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Share schemes

Introduction

There a number of different types of scheme available with many different ways in which they can be tailored. This means that a solution can inevitably be found. However, too often the rationale for having a scheme and its objectives are not properly considered before putting it in place. As a result it fails to deliver the expected benefits.

In this briefing we will focus on some of the questions you should ask yourself as you start to consider a share scheme and provide some comments from our experience of implementing schemes rather than give technical detail on the different types of schemes which are available.

Why do I want a Share Scheme?

This is an absolutely fundamental question. Reasons why you may want a scheme include:

1) You are likely to sell the company in the next five years or so. When you sell it is likely that a purchaser will expect a motivated second tier of management to be in place. You will also need them to maximise any earn out on sale and let you step back from the business.

2) To retain key individuals who are fundamental to your business. Having shares can be motivational (particularly when they are earned for good performance) and can serve to lock them into the business.

3) You would like to step back from the business. Again, to motivate managers to run the business you are likely to need to incentivise them and lock them into the business. You may also be thinking of this as a route to give you a partial exit from business and realise some equity.

You can see that all of these reasons have in common a need for a select group of employees to have shares.

Who should have shares?

Whilst "shares for all" sounds like a good way of motivating all members of staff, the reality is that this is rarely appropriate. Whilst shares can seem like a cheap reward for staff, the cost to you on a disposal of your business in terms of your reduced proceeds could be substantially higher than paying a marginally higher salary. Shares should therefore only be awarded to those individuals who are absolutely vital to the future growth of the business.

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Not everyone values shares as a reward. The further away a likely sale of the business or the less clear it is that there will ever be a sale (such that they can realise the benefit of having shares) the less the shares will be valued as a reward. Therefore, schemes tend to be most successful when accompanied by a clear medium term strategy for the business including some form of route to realise the value of the shares. As well as ensuring the shares are valued by the recipients, it will also motivate them to work to grow the value of the business.

Some employees are habitual nomads and consequently even if they have shares, they probably won't act as an effective tie.

Some employees would rather just have cash in which case a simple bonus scheme may be a far more effective way of motivating and retaining them.

In summary, you should be extremely selective when deciding to award shares and be sure that the recipient is someone who will be motivated by having shares and that the enhanced value of the shares you retain will increase as a result of their efforts by more than the cost of awarding them.

What happens if someone Leaves?

Since the reason for any award of shares should be to motivate someone to generate growth in the value of the business, you are unlikely to want them to be able to retain shares once they leave because they would then share in continued growth that they have not contributed towards. Normally therefore, a scheme will be designed to ensure that if someone leaves they will be required to sell their shares either to the company or other shareholders. You may want different prices to apply depending on the circumstances of departure, for example so that an employee who dies or leaves through illness may receive a better price for their shares than someone who leaves to work for a competitor.

A common way of dealing with this problem is to award options rather than shares such that they can only be exercised on a disposal of the business. Whilst the price of purchase will be fixed when the options are granted, they will not actually be acquired until the employee is able to sell them and make a profit.

Don't assume that everyone values having shares as a reward!

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The employee's position, therefore, is virtually unchanged (except that they don't physically own shares in the interim), but you don't have to go through a process of purchasing shares from departing employees (which could be costly and time consuming). Options would simply lapse on leaving the company.

How much should Employees Pay?

Employees often assume that they will get the shares for nothing. However, paying nothing for the shares rarely means that the employee values them any more highly. If the employee is required to pay for his shares you get a clear demonstration of commitment from the employee.

Whichever form of share scheme is used, it will be necessary to value the shares. If the employee receives them at less than market value, there will be tax to pay. The extent and timing of that tax depends on the precise type of scheme ultimately chosen. Obviously if the shares are purchased at their current market value, there will be no tax to pay at that time.

For a small holding (say 2%) that you are likely to give to an employee, market value will not necessarily be 2% of the value of the whole company. Unless a sale is imminent, the market value for a small holding will be discounted by perhaps 75% to 90% as compared to a simple pro-rata share of the value of the whole company to reflect the lack of marketability and control attaching to those shares. This therefore means that even if you issue shares for their market value employees could receive a significant benefit on a future sale despite there being no growth in value of the company.

When should Employees have the Shares?

You may want employees to have shares straightaway, for example so that they can share in future dividends. You may want them to only have the shares just before sale, or you may want to allow them to have shares in tranches over a period of time based on performance. All are possible.

Should the employee pay for their shares – will it make them value the shares more highly?

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All sorts of performance criteria can be considered. These may be based on the business, or they may be personal to the employee. They can be as simple or as complex as you like provided that it is possible to determine whether or not they have been met.

What type of Scheme?

Really this is the last part of the jigsaw. Too often the areas highlighted above are not fully considered before a scheme is implemented and as a result the benefits may be limited. With careful thought as to the objectives and parameters of a scheme this final decision will be relatively simple and the resulting scheme should help to deliver growth to your business.

If you are thinking of introducing a share scheme, give us a call and we will be happy to have a free initial meeting with you to help you to consider whether a share scheme may be appropriate for your business. Of course, we can also discuss the technical merits of the various schemes if you wish!

Summary

Share schemes are a popular method of incentivising key employees.

Too often the rationale for having a scheme and its objectives are not properly considered before putting it in place. As a result it fails to deliver the expected benefits.

Our approach is therefore solution based rather than product based. We ensure that it is right for your business to have a scheme, we work with you to determine the objectives of the scheme and only then do we recommend a particular type of scheme.

If you'd like to explore the possibilities of incentivising your key team members please contact us.

The right scheme can deliver substantial benefits, however it is important to understand why you're doing it, what you expect to achieve and what the tax implications may be.