Should LTIPs be abolished?

MM&K Remuneration Committee Dinner

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The subject of the dinner was to ask: "Should LTIPs really be phased out as soon as possible?" and was introduced by Cliff Weight, who said:

- There is a prevalent belief, promoted by the July 2016 report of the Investment Association, that restricted shares with no performance conditions might be preferable to LTIPs as an executive long-term incentive vehicle. This idea was taken further by the April 2017 report of the BEIS Commons Select Committee, which advocated the immediate abolition of LTIPs in favour of restricted shares.
- Are we at a turning point? Most people who are personally involved seem happy with the status quo, but is the pressure to change sufficient for change to happen? 3-year LTIPs have seemingly failed to deliver, but I believe that the suggested move to restricted stock schemes is the not the solution, especially for growth companies. Investors want directors to be incentivised and aligned with them.
- Is forsaking long-term performance measures desirable and really in the interest of shareholders? For a steady-as-you-go company with expected short CEO tenure, a reward emphasis on salary and bonus with modest equity incentives may be appropriate. Companies with strong growth prospects will have risks, and large equity incentives create better alignment. What is wrong, for example, with 10 year share options which give a genuinely long-term interest in company performance (and, surprisingly, got no mention in the recommended alternatives in the Working Group report). In the US, CEOs, on average, have nearly three times the amount of equity incentive than their UK counterparts and their stock market has performed much better than the UK's over the past several decades.

A lively discussion ensued. A participant asked for clarification about the definition of LTIPs in this context. It was explained that when performance shares became prevalent in the mid-90s, they were popularly labelled LTIPs, to distinguish them from share options. The label has stuck, although "LTIP" is often chosen as the scheme name for an individual company's own long-term plan, whether it be a performance share plan, some other kind of equity-based plan (including share option plans) or a long-term cash plan.

In the context of the recommendations of the Working Group and the Select Committee, it is particularly performance share plans that are eschewed.

One participant expressed the view that shares received under any company share plan should be retained until two years after retirement to deal with any performance legacy problems. Cliff told the dinner that the average tenure of a CEO amongst large listed companies is 5 years and in a quarter of companies it is over 8 years (in general the more successful ones!). So this would often mean a long deferment period, which is a good idea from a shareholder perspective.

There was then a discussion about the ideal life of long-term incentive plans. Some people said that a 10-year period (as with most share options) is too long. On the other hand, 3 years is too short for the strategic impact of management action to show. But 3 years has the advantage that in most companies it is possible to set meaningful performance targets three years ahead (though not in a start-up situation). It was agreed that it is important to be very thoughtful about the performance period chosen and any subsequent retention period.

The case of Aberdeen Asset Management was mentioned (becoming Standard Life Aberdeen plc). They have no variable pay based on long-term measures. Annual variable awards are made (on annual KIPIs) capped at 2½ times annual fixed pay (or less depending on the individual). 75% is paid in shares, deferred for five years, so creating long term alignment with shareholders.

One diner suggested that the problem with long-term incentives is not the structure of the plan but the magnitude of reward provided. He said that often this magnitude has not been reflective of the impact that executives have on value creation. A number of banks have not made any money for the shareholder but have continued paying some people a lot of money. Another, agreeing, said that he is a big fan of publishing the ratio of CEO to average employee pay so the magnitude can be tracked. It was 34 times across industry in1984 but now it is 140 times. He said that the Parliamentary Select Committee, placing blanket blame on LTIPs generally, misses the point.

The subject changed to the purpose of variable plans. Would executives necessarily jump higher for more money? A participant made the distinction between incentives (which are likely to be annual bonuses) and reward (which is more the nature of long-term plans).

There was then some disagreement as to whether LTIPs really are too complex. One said they are too complicated, with relative TSR and eps; another said these measures are, in reality, fairly simple, whereas EBITDA can be complex to track.

A participant said we have been so worried about shareholder alignment we have ignored all the other stakeholders. LTIPs are really just focused on the shareholders. We should be concerned with, for example, the company brand. But people say management can fudge such measures.

Share based awards have an important role in creating identification with the company and thus increasing motivation. Recipients feel they are part of the action. This thought was

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echoed by another diner, who said he remembers how feeling good about having stock options was really important to him and motivational at the time.

Another suggested that an important tool in managing performance is being prepared to sack them.

There was then a discussion as to what actions lead to long-term performance. One said the long-term was the sum of short-term actions generating cash. Some others disagreed, saying growth may require things to be done in different ways from now.

People businesses all have a similar model, but non-people business can all be very different. For example, you cannot measure an insurance business on one year's results.

Midcap and small cap businesses need to resist being pushed into following regulations designed for the FTSE 100. The hiatus due to the General Election gives firms an opportunity to build more resistance to this trend.

A participant said the key to a successful long-term incentive plan is getting the management team together and building a vision for the future.

It is not always necessary that participants understand the plan. One diner described a complex long-term incentive plan in an oil industry company he worked for. None of the plan participants fully understood it, in the sense that you could not say "if I do this I will receive this". But the team had trust in top management which overcame these uncertainties. In the event he personally made more from this plan than any other, with the share price going from £1.50 to £8.50.

There was then a discussion about the restrictions on selling shares if you are a director. You may need to sell some shares to fund the exercise price or income tax; this is explainable to shareholders. But beyond this, effectively, directors have to keep their shares and in any case are always constrained by insider information.

Finally, the dinner group was asked if the total value of long-term incentives in a year should be more or less than the value of short-term bonuses. There was no consensus on this.

In conclusion the best approach requires careful, thoughtful analysis based on a detailed understanding of the company, its strategy and plans. Each company will be different and a standardised approach is unlikely to be optimum.

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