Long-term Incentive Plans

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Align with the Corporate Strategy

Strategy is typically defined as the determination of long-term goals and objectives, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals. A perfect way to show confidence in the strategy is to link the long-term incentive ("LTI") plan to the goals and objectives in the strategic plan, i.e. "put your money where your mouth is."

Be Clear About the Role of Performance

The effectiveness of the design of the LTI plan can be greatly enhanced by being clear about the role of performance:

- Pay drives performance: if the primary goal is to influence people's behavior, it is vital that the LTI plan is structured in such a way that employees can influence the chosen performance metrics ("line of sight"). This typically involves executing an analysis of the most important underlying drivers of the strategic objectives and cascading these derived performance goals to the appropriate levels in the organization.

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M. Zeuch (ed.), *Dos and Don'ts in Human Resources Management,*
DOI 10.1007/978-3-662-43553-3_39

- Performance drives pay: if the primary goal is to legitimize pay based on achieved performance ("goal alignment"), the plan can be directly linked to the overall strategic objectives or for example a measure such as (relative) Total Shareholder Return. Most individuals will not be able to (directly) influence the outcome on these measures. It may therefore not create an effective *incentive*, but the plan could support other objectives, such as corporate glue, wealth creation, retention, etc.

Consider Different Payment Vehicles

LTI plans are often share-based payments. The basic payment vehicles are stock options vs. shares. An additional feature could be that the plan is settled in cash, i.e. stock appreciation rights (SARs) vs. phantom shares. Cash-settled share based payments sometimes have a cap (e.g. to prevent perceived excessive outcomes). The payment vehicle needs to fit the business profile and life-cycle of the company. Stock options may be effective in case of start-up/ high growth company but less effective otherwise.

Mind the Cost vs. Value Gap

When establishing the LTI policy, it goes without saying that it is important to carefully consider the funding, accounting costs, the impact on cash flow, overhang and dilution (limits) and corporate tax deductibility. However, this is only one side of the coin. The other side is the value to the recipient. Individual taxation is an important factor in various countries that sometimes even dominates the way plans are designed. However, here we are more generally talking about the "perceived value." The gap between the cost to the company and the perceived value to the recipient can be significant. The driver of the gap is the uncertainty about the reward. This "compensation risk" is, for example, higher if the performance volatility of the company is higher, but is also heavily influenced by the plan design and the degree of influence an individual employee has on the reward. A perceived value or "certainty equivalence" analysis is therefore recommended to fine-tune the design and bridge the gap.

Don’t Overcomplicate

The road to a simple and understandable LTI plan is not an easy one. Simplifying LTI plans may involve considering simpler structures, fewer metrics, fewer legacy plans, etc. Especially for Main Board LTI plans, mandatory features are typical, for example due to governance or regulation. However, there is no need to cascade these sometimes complex reward features to the entire eligible population.

Restrict Eligibility

Making LTI available to too many people may lead to awards that are considered too small in light of the intended effect. It may further create a disproportional administrative burden.

Invest in Effective Communication

More transparency, disclosure and better communication greatly enhance the effectiveness of LTI plans. For internal communication purposes, it is recommended to *brand* the LTI plan and operate a platform where employees can have easy access to the current (and potential future) status of their awards and the associated wealth. The external communication strategy aims to show the added value to shareholders and other stakeholders and to prevent reputational damage, e.g. as a result of top executive realized LTI compensation.