Unlisted Long Term Incentives: Equity Optional

Author: James Bourchier

Introduction

Long term variable remuneration (LTVR, LTI or long term incentives) is often viewed as the most powerful form of remuneration for executives and other key staff, because it is uniquely able to address a range of remuneration needs and purposes. Unlisted companies have long struggled to compete with, replicate or implement the LTI or LTVR that listed companies traditionally offer key staff. Thanks to substantial changes in the regulatory environment, and innovative solutions, this no longer needs to be the case; with or without equity, a compelling long-term structure is possible. This article provides a simple overview of why and how unlisted companies should approach this aspect of remuneration, including the four main approaches we observe in successful unlisted market examples (and the main alternative).

Why unlisted companies should have LTI/LTVR

LTVR is offered in the vast majority of ASX listed companies, and over 95% of the ASX 300, because it is uniquely positioned to address the following priorities:

1. Wealth creation
2. Shareholder alignment
3. Stakeholder alignment
4. Long term strategy delivery
5. Retention
6. Succession
7. Cash preservation, bonus cost management and/or salary sacrifice

Most businesses have a desire to address at least a sub-set of these priorities for at least a sub-set of their staff e.g. retention, succession and alignment of top employees and executives. However, most unlisted businesses do not have an LTVR because of preconceptions about complexity, cost and loss of control.

The Four Main Approaches (+ the Main Alternative)

1) Simple Cash-based LTVR

The simplest form of LTVR is broadly comparable to a typical short term variable remuneration or short term incentive (STVR or STI) plan, except that:

i. There is usually a multi-year service condition, sometimes in "tranches" (different portions that become available at different points in time),
ii. There are usually fewer performance metrics involved, and
iii. Performance is typically tested over 3 years.

The rules applicable to this plan may be a little more complex than for a typical STVR, because of the increased likelihood that something exceptional may occur over the longer term, like a change in business circumstances, control or redundancy.

An example could be summarised as: between $50,000 and $100,000, payable if the incumbent remains employed with the Company 3 years later, and the average return on capital over the 3 years is between 7% and 14% (pro-rata).

The main strengths of this approach are that:

i. the amount payable will always fall within a specified range i.e. tightly controlled expense,
ii. it is comparatively simple to document and communicate,
iii. it does not involve any actual shares, which some business owners may prefer,
iv. it is likely to seem more familiar to those that have not experienced LTVR before.

The main weaknesses of this approach are that:

i. it will not create the same kind of "skin-in-the-game" and "thinking like a business owner" that arises from approaches that are exposed to business valuation or equity ownership,
ii. it does not offer the same kind of up-side as approaches that are exposed to business valuation, and
iii. tax advantages associated with equity are not available.

2) Simulated, Virtual or Phantom LTVR

A simulated, virtual or phantom long term incentive or LTVR attempts to be as comparable to genuine share ownership as possible, without ever involving any actual shares. A simple business valuation formula can be selected, and a fictional number of virtual shares is decided upon, so that the resulting virtual share price is around say $1.00. The formula used to value the business may be any that the owner wishes to use as a proxy for business value, as it will never be audited or taxed e.g. 1 x Revenue, or something more complex that takes into account industry profit multiples and various financing adjustments.

The rules applicable to this plan tend to look more like equity plan rules, because it is seeking to simulate the equity ownership/exposure experience and may span long periods.

An example could be summarised as: between 50,000 and 100,000 $1.00 valued Virtual Rights vesting if the incumbent remains employed with the Company 3 years later, and the average return on capital over the 3 years is between 7% and 14% (pro-rata). However, the value that is payable will depend on the value of a virtual Share at the time of settlement. For example, if the business value has grown 50% and the Virtual Share price has risen to $1.50 over the 3 years, then the maximum reward opportunity also rises to $150,000.

There are two main variations in how this plan operates:

i. simulating an LTVR only: the Rights are automatically exercised/settled at the end of the measurement period, dividends are ignored. The ownership experience arises from ongoing grants of LTVR, rather than building up a holding. This is the most common approach because the costs to the business owner are predictable in both amount and timing, or
ii. simulating LTVR and share ownership: the Rights can be held indefinitely, equivalent to shares, and can be exercised at virtually any time in the future, potentially with dividend equivalent payments flowing to them. This approach is less common and can result in much larger cash payments at unpredictable times, if participants hold and accrue the Rights long term and the business value grows strongly. However, this can be manageable for many larger businesses, particularly if only a small portion of the business, say 5% to 10%, is linked to a plan like this and the business has ample cash-flow (e.g. 5% to 10% of business profits flowing into this plan to provide dividend equivalents also).

The main strengths of this approach are that:

i. it provides an experience that is in most respects comparable to equity-based LTVR and share exposure, creating the skin-in-the-game, ownership mentality that is often sought,

ii. it does not involve any actual shares, which some business owners may prefer,
iii. it is simpler to document and manage compared to approaches that involve shareholder agreements, multiple classes of shares, buy-backs etc.,
iv. taxation is simple for both the business and participants as it will be treated like any other cash remuneration.

The main weaknesses of this approach are that:

i. the complexity is higher than the simplest cash-based approaches,
ii. it may not offer the same kind of up-side as approaches that allow for indefinite share-holding and dividend streams, and
iii. tax advantages associated with equity are not available.

3) Equity-based LTVR

Equity-based LTVR is directly comparable to the LTVR offered by listed companies and involves genuine equity interests, and ultimately, shares being acquired/held following exercise. Following changes in the regulatory environment in recent years, this has become much easier for unlisted companies to adopt. The Shares involved may be of a different class to the business owners' shares, such as non-voting or "B-Class" shares. However, this approach requires some way to turn the equity into cash, so that participants will not face a tax bill which cannot be funded from the equity itself when the taxing point arises; this could cause bankruptcy in extreme cases. This is typically resolved by:

i. a high level of confidence in a liquidity event arising (trade sale or listing on the ASX for example) before the taxing point arises (15 years is the maximum tax deferral period), and/or
ii. having a buy-back agreement such that the Company will guarantee that employees can be sure of being able to turn equity into cash.

An example could be summarised as: between 50,000 and 100,000 $1.00 Share Rights vesting if the incumbent remains employed with the Company 3 years later, and the average return on capital over the 3 years is between 7% and 14% (pro-rata). However, the value that is payable will depend on the value of a Share at the time of sale of the Shares.

The main strengths of this approach are that:

i. it provides genuine share ownership and exposure, creating the skin-in-the-game, and ownership mentality that is often sought,
ii. it can be a way for business owners to sell-down their shareholding (to the business), and manage succession, in a way that does not involve cost for either employees (who receive equity as part of their pay package) or business owners (who may use LTVR in lieu of higher cash remuneration),
iii. it provides genuine wealth-creation and wealth-sharing opportunities that otherwise may not be available or cannot be funded (e.g. if linked to a liquidity event), and
iv. tax advantages associated with employee share schemes can be available.

The main weaknesses of this approach are that:

i. >10% shareholders will face up-front tax (see next plan for solution),
ii. the complexity is higher than the cash and virtual approaches, and often involve shareholder agreements and buy-back agreements, unless former employees are allowed to keep equity,
iii. allowing employees to retain equity post termination may trigger "public company" status,
iv. the business owners will often need to limit the personal activities flowing through the business, like personal expenses, and commit to some kind of dividend policy, to provide new shareholders with confidence that they will be treated equitably,
v. formal business valuations will be required for accounting and tax reporting purposes, which can often cost between $7,500 and $15,000 depending on complexity at each instance,
vi. tax is generally due at exercise; without a market for shares, it can be challenging to fund this,
vii. if done for a liquidity event that does not eventuate, either the arrangement needs to be cancelled ("lapse", which can be disengaging for employees) or the business may need to find new and unexpected ways to manage the plan (see next plan type).

4) Indeterminate/Hybrid LTVR

An indeterminate equity plan is identical to the equity-based LTVR approach described above, except that instead of the right or option being an entitlement to a share at exercise, it becomes an entitlement "to the value of a share" (potentially net of exercise price) which may be settled in cash and/or equity as determined by the board at the time of settlement. This is technically a derivative which until recent times was prohibited for unlisted companies, however, following regulatory changes, this has become much easier for unlisted companies to adopt.

This has the advantages of:

i. being treated as if it was always a cash-plan if it is settled in cash, and
ii. being treated as if it was always an equity-plan if it is settled in equity.

This can resolve many of the problems that exist for unlisted businesses if there is no market for the equity, or uncertainty about the market for the equity, such as an initial public offering (IPO) failing to eventuate. Even more powerfully, the business can choose to settle half of the Rights in cash, allowing the employee to pay their tax bill, and the other half in equity, on which no more tax is due (until sold); thus facilitating true ownership transfer and solving the tax problem while cutting the cash drain in half. This places a higher need for being able to fund at least 50% of the plan from cash flows and linking performance to reward. It can also address the tax problem that usually arises for employees that already have a >10% interest/shareholding in the business (effective tax deferral can be achieved for them).

Other than these advantages, the main strengths and weaknesses of the indeterminate/hybrid approach are identical to those applicable to equity-based LTVR. GRG recommends that most should use hybrid plans.

The Main Alternative – Deferred STVR (not a real LTVR)

If none of the foregoing approaches can be adopted, the primary alternative is to adopt "Deferred STVR". Usually, the amount of the STVR opportunity is increased, with a significant portion of it deferred, or "banked" for payment at a future date, if the employee remains with the business at that time.

A simple example could be summarised as: up to $100,000 STVR, with 50% of any end of year bonus payable immediately following the end of the year, 25% payable 12 months later (1 year deferral), and the remaining 25% a further 12 months later (2 year deferral) if still employed with the business.

This approach can achieve a similar retention effect to LTVR, with employees leaving significant money on the table if they resign but does not offer much incentive to grow business value. Additional conditions and modifiers may be applied to the deferred amount, such as reductions for risk and compliance issues, or even a multiplier for business improvement during the deferral period, providing some up-side. However, because performance is not usually measured over the deferral period and it is not usually over a 3 year period or more, it cannot be considered a genuine LTVR, and is likely to be limited in terms of getting employees to think and act as business owners, or in aligning stakeholder interests.

Ignoring LTVR

Some unlisted entities ignore the LTVR component of remuneration, by either benchmarking against remuneration excluding the LTVR component which can lead to uncompetitive packages and challenges attracting / retaining talent, or by upping the STVR component of the package to absorb the LTVR, which often carries a higher cost than LTVR, without the benefits. A simple LTVR plan is generally superior.

Conclusion

Most businesses, listed or unlisted, have a need to retain key talent, manage succession, encourage managers and other employees to think and act like owners, to incentivise long term strategy execution, and to align stakeholder interests. Thanks to changes in the regulatory environment, regardless of business circumstances, there is now an LTVR plan that can more effectively address these issues than any other form of remuneration. However, to navigate the human impact, legal compliance, tax and other business issues, this is an area that can benefit from obtaining some expert advice before putting a plan in place.