KORN FERRY | HayGroup

UK Executive Pay & Governance

Long-term Incentive Design

Long-term incentives now make up a significant portion of a senior executive's overall remuneration package – over one-third of the package of CEOs of the largest UK listed companies. These arrangements – which almost invariably use shares as their currency - also are the subject of high levels of focus from institutional shareholders, who have the opportunity to formally vote on their establishment at a General Meeting.

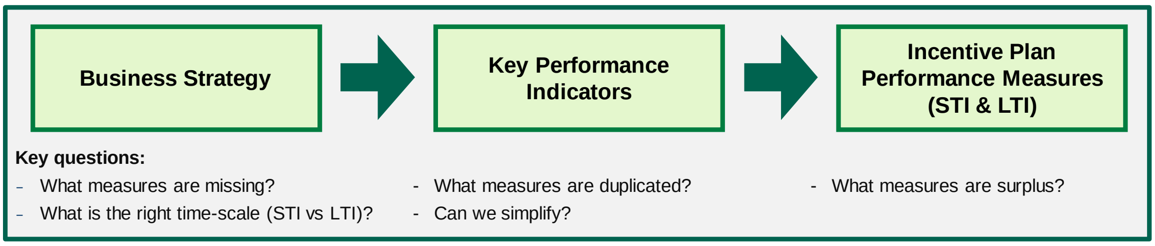
Therefore, it is vital that a company operates long-term plans that provide a genuine incentive to management to deliver against strategic objectives while also being acceptable to investors.

At Korn Ferry Hay, we have a specialist team of highly experienced, partner-level consultants that can guide a company through the establishment and ongoing annual operation of long-term incentive plans ("LTIPs"). We support our clients in addressing all the key issues that are raised during this process:

- **Who should participate?** – should participation in the plan be limited to the very most senior executives (perhaps only the main Board directors?), or should awards be cascaded further down in the organisation, with the associated cost and dilution implications that brings?
- **Award quantum –** what size of awards should be made to participants? Our pay databases allow us to advise clients on typical market rates of award for different levels of participants
- **What type of plan should be operated?** – most UK listed companies operate a "Performance Share Plan" under which awards are made over shares each year that vest 3-5 years later subject to the satisfaction of performance conditions. However, some companies operate private equity style "Value Creation Plans" under which a single one-off award is made of a higher value. Also, there is a continuing debate regarding whether "Restricted Share Plans" (under which share awards are made that vest subject to continued employment only) are a better way of aligning management's and shareholders' interests
- **What performance conditions should be applied?** – this is perhaps <u>the</u> most important design feature of LTIPs. Traditionally, Earnings Per Share and Total Shareholder Return measures were most commonly used. However, we are seeing a trend towards the use of a broader range of metrics, including some "operational/strategic" metrics that have previously only been used in bonus plans (e.g. customer satisfaction, employee engagement, market share etc).

  Having agreed upon performance <u>metrics</u>, the <u>weighting</u> of those metrics and a suitable target <u>range</u> needs to be agreed. The target range often "straddles" internal and external forecasts, with outperformance of these expectations typically required for full vesting. Our objective is to ensure our clients' LTIPs are genuinely aligned to company strategy

Figure 1: Alignment of incentives with business strategy



We are also able to provide sectoral practice from listed companies in order to understand how other companies in the same sector have selected performance measures, weightings and targets

Figure 2: LTI performance metrics in largest listed real estate companies:

Company	Market Cap. (12m average)	Earnings Per Share	Total Shareholder Return (compared to)	Total Accounting Return (compared to)	Total Property Return (compared to)
Land Securities Group	£8,250m		50% (Sector)		50% (IPD)
British Land Company	£6,400m		20% (Sector / FTSE 100)	40% (Sector)	40% (IPD)
Hammerson	£4,550m	33%	33% (Sector)		33% (IPD)
SEGRO	£4,175m		50% (Sector)		50% (IPD)
Intu Properties	£3,775m		50% (Sector)	50% (Absolute)	

- **What is the accounting cost and dilution impact of the plan?** – the value of share awards must be charged to the income statement. Also, share plans that involve the issue of new shares must comply with certain guidelines that limit the amount of equity that can be issued to satisfy awards. We can model cost and share usage to ensure they both remain within acceptable parameters
- **Should awards be capable of clawback?** – most LTIP rules now allow for awards/shares to be forfeited/reclaimed in certain unusual "negative" circumstances (e.g. misstatement of accounts, misconduct etc). We ensure the relevant provisions in plan rules are robust while also again providing flexibility
- **Use of shares or cash?** – the accounting treatment can differ significantly depending on the "currency" of the LTIP. More importantly, perhaps, is that many unlisted companies will not want to use shares and rely instead on cash. However, when using cash, they may want to reflect the benefits/disadvantages of market fluctuations in the value of the company. We have many years' experience in designing and helping clients operate such plans
- **How should we consult with our shareholders?** – as noted above, formal shareholder approval is required to establish a new LTIP. Therefore, it is vital that a company engages with its investors regarding the design of the plan well in advance of any formal AGM documentation being produced. This is particularly the case if the company is considering an atypical structure such as a Value Creation Plan or Restricted Share Plan. Our partners have many years of experience in guiding clients through shareholder consultation exercises.

In the current febrile investor environment, continuing to operate a traditional Performance Share Plan may seem the path of least resistance to companies. And for many listed companies, a PSP with standard metrics may well actually be the right solution. However, we encourage our clients to challenge this accepted model, as there may be an alternative approach that provides a more direct link between pay and long-term strategy.

Want to know more?

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