Alternative remuneration methods – accelerated options

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In November 2007 we came out in support for the application of share options for some companies (see HERE). In addition, we advocated consideration, in the right circumstances, of options granted with a discount to market price. This month we like to push the executive pay envelope a little further to breakout of cloistered thinking and practices that are not in shareholders’ best interests, suggesting consideration of accelerated options in some situations.

We like to challenge accepted notions of executive remuneration because, frankly, many of them are not effective. Yet companies and their advisers persist because it is the way things have always been done. Now, however, there is strong evidence that proxy firms and investors are willing to consider difference, providing it is supported by an appropriate rationale.

Accelerated options may be one of these.

Accelerated options may be simply a grant of options (often with service based vesting) that allows for vesting to be accelerated if certain performance requirements are met. But the employee may be able to get his/her hands on the option and exercise it earlier if certain performance requirements are met. For example, an executive will be allowed to exercise all options if the FDA approves its new drug for clinical trials in the US.

This is different from traditional Australian plans. Traditional plans allow only a proportion to vest according to performance criteria to be achieved over a set and inflexible performance period. For example, 50% of options could vest if the company’s total shareholder return (TSR) relative to peer companies’ TSRs is ranked at the 50th percentile after a set 3 year period.

Accelerated options are practiced in Australia by only a handful of companies. These tend to be, in the main, well managed but relatively newly listed mining companies with a lot of potential but
limited cash flow. However, they are standard practice in the US, where they originated as a way around certain US specific accounting requirements. Now these US accounting requirements have changed and are much closer to international and Australian standards. Yet US practices still seem bound by the quirkiness of dead and buried accounting treatments in how they construct incentive plans. Interestingly, most US applications of accelerated option plans are not congruent with business strategies, so many US companies would be hard put to provide a rationale for their continued use given other alternatives.

But in particular instances we envisage accelerated options as being a useful incentive and worthy of consideration by a reasonable number of Australian companies. In particular, they lend themselves to listed companies trying to emulate some aspects of a private equity model. That is, a listed company takes a big capital risk, such as a relatively large acquisition or new technology investment. Shareholders will make big returns, but these returns will not be fully realised for several years. Traditional rolling 3 year plans would not be appropriate, given the all consuming and longer term aspects of the investment. The sooner certain operational or strategic goals are achieved, the sooner these returns will be realised. In fact, given the time value of money, returns could be significantly enhanced if prescribed goals are realised sooner.

Accelerated options are not for all companies. In fact only a minority of companies would be well suited to use them. Even then, they would only be suited to a particular window of time for a particular type of strategy. They are generally not applicable for ongoing operational, organic growth strategies, requiring steady and measurable progress in sustainable earnings growth. They are better suited for transformational strategies. Examples that could be identified with major Australian company risk takers include:

- Major rollouts of transformational telecommunications networks
- Packaging and selling off non-core parts of an airline business
- Bringing into production a major iron ore operation for a newly listed mining company
- Finding new gas fields to fill the capacity of a LNG train under construction
- Doubling the company’s capitalisation to develop relatively untried
“hot rock” power generation technologies, or
• Swallowing a global acquisition that increases iron ore revenues by 140%

Yet over and over again we bear witness to companies like the above going through the motions with the same, often inappropriate incentive methods used by non-transformational companies. Perhaps proxy firms and investors should consider no votes to remuneration reports that, while describing remuneration frameworks similar to hundreds of other companies, are clearly inappropriate! Now, wouldn’t proxy firms and investors egging companies on to be more radical in their executive remuneration be a nice change?

There are no major taxation or accounting issues associated with their use compared to the regular model of incentive options used in Australia.