ADDISON INC.
TRANSACTION ADVISORY

MEMORANDUM

Designing equity-based incentives

GUY ADDISON: MANAGING PARTNER

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Disclaimer

1. Introduction

Incentive strategies are programs designed to incentivise management and staff of a company to grow the value of the company by linking their individual benefits to the growth of the organisation they represent. Incentives offer participants the ability to gain additional financial or other benefits above a set remuneration based on the achievement of certain targets. But incentives can also create enormous complexity and stress leading to undesired results for participants and companies alike. This memorandum seeks to explain the broad environment surrounding incentives as a means for informing and aiding all involved in *designing incentives that work*.

This document introduces the various incentive strategies available to a company in South Africa and provides a summary of benefits, pitfalls, risks and general guidance. We have written this document for senior and executive management of companies who require information and insight on designing incentives. Business Owners, Chief Financial Officers, Boards of Directors and Remuneration Committees would also benefit from the information contained in this document. Please note that this not an exhaustive study, but a summary of some of the issues involved.

Our series of resources

Memo	*Title*	*Contents*
1	***Designing incentives in companies***	***An introduction to incentives***
2	*The Accelerated Buy-In (ABI)*	*A synopsis of the structure*
3	*Implementing equity-based structures*	*A guide for boards, HR Directors & CFO's*

2. Why should companies design incentives?

Companies reward staff with incentives in order to align their interests with that of the company shareholders to mitigate the impact of the principal-agent problem.

The principal–agent problem, in political science and economics occurs when one person or entity, is able to make decisions and/or take actions on behalf of, or that impact, another person or entity: the "principal".

A conflict of interest is inherent in any relationship where one party is expected to act in another's best interests. In corporate finance, the agency problem usually refers to a conflict of interest between a company's management and the company's stockholders.

Problem

Agency…

Shareholders and managers of business have conflicting priorities. A shareholder looks to grow share value, whilst a manager may have different objectives.

Solution

Alignment…

A program designed to incentivise management/staff of a company to grow the share price of the company by linking their individual remuneration (wealth) to growth in the company's share value.

3. Goals of well-designed incentives

Incentives are considered the most important means of motivating and retaining management within a company. This often formed a significant portion of the 'total package' offered to retain and motivate company executives. But, recent changes in tax legislation have complicated (and reduced) many of the intrinsic benefits of such strategies, however, there remain sound reasons for using incentive strategies.

There are various types of incentive schemes such as employee share option plans (ESOPs), share purchase schemes, phantom schemes, trusts and share bonus plans. Each incentive strategy is characterized by a specific mechanism for rewarding employees and calculating the gain (or loss) accrued to the employee.

A WELL-DESIGNED INCENTIVE THAT WORKS WILL SATISFY THE FOLLOWING CRITERIA

Fair & Objective

- The rules are understood
- Set benchmarks and targets are acceptable
- The outcomes are manipulation proof

A Win : Win : Win Solution

- Stakeholders support the structure
- In the best interests of the company, shareholders and participants

Efficient and effective

- Tax impacts are appropriate
- Cash Flow
- Cost to company

Long-term in nature

- Timing differences are accomodated
- Retain talent with the organisation
- The incentive drives the right behavior

Meets the administration and compliance requirements

- Easy to understand
- Easy to manage
- Not easy to manipulate
- Lawful and appropriate

Pitfalls of many current share incentive schemes are as follows

- Employees often don't have resources to purchase shares in the company they work for.
- Using 'after-tax' remuneration is inefficient from a tax perspective for the company and employee.
- Issuing shares at a discount to fair value is dilutive for existing shareholders, taxable as a fringe benefit.
- Delaying the purchase of shares results in the employee "losing out" on the growth of the share value.
- Certain schemes promote the 'wrong' incentive which can harm the company and existing shareholders.

4. Types of equity-based reward strategies

There are various types of incentive schemes, with each strategy characterized by a specific mechanism for rewarding employees and calculating the gain (or loss) accrued to the employee.

INCENTIVE STRATEGIES CAN BE CATEGORISED AS FOLLOWS:

	TYPE	CHARACTERISTIC
1.	**Bonus**	Bonus pay is compensation over and above the amount of pay specified as a base salary or hourly rate of pay. The base amount of compensation is specified in the employee offer letter, in the employee personnel file, or in a contract. Bonuses can be contracted, based on company and individual performance, linked to sales, pay grade or discretionary. A bonus may be declared allowing an employee to purchase shares in the company.
2.	**Profit share**	These provide direct or indirect payments to employees that depend on company's profitability. The profit-sharing plans are based on predetermined economic sharing rules that define the split of gains between the company as a principal and the employee as an agent.
3.	**Forfeitable Share**	Full-value shares awarded to participants that will be forfeited if performance and/or service conditions not met.
4.	**Restricted Share**	Full-value share awarded to participants that have selling restrictions that are lifted if performance and/or service conditions met. These are commonly referred to as Performance or Bonus shares.
5.	**Share Appreciation Right**	Right to be awarded shares to the value of the growth/appreciation in the share value between award date and vesting date. Rights vest subject to performance and/or service conditions being fulfilled.
6.	**Share Option**	Right to buy a share at a predetermined price at a future date i.e. benefit from the growth/appreciation in the value of the share between the award and the vesting date. Options vest subject to performance and/or service conditions being fulfilled.
7.	**Phantom schemes**	Notional share 'created' where either the full value or the growth in the share value is awarded as a bonus, subject to performance and/or service conditions being fulfilled
8.	**Trusts**	Trust purchases the shares and 'warehouses' them until such time as the employee earns the right to purchase such shares. Often used in BEE transactions.
9.	**Derivative / hedging structures**	Derivatives underwritten by the company protect participants from adverse share price movements whilst exposing the participant to gains in the share price.
10.	**Unrestricted share structures**	Participants buy unrestricted shares that grow in value as the business performance grows.

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5. Benefits of incentive strategies

Successful incentive strategies provide numerous benefits to companies and individuals and have been part of effective organisational strategy for many decades.

The numerous benefits of introducing incentive strategies, include:

Creates shareholder value

Motivates management to grow the value of the enterprise by linking personal wealth with growth in the value of the Company's equity.

Improves business performance

Both the company and employees concerned benefit when the company performance improves. Companies that have share incentive strategies in place generally outperform those that do not.

Alignment of shareholder and employee interests

Management and shareholders see the business in the same light as they both own a stake in the company. Hence, their interests are aligned as well as their objectives to grow value over the long run. The challenge of management's incentives not being aligned to shareholders is called the 'Agency Problem'.

A mechanism for retaining and rewarding loyal and performing employees

Successful companies understand that rewarding loyalty of long-serving employees is in their own best interest. This reduces staff turnover costs as well as enhancing commitment to the company.

Creates a broad-based shareholding in the company

Providing access to purchase shares in a company creates an opportunity for staff to accrue long-term wealth through share ownership.

Tax and cash flow efficient

Many share incentive strategies were both tax and cash flow efficient for both the employee and company. Careful consideration of these benefits should be reviewed if your existing share incentive scheme was implemented prior to 2016.

POSITIVE IMPACTS ON COMPANY, EXISTING SHAREHOLDERS AND PARTICIPANTS

	Company Benefits	Participant Benefits
Improves performance of the business	✔	
Grow the value of the business	✔	
Alignment of shareholders and employees' interests	✔	✔
Retains employees with the company	✔	
Rewards commitment to the company	✔	
Creates wealth		✔
Tax efficient	✔	✔

6. Complexities, risks and pitfalls

The rules and compliance required to implement many of the strategies available are complex, time consuming and risky for all parties concerned.

Hidden costs

Issuing shares at a discount to fair value is dilutive for existing shareholders and taxable as a fringe benefit. The income tax payable thereon is a monthly deduction for PAYE purposes, the cost of which may not be matched by any dividend payable on the shares. The employee would consider any resultant cash shortfall as a disincentive. In addition, this deemed interest cost to the employee is not an allowable expense for the company. Delaying the purchase of shares results in the employee "losing out" on share value growth. This often results in warped incentives and unrealised gains for both the company and the employee respectively. In addition, employees often don't have resources to purchase shares in the company they work for, resulting in the issuing of loans to staff. These loans are subject to interest at the official rate (currently 7.75%), which places the company and staff member at a disadvantage.

Implementation and ongoing management is complex

The rules and compliance required to implement and manage many schemes can be complex, time consuming and risky for the company and employees concerned. Financing arrangements often require the involvement of external financiers, which adds a new level of complexity to these transactions. Hence, extensive management involvement is required to manage and administer such strategies.

Potential negative impacts on company, existing shareholders and participants

	Company	Participant
Dilutive for existing shareholders	x	
Requires significant cash to invest		x
Requires significant expertise to implement & manage	x	x
Creates friction within management	x	x
Not aligned to company performance	x	
Not aligned to individual performance	x	x
Tax inefficient	x	x
Long term business value not created	x	
Promotes the 'wrong' behaviour by participants	x	

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7. Tax changes affecting all share incentive structures

Since 2016, all gains arising from employment-linked share incentives, whether options or share purchase schemes, have been taxable as income, which can be as high as 45%!

The profit arising under a share option scheme has always been taxable as income in the hands of an employee, but until recently (2016), the profit arising from a share purchase scheme was treated as a capital gain, taxable at a lower rate. As indicated above, this has since changed, with the result that even gains made on share purchase schemes are now taxable as income. Equity instruments acquired by virtue of employment are governed by Section 8C of the Income Tax Act. The effect is that if the equity instrument (i.e. the option or share purchase) generates a gain, the taxpayer is required to include such gain in their personal income for the tax year in which the instrument vests in their name.

The taxable gain, included in the employee's tax return, is calculated by subtracting it from the market value of the equity instrument at the time that it vests in the taxpayer's name, from the sum of any consideration paid by the taxpayer in respect of the equity instrument.

8. An example of the tax treatment of a share option

Gains arising from any 'restricted' shares issued are taxed according to Section 8C of the South African Income Tax Act. Employees must be taxed as ordinary income (at rates up to 45%), rather than as dividends (at 20%), or as capital gains (up to 18%).

An option is issued to Employee A to buy 1 share in Company X at R5 (current Market Value) vesting, that is, actionable, in 5 years. On the vesting date the Market Value is R15 per share. Employee A buys the share in year 5 for R5 and is subject to Employees tax of 45% x R10 (R15 - R5) = R4.50.

If Employee A borrowed the money to purchase the share, the employee would be subject to interest at the official rate, failing which they would be subject to a deemed fringe benefit of R5 x 7.75% x 45% = R0.17 per share.

The costs arising for Company X in the above situation, are not allowable expenses for income tax purposes.

If Employee A is issued a bonus to purchase shares, each share would be taxed at R5 x 45% = R2.25. Therefore, the bonus would have to be increased to R9.09 (Net Proceeds / (1 - 45%), resulting in a tax paid of R4.09.

The total amount due to SARS for allowing the employee to purchase a share for R5 = R8.59.

9. Best practice in successful incentive strategies

The rules and compliance required to implement and manage share incentive schemes can be complex, time consuming and risky for the company and employee concerned.

Company executives and shareholders should be aware of the following matters when developing equity-based incentive structures:

Executive time and competence is often required to implement and manage the scheme.

Determining which employees are included and what performance benchmarks must be achieved is complex and may bring friction to the employment relationship.

Understanding and complying with the varied tax consequences for the company and the employee is often beyond the scope of most business executives' knowledge and skills.

JSE, IFRS, BEE and SA Companies Act compliance and reporting matters are necessary when implementing and managing such schemes.

The cash flow consequences for the company and employee concerned should be considered, as should the financing considerations.

An independent professional is necessary when determining the value of a company's equity as well as complying with sections of the Company's Act, JSE regulations and relevant tax legislation.

When determining which strategy to implement, consideration should also be given to the changing nature of the company, financial performance and the inevitable changes in workforce which need to be accommodated by such schemes.

Finally, any transactions involving the equity of a company, such as a merger or sale, would bring such an incentive plan into play, and may form an important part in the negotiation process.

10. Introduction to Addison Advisory Inc.

Addison Inc. is a professional service firm based in Sandton, South Africa. We provide insight, advice and direction to senior executives, shareholders of emerging and established companies and individuals. Our expertise covers corporate finance, share transactions, business development, strategy and governance matters including executive compensation, incentive structuring and succession plans. The firm is supported by a team of qualified professionals and associates. Our solutions are custom designed, with an emphasis on high-impact, value enhancing services that are clearly understood and supported by our clients.

We deliver upon our promises by offering:

- A track record and unique skills set.
- Measurable outcomes for our stakeholders over the short, medium and long-term.
- Knowledge sharing to create powerful institutional memory.
- Turn-key solutions that add value to our clients
- Best-practice tools and techniques assimilated with on-the-ground experience.

To learn more

At Addison Advisory, we enjoy helping clients achieve their business and financial goals and can often unlock seemingly insurmountable challenges. If we can help you complete that all-important transaction, please make contact.

FOR FURTHER INSIGHTS & OUR SERVICES CLICK

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