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THE USE OF EMPLOYEE SHARE OWNERSHIP PLANS IN RESTRUCTURING STATE-OWNED ENTERPRISES

POLICY RECOMMENDATIONS

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THE USE OF EMPLOYEE SHARE OWNERSHIP PLANS IN RESTRUCTURING STATE-OWNED ENTERPRISES

POLICY RECOMMENDATIONS

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EXECUTIVE SUMMARY

As with any government considering the most appropriate strategy for restructuring state-owned enterprises (SOEs), the Government of the Republic of South Africa (Government) must balance sometimes divergent goals of promoting economic efficiency with state responsibilities for ensuring the broad social welfare. The challenge is even greater in South Africa, given the historical inequities of its recent past. To correct these past wrongs Government is committed to addressing both efficiency and social empowerment objectives in its Policy Framework for restructuring SOEs, specifically with a view towards economically empowering previously disadvantaged individuals.

Yet as the shareholder of state-owned enterprises that account for approximately five percent of the country's gross domestic product, which include some South Africa's most prominent companies, the importance of establishing market-based mechanisms to help SOEs compete effectively in an increasingly globalized economy cannot be underestimated. Both the economic and the social priorities command equal attention in terms of Government policy.

One of the attractions of employee share ownership plans (ESOPs) in the context of restructuring initiatives as well as in their use in the private sector generally, is precisely the fact that they are perceived to address both economic and social policy goals. As a market-based mechanism for enabling employees to obtain ownership stakes in enterprises, ESOPs hold promise both as a means of promoting greater equity in regard to the distribution of state-owned (or other corporate) assets as well as a means of providing employees with incentive compensation and a financial stake in the long-term growth of the private sector.

The international experience with the use of employee share ownership in restructuring initiatives suggests that ESOPs can indeed play an important role in fostering widespread participation in ownership and can have a positive effect on enterprise performance. Dozens of countries around the world in both developing and post-industrial economies have implemented legislative incentives to promote the use of ESOPs to foster widespread participation in ownership in both SOEs and private companies. Similarly, the South African government's Department of Public Enterprises (DPE), which has the mandate to oversee the process of restructuring SOEs, seeks to establish an overarching policy framework and implementation guidelines for ESOPs that are defensible across a wide range of SOE restructuring initiatives.

The need for a policy framework is evidenced by conflicting goals and assumptions that were manifest in the negotiation, design and implementation of ESOPs in several SOE restructuring initiatives to date. The Government has faced challenges in resolving conflicting goals of economic empowerment and incentive compensation, including disputes of allocation of ESOP shares between workers and managers. The design of ESOPs has suffered from a lack of economic rigor in determining the size, pricing, allocation and liquidity of the ESOPs' shares and from a lack of consistency regarding policy assumptions and procedural guidelines governing the use of ESOPs.

One of the fundamental conflicts affecting the design and implementation of ESOPs in South Africa derives from differing assumptions of ESOPs as a means to promote economic empowerment versus their use as a means of introducing market-based incentive compensation programs. This is particularly apparent in trying to resolve the conundrum of how to allocate shares between workers and managers. Government has clearly indicated its intent to use its role as the shareholder of SOEs to promote an economic empowerment agenda to assist previously disadvantaged individuals. In the case of the Telkom ESOP, a decision was made to allocate shares equally among all employees from the top of the organization to the bottom. While arguably justifiable from a *political* perspective of promoting economic empowerment, it clearly had a negative impact on Telkom management which had argued for a larger

allocation of shares based on the *economic* necessity of attracting, retaining and motivating scarce management talent.

The ESOPs in SAA and ACSA, on the other hand, provided relatively larger, more market-based incentive share awards to managers and key employees, but those share awards were carved out from the shares initially set aside for the ESOP. In effect, non-management employees, the intended beneficiaries of Government's SOE restructuring empowerment agenda, were obliged to subsidize equity awards to senior managers through a dilution of their own ownership stake.

The proposed solution for resolving this conflict, as outlined in this report, is to first of all reaffirm that Government's guiding principle for the use of ESOPs in the context of restructuring transactions is to ensure economic empowerment of previously disadvantaged individuals by facilitating a non-discriminatory acquisition of shares by employees to provide them with an ownership stake in restructured SOEs. In short, Government's *political* objective of egalitarian economic empowerment should take precedence in regard to the *initial* sale of shares to an ESOP.

The problem of addressing the *economic* priority of providing management with sufficiently large, market-based share incentives can be resolved by reference to commonly accepted principles of shareholder dilution applied in thousands of similar transactions in private and state-owned companies around the world. The very popularity of management share schemes – and increasingly of broad-based employee ownership schemes – around the world is based on the premise that shareholders recognize the validity of providing managers with incentives that align their financial interests with those of the shareholders. Indeed, investors are typically willing to dilute the shareholding percentage to create a pool of shares that can be used to incentivize managers to help grow the business and create long-term shareholder value.

Having made the decision to restructure SOEs, Government should approach the perspective of management share incentives from the same perspective. Government as majority shareholder, strategic equity partners (SEPs), black economic empowerment (BEEs), the National Empowerment Fund (NEF), the employees through the ESOP, and any other shareholders have a shared priority of wanting to attract the best possible management team and to incentivize those managers to help grow the business. But that shared economic interest should therefore be shared equally *by diluting all shareholders in proportion to their respective shareholding percentages.* In the context of SOE restructuring, this means that the management share scheme would be created from a new issue of shares after the initial allocation to the representative shareholders referenced above. Managers would receive an equal number of shares and each of the other shareholders would own a slightly reduced percentage of overall shares based on an economically justifiable principle of aligning management incentives with those of all shareholders.

Such an approach is both philosophically sound and based on accepted business practices, but most importantly, it provides with a reasonable justification for adhering to its political imperative of using ESOPs in SOE restructuring as an economic empowerment strategy for previously disadvantaged individuals.

The process of separating management and employee stakes has the additional merit of allowing Government to create an approved "broad-based ESOP" subject to operating guidelines to ensure continued opportunities for employees to acquire ownership in a post-restructuring environment. The operating rules proposed for broad-based ESOPs are intended to both facilitate the initial transfer of shares to employees in the restructuring transaction and to provide for a seamless transition to their continued operation in the restructured company accordingly to established principles governing employee share trusts in the private sector.

The importance of establishing ESOPs, not just as a one-time opportunity for employees to acquire ownership in restructuring transactions but as a vehicle for on-going ownership participation in the private sector, has far-reaching implications. As noted above, the state-owned sector represents only about five

percent of South Africa's gross domestic product. As demonstrated by several decades of international experience, properly designed employee ownership schemes can play a role in broadening ownership effectively among private sector companies. Government's initial priority of empowering employees in restructured SOEs – where it's dominant shareholding position allows it to dictate the terms in regard to ownership allocation – would need to change in terms of incentivizing private sector companies to adopt similar schemes. International experience suggests that the most effective means of promoting private sector ESOPs is through designing targeted tax incentives to provide companies and shareholders with an incentive to contribute and/or sell shares to broad-based ESOPs.

Such a strategy goes beyond the mandate of the current paper, but some of the recommendations contained herein are offered with a view to encourage Government to think of ESOPs with a long-term perspective. By initiating broad-based ESOP strategies in the context of SOE restructuring, Government can promote its economic development programmes, demonstrate the viability of ESOPs as a business-friendly empowerment strategy that can have a positive impact on enterprise performance. In its role as a major shareholder in post-restructured enterprises, Government can use its influences to promote best-practices associated with participatory management, information disclosures and employee involvement strategies to create an "ownership culture" which has shown to be a statistically significant factor in capitalizing on the power of employee ownership to promote improved enterprise performance.

The successful implementation of ESOPs in SOE restructuring can therefore establish a basis for a more far-reaching application of broad-based ownership strategies to facilitate wider participation in the future growth of South Africa's economy. Such broad-based ownership reforms would require a comprehensive assessment of a wide range of legal, tax and fiscal implications. Our final recommendation is the Government considers undertaking such a study to assess the implications of pursuing an economic development strategy based on widespread ownership of productive assets.

Of the 30 recommendations proposed in this paper to enhance the policy and operating guidelines associated with broad-based ESOPs, the authors believe that all but the last two can be implemented immediately subject to government approval. The prospective ESOP incentives and the comprehensive policy analysis of potential ESOP incentives would obviously need to be considered within a much longer frame of reference.

INTRODUCTION

The Government of the Republic of South Africa ("Government") through the Department of Public Enterprises ("DPE") seeks to establish an overarching policy framework and implementation guidelines for Employee Share Ownership Plans ("ESOPs") that are defensible across a wide range of SOE restructuring initiatives. The need for a policy framework is evidenced by conflicting goals and assumptions that were manifest in the negotiation, design and implementation of ESOPs in several SOE restructuring initiatives to date[1].

Greater clarity from government concerning its policy priorities in regard to ESOPs would help facilitate restructuring negotiations. The process of implementing ESOPs could also benefit from clear procedural guidelines that would facilitate their design and operation. While government should allow sufficient flexibility to enable advisors to optimize ESOP design in the context of different restructuring initiatives, the establishment of general procedural guidelines to ensure that ESOPs meet government objectives will streamline the implementation process. It is important in that context that ESOPs be effectively integrated with established laws and procedures governing the operation of ESOPs as well as to ensure efficient plan design and administration and the equitable treatment of employees to the greatest extent possible.

This paper is divided into four sections. The first section discusses several key issues concerning the design and operation of ESOPs and offers recommendations for clarifying government policy regarding the use of ESOPs in SOE restructuring transactions. The second section offers guidelines for the design and operation of broad-based ESOPs. It includes recommendations for how government policies regarding the use of ESOPs can demonstrate their feasibility for fostering broad-based share ownership and establish precedents for the use of broad-based ESOPs in the private sector. The third section offers suggestions for how government can take advantage of its unique position as the principal owner of restructured SOEs to introduce certain enhancements to the implementation and operation of ESOPs. Such incentives could be designed specifically with a goal to improve the ability of employees to maximize their opportunities for acquiring shares in restructured SOEs as well as to foster the continued use of ESOPs in the restructured enterprises (as well as in private sector companies generally).

In addition to enhancements that could be implemented under current law, the final section of the paper offers suggestions for several legislative and regulatory changes that could further facilitate the implementation of ESOPs, both for restructured SOEs and for private companies, through several suggested tax and regulatory changes.

The conclusion provides a summary of the recommendations, including a discussion of those recommendations that can be implemented immediately and those that will require more thorough analysis and a wider process of engagement.

[1] The authors have analyzed in particular the role of ESOPs in the SAA, ACSA and Telkom restructuring initiatives.

I. RECOMMENDATIONS FOR CLARIFYING GOVERNMENT POLICY ON ESOPS

REINFORCE GOVERNMENT'S ENDORSEMENT OF ESOPS AS A KEY ECONOMIC EMPOWERMENT STRATEGY

As stated in its policy framework for the restructuring of SOEs,[2] the government of South Africa seeks to use employee ownership and other broadened ownership strategies to help promote "genuine empowerment for those denied access to the benefits of ownership and management during apartheid." The policy framework also states that "the inclusion of employees and communities on SOE restructuring plans is vital, not least because creating and enhancing "social capital" (roughly defined as the fabric of trust and mutual support that is recognized as vital to successful development) is one of the South African government's overarching socioeconomic objectives."

In the context of SOE restructuring initiatives, where government can have the greatest impact in defining the terms under which the ownership of SOE assets will be restructured, employee share ownership plans offer the prospect of achieving a variety of complementary policy goals. Economic empowerment of previously disadvantaged individuals can be facilitated via the sale of SOE shares to a broad base of its employees. ESOPs can be used to provide employees with ongoing incentive compensation and a stake in the future growth prospects of the restructured enterprise. Broad-based employee participation in ownership can build support for SOE restructuring initiatives and private sector reforms and can help create and "ownership culture" of shared risk, responsibility and rewards among employees, managers and outside shareholders.

Economic empowerment of employees and greater employee participation in operational issues affecting their work environment are trademarks of effectively managed employee ownership programs. As such ESOPs can address a variety of political and economic goals by creating an environment conducive to widespread participation in the ownership of productive assets. They therefore represent an attractive, business-friendly strategy of promoting empowerment through market-based principles that address political, economic and social priorities.

By helping to create broad-based participation through ownership in a growing economy, ESOPs will help build support for private sector development and ensure a better distribution of the benefits of South Africa's productive assets. By emphasizing the importance of ESOPs in the context of SOE restructuring, government can demonstrate the viability of broad-based ownership as a long-term economic restructuring strategy.

CLARIFY THE COMPLEMENTARY GOALS OF EMPOWERMENT, INCENTIVE COMPENSATION AND EMPLOYEE PARTICIPATION IN THE CONTEXT OF ESOPS

The concept of empowerment is a central tenet of government's overall economic development strategy. When applied to the use of ESOPs in SOE restructuring, empowerment can be interpreted to mean several complementary but different goals. On the one hand, ESOPs can empower employees economically by providing them with an opportunity to acquire ownership of shares as part of the initial restructuring transaction. Given government's stated political objectives of empowering previously disadvantaged individuals in the context of the restructuring process, targeting the sale of government's shares to that constituency, while avoiding reverse discrimination, is an important priority.

The restructuring process is also intended to prepare SOEs to operate in a new, competitive environment in which it will have multiple shareholders. While ensuring employees of the opportunity to acquire

[2] "An Accelerated Agenda Towards the Restructuring of State Owned Enterprises: Policy Framework", Ministry of Public Enterprises, Republic of South Africa, August, 2000.

shares in the restructuring transaction is an important first step, ESOPs should optimally help foster the continuing process of transformation by providing both employees and managers with common ownership incentives to help improve overall company operations over the long term. In that context, ESOPs should not be considered merely as a one-time means of reapportioning the ownership of SOEs, but as a vehicle that will continue to operate in the post-restructuring environment to provide employees with a chance to earn additional incentive compensation. It is therefore important that ESOPs established in the context of restructuring should conform as much as possible with established legal precedents to ensure a seamless transition to the private sector and facilitate continued use of employee share schemes by the restructured companies.

Finally, share ownership implies certain rights and responsibilities ranging from dividends to voting to access to information. Because ESOP transactions in South Africa typically involve the use of employee trusts and employee share options as opposed to direct share ownership, the issues of ownership rights and responsibilities are more nuanced than may be immediately apparent. In addition, ESOPs will typically acquire a minority ownership stake in restructured SOEs, which further limits their use as a "power-sharing" vehicle. There are nevertheless a number of operational issues involving ESOPs (discussed in more detail below) whereby government can ensure appropriate employee representation and participation in the operation of ESOPs. In addition, government can use its influence *as a shareholder* to encourage greater employee involvement through informed participation in decisions affecting their working environment to help facilitate improved corporate performance after the initial restructuring transaction.[3]

Each of these concepts of empowerment – economic empowerment, incentive compensation and employee participation – is a legitimate goal for ESOPs. Economic empowerment can be provided by ensuring employees of an ownership stake in restructuring transactions. Ongoing incentive compensation can be facilitated by establishing operational guidelines for broad-based employee share ownership schemes that conform to legal precedents established for share schemes in the private sector. And empowering employees through enhanced participation as employee-owners can promote improved labor-management relations and facilitate improvements in overall enterprise operations.

If government, the strategic equity partner, managers and employees can develop a common understanding of how to best capitalize on the shared incentive of ownership to implement operational reforms to enhance enterprise performance, ESOPs can play an important role in transforming SOEs to better prepare them for competing in a liberalized economy. As a market-based approach to broad-based participation in enterprise restructuring, ESOPs also offer government an opportunity to demonstrate the practical merits of encouraging broader participation through ownership in the private sector.

Recommendations:

1. Reaffirm that government's guiding principle for the use of ESOPs in the context of restructuring transactions is to ensure economic empowerment of previously disadvantaged individuals by facilitating a non-discriminatory acquisition of shares by employees to provide them with an ownership stake in restructured SOEs.
2. Emphasize that ESOPs are also intended to provide employees with ongoing opportunities to acquire ownership in restructured enterprises as an incentive to help improve the long-term performance of restructured SOEs.

[3] See "The Use of Employee Ownership Plans in Restructuring State-Owned Enterprises: A Review of International Practice," prepared as a background to this report, which discusses in greater detail the impact of ESOPs and participatory management practices in terms of enhancing enterprise performance.

3. Establish appropriate standards to ensure employees' share ownership rights through representation on ESOP trusts.

4. While government should not impose operational standards or management guidelines regarding employee participation in company operations, it can act *in its role as shareholder* to encourage the use of participatory management practices to facilitate improved labor management relations in the context of the shared incentive of ownership.

ESTABLISH A CLEAR DISTINCTION BETWEEN MANAGEMENT SHARE SCHEMES AND BROAD-BASED ESOPS

The term "ESOP" in South Africa is used in reference to a number of different employee share schemes.[4] While any of these plans can be used to provide ownership incentives to virtually all of a company's employees, they are more commonly used as management share incentive schemes. By contrast, in most other jurisdictions, the term "ESOP" typically designates schemes that are designed to facilitate broad-based employee participation. In the context of restructuring initiatives it is therefore exceedingly important to distinguish between broad-based ESOPs and management incentives schemes. This is critical not only in terms of determining the appropriate distribution of ownership among employees and managers, but also in terms of how the respective management share schemes and broad-based ESOPs operate in practice.

In addition, the complementary goals of empowering employees through broad-based ESOPs and providing both employees and managers with appropriate incentives to work for the future success of the enterprise requires the government policy incorporate both types of plans in its SOE restructuring strategy.

Recommendations:

5. Establish a clear distinction between broad-based ESOPs and management share schemes.

6. Clarify that both broad-based ESOPs and management share incentive schemes have a legitimate role in facilitating the restructuring of SOEs.

REVISE GOVERNMENT POLICIES FOR ALLOCATING OWNERSHIP INCENTIVES BETWEEN EMPLOYEES AND MANAGERS

The allocation of ownership incentives among employees and managers is obviously a politically charged issue since management ranks have traditionally excluded previously disadvantaged individuals who make up the majority of the workforce at large. The challenge is further complicated by the apparent tension between government's political and economic priorities in the context of restructuring. Whereas the government's *political* priority is to promote economic empowerment of previously disadvantaged individuals through expanded ownership opportunities for a broad range of workers, its *economic* priority is to improve the performance of SOEs. That economic priority must recognize the commonly accepted principle that ownership incentives provide managers (as well as employees) with a shared incentive to increase shareholder value. The problem is further exacerbated by the fact that management schemes typically provide more lucrative awards on a per-employee basis since managers can legitimately claim to be in a better position to influence improved enterprise performance.

Without separating management share schemes from broad-based ESOPs in terms of allocating shares in SOE restructuring transactions, the process of merging government's political and economic priorities

[4] See Appendix I for a description of the various approaches to ESOPs authorized under the Companies Act.

becomes problematic. Indeed, the SOE restructuring initiatives that have included ESOPs to date have often resulted in disputes over the allocation of shares between workers and managers.

This has been most apparent in the case of Telkom, in which management and employee groups have distinctly different expectations in terms of the distribution of shares within the ESOP. The apparent decision by government to emphasize the political imperative of treating all Telkom employees equally in terms of allocating share options within the ESOP has resulted in significant disaffection among Telkom's managers who feel they are being short-changed in terms of market-based standards for management incentive schemes.

On the other hand, the examples of the ESOPs at SAA and ACSA suggest that alternative strategies for splitting the ESOP into management and employee schemes are perceived as unfairly benefiting managers at the expense of employees. In the case of SAA the pilots and flight deck personnel were given attractive share option awards at significant discounts to the market price and a significant portion of the ESOP's share set-aside was also awarded to the management team. Employees at large feel that too large a percentage of the shares that were intended to provide for economic empowerment of previously disadvantaged individuals have instead been allocated to a select group of managers and employees.

Interviews with management at ACSA suggest that the process of allocating shares among employees and managers was less acrimonious. Indeed, ACSA managers suggest that the incentive of ownership has been very well received by the ACSA employees and that the company has made good progress in creating an "ownership culture" of shared risk and reward. Even so, the fact remains that of the nine percent of ACSA shares set aside for the ACSA ESOP in the restructuring transaction, a significant portion of those shares were reserved for allocation to top managers.

In economic terms, this means that the ACSA and SAA employees were obliged to dilute their shareholding incentives to accommodate the economic necessity of providing managers with market-based share incentives. The relative allocation of the shares among managers and employees at ACSA and SAA is arguably justifiable, but the political priority of empowering previously disadvantaged individuals was clearly diluted by the allocating of significant percentages of the ESOP shares to managers. At Telkom, by contrast, the political priorities were arguably realized via an equal distribution of shares among employees, but the economic principle of aligning the interests of managers and shareholders through ownership incentives is clearly absent.

A way to resolve this conundrum can be determined by reference to commonly accepted principles of share dilution used in most corporations throughout the world. For example, shareholders generally support management share incentive schemes based on the principle of shared incentives. Shareholders want managers to work for long-term growth in shareholder value. Providing managers (and increasingly employees at large) with share incentives aligns their economic interests with those of the shareholders. Shareholders are therefore willing to dilute their respective ownership percentages by issuing new shares to fund the management share incentive scheme.

Restructured SOEs should be no different from other companies in that regard. But rather than forcing only the employees in the ESOP to dilute their economic interests to accommodate the need for management share incentives, government should instead adopt the principle that *all* shareholders should "pay" for management share incentives through pro-rata equity dilution.

This can be accomplished in one of two ways. In allocating the initial shares to key shareholder constituencies such as the strategic equity partner (SEP), the National Empowerment Fund (NEF), Black Economic Empowerment (BEE) and the ESOP, the government could negotiate dilution rights whereby the respective shareholders would dilute their respective shareholding to provide for the management share scheme. Alternatively, the government as majority shareholder can approve a new issue of shares of the company for the management scheme.

The economic principle of this approach to funding the management share scheme is economically sound. Every shareholder should want to incentivize managers to create shareholder value. Every shareholder should therefore accept the economic necessity of diluting its pro-rata ownership share to fund the management plan. In addition, this approach solves the political problem of having the ESOP alone subsidize the management plan.

The following table illustrates the economic impact of the all-shareholder approach to dilution versus the ESOP-only strategy in a hypothetical distribution of shares in an SOE restructuring transaction:

Relative Impact of Shareholder Dilution	
ESOP-Only Dilution	**All-Shareholder Dilution**
Government – 52%	Government – 51%
SEP – 30%	SEP – 29,4%
NEF – 6%	NEF – 5,9%
BEE – 6%	BEE – 5,9%
ESOP – 6%	ESOP – 5,9%
Employees – 4% Managers – 2%	Managers – 1,96%
• 2% needed to fund management share scheme comes from the 6% reserved for the ESOP • Non-management employees are the only shareholders affected • Non-management employee stake is diluted by 33%	• Assumes same initial share allocation • Management share scheme funded with new share issue, increasing total share capitalization by 2% • All shareholders diluted proportionate to respective shareholding percentages • ESOP stake is diluted by 3%

Several points should be emphasized in regard to the all-shareholder approach to funding the management share scheme:

The dilution strategy will clearly need to be a priority issue in negotiations with the strategic equity partner (SEP). The SEP will need to know as a condition of making its investment that it will also be expected to pay for its pro-rata share of the management share scheme. While this could possibly affect the negotiations with the SEP, most investors accept the principle of share dilution.[5] In addition, as discussed more fully below, the SEP should be authorized to manage the management share scheme as it deems appropriate to incentivize the management team. If negotiated effectively from the perspective of establishing appropriate performance incentives for the restructured SOE, this approach can help establish a precedent for a government-SEP-management-employee partnership that will enhance the restructuring process itself and facilitate government's transition to its new role as a major shareholder.

[5] In many change of control transactions, investors will commonly accept dilution of 10% to 20% of their ownership interest to fund performance-based share incentive schemes. They are normally implemented over a five to ten-year time and awarded annually based on performance criteria. Thus, dilution could be as low as 1% per year or as high as 4% per year.

The all-shareholder dilution principle obviously means that the beneficiaries of government's political empowerment strategy – the NEF, BEE and ESOP – will each "pay" for the management scheme through dilution of their respective ownership stakes. While this may be politically problematic in the sense that previously disadvantaged individuals and groups will be subsidizing economic awards for "elite" groups of managers, the economic impact of the dilution should be relatively small and government in its role as majority shareholder will suffer the largest proportionate economic impact. In addition, the all-shareholder dilution principle is dramatically fairer to the ESOP, which would otherwise be obliged to subsidize the management share scheme from its own stake.

It is also worth noting that, because management share schemes typically involve the award of stock options, the dilution of the other shareholders does not happen immediately, but only when the options are exercised. Assuming that no options would be exercised unless there has been an increase in the value of the shares, the other shareholders should never suffer actual economic dilution, just a dilution in their respective ownership percentages.

While the all-shareholder dilution principle should be the preferred approach to funding management share schemes, in may not be feasible in every instance due to unforeseen complications. In those cases, the set-aside for the management share scheme should be based on economic rather than political assumptions. This means that the size of the management stake should be based on calculations of the value of comparable incentive schemes provided in similar private sector companies. Once an appropriate market-based calculation for the size of the management scheme is determined, government can proceed with a corollary assessment of the size of the respective stakes to be allotted to the broad-based ESOP, the NEF and BEE. This does not suggest that the management share scheme is "first in line" in terms of the priority share allocation. Rather, it recognizes the principle that management share incentives should be market-based as much as possible in order to achieve the intended goal of aligning management and shareholder interests. The corresponding allocations to the ESOP, the NEF and the BEE can be based on their relative value to the management scheme.

Finally, once the principle of all-shareholder dilution to fund the management share scheme has been established, government can justifiably emphasize its political objectives of economic empowerment in the initial allocation of shares within the broad-based ESOP. Given the intention of empowering previously disadvantaged individuals, an equal allocation of shares to each employee can be justified on political terms irrespective of the relative merits of managers and employees in an economic sense. While "equal" allocation would most probably mean an equal number of shares per employee as was done in the Telkom ESOP, in certain cases allocation based on an equal percentage of salary or a formula employment level, salary and years of service (or a similar formula) may be appropriate.

Recommendations:

7. Government policy for funding management share schemes should be based on the principle of pro-rata dilution by all shareholders. After the initial share allocation has been made to an SEP, the NEF, the BEE and the broad-based ESOP, new shares would be issued to fund the management scheme, thereby diluting the initial shareholders on a pro-rata basis.

   In those cases in which an all-shareholder approach is not feasible for any reason, the size of the management share scheme should be determined to the greatest extent possible based on an economic calculation of comparable equity incentive awards in similar private sector companies. Once the appropriate size of the management stake is determined, the NEF, BEE and ESOP stakes can be determined proportionately.

8. Government should clarify that the allocation of the initial ESOP stake in restructuring transactions will be based on the political principle of equal distribution. The term "equal distribution" may have the following application as determined by government on a case-by-case basis:

   a) Distribution based on an equal number of shares or share options per employee;

b) Distribution based on an equal percentage of employee's salaries;

c) Distribution based on a formula that takes into account employment status, salary, years of service, or other factors.

RECOGNIZE OPERATIONAL DISTINCTIONS BETWEEN MANAGEMENT SHARE SCHEMES AND BROAD-BASED ESOPS

Another important consideration in distinguishing management incentive schemes and broad-based employee schemes is how the respective schemes are typically used in practice. While management schemes often involve multiple awards based on individual performance, broad-based ESOPs in the context of restructuring have been designed as one-time offers to employees in conjunction with the restructuring transaction, albeit with vesting and exercise restrictions to ensure that the ownership incentives will be deferred for a certain period of time. This is consistent with government's primary rationale for using broad-based ESOPs in restructuring to advance economic empowerment strategies.

Optimally, however, broad-based ESOPs should also serve as incentive compensation schemes that provide employees with an ongoing opportunity to share in the long-term financial prospects of the restructured company. While government can dictate the terms of sale of its shares to broad-based ESOPs in the context of the restructuring transaction, any subsequent transactions involving those shares will be subject to the direction of the company's board of directors. Therefore, to promote the continued use of broad-based ESOPs in a post-restructuring environment ESOPs should be designed to accommodate their use as an incentive compensation scheme in the restructured company.

Towards that end, the use of broad-based ESOPs can be enhanced by designing them to provide employees with more than a one-off opportunity to acquire shares. Rather than merely serving as a vehicle for transferring ownership to employees in the context of the restructuring transaction, ESOPs should be designed to operate according to established principles of the Companies Act to facilitate their continued use in a private company. By establishing operating principles for broad-based ESOPs, as opposed to management share schemes, government can encourage the continued recycling of the ESOP's shares among a broad base of employees once the initial "empowerment shares" have been sold by employees of the restructured SOE.

Whereas government's *political* emphasis on economic empowerment of previously disadvantaged individuals in the context of the restructuring transaction justifies an equal distribution of shares to all eligible employees, the *economic* rationale of using ESOPs as incentive compensation should accommodate more performance-based standards for the operation of broad-based schemes in the post-restructuring environment. While it should clearly be in the government's interest to promote the continued use of broad-based ESOPs in the post-restructuring environment (and among private sector companies generally) the economic principle of incentive compensation means that, subject to the general ESOP operating principles outlined below, the directors and management of the post-restructured enterprise should be able to use ESOPs to reward individual and group performance. In many cases this should result not in an equal allocation of shares but an allocation based on individual and/or group performance.

While the use of ESOPs as incentive compensation can be true for employees at large, the incentive of ownership can be particularly useful in motivating managers and key employees with performance-based incentive awards. There is ample precedent in South Africa's business culture for the use of management stock options and similar share incentive schemes but the dynamics of these arrangements differ in fundamental ways from broad-based employee share schemes. In contrast to broad-based ESOPs, management share schemes are typically tied more directly to individual employee performance and thus involve more operational complexity. For example, stock option grants or stock purchase offers may be contingent upon a manager meeting pre-determined financial or operational goals. The number of options offered may be contingent upon an individual's annual performance evaluation. In addition, while the

share awards themselves usually include restrictions to ensure that the value of the award can only be realized over a number of years, the granting of the incentive itself is often done on an annual or at least periodic basis. As such, management share schemes tend to tie the incentive awards to mid-term tactical and operational goals that can facilitate the creation of long-term shareholder value. The well-established precedent for the use of management share incentive schemes in South Africa, as well as the growth of stock-based compensation plans internationally, suggest that most strategic equity partners that invest in restructured SOES are likely to want to establish similar schemes.

Given the close link between the use of management shares schemes and the strategic management of the company itself, government should establish a clear principle that the operation of management share schemes should be the responsibility of the strategic equity partner or, in the absence of an SEP, the senior management of the company.

It should be recognized that ceding operational control of the management share scheme to the SEP or senior management team could result in an allocation of economic incentives within the scheme that may violate political principles of economic empowerment of PDIs. In fact, the allocation of equity incentives within management schemes is often weighted towards more senior managers. As may very well be the case in many SOEs, PDIs may comprise the majority of the junior management ranks and therefore receive a proportionately lesser percentage of the awards within the scheme.

Problematic though this may be from the perspective of economic empowerment of PDIs, the principle of management operational independence – including the design and structure of management compensation systems – should be respected. The fact that even junior managers are likely to qualify for relatively large equity incentives in the management scheme as compared to comparable allocations in the broad-based ESOP, even if the management scheme is weighted to provide larger benefits to senior managers, suggests that government should best leave the operation of the management scheme to the SEP or senior management team.[6]

Recommendations:

9. Clarify that it is the intent of government to promote, *in its role as a shareholder*, the use of broad-based ESOPs in a post-restructuring environment. The reallocation of shares or share options within a broad-based ESOP (i.e., after the initial shares received by employees in the restructuring transaction have been sold) would be subject to the direction of the company's board of directors in accordance with the Companies Act, and subject to government guidelines for the operation of broad-based ESOPs (discussed below)

10. Clarify the principle that management share incentive schemes should be managed at the discretion of the strategic equity partner (SEP) or, in the absence of an SEP, at the discretion of senior company management.

[6] In South Africa, as elsewhere, there is growing criticism of the size of share option awards provided to senior managers in private companies. To avoid a similar criticism being applied to post-restructured SOEs, government may want to at least address this issue in the negotiations with the SEP to reach a common understanding that the management share scheme incentives should include an element of broad-based participation within the ranks of eligible managers.

II. RECOMMENDED OPERATIONAL GUIDELINES FOR BROAD-BASED ESOPS

While it is certainly true that existing ESOP laws permit the use of broad-based ESOPs, and there is some precedent in South Africa for the use of these schemes to benefit virtually all of a company's employees, most of the existing share schemes tend to provide the bulk of the incentives to higher-paid employees. The rationale for establishing operating guidelines for broad-based ESOPs is that, if it is in the government's interest to promote broad-based participation in ownership in the context of restructuring transactions, it should also promote the use of broad-based participation in the ownership of shares of companies in the private sector.

If effective guidelines for broad-based ESOPs can be established for restructured SOEs, government will be able to demonstrate both the viability of the concept of broad-based participation in ownership. Establishing the viability of broad-based ESOPs could also establish the basis for a longer-term policy of introducing incentives to encourage the use of broad-based ESOPs in private sector companies (see Section III for a discussion of potential ESOP incentives for the private sector).

ESOP laws in other countries typically require broad-based participation by all eligible employees, that the allocation of the assets within the scheme are subject to anti-discrimination requirements so that the scheme does not benefit a small minority of employees, i.e., highly paid managers, and that the schemes are operated in the best interests of employees. In many cases specific tax incentives are provided for corporate contributions of shares or cash to ESOPs to encourage companies to share ownership incentives widely among their employees.[7]

The following recommended operating guidelines for broad-based ESOPs are based on similar principles as applied in the context of existing South African laws governing ESOPs generally.

Recommendations:

11. **Shares must be held in an ESOP trust** – A trust must be established to hold employee shares, share equivalents or share options. The trust must be managed by a trustee or group of trustees with the fiduciary responsibility to ensure proper management of the trust's assets for all employees in accordance with established legal principles in the Companies Act.

12. **Eligibility requirements** – All full-time employees who have worked at the enterprise for a minimum period of time, e.g., one year[8] must be eligible to receive offers of shares, share equivalents or share options each time that such offers are made in accordance with procedures determined by the company's board of directors.

13. **Allocation standards to ensure broad-based participation** – The allocation of shares, share equivalents or share options must be determined according to a written formula in the trust document. Such formula must be designed to ensure that all eligible employees have an opportunity to benefit from each allocation. Such formula could provide for:

    a. equal allocation of shares, share equivalents or share options for all employees;
    b. allocation based on an equal percentage of annual salary;
    c. allocation based on a combination of salary and years of service or similar formula;

[7] The appendix of the previously referenced paper on "The Use of Employee Ownership Plans in Restructuring State-Owned Enterprises: A Review of International Best Practice" contains a synopsis of ESOP legislation in selected countries.

[8] This one-year waiting period significantly reduces the administrative burden on the ESOP for short-term employees who start and leave the employment of the company in the first year.

d. allocation based on the discretion of company management and/or the ESOP trustees according to an assessment of individual employee performance, subject to anti-discrimination standards in #14, below.
e. Any combination of the above.

14. **Anti-discrimination standards** – Whichever formula is used to determine how to allocate share incentives to employees per #13 above, the formula must ensure that:

    a. All eligible employees must receive some portion of each allocation, and;
    b. No more than one-third of each allocation may be allocated to the top 10 percent of eligible employees as determined by annual salary.

15. **Vesting requirements** – Shares, share equivalents or share option awards may be subject to vesting schedules to defer the time in which employees obtain full rights to the shares or share options allocated to them. Awards subject to vesting requirements may vest no less rapidly than in one of the following options:

    a. 10-year vesting in equal annual percentages so that an employee would be 10% vested after one year, 20% after two years, etc.

    b. 7-year vesting in which an employee would be 20% vested after three years with equal annual vesting of 20% per year thereafter.

    c. 5-year cliff vesting whereby an employee is unvested until the end of the fifth year at which time he would become 100% vested.

    Employees will qualify for immediate 100% vesting upon any of the following events:

    - Retrenchment due to a workforce reduction initiated by the company within three (3) years of an SOE restructuring initiative (voluntary departure or dismissal for cause do not qualify for purposes of this provision);

    - Attainment of qualified retirement age as determined by company policy, subject to a maximum retirement age of 60;

    - Disability;

    - Death

16. **Valuation of shares**[9] – Companies whose shares are not listed on an established stock exchange must have their shares valued by an independent valuator on at least an annual basis. The valuator must be independent of the company to ensure an arms-length analysis of the share valuation. "Independent" in this context means that:

    - The valuator may not have any other fee-based relationship with the Company;
    - Valuation fees may not be based on the amount of the transaction;
    - A substantial aspect of the business of the valuation firm must be regularly providing company valuations;

[9] Appendix II includes a more detailed discussion of recommended standards and procedures for ensuring fair and accurate ESOP valuations.

- The valuator may not be affiliated with any other companies or advisors who have an economic interest in the transaction.

Any subsequent valuation of the trust's assets must be based on this valuation.

17. **Record-keeping, communications and information disclosure** – The Compliance Officer is, among other things, responsible for the following, according to standards established under the Companies Act:

    a. Maintaining accurate records of plan transactions and the status of individual employee accounts;
    b. Providing employees with timely information about their assets in the trust, including:
        - the number of shares, share equivalents or share options in their account;
        - their vested rights to such assets;
        - their rights to exercise and/or sell the assets held in their account;
        - the value of the company's shares, at least on an annual basis.
        - the risk of equity and the fact that share values can rise and fall and provide no guaranteed value
        - that, in the case of unlisted companies, share liquidity is subject to the trust or sponsoring company's ability to repurchase the shares.

18. **Exercise of share options and sale of shares** – The trust document must clearly state the means and procedures whereby employees may exercise their share options and the terms by which employees may sell their shares. Such provisions shall specify that:

    a. Upon termination of employment employees shall have the right to transact for all vested shares, share equivalents or share options;
    b. Upon termination of employment share options will be deemed to have been exercised and shares and share equivalents will be deemed to have been sold.

19. **Liquidity** – The trust document must specify the means and procedures whereby employees will be able to redeem their shares or share equivalents for cash.

    a. To the extent that cash is readily available in the trust or the Company has ready cash reserves or the financial capacity to provide liquidity for employee shares or share equivalents tendered to the trust, employees must receive payment for their shares within a reasonable period of time.
    b. If the trust does not have ready cash reserves and the Company lacks the financial capacity to purchase shares or share equivalents tendered by employees to the trust, the ESOP trustees or the Company may defer the repurchase of qualifying shares tendered by employees for a maximum of three years;
        - In circumstances in which the Company elects to defer repurchases of shares tendered by employees, such shares will be deemed to have been purchased at the then-prevailing fair market value of the shares.
        - A corresponding liability will be recorded in the trust, with such debt obligation credited to the selling shareholder's account. Market interest rates must accrue on unpaid balances.
    c. Payments for ESOP shares may be made in equal annual installments of a maximum of three years. Market interest rates must be provided on unpaid balances due from installment payments.

20. **Employee representation on ESOP trusts** – Employees must be given the right to elect at least one-third of the ESOP's trustees. The sponsoring company's directors may determine procedures for determining the remaining trustees. One of the ESOP trustees must be the trust's Compliance Officer as defined in Section 144 A(3) of the Companies Act.

21. **Voting procedures**– The trustees shall vote shares held in the ESOP trust according to procedures spelled out in the trust document.

22. **Corporate governance principles** – The ESOP trust is expected to operate according to corporate governance principles as described in the King II Report.

III. FACILITATING THE USE OF ESOPS IN SOE RESTRUCTURING TRANSACTIONS

ADOPT FLEXIBLE GUIDELINES FOR ESOP DESIGN AND IMPLEMENTATION AMONG DIFFERENT SOE RESTRUCTURING TRANSACTIONS

While government policy must be as consistent as possible in regard to the principle of ESOP participation in SOE restructuring initiatives, that policy should nevertheless be flexible enough to allow for alternative strategies in regard to the design and implementation of the ESOP. Each SOE restructuring transaction is unique in keeping with the different size, value, number of employees, industry, market position and marketability of the SOE being restructured. Rules for ESOP design, financing and implementation therefore need to be flexible so as to accommodate creative approaches to restructuring initiatives.

An ESOP strategy could vary considerably under the following scenarios:

- **When SOE restructuring contemplates an IPO in the relatively near future:** A reasonably high level of confidence that an IPO will be possible in the not-too-distant future following the implementation of an ESOP would influence both the amount of the ESOP set-aside (a smaller set aside may be justifiable on the assumption of the potential for significant share appreciation after the IPO), the structure of the ESOP trust (the ability of the trustee to sell shares on the market and thereby create liquidity for purchasing employee shares) and the structure of management share incentives (one set of incentives targeted at achieving the IPO and another in conjunction with the IPO, financed from the IPO proceeds itself).
- **When the restructured SOE expects to remain unlisted for a period of several years:** If an IPO is not contemplated in the foreseeable future the design of the ESOP will need to take that into account in terms of ongoing valuation of the shares and provisions for enabling employees to sell their shares over time. The issue of providing liquidity for employee shares is a particularly important consideration since the ESOP trust and/or the sponsoring corporation must eventually finance the repurchase of employees' shares.
- **When the restructuring transaction contemplates selling shares to an SEP:** The involvement of an SEP could influence the structure of the ESOP in several important ways. The involvement of an SEP influenced the ESOP in the SOE restructurings at SAA, ACSA and Telkom by establishing the price of the shares offered to the ESOP. (See discussion of pricing, below)

  Many international corporations have implemented some form of broad-based ESOP or employee share option plan. They may be willing to offer the employees of the restructured enterprise options on their own (parent company) shares. If their proposal meets guidelines as proposed above for broad-based ESOPs that may provide an attractive incentive.

  Alternatively, the SEP may be willing to finance additional shares for the ESOP on the condition of reaching employment agreements with the union. One could imagine a competitive bidding scenario in which an SEP would agree to finance the ESOP's share acquisition to improve the competitiveness of its bid and/or work cooperatively with organized labor's financial advisors to structure a mutually-financed bid to acquire a larger stake for the ESOP.[10]

  Such innovative approaches will obviously be subject to a case-by-case analysis but, if the government were to incentivize SEP bidders, as proposed below, by giving them credit in the bid

[10] There is ample international experience in which organized labor has entered into a financing arrangement to acquire a larger ESOP stake, often in conjunction with negotiated work rule changes. See "Selected Restructuring Case Studies" in "ESOPs in Restructuring SOEs: A Review of International Practice"

selection process for enhancements to the SOE's ESOP, there may well be a number of innovative approaches proposed for structuring the ESOP.

- **When employees will be the only shareholder in addition to government:** In situations in which additional structural reform is required in order to prepare an SOE for an eventual restructuring initiative it may be appropriate to allow an ESOP to buy in at a nominal value. The design of the ESOP in such a scenario would need to incorporate longer-term expectations for providing employees with an opportunity to sell their shares.

  Separately, in cases where the government does not intend to sell shares to outside investors, an ESOP could be established to provide SOE employees with an incentive to improve enterprise performance. Such an ESOP could use actual shares or share options, or could create synthetic equity (phantom shares or share appreciation rights). In either case, the ESOP would be subject to the same rules as proposed for ESOPs in restructured enterprises that are not yet listed companies in regard to valuation standards and provisions for providing employee liquidity.

- **When SOE restructuring will result in total divestiture or full privatization:** Transactions in which government contemplates a sale of its entire (or virtually all of its) ownership stake could be structured to allow for a pre-transaction sale of a minority interest to an ESOP to enable employees to benefit from a potential premium share price upon sale of the enterprise (subject to deferred sale terms to require them to stay with the privatized company for a minimum period of time).

- **When management buyouts are feasible options:** In situations in which it may be preferable to facilitate a divestiture of a non-core asset (e.g., a small division that provides printing or transportation or training services that are tangential to the SOE's primary operations) that is not likely to attract strategic investors, it may be justifiable to permit management buyouts. Under these limited circumstances, government could provide management with an opportunity to acquire larger-than-normal equity stakes in exchange for ensuring that a broad-based ESOP could also acquire a comparatively large ownership stake.

There may be other, unforeseen scenarios that would justify alternative approaches to ESOP design. Government policy should welcome creative approaches that meet policy guidelines in regard to employee participation and which offer attractive economic opportunities for employees in the restructured enterprise.

CLARIFY GOVERNMENT POLICY ON PRICING OF ESOP SHARES

Heretofore, ESOP shares have been valued at the SEP bidding price. While this may be an appropriate pricing strategy in the right circumstances, in at least one instance (ACSA) the ESOP's financial advisor believed that the SEP paid a premium price for reasons unique to its strategic plans and advised the employees not to purchase shares at that inflated value. In other cases (SAA) different employee groups received shares or share options at differing prices and different times, which resulted in accusations of favoritism.

Optimally, ESOP shares should be valued by an independent valuator as proposed in the recommended operational guidelines for ESOPs. Not only can qualified valuators bring professional standards to the valuation process, they can also assist in adjusting values as appropriate to reflect a variety of different circumstances. For example, ESOPs will typically acquire a minority stake in an illiquid (not readably tradable) security. Standard valuation procedures generally justify a price discount for minority stakes and lack of liquidity.

Government should also clarify when and under what circumstances it will provide additional price discounts or favorable payment terms to facilitate an ESOP's share acquisition. Given the ESOP's unique role as a vehicle for providing economic empowerment to a broad range of previously disadvantaged

individuals, it may be appropriate for government policy to permit loan guarantees or similar financing subsidies to facilitate an ESOP's acquisition of shares. Self-liquidating debt over a 5-7 year period is a typical feature of "leveraged ESOP" transactions in other jurisdiction. Such financing support would need to be subject to stringent financial standards and oversight to prevent excessive debt financing, but properly structured ESOP financing arrangements should represent minimal risk exposure for government ESOP guarantees.

It may be possible in certain situations to conduct a preliminary valuation and offer the ESOP the chance to buy in at that price, prior to tendering for competitive SEP bids that would be expected to result in a higher valuation. This strategy should only be used, however, when government has a high level of confidence that competitive bids among potential investors will indeed result in a price premium.

USE GOVERNMENT'S INFLUENCE AS A MAJOR SHAREHOLDER TO ENCOURAGE THE CREATION OF AN "OWNERSHIP CULTURE"

Research on the impact of employee ownership on corporate performance demonstrates a strong link between broad-based ownership strategies as embodied in ESOPs and participatory management practices.[11] While such practices often include employee representation on ESOP trusts, trust committees and, more rarely, company boards of directors, the research has found that the most important aspects of participatory management relate to operations in which employees can provide marginal improvements to aspects of the job over which they have some control.

The most effective participatory management practices seek to establish an "ownership culture" in which employees are provided not only with financial information about overall company operations, but more importantly, information pertaining specifically to the operating division where they work. A combination of information disclosure, management practices that facilitate two-way communications to solicit employee input into decisions affecting their workplace, as well as training to help employees understand and help improve operational procedures to enhance company performance are the essential components of an ownership culture.

In a post-restructuring environment, government should not attempt to impose specific management practices, but in its role as a major shareholder, and commensurate with its policy to promote widespread ownership to facilitate both economic empowerment and incentive compensation, government should encourage restructured enterprises to implement management practices to capitalize on the shared incentive of ownership with managers and employees.

The creation of an effective ownership culture is a evolutionary process that will be implemented and practiced differently in each company. It requires an added level of commitment from both managers and employees in order to affect behavioral changes that can result in improved corporate performance. But the growing body of evidence in a variety of countries that have implemented broad-based ESOPs suggests that government would be well served to use its influence as a shareholder to promote the use of participatory management practices and the creation of an ownership culture as an incentive to enhance corporate performance.

Recommendations:

23. Government policy should not preclude alternative approaches to ESOP transaction strategy and trust design proposed by strategic bidders so long as the proposed structure meets guidelines for broad-

[11] For a comprehensive review of the research, see Employee Ownership and Corporate Performance, The Journal of Employee Ownership Law and Finance, Winter, 2002, published by The National Center for Employee Ownership, Oakland, CA (USA) www.nceo.org

based participation, empowerment and opportunity as described in the proposed ESOP guidelines referenced above.

24. Government should consider providing incentives for strategic equity partners to enhance potential ESOP participation by giving credit for proposals from prospective investors that would include plans to enhance the funding, operation and/or value of a broad-based ESOP.

25. Permit management buyouts under limited circumstances with the proviso that employees should be able to benefit from ownership through a broad-based ESOP.

26. Government should clarify the terms and conditions upon which it will receive payment for ESOP shares and the circumstances in which it will subsidize employee purchases via any of the following subsidies.

    a. Price discounts
    b. Deferred payment terms
    c. Permitting ESOP purchases at preliminary (pre-investor) values
    d. Providing government loan guarantees to assist with a broad-based ESOP's acquisition of shares.

27. Government should develop strategies for using its influence as a major shareholder in the post-restructuring environment to encourage the use of ESOPs as both an incentive compensation vehicle and as a means to promote greater employee participation in improving overall enterprise operations.

    In addition to encouraging the use of broad-based ESOPs to provide employees with an ongoing opportunity to acquire ownership incentives, such efforts could include promoting financial disclosure, employee education and training, enhancing opportunities for employee participation in job-level decision-making, etc., in order to encourage the development of an "ownership culture."

IV. POTENTIAL ESOP ENHANCEMENTS

The recommendations discussed up to this point include policy, strategy and implementation guidelines for broad-based ESOPs. These recommendations can all be implemented immediately subject to review and acceptance by the appropriate government officials.

The recommendations that follow in this section, with the exception of the first proposal, which could also be implemented immediately subject to government approval, will require a more detailed analysis and a wider process of engagement with various constituencies including a range of government agencies, business and professional groups, organized labor and citizens' groups.

The following recommendations are offered as a means to enhance the use of ESOPs both in the context of restructuring transactions involving SOEs as well as to suggest means whereby the government may incentivize greater use of broad-based ESOPs in the private sector. Given that the SOE sector is estimated to comprise no more than approximately five percent of South Africa's gross domestic product (GDP), it stands to reason that a policy promoting widespread ownership opportunities in the SOE sector should also merit consideration in the private sector as well.

Such a policy perspective must initially focus on establishing the viability of broad-based ESOPs in the context of SOE restructuring initiatives and also ensure that proposed guidelines for the operation of broad-based ESOPs comply with established legal requirements that apply to private companies.

Once the viability of broad-based ESOPs is established, the government could then consider a range of tax and other incentives discussed below. However, any further expansion of government's role in promoting broad-based ESOPs beyond its role as a major shareholder in restructured SOEs requires a careful consideration of a broad range of legal, fiscal and social issues concerning changes to existing law.

ENHANCING ESOP PARTICIPATION FOR LOW-INCOME WORKERS

As noted, we believe it is feasible for government to implement this policy immediately, subject to a policy decision advocating the use of targeted ESOP incentives to benefit low-income workers.

According to the Income Tax Act, a donations tax of 20 percent is imposed on the value of any property disposed of under any donation by any resident. Such property includes donations of corporate shares. The donor is liable for the tax provided that, where the donor fails to pay, the donee shall be jointly and severally liable for the tax.

In the context of SOE restructuring, where the donor is the government itself and therefore exempt from taxation, it would appear that a grant of SOE shares owned by the government to a broad-based ESOP will be exempt from the donation tax.

Under this scenario, the government could grant shares directly to those employees in the lowest tax bracket (for the year 2002, this includes individuals whose annual income is less than R38,000). The shares would be contributed to the ESOP trust and immediately allocated to the accounts of qualifying employees.

Employees would be exempt from the 10 percent fringe benefits tax applied to company-provided benefits, since this would be a direct contribution of the government's SOE shareholdings to qualified employees.

Assuming that the shares would be subject to restrictions to ensure that employees may not sell the shares for quick profits, such a plan could serve to facilitate long-term ownership by low-income workers.

Recommendation:

28. In circumstances in which a restructured SOE includes employees whose annual income is in the lowest tax bracket (currently R38,000 per year), government could consider dedicating a small percentage of the ESOP's ownership stake for targeted donations of shares to low-income employees. While this would represent a "give-away" of government assets, the fact that such a donation would be both modest in value and targeted to low-income employees may justify such an expense.

    Such donations would have the following characteristics:

    a. The value of shares donated would be relatively small, e.g. R2-3,000 per employee;
    b. The shares would be contributed to a broad-based ESOP and immediately credited to the accounts of qualifying low-income employees;
    c. Employees would be exempt from the 10% fringe benefits tax applied to company-provided benefits, since this would be a direct contribution of the government's SOE shareholdings to qualified employees;
    d. The donated shares would be subject to a 4-year cliff vesting schedule whereby employees would not be able to sell their shares before the end of four years, at which time they become 100% vested;
    e. Employees would pay capital gains taxes on any increase in the value of the shares from the date the shares are allocated to their accounts in the ESOP until the date on which the shares are sold;
    f. Employees who receive share donations under this provision would still be eligible to receive their pro-rata allocation of shares under the ESOP's standard allocation formula.

TAX-DEFERRED EMPLOYEE SHARE SAVINGS SCHEMES

Another potential enhancement to the current structure of broad-based ESOP would require approval by Parliament. However, the proposed change is based on current rules governing the operation of provident funds and would require a fairly simple change.

Under current law, employees may defer a portion of their pre-tax salary to a provident savings fund. Interest accrues tax-free on the deferred amounts. Account balances can be transferred to other provident funds without triggering taxes. Tax is due upon distribution of the assets from the fund.

The same concept could be applied to facilitate the ability of employees to exercise their deferred stock options in a broad-based ESOP. Employees could be allowed to defer a portion of their pre-tax salary to their individual account within the ESOP. Interest would accrue tax-free. As the employee's options vest, assuming they are in the money, employees could use their savings to help pay for the exercise of the option. If the option is not in the money, the employee would simply not exercise. The cash in his account could remain there for future option opportunities, be transferred to a provident fund or paid as a taxable benefit to the employee.

Recommendation:

29. Government should introduce a proposal for consideration by Parliament to facilitate the ability of employees to save money on a pre-tax basis to improve their ability to exercise stock options in broad-based ESOPs. Such employee share savings schemes would have the following characteristics:

    a. The schemes would apply only to employee shares schemes meeting the definition of a broad-based ESOP;
    b. Employees would be permitted to defer a portion of their salary to the ESOP savings plan.
    c. The ESOP savings plan would be managed in accordance with existing standards for provident funds;
    d. Employees could use their savings to exercise their share options within the ESOP trust without triggering tax;

e. Employees could also elect to transfer their funds at any time to a provident fund without triggering tax.

OTHER POTENTIAL ESOP TAX INCENTIVES

One of the major limitations of the legal system governing ESOPs in South African is that, even with price discounts and deferred payment terms, at the end of the day employees must essentially purchase their shares. Given the limited financial resources available to most employees, their ability to purchase any significant shareholdings is quite restricted.

The success of ESOPs in other jurisdictions, particularly in the U.S and U.K.,[12] is based on the ability of employers to make tax-deductible contributions of shares to ESOPs. In addition, the ability to provide employees with access to capital credit through tax-subsidized corporate guarantees has been instrumental in enabling ESOPs to purchase relatively large blocks of shares and to pay for them with the future earnings of the company itself.

Samples of the types of tax incentives used to promote widespread use of ESOPs in private companies include the following:

- Exempt company contributions of shares or cash to broad-based ESOPs from the 20 percent donations tax (as proposed for SOE transactions);
- Allow companies to deduct from current taxation the value of company shares or cash contributed to broad-based ESOPs;
- Allow companies to deduct from current taxation contributions to repay the debt of broad-based ESOPs;
- Allow companies to deduct from current taxation the value of dividends used to repay ESOP debt or passed through to ESOP participants in cash;
- Allow companies a current tax deduction for the value of dividends declared on shares held in a broad-based ESOP;
- Permit selling shareholders to defer capital gains taxes on sales of shares to a broad-based ESOP;
- Allow lenders to ESOPs to exclude from current taxation 30% of the interest income earned on a loan to an ESOP (to encourage banks to loan to ESOPs and to allow them to reduce interest rates for ESOP borrowers by passing through a portion of their tax savings).

These concepts cannot easily be implemented in South Africa due to the very different legal principles enshrined in the Companies Act. Any consideration of more far-reaching reforms would require a comprehensive tax and legal review that goes beyond the scope of the current effort to improve the use of ESOPs in the context of SOE restructuring.

However, given the South African government's priority of promoting broad-based ownership SOE transactions, employee ownership offers an attractive means of connecting employees directly to the long-term prospects for economic growth in South Africa. Connecting the economic empowerment agenda of broad-based ownership with a strategy to promote growth of the private sector offers the prospect of combining economic and social goals. A public/private partnership predicated on government tax incentives for businesses that are tied to broadening ownership of productive assets has contributed to

[12] The appendix to "The Use of Employee Ownership Plans in Restructuring State-Owned Enterprises: A Review of International Practice" contains detailed descriptions of tax incentives used to promote ESOPs in a number of selected countries, including the U.S. and U.K.

robust economic growth and widespread wealth creation in a number of countries that have adopted this strategy.[13]

A policy based on providing growing numbers of workers with a stake in the future economic growth prospects of South Africa offers a vision in which widespread participation in the ownership holds the promise of reducing the need for government welfare and other redistribution programs. The process is imperfect and there will be winners and losers along the way. Share ownership offers attractive opportunities for wealth creation but no guarantees. But a government strategy focused squarely on promoting the growth of the private sector – predicated on widespread participation in ownership – is precisely why the government has devoted such considerable resources to restructuring state-owned enterprises.

Expanding that practical vision of participatory ownership from the state-owned sector to the private sector at large requires a different and more comprehensive strategy that will of necessity rely on the use of tax and other incentives to encourage private companies to adopt broad-based ESOPs. Such a strategy will clearly require extensive analysis across a wide range of government and business interests to ensure that it can be effectively integrated within the framework of legal, financial and tax regimes and be structured in a way to be of practical benefit to both companies and employees.

Not least, the analysis of a long-term government strategy to promote ESOPs in the private sector will require careful consideration of the costs of such incentives in terms of deferred government tax revenues. The cost of government's "investment" in long-term, widespread capital appreciation must be measured in terms of prospective revenue enhancements to be realized from an expanded tax base for capital gains and related tax revenues. A macro-economic analysis and econometric modeling of various assumptions related to the implementation of such a proposal can provide government with a reasonable basis for judging the relative merits of specific tax incentives.

Recommendation:

30. Government should underwrite a policy analysis for the purpose of determining the feasibility of introducing comprehensive reforms to encourage the rapid growth of broad-based ownership in the private sector. Such a study could consider the following:
    - What will be required in terms of legal and tax changes to facilitate more rapid implementation of broad-based ESOPs and similar ownership-broadening strategies?
    - How can government's ESOP policy facilitate the use of tax-deductible corporate contributions of shares to ESOP trusts and/or facilitate the ability of employees to obtain access to corporate credit to acquire larger blocks of shares at fair market value?
    - Which types of tax or other incentives hold the most promise in the context of South Africa's business and social environment?
    - What will be the short-term cost of a program of tax incentives for ESOPs and what would be the mid-term and long-term projections for recapturing such an "investment" through increased revenues from capital gains and related taxes?
    - What will be required of government, business and labor organizations in terms of education, communications and advocacy efforts to facilitate the implementation of broad-based ownership strategies?

[13] Employees are estimated to own, directly or indirectly through employee trusts and stock options, approximately 7-8 percent of the total stock market capitalization in the United States.

Conclusion

The restructuring of SOEs is both a political and an economic project. Particularly in South Africa, with its history of social and economic inequality, Government has an over-riding political priority to use its unique position as the owner of SOEs to restructure that ownership in such a way as to help empower previously disadvantaged individuals. Employee share ownership plans can be an important tool in facilitating both the political goal of economic empowerment of PDIs and the economic goals of preparing restructured SOEs to better compete in the global economy and to help promote continued growth of South Africa's own economy.

Equally important, properly designed ESOPs offer a transition vehicle from the SOE sector to the private sector to provide employees with ongoing opportunities to participate in the ownership of productive assets. To facilitate those goals ESOPs need to be structured in accordance with established legal, tax and financial rules governing private companies. While adhering to principles of broad-based participation by all eligible employees, ESOPs should be flexible enough to accommodate a variety of SOE restructuring transactions and to facilitate their operation as incentive compensation tools in the private sector.

Most important of all, ESOPs should not be seen as a one-time opportunity to achieve SOE restructuring goals but as the first stage of a long-term effort to promote widespread participation in the ownership of productive assets in the South African economy. The track record of ESOPs worldwide suggests that a carefully considered and properly implemented program of ESOP incentives based on a public-private partnership of government, business and labor interests can play an important role in empowering a broad and growing sector of the population.

SUMMARY OF RECOMMENDATIONS

Of the following 30 recommendations proposed in this paper to enhance the policy and operating guidelines associated with broad-based ESOPs, the authors believe that all but the last two can be implemented immediately subject to government approval.[14] The prospective ESOP incentives and the comprehensive policy analysis of potential ESOP incentives would obviously need to be considered within a much longer frame of reference.

1. Reaffirm that government's guiding principle for the use of ESOPs in the context of restructuring transactions is to ensure economic empowerment of previously disadvantaged individuals by facilitating a non-discriminatory acquisition of shares by employees to provide them with an ownership stake in restructured SOEs.

2. Emphasize that ESOPs are also intended to provide employees with ongoing opportunities to acquire ownership in restructured enterprises as an incentive to help improve the long-term performance of restructured SOEs.

3. Establish appropriate standards to ensure employees' share ownership rights through representation on ESOP trusts.

4. While government should not impose operational standards or management guidelines regarding employee participation in company operations, it can act *in its role as shareholder* to encourage the use of participatory management practices to facilitate improved labor management relations in the context of the shared incentive of ownership.

5. Establish a clear distinction between broad-based ESOPs and management share schemes.

6. Clarify that both broad-based ESOPs and management share incentive schemes have a legitimate role in facilitating the restructuring of SOEs.

7. Government policy for funding management share schemes should be based on the principle of pro-rata dilution by all shareholders. After the initial share allocation has been made to an SEP, the NEF, the BEE and the broad-based ESOP, new shares would be issued to fund the management scheme, thereby diluting the initial shareholders on a pro-rata basis.

   In those cases in which an all-shareholder approach is not feasible for any reason, the size of the management share scheme should be determined to the greatest extent possible based on an economic calculation of comparable equity incentive awards in similar private sector companies. Once the appropriate size of the management stake is determined, the NEF, BEE and ESOP stakes can be determined proportionately.

8. Government should clarify that the allocation of the initial ESOP stake in restructuring transactions will be based on the political principle of equal distribution. The term "equal distribution" may have the following application as determined by government on a case-by-case basis:

   a. Distribution based on an equal number of shares or share options per employee;

   b. Distribution based on an equal percentage of employee's salaries;

   c. Distribution based on a formula that takes into account employment status, salary, years of service, or other factors.

[14] The recommendations have been vetted thoroughly with qualified South African attorneys. Because the guidelines are intended to integrate seamlessly with existing South African legal, tax and financial standards, prudence would suggest that they nevertheless be subject to a final legal review to ensure their operational suitability.

9. Clarify that it is the intent of government to promote, *in its role as a shareholder*, the use of broad-based ESOPs in a post-restructuring environment. The reallocation of shares or share options within a broad-based ESOP (i.e., after the initial shares received by employees in the restructuring transaction have been sold) would be subject to the direction of the company's board of directors in accordance with the Companies Act, and subject to government guidelines for the operation of broad-based ESOPs (discussed below)

10. Clarify the principle that management share incentive schemes should be managed at the discretion of the strategic equity partner (SEP) or, in the absence of an SEP, at the discretion of senior company management.

11. **Shares must be held in an ESOP trust** – A trust must be established to hold employee shares, share equivalents or share options. The trust must be managed by a trustee or group of trustees with the fiduciary responsibility to ensure proper management of the trust's assets for all employees in accordance with established legal principles in the Companies Act.

12. **Eligibility requirements** – All full-time employees who have worked at the enterprise for a minimum period of time, e.g., one year[15] must be eligible to receive offers of shares, share equivalents or share options each time that such offers are made in accordance with procedures determined by the trustees.

13. **Allocation standards to ensure broad-based participation** – The allocation of shares, share equivalents or share options must be determined according to a written formula in the trust document. Such formula must be designed to ensure that all eligible employees have an opportunity to benefit from each allocation. Such formula could provide for:

    a. equal allocation of shares, share equivalents or share options for all employees;
    b. allocation based on an equal percentage of annual salary;
    c. allocation based on a combination of salary and years of service or similar formula;
    e. allocation based on the discretion of company management and/or the ESOP trustees according to an assessment of individual employee performance, subject to anti-discrimination standards in #14, below.
    f. Any combination of the above.

14. **Anti-discrimination standards** – Whichever formula is used to determine how to allocated share incentives to employees per #13 above, the formula must ensure that:

    a. All eligible employees must receive some portion of each allocation, and;
    b. No more than one-third of each allocation may be allocated to the top 10 percent of eligible employees as determined by annual salary.

15. **Vesting requirements** – Shares, share equivalents or share option awards may be subject to vesting schedules to defer the time in which employees obtain full rights to the shares or share options allocated to them. Awards subject to vesting requirements may vest no less rapidly than in one of the following options:

    a. 10-year vesting in equal annual percentages so that an employee would be 10% vested after one year, 20% after two years, etc.
    b. 7-year vesting in which an employee would be 20% vested after three years with equal annual vesting of 20% per year thereafter.

[15] This one-year waiting period significantly reduces the administrative burden on the ESOP for short-term employees who start and leave the employment of the company in the first year.

c. 5-year cliff vesting whereby an employee is unvested until the end of the fifth year at which time he would become 100% vested.

Employees will qualify for immediate 100% vesting upon any of the following events:

- Retrenchment due to a workforce reduction initiated by the company within three (3) years of an SOE restructuring initiative (voluntary departure or dismissal for cause do not qualify for purposes of this provision);
- Attainment of qualified retirement age as determined by company policy, subject to a maximum retirement age of 60;
- Disability;
- Death

16. **Valuation of shares**[16] – Companies whose shares are not listed on an established stock exchange must have their shares valued by an independent valuator on at least an annual basis. The valuator must be independent of the company to ensure an arms-length analysis of the share valuation. "Independent" in this context means that:

- The valuator may not have any other fee-based relationship with the Company;
- Valuation fees may not be based on the amount of the transaction;
- A substantial aspect of the business of the valuation firm must be regularly providing company valuations;
- The valuator may not be affiliated with any other companies or advisors who have an economic interest in the transaction.

Any subsequent valuation of the trust's assets must be based on this valuation.

17. **Record-keeping, communications and information disclosure** – The Compliance Officer is responsible for the following, according to standards established under the Companies Act:

a. Maintaining accurate records of plan transactions and the status of individual employee accounts;
b. Providing employees with timely information about their assets in the trust, including:

- the number of shares, share equivalents or share options in their account;
- their vested rights to such assets;
- their rights to exercise and/or sell the assets held in their account;
- the value of the company's shares, at least on an annual basis.
- the risk of equity and the fact that shares values can rise and fall and provide no guaranteed value
- that, in the case of unlisted companies, share liquidity is subject to the trust or sponsoring company's ability to repurchase the shares.

18. **Exercise of share options and sale of shares** – The trust document must clearly state the means and procedures whereby employees may exercise their share options and the terms by which employees may sell their shares. Such provisions shall specify that:

[16] Appendix II includes a more detailed discussion of recommended standards and procedures for ensuring fair and accurate ESOP valuations.

a. Upon a break in service employees shall have the right to transact for all vested shares, share equivalents or share options;

b. Upon a break in service shares options will be deemed to have been exercised and shares and share equivalents will be deemed to have been sold.

19. **Liquidity** – The trust document must specify the means and procedures whereby employees will be able to redeem their shares or share equivalents for cash.

    a. To the extent that cash is readily available in the trust or the Company has ready cash reserves or the financial capacity to provide liquidity for employee shares or share equivalents tendered to the trust, employees must receive payment for their shares within a reasonable period of time.

    b. If the trust does not have ready cash reserves and the Company lacks the financial capacity to purchase shares or share equivalents tendered by employees to the trust, the ESOP trustees or the Company may defer the repurchase of qualifying shares tendered by employees for a maximum of three years;

        - In circumstances in which the Company elects to defer repurchases of shares tendered by employees, such shares will be deemed to have been purchased at the then-prevailing fair market value of the shares.

        - A corresponding liability will be recorded in the trust, with such debt obligation credited to the selling shareholder's account. Market interest rates must accrue on unpaid balances.

    c. Payments for ESOP shares may be made in equal annual installments of a maximum of three years. Market interest rates must be provided on unpaid balances due from installment payments.

20. **Employee representation on ESOP trusts** – Employees must be given the right to elect at least one-third of the ESOP's trustees. The sponsoring company's directors may determine procedures for determining the remaining trustees. One of the ESOP trustees must be the trust's Compliance Officer as defined in Section 144 A(3) of the Companies Act.

21. **Voting procedures**– The trustees shall vote shares held in the ESOP trust according to procedures spelled out in the trust document.

22. **Corporate governance principles** – The ESOP trust is expected to operate according to corporate governance principles as described in the King II Report.

23. Government policy should not preclude alternative approaches to ESOP transaction strategy and trust design proposed by strategic bidders so long as the proposed structure meets guidelines for broad-based participation, empowerment and opportunity as described in the proposed ESOP guidelines referenced above.

24. Government should consider providing incentives for strategic investors to enhance potential ESOP participation by giving credit for proposals from prospective investors that would include plans to enhance the funding, operation and/or value of a broad-based ESOP.

25. Permit management buyouts under limited circumstances with the proviso that employees should be able to benefit from ownership through a broad-based ESOP.

26. Government should clarify the terms and conditions upon which it will receive payment for ESOP shares and the circumstances in which it will subsidize employee purchases via any of the following subsidies.

    a. Price discounts
    b. Deferred payment terms
    c. Permitting ESOP purchases at preliminary (pre-investor) values
    d. Providing government loan guarantees to assist with a broad-based ESOP's acquisition of shares.

27. Government should develop strategies for using its influence as a major shareholder in the post-restructuring environment to encourage the use of ESOPs as both an incentive compensation vehicle and as a means to promote greater employee participation in improving overall enterprise operations.

    In addition to encouraging the use of broad-based ESOPs to provide employees with an ongoing opportunity to acquire ownership incentives, such efforts could including promoting financial disclosure, employee education and training, enhancing opportunities for employee participation in job-level decision-making, etc., in order to encourage the development of an "ownership culture."

28. In circumstances in which a restructured SOE includes employees whose annual income is in the lowest tax bracket (currently R38,000 per year), government could consider dedicating a small percentage of the ESOP's ownership stake for targeted donations of shares to low-income employees. While this would represent a "give-away" of government assets, the fact that such a donation would be both modest in value and targeted to low-income employees may justify such an expense.

    Such donations would have the following characteristics:
    a. The value of shares donated would be relatively small, e.g. R2-3,000 per employee;
    b. The shares would be contributed to a broad-based ESOP and immediately credited to the accounts of qualifying low-income employees;
    c. Employees would be exempt for the 10% fringe benefits tax applied to company-provided benefits, since this would be a direct contribution of the government's SOE shareholdings to qualified employees;
    d. The donated shares would be subject to a 4-year cliff vesting schedule whereby employees would not be able to sell their shares before the end of four years, at which time they become 100% vested;
    e. Employees would pay capital gains taxes on any increase in the value of the shares from the date the shares are allocated to their accounts in the ESOP until the date on which the shares are sold;
    f. Employees who receive share donations under this provision would still be eligible to receive their pro-rata allocation of shares under the ESOP's standard allocation formula.

29. Government should introduce a proposal for consideration by Parliament to facilitate the ability of employees to save money on a pre-tax basis to improve their ability to exercise stock options in broad-based ESOPs. Such employee share savings schemes would have the following characteristics:

    a. The schemes would apply only to employee shares schemes meeting the definition of a broad-based ESOP;
    b. Employees would be permitted to defer a portion of their salary to the ESOP savings plan.
    c. The ESOP savings plan would be managed in accordance with existing standards for provident funds;
    d. Employees could use their savings to exercise their share options within the ESOP trust without triggering tax;
    e. Employee could also elect to transfer their funds at any time to a provident fund without triggering tax.

30. Government should underwrite a policy analysis for the purpose of determining the feasibility of introducing comprehensive reforms to encourage the rapid growth of broad-based ownership in the private sector. Such a study could consider the following:

    - What will be required in terms of legal and tax changes to facilitate more rapid implementation of broad-based ESOPs and similar ownership-broadening strategies?
    - How can government's ESOP policy facilitate the use of tax-deductible corporate contributions of shares to ESOP trusts and/or facilitate the ability of employees to obtain access to corporate credit to acquire larger blocks of shares at fair market value?
    - Which types of tax or other incentives hold the most promise in the context of South Africa's business and social environment?

- What will be the short-term cost of a program of tax incentives for ESOPs and what would be the mid-term and long-term projections for recapturing such an "investment" through increased revenues from capital gains and related taxes?
- What will be required of government, business and labor organizations in terms of education, communications and advocacy efforts to facilitate the implementation of broad-based ownership strategies?

APPENDIX I: A SUMMARY OF THE VARIOUS FORMS OF EMPLOYEE INCENTIVE SCHEMES IN SOUTH AFRICA AND THEIR TAX CONSEQUENCES

There is currently, in South Africa, a variety employee share incentive schemes available, each of which has certain advantages and disadvantages. The tax consequences of each of these schemes also differ significantly.

The regulatory framework within which the employee share incentive schemes operate in South Africa and which should be taken into consideration include:

1. **Trust Property Control Act**

   In the event of the scheme being established by a company for the purpose of offering participation therein to employees of the Employer Company or its subsidiaries either by means of the sale of shares or the grant of option on shares in the company to the employees by means of a Trust, the provision of this Act will regulate the registration of the Trust and the powers of the Trustees.

2. **Companies Act**

   To the extent that employees would directly or indirectly become shareholders in a company, generally the provisions of the Companies Act become relevant, however in so far as the employee share incentive scheme is concerned, the relevant sections are Sections 38 (2) (b), 144 (f) and 144A respectively. Section 38(2) (b) deals with the provision of financial assistance to a Trust for the subscription or purchase of the company's shares for the benefit of the employees of the company. Section 144A provides for the appointment of a compliance officer by the company. In terms of the Act the compliance officer is accountable to the directors of the Employer Company and is responsible for the administration of the scheme. His duties includes inter alia the furnishing in writing to any employee who receives an offer of shares:

   2.1 full particulars on the nature of the transaction including the risk arising therefrom;
   2.2 information relating to the company, including its latest annual financial statements, the general nature of the business and its profit history over the last three years; and
   2.3 full particulars of any material changes which take place from time to time, in respect of any information furnished in terms of 2.1 or 2.2 above;

   The compliance officer must also:

   2.4 ensure that copies of the documents containing the information referred to in 2.1 and 2.2 above are lodged with the Register of companies within 30 days after the employee share scheme has been established;
   2.5 lodge a certificate with the Register within 60 days after the end of each financial year to the effect that he or she has complied with the obligations in terms of this section (144A) during such year and attach thereto any documents containing particulars contemplated in 2.3 above, issued during such year.

3. **The Income Tax Act**

   The tax implications in respect of each scheme are dealt with below ;

4. **Capital Gains Tax Act**

   Our comments relate specifically to the workings of the most common type of scheme, the deferred delivery scheme. This type of scheme functions as follows:
   The deferred delivery scheme is aimed at minimising the section 8A (of the Income Tax Act) incurral of the exercise of an option under a share. At the same time it also avoids the fringe benefits tax that would normally apply where the share is sold, delivered and pledged back to the trust and an outstanding (interest free) loan account remains.

The tax implications of a deferred delivery scheme can be illustrated by the following example:

1 On, say, 1 June 2002 the share is valued at R2.50 in terms of an objective valuation (in the case of a listed share it will be the listed price).

2 On this date, the share is offered to the employee for R2.00. The offer must be accepted within one month. This opening of an offer equates to an option in terms of section 8A.

3 On 1 July 2002 the employee exercises the option on the share, now with a value of R2.85. This results in a concluded sale agreement. In terms of section 8A, the employee will pay income tax on the difference between the value on the date of acceptance of the offer, i.e. exercise of the option, and the offer price. If the offer price is R2.00 and the share value at the relevant date was R2.85, the section 8A gain will be 85 cents, which will be subject to income tax.

4 At the end of the incentive period, say 3 years, the share is delivered on (1 July 2005). On this date the share is worth, say R7.50. However, the deferred delivery scheme operates on the basis that the mere implementation of the sale, i.e. the performance by delivery and payment, is not a tax event in itself. The employee will pay the R2.00 price and receive the share for R7.50. However, he has already paid the section 8A gain upon exercise of the option. Since the shares were not delivered to him before this date, he is also not liable for the purchase price until delivery, so there can be no soft loan account outstanding.

From the trust's perspective, the sale of the share at below the market value should constitute a capital loss for CGT purposes. However, since it is a connected person sale, the base cost will be equal to the actual selling price (R2.00). There will therefore be no taxable capital gain in the hands of the trust upon the conclusion of the sale. From the employee's perspective, he will be subject to CGT upon the sale of the shares delivered to him on 1 July 2005. If he would immediately sell his shares, the first question is what is the base cost in respect of such shares? In terms of paragraph 20(h) of the Eighth Schedule to the Act, the employee can regard as his base cost the market value of that marketable security that was taken into account in determining that gain for purposes of section 8A. This was the value of R2.85. Thus, a base cost of R2.85 under paragraph 28 will result in a capital gain if it is sold at the actual value of R7.50 less R2.85 which equates to R4.65. At the current effective rate of 10% CGT of 46.5 cents will be payable in respect of each share.

In this article we discuss and summarise mechanics and income tax considerations of different employee share incentive scheme, which may be relevant to a decision to adopt any particular scheme.

1. TRADITIONAL SHARE PURCHASE SCHEMES

This scheme involves the formation of an inter vivos trust ("share incentive trust") by the Employer Company, falling within the provisions of section 38(2)(b) of the Companies Act as amended. The share incentive trust either purchases or subscribes for shares in the company, and then on-sell such shares to the employees at the same price at which the share trust has acquired such shares. Ownership of the shares pass to the employee immediately but since the employee does not pay the purchase price until some future date, the trust advances a soft loan to him and as security for that loan and interest thereon, the employee, in turn, pledges the shares back to the trust. The dividends declared on the shares accrue to the benefit of the employee and are utilised to off set the loan debt including interest (if any). The purchase price is payable by the employee within a prescribed period, usually in tranches over three to ten years. When the loan is repaid, the shares are released to the employee and he is free to deal therewith.

Advantages

(a) Employees receive dividends.

(b) No net cash cost to employee.

(c) Gains made on the ultimate sale of his shares by an employee are not subject to income tax.

(d) Little downside for employees

Disadvantages

(a) Perks tax is deemed in respect of interest on soft loan and taxable.

(b) Since the introduction of fringe benefits tax in 1985, this scheme has become largely unattractive from a tax point of view since employees are taxed on an amount equal to the difference between the official rate of interest and the interest if any actually charged on the amounts owing to the share incentive trust.

(c) This could lead to cash flow problems for an employee since his income tax liability may exceed his dividend income.

(d) Employees are locked into the purchase contract upfront and thus bear the risk of financial loss should the market price fall below the purchase price payable by them.

Regarding (d) above, in terms of Section 10(1)(nE) of the Income Tax, the company can elect to introduce into the scheme a stop loss protection, for the employee against any financial loss on the ultimate disposal of his shares without the employee suffering any adverse income tax consequences. This Section provides that:

There shall be exempt from the tax any amount (including any taxable benefit under the provisions of the 7th schedule) received by or accrued to an employee, as so defined, under a share incentive scheme operated for the benefit of employees of the taxpayer's employer as so defined, which was derived:

(i) upon the cancellation of a transaction under which the taxpayer purchased shares under such scheme; or

(ii) upon the repurchase from the taxpayer, at a price not exceeding the selling price to him, of shares purchased by him under such scheme,

if the consequences of such cancellation or repurchase the taxpayer has not received or become entitled to receive any compensation or consideration other than the repayment of any portion of the purchase price actually paid by him.

2. **Share Option Scheme**

In terms of the share option scheme, the employee is granted an option by either the company itself or a share trust to purchase or subscribe for shares in the company at the market price at the date of the grant of the option. The employee is then obliged (but not forced) to exercise the option within a certain period of time (normally 10 years) and until he exercises the option, the employee does not acquire the shares and is therefore not obliged to pay for them. The employee does not acquire any loan and there is therefore no deemed interest benefit for income tax purposes. Since the employee does not acquire the shares there is, however, no dividend flow or other income, which accrues in his favour.

The options are exercisable usually in tranches over a three to ten years period.

Advantages

(a) Easily understandable.

(b) The employee is only locked into buying the shares once he decides to exercise the option. Accordingly no downside for employee as if the share price falls below option price due to market fluctuation, he simply does exercise the option.

(c) No loan or credit is extended to the employee and fringe benefits tax payable by the employee. Deemed interest and cash flow problems avoided.

(d) No employee cost till gain arises.

(e) Scheme does not rely on tax loopholes.

(e) EPS not affected until options exercised.

(f) Administration simpler and less costly.

(g) Suitable for more junior staff.

Disadvantages

The major disadvantage of this scheme is that any gain made by the employee on the exercise of the option by him ie the difference between the market value of the shares at the time that the option is exercised by the employee and the purchase price payable by him will be fully taxable in the employee's hands as income in terms of S8 (A) of the Income Tax Act even if he does not realise the gain by selling the shares.

3. **The Convertible Debenture / Preference Share Scheme**

In this scheme preference shares or convertible debentures are issued to the employees normally via a share trust if the company intends giving financial assistance to its employees to acquire the preference shares. Both preference shares and convertible debentures are a form equity participation with the only difference being that convertible debentures cannot be converted into a share. However, in the scheme the redeemable debenture is redeemed into cash, which is then utilised to subscribe for ordinary shares. The net effect of both schemes, however, is the same.

The preference shares can be non-voting or redeemable and can also carry dividend rights, which may differ from the rights attaching to ordinary shares. The employee is given the option to convert the preference shares into ordinary shares at the time that he has repaid his loan, which he utilised to subscribe for or acquire the shares as the case may be.

In the event that the employee does not exercise his right to convert the shares into ordinary shares, the shares become automatically redeemable at the option of the company. The company therefore does not have to repurchase the shares if the market price drops because in such event the employee would not exercise his conversion right and the company would simply redeem the preference shares.

There are a variety of options available on this scheme, i.e., the interest rate on the dividends may be fixed providing an income to the employee with which he can repay the loan made to acquire to the shares in the first place. The shares may also be compulsorily convertible thereby avoiding the provisions of Section 8(A) of the Income Tax Act in that the employee does not "exercise a right to acquire" as the shares convert automatically.

These schemes are however ineffective from the company's view point in that the company receives interest from the employee which is taxed at full rate and, in turn, the company has to service the preferential rate on the shares or debentures with after tax income.

Advantages

(a) Participant obtains benefit of any intervening growth in share price.

(b) Cash and tax neutral to both parties.

(c) No deemed interest (should the trust provide for a fixed preferential dividend equal to the interest (if any) payable by an employee on his loan from the share trust.

(d) S8 (A) does not apply as preference shares automatically convert into other class of share.

(e) Useful if company has low tax rate due to assessed losses.

Disadvantages

(a) By law a debenture cannot be converted into a share, therefore legally debenture is repaid and proceeds used to subscribe for shares.

(b) Under S8 (A) of Income Tax Act any gains due to above must be included as gross income.

(c) The company receives interest income from participant, which pays tax but does not get tax relief on dividend coupon.

4. **Deferred Sale or Allotment Scheme**

In this scheme, the employee and the company enter into an agreement in terms whereof the company agrees to issue or sell shares to the employee who undertakes to subscribe or purchase them in certain numbers over a period of years at a subscription or purchase price which is the then market. However, payment for and delivery in respect of the shares is deferred for a period usually in tranches over three to ten years.

This scheme may be implemented by way of a deferred subscription of shares in the company or by interposing a share trust and selling the shares to the employee. The parties therefore enter into a legal binding contract, which is not an option or a right to acquire shares at a future date as envisaged by the provisions of Section 8(A) of the Income Tax Act. Any increase in the share price between the time of delivery and the actual payment will not give rise to a taxable gain as envisaged by S8 (A) of the Income Tax Act. There is further no extension of credit or the making of any loan and the provisions of fringe benefits tax do not apply.

However, paragraph 2(a) read with paragraph 5 of the Seventh Schedule to the Income Tax Act may be applicable in that the employee acquires an asset at a consideration which is less than the value of the assets as determined under paragraph 5. There may be an argument in that in paragraph 2(a) the word "acquire" refers to the contract of acquisition and since the contract price payable in terms of the original agreement is less than the actual market value at the time of delivery of the shares, the employee could be taxed on the benefit received.

Advantages

(a) No deemed interest for employee.

(b) No loan cost to the company.

(c) Profit not taxable as income.

Disadvantages

"Perks tax" - tax on benefits of sale of an asset less than market value at time of delivery may be applicable.

5. **Combined Option / Deferred Sale Scheme**

In terms of this scheme, the company agrees to grant an option to the employee to enter into an agreement with the company to subscribe for or purchase shares upon the happening of certain events. The terms of the agreement stipulate that the option may be exercised at any time after the grant thereof and prior to a certain cut-off date.

Once the option is exercised a legally binding agreement will come into effect and the subscription price of the shares will be the market price on the date of the grant of the option. Again a share trust may be interposed to facilitate the transaction.

The critical provision in this combined scheme is that performance by both parties in terms of the agreement is deferred for a stipulated period or when a certain event occurs, therefore delivery of the shares will only be effected at some future date against payment of the purchase price.

The manner in which this scheme is then practically implemented is that the option is granted to the employee who then almost immediately exercises the option. In the event that a small increase in the market value of the shares occur between those two dates it would obviously be subject to the provisions of Section 8(A) of the Income Tax Act. However, since delivery and payment for the shares is effectively deferred to a future date, the market value of the shares during that period may increase substantially. However as no credit has been granted to the employee, the scheme will not attract income tax in terms of the interest free or soft loan provisions of the Income Tax Act.

The scheme will, however, be subject to the provisions of Section 8(A) of the Income Tax but since the gain made by the employee upon the exercise of the option is very little, the income tax thereon should be negligible.

Paragraph 2(a) of the Seventh Schedule to the Income Tax Act contains a proviso, which exempts marketable securities acquired by the exercise by the employee of any right to acquire any marketable security, and therefore it does not apply. The employee therefore does not derive any taxable benefit from the eventual implementation of the transaction.

The only possible manner in which this scheme can be taxed would be under the provisions of Section 103 of the Income Tax Act.

This scheme is relatively complex and could give rise to administrative problems. Accordingly, they should be restricted in their availability to senior management.

6. **Subordinated participating convertible loan stock scheme**

In this scheme executives become entitled to subscribe for loan stock units which are issued by the company and on which interest is payable at a rate equivalent to twice the dividend rate on the ordinary shares with a specified minimum rate. The issuing company arranges for personal loans to the executive through its bankers. In effect this type of investment is equity disguised as loan stock. The loan stock is subordinated in favour of all creditors' claims and is ultimately converted into equity. The loan stock units are issued at the same price as the ordinary shares and ultimately each loan stock unit is converted into one ordinary share.

The conversion is at the election of the executive at any time between the two specified dates.

Advantages

(a) It is tax sufficient from the point of view of the participant.

(b) There should be no tax on the ultimate capital profit unlike share option schemes.

(c) The scheme does not involve substantial cash costs to the employee.

(d) No company funds are tied up.

(e) This scheme is also open to non-executive associates of the company i.e. certain non-executive advisors and directors.

Disadvantages

(a) It is necessary to have two classes of listed securities in issue prior to conversion of the loan stock units.

(b) The company has to arrange for the funding of the executives' holdings on an individual personal loan basis.

(c) The scheme does not contain a mechanism to hold employees in the employment of the company and employees can cash in and leave the company at any time especially if there is a sudden increase in the company's share price.

(d) Loan stock units must be issued to both members of the public and to the executives simultaneously to ensure that it is not linked to employment and the adverse tax implications which will follow by virtue of section 8(A).

(e) The potential exists that the loan stock units can in fact be regarded as a disguised equity investment and the Receiver of Revenue could be justified in disallowing the interest payable by the issuing company.

7. **Performance linked participating preference share scheme**

In this scheme a participating convertible preference share coupled with a trust structure to provide a phased share increase over a period of say ten years is put in place. Executives are given the opportunity to participate by way of a buy in mechanism. This form of participating preference shares is a high risk, high reward instrument. The part preference shares participate in the profits only if there is profits in the company concerned. For example, the participants may be entitled to one third of the growth in earnings above the earnings achieved in the previous year, subject to an ultimate maximum participation of 25% in all profits. The part preference shares have a low initial value but a highly accelerated participation in income if the desired growth targets are achieved.

When the predetermined level of participation in income is achieved or a defined period has lapsed, the part preference shares are converted into ordinary shares. The number into which they convert is determined by the level of profit achieved by the time of the conversion. In the event that no growth is achieved the part preference shares are redeemed at nominal value and the holders of such shares effectively forfeit most of their original subscription price to the company.

No "soft loan" funding is normally involved on the part of the Employer Company although executives may borrow from the company in terms of Section 38(2)(b) of the Companies Act.

The subscription price for the part preference is only between 12% and 18% of the value of an ordinary share in the company at the outset. This price is usually determined by the company's auditors on a fair and reasonable certification basis to ensure fair treatment in relation to ordinary shareholders of the company.

Provided the growth anticipated by the company is achieved, the benefits are much more meaningful than those available under alternative schemes.

The part preference mechanism is very flexible and can be designed to suit the particular requirements of the company concerned. The part preference shares can also be linked directly to the income generated by particular companies or divisions within a group thus giving a far more effective and direct performance linked incentive. The rewards for participants are directly dependent on the company's profit performance rather than on its share price and stock market factors.

The scheme is however not suitable to the low-level management since it places the employee at risk financially and is complex in both concept and administration.

It may be adopted in combination with share incentive option schemes as an alternative, which would be more attractive to middle management staff, and both schemes can be administered by a single trust.

Observations

It is clear from the above that a variety of schemes or combinations of schemes exist which could serve the same purpose. The perspective from which any scheme is evaluated determines its ultimate advantage or disadvantage.

For senior executives a more innovative type of structure is required which could be specifically designed to meet the individual objectives of the company concerned.

For middle management and junior staff a share option scheme is still the recommended option.

However, having regard to the above schemes it must be borne in mind that such schemes may be adapted and combined to provide for the particular needs of a company concerned.

An ESOP can function as a complementary mechanism to the general well-being of both employees and their employing company. By its very nature, it links the fortunes of the shareholders with those of the employees. Without this, the interests of employees and the employer are generally diametrically opposed.

In certain cases an ESOP can also be tailored to reward and encourage entrepreneurial flair within the company. The ESOP promotes an identity of interest that has not existed before between the company and its employees. Due to its suspensive operation (i.e. to obtain the full benefits of the scheme, the employees must remain employed for a certain minimum period with the company), It also enables the company to retain valuable employees. (This is the so-called "golden handcuff" principle).

Without doubt, an ESOP has to be simple and clear to enable it to have its intended beneficial effects. Without simplicity or clarity, the employment force will not understand the scheme and an understanding of the scheme is a pre-requisite for them to be incentivised. An ESOP must also be a true incentive scheme, and should not be driven by other considerations for its primary motivation. Obviously, the enabling of a significant black ownership and the broadening of the share base of the company are complementary considerations for an ESOP but the underlying criteria must still be an effective incentive to the employees. An ESOP without an incentivising focus often develops into a burden.

A good ESOP should also have flexible but predictable exit mechanisms. For example, where the employee is dismissed or where he or she resigns at different stages of the incentive scheme. It should also be flexible enough to allow for corporate buy-out.

Although employee share incentive schemes have become almost standard in the recruitment, motivation and retention of staff, they could also have a downside. A good example is that of a scheme in which employees had to purchase shares at a particular price which was recorded as a liability to the incentive trust involved. Once the share price dropped, the underlying assets purchased had little value, while the liability remained in place at the original price. This threat can act as a serious disincentive that can undo the intended effect of any ESOP. An ESOP therefore has to be flexible enough to address these issues.

Lastly, but not least, a good ESOP should also be tax efficient to ensure the maximum commercial benefit arising from participation by employees in the scheme.

Generally, of the schemes mentioned above, three could be distinguished that has developed over the last 20 years or so. They are:

- Traditional share option scheme;
- The share purchase scheme;
- The so-called "deferred delivery" scheme.

Generally speaking, however, any one of the above schemes can be run through a single trust deed that has been properly drafted with the necessary flexibility to allow for various structures.

The fact that there would be three different types of scheme does not presuppose that three different trusts should be set up. In essence, any share incentive scheme, irrespective of its structure, would involve the setting up of a trust, the formulation of incentive rules (very often part of the trust deed itself), the drafting of standard documentation such as allotment letters, and the management and compliance requirements of such a scheme. The decisive advantage of using a trust is that it enjoys a specific exemption from the (often-prohibitive) operation of section 37 of the Companies Act.

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APPENDIX II: OVERVIEW OF ESOP VALUATION STANDARDS AND METHODOLOGIES[17]

Ensuring that company shares in an unlisted company are properly valued is one of the most critical elements of an effective employee share ownership programme. From the initial sale of shares to an ESOP to the time when an employee cashes in his or her shares, an accurate valuation serves as the basis upon which the ESOP is operated. Indeed, to the extent that disputes arise in regard to the operation of employee share schemes, such disputes most often revolve around the valuation of the company's shares.

The following information is based primarily on ESOP valuation standards as they have been developed in the United States, where employee ownership has been a fixture of the economic landscape for several decades and where ESOP valuation standards are well established.[18] While it is readily apparent that the financial services industry in South Africa is fully capable of providing the technical expertise required to help companies value their ESOP shares properly, the widespread use of broad-based ESOPs as proposed in this document suggests that the Government of South Africa would be well-advised to establish certain principles and standards to ensure that the ESOP valuation is properly regulated.

The information provided here is intended as a reference to the standards and methods commonly used in business valuations for ESOP purposes. It should not be considered as a prescriptive approach to business valuation.

Frequency of the Valuation

Valuations should be conducted at least annually and at any time in which the company engages in a significant transaction involving the sale of a block of shares. The annual valuation is then used for any transactions involving the sale or transfer of ESOP shares in the following twelve months.

Independence of the Appraiser

The appraiser should be independent of the Company and should not have any other fee-based relationship with the Company, nor be affiliated with any other companies or advisors who have an economic interest in the ESOP transaction.

Qualifications

A substantial aspect of the business of the valuation firm must be regularly providing company valuations;

Fair Market Value

The definition of *fair market value* (as defined in regulations, appraisal cases and by professional appraisal associations) is generally accepted to be "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

Determination of *fair market value* typically includes a review of the following:

- Internally-prepared financial statements
- Company income tax returns

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[17] This summary is based on information obtained from Barry Goodman of Advanced Valuation Analytics, Washington, DC, and from "An Introduction to ESOP Valuation" by John W. Murphy and John P. Murphy, Atlantic Management Company, Portsmouth, NH, as published in ESOP Valuation published by the National Center for Employee Ownership, Oakland, CA

[18] Two practical reference guides to the valuation of ESOP shares are An Introduction To ESOP Valuations available from the The ESOP Association (U.S.) www.esopassociation.org, and ESOP Valuation from the National Center for Employee Ownership (U.S.), www.nceo.org.

- Internally-prepared projections of income
- Company articles of incorporation and by-laws
- Schedule of Company's contracts
- Other relevant financial schedules and legal documents
- Interviews with management regarding the company's operations and financial situation
- Reviews of databases of publicly-available financial information on comparable companies.

Factors to Consider in Company Valuations

The factors that should be taken into consideration in valuing company shares are based upon a long-standing regulation ruling by the U.S. Internal Revenue Service[19] that outlines and reviews, in general, the approach, methods and factors to be considered in valuing shares of the capital stock of closely-held corporations for estate tax and gift tax purposes. The ruling outlines the following eight "factors to consider" in determining fair market value, but notes that these factors should not be considered to be all-inclusive:

- The nature of the business and the history of the enterprise from its inception.
- The economic outlook in general and the condition and outlook of the specific industry in particular.
- The book value of the stock and the financial conditions of the business.
- The earning capacity of the company.
- The dividend-paying capacity.
- Whether or not the enterprise had goodwill or other intangible value.
- Sales of the stock and the size of the block of stock to be valued.
- The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the counter.

The relative weight afforded a particular factor depends upon the nature of the corporation's business.

It is generally accepted that there are basic *approaches* to valuation. Each general *approach* yields various valuation methods by which the applicable approach(s) is (are) applied.

Valuation Methods

Because no single valuation formula can accurately determine the value of an unlisted company, a number of generally accepted approaches and methods of valuing company shares have been developed over time. The particular methods used depends on the purpose of the valuation and the type of company being valued, among other factors. The principle, though not exclusive, approaches to valuation are:

The **asset based approach** is a general way of determining a value indication of a business's assets and/or equity interest using one or more methods based directly on the value of the assets of the business less liabilities.
The **income approach** is a general way of determining a value indication of a business, business ownership interest or security using one or more methods wherein a value is determined by converting anticipated benefits.

The **market approach** to valuation utilizes a comparison of the interest being valued with actual trades of other similar interests. This valuation approach is appropriate to use only in situations where there have been actual trades of similar business interests. Valuation methods that are categorized in the market approach include some type of comparison of the interest being valued with actual trades of other interests of the business being valued, trades of similar businesses that are not publicly-traded or shares of businesses that are publicly-traded. This comparison can be based on a multiple of earnings, book value or some other ratio that might be appropriate, considering the facts and circumstances of the case.

[19]Revenue Ruling 59-60, 1959-1 C.B. 237.

The **capitalization of earnings** method of valuation develops an indicated value on the basis of the company's historic earnings. It is usually given some weight when there are either no publicly-traded comparables or the comparables that are used have questionable comparability. The first process in the computation of the value using this method is the estimation of the *anticipated benefits* of the Company. Anticipated benefits may be reasonably represented by such items as net cash flow, dividends and various forms of earnings and should be estimated considering such items as the nature, capital structure, and historical performance of the related business entity, expected future outlook for the business entity and relevant industries, and relevant economic factors. The *earning or cash flow capacity* is the current profit picture of the Company, ignoring extraordinary factors, as well as cyclical and seasonal changes in earnings or cash flow. The earning or cash flow capacity should not take into account future growth in earnings or cash flow, but rather it should be the **current** earning or cash flow capacity.

The **discounted cash-flow** method develops an indicated value based on the company's projected future cash flows. This method is often used to value the stock of development-stage companies and to value those companies where historic earnings are not necessarily a representation of the *earning or cash flow capacity* of the company being valued. It is also the most common method used for valuations in mergers and acquisitions.

The appraiser must use informed judgment when determining the relative weight to be accorded to indications of value reached on the basis of various methods or whether an indication of value from a single method should dominate. The appraiser's judgment may be presented either in general terms or in terms of mathematical weighting of the indicated values. In any case, the appraiser should provide the rationale for the selection or weighting of the method or methods relied on in reaching the conclusion

Capitalization and Discount Rates

When valuing closely-held business interests, there are sometimes adjustments to the values as derived from the various approaches discussed above. Typically, this is to account for whether the interest being valued is controlling or non-controlling, and whether or not the interest is freely traded on a public market. A discount or premium is warranted when characteristics affecting the value of the company differ sufficiently from those inherent in the base value. A premium or discount quantifies an adjustment to account for differences in characteristics affecting the value of the subject interest relative to the base value to which it is being compared.

A capitalization rate is any divisor, usually expressed as a percentage, that is used to convert an earnings stream into value. It is usually derived by subtracting the company's expected long-term average growth rate from its discount rate.

A discount rate represents the rate of return an informed investor would expect to receive on an investment in the company, given the degree of risk inherent in that investment. Unlike a capitalization rate, a discount rate is not used as a divisor to determine a company's value. It is instead used as a base to determine present value factors, which are then used to discount a future benefit stream. In practice, the discount rate of often derived from the a compilation of the following factors:

- Risk-free rate of return
- Equity risk premium
- Risk premium for size
- Premium for other risk factors

Control Premiums

A controlling interest in an unlisted company is generally held to be worth more than its proportionate share of the value of all the outstanding shares. The magnitude of a control premium is influenced by the shareholder's ability to exercise any or all of a variety of right typically associated with control, such as electing directors and managers, setting company policy, acquiring or liquidating assets, selling or acquiring treasury shares, declaring and paying dividends, and others. Control premiums are often derived from actual premiums paid by buyers in corporate transactions, and can range from 25% to 50%

Minority Discounts

A minority stake in an unlisted company is generally considered to be worth less than its proportionate share of the value of all the outstanding shares because minority shareholders usually cannot effect control of the company. The magnitude of a minority discount depends on the shareholder's inability to exercise any or all of a variety of rights typically associated with control. Minority discounts typically range from 20% to 30%.

Marketability Discount

Because shares in private companies are not readably tradable as with shares registered on a stock exchange, a marketability discount is applied to reflect the reduction in value attributed to the lack of marketability. A greater or lesser discount is applied on the basis of the impact of factors such as agreements relating to the shares or restrictions on the transfer of shares, buy-sell agreements, the prospects of an IPO, put options, the existence of a market for the shares and dividends.