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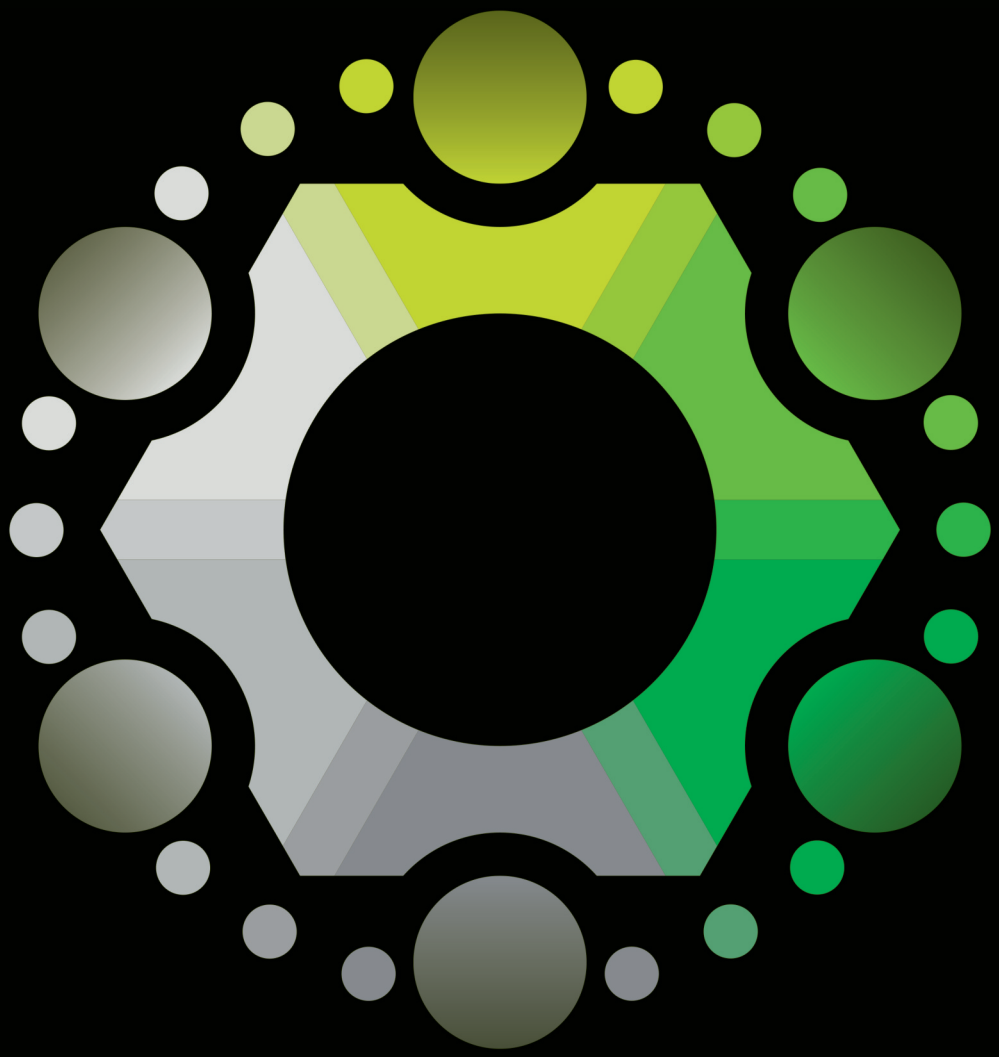


Introducing long-term incentives

Global Employer Services whitepaper
Volume 1

In the Middle East
since 1926

Businesses think long term in terms of their organizational objectives, and in doing so they need to carefully consider how they will incentivize and reward the key people who will help ensure those organizational objectives are met.

This whitepaper is designed to provide insights into different reward strategies and mechanisms that can be used by organizations to ensure their key people are retained, incentivized, and motivated to achieve long-term goals.

Many of the countries in the region have published long-term strategic visions. For example, the Saudi Vision 2030 is a plan aimed at diversifying the economy and achieving sustainability. Recent immigration policy in the region is also geared towards the long-term. For example, the potential for individuals to obtain 10-year visas in the UAE will attract key talent to the region and help retain it. Government policy is therefore clearly targeted towards strategic objectives.

Businesses also think long term in terms of their organizational objectives, and in doing so they need to carefully consider how they will incentivize and reward the key people who will help ensure those organizational objectives are met.

There is an opportunity for businesses in the Middle East to implement well-thought out, long-term reward strategies that are in line with organizational objectives and global best practices. These strategies can significantly contribute to the sustained performance of the business.

Volume 1 – Introducing long-term incentives

This volume explains how incentive plans can impact different organizational stakeholders. It also describes the more common reward mechanisms used globally, being:

- Cash-based mechanisms
- Performance shares
- Leveraged equity mechanisms

Some of the key considerations in relation to reward arrangements for organizations operating in the Middle East are also highlighted, such as:

- Aspects relevant to designing arrangements
- Communicating the benefits of the plan to participants and third-party investors
- Implications for the organization's financial statements
- Potential tax or social security implications

Volume 2 - Funds. People. Incentives.

Given the significant role that investment funds play in the regional economy, this chapter provides an insight into how investment funds can incentivize key business personnel.

It provides an overview of how funds that invest for the medium and long term can implement reward arrangements, including the mechanics of carried interest, sweet equity, and co-investment.

Also considered are:

- The factors that funds acquiring a minority stake in organizations should analyze
- The dynamics that determine how much value should be delivered to key people
- How people who cease to be part of the organization can be treated if value has not yet been delivered (e.g. good/bad leaver provisions)

Introducing long-term incentives

Designing an incentive plan to deliver long-term benefits to the business

In a world of disruptive, innovation-based competition, price and performance rivalry, and economic uncertainty, it is essential for businesses to stay ahead of the curve. A key asset to any organization is its people, and employers therefore need to have a strategy to ensure that they are attracting and retaining the right talent, and that their objectives are aligned with those of the business over the long term. Leading businesses can seek to optimize the performance of key people by implementing long-term reward and incentive arrangements.

A good incentive package should:

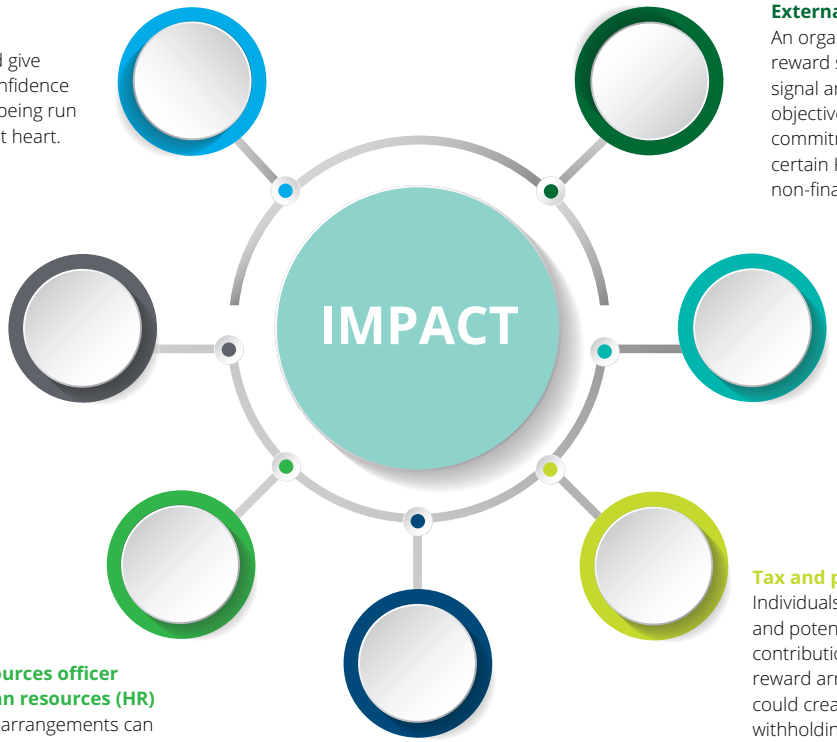
- Attract and retain the right people
- Incentivize those people to lead their organizations to perform
- Motivate those people to focus on key performance indicators (KPIs)
- Align teams and promote the right organizational behavior

It is important to get the design elements right. When an organization is successful, a well-designed incentive package is seen as a key contributing factor. However, when things go badly, the blame is often attributed to short-termism or reckless behavior by those in charge.

An organization's incentive arrangements may include a combination of long-term and short-term reward mechanisms, designed to achieve the objectives set out above. A number of factors will determine the ultimate design of an incentive package, and there is clearly no 'one size fits all' approach.

The design of the organization's incentive arrangement can impact a number of stakeholders as shown in figure 1.

Figure 1



Shareholders
Aligned incentive arrangements would give shareholders the confidence that the business is being run with their interests at heart.

External stakeholders
An organization's incentive and reward structure can powerfully signal an organization's objectives and demonstrate a commitment to achieving certain KPIs, both financial and non-financial.

Chief finance officer (CFO) and finance team
Incentive arrangements have many accounting and statutory reporting implications (notably from IFRS 2 and IAS 19, and potentially FATCA/CRS). The impact of these should be understood before any arrangements are implemented.

Senior management, C-Suite, and key directors
Appropriate incentive arrangements will help ensure that the organization is geared towards long-term value creation, and that its leaders appropriately share in that value creation.

Tax and payroll teams
Individuals may be subject to tax and potentially social security contributions in relation to reward arrangements, which could create employer withholding liabilities. These should be understood to ensure compliance with global tax law.

Chief human resources officer (CHRO) and human resources (HR)
Attractive incentive arrangements can make the job of talent acquisition easier. It can also significantly enhance the retention of key people. HR may also play a role in ensuring the benefits of any arrangement are understood by the participants.

Remuneration committee
The purpose of the committee is to determine the strategy and policy in relation to the reward of the organization's key people. They will be key to any major reward decision.

There is a large menu of mechanisms available for the long-term incentivization of key people, which can add complexity to the design process. The alternatives set out below are not intended to be exhaustive, but they highlight some of the more common reward mechanisms that are used globally, as well as key considerations for organizations operating in the Middle East.

Cash-based mechanisms

Broadly, these are incentive arrangements where participants receive a cash payment in the future, usually dependent on the satisfaction of certain objectives, e.g. earnings or balanced scorecard-based objectives.

Many businesses seek to reward high performing people with a cash bonus. However, a more recent trend, especially amongst larger listed organizations, is to defer a significant proportion of these payments such that they are paid over a period of years (usually three to five years).

These types of arrangements are simple to set up and straightforward to administer. They tend to be preferred by unlisted or family-owned business as there is no dilution of the interests of the existing shareholders – although it should be noted that there are structures which can work for this group, aside from traditional cash-based rewards, as explained below.

Whilst cash-based arrangements can deliver alignment with third party investors in terms of organizational objectives, larger institutional investors usually prefer arrangements that deliver shares (or other equity interests) to key people as there is more direct alignment with third-party investors.

Performance shares

These types of arrangements deliver shares to participants depending on the performance of the organization. The shares will be delivered on a set vesting date or by the participant exercising a call option over shares, subject to achieving certain pre-determined performance targets over a period of years. Where a call option is granted to participants, the exercise price of that call option should be considered. If the commercial objective is for participants to only benefit from growth in equity value, an exercise price equal to the market value of the shares may be more appropriate. If the goal is primarily for participants to be rewarded for achieving the pre-determined performance targets, an exercise price below the market value of the shares at the grant date would be more common. In listed companies, the shares can then be sold on the stock market. The shares may also be subject to a holding period where they can only be sold after a period of time (e.g. 12 months from the acquisition date). In unlisted companies, the shares could potentially be acquired by the majority investor or by an employee trust to deliver cash to the participant. Although, it is considered good practice from a governance perspective for senior employees to continue to hold shares.

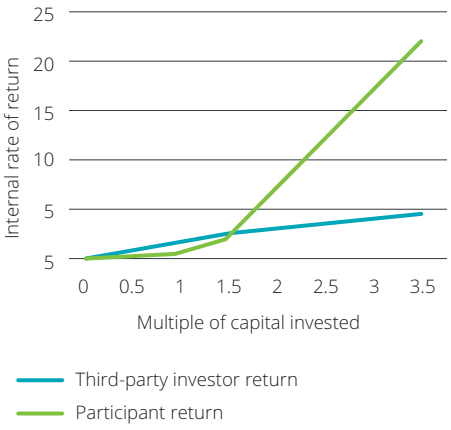
Equity-based arrangements are still fairly straightforward, but they do introduce an additional layer of administration and complexity. They provide clearer alignment with third-party investors because participants also share in the performance of the business. The majority of listed companies in the US and Europe have implemented these types of arrangements.

Unlisted and family-owned businesses could replicate these types of arrangements without diluting the interests of existing shareholders by offering 'phantom' or 'pretend' shares to their key people. The participants may then receive a cash bonus after a set period, linked to the value of those 'phantom' or 'pretend' shares.

Leveraged equity mechanisms

These are most commonly seen in an investment fund environment, but they can also be relevant to new start-ups which are funded by third-party investors who are not involved in the day-to-day running of the business. Participants usually acquire a combination of equity and/or debt interests. A portion of these will be granted on the same terms as third-party investors (the 'co-invest'), while a portion will reward the participant after a set performance hurdle is achieved (the 'incentive equity'). Once the hurdle is achieved, participants can potentially benefit from significant upside potential, which can be proportionally greater than the returns received by third-party investors.

Figure 2



As individual participants may be required to pay for these equity interests, consideration should be given as to how they can fund their upfront investment. Alternatively, if participants already hold some equity interests (e.g. in a company before a private equity-related investment), consideration should be given to how these could be exchanged to deliver the commercially desired balance between co-invest and incentive equity.

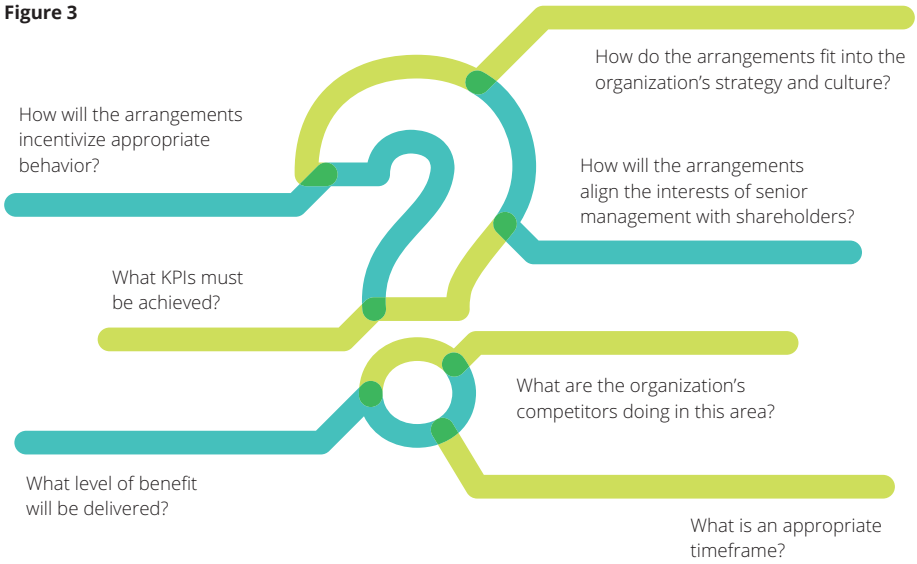
As these arrangements are more complex, cash-based alternatives could be an effective and simpler approach for the incentive equity. Commercially though, the co-invest can deliver real "skin in the game," which is harder to achieve without an upfront investment by the participant.

Considerations

Design

There are a number of factors which should be taken into consideration in the design of any incentive plan. Some elements that need to be considered are summarized in the diagram on the right.

Figure 3



Tax

Businesses and individual employees should be aware of the potential international tax implications of any incentive plan, particularly in the context of mobile employees. Tax and social security withholding obligations may arise for employers who have a global presence. Employers can use technology to manage this.

Consideration should also be given to any potential tax implications on a future disposal of equity interests, depending on the employee's personal circumstances. The gain derived on disposal may be treated as an investment return, as opposed to employment income, which in many cases is subject to a different tax treatment.

Communications – participants and third-party investors

It is important that both participants and third-party investors understand how the arrangements work and their associated benefits.

For participants, any communications should be easily digestible and clearly spell out the benefits of the arrangements, to ensure that they understand the organizational objectives and can focus on the KPIs.

It is essential that third -party investors also understand the arrangements and that it is clearly visible that their objectives are aligned with the objectives of the individuals running the organization.

Where they are not acquiring a majority stake, many institutional investors will dictate how they expect executive compensation to be structured in the organizations they invest in. This will include the performance targets they expect to see, the level of disclosure they consider appropriate in the annual reports, and the shareholding requirements of the key participants.

Accounting

Accounting implications should also be considered. The accounting treatment, and the impact on financial statements, differs between cash and share-settled awards. Share-based awards are normally valued when the awards are initially acquired by participants, while cash-based awards are usually required to be revalued at each reporting date. The expenses in both cases are then spread over a 'service period'. Accounting standards also set out several details that need to be reported in the annual accounts in relation to these types of incentive arrangements.

Building engagement for the long term

It is the people within an organization that provide the inspiration, agility, and drive that enables the organization to succeed. Whilst there are different elements to consider, employers need to define an appropriate reward and incentive strategy to attract, retain, and motivate the right people and keep them engaged over the long term. Whether it is a cash bonus plan, a performance share plan, a leveraged equity model, or a variation on one of these models, an appropriate long-term incentive plan can significantly contribute to the long-term performance of the organization.

Businesses and individual employees should be aware of the potential international tax implications of any incentive plan, particularly in the context of mobile employees.

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