Introduction to Variable Pay

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SARA Conference 2013
Remuneration Package Structuring

Rewards: Variable Remuneration
PwC

03/04/2013
Remuneration package structuring

1. Long Term Incentives (LTI)
   - LTI’s reward participants for attaining results over a long measurement period.
   - e.g. performance shares

2. Short Term Incentives (STI)
   - STI’s reward employees for achieving certain goals over a shorter period.
   - e.g. annual performance bonus

3. Benefits
   - Non-salary compensation provided to employees in addition to their normal salary / pay.
   - e.g. pension, travel allowance

4. Base Salary
   - The salary paid to an employee for performing daily duties.
Variable Remuneration
Short-term Incentives (STI)
**Short-term incentive approaches**

**Bottom Up**

Begins with how much to pay based on business and personal performance and aggregates rewards to determine Bonus Pool. For example:

- Mining
- Retail
- Telecommunications

**Top Down**

*Begins with a Bonus Pool determined by financial performance, and then disburses this pool to participants, for example:*

- Banks
- Other Financial Services
Short-term incentives: Top-down approach

**Company Performance Hurdles**
- Return on Equity (ROE)
- Return on Capital Employed (ROCE)
- Return on Net Assets (RONA)
- EBITDA/Profit before Tax

**Bonus Pool**
Maximum that can be awarded to participants in total.

**Disbursements & Distributions**
- Business Unit Performance
- Individual Performance

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Short-term incentive: Bottom-up approach

Personal Performance + Business Performance = Final Annual Bonus

Guaranteed Package \( \times \) On-target bonus %

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Short-term incentives: Levels of targets

**Stretch**
- Exceptional performance which is truly challenging in the context of the prevailing business.
- (E.g. 110% of Budget)

**On-target**
- Good performance with some “stretch”.
- (Meets budget)

**Threshold**
- Adequate or acceptable performance.
- (e.g. 90% x Budget)
**Bottom-up methods: Additive (Example)**

Weight:

- **Business Score**: 70% (70%)
- **Personal Score**: 30% (30%)

Final score =

\[
\text{% Business Score (0 - 200%)} \times \text{Business Weight (70%)} + \text{% Personal Score (0 - 200%)} \times \text{Personal Weight (30%)}
\]

Bonus % = Final Score \times \text{On-target %}

**Bonus = Bonus \% \times GP**
**Bottom-up methods: Multiplicative (Example)**

- Final score = Business Score (0 - 150%) \times Personal Score (0 – 150%)
- Bonus % = Final Score \times On-target %
- Bonus = Bonus % \times GP

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**Business score (Example)**

<table>
<thead>
<tr>
<th>Operating Profit</th>
<th>Levels</th>
<th>Business Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stretch</td>
<td>R220,000,000 (110% of budget)</td>
<td>200%</td>
</tr>
<tr>
<td>On-target</td>
<td>R200,000,000 (Budget)</td>
<td>100%</td>
</tr>
<tr>
<td>Threshold</td>
<td>R180,000,000 (90% of budget)</td>
<td>30%</td>
</tr>
<tr>
<td>&lt; Threshold</td>
<td></td>
<td>0%</td>
</tr>
</tbody>
</table>

*Linear interpolation between levels*

... so if operating profit = R 210 million, then Business Score = 150%
Performance score (Example)

<table>
<thead>
<tr>
<th>Score</th>
<th>Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>Exceptional performance</td>
<td>150%</td>
</tr>
<tr>
<td>4</td>
<td>Exceeds objectives</td>
<td>125%</td>
</tr>
<tr>
<td>3</td>
<td>Meets objectives</td>
<td>100%</td>
</tr>
<tr>
<td>2</td>
<td>Adequate performance</td>
<td>50%</td>
</tr>
<tr>
<td>1</td>
<td>Poor performance</td>
<td>0%</td>
</tr>
</tbody>
</table>

Linear interpolation between levels

... so if Personal Appraisal = 3.8 then Personal score = 120%
## On-target % by job grade

<table>
<thead>
<tr>
<th>Roles</th>
<th>Grades (Paterson)</th>
<th>On Target %</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO F3 - F5</td>
<td></td>
<td>60% - 100%</td>
</tr>
<tr>
<td>Executive Directors F2 - F3</td>
<td></td>
<td>40% - 50%</td>
</tr>
<tr>
<td>Other Exco E4 - F3</td>
<td></td>
<td>40% - 50%</td>
</tr>
<tr>
<td>Executive Management E5 - E1</td>
<td></td>
<td>20% - 40%</td>
</tr>
<tr>
<td>Management and Professional D5 - D1</td>
<td></td>
<td>12% - 20%</td>
</tr>
<tr>
<td>Supervisory and skilled C5 - C1</td>
<td></td>
<td>8% - 12%</td>
</tr>
<tr>
<td>Semi-skilled B5 - B1</td>
<td></td>
<td>6% - 8%</td>
</tr>
<tr>
<td>Unskilled A3 - A1</td>
<td></td>
<td>6% - 8%</td>
</tr>
</tbody>
</table>
Short-term incentive calculation

Job Grading / Job Evaluation → Job Grade → GP x On-target% [6% - 100%] → X → Personal Performance Score [0% - 150%] → X → Business Performance Score [0% - 200%] → = STI
Short-term incentives: Levels and schemes

CEO, Executives and Directors
Top-down or multiplicative bottom-up

Management and Skilled
Additive bottom-up

Junior / Semi-skilled / Bargaining Units
Only performance score
GP x On-target % x performance score
Summary: Top-down and bottom-up

Top-down (Pool)

Bottom-up
(GP x on-target x total score)

Multiplicative
Total Score = Business Score \times Performance Score

Additive
Total Score = \% Business Score + \% Performance Score

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Variable Remuneration
Long-term Incentives
Long-term Incentives ("LTI")

General

Long-term incentive payments are made to employees based on performance over a period of more than 1 year (usually 3 years).

These payments are either settled in:

- Equity (receive shares); or
- Cash (receive cash)
Types of long-term incentives

Conditional Cash
- Cash paid in three (3) years
- Subject to performance and/or continued employment

Shares
- Appreciation Types
  - Share Options
  - Share Appreciation Rights (Cash / Equity-settled)
- Full Share Type (Retention, Performance and Bonus)
  - Conditional Shares
  - Forfeitable Shares

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Types of share-based long term incentives

- **Options** – the right to buy a share at the original grant price many years later ... eg the right to buy a share now worth R 10 in 5 years time for the same R 10 value ... it may be worth much more then!

- **Share Appreciation Rights (SARs)** – similar to an Options – the right to receive cash or shares equal to the increase in value from grant date to exercise date (many years later). Cash-settled Share Appreciation Rights = “Phantom Options”

- **Conditional shares (CSPs)** – the right to receive a certain number of free shares on a future vesting date, depending on the fulfilment of vesting conditions.

- **Forfeitable shares (FSPs)** – free shares delivered on the award date, but forfeited if the participant resigns or doesn’t meet performance conditions.

- **Retention shares (RSPs)** - Conditional or Forfeitable shares with no company performance conditions, only continued employment required.

- **Performance shares (PSPs)** – Conditional or Forfeitable shares with company performance conditions.

- **Bonus shares (BSPs)** – conditional or forfeitable shares granted as part of the annual bonus, or to match the annual Cash bonus.
Long-term incentives (Shares and Dividends)

Example

Company X has a start-up capital of R150m, comprised of R100m from shareholders (“equity”) and R50m from bank (“debt”).

Company X issues R10m worth of shares at a price of R10 / share.

Company X makes R60m profit, and decides to distribute R20m in dividends. Dividends are declared at R2 / share (R20m ÷ 10m shares)

The Dividend Yield is thus $\frac{R2}{R10} = 20\%$

<table>
<thead>
<tr>
<th>Equity</th>
<th>R100m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>R50m</td>
</tr>
<tr>
<td>Plant and Equipment</td>
<td>R150m</td>
</tr>
</tbody>
</table>
**Long-term incentives: Time frame**

**Example**

2013
- Grant of award / grant letter / notice of award
- A “conditional promise”

2013 – 2016 (3 years)
- Vesting period in which performance conditions are tested
- “Wait and perform!”

2016
- Vesting / Delivery / Settlement Date
- Start of Exercise period for Options and Share Appreciation Rights (SARs)

2020
- Lapse Date for Options and SARs (must exercise by this date)
Long-term incentives: Vesting conditions for Full-share type awards

<table>
<thead>
<tr>
<th></th>
<th>Retention (R)</th>
<th>Performance (P)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conditional (C)</td>
<td>Conditional Retention Shares</td>
<td>Conditional Performance Shares</td>
</tr>
<tr>
<td>Received at the end</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(sometimes with</td>
<td></td>
<td></td>
</tr>
<tr>
<td>accumulated dividends)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forfeitable (F)</td>
<td>Forfeitable Retention Shares</td>
<td>Forfeitable Performance Shares</td>
</tr>
<tr>
<td>Granted in the</td>
<td>and</td>
<td></td>
</tr>
<tr>
<td>beginning, with</td>
<td>Bonus Shares</td>
<td></td>
</tr>
<tr>
<td>dividends</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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Long-term incentives
Earnings growth performance conditions

- **Total Shareholder Return “TSR”**
  (Share price growth and Dividend yield)

- **Absolute Performance**
  e.g. 15% p.a. or inflation + 9% p.a.

- **Relative Performance**
  e.g. vs median and upper quartile of peer group
Measuring the value of Long term incentives

- **Face value** – the value of the shares allocated to the award. Used to determine maximum potential dilution and award limits.
  
  \[ \text{Face value} = \text{number} \times \text{share price on the grant date} \]

- **Expected/Fair value** – the present value of the award, adjusted to reflect the nature of the award and the probability of vesting. Can be measured on grant or during the vesting period. Complex valuation techniques are used to determine this including Black and Scholes and Binomial tree methods for SARs and Options, and Monte Carlo methods for conditional shares. Don’t panic! There are simple “rules of thumb” that work well. Used for benchmarking and pay design (at grant), and for the Executive Balance Sheet (during vesting period).

- **Settlement value** – the value of the cash or shares actually delivered to the participant net of any payments, when the award vests or is exercised (Options/SARs).

- **Value accrued** – the actual value of the award on the date when the performance conditions are satisfied. Used in the Remuneration Table of Part II of the Remuneration Report to report the “single figure value” for annual remuneration.
**Long-term incentives**

**Face value vs Expected Value ("Rules of Thumb")**

Example - 100,000 shares at R10 a share. Face value = R1,000,000 (R10 x 100,000)

**Expected values ...**

- **Retention / Bonus - Forfeitable**
  
  \[
  = 100\% \times \text{Face Value}
  \]
  
  \[
  = R1,000,000
  \]

- **Retention / Bonus - Conditional**
  
  \[
  = 90\% \times \text{Face Value}
  \]
  
  \[
  = R1,000,000
  \]

- **Forfeitable - Performance**
  
  \[
  = 60\% \times \text{Face Value}
  \]
  
  \[
  = R600,000
  \]

- **Conditional - Performance**
  
  \[
  = 50\% \times \text{Face Value}
  \]
  
  \[
  = R500,000
  \]

- **Option / SAR**
  
  \[
  = 30\% \times \text{Face Value}
  \]
  
  \[
  = R300,000
  \]
### Long-term incentives calculation (Example)

CEO receives:
- R2,000,000 base pay
- 60% on-target STI
- 20,000 forfeitable retention shares
- 40,000 forfeitable performance shares
- 100,000 SARS

**LTI calculation:**

- 20,000 x R10 x 100% = R200,000
- 40,000 x R10 x 60% = R240,000
- 100,000 x R10 x 30% = R300,000*

Total LTI = R740,000

**Total On-target Package Calculation:**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>GP</td>
<td>R2,000,000</td>
</tr>
<tr>
<td>STI</td>
<td>R1,200,000 (60% x GP)</td>
</tr>
<tr>
<td>LTI</td>
<td>R740,000</td>
</tr>
<tr>
<td>Total On-target package</td>
<td>R3,940,000</td>
</tr>
</tbody>
</table>

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