GRG Remuneration Insight 95

Making LTIs More Relevant

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INTRODUCTION

For some time it has been anecdotally noticeable that many executives do not tend to fully value the long-term incentive (LTI) element of their total remuneration packages. This GRG Remuneration Insight identifies the underlying reasons for executives not being fully engaged by their LTI plans and proposes changes to increase their engagement.

The trigger for this topic has been the emergence of what has been branded as a "Total Incentive Plan" (TIP), which in reality is more akin to a short-term incentive (STI) plan with a deferred element. Under a TIP plan, previous STI and LTI award opportunities are combined into a larger STI award opportunity. Part of the STI award is then deferred into equity with a typical holding period of around 2 years. This deferral, in addition to claiming "simplicity", is the extent to which proponents of TIPs seem to agree. However, when it comes to the extent to which long-term performance measures and value creation are catered for by TIPs, responses are imprecise, varied and come in all shades of grey depending on who you talk to; and herein lies the TIP's defects.

SOME SHORTCOMINGS OF TIPs

Gaming of the STI Plan

STI plans usually relate to annual business plans and budgets that are largely constructed and shaped by management. This automatically places executives in a conflict of interest position in that the plans and budgets they set will impact the STI awards that they may earn.

That such conflicts should be avoided has been made clear in the ASX Corporate Governance Council's Principles and Recommendations, which prescribe that non-executive directors (NEDs) should not participate in incentive plans for executives and that they (i.e. NEDs) should set the performance goals for such plans.

Moreover, increasing the value of the STI award opportunity may result in a corresponding temptation for some executives to game the STI plan, thus escalate the risk of unethical behaviour (there are many recorded instances of executives inaccurately depicting company performance for personal benefit).

Boards will need to decide if these additional risks are worth taking and appropriate to their company's circumstances.

Short-termism

The nature of STI plans is that they focus on key performance indicators (KPIs) and performance standards that relate to the measurement period which is the company's financial year, hence short-termism. The other side of the same coin is that goals related to long-term growth in shareholder value tend not to be included in STI plans. A reason for this is that it is generally challenging to identify annual milestones that will convincingly result in progress to achieving longer-term goals. Furthermore, such milestones may not necessarily reflect success or failure of the longer-term goals or result in growth in shareholder value.

In view of the above, it is unlikely that STI plans with deferral will have any meaningful KPIs related to the long-term or will include them with a minor weighting. Either way, such watered down long-term KPIs will be relegated low on an executive's STI priority list.

Of more significant concern is that when performance is mainly measured over a one-year period, executives are bound to excessively focus on the short-term. Since most STI plans use annual profitability relative to budget at company and business unit levels as KPIs, it is possible that increasing the STI award opportunity, combined with LTI removal/dilution, will result in decisions that produce increased short-term profits at the expense of longer-term growth in shareholder value.

No Improvement in Holding of Shares

An STI with a deferred element falls well short of the impact of a balanced combination of STI and LTI. Moreover, even deferring part of STI into equity, however large, does nothing to encourage long term holdings of equity and is not a substitute for LTIs which focus executives on achieving long term performance goals.

Deferred STI equity awards, irrespective of vesting periods whether 2 or more years, will not be longer than most LTI vesting periods; and of course, vesting tends to trigger sale of equity to fund the tax liability on the vested equity. Thus, there is no good reason to believe that deferring STI into equity will produce greater holdings of equity than LTI plans.

IMPROVING LTI PLAN DESIGN ASPECTS

Rather than ditching the LTI plan and replacing it with a STI plan with deferral, consideration should instead be given to those design aspects of LTI plans that have led to them being less valued than they should be (irrespective if it is a perception or reality).

Good Leaver Provisions

Most LTI Plan Rules treat "Good Leavers" and "Bad Leavers" differently on termination of employment. Bad Leavers generally forfeit all unvested LTI grants whereas Good Leavers either retain unvested grants for possible future vesting or have a degree of vesting triggered by the termination of employment.

As LTI plans typically use vesting periods of 3 years or longer, it follows that Bad Leavers actually realise very little of the LTI grants they receive even when they are on target to achieve high vesting due to strong performance. Given that many senior executives have average expected tenures of less than 7 years after which they tend to resign to pursue career progression, it is understandable that they would not place a high value on the LTI and would see it as having a value of less than 50% of its face value being the percentage of grants that may vest after 5 years of employment. This is illustrated in the table overleaf for a typical LTI plan. The model looks at the position of a Good Leaver and a Bad Leaver should they cease employment during the indicated year.

Financial Years		**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
LTI Grants		Receives LTI Grant 1	Receives LTI Grant 2	Receives LTI Grant 3	Receives LTI Grant 4	Receives LTI Grant 5	Receives LTI Grant 6	Receives LTI Grant 7	Receives LTI Grant 8
Vesting of LTI Grants					Grant 1 Vests	Grant 2 Vests	Grant 3 Vests	Grant 4 Vests	Grant 5 Vests
Good Leaver	**Cumulative Available for Testing for Vesting or Vested**	0	0	0	4	5	6	7	8
	Cumulative Vested or Available for Vested as % of Total Grants	**0**	**0%**	**0%**	**100%**	**100%**	**100%**	**100%**	**100%**
Bad Leaver	**Cumulative Available for Testing for Vesting or Vested**	0	0	0	1	2	3	4	5
	Cumulative Vested as % of Total Grants	**0%**	**0%**	**0%**	**25%**	**40%**	**50%**	**57%**	**63%**

Given the foregoing it is suggested that consideration be given to making the following three changes to LTI Plan Rules:

1. Change the definitions of Good and Bad Leavers such that:
    a. "Bad Leavers" are those who are dismissed for cause (or those that resign without providing adequate notice, or have not put in place good succession plans), and
    b. "Good Leavers" cover all other terminations of employment.
2. Change the treatment of LTI for Good Leavers such that:
    a. Some or all of the LTI grant received in the year of termination is forfeited, and
    b. All remaining unvested LTI grants are retained to be tested for vesting at the end of their performance measurement periods, and
3. Unvested LTI grants retained following employment termination are subject to forfeiture should a departed executive engage in conduct that is deemed detrimental to the company's interests.

These changes should have a number of positive impacts on executives including:

a) The perceived value of the LTI remuneration will increase significantly,

b) Executives will more strongly focus on achieving long-term goals,

c) Executives will have a greater vested interest to leave the company in good shape when they leave, and

d) Departed executives will be less inclined to engage in any conduct that will potentially harm the company for at least 2 years (remainder of measurement periods for unvested LTI grants) following employment termination – (i.e. the unvested LTI grants will act as a "good behaviour" bond).

While it is acknowledged that the retention impact of LTI will be diminished by these changes, it would be no less than would occur if LTIs were to cease and be replaced with a larger STI with partial deferral into equity.

Performance Metrics

The preference of executives for STI over LTI may be partly attributed to the nature of the KPIs used. In STI plans the dominant KPIs used for measuring company and business unit performance are financial. There can also be other KPIs such as individual and operational performance. Executives would see that all of these KPIs are ones that they can directly influence.

With LTIs on the other hand, performance metrics have been traditionally dominated by ranked total shareholder return (rTSR) which involves comparing the company's TSR with the TSRs of companies in a comparator group. Vesting then depends upon the ranking of the company's TSR within the comparator group.

If TSR is to be used, then consideration should be given instead to indexed TSR (iTSR) which compares a company's TSR with the Total Return achieved by an index. Broadly, this approach eliminates the impact on TSR of market movements and allows a company's TSR performance to be judged against the Board's expectations. It is, therefore, more about how the company has performed relative to expectations instead of relative to a small group of companies who have Boards that may have very different company performance expectations given their very different circumstances even if they are in the same industry sector or who experience irrational share price movements during the measurement period.

As has been the market trend over recent years, LTI can be made more relevant to executives by assessing performance against financial metrics, which executives tend to be more comfortable with and feel that these are more under their control. In these cases, it is important for the weighting placed on such financial metrics to be at least 50% and use other/different types of financial metrics than traditional ones.

Although earnings per share (EPS) growth is commonly used as a financial metric, it has the least direct correlation with growing shareholder value over time. As any respectable investor knows, more appropriate metrics would be those that relate to growing ***real*** shareholder value with probably economic profit being most relevant; but others such as a combination of return on equity (ROE) or return on invested capital (ROIC) and growth in shareholders' equity could also be considered.

Whichever metrics are chosen, their relationship to longer term growth strategies should be both apparent and explainable to shareholders and LTI participants alike.

Clarity of LTI Grant and Vesting Methodology

An area that is not well understood or communicated clearly is the relationship between target and stretch award opportunities and the vesting scale for LTI grants. In our experience, some Boards are unclear as to the level of LTI to be offered and the method of converting an LTI target award opportunity into an LTI grant. When Boards do not have clearly specified LTI policies and procedures, it is unlikely that their LTI grant decisions will be consistently applied between executives and from year-to-year. This inconsistency contributed to concern amongst executives regarding the LTI and its value.

CONCLUSION

While current LTI plan designs may need improvement, it is clear that replacing them with a larger STI with a deferred component is certainly not the remedy. There are some aspects of LTI that may be changed with relative ease and should be canvassed before throwing out the baby with the bath water.