HaRe Group newsletter: 17 July 2003

Subject: Microsoft's incentive sea change

As reported in The Age last Saturday, Microsoft has sent a shock through the technology sector by announcing the replacement of its employee stock option plan.

This long term incentive (LTI) has been a huge generator of employee wealth, so why the radical change? It seems that reward inequity was a major concern - about 90% of Microsoft's outstanding options are currently worthless, which creates a great disparity between new employees and their longer-serving peers. The option plan has lost its strength in attracting and retaining quality people.

While the technology-driven boom continued, stock options provided US companies with a device to reduce their reported employments costs and their tax liability, while giving very generous rewards to employees. Now, many option plans cannot deliver the high rewards of the past - also, US companies will be forced to expense option values in their accounts. (ASIC expects the same from Australian companies in their 2003 accounts).

Microsoft's new LTI will provide progressive grants of "restricted stock" where employees will receive a share allocation over five years. (Senior executive allocations will depend on performance hurdles, such as growth in customers). This approach provides a more direct link to the fortunes of shareholders, since the value of the employee's LTI depends on the full movement in the share price. (Underwater options don't require a reward reduction).

In Australia, company boards have the same imperative to attract and retain quality executives, and performance-based rewards have become an integral part of this imperative. Given the share market downturn and the need to restore value to LTI plans, a performance (restricted) share plan may be a sound alternative. One design may look like:

- A grant of a block of, say, 10,000 shares, held in trust, vesting annually over 5 years (eg. 2000 each year on the anniversary of allocation);
- Annual vesting depends on performance targets based on the total shareholder return (TSR) of peer companies, and value-based measures that monitor business drivers;
- Vesting also depends on continuing employment.

To be a meaningful incentive, the potential value of this LTI must be significant in proportion to the "come-to-work" fixed remuneration package. This "incentive weight" promotes a strong focus on wealth creation, as well as the possibility of losing wealth if performance expectations are not met.

Alternatively, for the company with a high "investment growth" strategy, a discount-priced option plan may still be appropriate. In this LTI, share options would be issued with a low exercise price, with incentive weight and vesting conditions similar to the above performance share plan.

In any situation, company executives should be focusing on the drivers of long-term business success. If this success is realised, then it is reasonable for the executives to share in this success. A well designed equity-based reward program (such as those outlined above) can be very effective in attracting and retaining the quality people who will be instrumental in delivering long-term business success.

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