Executive Long-term Incentive Cash Plans

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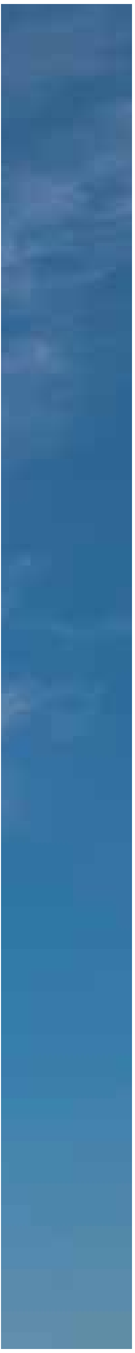
In 2007 align your executives' pay with the goals for your organization.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Over the last few years we have witnessed the steady rise of the cash-based long-term incentive plan ("LTIP") as organizations seek to properly align the pay of their key executives with the goals and strategies for their organization.

We predict that in 2007 this rise will become more evident as companies lock their executives into pay arrangements that reflect the long-term goals for their organization. In addition, others will forsake the beloved but volatile stock-based incentive arrangements for the more predictable, practical and effective cash alternative.

The only surprise is that it has taken this long for cash-based long-term incentive plans to re-establish themselves as the most workable arrangement for the management of long-term executive remuneration. We can only put this down to a number of myths all of which, let me assure you, are completely false but here is a selection of them anyway:

"Cash LTIPs cannot generate the level of financial reward possible under stock plans."

This is just not the case. Cash LTIP plans can generate any size of payment that shareholders or boards care to approve and we know of schemes that have been just as motivational and powerful an incentive as stock plans and considerably more measurable and a genuine reflection of the added value of the executives.

"Cash LTIPs cannot be linked to stock and therefore do not provide a link between the success of investors and executives."

This is also completely false. Cash LTIP performance measures can easily capture real stock measures such as earnings per share and stock performance relative to the sector stock performance or a group of comparator companies within the sector.

"The individual executives are fundamental to the share price and therefore must be measured on it."

Of course the executives have a fundamental influence on the rating of your stock within its sector by analysts and active investment managers. However other factors such as market sentiment concerning asset allocation, market allocation and sector allocation also come into play and can also have a considerable bearing on the actual price of your stock.

Probably of the widespread belief that long-term incentive plans have to be stock based and because many organizations don't have stock to issue, we find that many senior executives in strategic roles are paid on the same basis as those employees whose influence on organization can be measured in days. If you need any more convincing, if your answer is "yes" to any of the following questions, then you need to seriously consider implementing a cash-based LTIP in 2007.

- Do you have a strategy to improve service to your customers that will take longer than a year to implement and see the returns?
- Are you looking to develop new areas of exploration, products or services that require considerable capital investment over a number of years and will have a payback also over a long time period to which you need to link the rewards of your executives?
- Does your business have value through the reputation of its people, services, products or brands, built over a number of years, and that you do not want compromised by short-term decision making?

- Do you currently bonus your executives as if there was nothing more to achieve after the end of the current financial year?
- Is your only form of executive long-term incentive a stock price-based plan that you have no effective control over how much will actually be paid to the executives, whatever their achievements?

So now that you know you do need a cash-based LTIP to protect and drive your business, what type of arrangements are possible?

There are a number of different generic designs for cash-based LTIP arrangements and here is a brief summary of them:

- Deferred bonus
- Cliff-vested plan
- Performance units
- Rolling cliff-vested plan

Deferred Bonus

The simplest form of long-term payment is the deferred bonus. Essentially a proportion of the bonus that the executives earn in this year is actually held back and paid the following year or in two or three years' time. It is not really an incentive plan because there is no additional money on offer. However deferred bonuses can act as a basic retention tool as executives must remain with the business and perform well in order to collect the bonus that they already earned.

Cliff-vested Plan

These are the simplest long-term incentive plans. The cliff-vested plan requires that the executives meet performance targets over typically a three- to five-year period and that at the end of the period the performance over the whole time period is measured and the payment is made. At that point a new plan is launched and the process starts over again.

Performance Units

Performance units-based schemes distribute a pool of cash to executives in accordance with the number of performance units that they hold.

The cash pool will have been generated from business performance over typically a three- to five-year period. Performance units can be weighted by seniority. For example, the CEO may be awarded more performance units than the VPs, who may be awarded more performance units than the other senior executives.

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Rolling Cliff-vested Plan

Rolling cliff-vested plans operate in the same way as the cliff-vested plans. However, rather than wait for each plan to mature before launching another, in a rolling cliff-vested LTIP a new plan is launched every year. Therefore in a three-year rolling cliff-vested plan, a plan will mature every year and a payout will be made to executives annually in respect of strategic achievements.

There are of course many variants on the above plans and they can also be run alongside stock plans at times when actual share price is critical — for example, at time of float. But all cash LTIPs have the advantage of linking a given level of payment to actual results measured over a time period longer than the current financial year.

So if your organization has no long-term incentive arrangements for its executives or is currently only providing a stock price-based scheme, then 2007 is the year when you can make the change to a cash-based long-term incentive plan to align the pay of your executives with the horizon, strategy and longer-term results for your organization. ■