Responsible Investing

Perspectives

Restricted share awards — all carrot, no stick

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Summary

- The introduction of restricted share awards (RSAs) to reward executives at UK companies looks appealing in theory, with a promised reduction in the overall levels of pay (quantum), closer alignment with shareholders and simplification of remuneration policies.
- Yet proposed RSA schemes have received a mixed reception from investors, with several drawing high levels of dissent or being withdrawn altogether.
- Our assessment is that, in practice, the current implementation of RSAs has achieved few of its intended goals and made pay structures worse in some cases.
- However, we do not think that all is lost and suggest several elements that we believe would make a positive contribution to future RSA plans. This style of scheme is developing quickly and final conclusions remain to be drawn.

Background

For several years, the battle lines have been drawn between investors and companies on executive remuneration. For every well-intentioned guideline that added to the increasing layers of existing pay guidance, concerns from companies regarding complexity and a cumbersome one-size-fits-all approach have grown louder and louder. Meanwhile, year-on-year, pay has continued to rise and both companies and investors have felt the wrath of the media and public sentiment.

The independent Executive Remuneration Working Group (ERWG) was established by the Investment Association (the trade body for UK investment managers) in late 2015 with the aim of assessing whether current pay structures are fit for purpose and what can be done to improve the situation. The ERWG produced several recommendations in its final report, including improvements to transparency and stakeholder engagement, but the most provocative was the endorsement in its report of RSAs.

This challenged decades of conventional thinking on pay in the UK, and came from a place of growing frustration with the status quo. Following these findings, several companies who were equally frustrated with their conventional pay schemes seized the opportunity to introduce the use of RSAs. But this enthusiasm bypassed many of their shareholders, unconvinced that such a dramatic shift from the norm was appropriate for all companies.

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What are RSAs?

Since the 1995 Greenbury Report, which was set up to examine concerns over rapidly increasing executive pay, there has been an expectation among investors that share awards should be granted with performance conditions attached. These determine the level of award that vests. As institutional investor guidance on pay reinforced this view, this resulted in most UK companies having a long-term incentive plan (LTIP) structure, where share awards are granted with pre-set financial targets measured over a three-year period, which are then released to participants in proportion to the level of performance achieved. The resulting one-size-fits-all LTIP model, and efforts by companies to adapt it to their own business model, was criticised by the ERWG as making pay more complex and less aligned to shareholders' experience.

> The Working Group believes that there is a need to recognize that the current LTIP system does not accommodate the variety of needs of the broad range of companies which operate within it. There needs to be more acknowledgement that all companies are different and will need different remuneration structures to recognize their particular business context.
>
> **Executive Remuneration Working Group Final Report, 2016**

The report suggested that new models should be explored—first in line being RSAs. With RSAs no pre-set performance conditions are applied. Instead, a set number of shares are simply awarded that vest after a fixed period of time. The intention is that by using RSAs to reward executives, the total value (quantum) of awards will be reduced by increasing the certainty of payout; there will be closer alignment with shareholders by simply tracking the share price rather than a range of metrics; and the structure will be simpler and therefore better understood by all.

Sound in theory, mixed results in practice

Despite support from the respected ERWG, the implementation of RSAs has been far from smooth. This Viewpoint assesses the 'first wave' of RSA proposals in the UK since the formation of the ERWG until the summer of 2017. This includes eight UK companies that introduced, or attempted to introduce, RSAs into their pay structures in 2016 and 2017. The majority have received a high level of dissent at the shareholder meeting, with some having been withdrawn prior to the meeting.

Table 1. Vote results for companies proposing RSAs

Company	Date	Outcome[1]
AVEVA (AVV)	Jul-17	Withdrawn
Aggreko (AGK)	Apr-17	Withdrawn
Kenmare Resources (KMR)	May-17	8% dissent
Kingfisher (KGF)	Jun-16	5% dissent
Pets at Home (PETS)	Jul-17	15% dissent
Premier Oil (PMO)	May-17	31% dissent
Royal Bank of Scotland (RBS)	May-17	4% dissent
Weir (WEIR)	Apr-16	73% dissent (failed)

[1] Note: "dissent" is defined as votes not in favor of a proposal (against & abstain)
Source: BMO Global Asset Management

Our view has long been that share awards with appropriate and challenging performance targets are the preferred way of rewarding executives in the long term. While we are keen to address the current challenges faced in executive pay, some of the drivers and justification provided by companies in the examples have led us to not support the RSA proposals at recent shareholder meetings.

Here we discuss our principal concerns with each argument proposed in favor of the RSA structure, and the criteria that we would like to see implemented in future proposals. We believe that while the initial introduction of RSAs had its challenges, all is not lost.

"RSAs lead to a reduction in quantum"

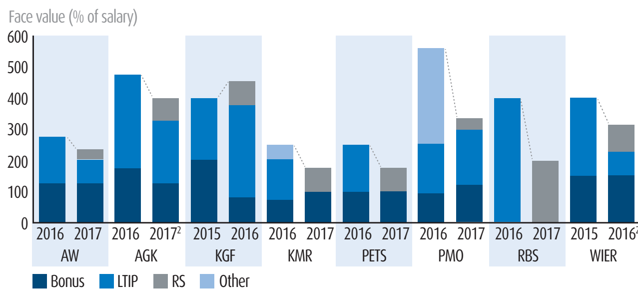
One of the main arguments put forward in favor of RSAs is that the size of granted awards can be substantially reduced, due to the increase in certainty that results from removal of multi-year financial targets.

Against a backdrop of continuing pressure to reduce the quantum of executive pay from a variety of stakeholders, the adoption of RSAs can be a more palatable method for companies to achieve this as it offers participants the quid pro quo of reducing maximum potential payouts but also increasing the certainty of a payout occurring.

> Introducing a restricted share plan addresses the continuing debate surrounding overall levels of Executive remuneration head on, as [it]... would reduce the maximum value of our Executive Directors' long-term incentive opportunity by 40% of salary in face value terms.
>
> **AVEVA plc, Annual Report 2017**

An examination across our sample confirms that in nearly every instance there was a decline in the face value of potential total variable pay. The average decrease was 23%. When examined on a like-for-like basis (the value of new RSAs against the value of sacrificed LTIP awards) this discount is 46%.

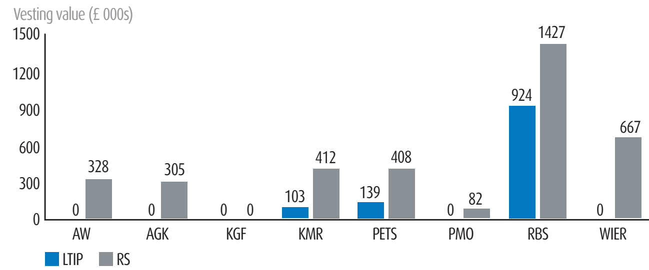
Graph 1. Old vs new — face value of variable pay at grant



[2] Either rejected or withdrawn
Source: BMO Global Asset Management

However, despite a decline in the headline rate of pay, the actual payout executives received would be higher under the RSA regime. To illustrate this point, we look at how a switch to RSAs influences the value of awards when they actually pay out, rather than their face value at grant which tells a different story. We have conducted a hypothetical exercise comparing the vesting of actual LTIP awards granted in 2014 for companies within our sample against simulated RSAs over the same three-year period. This was calculated by applying the applicable like-for-like discount on grant size to each case.

Graph 2. Value of actual 2014 LTIP vesting vs. simulated RSA



Note: KMR calculation not provided as awards are due to vest in October '17.
Source: BMO Global Asset Management

As demonstrated, even when the like-for-like discount is applied, there is a substantial increase in the resulting payout for companies in all instances. The lack of vesting under the actual 2014 LTIP awards was due to the companies not meeting set performance conditions. By comparison, the simulated RSA awards do not take performance into account outside of movements in the share price, hence the higher payouts.

Secondly, we note that when the realities of how participants value awards are considered, there is no real reduction in quantum to compensate for the significantly increased certainty of payout. It is well established that participants already apply a substantial discount to the present value of equity awards to, at best, half of their face value at grant due to the multi-year performance targets attached and the requirement to wait for up to five years before they are released.

> Executives typically discount at around 30% per annum — this is the economics of 'eat, drink and be merry, for tomorrow we may die.'
>
> **PwC, Making executive pay work. The psychology of incentives, 2012**

At most, the current like-for-like average discount rate of 46% matches what participants were already assuming to be the case, meaning that no real reduction has been achieved.

Finally it is worth observing that, among our sample, the adoption of RSAs generally occurred at a time when the share price of the companies in question were relatively depressed. Our analysis has shown that the eight companies' share price all underperformed the FTSE All-Share benchmark index since the start of 2014. In the case of Premier Oil and Kenmare Resources — by more than 80 percentage points.

Under the UK pay regime, the size of awards is calculated using an intended face value, normally expressed as a percentage of salary. At the time of grant this figure is then divided by the share price in order to determine the number of share awards allocated. When the share price is at historically low levels this can lead to a substantial increase in the number of awards actually being granted, all being at a time when the value of each share has substantial potential up-side.

Table 2. Illustration of share price influence on number of awards granted at Premier Oil

Date	Face Value	Share price	Number of awards
27-Feb-14	£442,000	£3.03	145,888
27-Feb-15	£442,000	£1.63 **(-46%)**	271,165 **(+86%)**

Source: BMO Global Asset Management

Established best practice dictates that if there has been a substantial decrease in share price then companies should consider granting lower awards to reflect the increased number of awards; however, this logic does not appear to have been applied in any instances across our sample.

"RSAs create better alignment with shareholders"

An argument that companies often make when diverging from the traditional LTIP structure is that it frees them from the challenge of setting three-year targets.

> The restricted share alternative was seen as a helpful option by companies who, due to the nature of their business, find it difficult to set meaningful long-term targets under an LTIP structure.
>
> **Executive Remuneration Working Group Final Report, 2016**

This can be due to several different reasons: future uncertainty within the market, lack of internal projections or just an inability to distill complex company performance down into a few metrics. Companies argue that targets set prior to grant can become misaligned with the state of business by two years into the three-year life of awards, making them no longer effective at incentivising or rewarding the delivery of results. By contrast, the adoption of restricted shares is appealing as the challenge of setting such targets is avoided altogether, with shareholder alignment achieved not through focusing on performance metrics but rather aligning with outcomes reflected in movements in the share price.

This begs the question, are the outcomes of using RSAs more aligned with shareholders' experience than conventional LTIPs? As already shown in Graph 2, the level of payout is substantially greater for RSAs across the board when compared to conventional LTIPs in case of lower than expected company performance. In the table below we put this with the context of the shareholder experience (measured by share price performance) and relative company performance (using industry index performance) over that period.

Table 3. Vesting values and shareholder alignment

	2014 LTIP vested value ('000s)	Simulated 2014 RSA value ('000s)	Share price performance over review period (%)	FTSE Industry Index performance (%)
AVEVA	£0	£328	4.40	80.90
Aggreko	£0	£305	-45.60	16.70
Kenmare Resources	£103	£412	4.10	-11.90
Kingfisher	£139	£408	-21.70	-11.90
Pets at Home	£0	£82	-75.80	-20.00
Premier Oil	£924	£1,427	-5.60	-26.60
Royal Bank of Scotland	£0	£67	-27.10	18.20

Source: BMO Global Asset Management

When compared to both absolute and relative share price performance, most of the companies in our sample have performed poorly over the three years examined. Under the basic principle that only performance should be rewarded, it therefore seems counter-intuitive that by switching to RSAs, and the substantial increase in payout that results, this is increasing alignment with shareholders, when they have experienced only pain.

It should also be noted that although RSAs are structured to have their value closely track movements in the share price, this does not mean that it necessarily tracks with the performance of management. A very substantial proportion of long-term share price performance is driven by overall market movement. RSAs will therefore reward or penalize executives for factors entirely outside their control. Confidence in management and the delivery of financial results do influence movements in the share price, but so do many other factors such as economic outlook, currency movements and M&A speculation, all of which are beyond the control of management. Likewise, there can be instances in an economic downcycle where the efforts and positive results of management do little to counteract the overwhelming pessimism of the market.

"RSAs are simpler"

The final part of the case for restricted shares is that with no performance tests attached and only time restrictions applying, they are themselves simple and, in turn, have a simplifying effect on remuneration policies. There has been a call for greater simplification over recent years in response to the increasingly complex remuneration structures found at blue-chip companies. Following years of additions and tweaking the resulting arrangements are often so complicated that they are not clearly understood by either participants or investors, making them much less effective at incentivizing performance.

Out of all of the arguments presented, we consider that this one is the strongest. However, as has been the case at a number of the companies considered, RSAs have been added into the basket of existing plans that make up total pay, alongside an annual bonus plan and conventional performance based LTIP, rather than in replacement. In turn, this made these policies more complicated, rather than less, which somewhat dilutes the impact that RSAs can offer.

Conclusion and next steps

The above analysis points to several potential pitfalls for companies introducing RSA awards, including increased complexity and higher pay for poor performance. We have generally not been supportive of the RSA awards introduced to date. However, we are keeping an open mind to future proposals from companies and as our thought process has developed, believe the following features will make the adoption of RSA awards more palatable:

- **A credible Remuneration Committee:** Before the details of the scheme are considered, given the nature of the awards we will consider if the behaviour of the committee can be clearly shown to benefit shareholders.
- **A tangible performance underpin:** Financial reward for failure must be avoided at listed companies to stop the reputation of the market worsening. The remuneration committee needs to avoid the situation where directors receive substantial payouts on RSA awards when shareholders have suffered losses over the same period. The addition of a performance underpin should be introduced to prevent this situation from occurring. We accept that this underpin is a form of performance condition and therefore counter to the philosophy of RSAs. However, we would expect participating directors to understand the potential reputational damage that could be inflicted by RSA awards paying out in full to board members that have not delivered share price growth. An underpin that uses a relative total shareholder return (TSR) performance comparator group could be a way of rewarding performance against peers and best capture true performance during economic cycles. With reference to Table 3, the payouts for RSAs in many of these situations where we argue they would be unjustified would be avoided with this feature in place. We would also consider underpins linked to the strategic direction or financial health of the company.
- **Remuneration Committee discretion:** We value the ability of the remuneration committees to reduce awards if the shareholder experience has been poor. This is all the more important given that share prices, and therefore the value of RSAs, can often be beyond the control of management.
- **Reduction in award size:** To take account of the increased certainty of vesting, we consider a minimum reduction of 50% in award size when compared to current long-term incentive awards to be appropriate. At the same time this should not be seen as a ceiling, with greater discounts encouraged to counter-balance less stringent requirements elsewhere.
- **Future award size:** To avoid a situation where the company's share price is significantly depressed and there is the possibility that this could result in an unusually large number of shares being awarded, the remuneration committee should be prepared to further reduce the award size where appropriate.
- **Holding periods of at least five years:** To encourage the long-term holding of company shares, we consider a five-year holding period to be an appropriate starting point. We believe that this will reduce temptation for short-term financial gain.
- **Post retirement holding:** To encourage long-term values to be instilled in a director's minds, we are supportive of a percentage of the individual's shareholding to be held beyond retirement for at least two years.
- **Clawback/malus:** We support the principle of clawback and malus as defined by the Investment Association and consider it appropriate for these provisions to potentially apply to RSA awards.

Many of the above features are already mainstream expectations for traditional long-term incentive plans and we are keen to see these continue being used. We will need to carefully consider the specifics of the situation for companies going forward so that directors can be sufficiently held to account for poor performance.

The debate continues to evolve and be relevant as we have already seen the next generation of RSA proposals coming through. From early indications of these we are supportive of the direction of travel (with some of our recommendations included in recent proposals at **Pets at Home** and **Hargreaves Lansdown**), but we remain wary of the unintended consequences and potential misuse of the structure as outlined in this paper.

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