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Global Business Consulting

Long-term incentive plans (LTIPS): Cash vs. Equity

Table of contents

Introduction

When it comes to executive compensation, one of the most popular incentives is the Long-Term Incentive Plan (LTIP). LTIPs are designed to motivate top executives to work towards achieving long-term goals that benefit the company and its shareholders. These plans usually in two forms: cash and equity-based LTIPs.

Do you know how to choose between cash-based and equity-based LTIPs? This article highlights the differences and how the choice depends on various factors, including the industry practices, stage of growth, business strategy, shareholder interests, and executive perceptions

Cash-based LTIPs offer executives a cash reward when certain performance targets are achieved. This type of LTIP is more common in companies that are not publicly traded or have limited shares available for issuance. Cash-based LTIPs provide immediate gratification to executives, as they receive cash bonuses that they can spend however they choose.

On the other hand, Equity-based LTIPs offer executives stock options or restricted stock units (RSUs) as a reward when performance targets are met. This type of LTIP is more common in publicly-traded companies as the stock options or RSUs can be easily issued and traded on the stock market. Equity-based LTIPs align executives' interests with those of the company and its shareholders, as the executives are incentivized to improve the company's stock price.

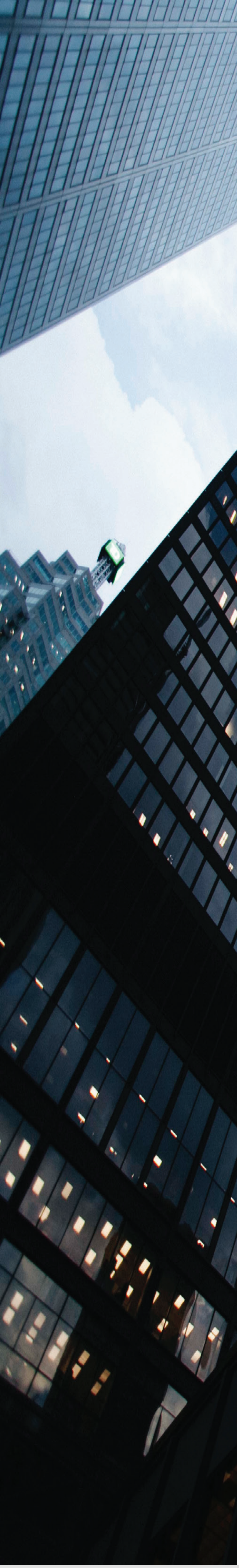
Market practices often influence the choice of LTIPs. For instance, cash-based LTIPs may be favored in industries that are more stable.

This is mainly because cash-based LTIPs offer a guaranteed reward, regardless of the company's stock performance. On the other hand, equity-based LTIPs may be more common in industries that are more dynamic, such as technology or biotech, as the potential for stock appreciation is higher.

Another market practice that can influence the choice of LTIPs is the company's stage of growth. For instance, startups may offer equity-based LTIPs as a way to attract and retain talent, as the potential for stock appreciation is higher in these companies. Established companies, on the other hand, may offer cash-based LTIPs as a way to reward executives for achieving long-term goals.

A Comparative Overview

Parameter	Equity-based LTIPs	Cash-based LTIPs
Type of company	Common in Publicly-traded companies	Common in non-publicly traded companies or those with limited shares
Industry	More volatile or growth industries	Less volatile, stable and predictable;
Company's stage of growth	Common in companies at startup/ growth stage	Common in companies at the maturity stage
Financial impact	Dilution of the stock	No dilution but impact on cash flow
Eligibility	Top executives and key employees	Top executives and key employees
Grant size and criteria	Employee's grade, performance, and tenure	Employee's grade, performance, and tenure
Performance measures	Financial and non-financial are directly linked to strategic goals. Examples: TSR, ROE, EPS, ROA, ROI, revenue growth, profit margins, market share, or share price performance.	Financial and non-financial are directly linked to strategic goals. Examples: Milestones, ROA, ROI, ROC, revenue growth, profit margins, market share, new innovation
Vesting schedule	Gradual/ staggered or cliff	Gradual/ staggered or cliff
Vesting condition	Continued service over a specified time period	Continued service over a specified time period
Payout vehicle	Shares	Cash
Type of plans	Full value-based LTIPs: • Restricted Stock • Restricted Stock Units (RSUs) • Performance Shares Appreciation-based LTIPs: • Stock options, and • Stock Appreciation Rights (SARs)	Full value-based LTIPs: • Performance Deferred Cash Plans • Performance Unit Plans (PUPs) • Cash-settled Performance Shares • Cash-settled Restricted Stock Units (RSUs) • Phantom Units Appreciation-based LTIPs: • Cash-settled Stock Appreciation Rights (SARs) • Phantom Stocks



Key Takeaways

Consider market practice

Cash-based LTIPs (Long-Term Incentive Plans) may be favored in less volatile industries, and non-publicly traded companies at the maturity stage. Equity-based LTIPs may be more common in highly volatile industries, and publicly-traded companies at the start-up/growth stage.

Critical selection factors

Among critical factors impacting the selection of appropriate LTI vehicles is the alignment with the business strategy and shareholder interests, the financial impact, and executive perceptions.

Equity-settled LTIPs: Full value-based

Full-value LTIPs provide employees with the full value of the underlying stock upon meeting performance criteria.

Equity-settled LTIPs: Appreciation-based

Appreciation-based LTIPs are a method of providing employees with the option to purchase a pre-determined quantity of shares. The employee’s estimated gain is the difference of share-value from the exercise price and the current market post-vesting.

Cash-settled LTIPs

Cash-settled LTIPs are similar to equity-settled plans, but instead of receiving shares in the company, the employee receives a cash payment if they achieve certain performance targets. Cash-settled LTIPs may be in the full value or appreciated-based.

Select proper measures

To select proper performance measures, consider the company's stage of growth, company's shareholding structure, plan type, and company strategy, and identify whether the measures are linked to stock price or to other non-market-based measures.

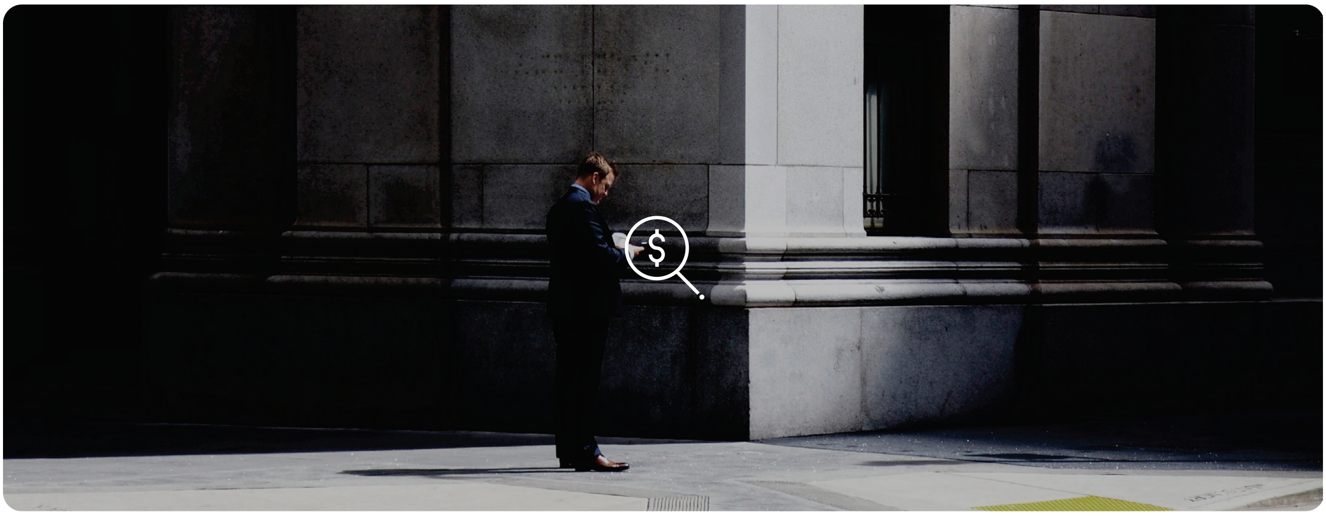
Vesting type: a tool for retention or for aligning shareholders’ and executives’ interests?

If a company pays more attention to employee retention, cliff vesting suits better. But gradual or staggered more balance between the shareholders’ and employees’ interests.

Consider executives’ perceptions

While aligning with shareholders’ interests, business strategy and nature of business, a final consideration in selecting appropriate LTI vehicles is the executives’ perceptions of the value these plans deliver. It is important to use the plans that executives perceive in the most positive light, given current conditions.

Equity-based LTIPs



A stock-settled LTIP is a long-term incentive plan where the employee receives share grants as a reward for achieving certain performance targets. The shares are usually granted on an appreciation basis for meeting certain performance or business targets. These are granted at a discount to the market stock price or on a fair-value basis and are subject to a vesting period, during which the employee must continue to work for the company to retain the shares. If the employee leaves the company before the vesting period is over, they may forfeit some or all of the shares.

Once the shares have vested, the employees may either hold onto them or sell them. If the employee sells the shares, they will be subject to capital gains tax on any profit made. Equity-settled LTIPs are popular with companies because they align the interests of the employees with those of the shareholders. If the company performs well, the value of the shares will increase, benefiting both the employees and the shareholders.

There are two types of stock-settled LTIPs:

Full value-based equity- settled LTIPs

Appreciation-based equity-settled LTIPs

Full value-based Equity-settled LTIPs

Full value-based Long-Term Incentive Plans (LTIPs) are compensation programs designed to motivate and reward executives and key employees for achieving specific performance goals over an extended period. Unlike other forms of incentives, such as stock options or stock appreciation rights (SARs), full-value LTIPs provide employees with the full value of the underlying stock upon meeting performance criteria.

Here are some key characteristics of full-value LTIPs:

Performance Measures: The performance measures for full-value LTIPs are generally specific, measurable, and directly linked to the company's strategic goals. Examples of metrics could be TSR (Total Shareholder Return), ROE (Return on Equity), EPS (Earning Per Share) ROA Return on Assets), ROI (Return on Investment) revenue growth, profit margins, market share, or share price performance.

Vesting Period: Full-value LTIPs typically have a multi-year (typically 3 or 5 years) vesting period, meaning the employee must remain with the company for a certain period before the awards are fully vested.

Payout Structure: Full-value LTIPs can be structured as equity awards.

Examples of Full-value Equity awards:

- **Restricted Stock:** Plans that provide stock to employees without any cost, however with certain conditions or restrictions (performance or time or both) to trigger the vesting or transferring of the stock.
- **Restricted Stock Units (RSUs):** Like the restricted stock plan but differ in some ways: as they do not convert into shares until vested, and there are no dividend or voting rights.
- **Performance Shares:** Plans that provide actual shares of stock or stock units without any cost to the employees based on performance over a multi-year performance period.

Performance Thresholds: Full-value LTIPs often have performance thresholds that must be met before the awards can be paid out. These thresholds can be set at different levels, such as minimum, target, or stretch, depending on the difficulty of the performance metrics.

Performance Period: The performance period for full-value LTIPs can range from one to five years, depending on the company's strategic objectives and industry conditions. However, as per leading practice, a 3-year performance period is most common within the growing Middle East and Asian economies.

Overall, full-value LTIPs can be an effective way to align executive and employee interests with the long-term goals of the company, leading to improved performance and value creation for shareholders.

Appreciation-based Equity-settled LTIPs

Appreciation-based LTIPs are a method of rewarding and retaining employees by providing them with the option to purchase a pre-determined quantity of shares at a pre-determined “exercise price” after a specific “vesting period” from the grant date of the option. The exercise price may or may not be discounted to the calculated fair value or market rate.

After the vesting of shares, employees can purchase the shares at the exercise price, which was set during the shares grant date. The employee’s estimated gain is the difference of shares from the exercise price and the current market price post-vesting.

Examples of Appreciation-based equity-settled LTIPs:

- **Stock options**: Plans that provide employees with the option to purchase a pre-determined quantity of shares at a pre-determined “exercise price” after a specific “vesting period” from the grant date of the option.

- **Stock Appreciation Rights (SARs)**: Plans that give employees the right to receive a cash payment equal to the appreciation in the value of a company's stock over a certain period. Under the SAR plan, an employee is granted a certain number of SARs, which typically vest over a period or are based on the achievement of certain performance goals. When the SARs vest, the employee has the option to receive a cash payment equal to the appreciation in the value of the company's stock since the grant date of the SARs. Alternatively, the employee may choose to receive shares of the company's stock equal to the cash value of the SARs. SAR plans are a popular alternative to traditional stock option plans because they allow employees to receive the benefits of stock ownership without having to purchase the underlying stock. Additionally, SAR plans are often structured to pay out only if the company's stock price has increased, which aligns the interests of employees with those of the company's shareholders.

The aim of these plans is to align the interests of employees with those of the company's shareholders, creating a sense of ownership and accountability.

One of the main advantages of appreciation-based LTIPs is that they encourage employees to think and act as owners, which can lead to improved performance, innovation, and commitment. Additionally, these plans can help companies retain talent, as employees are incentivized for loyalty to receive the full value of their equity awards.

However, appreciation-based LTIPs also come with some potential drawbacks. For example, if the company's stock price does not perform well, the value of the equity awards may not increase, which can lead to dissatisfaction and demotivation among employees. Additionally, these plans can be complex and require careful design and communication to ensure that employees understand the potential risks and benefits.

Overall, appreciation-based LTIPs can be an effective tool to incentivize and retain top talent in a company. But they should be carefully designed and communicated to ensure that they align with the company's goals and values and provide meaningful rewards to employees.

Accounting for Equity-based Compensation

All equity-based compensation must be accounted for based on its fair value. This value is the amount at which an asset could be bought or sold in a current transaction between willing parties. When no observable market value exists (e.g., stock options, SARs settled in stock), the use of an option pricing valuation model (Black Scholes model, Binomial Model, etc.) is necessary.

If awards are settled in stock, compensation cost is fixed on the grant date and recognized over the vesting period, fair value method is used. If awards are settled in cash, they are considered liability awards and the value of the awards is variable, measured each quarter over the requisite service period.

Companies may be able to reconcile the expense of an award in certain cases.

Years of service-based awards vest depending on continued service. The expense taken for the award can be reconciled in subsequent periods based on the number of awards earned.

Performance-based Awards that are contingent on non-market-based goals (e.g., EPS, income, profit, etc.) can also be reconciled based on the actual number of awards earned.

Market-based Awards include performance conditions linked to the company's stock price relative to the market (e.g., a percentage increase in stock price, Relative Total Shareholders' Return [TSR], etc.), a reconciliation is not permitted, and the expense fixed at grant needs to be taken regardless of performance.

Cash-Settled LTIPs

Cash-settled LTIPs are similar to equity-settled plans, however instead of receiving shares in the company, the employee receives a cash payment. The cash payment is usually based on the market value of the shares at the time the award is granted, and the amount is subject to a vesting period.

Like equity-settled plans, the employee must achieve certain performance targets to receive the cash payment, and the payment may be subject to clawback provisions if the employee leaves the company before the vesting period is over. Cash-settled LTIPs are popular with employees because they offer a guaranteed cash payment, rather than the uncertainty of stock prices.

Examples of Full Value-based Cash-settled LTIPs are:

- **Performance Deferred Cash Plan (DCP):** A method of rewarding employees for defined performance parameters by granting cash post-meeting performance criteria over a period of time (deferred for 1-3 years). The award is granted to an employee based on the employee's grade, and corporate and individual performance.
- **Performance Unit Plans (PUPs)**: Plans that provide employees with cash awards based on achieving key strategic and financial goals over a multi-year performance period and use non-market-related performance measures.
- **Cash-settled Performance Shares:** Similar to the equity-settled performance shares plan, however the shares are converted into cash after fulfilling the vesting conditions.
- **Cash-settled Restricted Stock Units (RSUs):** Similar to the equity-settled restricted stock plans, however the units are converted into cash after fulfilling the vesting conditions.
- **Phantom Units:** This is an LTI plan that offers some of the features of equity compensation without the actual use of company stock. Executives receive the full value in book, formula or fair market value of shares over a set time period.

Examples of Appreciation-based Cash-settled LTIPs are:

- **Cash-settled Stock Appreciation Rights (SARs):** Plans that give employees the right to receive a cash payment equal to the appreciation in the value of a company's stock over a certain period. Under the SAR plan, an employee is granted certain number of SARs, which typically vest over a time-period or are based on the achievement of certain performance goals. When the SARs vest, the employee has the option to receive a cash payment equal to the appreciation in the value of the company's stock since the grant date of the SARs.

- **Phantom stock:** This is an LTI plan that offers some of the features of equity compensation without the actual use of company stock. Executives receive the appreciation in book value, or fair market value of shares over a set time period.

Cliff vesting vs. Gradual vesting

Cliff vesting and Gradual vesting are two different ways by which an award and other forms of employee benefits can be vested, or made available for the employee to access.

Cliff vesting refers to a vesting schedule in which the employee LTIP grant becomes fully vested in an award after a certain period, often more than two years. Until that point, the employee has no vested interest in the award, and if they leave the company before the cliff period is over, they may forfeit any unvested award fully or partially.

For example, an employee might receive stock options with a cliff vesting schedule that requires them to stay with the company for at least two years before they can exercise the options. If they leave before that time, they will not be able to exercise any of the options.

Gradual or staggered, on the other hand, refers to a vesting schedule in which the employee becomes partially vested in the benefit over time. For example, an employee might receive stock options that vest 25% after year one, another 25% after year two, and another 25% after years three and four, respectively. Hence, 100% vested after completing four years. If the employee leaves the company before the full vesting period is over, they would not be able to exercise the unvested portion of the options.

In summary, the main difference between Cliff vesting and Gradual vesting is the timing and extent of the vesting. Cliff vesting occurs all at once after a certain period, while Gradual vesting occurs over time in predetermined increments.

Conclusion

Long-Term Incentive Plans can be an effective way for companies to incentivize their top executives and key employees to work towards long-term success. Equity-settled and cash-settled plans are two common types of LTIPs, with different benefits and implications.

Equity-settled plans offer shares in the company, which aligns the interests of the employees with those of the shareholders. Cash-settled plans offer a guaranteed cash payment, which can be more attractive to some employees.

Both types of plans have different accounting treatments, and careful consideration should be given to the most appropriate type of plan for the company's needs.

A final consideration in selecting appropriate LTI vehicles is the executives' perceptions of the value these plans deliver. Because the plans are a tool to attract, motivate and retain executives, it is important to use the plans that executives perceive in the most positive light, given current conditions.

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Contact Us

Sanjay Bhattacharya
Managing Director
Mobile: +971 507081135
Email: sanjay.bhattacharya@protivitiglobal.me

Our Middle East Offices:

Abu Dhabi
Al Ghaith Holding Tower
9th Floor, Airport Road
P.O. Box: 32468, Abu Dhabi, UAE
Tel: + 9712 658 4640
Fax: + 9712 6584641
Email: abudhabi@protivitiglobal.me

Bahrain
Platinum Tower, 17th Floor
P.O. Box 10231, Diplomatic Area
Manama, Kingdom of Bahrain
Tel : + 973 17100050
Fax: +973 17100051
Email: bahrain@protivitiglobal.me

Dubai
Office No. 2104, 21st Floor
U-Bora Tower 2, Business Bay
P.O. Box 78475, Dubai, UAE
Tel: + 9714 4380660
Fax: +9714 4380655
Email: dubai@protivitiglobal.me

Kuwait
Al Shaheed Tower, 4th Floor
Khaled Ben Al Waleed Street, Sharq
PO Box 1773, Safat 13018, Kuwait
Tel: +965 2242 6444
Fax:+965 2240 1555
Email: kuwait@protivitiglobal.me

Oman
Al-Ufuq Building, 2nd Floor
Office No.26, Shatti Al Qurum
P.O.Box 1130, P.C.112
Ruwi Muscat, Oman
Tel: + 968 24699403
Fax: +968 24696356
Email: oman@protivitiglobal.me

Qatar
Palm Tower B 19th Floor
P.O. Box 13374, West Bay Doha, Qatar
Phone: +974 4421 5300
Fax: +974 4421 5288
Email: qatar@protivitiglobal.me

Egypt
Cairo Complex
Ankara Street Bureau 1
Second Floor, Sheraton Area
Heliopolis - Cairo, Egypt
Phone: +20.106.996.6659
Email: egypt@proviglobal.me

Saudi Arabia
Al-Ibdaa Tower, 18th Floor
King Fahad Branch Road, Al-Olaya,
Building No. 7906, P.O. Box 3825
Riyadh, 12313, Kingdom of Saudi Arabia
Tel: +966 11 2930021
Fax: +966 11 4615810
Email: saudiarabia@protivitiglobal.me