# Share-settled Share Appreciation Rights provide more upside reward if management can deliver value

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A share-settled share appreciation right entitles the holder to a payment, in shares, equal in value to the amount by which the underlying share has appreciated since the right was granted. Share-settled SARs are economically similar to share options, but offer distinct advantages to the granting company in the form of reduced plan dilution and less drain on plan reserves. By providing executives with net shares from share price growth, share-settled SARs can also encourage long-term share ownership.

**Characteristics of SARs**

SARs provide an economic benefit that is similar to share options; upon exercise the employee realises a gain equal to the amount by which the share has appreciated since the right was granted. In the case of share-settled SARs, the gain is paid out in shares, so there is no cash outflow for the company if new issue shares are used. The employee is not required to pay anything for the right itself or to exercise the right.

For example, assume an employee holds a share-settled SAR for 100,000 shares with a price or basis of $2 per share. If the employee exercises the right when the market value of the share is $2.50 per share, the employee receives 20,000 shares ($50,000 gain divided by $2.50 per share).

In other respects, share appreciation rights are very similar to share options. The rights are generally subject to a vesting schedule (typically three to five years in length) and an exercise period. Under the new Employee Share Scheme (ESS) taxation legislation the exercise period could be up to 15 years (see HERE). If not exercised within the exercise period, the right expires.

Note that the longer the exercise period, the more valuable the SAR; this is recognized in the accounting standard. Consequently, for a given grant dollar value, employees will receive fewer SARs if the SARs have long exercise periods rather than shorter exercise periods.

If the board has discretion to settle the SAR in cash instead of the default shares, then the SAR is an “indeterminate right” under Division 83A of the Income Tax Assessment Act 1997. Where the SAR qualifies for tax deferral, tax will be deferred until the SAR is exercised, even if exercise is post employment. Where the SAR is settled in cash tax is assessed on the value received in the year of exercise. Where the SAR is settled in shares, the value of the SAR at the date of termination of employment must be included in the assessable income of the individual holding the SAR for the year in which employment terminated (this may require submitting an amended tax return for the relevant tax year).

Allowing post employment vesting and exercise provides for better governance, in that an executive is encouraged to build and maintain a sound legacy (e.g. potential successors, prudent investment etc.). It also positions the company for better attraction and retention, because the SAR would be seen as more valuable to executives if it remains on foot post employment.

**Advantages**

From the company’s perspective, share-settled SARs display many of the strengths of employee share options. They enhance the company’s ability to recruit and retain talented employees. They encourage entrepreneurialism because there is a higher upside from share price growth than traditional rights to shares. As with other equity arrangements, they allow the company to align the interests of the employees with those of its shareholders. For example, the employee only benefits when share prices increase and shareholders benefit. This would prevent the potential for an employee to benefit as they may do now when share rights vest and yet when share price growth has been negative.

For executives, share-settled SARs provide a way to acquire and maintain an equity interest in the company. They may be a strong motivational tool, as executives recognise that their individual performance can directly affect the company’s prospects and, therefore, the value of the company’s shares. In addition, the employee has control over the timing of exercise, and, thus, taxation, of vested SARs (subject to earlier taxation on cessation of employment for share-settled SARs that do not provide for a cash alternative).

Compared with options, share-settled SARs eliminate the need to finance the cost of purchasing the underlying share at exercise and eliminate the need for an open-market sale to raise this cash (however shares may still be sold to pay income tax).

By providing employees with shares from the net gain in share price, share-settled SARs also encourage long-term ownership. Exectuves are more likely to hold shares when they are not required to pay cash out-of-pocket to do so. Companies that are particularly concerned with encouraging long-term ownership could place sale restrictions on the shares once the SAR is exercised. This will further defer tax (up to a maximum of 15 years from grant or earlier cessation of employment).

Reducing the number of shares sold into the market compared to shares from option exercises reduces the plan’s dilutive impact. Unlike restricted shares or share rights, which also eliminate the need for exercise financing, share-settled SARs are not a “freebie”, since the company’s share price must appreciate for the right to be valuable.

From an accounting standpoint, under AASB 2, share-settled SARs are accounted for in the same manner as share options. Thus the company achieves the benefits described above without increasing the cost of the plan compared to a share rights plan.

Although subject to the effectiveness of the company’s engagement process, investors and proxy advisers should support the use of SARs, because executives benefit only when investors benefit.

At a low point in the business cycle, SARs are likely to be more valuable than share rights, especially for growth and cyclical stocks.

**Disadvantages**

There can also be drawbacks to using share-settled SARs as a remuneration tool. Just as with employee share options, the share price must appreciate after the rights are granted for them to be valuable to employees. When an at-the-money share option is underwater, a share-settled SAR will be underwater as well. (However, a SAR, like an option, would still have value if the exercise period stretches beyond the vesting period. At some point there is a likelihood that the market price will increase above the share price at grant date.)

Share-settled SARs do not produce any cash inflow for company, as opposed to share options, which do so in the form of the exercise price.

At a high point in the business cycle, SARs are likely to be less valuable than share rights, since the probability of share price falls is higher, especially for growth and cyclical stocks.

Unless a SAR also incorporates dividend entitlements (a subject for another article), it would encourage management to argue for the retention of earnings and reduce dividends to invest in longer term growth. While this may please Australia’s Reserve Bank and Treasury economists, it may displease some investors in an economic environment that currently values dividend yield.