GRG Remuneration Insight 99

Does Deferred/Held Equity Give Better Alignment than LTI?

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Introduction

GRG observed that some companies appear to use requirements for equity to be held by executives as a means of partially (or fully) replacing long term incentive (LTI) plans. This is manifested by deferring a significant part of awards earned under short term incentive (STI) plans into equity holdings that must be retained for several years and simultaneously reducing (or even eliminating) LTI grants to fund larger STI award opportunities.

Such an approach has significant defects, which include encouraging short-termism combined with equity holding periods that are manifestly too short, the dampening of "shareholder experience" signals (like share price or TSR change) in the remuneration mix, as well as de-risking of at-risk remuneration. This GRG Remuneration Insight explores what happens when equity holding through STI deferral is used as a replacement for LTI plans; especially when done via the implementation of Single Incentive Plans (SIPs, sometimes referred to as Total Incentive Plans).

Executive Remuneration Models

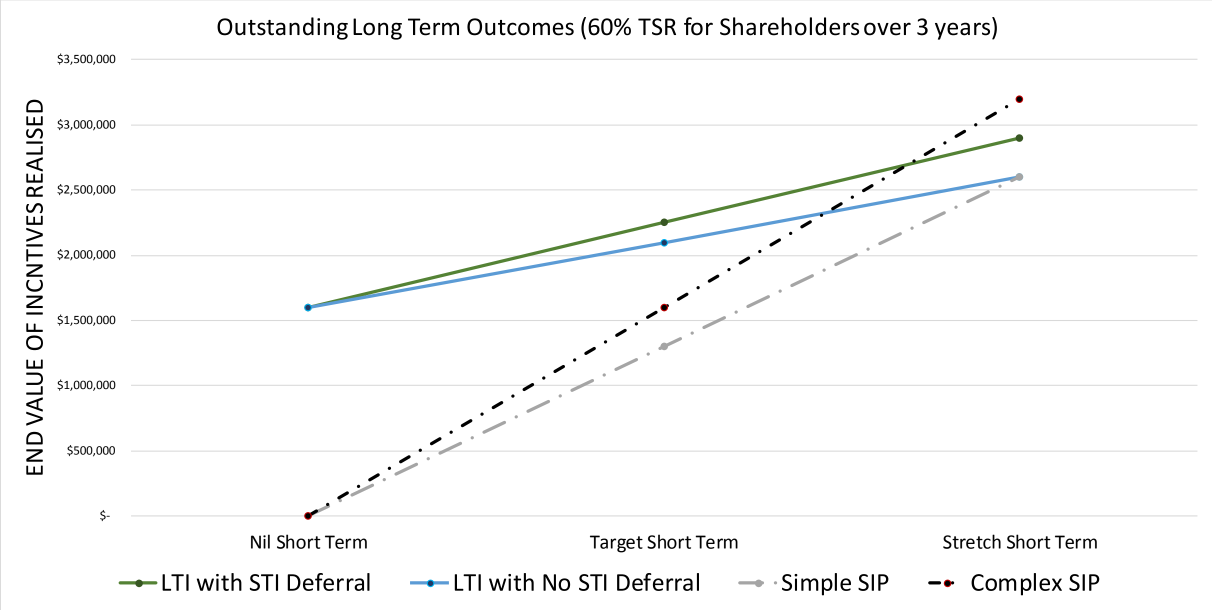
GRG modelled the following four remuneration structures to assess the extent to which they are responsive to shareholder value outcomes and short term KPI achievement:

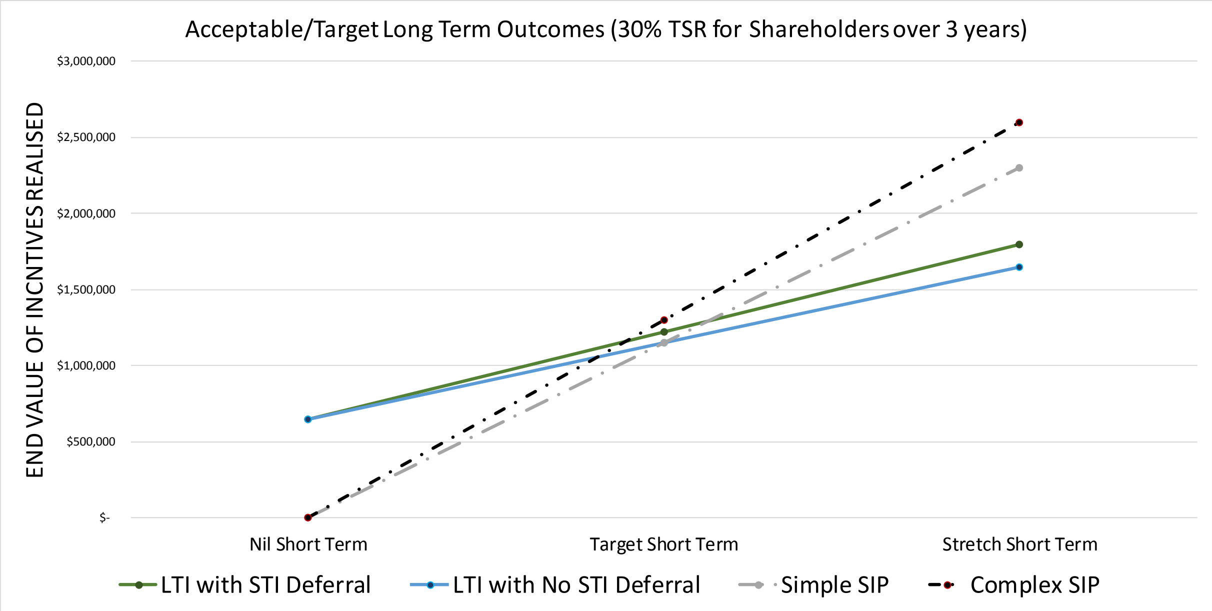
1. Standard Profile, which uses STI and LTI with no STI deferral,
2. Standard Profile with Deferral, which uses STI and LTI with 50% STI deferral,
3. Simple Single Incentive Plan (Simple SIP) where STI awards are partially or wholly deferred into equity that is not subject to performance vesting conditions (deferred STI), and
4. Complex Single Incentive Plan (Complex SIP) where STI awards are deferred partly into equity that is not subject to performance vesting conditions (effectively a deferred STI) and partly into equity subject to performance vesting conditions (effectively a LTI, only with more steps).

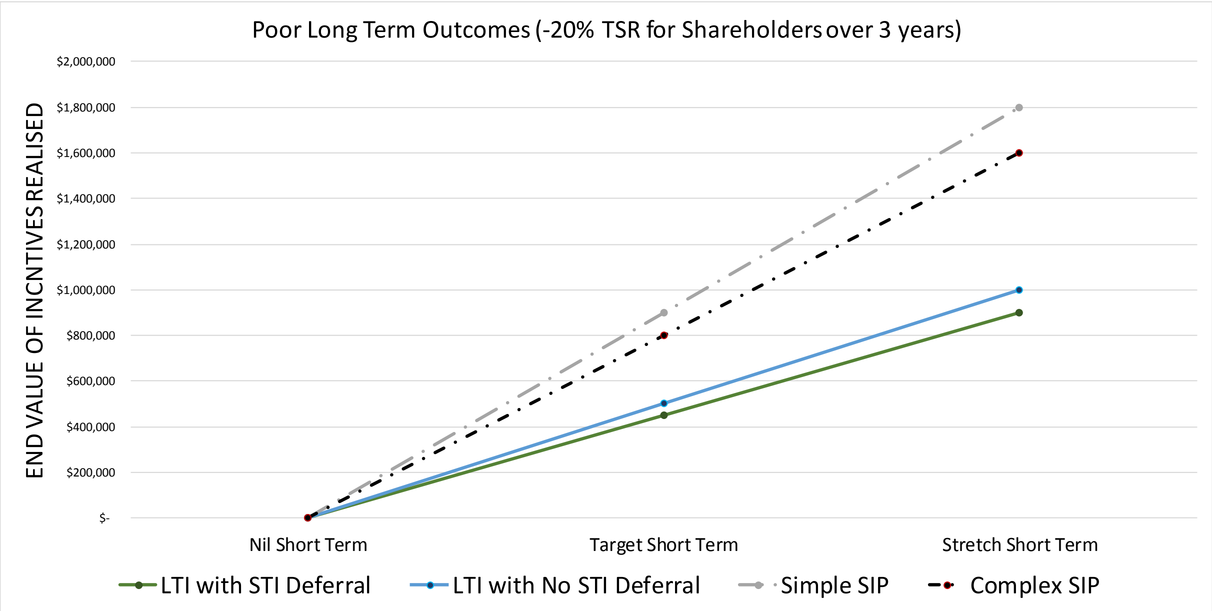
The following scenario matrix table reflects whether a SIP or Traditional Incentives deliver the most financial benefit to Executives vs Shareholders. Each cell represents one of nine different combinations of short and long term performance:

Performance	**Poor Short Term Performance**	**Expected/ Target Short Term Performance**	**Outstanding Short Term Performance**
Outstanding Long Term Performance	Most Benefit to Executives: **Standard Profiles** Best Shareholder Alignment: **Standard Profiles**	Most Benefit to Executives: **Standard Profiles** Best Shareholder Alignment: **Standard Profiles**	Most Benefit to Executives: **Complex SIP or Standard Profiles** Best Shareholder Alignment: **Complex SIP or Standard Profiles**
Expected/ Target Long Term Performance	Most Benefit to Executives: **Standard Profiles** Best Shareholder Alignment: **Standard Profiles**	Most Benefit to Executives: **Draw** Best Shareholder Alignment: **Draw**	Most Benefit to Executives: **SIPs** Best Shareholder Alignment: **Standard Profiles**
Poor Long Term Performance	Most Benefit to Executives: **Draw** Best Shareholder Alignment: **Draw**	Most Benefit to Executives: **SIPs** Best Shareholder Alignment: **Standard Profiles**	Most Benefit to Executives: **SIPs** Best Shareholder Alignment: **Standard Profiles**

The charts, overleaf, present the outcomes of the financial modelling that underpins the conclusions presented in the matrix summary above:







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Observations

It is clear that the two Standard Profiles perform similarly to each other, in terms of executive benefit, as do the two SIPs, under most scenarios. However, the Standard Profiles produce very different outcomes compared to SIPs in most cases, as follows:

1. When shareholders are suffering, SIPs minimise the risks of lesser remuneration to executives compared to Standard Profiles, when some level of STI is awarded (i.e. minimises the risk aspect of the at-risk remuneration).
2. When STI awards fall around the target level and shareholders achieve reasonable gains; both the SIPs and the Standard Profiles produce similar benefits for executives.
3. When shareholders do very well; SIPs result in executives doing much worse than they would under the Standard Profiles except when STI awards are around the maximum award opportunity.

The results indicate that under any version of the SIP, executives can strive to maximise their STI awards without concerning themselves with the impact of short term decisions on benefit to shareholders. Even when shareholders experience a disaster, SIPs produce superior rewards (compared to Standard Profiles). In fact, the benefit of SIPs to executives compared to Standard Profiles is least when shareholders experience the most benefit. It is almost a perfect misalignment with shareholder interests, and a very curious outcome for an "incentive" or at-risk remuneration.

What is happening is that any form of the SIP will dampen the shareholder experience signal in the remuneration outcomes for executives, whereas LTI amplifies the shareholder experience signal for executives.

The main problem perceived with the long term performance signal which is believed to be driving much of this change towards SIPs, is the use of ranked relative TSR as opposed to other forms of TSR assessment, as the ranking of TSR produces a lottery-like effect (i.e. difficulty to plan around or predict, and effectively random - refer to GRG's online knowledge centre for more on this). The other motivating factors seem to be based on:

- Claims of "simplicity", which the complex SIP is anything but (refer to Wesfarmers and Telstra SIP plans as examples), and noting that if an executive does not understand what TSR is then they cannot understand their responsibility to shareholders, and
- Claims of "Longer term alignment" (beyond 3 years), which are much better achieved through a combination of:
    - Removing service conditions from LTI and requiring executives to hold Performance Rights post-employment,
    - Deferring LTI (and tax on LTI) post vesting via Restricted Shares (which also doubles the dividend stream), or deferring STI, or both, and
    - Introducing a KMP equity holding policy and a tax effective salary sacrifice equity plan to facilitate achievement of the holding requirements.

It is interesting that no companies are suggesting that the introduction of an equity holding policy alone can justify the removal of LTI plans, as the effect of such a policy is effectively the same, even stronger, than STI deferral or simple SIP arrangements, due to generally higher percentages of Base Package, and permanent holding periods).

Changing Mix of Incentive Elements

Following on from the Australian Productivity Commission Report on Executive Remuneration in December 2009 a view formed that:

1. STI cash awards should be reduced, and
2. Part of STI awards should be exposed to the longer term impacts of decisions taken in the year the STI award was earned.

This resulted in pressure from proxy advisors and other stakeholders for part of STI awards to be deferred into equity. However, the following tables clearly indicate that companies that have introduced STI deferral have done so by reducing LTI and increasing the STI award opportunities. The resulting outcomes have been that:

1. Cash STI awards have not reduced,
2. Incentives exposed to longer term performance has reduced, and
3. Deferred STI awards are either not subject to any vesting conditions or only subject to service vesting conditions.

The following tables show the additional "premium" on STI that has been applied by companies utilising STI deferral, compared to companies that do not have deferral, and the amount of the STI award that is actually deferred. Please note that this data is based on the limited companies that clearly disclosed their "Target Policy" for both STI & LTI:

Direct Reports to Managing Director/CEO Roles						
Market Capitalisation	Companies with STI Deferral & Disclosing Targets			Companies without STI Deferral & Disclosing Targets		STI Premium When Deferral Applies vs No STI Deferral
	Company Count	P50 Target STI as % of Target LTI	P50 % of STI that is Deferred	Company Count	P50 Target STI as % of Target LTI	
> $10 billion	25	167%	41%	5	100%	67%
$5 - $10 billion	10	150%	38%	8	83%	80%
$2 - $5 billion	16	167%	33%	8	92%	82%
$1 - $2 billion	2	200%	19%	8	129%	55%
$500 - $1 billion	4	200%	50%	13	100%	100%
$250 - $500 million	2	75%	43%	13	120%	-38%

Managing Director/CEO Roles						
Market Capitalisation	Companies with STI Deferral & Disclosing Targets			Companies without STI Deferral & Disclosing Targets		STI Premium When Deferral Applies vs No STI Deferral
	Company Count	P50 Target STI as % of Target LTI	P50 % of STI that is Deferred	Company Count	P50 Target STI as % of Target LTI	
> $10 billion	19	142%	45%	2	n/a	n/a
$5 - $10 billion	9	100%	26%	8	80%	25%
$2 - $5 billion	14	133%	36%	7	108%	23%
$1 - $2 billion	4	169%	23%	8	70%	141%
$500 - $1 billion	5	193%	50%	11	75%	157%
$250 - $500 million	2	n/a	n/a	10	117%	n/a

Note: as company value decreases, the quality of incentive disclosure, particularly Targets (as opposed to maximum/stretch values) also decreases. In addition, STI deferral becomes more common as market capitalisation increases, which is assumed to be largely due to the impact of proxy advisors' preferences and increased activism.

It is particularly interesting to observe that the amount of STI that is deferred is in many cases less than the amount of additional STI opportunity that has been granted to compensate for the STI deferral (peach highlights in the above tables). This is particularly evident in the case of direct reporting roles. This has produced the opposite outcome from what was sought by shareholder activists advocating STI deferral as cash STI has increased and the performance risk associated with equity-based incentives has been reduced which is another interesting outcome for "incentives" and shareholder alignment.

Continuation of Poor Trajectory

It should be noted that when STI is increased to accommodate a deferral component and LTI is reduced, then the standard remuneration profiles migrate towards the outcomes shown for SIPs.

SIPs continue the poor trajectory started by the way companies dealt with the introduction of STI deferral, which can be summarised by:

1. STI awards are further increasing and
2. LTI award opportunities are further decreasing.

GRG acknowledges that requiring executives to have "more skin in the game" via larger equity investments in the companies for which they work is a position to be strived for. However, we are concerned that structures that seek to achieve this by placing too much emphasis on short term performance will be counter-productive. The magnitude of the impact of changes in the share price on realised executive remuneration will be insignificant compared to the impact of short term performance assessment, as is evident from the graphs presented earlier: short term performance outcomes can give say +/- 100% of target reward outcomes, whereas share price movement will almost certainly be less. This clearly incentivises excessive short term risk taking.

Way Forward

GRG has been working with clients on improving executive remuneration profiles and stakeholder alignment. Some of the insights/experiences that have emerged from this work include:

1. STI and LTI plans are much easier to explain and for executives to understand them than comparable SIPs (despite the false claims that SIPs are "simplified" incentive plans),
2. Continuation of cash STI can be desirable and achieved but with lower opportunity weighting,
3. LTI awards should be less at risk of being lost when executives have done nothing wrong e.g. resignations,
4. Increased emphasis on LTI grants with improved performance vesting metrics will foster executive understanding and confidence in the LTI plan. This requires Boards to assess and calibrate LTI vesting conditions each year, in the context of new expectations, which is an activity that if overlooked, can lead to serious undermining of the efficacy of LTI,
5. Equity acquired from LTI can be retained including up to and beyond cessation of employment (of course with the taxing point also being deferred and/or equity being available for sale to meet tax obligations when they ultimately arise), which can also assist in managing governance issues related to equity transactions by executives, and
6. Where executives do not "understand" long term incentives, this is usually because there is no internal discussion or support for executives to understand the specific levers/drivers of long term value creation within the business.