the Options are granted. This exercise price needs to be paid by the employee when Options are exercised. Because of the need to pay the exercise price the benefit that may be realised from an Option is the excess of the share price over the exercise price. If the share price is below the exercise price the employee would be better off by purchasing shares on market rather than exercising an out of the money Option.

SARs are similar to Options except that on exercise the exercise price is not paid and the employee receives shares equal in value to the excess of the share price over the exercise price for the parcel of SARs being exercised. One of the most significant outcomes of this approach is that it is typically 50% to 70% less dilutive than Options (which can be significant when limit issues come into play), and participants do not have to struggle to find the financial liquidity to pay the exercise price (often a costly process).

Plan Limit

Offers of equity to employees need to comply with disclosure and other requirements of the Corporations Act or a Class Order released by the Australian Securities and Investments Commission (ASIC). Under the Corporations Act there are various disclosure exemptions including:

1. Senior Manager exemption which only extends to senior managers and therefore does not cover general employees,
2. Sophisticated Investors who have high incomes (>$250,000) or net assets (>$2 million), and
3. Small Scale Offerings which means that no more than 20 people can receive offers and no more than $2 million may be raised during any period of 12 months. This is often not available to Micro Resources Companies in relation employee equity issues as they often undertake regular capital raisings.

If a company relies on Class Order 14/1000 then there is a limit of 5% of issued shares over a rolling three year period, and it allows the company to offer more sophisticated instruments like SARs. This limit applies equally to the number of shares that may be issued on exercise of Rights, Options and SARs.

Vesting Conditions

Vesting conditions are conditions that must be satisfied or waived before Rights, Options and SARs may be exercised. There are two types of vesting conditions being:

- Performance vesting conditions such as share price growth, and
- Service vesting conditions such as needing to remain an employee for two years after the grant of the Right, Option or SAR.

These two types of vesting conditions may be combined.

Proxy advisors and institutional stakeholders prefer performance vesting conditions to be attached to all equity instruments (including Options) issued by large ASX listed companies. The same preference does not appear to apply to Micro Resources Companies, noting that proxy advisors generally do not opine on Micro Resources Companies and institutional investors are less commonly invested in this space. With Options and SARs it is arguable that the exercise price represents a performance hurdle in that there will be no benefit in Options and SARs unless the share price exceeds the exercise price. Thus, it may be reasonable to issue Options and SARs with no explicit performance vesting conditions. The concern of institutional investors for larger companies is that market sentiment can impact price in a way that is unrelated to the Company. For Micro Resources this tends to be less the case, and outcomes tend to be binary with the company either flatlining for a long period, or rising sharply with a discovery i.e. they are generally more separated from broader market movements and sentiment, with prices very much related to their particular circumstances.

As there will always be value in Rights there is a stronger case for performance vesting conditions to be applied to Rights. Such vesting conditions need not be overly complex and may be as simple as the share price needing to be above a specified level at the end of period for the Rights to vest.

For Rights, Options and SARs, service vesting conditions should be appropriate for Micro Resources Companies, unless the instrument represents a reward for prior service or performance. If a service vesting conditions is applied the grants can be used as a retention tool.

Retirement Benefit Limit

The Corporations Act specifies a maximum retirement benefit that may be provided to managerial and executive officers; of one times the average of the last three years' annual base salaries. Higher retirement benefits can be provided if prior shareholder approval is obtained. When vesting of equity instruments is triggered or accelerated by a termination of employment the value that vests is part of the total retirement benefit provided. Accordingly, if prior shareholder approval for a higher retirement benefit has not been obtained the value of equity instruments that may vest may need to be reduced to comply with the limit. This is often a problem for Micro Resources Companies using old style equity plans with small cash salaries and high equity interests. Generally, the problem is the termination, good and bad leaver clauses in the plans. Modern equity plans can address this more effectively.

Taxation Consequences for Employees

Provided the Equity Plans are designed correctly, employees will not be taxed on the value of the Rights, Options or SARs until exercise. The taxing point may be deferred until the earlier of cessation of employment and the elapse of 15 years after the Rights, Options or SARs were granted. If the company is not paying dividends, this gives employees maximum tax flexibility and opportunity to maximise the financial benefit that arises from tax deferral when share prices are rising.

If not exercised then there is no tax payable in respect of the Right, Option or SAR.

WHICH INSTRUMENT TO USE

In order to consider which instrument to use it may be helpful to use an example. The example company has issued 150,000,000 shares which have a market value of $0.10 each. The company employs six key contributors being the Board Chair, two other non-executive directors (NEDs), a CEO, a CFO and an Exploration Manager.

The company wishes to provide equity in the amounts indicated in the following table, so as to preserve cash:

Role	Annual Equity Value
Board Chair	$30,000
NED 1	$20,000
NED 2	$20,000
CEO	$80,000
CFO	$45,000
Exploration Manager	$45,000

The above amounts were derived from consideration of market remuneration practice data in the **GRG Micro Resources Remuneration Guide**, taking a typical Micro Resource company's policy position for Fixed Pay and target total remuneration packages.

As the company does not pay dividends the value of a Right equals the share price of $0.10 and a Black-Scholes valuation of the Options and SARs produced a value of $0.0525. For simplicity it is also assumed that service is the only vesting condition.

The following table shows the number of Rights and Options or SARs that would be granted each year.

Rights With Share Price of $0.10		
Role	**Annual Equity Value**	**Number of Rights to be Granted**
Board Chair	$30,000	300,000
NED 1	$20,000	200,000
NED 2	$20,000	200,000
CEO	$80,000	800,000
CFO	$45,000	450,000
Exploration Manager	$45,000	450,000
	Total	2,400,000
	Annual Grants as % of Issued Shares	1.60%
	Issued Shares	150,000,000

Options or SARs With a Value of $0.0525		
Role	**Annual Equity Value**	**Number of Options or SARs to be Granted**
Board Chair	$30,000	571,429
NED 1	$20,000	380,952
NED 2	$20,000	380,952
CEO	$80,000	1,523,810
CFO	$45,000	857,143
Exploration Manager	$45,000	857,143
	Total	4,571,429
	Annual Grants as % of Issued Shares	3.05%
	Issued Shares	150,000,000

If the company were to be intending to rely on Class Order 14/1000 for disclosure and other relief then Options would cease to be a viable alternative as the numbers to be granted over three years (3.05% x 3 = 9.15%) would far exceed the 5% limit. If the Company were to rely on the senior manager exemption under s708 of the Corporations Act, then Options could be used but SARs could not as they would not be classed as securities. While there is technically no limit on the number of instruments that may be offered to employees the likely reaction of shareholders needs to be considered. They may consider that annual grants of over 3% of issued shares will result in excessive dilution and may vote against resolutions seeking approval of the plan and/or grants to directors. This may be another reason to consider using SARs, which are substantially less dilutive than Options.

It should be noted that when big changes in value occur, leveraged structures like Options and SARs deliver the greatest reward for the same cost to the company. This means that SARs are likely to be the best instrument for explorers, in particular.

Conclusion

Although the start-up ESS taxing concession does not apply to Micro Resources Companies there are various approaches that may be used to provided equity remuneration to key contributors. Various factors need to be considered when selecting the most appropriate equity instrument to use. One of the important factors is dilution and this factor alone can often lead to the use of Rights in preference to Options.

Irrespective of the equity instrument that is used the terms and conditions attached to them need not be overly complex. Simple vesting conditions will often be adequate.