Rethinking Long-Term Incentive Schemes: Beyond Stock Options

By Towers Watson

There is growing urgency for companies to rethink their long-term incentives for employees. In recent conversations with heads of several companies in South East Asia, we have heard less than encouraging comments about their long-term incentive plans.

In the last two decades, companies have tried to use long-term incentives (LTIs) primarily to achieve two objectives: to focus the work behaviour of the covered employees on the desired performance, and to assist in the retention of executives and other key employees. Historically, the long-term incentive vehicle of choice in South East Asia, including Singapore, has been stock options as there was no associated accounting expense for stock options prior to the introduction of FRS 2, accounting for share-based payments, in 2006.

But, when asked how successful their long-term incentive plans are in achieving the objectives, senior management generally conveyed non-specific or unsatisfactory outcomes. Four responses were common:

- The company's long-term incentive plan is not cost-effective. The company's expense for the long-term incentive plan is more than the employee benefit received.
- We are not sure how much our long-term incentive plan contributes to the retention of employees and/or motivating desired performance.
- Our employees do not view our scheme as "long-term" – disposing of shares when they vest – rather than holding the shares and receiving dividend payments and enjoying future stock price appreciation.
- Our shareholders are not happy with their ownership being diluted by the newly issued shares that are used to fund the long-term incentive plan.

So where do the problems lie?

The subject of LTIs has always been complex. The design, or re-design, of an appropriate and effective long-term incentive plan for an organisation involves the careful consideration of many questions, including:

- What are the appropriate LTI vehicles?
- Are we using the right performance metrics in performance share plans?
- Are we including the right people in the plan?

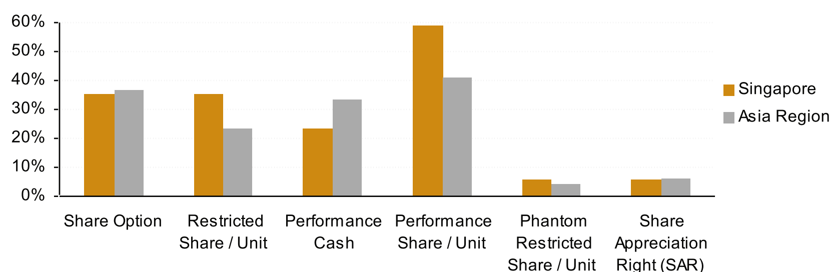
- Has the plan encouraged stock ownership? Should participants be able to simply exercise or cash-out an award without maintaining ownership?
- Have the benefits enjoyed by participants exceeded the expense incurred by the company?
- Do we have a "status quo" plan, i.e. compared to what other companies offer, does the LTI plan allow us to maintain a competitive position?

Comparing LTI Vehicles

Common forms of long-term incentive equity vehicles include stock options, performance shares and restricted share. Each vehicle has its strengths and weaknesses. The right vehicle to adopt depends on the organisation. For example, a high-growth organisation may prefer to use employee stock options plan – which gives employees the right to purchase a specific quantity of shares of the company's stock at a stated price within a set time period – to help attract and retain talent while keeping fixed costs low. A mature organisation may be better served by using performance shares to drive and reward employee performance, which can be measured against predicted performance targets. And an organization facing employee attrition may use restricted stock awards, which vest over a period of time, as a means of retention.

Since the turn of events in 2006, Asian economies, including Singapore, is moving away from stock options towards performance shares, which are generally awarded to senior managers and key employees only if certain company-wide performance criteria are met, such as total shareholder returns (TSR) and earnings per share (EPS) targets. Towers Watson research also points to increased use of restricted shares, which are granted with restrictions on the vesting period. The popularity of performance share and restricted share plans stems from the ability of such plans to motivate and reward performance, create ownership and limit dilution.

Figure 1. Long-term Incentive Plan Vehicle Prevalence*



** Data taken from Towers Watson's 2011 Asia Incentive Plan Design Survey - Singapore*

Performance Measurement

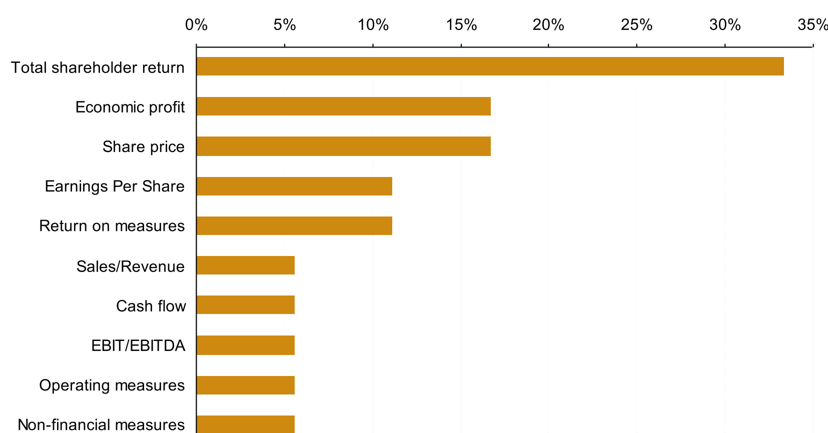
Responding to shareholder concerns about pay-for-performance, companies have continued to explore additional performance metrics. One of the most challenging tasks of a remuneration committee today is determining the performance metrics for a plan. Selected measures must be both meaningful and achievable. Performance measures that are unrealistic or not within the control of participants do little to influence desired behaviours. For example, while EPS is a common metric, some argue that it is an unstable measure. Earnings per share may rise or fall, due to uncontrollable external business factors like changes in the worldwide prices for raw materials.

An interesting insight from Towers Watson research is that in terms of compensation mix, high-performing companies place greater emphasis on long-term incentives than what is typical in the market. They also rely on at least two performance metrics in their LTI plans.

Based on Towers Watson's 2011 Asia Incentive Plan Design Survey, total shareholder return (TSR) is the most popular metric in all markets in Asia except Mainland China and South Korea where net profit and sales/revenue are most popular respectively. In the US, the prevalence of TSR as a metric in long-term performance share/cash plans has surged by about 30% in the past two years and the metric was used by more than one-third (35%) of companies in 2011. TSR is a measure of share price performance and dividends paid over a period of time to show the total return to the shareholders.

The selection of performance metrics is ultimately a matter which warrants serious consideration by the Board as metrics appropriate to one company

Figure 2. Prevalence of Performance Metrics in Long-term Incentive Plans in Singapore*



** Data taken from Towers Watson's 2011 Asia Incentive Plan Design Survey - Singapore*

In the last two decades, companies have tried to use long-term incentives (LTIs) primarily to achieve two objectives: to focus the work behaviour of the covered employees on the desired performance, and to assist in the retention of executives and other key employees. Historically, the long-term incentive vehicle of choice in South East Asia, including Singapore, has been stock options as there was no associated accounting expense for stock options prior to the introduction of FRS 2, accounting for share-based payments, in 2006.

may not be suited for another. Factors influencing choice of metrics include but are not limited to industry differences, company development stage and ownership structure.

Eligibility

The choice of participants in the long-term incentive plan is an important decision which must be carefully modelled based on the amount of equity available. Some companies, in trying to be inclusive, make the mistake of including too many people. This results in a limited number of shares being spread over a large number of people and the value of each award becomes too small to motivate or drive the right behaviours. Actually, this is an inefficient use of the company's reward dollars.

This problem is somewhat mitigated by the introduction of an accounting expense for all equity awards. As a result, more companies have focused their long-term incentive plans on a selected group of senior executives and key employees who can directly influence company performance. This is the case for Singapore where most companies would only limit the participation to Senior Management and selectively to high potential/performing employees.

Reasonable Performance Period

How long should the performance period be? The general practice and most commonly seen arrangement in Singapore when designing long-term incentive plans is to set the performance period at three years. But some CEOs argue that it is difficult to set achievable goals for a multi-year period because their businesses change too frequently. Then should the performance period be flexible, depending on industry and business strategy? For example, a shorter time period of two years may be appropriate for a start-up or a company in the high-growth stage, or an organisation undergoing radical changes such as merger and acquisition.

For other companies, setting a performance period of three to as long as five years may be necessary to ensure participants don't take a short-sighted view and will be driven to work for the long-term financial success of the organisation.

Figure 3. Long-term Incentive Plan Eligibility and Participation in Singapore*

	Eligibility, % of Companies	Participating, % of Companies
Group CEO/ Chairman	96%	67%
Direct reports to CEO	89%	63%
3rd tier executives (and equivalent)	74%	52%
Management	44%	30%
Non-management	19%	11%
Clerical/ Support staff	15%	7%

** Data taken from Towers Watson's 2011 Asia Incentive Plan Design Survey - Singapore*

The Question Of Leavers

It is a fact that in spite of the best intentions of the company, employees do leave. How will their long-term incentives be affected when they leave? Typically, companies give "good" leavers a pro-rata benefit while "bad" leavers forfeit their future entitlements. Companies have to consider if such an approach is consistent with the objective of key employees retention.

Performance reward is a sensitive issue. Experience shows that shareholders do not mind rewarding performance but are concerned and even outraged when they perceive that poor or inconsistent performance is rewarded.

Performance share plans are becoming a key component of senior executive compensation today. In designing performance share programmes and other long-term incentives, companies need to be careful that their long-term incentive plan supports a sharp focus on performance and aligns executive behaviour with shareholder interests.

The right long-term incentive plan for an organisation is one that drives high performance and contributes to overall business goals including sustainable long-term growth. Achieving this requires thoughtful consideration and precision in the design process. ■