Looking to the Future: How E&C Firms Can Leverage Long-Term Incentive Plans

By Sal DiFonzo and Priya Kapila

An in-depth look at the value of using long-term incentive plans in the engineering and construction industry.

Retaining key employees has become a salient issue in the engineering and construction (E&C) industry as unemployment rates continue to drop (below 5% in the general economy and below 6% in the E&C industry). Rather than wait until it's too late, now is the time to consider strategies to keep executives and high-potential employees from departing and defecting to the competition. This is quite a change from 2011 when industry unemployment rates hovered around 22%; but it's not insurmountable.

Management succession is also impending as baby-boomer owners exit the workforce at an average of 10,000 individuals per day. In "FMI's Ownership Transfer and Management Succession Survey," 76% of owners over age 50 planned to retire in the next 10 years, but less than half were actually working on a succession plan. Concurrently, a new crop of millennial workers is entering the workforce, many of whom lack the necessary skill sets and experience to effectively take over for the departing boomers.

The good news is that there are ways to offset these challenges and ensure long-term growth and profitability in the E&C field. A long-term incentive plan (LTIP), for example, is an effective tool for supporting retention and management succession objectives. An LTIP can also support the business strategy by driving long-term performance. The following article provides an overview of LTIPs and shows how companies use them in today's engineering and construction environment and uncertain labor market.

What Are Long-Term Incentive Plans?

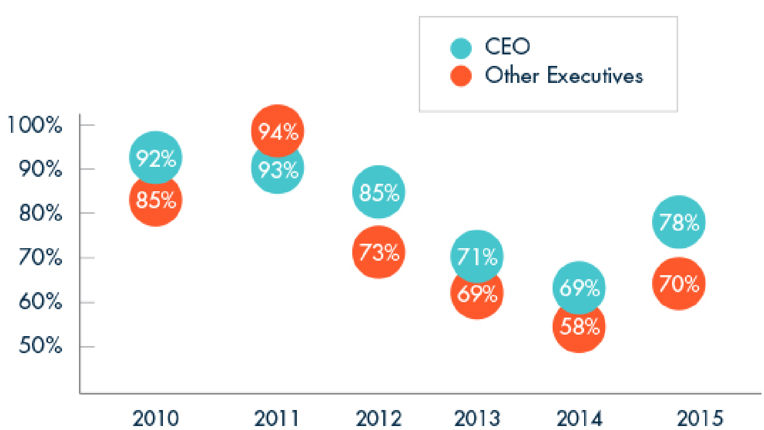
Often referred to as non-qualified deferred compensation plans, LTIPs differ from qualified plans (e.g., 401(k)s and employee stock ownership plans) because the company itself can select who is (or isn't) eligible for the plan. "Deferred" refers to the payout horizon. Whereas incentive plans typically pay out as or when they vest, deferred plans pay out sometime at a later date and, thus, defer the taxable event until the future payout.

Both qualified and non-qualified plans are generally subject to the Employee Retirement Income Security Act of 1974 (ERISA). However, non-qualified plans typically satisfy the “top-hat” exemption and are therefore not subject to many of the more onerous ERISA requirements. A distinct characteristic of non-qualified plans is that allocated awards for participants are subject to creditors of the employer in a bankruptcy, whereas assets in qualified plans have protection from both employer and participant creditors.

Exhibit 1 shows the prevalence of LTIPs for the last five years (information is based on “FMI’s Executive Compensation Survey”). As shown, CEOs have LTIPs most often, but other executive positions also employ LTIPs frequently. Variance in LTIP participation is likely due to an increasing number of survey participants from 2010 to 2015. The average company size during that time ranged from $1 billion to $1.5 billion. At this revenue level, many companies have installed LTIPs, but there is no reason that smaller companies cannot employ the LTIP strategy as well.

EXHIBIT 1

Percent of Organizations Providing Long-Term Incentive Compensation to CEO and Other Senior Executives



Source: FMI Compensation

Understanding Your Eligibility Guidelines

Because non-qualified plans are subject to creditors in a bankruptcy, companies must follow eligibility guidelines to ensure that the participants have insights to possible risks, given their position within the organization.

While these criteria are not comprehensive, they are generally recognized as basic eligibility guidelines:

- Officers of the company or anyone with significant management of the organization
- Professional employees who earn more than $100,000 annually
- Case precedent suggests no more than 15% of total employee population in the LTIP (includes hourly and union employees in the total headcount).

Including individuals outside of these criteria may subject the plan to change from non-qualified to qualified.

Vesting: What It's All About

Another characteristic of LTIPs is a vesting schedule, which outlines when a company conveys ownership of the LTIP award. For example, a plan participant earns an award at the end of 2016 but doesn't own the award until the end of 2020. Keep in mind that the vesting period does not necessarily equate to the payout period and that non-qualified plans define when employees receive payment. This could be at a specified retirement age, a point system of age and service, or a separation event like disability or termination of employment.

Exhibit 2 shows an example of a four-year "cliff-vesting" scenario in which awards vest at the end of the four-year period (thus the "cliff" terminology). If the awards were to vest 25% a year or some other combination over four years, this would be considered graduated vesting. Notice in the illustration how the awards stack on each other. As a result, by the fourth year in the program, the first award has vested but there are three more awards acting as "hooks" into the participant in the form of unvested awards. These unvested awards accumulate to create "golden handcuffs" and make it difficult for competitors to buy out. Imagine an executive receiving $50,000 per year in the program. It would not take long for the accrued funds to be significant.

EXHIBIT 2 | A Four-Year Cliff-Vesting Scenario

		Vesting Schedule (End of Year)							
Award Year	Total Award Amount	1	2	3	4	5	6	7	8
1	$50,000	0%	0%	0%	100%				
2	$50,000		0%	0%	0%	100%			
3	$50,000			0%	0%	0%	100%		
4	$50,000				0%	0%	0%	100%	
5	$50,000					0%	0%	0%	100%
Total Vested Amount		$0	$0	$0	$50k	$50k	$50k	$50k	$50k

Source: FMI Compensation

LTIP Plans Come in Different Shapes and Sizes

There are many different types of LTIP plans. Since most E&C companies are privately held, the following plan types are most common in the industry:

Cash

This is the simplest program to administer and understand. A participant earns a cash award and then receives a cash payout at some point in the future.

- **Pro:** Cash is the simplest concept and is typically related to performance.
- **Con:** Inflation and time value of money erode cash value over time. Companies may compensate by paying interest on unpaid funds or allowing participants to use deferred compensation accounts where they can invest the cash similar to 401(k) style investments.

Restricted Stock

This type of stock does not require performance contingencies. The company simply allocates real stock after a designated time period has passed.

- **Pro:** Stock equity transfers actual ownership to participants.
- **Con:** Restricted stock is also called a “pay-for-pulse” plan because it only requires participants to be breathing. There is no performance element.

Performance Shares

Participants receive performance-based shares. Awards could range from zero to above target allocation, depending on performance of a predesignated measure.

- **Pro:** Stock equity allocation correlates to performance and achievement of goals that are tied to the business strategy.
- **Con:** There is a risk that the award is below target or zero. A below-target allocation could reduce the retention value of the award over time.

Phantom Stock

Phantom stock is not real stock. Its price can link to the actual share price, and the company can pay discretionary dividends on the shares, but phantom shares are not voting shares.

- **Pro:** Phantom stock is effective in family situations where the family has no intention of broadening ownership beyond the family but needs a means of retaining a professional management team. Another pro is that the value of phantom shares can increase over time (e.g., from $50 per share to $70 per share over four years).
- **Con:** This LTIP vehicle is the most complex option. There is also the risk that the share price could drop over time (e.g., from $50 per share to $30 per share over four years).

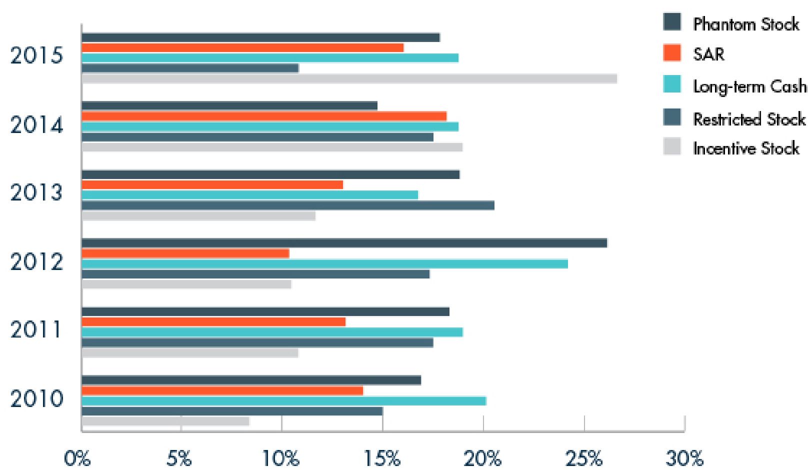
Stock Appreciation Rights (SARs)

Stock appreciation rights (SARs) are similar to phantom stock. The main difference is that the share value is only based on the stock appreciation. If the stock price depreciates, the value drops to zero.

- **Pro:** The management team is motivated to increase the share price over time. The company has no downside risk for payouts if share value drops below the award price.
- **Con:** Shares are worthless if they drop in value. There is risk that the program loses retention value when shares fall below the award price.

Exhibit 3 shows the prevalence of different plan types from 2010 to 2015, based on "FMI's 2015 Executive Compensation Survey."

EXHIBIT 3 Types of Long-Term Incentives Provided to Executives (Among Survey Participants Reporting a Long-Term Incentive Plan)



Source: FMI Compensation

Five Steps to Get Started With an LTIP

There are useful guidelines to follow when implementing an LTIP, including:

1. **Pay for performance:** There should be a performance measure and a goal in every LTIP. The performance measure should be tied to the business strategy. Most LTIP measures are tied to the balance sheet whereas short-term measures are usually derived from the income statement.

2. **Do not duplicate the short-term plan:** The long-term plan should not be a mirror image of the short-term plan. If the short-term plan performance measure at the company level is net profit before tax, perhaps the long-term measure is Return on Equity (ROE), Book Value or Return on Assets (ROA). Sometimes return-type financial measures require profitability hurdles to balance unintended consequences, but the plans should be distinct from one another.

3. **Develop a fail-safe:** Financially responsible planning requires that both the short- and long-term plans contain a fail-safe. This is the minimum level of profit required at the company level in order to fund all incentive plans, including the LTIP.

4. **Allocate an award opportunity:** A design error requires participants to use most or all of their short-term bonuses to “fund” or buy into the long-term program. This may work in real equity plans where ROE is high. If the ROE is low, forcing participants to buy the company’s low-return stock or synthetic stock with their own cash is forced servitude. Create a budget and allocate an award by job level for the LTIP.

5. **Do not confuse award horizon with payout horizon:** Design the plan to include an annual performance measure and then allocate an award. The award will be designated after 12 months but will pay out in the future, according to the plan design. Companies that create performance measures that are assessed after several years may find that the measure was missed so severely in the beginning of the performance period that participants give up trying to attain the target, and the program loses retention effectiveness.

The Accounting Perspective

One of the advantages of LTIPs is that the company does not actually fund the plan until payout. From a book accounting perspective, the company accrues an expense over the vesting period and assumes a liability on its balance sheet. At payout, the company receives a deduction for the accrued expense, and the liability is removed from the books. There obviously needs to be enough operating income in future years to pay for the impending liability. But if the vesting and awards are staggered, all payments will not be due at the same time.

When participants finally have access to their awards, the event is called constructive receipt. They are in control of the funds, and, therefore, it is a taxable event at ordinary income rates. Unfortunately, deferred stock price appreciation (including phantom stock price appreciation) is still taxed at ordinary income rates and not at capital gains rates.

A Look to the Future

Large E&C companies have been using LTIPs for years, but companies of any size can employ these strategies to retain key employees or to facilitate ownership transfer or management succession. With the talent war growing increasingly intense in the engineering and construction industries, and with millennials bringing their own career expectations and capabilities to the workforce, LTIPs can help firms create a compensation package that protects their investments in top talent and leaders. Rather than standing by while a competitor sweeps up your best employees, why not fold LTIPs under your compensation umbrella and let team members pick a long-term investment solution that best meets their needs and those of your company?

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