GRG Remuneration Insight 160

Long Term Incentive Fundamentals

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Introduction

Long term incentives, also known as long term variable remuneration (LTI or LTVR) is likely the most poorly understood element of remuneration across stakeholder groups. It can be viewed as overly complex, legalistic, opaque and challenging to communicate and administer, while the performance metrics tend to be unintuitive or unfamiliar to many. A history of poor design and communication around this element of remuneration has led to some not valuing it, or worse, opting out of participation because they have experienced financial losses. At the same time, LTI/LTVR should be, and often is, the most powerful, effective and rewarding element of remuneration. This GRG Remuneration Insight seeks to provide clarity as to the fundamentals of LTI plans and their critical success and failure factors, alongside an overview of market practice data (extracted from the GRG Variable Remuneration Guide).

What is a Long Term Incentive or LTVR Plan?

When referring to LTI plans, most Remuneration Committees have equity-based plans in mind, subject to conditions that need to be fulfilled over several years, such as continued employment, performance, and minimum share price conditions. While it is possible to offer LTI/LTVR that is not equity based, instead based on "phantom" or "virtual equity" (simulated equity ownership), or arrangements that result in a cash payment after several years when conditions are met, this Insight will focus on equity plans, which are used by over 95% of the ASX 300.

The defining feature of an LTI/LTVR is that it is a conditional reward opportunity ("unvested") that can only be converted ("vested" and "exercised") into a benefit after several years, subject to delivery of required outcomes, which are generally referred to as "vesting conditions". Most stakeholders define LTI/LTVR as being subject to a minimum 3-year condition assessment period, called the "Measurement Period". There are broadly two categories of equity LTI/LTVR, being:

1. Rights (Nil priced): these are an entitlement to a share (determinate rights) or the full value of a share that may or may not be settled in cash or equity (indeterminate rights). These are "unleveraged" and will deliver value as long as conditions are fulfilled and the share price does not fall to nil. These are usually utilised by mature businesses or businesses that are not certain of exceptional share price growth.
2. Option-type structures: these are entitlements to a share subject to the payment of an "Exercise price" by holder ("options") or to the value of a share net of a virtual exercise price ("indeterminate" Share Appreciation Rights). These are "leveraged" and only have value if the share price exceeds the exercise price. These are usually utilised by rapidly growing businesses looking to leverage exceptional share price growth expectations.

It should be noted that shares are generally not used directly, because of tax issues that arise.

Should All Companies use Long Term Incentives?

The simple answer is generally yes. LTVR is uniquely positioned to address the following priorities:

1. Wealth creation/sharing

2. Shareholder/owner alignment
3. Other stakeholder alignment (e.g. regulators, customers, community)
4. Incentivising long term strategy delivery
5. Retention
6. Sustainability, risk management and genuine ESG initiatives
7. Succession
8. Cash-preservation (if equity-based)

Most businesses have a desire to address at least a sub-set of these priorities for at least a sub-set of their staff, meaning that most businesses should consider some form of LTVR e.g. retention, succession and alignment of top employees and executives.

Design features of LTI/LTVR Plans

Measurement Period

The vast majority of ASX listed companies with LTI/LTVR plans use 3 financial years as the measurement period. The financial year is the obvious choice as it aligns with budget processes and planning. It also ensures that LTVR vesting is consistent with annual published financial results/reporting, and therefore the expectations of shareholders.

While a few companies prefer to wait for financial results release to calculate vesting, this tends to undermine the transparency of performance/reward links, because it creates a further 1-year delay before the outcome is reported and disclosed. Some companies, particularly smaller companies in the technology sector, will have Measurement Periods of say 1, 2 and 3 years (annual vesting), however, only the 3 year tranche would be classified as LTI/LTVR by most stakeholders, and these structures are often criticised. It should be noted that when granted annually, 3 year overlapping LTI/LTVR will vest annually in any case. This is the practice of the vast majority of the ASX.

It should also be noted that in the financial sector, regulators have successfully pushed for longer periods: typically 4 years between granting and first vesting.

It is possible to have measurement periods for service/ongoing employment that are separate from any performance condition measurement period, such that unvested LTI/LTVR can be retained by employees following termination if the required period of service has been fulfilled, for future outcome testing.

Performance Metrics and "Vesting Conditions"

LTI/LTVR is granted unvested and will only "vest" (become available to be exercised into a benefit) when certain conditions are met. Generally, the conditions will relate to some period of ongoing employment/service with the company, and conditions that measure whether sustainable value has been created or key steps in long term strategy execution have been achieved. The most common conditions relate to:

1. Earnings per share
2. Return on equity
3. Return on capital
4. Total shareholder return, which may be a percentage growth rate, or assessed relative to peers (ranked TSR) or an index (indexed TSR)
5. Key development milestones, such as the development of new production facilities or regulator approval for a new product or technology

Performance Scales

Unlike short term incentives or short term variable remuneration (STI or STVR), grants are made up-front at their maximum or stretch level, meaning that they will only vest in full if the maximum level of all performance conditions is met or exceeded. Additional grants are not made if targets are exceeded, so the full range of outcomes needs to be considered up-front and provided for. As such, the expected or "Target" level of vesting of LTI/LTVR is generally around 50%. The actual level of vesting is determined

by "vesting scales" that specify a percentage out of 100% that will vest, when different performance outcomes are achieved. An example follows:

Performance Level	Earnings Per Share Compound Annual Growth Rate (CAGR)	% of Grant Vesting
Stretch	≥ 12%	100%
Between Target and Stretch	> 8% & < 12%	>50% & <100%
Target	**8%**	**50%**
Between Threshold and Target	> 8% & < 6%	>25% & < 50%
Threshold	= 6%	25%
Below Threshold	< 6%	0%

Threshold is a near miss or minimum performance that warrants a minimal level of vesting; Target is usually associated with the expected "challenging but achievable" outcome; and Stretch is an outstanding level of performance unlikely to be achieved.

Such a range of outcomes and awards has a material impact on behaviour, as the incentive can remain motivating even when the target objective cannot be fully achieved, and outperformance of targets already achieved during is additionally rewarded.

Unlike STI/STVR scales, it is common for LTI/LTVR scales to fail to clearly identify the "target" or expected outcome, which is often confusing for all stakeholders; some scales only specify a Threshold and a Maximum/Stretch, making it impossible to identify what the actual objective is.

Weightings

There are usually 1-3 metrics for LTI/LTVR, which is significantly fewer than for STI/STVR. They tend to be equally weighted unless a metric is binary (achieved or not achieved, no scale of outcomes) in which case, a smaller maximum opportunity tends to relate to these types of metrics.

Reward Opportunities

The value of 50% vesting at target performance should relate to the amount determined by reference to the target remuneration profile for the role. Typically, it will be expressed as a percentage of the Base Package and derived from market benchmark data.

Vesting and Settlement

When options or rights vest, they need to be exercised in order to be settled and ultimately converted into a benefit. Vesting usually occurs following the board assessing whether and to what extent conditions have been met, and a percentage out of 100% vesting determined, usually using pro-rata calculations. Vested rights may be exercised automatically in some cases, which can often trigger tax liabilities at undesirable times. Options and rights with an exercise price (whether virtual/cashless or genuine), and the most flexible rights, will involve the holder submitting an "exercise notice" to choose when they want to trigger the benefit. For "indeterminate" rights, the benefit may be settled in cash or in shares, while for options and share rights the holder will receive 1 share for every right or option exercised.

Termination of Employment

If a KMP ceases employment during a measurement period it is usual for entitlements to be forfeited in cases of dismissal for cause, and if resigning prior to the elapsing of the required service period. In other cases, entitlements may not be fully forfeited. Often, unvested opportunities will remain "on foot" for long term outcomes testing at the end of the measurement period if the holder was not a "bad leaver". If instead the company decides to vest a pro-rata amount on termination of employment, then the vesting will constitute a termination benefit. The total of all termination benefits for KMP must not exceed the Corporations Act default limit of one times base salary unless prior shareholder approval for a higher

termination benefit has been received. The treatment of "good leaver" needs to be carefully crafted to avoid unintended termination benefit problems.

Change of Control

Market practice for LTI/LTVR plans in relation to change of control is a contentious area. Many argue that if the termination clauses are appropriately drafted, there is no need to provide a safety net for a change in control, because redundancy will not impact entitlements. A de-listing of listed shares will usually result in some level of vesting, although many shareholders take issue with plans that specify full vesting, or even board discretion in the case of a change in control or delisting. It should be noted that early payment of LTI/LTVR awards that are triggered by a change of control would not be subject to the Corporations Act termination benefit limit.

Risk Assessment, Gates and Malus

An important feature of LTI/LTVR plans design and implementation is to ensure that excessive risk is not encouraged and that adjustments can be made should objectives be pursued in a way that is ultimately unsustainable or unacceptable. Careful selection of performance metrics, and appropriate controls, will assist, although no single metric is without risk. Often a "gate" will apply that will "turn off all vesting" if it is not exceeded, such as managing risk within acceptable ranges, or ensuring the safety of employees. In addition, LTVR will often be subject to "Malus" which allows for vesting to be modified downward if undesirable activities are uncovered.

Policies and Plan Rules

An LTI/LTVR policy is one component of a Remuneration Governance Framework. It should sit alongside the STI/STVR policy, the senior executive remuneration policy and the non-executive director remuneration policy. The policy and procedure should be separate from the plan rules. Because this aspect of remuneration typically involves securities and is a "financial instrument" or "financial product" the documentation surrounding opportunities is necessarily legalistic. LTVR is usually defined in two parts: plan rules need to cover all of the essential plan design features yet leave sufficient flexibility for the Board to modify specific "invitations" (which contain the finer details like performance scales) to meet the changing circumstances and needs of the company.

Avoiding the Pitfalls

Where LTI/LTVR plans are not valued, are not understood or are viewed as failing, it is usually because of one or more of the following issues, which need to be managed and avoided:

1. Participants do not understand how it works, or participants do not understand the performance metrics or how they can influence the outcomes; offering roll-out webinars and workshops resolves these issues.
2. Participants face financial losses or risk when participating; ensuring tax considerations are part of the design process is an essential step.
3. The opportunity causes a breach of the law, usually the Corporations Act; ensuring legal considerations are part of the design process is an essential step.
4. The opportunity does not vest because vesting conditions cannot be met; selecting and calibrating hurdles that are directly relevant to the business, not just reflecting typical market practices, is essential.
5. Participants are not engaged; ensuring regular reporting of performance against vesting conditions throughout the measurement period is recommended to maximise engagement.
6. Little or no benefit arises because the share price is not growing fast enough or falls; selecting structures that are appropriate to growth expectations of the business is critical.

Conclusion

While LTI/LTVR should be present in some form for some employees in most businesses, it is not a one-size-fits-all remuneration element, and requires more tailoring, education and management of regulatory issues than any other form of remuneration in order for it to achieve its function as intended.