Executive Compensation

2016

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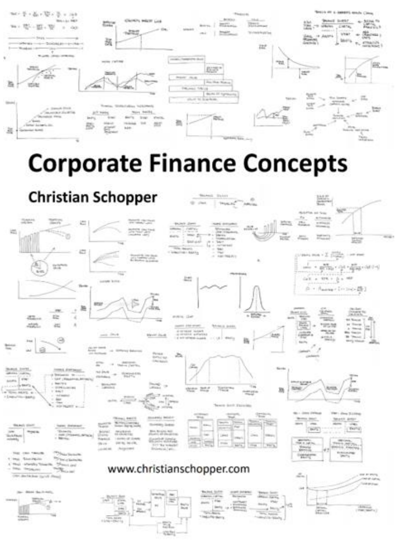


CorpFinCE
Corporate Finance Central Europe

www.christianschopper.com

Introduction

The way in which executive directors are paid can influence how they run the business

- Remuneration committees have to devise schemes that will **align directors´ interests with those of shareholders**

- Many companies adopt a **short-term bonus scheme** for their executives, …
- … together with a **longer term scheme** which may be based on share options

- The **performance conditions** attached to these schemes **generally relate to accounting measures** …
- … **however**, these can bear little **relation** to the creation of **shareholder value** …
- … and shareholder return is not necessarily related to **management performance**

- Furthermore, even when the performance measures have been selected, the company needs to **set relevant targets**

- Finally, the scheme parameters must set a **currency** for the payment of the award: in cash, or in shares or options

The Agency Debate

In agency theory terms, shareholders are principals and employ executives, their agents, to run the company on a day-to-day basis

- **Executives** may be motivated to act other than in the shareholders' best interests, for any of the following reasons:
  1. Might see advantage in incurring expenses not strictly value-adding ("**perks**")
  2. Do not have shareholders' advantage of diversification, and **not wish to take risks** with the company that shareholders would be prepared to accept (ie losing job)
  3. Might not wish to expend the effort to extract the full potential value from a project or investment, opting instead to **'satisfice' for an easier life**
  4. Time horizons, reflecting **individual expectations, may be shorter** than those for long-term shareholders, implying an unwillingness to take on long-term projects

- In **summary**, agency theory views executives as **potentially risk-averse and effort-averse**, and sees the need for shareholders somehow to control their actions

Structuring Directors´ Remuneration Contracts

Underlying objectives

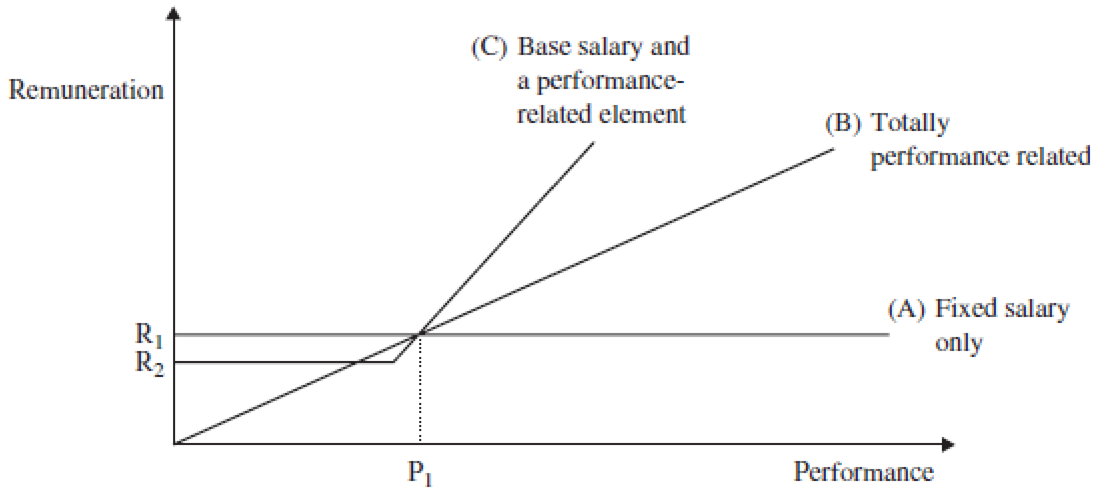
1. Attract good executives to the company
2. Retain them in the company
3. Align directors ' interests with those of the shareholders, in order to promote the company's performance

Key Issues

1. How much should be paid for" expected" performance?
2. Of that, how much should be fixed, and how much performance related?
3. For the performance-related elements, what performance measures should be used?
4. What targets should be set for these measures?
5. How can we use the scheme to ensure that good executives are retained?

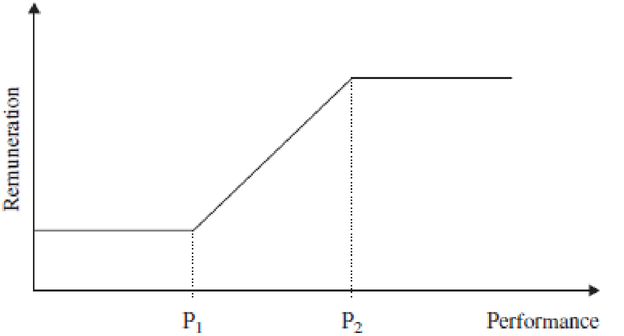
Gearing of Pay

- **Because different strategies and styles are needed at different stages of the lifecycle, it would seem appropriate for different remuneration structures to be applied**



Annual Bonuses

- Common for executives annual bonuses **based o**n:
  - annual profitability;
  - non-financial targets (eg sales growth); or
  - measures related specifically to their individual or team goals for the year
- Bonuses are often **capped**
  - Shareholders unwilling to see large windfall bonuses based on fortuitous market circumstances …
  - … or insensitive in the public eye
- **Motivational impact** of bonus caps:
  - Executives of knowing that their superb performance is (in financial terms) unrecognized …
  - … and research indicates that the cap and floor on bonus levels can lead to manipulation of accounting figures



Long Term Incentives

- Many jurisdictions include longer term incentives taking the form of either **long-term incentive plans** ('ltips') or **executive share** (stock) **option plans**, or both

  - Generally run for three or more years.
  - Incentivize performance over the period, with the executive receiving the reward at the end of the period.
  - Often there is no award if the executive leaves the company during the award period.
  - Remuneration is often paid out in shares in the company.
  - There may be a secondary period during which the executive is required to retain the shares.
  - If there is a secondary period, often the company will award the executive additional shares at the end of that period.

Features of Performance Measures

	Advantages	Disadvantages
Accounting measures Example: profit, return on investment, eps growth	• Simple to use. • Easily understandable by all parties. • Based on audited figures.	• Take no account of the cost of capital, and so do not necessarily reflect shareholder value. • Take no account of risk, and so do not necessarily reflect shareholder value. • Easily manipulable by changes in accounting policies. • May be difficult to compare across companies due to different accounting policies. • May encourage short termism to inflate profits.
Market measures Example: TSR, share price	• Reflect value received by shareholders.	• Share prices reflect market expectations rather than management performance. • Market imperfections may lead to over/under-valuation of the shares. • Schemes may be complex and misunderstood by participants.

Setting Performance Targets

No single performance measure is suitable for all circumstances; each has its flaws

- However, a **remuneration committee** has to determine measure(s) it will use, and set targets
- Performance targets might be based on **internal company figures**, or on **external benchmarks**, or on a **mixture** of both

- **Challenges**
  - ‘**Sandbagging’ of budgets** (to ensure that targets are low enough to achieve easily), …
  - … or mental attitude that what is important is to beat the budget, rather than to beat the competition …
  - Calculation of Total Shareholder Return schemes …
  - … or measuring an “**out-performance**” of a stock (basis?) …
  - … or index outperformance despite **losses** …

Setting Performance Targets (cont´d)

Total Shareholder Return represents the dividend and capital gain on the share, as a percentage of the share price at the start of the period

- On 1 January the company’s share price is 100p …
- … on 31 December it is 110p
- On 1 July the company paid a dividend of 5p

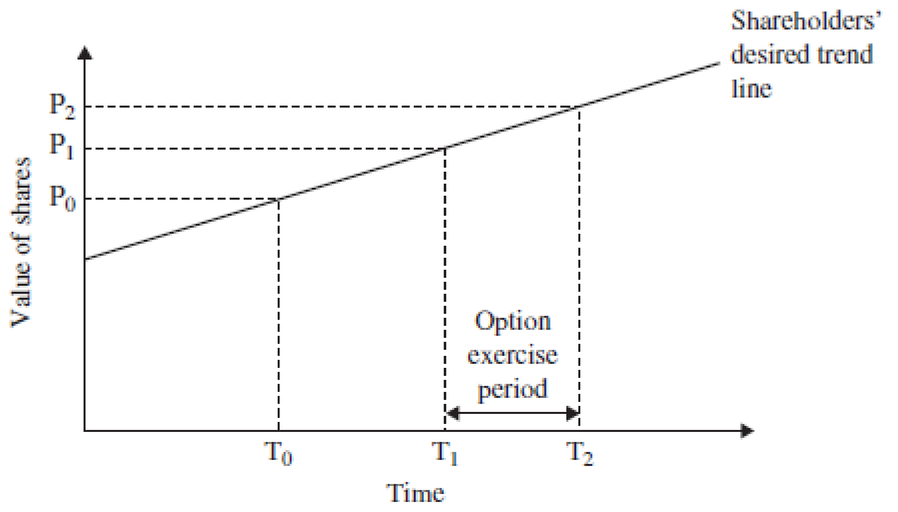
Increase in share price over the period	10p
Dividend paid in the period	5p
Total return to the shareholders	15p
TSR	15%

- **In practice**, the TSR performance period would be considerably **more than one year**
  - The calculation could be made more sophisticated by assuming that the **dividend** received in the middle of the year was **reinvested** in the company’s shares at the then-current price
  - The calculation may also be adjusted by **smoothing share prices** to eliminate market distortion, for example by taking a six month average share price rather than that on a single date

Features of Payment Methods

	Advantages	Disadvantages
Cash	• Universally acceptable to executives. • No uncertainty as to the value.	• Depletes company's cash resources. • Provides no alignment or incentive to stay with the company.
Shares	• If the executives retain the shares, provides some alignment of interests. • May encourage executive retention if structured properly. • Does not deplete the company's cash resources.	• Dilutes existing shareholders. • Shares are often not retained for the longer term. • Directors benefit even if the share price falls. • If the director's shareholding forms a very high proportion of his/her personal wealth, this may overly discourage risk taking.
Share options	• Provides a means to give equity to executives. • Does not deplete the company's cash resources. (In fact, cash is received from the executive when the option is exercised.) • Directors only benefit if the share price rises.	• Dilutes existing shareholders. • Shares are often not retained for the longer term. • May be difficult to value. • If the options are out of the money ('underwater') they may not have an incentive effect. • Alignment of directors' and shareholders' interests is not assured – see section on *options*.

Executive Share Option Schemes



Executive Share Option Schemes (cont´d)

Executive Share Options and Dividend Policy

- For mature companies attractive investment opportunities may be rare and therefore **higher dividend payout may add value** …
- ... **but**, there may be **no incentive** for directors to propose increased dividends **during** the life of any significant **share option scheme**

- If the excess funds are retained within the company, the price of the shares should increase to reflect the cash held by the company, even though shareholder value may be being destroyed by such a dividend policy …

Executive Share Options and Holding Costs

- Instead of paying in / investing, **managers are commonly "given" share options** …
- … hence, **only the shareholder has an opportunity cost of holding the shares**
  - An increased value of the shares over the option period does not automatically create value for the investor, whereas it would translate into a real capital gain for the manager
  - Shareholders incur a holding cost due to liquidity preference, inflation, and risk

Executive Share Option Schemes (cont´d)

- **Stock options represent a one-sided bet for the directors**
  - If the share price appreciates, they make potentially large capital gains; …
  - … but if the share price declines, they do not lose, they simply do not make a capital gain

A company has a share price of P0 and a cost of capital Ke, and is due to pay a dividend of D1

- The shareholders ' cost of capital will be met by dividend and capital gain:

$$K_e = \text{dividend yield} + \text{expected growth in share price}$$
$$= D_1/P_0 + g$$

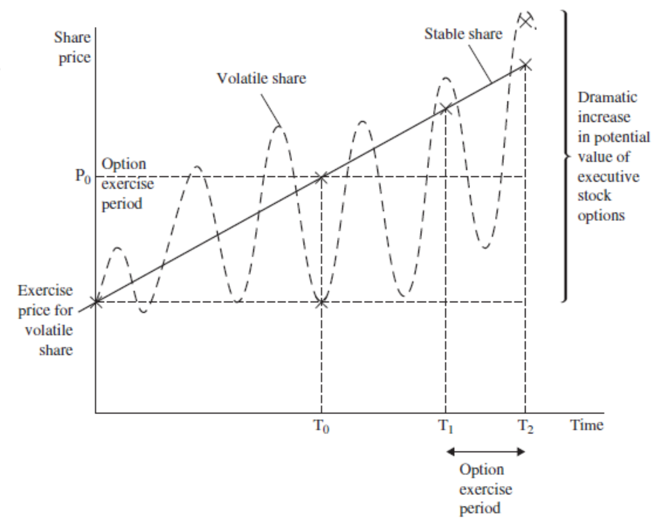
- Therefore expected growth in the share price is $K_e - D_1/P_0.$

- It would be **possible to construct an executive share option for which the exercise price rose at the rate of g per year**, …
- … thus only **rewarding the director if the share price rose above that implicit in the current value**
  - In practice, the factor of g might be reduced slightly, to compensate the executive for the risks being taken

Price Performance Criteria Used in Share Option Schemes

- Many executive share option schemes attach a **condition** to the exercise of the options
  - Merely increasing the share price is insufficient

- Regular surveys of share option schemes show that **growth in eps** is the major performance measure used to determine whether options are to be granted
  - Unfortunately, growth in eps **does not automatically translate into shareholder value**
  - In fact, it does not even necessarily translate into growth in the company's share price



Required Growth in EPS

- In December 2007, inflation in the UK was running at just over 4%
- Data from the *Financial Times* for the FTSE 350 indicated an average P/E ratio of about 12.5; dividend yield of about 3%; and dividend cover of about 2.7 times (implying a dividend payout ratio of about 40%)
- The yield on UK government bonds was about 4.7%, the market risk premium is assumed at 5% and an average beta of 1

$$\begin{aligned} K_e &= R_f + \beta(R_m - R_f) \\ &= 4.7\% + 5\% \\ &= 9.7\% \end{aligned}$$

- This cost of equity can in turn be used to evaluate the anticipated earnings growth

$$\begin{aligned} &P/E \text{ ratio} = \text{payout ratio} \times 1/(K_e - g) \\ &12.5 = 40\% \times 1/(9.7\% - g) \end{aligned}$$

- Solving this gives an estimated growth expectation of 6.5%

- What this means is that the share price of the average FTSE 350 company implicitly includes an expectation of growth of 6.5%
  - Even if we ignore any potential reduction in the P/E ratio, this represents eps growth of 6.5% as a minimum, that is, 2.5% above inflation
  - Shareholder value will only be created if companies generate more than this …

Earnings Per Share Growth Bonus Schemes

Normal scheme is driven by

$$\frac{eps_1}{eps_0} = \frac{\dfrac{\text{PAT in year 1}}{\text{No of issued shares in year 1}}}{\dfrac{\text{PAT in year 0}}{\text{No of issued shares in year 0}}}$$

$$= \frac{PAT_1}{PAT_0} \times \frac{\text{No of shares in year 0}}{\text{No of shares in year } \mathbf{1}}$$

where eps_1 = earnings per share this year and eps_0 = earnings per share last year

Contact

Christian Schopper
Private: christian.schopper@aon.at
Business: christian.schopper@corpfince.com

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