David Craddock Consultancy Services

A Presentation
by
David Craddock
for
The ESOP Centre and STEP

to be held at The Old Government House Hotel,
Ann's Place, St Peter Port ,
Guernsey, Channel Islands

on Friday, 30th November, 2018

General Economic Environment

<u>Key Economic Indicators with Headline Commentary</u>

- The increase in wages in the UK in the 12 month period to October, 2018 is 3.2% compared with the increase in the Consumer Price Index in the same 12-month period to October, 2018 of 2.4%.

<u>Commentary</u>: The wage rate rise is sensitive for the Bank of England who may increase interest rates in response over and above the ¼% per annum already agreed for each of the next 3 years.

- The unemployment rate in the UK as at 24th November, 2018 is 4.1% compared with 3.7% in the USA, 3.4% in Germany, 9.3% in France and 10.9% in Spain.

<u>Commentary</u>: The conundrum for UK business is in its direction of focus post-Brexit, looking west to a revitalised US economy or east to the EU with labour challenges in France and migrant assimilation difficulties in Germany .

- The Gross Domestic Product for the UK has risen by 1.5%% over the last year compared with 3.0% for the USA, 1.2% for Germany, 1.5% for France and 2.5% for Spain.

<u>Commentary</u>: The key question is whether the process of deglobalisation, with companies coming home, as evidenced in the USA, will be replicated in the UK or will Brexit scare them off into other European centres, e.g. Frankfurt or Paris?

General Economic Environment

<u>The Impact on the Workplace and Employee Share Ownership</u>

- The productivity per worker in the UK has risen over the last 12 months whereas the productivity per hour has fallen. This can only be explained by concluding that UK workers must be working longer hours. It is interesting to explore the implications that longer time in the workplace has on employee share ownership initiatives.
- With longer time in the workplace, employee share schemes can contribute as follows:

➢ With higher staff retention levels: John Lewis Partnership at 21% annual turnover compared with 38% to 43% in the sector.

➢ With reduced absenteeism levels: The Peel and Wilson Study 1991 evidenced a reduction in absenteeism of between 8% and 13%.

➢ With enhanced job satisfaction levels: The Davies Study 2011 demonstrating the sense of well-being in employee-controlled companies through long-term objective-setting.

➢ With improvement in business performance: The Matrix Study 2010 demonstrated higher productivity in employee share ownership companies.

➢ With increased economic resilience: The Lampel Report 2010 showed the resolve of employee share ownership companies to emerge from recession faster.

➢ With enhanced business innovation: The Burns Report 2006 captured 44% of respondent companies believing that employee shares involvement spurs innovation.

General Economic Environment

The Impact of Brexit on Economics and Employee Share Ownership Initiatives

- The main observation is that as well as moving away from favourable economic alliances in Europe, the UK's main trading partner, into less favourable economic conditions, uncertainty is created both before March 2019 with the political gridlock and after March, 2019 as businesses wait to see the outcome on key economic parameters.
- The main economic consequence of uncertainty in economic history is deflation, specifically caused by waiting to see outcomes on inflation, interest rates and employment levels. It is in the waiting, though, where the self-fulfilling prophecy comes into realisation and deflation degenerates into recession.
- The time lag for response to a stimulation package in the UK in those conditions is long, to be contrasted with a favourable economic initiative in the USA, such as the recent tax cuts, where the time lag for positive response is typically only one to three months! Time lay also impacts through the time-period required to negotiate trade deals while at the same time walking away from EU initiatives such as the recently negotiated free trade deal with Japan.
- The impact on the workplace in, say agriculture and hospitality, could cause understaffing, resulting in demand-pull inflation as demand exceeds supply or cost-push inflation as UK workers demand high wages to undertake the same work. Lower exchange rates are already enhancing the profit margins of export companies and, ironically, globalisation could save the day for the UK economy.

General Economic Environment

The Impact of Brexit on Employee Share Ownership: In the UK

- For profit-sharing schemes, if profits of UK companies are reduced then the employee profit share pot available for distribution will be reduced. Maybe the longer hours that employees are working will compensate and profits will not suffer.
- For saving-related share option schemes, employees may continue to save at the same levels as the accumulated cash saving is always the fall back position if the share price fails to perform. Is this the time to see a resurgence of Sharesave?
- For partnership shares, employees may not want to take the risk. Companies should consider majoring on the profit-sharing module of the Share Incentive Plan or possibly ensuring that the matching shares module is in place if they wish to uphold the strength of the partnership shares module.
- Variable reward could come back on to the agenda with a renewed vigour, possibly through a new profit-related pay initiative, as a progressive approach to avoid unemployment. Variable reward works best, according to the evidence, when it contains a meaningful element of reward through shares.
- If employees are working longer hours then there may be a move to personal performance conditions rather than reliance on corporate performance targets in circumstances where those targets cannot be met but the commitment from the workforce at all levels is stronger than ever.

General Economic Environment

<u>The Impact of Brexit on Employee Share Ownership: Beyond the UK</u>

- The current decline in sterling triggered by the 2016 referendum decision has heightened the exposure in international employee share schemes to exchange rate movements, not just for savings-related schemes but for any market option pricing model, where saving is in a foreign currency or a market option price has to be paid in a currency other than the participant’s home currency. The benefit to the employees could go either way depending on the swing, where they are resident and where the issuing company is resident.
- The movement of the UK away from any leadership role in the EU will undermine the momentum for the development of employee share ownership in the EU countries. The perennial question will continue to surface: why do German companies not embrace employee share ownership more readily? Part of the answer lies in the influence of major German families in the control of German companies. The leadership role to develop employee share ownership in the EU will fall in France which has its own esteemed history in the subject.
- The contribution of employee share ownership in a macro-economic environment where there is turmoil with Brexit, with tariffs wars between the USA and China and with the quantum impact of the potential reversal of globalization is to continue to bring stability to the micro-economic environment. This is done by continuing to introduce share scheme motivation and incentive as part of a business ethic that embraces wider employee participation in its various manifestations.

Current State of the Long-Term Incentive Plan

The Trends from this 2018 Reporting Season in FTSE100 Companies

- The most popular model for executive incentive continues to be the Performance Share Plan, operating of course in the guise of the LTIP structure, reinforcing the trend of some 15 years now away from traditional share options and thereby avoiding the potential damage to the scheme of having to deal with underwater options.
- The Restricted Share Plan does appear to have increased prominence but not at the senior executive level. Instead, it appears to have captured a position for the support management team for the senior executive level, i.e. the executives from the strata that aspires to the senior executive level.
- The Restricted Share Plan is also used for one-off awards to augment an existing package or to incentivise a senior employee in "an odd-ball job" that is outside the main executive reporting structure, say for example a logistics specialist recruited to address a specialist area of logistics management.
- The Deferred Bonus Plan also has a profile within a combination of schemes that might typically make up an executive package. The use of the Deferred Bonus Plan is a response to market disapproval of reward not linked to meaningful performance and the need to literally defer some element of the reward.
- The Financial Reporting Council through the Corporate Governance Code has encouraged a pattern towards executives maintaining shareholdings for typically two, maybe three years into retirement.
- The LTIP arrangements are supported by a number of performance measures and not limited to a single measure, in a resolve to produce a balanced incentive that seeks to maximise business returns.

A Case Study LTIPS in a FTSE100 Company with various plans in place

<u>The Incentive Bonus Share Plan Model</u>

- The Remuneration Committee assesses the financial performance of the company and the individual performance of each scheme participant.
- The Remuneration Committee determines the total bonus entitlement which includes the cash payment under the annual cash bonus scheme and the share allocation under this share scheme.
- The shares are allocated through a grant of option to each scheme participant over shares held in the trust.
- The share price is set at the date of grant and is calculated by dividing the local currency gross bonus amount that is available for the share allocation by the average closing mid-market price of the share over three consecutive dealing days selected by the Remuneration Committee.
- The vesting date is the third anniversary of the date of grant.
- The opportunity to exercise is over a set period of six months.
- The employee required payment is nil.

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The Performance Share Plan Model

- The Remuneration Committee decides upon the share allocation, based upon an agreed multiple of salary, and minutes the decision to grant the options.
- The Remuneration Committee reviews and decides upon the performance condition, notably in comparison with a comparator group.
- The shares are allocated through a grant of option to each scheme participant over shares held in the trust.
- The share price is set at the date of grant and is calculated by dividing the local currency gross salary amount that is available for the share allocation by the middle market quotation of the shares on the dealing day before the date of grant or the average of the middle market quotations during a period determined by the Remuneration Committee not exceeding the three dealing days ending with the dealing day before the date of grant.
- The Total Shareholder Return calculations are independently verified.
- The vesting date is the third anniversary of the date of grant.
- The opportunity to exercise is over a set period of six months.
- The employee required payment is nil.

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The Retention Share Plan Model (Version One)

- The Remuneration Committee decides upon the share allocation, based upon whatever basis is agreed by the board.
- The shares are allocated through a grant of option to each scheme participant over shares held in the trust.
- The first vesting date for 50% of the shares over which the options have been granted is the first anniversary of the date of grant or such later date as the Remuneration Committee determines.
- The opportunity to exercise is over a set period of six months.
- The employee required payment is nil.
- The second vesting date for the remaining 50% of the shares over which the options have been granted is the second anniversary of the date of grant or such later date as the Remuneration Committee determines.
- The opportunity to exercise is over a set period of six months.
- The employee required payment is nil.

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The Retention Share Plan Model (Version Two)

- The Remuneration Committee decides upon the share allocation, based upon whatever basis is agreed by the board.
- The shares are allocated through a grant of options to each scheme participant over shares held in the trust.
- The vesting date for 100% of the shares over which the options have been granted is the second anniversary of the date of grant or such later date as the Remuneration Committee determines.
- The shares must be held by the scheme participants for a minimum period of two years as the minimum holding period before sale unless an event arises, for example: a takeover.

A Case Study LTIPS in a FTSE100 Company with various plans in place

The Matching Share Plan Model

- The Remuneration Committee decides upon the share allocation, based upon whatever basis is agreed by the board.
- The shares are allocated through a grant of options to each scheme participant over shares held in the trust on the condition that the scheme participant takes beneficial ownership of an equivalent number of shares through their own purchase, a matching arrangement either way depending upon the structuring of the scheme rules.
- The purchase by the scheme participant is funded either by the scheme participant's own resources or by a loan arrangement from the company, repayable through the ultimate sale of some of the shares that are made available through the scheme.
- The vesting date for 100% of the shares over which the options have been granted is the third anniversary of the date of grant or such later date as the Remuneration Committee determines.
- The shares must be held by the scheme participants for a minimum period of two years as the minimum holding period before sale unless an event arises, for example: a takeover.

The Role of the Channel Islands in the Current Economic Climate

- The role of the Channel Islands is to offer stability in supporting businesses from the UK and elsewhere through a combination of the political structures that prevail within these islands, the reputation for sound financial management and access from Europe for businesses wherever they are operating on the continent.

- If there is an impact on the Channel Islands through a downturn in UK trade, the Channel Islands may be able to rebound quicker with a shorter time lag because of its global outlook and network and because of its particular mix of business in asset management, private equity and real estate.

- The Channel Islands are outside the EU. However, they are members of the customs union and the single market. The question is: how is this affected by the negotiations between the UK and the EU? On financial regulation, if they are treated as having third country status then do they retain that status and maintain passporting rights?

- Whatever the outcome of the Brexit talks, the Channel Islands will continue to be crown dependencies with a special relationship with the UK and ties that culturally will over time evolve into working together to explore new opportunities within this changing and sometimes surprising economic and political landscape.

David
Craddock
Consultancy
Services

Employee Share Schemes

All Best Wishes For Your Business Initiative

From David Craddock
Consultant, Lecturer, Author
and Specialist in Employee Share Schemes and
Reward Management,
Management Buyouts, Share Valuation and
Investment Education

David Craddock Consultancy Services
Telephone: 01782 519925
Mobile Phone: 07831 572615
E-mail: d.craddock@dcconsultancyservices.com
www.DavidCraddock.com
www.TimeForInvestment.com