LTIP Options

How to Share Value with Employees Who Drive Long-Term Business Growth

MPN INC.

The Key to Success for Owner-Managed Business

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If you are a company leader with ambitions for business growth, your compensation strategy needs to make it easy for your employees to invest in your vision—especially your key performers. It should help build a unified financial vision for growing the business. Among other things, this means you will need an effective way to share long-term value with those who help create it. The dilemma is finding the value-sharing approach that will best help you drive the sustained performance you seek.

This issue becomes especially sticky if you own or run a privately-held business. You are likely reluctant to share equity but might assume that is your only option. Giving stock dilutes owner equity, invites additional scrutiny and broadens the circle of decision makers that have to be consulted when making strategic decisions. The other issue is that you are probably competing in a global talent marketplace where some of those you are trying to attract are working for public companies where stock or stock options are a customary part of an employee's compensation. To persuade those people to join your company, you might wonder if you must mirror the opportunity those recruits had at their previous employer.

In reality, sharing stock is not the only way to reward long-term value creation. And in private companies especially, it is not even the preferred approach—for a range of reasons. You have a whole portfolio of incentive plan options from which to choose.

ULTIMATELY, THERE ARE NINE DIFFERENT LONG-TERM INCENTIVE PLANS FROM WHICH TO CHOOSE.

Ultimately, there are nine different long-term incentive plans (LTIPs) from which to choose—and variations of each of those nine. They fall in three categories: stock, phantom stock and plans rooted in financial metrics other than business value.

So let's explore each and how you can determine which approach is best for your company.

Stock Plans

If your intent is to share equity with some of your people, you essentially have to decide whether you want to give away current value right now (restricted stock), give away current value after certain performance thresholds are met (performance shares) or give away future company value only (stock options).

Restricted Stock
This plan is a common way public companies share value with their employees. A restricted stock plan is simply the issuance of company shares to selected participants.

Unlike stock options, employees receive the full starting value of the shares. Customarily, restricted stock will carry a vesting schedule so that those included in the LTIP will forfeit some or all of the shares unless they remain with the company for a specified number of years (commonly three or four). Employees must pay ordinary income taxes on the value of the shares. The tax is due no later than the time the shares vest. Stock recipients can elect to be taxed as of the date of grant by filing an "83b" election within 30 days of receiving the shares.

Performance Shares
This incentive arrangement allows employees to receive actual stock in their company, just like a restricted stock plan. However, in this case the company establishes specific financial objectives that trigger the

awarding of stock grants to LTIP eligible participants—but only once the performance measures are met. Financial targets might include such measures as earnings per share or EBITDA. Once issued, the shares may still remain subject to vesting schedules or other restrictions. The tax effect to employees is identical to that of restricted stock.

Stock Options

Under this type of plan, employees are able to purchase company stock at a future date, but at today's price. For example, an employee might be given 100 options to purchase shares that are currently priced at $10. He may have to wait three years or so (the vesting period) to exercise his right to purchase. At that time or thereafter (up to the expiration date—commonly 10 years), he can choose to purchase the shares. Suppose he waits until the shares are valued at $18. He would write a check to the company for $1,000 and instantly own shares worth $1,800. Depending on the nature of the shares, he may or may not be taxed on the $800 value. Should he then hold the shares for at least another year before selling them, he should expect capital gain taxation on any growth beyond the $1,800 value. Stock option plans are most commonly found in public companies or in private companies on an IPO track. Private companies should consider the liquidity needs and dilution impact of a stock option plan before implementing one.

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Phantom Stock Plans

As previously indicated, many private business owners are reluctant to share actual equity with their employees. However, they do like the idea of tying the value of a future reward to company growth. For them, phantom stock can be an ideal alternative to sharing real shares. Here, the three choices are similar to the ones needing to be made with stock plans. Do you want to give away current value (full value phantom stock), future value (phantom stock options) or present value once performance thresholds are met (performance phantom shares)?

PHANTOM STOCK CAN BE AN IDEAL ALTERNATIVE TO SHARING REAL SHARES IN PRIVATE COMPANIES.

Full Value Phantom Stock Plan

A Full Value Phantom Stock Plan is a deferred cash bonus program that creates a similar result as a restricted stock plan. The sponsoring company determines a phantom stock price through an internal or external valuation of the company. Employees are awarded some number of phantom shares that carry specific terms and conditions. At a designated time, active employees will receive a cash payment equal to the value of the original shares plus appreciation. For example, assume an employee receives 100 phantom equity shares with a starting price of $10. At a pre-determined future date the company will calculate the value of the phantom stock price and pay the employee the full value. Assume, for our example, the share price grows to $18. The company will pay the employee $1,800. Phantom stock plans do not result in shareholder dilution because actual shares are not being transferred. Employees do not become owners. Instead, they are potential cash beneficiaries in the underlying company value. Phantom shares result in ordinary income taxation to the employees when they turn into an actual cash payment.

Performance Phantom Share Plan

This kind of phantom equity plan contains two distinct performance-based elements. First, employees must achieve certain pre-determined performance targets. Should they do so, they are awarded phantom shares. The number of shares may vary by employee and by the degree to which the targets were achieved. Financial targets might include such measures as pre-tax Income or EBITDA. The second performance element relates to the potential improvement in value that may come through phantom stock value appreciation. Once awarded, the phantom shares may still remain subject to vesting schedules or other restrictions. The tax effect to employees is identical to that of full value phantom stock.

Phantom Stock Option Plan

A Phantom Stock Option Plan is also known as a Stock Appreciation Rights (SAR) plan. It is a deferred cash bonus program that creates a similar result as a stock option plan, but without employees having to actually purchase shares. The sponsoring company determines a phantom stock price through an internal or external valuation of the company. Employees are awarded some number of phantom options that carry specific terms and conditions. Should the company phantom stock appreciate over time, employees will receive a cash payment equaling the difference between the original price and the appreciated price. For example, assume an employee receives 100 phantom stock options (PSOs) with a starting price of $10. At a pre-determined future date the company will calculate the value of the phantom stock price and pay the employee any positive difference.

A PHANTOM STOCK OPTION PLAN IS A DEFERRED CASH BONUS PROGRAM THAT CREATES A SIMILAR RESULT AS A STOCK OPTION PLAN, BUT WITHOUT EMPLOYEES HAVING TO ACTUALLY PURCHASE SHARES.

Assume, for this example, the share price grows to $18. The company will pay the employee $800. Phantom stock plans do not result in shareholder dilution because actual shares are not being transferred. Employees do not become owners. Instead, they are potential cash beneficiaries in the appreciation of the underlying company value. Phantom options result in ordinary income taxation to the employees when they turn into an actual cash payment.

LTIPs Tied to Other Financial Metrics

If you prefer not to share equity, and phantom stock also isn't your cup of tea, you still have meaningful options for effectively sharing long-term value with those who help create it. Essentially, you will have to decide if you want to base the benefit on certain KPI metrics, profits or a combination of individual and company performance measures. To make your alternatives clearer, let's look at three LTIP plan examples.

Performance Unit Plan (PUP)

In a Performance Unit Plan (PUP), the sponsoring company selects two or more financial metrics that will be used to value units that are awarded to employees. The units will be converted to cash payments at a future time (commonly three or four years). For example, a company establishes a unit price of $100 (the determination of the starting value is completely arbitrary).

Next, the company creates a table that illustrates targeted improvements in two important metrics—such as increased margin and sales growth (any metrics will do—even department level ones). The table will show the employees how much the value of the PUPs would grow assuming achievement of the specified metrics. The employees are rewarded for achieving the targets identified. Commonly, the company will award new PUPs each year with either the same or different targets. Alternatively, new PUPs may be issued at the end of the first payment, thus beginning a new cycle. Starting a pre-designated period—typically three to five years in the future—employees begin redeeming their units. They begin with the first year grants. In the subsequent year they cash in the second year units—and so on from there. This kind of plan has strong retention value because if an employee leaves before all of his or her units are redeemed, they are abandoned.

Profit Pool

A Profit Pool is the simplest of all long-term incentive plans. The sponsoring company selects a percentage of annual profits to

contribute to a pool for employees. The percentage may reflect an amount above a minimum profit threshold. The pool contribution is then allocated among the participating employees. The company may be discretionary when determining the allocation formula. This process continues annually for several years. For our purposes, let's assume it is a three-year period. At the end of the third year, the company pays one- third of the accumulated value to each employee and carries the remaining two-thirds forward. The idea is that each employee's pool would grow as profits grow. Likewise, their annual payment (beginning after the third year) would also increase. When employees leave the company they would customarily forfeit any remaining amount. The pool may or may not be credited with interest.

Strategic Deferred Compensation Plan

Strategic Deferred Compensation is a performance-based retirement program. Individual, non-qualified retirement accounts are created for the plan participants (typically executives and senior managers). The company annually establishes performance targets which, if achieved, will lead to contributions to the participants' accounts. Better results lead to higher contributions.   Once the contribution has

STRATEGIC DEFERRED COMPENSATION IS A PERFORMANCE-BASED RETIREMENT PROGRAM.

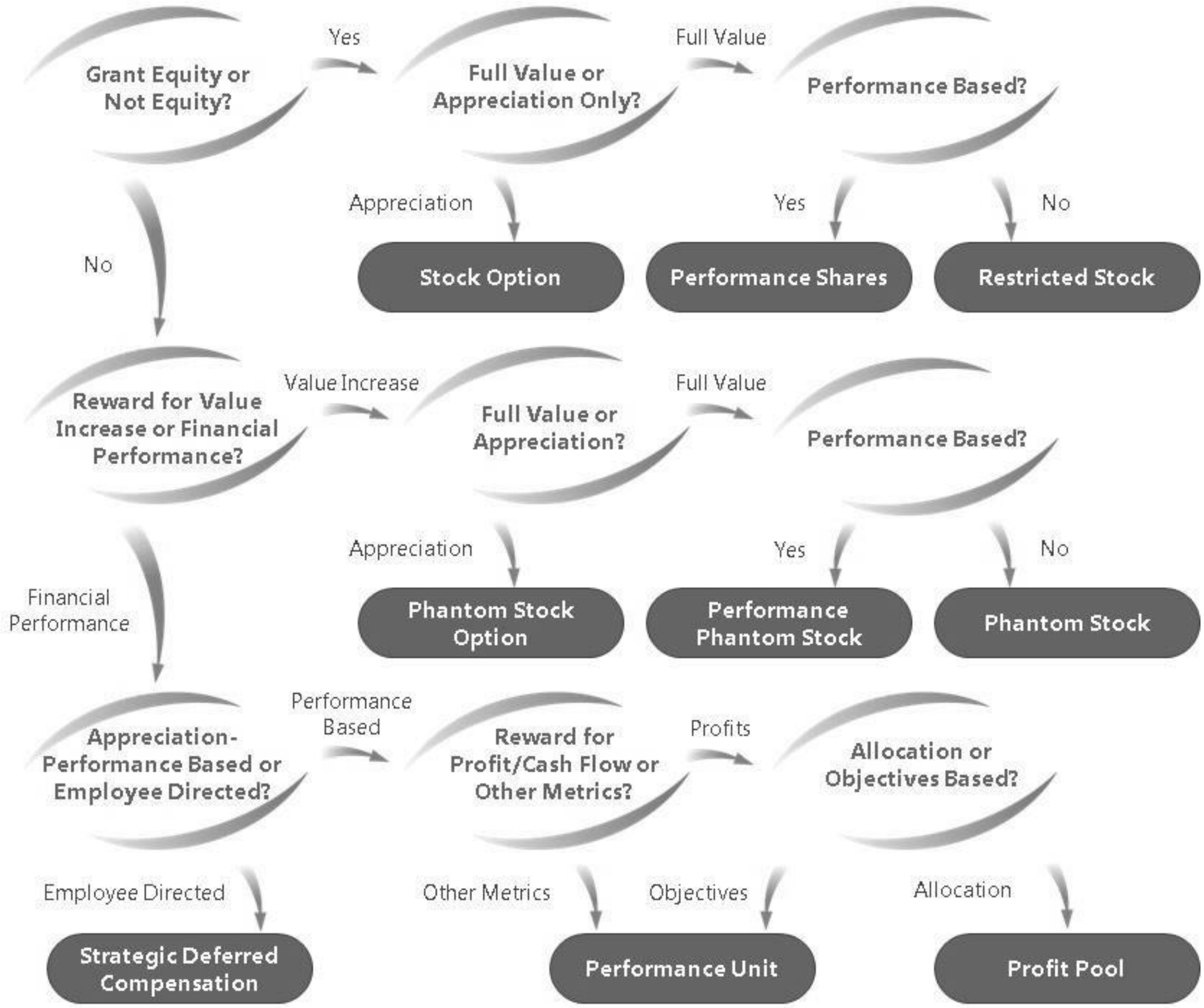
been made, the employees are given the ability to self-direct their account allocation among a variety of investment options. The investments are handled in the same way as a standard deferred compensation plan and are subject to the same limitations and risks. Plan accounts are also typically subject to vesting schedules.

Deciding Which Plan is Best

So, now you know the alternatives you have to choose from in developing a long-term value-sharing approach that will help turn your employees into growth partners as you envision your future company. But how do you decide which of those options is best suited to your circumstance?

At MPN Inc., we have found an LTIP Decision Tree to be an effective tool for making that decision. The Decision Tree guides you through a logic pattern that helps you arrive at a solid conclusion about which plan is most suitable. It is essentially a process of elimination. For example, if you know you don't want to share equity, then certain plans are automatically eliminated from consideration. On the other hand, you may be willing to share equity, but want to base the reward on an increase in the company's value as opposed to its present value. This helps narrow down the kind of stock-sharing arrangement that would be appropriate.

You can find an interactive version of the Decision Tree on our website or by clicking on the image below.


Grant Equity or Not Equity?
Yes
Full Value or Appreciation Only?
Full Value
Performance Based?
Appreciation
Yes
No
Stock Option
Performance Shares
Restricted Stock
No
Reward for Value Increase or Financial Performance?
Value Increase
Full Value or Appreciation?
Full Value
Performance Based?
Appreciation
Yes
No
Phantom Stock Option
Performance Phantom Stock
Phantom Stock
Financial Performance
Appreciation-Performance Based or Employee Directed?
Performance Based
Reward for Profit/Cash Flow or Other Metrics?
Profits
Allocation or Objectives Based?
Employee Directed
Other Metrics
Objectives
Allocation
Strategic Deferred Compensation
Performance Unit
Profit Pool

Ready to Speak to a Compensation Specialist?

If you would like to speak with a pay expert about your business goals and pay strategy, call me at (210) 872-1055 or email tjordan@mpninc.com.

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Tom has advised organizations on executive compensation and benefit plans for 39 years. An inveterate entrepreneur, he has founded and operated two compensation consulting businesses as well as a benefits administration company. As an entrepreneur who understands how to grow a company (and support the people that power the results), Tom is one of the most experienced business planning professionals in the industry. He specializes in the design, implementation, funding and the administration of executive and key employee incentive plans.

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