



**Session 9.5 - Valuing Equity Awards
Providing Incentives while introducing a
Salary Reduction Plan**

Alan Judes

Managing Director, Strategic Remuneration, alan.judes@strategicremuneration.com

Mary K. Samsa

Partner, Seyfarth Shaw LLP, MSamsa@seyfarth.com

Agenda

This session deals with two current hot topics:

- 1. Market values of shares have fallen dramatically. How can companies give their executives share awards that are fairly valued? What is the best way to value equity for these purposes? This part of the session gives suggested answers and methodologies.
- 2. Companies, amongst other actions, are cutting salaries to preserve jobs. Is there a way to offer shares as an incentive that can replace some of the salary forgone and yet have no cash cost for the employer? This part of the session illustrates equity opportunities for employers in tough times.


Valuing Equity Awards

- Share prices have fallen dramatically over a very short period of time
- This means that the volatility of share prices is very high
- High volatility drives very high option prices under the Black-Scholes option pricing model
- Shares look to be very cheap, options may look to be very expensive
- How do companies deal with this situation?

Purposes of valuations

- Context is long-term incentives planning
 - Does a 12 month blip matter in a ten year plan?
 - Do regular annual grants or awards solve the problem?
- IFRS2/FAS123R requirement for expensing of Share-Based Payments
- Perception of employees receiving the awards and grants
- Perception of shareholders and other stakeholders

Context is long-term incentive planning

- Two views of the present situation
 - Falls are a temporary blip and normal growth will resume in the not too distant future – (Alistair Darling type optimism)
 - The capitalist model is almost broken and present asset values will persist for many many years – the growth enjoyed over the last 30 years is the aberration not the mean to which we will revert
 - Discussion is about the shape of the curve
 - U shaped, W shaped, Y shaped, George Soros upside square root shaped 
- Your view might drive your valuation approach and perception

IFRS2/FAS123R

- Value of a share is the market value of the share. Appendix B Application Guidance Para B2
- Valuation of an option using an option pricing model
 - B6 All models must take into account
 - Current price of the share
 - The expected volatility (my underlining)
 - The dividends expected
- In recent valuations for clients for incentive design purposes I have treated the falls of late 2008 as not being representative of future expected volatility or dividend yield
 - Simply using historic data – volatility 94% dividend yield 17%
 - Ignoring price falls last year – volatility 30% dividend yield 4.4%

Perception of Employees

- Communication is key
 - Employees need to understand how they can act as a link in value creation in the company
 - Explain how the pay system supports the corporate strategy
- There is a danger that all equity awards become devalued and that share plans are abandoned
- Stress the link to sustainable earnings
- Show market values over a long period of time
- Explain the mechanism well
 - the vesting targets that support business strategy
 - the contractual life of up to 10 years

The perception of shareholders and other stakeholders

- Extract from ABI letter of 19 September 2008 to Chairmen of Remuneration Committees
 - Where a company has underperformed and seen a significant fall in its share price, this should be taken into account when determining the level of awards under share incentive schemes. In such circumstances, it is not appropriate for executives to receive awards of such a size that they are perceived as rewards for failure.
- Risk Metrics UK 2009 Guidelines contains
 - Dilution – where significant share price depreciation would lead to a vastly increased number of shares being awarded based on a percentage of basic salary, consideration should be given to lowering award levels to address the management of dilution.

Suggested answers and methodologies

- Try to remove abnormal volatilities
- Average prices for longer than usual when fixing awards of shares or setting option strike prices
- Some US consultants are suggesting adding \$10 to the price of a share for award purposes – rough justice?

Cutting salaries to preserve jobs

- This is nothing new
- The Share Economy 1984 Martin L Weitzman – chapter 9
Vaccinating Capitalism Against Stagflation
- Book enthusiastically read by Margaret Thatcher who introduced Profit-Related Pay in 1987
 - Concept quite simple: if fixed pay is low and the balance of variable pay is related to profit, then in difficult times pay is automatically reduced and you do not need to cut jobs to survive
 - By contrast if fixed pay is high then in difficult times if the firm does not sack workers it goes insolvent
 - Significant tax free pay was given in the UK to encourage the introduction of PRP into the UK economy
- It did not work in macro-economic terms, recessions after its introduction saw significant job losses

This recession is different

- There has been a remarkable level of innovation in an attempt to preserve jobs
 - KPMG - 4 day week
 - Honda – factory closure for 4 months but staff retained
 - Toyota – pay reductions and short time working
 - Law firms – postponement of starting date for new trainees with £10,000 “gap year” payment
 - Generally – sabbaticals, job-sharing, shift closures, and actual reductions in fixed salary

Cutting pay is not easy

- Message needs to be given in a prepared manner and with the utmost caution
 - If reduction is globally, then message needs to be uniform to the extent possible in each country
- Communicate business imperatives, give precise answers to head off employee concerns
 - Q&A documents can be highly effective
- Focus on
 - Reason for pay reduction – not granular but not 30,000 foot level either so that the typical non-financial person cannot understand
 - How it will be processed
 - When it becomes effective
 - Whether it is a one-time adjustment

Introducing share incentives after a salary reduction

- If you have just reduced your payroll then why not introduce a share incentive plan to replace some of the salary forgone?
- The concept is similar to Profit-Related Pay, but delivered in the form of shares
- Cash flow management is vital for many businesses
- Awards of newly issued shares have no cash flow cost to the company
 - There is a “notional” accounting charge under IFRS2
 - There is dilution of exiting shareholders

Introducing a share incentive plan

- Where employees have a lower level of base pay then annual incentive opportunity should be greater
- Annual incentive should be focused on key metrics and milestone achievements necessary for the business to survive and prosper
- Annual incentive can be delivered in the form of newly issued shares
- Zero cash flow cost, but with accounting charge and dilution of shareholders

The share replacements can be tax approved/qualifying

- UK SIP allows up to £3,000 to be given to each employee
- Performance conditions can be set in advance for the delivery of the shares
- Income tax and NIC can be deferred and eliminated if holding periods are complied with
- US Section 401(a) Stock Bonus Plan permits similar awards of shares to be made
- US income tax can be deferred while the shares are held inside the plan
- If plan is not approved or qualifying, outright share grants will be taxable when awarded to employees – therefore, if in combination with a salary reduction, need net share delivery to cover the tax implications

Simultaneous Implementation Issue

- Should salary Reduction be simultaneous with share scheme introduction
 - Possibility to be viewed as a step transaction for tax purposes or substitution/replacement for cash with immediate tax consequences (depending on the country)
 - Need to analyze by country the significance of timing and introduction of any new arrangement – avoid adverse impacts to employees
- If simultaneous is decided upon, you want the final agreement or offer to employees in writing

Other Considerations

- Type of equity award to use
 - Stock Options – Employee retains control on time of exercise (permit potentially longer period of time to recover)
 - Restricted Stock – Immediately taxable (now with less cash to pay the tax unless use net share delivery)
 - Restricted Stock Units – tax deferred until actual shares delivered
- Value per share in this economy could reduce further after issue (are you in the rebound phase yet)
 - Stock Options – possibility
 - Restricted Stock/ RSUs – inherently always has value for the employee (may not be viewed as favorably by shareholders since not as much downside risk)
- Impact on retention – added bonus?

Other Considerations

- Eligibility for Share Scheme
 - Management or broad based – depends on what is trying to be accomplished
- Time-Based Vesting
 - Realistically, it is an incentive due to salary reduction issue. As such, is a more accelerated vesting schedule a greater incentive in this situation?
- Performance-Based Vesting– definitely more palatable to the shareholders in this instance (which ones and how to measure?)
 - Consider using value-added metrics (proof of adding to the bottom line)
 - Focus on profitability margins (focus on percentage increases)
 - Cash flow measure (given direct impact on profits)
 - Utilize non-financial metrics for non-management

Other Considerations

- Legal issues for implementing share scheme (the usual suspects)
 - Securities law application
 - Labour law application (works councils)
 - Exchange controls
 - Tax laws
- Does the introduction affect any other aspect of the business adversely – make sure you have all the right players at the table for the discussion
 - HR
 - Legal
 - Treasury/Finance
 - Tax

Other Considerations

- Understand the full impact of salary reduction to employees
 - Reduction in take home pay
 - Reduction in pensionable earnings
 - Reduction in severance pay – if necessary
- Understand the positives of the share scheme to employees
 - It is a way to recover more than you lost
 - Ownership mentality
 - Individual efforts can significantly contribute to the whole
- Help employees to focus on the positives

Question and Answer session

Questions?