

Global equity effectiveness

A new perspective



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Today, equity compensation has become an integral part of executive and employee compensation across the globe. As companies continue to widely use equity compensation, they are increasingly finding that being competitive is not enough. They have begun to look beyond the market requirements for plan design and focus on measuring the effectiveness of these plans. This article will help to build an understanding of the return on investment provided by equity plans from the perspective of key constituencies: shareholders, the company and participants. It will also discuss how companies can maximize equity effectiveness by maximizing the value provided to each of these constituencies.

Defining equity effectiveness

While there are several ways to look at this return on investment, this article suggests a simple approach: equity effectiveness. Equity effectiveness is the point of equilibrium in share utilization that balances the efficiency of the plan (i.e., the cost from the perspective of tax, accounting, administration and dilution) with its motivational value. Optimum utilization occurs when the return (motivational impact on results) exceeds the cost.

Some perspective

The practice of making broad-based equity grants to a global workforce began with United States technology firms. Initially, these companies made equity grants to their non-U.S. workforce from "vanilla" stock option plans that had been developed for their U.S. employees.

This approach was driven by a desire to treat all employees as part of a global workforce. In most cases, local practices were not a primary driver in determining long-term incentive practices. Instead, U.S.-based companies drove competitive practices by making equity grants, regardless of local practices. Few companies at that time considered the efficiency of their equity vehicles. The bull market of the 1990s drove the motivational value of stock option gains, and the favorable accounting treatment afforded stock options under Accounting for Stock Issued to Employees Option 25 (APB 25) helped to minimize concerns about cost. Under APB 25, companies were not required to expense most forms of stock options. As a result, the participant recognized income if the stock price went up. The company received a corresponding tax deduction. However, there was no cost impact on the bottom line. Among multinational companies, there was generally little concern if these plans resulted in the loss of favorable local tax treatments, loss of savings or even non-compliance.

In the years following the 2001-2002 recession, optimization became more difficult. Underwater stock options began to tarnish equity grants for many participants. Economic pressure along with changes in expensing requirements under Financial Accounting Statement 123 (FAS 123) drove increased diversification in the use of equity plans. FAS 123, later FAS 123R and now called Financial Accounting Standards Board Accounting Standards Codification Topic 718 (FASB ASC Topic 718), required that companies expense all forms of equity compensation, including stock options.

Changes in plan design were felt across many participation levels and geographies. Still, the solutions to re-establishing equilibrium were fairly simple. U.S.-based firms decreased broad-based equity grants to manage expense and annual burn rates. Companies also moved away from a sole reliance on stock options. Restricted stock and restricted stock units (RSUs) were offered to more levels of employees, with higher conversion ratios for lower tiers of employees. Options were often granted in tandem with restricted stock/units (National Association 2007).

Companies also began to move away from a one-size-fits-all approach to global equity grant size. Most of the companies grouped countries with similar competitive values into regions to provide common award levels.

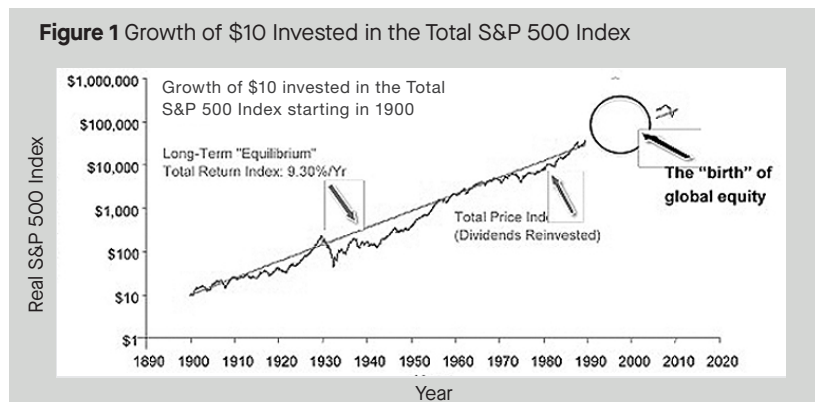
The new reality

This new level of equilibrium lasted until the 2008-2009 recession. This period's effect on equity compensation was profound.

Some have looked back at equity markets to gain a historical perspective. Based on this perspective, it is surprising that the impact of economic markets on equity compensation plans was not anticipated.

Taking a long-term perspective of equity markets, the period between 1990 and 2000 stands out as an anomaly, a prolonged period where stock prices generally rose and continuously remained above the Long-Term "Equilibrium" Total Return Index. (See Figure 1.) It is important to note that is also the period where the principles of equity compensation, as they are known today, were founded. These principles guided most aspects of award structure, including the size, timing, valuation and terms of grants. Today, companies are still using many of the design principles that were established during this period.

The result of this economic turmoil is that there are now major disconnects between conventional wisdom and a new reality.

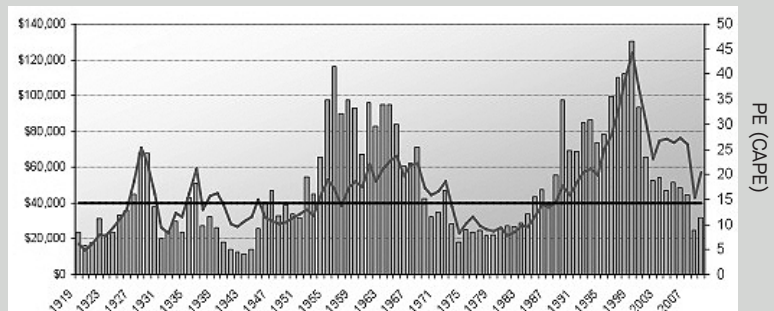


Consulting

- **Valuation:** Historically, companies have used option pricing models, such as Black-Scholes and Binomial models to plan, establish and communicate grant values. Now, market volatility has called into question the accuracy of these option pricing models. For example, does a stock option granted in March 2009 with a stock price of \$4 have less value than an option granted in March 2012 at \$20? Conventional wisdom (and Black-Scholes) would say yes, but employees would generally disagree. The rebound in the stock market has confirmed employee perceptions — the awards with the lower grant price generally proved to be more valuable.
- **Survey data:** For years, companies have used surveys as a reliable source for equity compensation comparison and planning. However, companies are finding that volatility in geographic markets can cause significant swings in stock price over short periods of time. They are also finding that data can significantly vary across survey sources. So while conventional wisdom says that survey data is highly reliable, companies today are finding that the timing of data collection and differences in survey methodologies can produce results that require greater interpretation by the user in converting data into usable information.
- **Motivation:** Equity awards will motivate employees to produce results that lead to increased shareholder value. Conventional wisdom says that if you provide employees with equity grants that vest over time, the employees will be motivated to perform in a way that will serve to increase stock prices. However, major research studies have shown that equity grants tend to have a reciprocal effect. Reciprocity occurs at the payoff from a grant, which is often viewed as a gift that participants feel compelled to repay by working harder. So while conventional wisdom says that the opportunity for future value that an equity grant provides can motivate employees, studies show that this motivation is more likely to occur when the participant actually recognizes value (Cappelli and Conyon 2011).
- **Long-term value:** Stock compensation provides value over the long run. Conventional wisdom says that value is realized over long periods of time. Because market returns exhibit cyclical periods of bull and bear markets and corresponding over-valued and under-valued conditions, the new reality shows that the timing of when shares are sold can be everything in determining wealth creation (Malagoli and Young 2010). (See Figure 2.)

This has also resulted in continued discontent among the major constituencies of equity compensation programs:

Figure 2 15-Year Holding Period Returns



- For shareholders, dissatisfaction remains high as concerns about risk, dilution and ownership have fueled broad-ranging governance initiatives and continued shareholder activism.
- For employers, dissatisfaction remains high, fueled by the increasing cost and time commitment of administration, financial reporting, compliance and disclosure without clear evidence of the return on this investment.
- For employees, the motivational value remains low due to options that remain underwater, line of sight concerns and the reciprocity effect of equity awards (Cappelli and Conyon 2011).

A new perspective

In the design and delivery of equity programs, companies have largely focused on issues related to equity efficiency. This means that they have spent most of their time on issues related to the tax, accounting, compliance and the operational aspects of equity compensation. In many ways, an advanced state of technical proficiency has been reached. This logical approach is characteristic of left-brain thinking.

However, companies have focused much less attention on the psychology of motivation. But, while companies tend to base their actions on advanced left-brain thinking, employees are more likely to think with the right side of the brain. They are more holistically focused on value rather than cost. For employees, value is driven by their perceptions and perceptions are their reality. For example, a company may grant stock options to two employees. If the first employee's experience has been based on options that have gone underwater, that person may associate a low perceived value to the grant. However, if the second employee has had positive experiences with options that have paid off in the money, that person's perceived value will be high. As a result, a company can make the same option grant to two employees in the same position with each assigning a different value to the grant. This can be occurring in different ways across the organization. To compound the problem, the company is usually unaware that differences in perceived value exist. The implication is clear — to achieve true equity effectiveness, a company must think with both sides of the brain.

Characteristics of equity vehicles

Table 1 shows how different equity vehicles possess different characteristics. To develop their right-brain thinking, companies must understand what shapes perceived value and how those perceptions can vary across different equity vehicles. The article will next focus on three key areas that are primary determinants of perceived value:

- Personal biases and experiences
- Generational differences
- Global cultures.

Behavioral finance and perceptions

Behavior finance uses psychology to explain anomalies in the equity market by focusing on how the personal biases and experiences of an individual impacts their decisions related to the stock market, money management and asset valuation (Thaler 1993; Thaler and Sunstein 2008; Camerer et al. 2003).

The three main themes in behavioral finance are:

- People often make decisions based on rules of thumb, not rational analysis.
- The way a problem is presented will affect the decision a person makes on how to act.
- There are behavioral explanations for observed market outcomes that are contrary to rational expectations and market efficiency.

While a detailed discussion of behavioral economics and equity compensation goes beyond the scope of this article, those factors can provide some explanations for the suboptimal results of some equity programs. Table 2, though not meant to be comprehensive, shows some examples of behavioral economics at work.

Table 1 Characteristics of Equity Vehicles		
Equity vehicle	Characteristics	Pros/Cons
Stock Options	<ul style="list-style-type: none"> • Greater upside based on number of shares and appreciation potential • Greater downside; can go underwater • Greater flexibility in design; participant can time when options are exercised 	<ul style="list-style-type: none"> • High risk/reward profile works best in situations when participants are comfortable with uncertainty and are less effective where participants are risk adverse • Relationship of vesting date and term works best with long-term perspective and less effective with short-term orientation
Service-Based Restricted Stock/ Units	<ul style="list-style-type: none"> • Lower upside since there are usually fewer shares than options • Lower downside; cannot go underwater • Less flexible; fixed payment date 	<ul style="list-style-type: none"> • Lower risk/reward profile works best in situations when participants are more risk adverse and less comfortable with uncertainty • Fixed vesting/payment date works best in near-term situations
Performance Shares	<ul style="list-style-type: none"> • Risk/reward profile varies based on leverage • High leverage (aggressive design) can produce risk/reward profile similar to options • Low leverage (conservative design) can produce risk/reward profile similar to restricted stock/units • Moderate leverage can fall on the spectrum between high and low 	<ul style="list-style-type: none"> • Leverage can be tailored to desired profile • Potential for greater line of sight • Greater complexity, especially regarding setting/ communicating metrics

Generational differences

Generational differences manifest themselves in several ways, including how individuals view their work, workplace, career and correspondingly, their compensation. There is variation in the nature of intrinsic rewards each generation considers important (Camerer et al.). This manifests itself in many ways, for example:

- Baby Boomers have generally strived to build their career within a single firm or single career track, while Generation X thinks more in terms of portable careers. Generation Y looks more holistically at career to include current and future opportunity, quality of work and life experience.
- Baby Boomers rarely share salary information or bonus with their peers. Generation X may share information anonymously over social networks. In contrast, it is common for Generation Y workers to call or email friends to share details upon receiving a raise.

Media focus may cause many to think of generational differences as a U.S. phenomenon; however, as Table 3 shows, generational differences exist across the globe.

These differences in generational characteristics have clear implications on equity compensation programs, as shown in Table 4.

Table 2 Behavioral economics at work		
Principal	Employee behaviors	Impact on perceptions
Mental accounting	How much will an employee discount the value of an option until it is vested?	People frame assets as belonging to current or future income and associate value accordingly.
Hyperbolic discounting	Which would an employee perceive as more valuable – a \$10,000 restricted stock grant that vests in two years or a \$25,000 grant that vests in four years?	Given two awards, people will prefer the one that arrives sooner and discount the one that arrives later.
Loss aversion	Why will an employee exercise an option as soon as it vests, if it is in the money, even if there is not an immediate need for the cash?	People have a strong tendency to prefer avoiding losses to acquiring gains.
Endowment effect	Why will an employee hold a large number of worthless stock options rather than exchange them for a smaller number of new in-the-money options?	People place a higher value on objects that they own and a lower value on those they do not.

Behavior and global culture

A country’s culture is the underlying value framework that guides an individual’s behavior. This culture is reflected in the perceptions, social interactions and business interactions and guides the selection of appropriate responses in social and business situations.

Consulting

Some countries, such as India, China, the United States and Russia, are multicultural. These countries have several subcultures. Many countries, like the U.K., France, Germany, Colombia and Peru, are monocultural. They would tend to have a single dominant culture. Culture is the “Silent Language” in international business (Maitah 2008).

There are many ways to gain an insight into culture and its implications on behavior. G Clotaire Rapaille, a marketing specialist born in France, provides seven archetypes that point to the importance of cultural awareness in global success (Tolbize 2008). He points out the importance for global companies to localize their thinking. For example, quality is the key to success, but the word “quality” means different things in different countries:

- U.S.: It works
- Japan: Perfection
- Germany: Made according to the standard
- France: Luxury
- India: Reliable.

Table 3 Global generational differences

	1950	1960	1970	1980	1990	2000	
China		Post 1950s Generation (1950-1959)	Post 1960s Generation (1960-1969)	Post 1970s Generation (1970-1979)	Post 1980s Generation (1980-1989)	Post 1990s Generation (1990-1999)	
India	"Traditional" Generation (1948-1968)		"Non-Traditional" Generation (1969-1980)	Gen Y (1981-onward)			
South Korea		"475" Generation (1950-1959)	"386" Generation (1960-1969)	Gen X and Gen Y (1970-onward)			
Japan	1st Baby Boomer (1946-1950)	Danso Generation (1951-1960)	Shinjinrui Generation (1961-1970)	2nd Baby Boomer (1971-1975)	Post Bubble (1976-1987)	Shinjinrui Junior (1986-1995)	Yutori (1987-2002)
Russia	Baby Boomers (1943-1964)		Gen X (1965-1983)		Gen Y (Gen "Pu") (1983-2000)		
Bulgaria	Post War Generation (1945-1965)		Communist Generation (1965-1980)		Gen Y (1980-onward)		
Czech Republic	Baby Boomers (1943-1970)		Gen X- "Husak's" Children (1965-1982)		Gen Y (1983-2000)		
South Africa	Baby Boomers (1943-1970)			Gen X (1970-1989)		Gen Y (1990-2001)	
Brazil	Baby Boomers (1946-1964)		Gen X (1965-1980)		Gen Y (1981-2001)		
US	Baby Boomers (1943-1964)		Gen X (1965-1980)		Gen Y (1981-2001)		

Another perspective is provided by Geert Hofstede in his Cultural Dimension Theory (Tolbize). Hofstede, a Dutch researcher in the fields of organizational studies and organizational culture, identified systematic differences in national cultures on four primary dimensions: power distance (PDI), individualism (IDV), uncertainty avoidance (UAI) and masculinity (MAS). For several countries, Hofstede has introduced a fifth dimension, long-term orientation (LTO). (See Table 5.)

Consulting

These dimensions consider the behavioral tendencies of different countries or geographic regions with inequality, uncertainty, group relationships, aggression and materialistic behavior. They also provide a valuable insight into how well a global equity plan is aligned with the culture in which it is asked to operate. For example, the early stock option plans implemented in the 1990s were well aligned with the culture in the United States, which was characterized by a high index for individualism (IDV) and a low index for uncertainty avoidance (UAI). (See Table 5.)

Table 4 General characteristics and equity compensation programs

Generation	Characteristics	Implications on preferences
Baby boomer	Optimistic; involved; high risk/ high reward	Stock options; highly leverage performance shares
Generation X	Cautious; conservative; distrustful	Service-based restricted stock; low leverage performance shares
Generation Y	Realistic; confident; career focused	Moderate leverage performance shares
Endowment effect	Why will an employee hold a large number of worthless stock options rather than exchange them for a smaller number of new in-the-money options?	People place a higher value on objects that they own and a lower value on those they do not.

However, when these plans were transported globally as part of a “one company, one plan” global equity strategy, the alignment becomes questionable. The cultural dimensions for the world average paint a different picture. Here, the index for individualism is much lower and the index for uncertainty avoidance is much higher. As expected, the cultural profiles for different countries vary widely from either of these two profiles. For example, only seven countries have Individualism as their highest dimension.

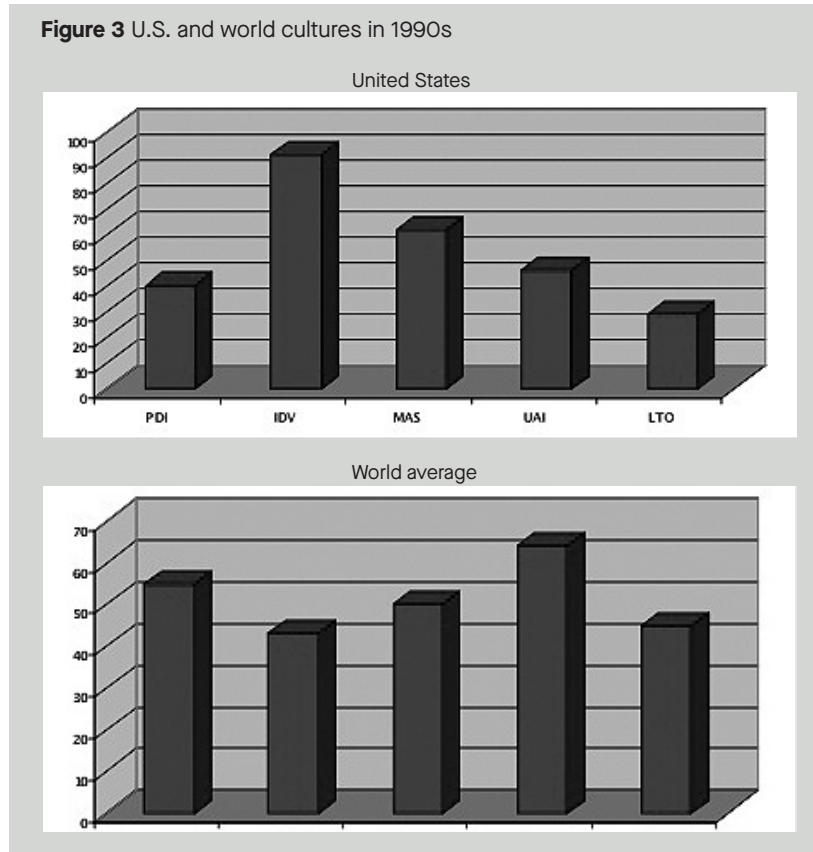
The implications are clear. Early stock option plans in the United States reflected an entrepreneurial culture that was comfortable with risk. Given the stark differences in other cultures in other countries, the alignment (and corresponding motivational value) would be diminished. Based on a country’s

Table 5 Equity vehicle effectiveness and cultural dimensions

A High Ranking in...	Stock Options	Restricted Stock	Performance Shares (High Leverage)	Performance Shares (Moderate Leverage)	Performance Shares (Low Leverage)
Individualism	High	Low	High	Moderate	Low
Power Distance	Low	High	Low	Moderate	Low
Masculinity	High	Low	High	Moderate	Low
Uncertainty Avoidance	Low	High	Low	Moderate	Low

profile, it is expected that different vehicles work better in different conditions, as shown in the Figure 3.

An understanding of global culture gives insight into how the workforce perceives value. As a result, it also allows for a better understanding into which equity vehicle will contribute to the highest level of motivational value based on the culture of the country where the grants are being delivered.



Looking forward

Global equity effectiveness will require a combined focus on plan efficiency and motivational value, based on the perceived values of participants. Ironically, this can be optimized under the return to a “one company, one plan” philosophy. The difference this time is the plan design framework will be adaptable to the range of workforce factors that can determine perceived value.

A performance share plan provides that flexibility. (See Figure 4.) Global participants can be covered by a common framework. The leverage can be adjusted up or down to reflect the risk/reward profile of the participation group. Performance metrics can be set at a company and/or global level to reinforce “one company” but also at a local and/or employee level to enhance line of sight. A person who moves from one country to another can stay in the same plan framework, with adjustments to the mechanics as dictated by the length

Consulting

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of the assignment. Whether domestic or multinational, companies can design a plan that maximizes equity effectiveness for all constituencies by asking five simple questions:

- What does our participant group look like?
- Does our plan create alignment with our work culture?
- How should the plan work?
- What behaviors and outcomes do we want to drive?
- Are we meeting the needs of all constituencies?
 - Figure 5 illustrates the following five tools that can help ensure that the resultant plan meets effectiveness needs.
- **Workforce Analysis:** Looks at the demographics of the company and the diversity and deployment of its employees. It is designed to provide insights into who the employees are, how their perceptions are formed and how the company can better manage them.

Figure 4 Performance share plan flexibility

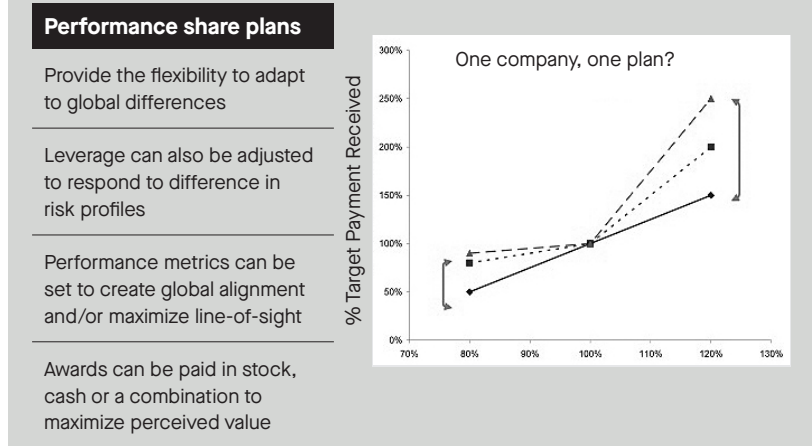
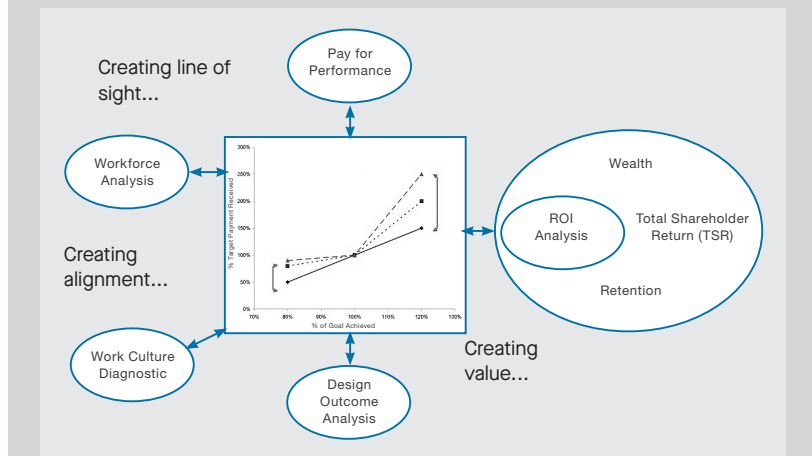


Figure 5 A road map to equity effectiveness



- **Work Culture Analysis:** Provides context for the plan design by creating consensus around who we are as a company and how we work together.
- **Design Outcome Analysis:** Allows a company to look at the inner workings of the plan before it is implemented by modeling potential outcomes. It helps eliminate unintended consequences by allowing the company to simulate the plan before it is implemented.
- **Pay for Performance Analysis:** Looks for the cause-and-effect relationship between plan design and performance outcomes. It allows the company to test whether the plan drivers (behaviors and results) correlate to plan outcomes. It also allows the company to maximize the motivational value by testing for line of sight.
- **Return on Investment (ROI) Analysis:** Is the only tool that is used at the conclusion of the plan period. It provides a key look at the effectiveness of the equity plan based on the end-of plan return to all stakeholders (shareholders, the company and participants). It can also help to determine the degree of equilibrium between the return to shareholder and the company (left brain) and the return to the participants (right brain).

Conclusions

There are several key concepts that can prove to be invaluable in designing global equity plans:

- The technical aspects of equity compensation are important, but not enough.
- Classical rational decision making is not the model for actual employee decision making.
- From a participant's perspective, value is perceived, not calculated.
- To understand how participants perceive value, companies need to understand who makes up their global workforce.
- Simplicity must be balanced with the desire for robustness. When in doubt, err on the side of design simplicity.
- Operating in the new reality requires more intuition and less conventional wisdom.
- A single point of reference is usually insufficient to provide the information necessary to develop a solution. Developing multiple reference points allows a company to triangulate the issue to get at a more robust solution.

Let's talk

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