JOURNAL OF SELECTED READINGS 1987 - 1995

Foundation for Enterprise Development

EQUITY COMPENSATION AS AN EFFECTIVE BUSINESS STRATEGY

F.E.D. CONFERENCE, SEPTEMBER 1994

Dr. J. Robert Beyster
Chairman and CEO, Science Applications International Corporation and President, Foundation for Enterprise Development

There's not much I can say about today's competitive business environment that you aren't already experiencing or at least keenly aware of. Economic pressures and global competition are forcing radical changes in many companies. I know we are being profoundly affected by these changes at Science Applications International Corporation (SAIC).

Responding to competitive pressures, companies are becoming leaner — downsizing — to become more cost competitive. A survey by the American Management Association showed that 47 percent of companies reduced employment in 1993, and on average it was by 10 percent of the work force.

While many companies are reducing staff levels, there is also the need to become global and adjust to rapidly changing markets and do more with less people. Leaner organizations are pushing responsibility down to the lower levels. Employees must be multi-skilled, computer-oriented, and take on more responsibilities.

We are also seeing significant changes in the work force. Diversity of gender and ethnicity is growing. Companies are relying more on part-time, temporary and consulting employees because it is more cost efficient. "Job Security" may be a thing of the past. Companies can't guarantee it and smart, highly motivated people know they must be willing to move from organization to organization to find new opportunities. This has weakened loyalty to the organization.

Technology is changing the way we do business: phone conferencing; video teleconferencing; faxing; cellular phones; e-mail; the Internet — are all making it possible to do business from just about anywhere. The ease with which information can be transmitted is changing the way we communicate internally and with our external customers.

As you can imagine, these changes have many companies exploring new ways of compensating their employees so they can better compete. With that in mind, let's take a look at some trends in equity compensation.

Trends in Equity Compensation

Equity compensation plans can be categorized a few different ways. There are direct stock methods, in which stock is put directly into the hands of employees, and there are indirect methods, in which the stock is held in trust for the employees.

Stock plans can also be categorized by how the employee gets the stock. One category is management directed plans, usually stock bonus and option plans which are used to motivate the strongest performers and build the equity of future leaders.

Until a few years ago, these were almost exclusively shared with only the top few people in a company. Recently, we see more of a willingness to share these types of stock awards more broadly. Companies are realizing that many employees besides the top three executives can have a major impact on the success of the company — if they are motivated.

Broad-based option programs based on performance are ideally suited to align employees with corporate goals. We had a scare from the Financial Accounting Standards Board, or FASB, which last year proposed to change the way stock options are valued — a change that would have negatively impacted our income statements. That move could have effectively ended the use of employee stock options in volatile firms. FASB now seems to be reconsidering its approach on this issue.

The second category, based on how the stock is obtained, is employee-initiated purchase plans such as 401(k) plans, payroll withholding stock purchase plans, and direct stock purchases.

In the 1980s, there was an "invisible" growth in these types of plans in the public sector as uncovered by researcher Joseph Blasi of Rutgers University. He is also a Senior Research Advisor to the Foundation. In reviewing the SEC filings of all of the 7,000 companies on the over-the-market stock exchanges, he discovered that in 1,000 of these companies, employees own an average of 12 percent of the company. Employee holdings in public companies are worth about $130 billion in total. Until this research, many of these companies didn't know that employees are their largest shareholder block.

The third category is universal retirement plans such as Employee Stock Ownership Plans, or ESOPs, and other ERISA plans. These plans usually make everyone an owner, align your communications, and build a sense of teamwork.

ESOPs are commonly used as financing vehicle, where salary reductions are sometimes traded for equity. In the early 1980s, Congress passed legislation giving significant tax incentives to companies implementing ESOPs and as a result, ESOP growth soared. Congress has since trimmed the tax incentives, but ESOPs are still an important tool in certain circumstances, witness the recent UAL employee buyout.

Given these trends, let's look how companies are using the different forms of equity compensation to achieve important business goals.

Why Are Companies Using Equity Compensation?

At the Foundation, we've found that the best way to design an equity compensation program is to start with the company's objectives — what are they hoping to accomplish through the program? There are many different reasons why companies establish equity compensation plans. Considering these reasons, and various other factors such as cost and administration, programs can be designed in a multitude of ways to complement the nature and culture of an organization.

Many companies use equity compensation strategies to motivate employees to work harder and smarter and to reward performance. Most companies who share equity with employees have this as one of their objectives, and in many cases it ranks number one.

You can use numerous methods to achieve this objective. Some companies use performance-based stock bonus or option plans, in which agreements are made with employees that if they meet specific performance goals they will receive the award or vesting in the award. For example, at SAIC we use pre-negotiated stock bonus and option arrangements to reward employee and team accomplishments such as a proposal team winning a contract award, a program manager meeting cost and schedule objectives, or a marketing person bringing in a new customer.

ESOPs are used to motivate the work force more broadly. When combined with participation and communications, you can achieve a cultural change where employees are motivated to work in a team sense more productively. By including employees in the ownership and involving them in improving business operations, you can achieve an "ownership culture."

Another major reason companies establish equity compensation plans is to help recruit and retain key employees. Start-up or emerging growth companies may not have the cash to recruit top performers to their company and therefore will use equity as the "carrot" to recruit these employees to their company. Employees of start-ups also find the opportunity to participate in the potential financial success of the company quite appealing. At a recent Foundation roundtable, one entrepreneur said that he likes to have his senior people hungry, not well paid, during start-up. "If they're living close to the edge and have an equity stake," he said, "I know they will work with me 80 hours a week to make the company worth something."

In a more mature company, a regular series of stock awards with vesting schedules and options can help retain top performers for the long-term. I know we use them that way at SAIC. If one of our key contributors gets an offer they think they can't refuse, we can sit them down and tell them the value of unvested stock and options they would forfeit by leaving. It has helped us keep people on a number of occasions.

Many companies are now looking at employee ownership as a competitiveness strategy. Using equity can help reduce company expenses and motivate employees to work harder. Equity can also give the company added flexibility in corporate decisions, especially in companies with large numbers of union employees such as United Airlines. At United, the unions traded increased salary demands and work rules concessions for a share of the company. In this case, the employees would give up $5.5 billion in wage cuts and work rule changes over the next six years for 55 percent of the company. The unions also agreed to allow United to establish a new low cost airline to compete with the Southwest's of the world. The idea is that this can be a win-win-win situation for the employees, management and the current shareholders.

For these types of deals ESOPs are the primary form of employee ownership. ESOPs are the only form of equity compensation that can be leveraged and therefore act as the perfect financing vehicle for large employee buy-outs. The great growth of ESOPs today is due to a provision in the tax code that allows owners of private corporations to sell their stock to employees and defer the gain from the proceeds of that sale.

Stock ownership can also be used to raise capital. Selling stock to employees can help bring in needed capital especially for start-ups and emerging growth companies. Generally, employees can't afford to purchase significant amounts of stock, but I can tell you from our experience that sales of stock to employees in the early day's of SAIC was very important to the growth of our company.

> "...one entrepreneur said that he likes to have his senior people hungry, not well paid, during start-up. "If they're living close to the edge and have an equity stake," he said, "I know they will work with me 80 hours a week ..."

Employee stock purchase plans and 401(k) plans also bring in capital, while allowing employees to invest in the company. As the company grows, these plans, like ESOPS, usually become net users of cash when the company is eventually required to repurchase the stock from employees, unless the company goes public.

Many companies feel that their executives should have significant ownership in their company, and believe that this ownership will help align executives' goals with those of the company and other shareholders. In fact, many large public companies are now requiring their executives to own substantial amounts of company stock as a condition of employment. For example, Kodak requires its 40 top managers to own between one and four times their annual salary in Kodak stock, within five years of employment by purchasing the stock on the open market or by exercising options. Direct purchases, stock options and bonus plans are the primary vehicles used by companies to implement these types of requirements.

The final objective I'll mention may seem somewhat idealistic, but we are hearing it from more and more companies. That is that sharing equity with those who contribute their energies to making the company successful is intrinsically fair. At SAIC, our philosophy is that "those who contribute to the company should own it in a manner that is fair and equitable in recognizing their contributions."

Lessons Learned at SAIC Over 25 Years

Since we've been almost entirely employee-owned for 25 years at SAIC, many people look to us for all of the answers. Well I can tell you with some certainty that we don't have them. We are still learning and part of the reason is that as times change, what employee ownership means at your company changes as well. But I can offer a few insights into what we've learned over the years and what we're still learning.

First, senior management must buy into it. It requires a fundamental change in the relationship of managers and employees, and managers must be willing to involve employees, communicate with them and accept their input.

Second, I can't over emphasize the importance of employee participation. For employees to act like owners, they must be treated like owners. This doesn't mean voting or reaching a consensus on every business decision, but it does mean sharing financial and operational information and involving employees in matters that concern them and their work environment. At SAIC, we have created a number of committees and ad hoc groups and informal mechanisms for bringing people together and sharing viewpoints across a large cross section of the population. It is somewhat chaotic at times, but I believe it allows for a lot of employee involvement in employee benefits and workplace issues.

One side note on this point: The National Labor Relations Board has found in two recent cases that companies' employee committees were in violation of the National Labor Relations Act. These rulings have set a precedent that defines the role an employee committee can play in decision-making. If you have an employee committee, you may want to more details on these decisions. It is unfortunate that rules set forth in the 1930s are now being interpreted to hinder a company's attempts to involve employees in creating a healthy, productive work environment.

The third lesson we've learned over the years at SAIC is that employee communications is critical. You must clearly communicate how the plan works and its intentions. And be ready for negative feedback, because not everyone will agree. Some employees will not appreciate the value of stock ownership. But through communications and employee involvement you can develop some understanding of what you are trying to accomplish and you will receive a lot of good ideas for improving the system.

Fourth, I believe you must constantly reevaluate your ownership system — not only looking at whether you are following the rules and taking advantage of the tax and other benefits of the various plans, but also whether your program is doing what you had intended it to. We have changed our program countless times over the years. In the past few years we have added at least three new programs. For example, we began a formalized program of pre-negotiating option awards because we felt our stock awards weren't closely enough tied to specific performance objectives.

Don't expect all employees to treat the company fairly in response to the company's willingness to share its ownership with them. Abuses of ethical principles occur in companies with equity sharing as in other companies. My feeling is they are equally painful but less frequent. Employees are not inclined to risk harming the organization they own personally.

Finally, in establishing your plan, and really throughout its evolution, good advisors can help you steer clear of problem areas. In the early days of SAIC, we made some decisions that we later had to fix. By not including certain stock restrictions, 15 percent of our company ownership moved to outsiders through departing employees. Many of the professionals here today are the best in the area with regard to equity compensation issues and can help you avoid the pitfalls.

Also, remember to use the Foundation as your resource. Through our free advisory services we help many companies each year — companies of all sizes and in all industries, both public and private. I hope you find the information presented today of value as you consider developing the workforce, culture and competitiveness of your company.