EQUITY INCENTIVES LIMITED

equity@work

Equity incentives and the technology company

October 2000

Foreword

Welcome to the first edition of **equity@work.**

This report focuses on the use of equity incentives in technology companies. To ensure that our research covers an identifiable type of company, we have analysed in detail 88 UK quoted software and computing services companies (as defined in The Holway Report). However, we believe that most, if not all, of our findings will be relevant to any company whose business is based on the development of technology, or indeed any company that is dependent on human capital.

- The report begins with a discussion on a number of topical issues affecting share plans in technology companies. These may have an impact on the choice and appropriate design of schemes.

- We then give an analysis of the main findings of our research into current practice in the technology industry.

- This is followed by case studies illustrating the way in which some of the firms we cover have implemented equity incentive schemes.

- We also provide a report on The UK Employee Ownership Index™, which measures the relative weekly share price performance of UK quoted companies with significant levels of employee share ownership, against the FTSE All Share Index from January 1992.

- An overview of some of the most common equity incentive plans currently used in the UK is presented at the end of this report. The overview includes information on the two new Inland Revenue approved schemes – the New All Employee Share Plan and the Enterprise Management Incentive. We consider the likely relevance of all these plan designs to technology–based companies.

Contents

1. EQUITY INCENTIVES AND THE TECHNOLOGY COMPANY

The Challenge

A key challenge for any company is the ability to recruit, retain and motivate good people. Getting the remuneration package right is a critical factor and the use of equity to incentivise, retain and reward staff is becoming increasingly common. European companies, especially UK ones, are drawing on the experience and practice of their counterparts in the United States. Equity incentives are being offered to more employees, in larger amounts, and more often.

It is estimated that in the UK 3.5 million employees participate in Inland Revenue Approved Employee Share Schemes alone. The benefits of employee share ownership are also becoming recognised on an increasingly global scale and the range of equity incentive schemes available is expanding. In the United States, the National Center for Employee Ownership (NCEO) estimates that around 10 million US employees now receive options, roughly a 10–fold jump since 1992. Closer to home in France, the Finance Minister Laurent Fabius recently announced substantial tax breaks for company savings schemes in an attempt to increase share ownership by employees. And here in the UK, Gordon Brown has introduced two new schemes – the New All Employee Share Plan, and the Enterprise Management Incentive – to boost employee ownership.

A key challenge for any company is the ability to recruit, retain and motivate good people

The Environment

The use of equity incentives is of particular importance to technology–based companies. As some technology company valuations neared stratospheric levels late last year, some firms in more traditional sectors of the economy saw an exodus of staff eager for technology share options promising huge gains. Many of these gladly traded higher salaries for larger option packages. Just as technology companies are competing with each other for talented staff, more traditional companies are having to try harder to encourage employees to stay. This trend continues.

However, much of the froth surrounding technology companies subsided in Spring 2000 with market expectations of technology firms falling to more modest levels. Optimism is now gradually returning, though the industry itself may need more time to settle. The dramatic re–dressing of dot.com valuations has had an effect on share prices of the more established technology firms. This, together with the recent spate of profit warnings (or at least *expectations* of profit warnings) caused by a longer than expected Y2K hangover, failure to reach sales targets, strong competitive pressures and rising costs has meant that firms such as CMG, Logica, Misys, Sage and Sema all experienced drops of over 35% from their first–quarter highs. The third quarter of 2000 may see several technology share prices recover – for the companies covered in this report, the average percentage fall in share price from the 31st March 2000 to the 31st August 2000 was 13.17%.

The Issues

Underwater options

On the back of dramatically falling share prices many technology share options have quickly turned to dust, at least for the time being. Of course, part of the attraction of options is that what seems worthless one day may well turn out to be of great value the next. Share price volatility can lead to situations where, more by accident than design, huge gains can be made if options are granted at a low, and the time when they become exerciseable coincides with the share price reaching a high. The flip side of this however, is the granting of options at a high, followed by a long term share price decline and share options sinking underwater. Later in this report we will look more closely at where this has been the case in the technology industry and at the action (if any) some firms have taken to address the issue.

Technology companies – and their key asset, their employees – have experienced a reality check, one consequence of which is that share based remuneration packages will be seen by employees as marked 'handle with care'. This highlights the importance of designing equity incentives with intelligence, and based on realistic expectations of the connections between equity incentives and company performance.

Flexibility of granting options

A key issue, that looks set to grow in importance, is the extent to which options may be granted over new issue shares. Some technology companies covered in our report have already made it clear that the headroom guidelines of the Association of British Insurers (ABI) are too restrictive given the importance of share options as part of their remuneration package. The ABI guidelines state that commitments to issue new shares under all a company's schemes must not exceed 10% of the issued ordinary share capital of the company in any rolling ten year period. Earlier ABI flow–rate restrictions (5% over five years for all schemes and 5% over ten years and 3% over three years for discretionary option schemes) were slightly relaxed last year, with remuneration committees being tasked with ensuring that dilution takes place at as smooth as possible a rate. The overall 5% over ten years for discretionary schemes, and 10% over ten years for all schemes, remains.

Whilst most of the firms we have considered currently comply with the overall 10% limit, there are signs of a desire to break out. For example, late in 1998 Torex obtained agreement from the ABI to raise this limit to 12.5%.

A brief comparison with US practice is useful. In 1999, 200 of the USA's largest companies granted options over 2% of their capital, compared with 1% in 1989 (Source: Frederick W. Cook). Dilution rates under outstanding options in US quoted companies average 12.6%, and in a third of them the rate exceeded 15% (source: National Center for Employee Ownership). None of these findings would appear to concern the US's largest pension fund, TIAA–CREF, which earlier this year stated its own guidelines on dilution, but which drew a line in the sand at 15%, or 2% a year, or 25% and 3% a year for human capital companies where middle management participate in equity incentives.

The stage is set for UK technology companies to be increasingly prepared to exceed current UK dilution limits. In March of this year, Reuters threw down the gauntlet by indicating in its 1999 Annual Report an intention to offer as many share options as it considers necessary.

The importance of designing equity incentives with intelligence, and based on realistic expectations of the connections between equity incentives and company performance

It would be wrong to conclude, however, that corporate America is entirely free of scepticism about share options. US investors will have little patience with companies that grant new options to replace underwater ones (some have even threatened litigation). Many US companies are countering the dilution resulting from share option grants by buying shares back, at significant financial cost which some analysts suggest could have been spent on research and development. And there is emerging suspicion that some US company directors manage the release of news into the market to influence the value of their options. Major investors like TIAA–CREF support moves to show the value of options granted as a charge to the profit and loss account (see below). The message from the US is 'grant the options you need, but be prepared to suffer the bad times, and be crystal clear about how much they really cost the company and its shareholders'.

Accounting

Technology firms are certain to be highly concerned at the impact of the Accounting Standards Board's recent proposals relating to share options.

Currently, share options are principally covered by the Urgent Issues Task Force (UITF) Abstract 17, under which any difference between the exercise price and the market value at the date of grant must be charged to the profit and loss account. In other words, only discounted options are shown as a cost. The Accounting Standards Board (ASB) has recently proposed that any grants of share options should be charged to the company's profit and loss account, their argument being that the company is transferring something of value.

The ASB proposals would work in the following way: a charge to the profit and loss account would be recorded for each year over the period between the date of grant and the date when the option becomes exercisable (vesting date), based on the fair value of the option in each year of the vesting period. Normally, an option pricing model ('Black Scholes' being the most commonly used) should be used to determine the fair value (as a very approximate rule of thumb, this would typically mean that an option might be valued at 20% of the market price of a share – this is likely to be higher than 20% in companies with a volatile share price, but less than 20% where the share price is relatively stable).

The Accounting Standards Board (ASB) has recently proposed that any grants of share options should be charged to the company's profit and loss account

What would be the impact of these proposals? We have developed a model to illustrate the possible impact of this new accounting treatment on the companies covered in this report.

The model assumes that in a given year a company grants options over 1% of its share capital and that the fair value of a technology share option is considered to be 25% of share price. The model also assumes that the vesting period is three years. The impact of the resulting charge on the profit and loss account for each technology company in the year of grant is then calculated. The model yields the following results:

- The average charge to the profit and loss account would represent 5.19% of pre–tax profits (loss)
- In 64% of firms, pre–tax profits would be reduced by (or loss increased by) 0 – 3%
- In 10% of firms, pre–tax profits would be reduced by (or loss increased by) 3 – 5%
- In 21% of firms, pre–tax profits would be reduced by (or loss increased by) 5 – 10%
- In 5% of firms, pre–tax profits would be reduced by (or loss increased by) greater than 10%
- In the most extreme case, one company would see its pre–tax profits wiped out, slipping agonisingly back into the red by 174%

If we adapt this model by removing the assumption that firms grant options over 1% of their share capital, and use actual data (where available) on options issued in the last year, we generate the following results:

- The average charge to the profit and loss account would represent 5.65% of pre–tax profits/loss
- In 58% of firms, pre–tax profits would be reduced by (or loss increased by) 0 – 3%
- In 20% of firms, pre–tax profits would be reduced by (or loss increased by) 3 – 5%
- In 11% of firms, pre–tax profits would be reduced by (or loss increased by) 5 – 10%
- In 11% of firms pre–tax profits would be reduced by (or loss increased by) greater than 10%
- In the most extreme case one company would see its loss for the year increase by 52%

Although the results from our model are only intended to broadly illustrate the likely effect of the ASB's proposals, it is reasonable to expect that on average the technology company would see its pre–tax profits/loss impacted by around 5%. And for any technology company struggling to break into profit, the effect will often be to knock it back into loss.

If the new proposals do come into effect, it may be possible to fix the profit and loss charge at the outset by financing a trust to acquire shares needed in the future to satisfy share options, and we expect that many companies will wish to consider this.

Will the proposals be acted upon? Whilst there is a certain logic to them, there is no doubt from our analysis that their impact will be material in most technology companies. Investors may welcome the additional transparency, but finance directors will be hostile to reductions in headline profits. For unquoted companies, we think the proposals are irrelevant to accurate accounting, and, if activated, risk dealing a body blow to their use of share options. Although there is a potential silver lining to the proposal in the form of a corporation tax deduction for any profit and loss charge, this is likely to be of little consolation to the companies affected.

on average the technology company would see its pre–tax profits/loss impacted by around 5%

National Insurance

A more immediate concern to many technology companies is the treatment of the employer's National Insurance Contributions (NIC) on the exercise of unapproved share options. On exercise of unapproved share options granted after 5 April 2000, gains are chargeable to employers national insurance at 12.2%. This is a severe problem to many technology–based companies, which can neither plan for this liability (because they don't know when employees will exercise their options) nor predict how much it will be (because that is affected entirely by share price on the date of option exercise). Highly valued companies are faced with the prospect of option exercises causing severe depletions in annual profits. The Government has sought to address this by allowing the NIC burden to be transferred from the employer to the employee (with the employee qualifying for income tax relief against the NI they now pay).

The new share plans

In the next section of the report we look at the types of equity incentive arrangements that technology firms currently have in place. The range of approved schemes in the UK has now expanded to include the Enterprise Management Incentive (EMI) and the New All Employee Share Plan (NAESP). These schemes are described in more detail at the end of this report but it is worth considering here how they might be of benefit to the technology company.

EMI is a discretionary scheme and the aim is to enable small (gross assets of less than £15m), 'higher risk' fast growing companies to attract and retain key employees. It allows up to fifteen employees in any one company to hold options over up to £100,000 worth of shares. The fact that it is more flexible, more beneficial and easier to implement than the other approved plans gives the smaller technology company a powerful new weapon in its fight to attract employees from larger, richer companies.

EMI...is more flexible, more beneficial and easier to implement than the other approved plans

Once the company grows to the point where it has gross assets in excess of £15m, no further EMI grants can be made. It is an ideal plan to enable the small fast growing technology company to incentivise and retain key staff, at least in the short term.

The New All Employee Share Plan has already attracted attention from some of the companies covered in this report. Originally it was thought that the NAESP would replace both Profit Sharing and SAYE schemes. However, SAYE will continue and companies now have the opportunity to replace it or supplement it with the new plan.

The NAESP's benefits include flexible performance criteria for the award of free shares, tax–deductible share purchase for employees and capital gains tax free growth in value of shares. Shares can be allocated free to employees, with a limit of £3,000 per year per employee; or can be purchased by employees out of pre–PAYE and pre–NI salary, with a maximum annual value of £1,500 per year, or 10% of salary. Where an employee does buy shares, a company can match those shares with further free shares at a maximum ratio of 2:1. Shares are held in a trust and, provided they remain there for five years, employees pay no income tax or NI. The shares used in the plan must be fully paid–up, non–redeemable, quoted or in a company not under the control of another company (unless that company is quoted), and they must not be subject to any unauthorised restrictions.

Some technology companies have expressed concern that employees would be exposed to share price volatility in relation to bought shares. Whilst an underwater share option does not expose the employee to any financial risk, share purchase clearly does, and makes the company vulnerable to damage to employee morale if the share price subsequently falls, even if only temporarily.

Some technology companies have expressed concern that employees are exposed to share price volatility in relation to bought shares...but careful design of the NAESP can significantly reduce the risk of loss

However, we believe the NAESP is sufficiently flexible for this concern to be addressed. The fact that the employee purchases out of pre–tax salary means that he is effectively buying shares at a discount of up to 40%. Then, to protect the employee even further from any potential financial loss, the company has the ability to match those shares with further free shares at a maximum ratio of 2:1.

We can demonstrate the extent to which careful design of the NAESP can significantly reduce the risk of loss (or perceived loss in the case of short term share price reductions) with the following example:

Assume that an employee earning £25,000 per annum and incurring an income tax and NI charge of 32% of his salary chooses to purchase a share with a market value of £1 through the NAESP. The following scenarios illustrate how far the share price would have to drop before he begins to make a loss:

	Outlay by employee	Total value of shares held by employee	To make a loss, the share price must fall by more than:
Employee buys 1 share	£0.68	£1.00	32%
Employee buys 1 share and receives matching shares at a rate of 1:10	£0.68	£1.10	38%
Employee buys 1 share and receives matching shares at a rate of 1:2	£0.68	£1.50	55%
Employee buys 1 share and receives matching shares at a rate of 1:1	£0.68	£2.00	66%
Employee buys 1 share and receives matching shares at a rate of 2:1	£0.68	£3.00	77%

An employee earning £50,000 per annum and incurring an income tax and NI charge of 41% of his salary would be sheltered from financial risk in the following way:

	Outlay by employee	Total value of shares held by employee	To make a loss, the share price must fall by more than:
Employee buys 1 share	£0.59	£1.00	41%
Employee buys 1 share and receives matching shares at a rate of 1:10	£0.59	£1.10	46%
Employee buys 1 share and receives matching shares at a rate of 1:2	£0.59	£1.50	61%
Employee buys 1 share and receives matching shares at a rate of 1:1	£0.59	£2.00	71%
Employee buys 1 share and receives matching shares at a rate of 2:1	£0.59	£3.00	80%

It is clear that by simply buying shares out of pre–tax salary the employee is able to substantially protect himself from any financial risk associated with share price volatility. The greater the rate at which matching shares are supplied, the more the employee becomes protected.

The company can provide matching shares at a rate of 1:10, paid for entirely out of the employer NI savings

The company can provide matching shares at a rate of 1:10, paid for entirely out of the employer NI savings the company makes on the bought shares. And in addition, the cost of providing free shares is deductible against corporation tax, as is the cost of establishing the Plan.

2. CURRENT USE OF EQUITY INCENTIVE SCHEMES IN THE TECHNOLOGY INDUSTRY

Companies Covered

Our research covers the following 88 UK quoted software and computing services companies:

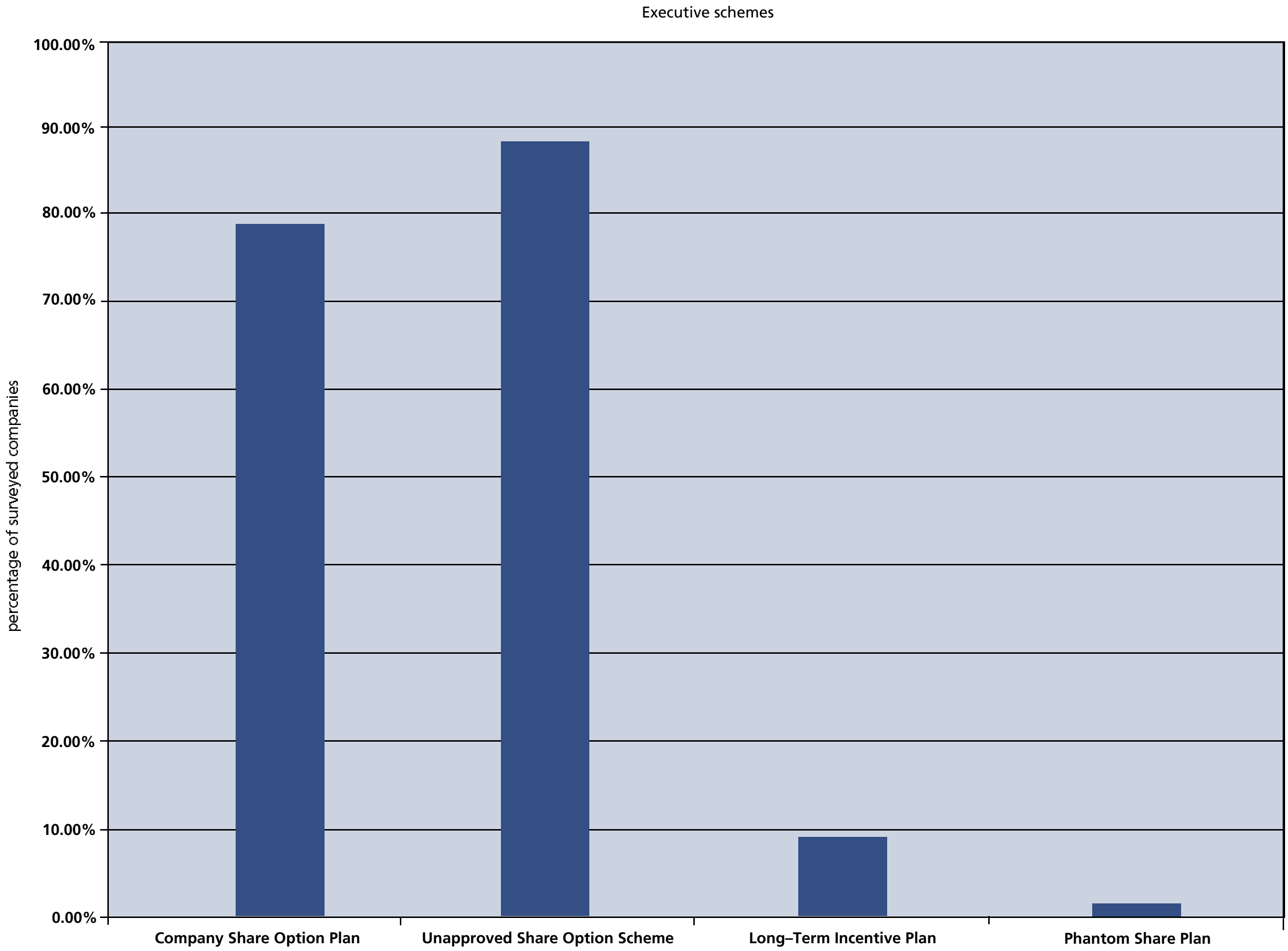
Admiral
AFA Systems
AIT Group
Anite Group
Axon
Azlan Group
Baltimore Technologies
Bond International Software
Cadcentre Group
Capita
Cedar Group
CFS Group
Clinical Computing
CMG
Comino
Compel Group
Computacenter
DCS Group
Delcam
Diagonal
DRS Data & Research Services
Druid Group
ECsoft Group
Eidos
Electronic Data Processing
FI Group
Financial Objects
Flomerics Group
Gresham Computing
Guardian IT
Harvey Nash Group
Highams Systems Services Group
ICM Computer Group
Ilion Group
Intelligent Environments Group
IS Solutions
ITNET
JSB Software Technologies
Kalamazoo Computer Group
Kewill Systems
Logica
London Bridge Software Holdings
Lorien
Lynx Group
Macro 4
Merant
Microgen
Misys
MMT Computing
Mondas
Morse Holdings
MSB International
MSW Technology
NetBenefit
Northgate Information Solutions
NSB Retail Systems
Oxford Molecular
Parity
Pegasus Group
Planit Holdings
Policy Master
QSP Group
Quantica
Rage Software
Real Time Control
Recognition Systems Group
Rolfe & Nolan
Romtec
Royalblue Group
Sage Group
SBS Group
Science Systems
Sema Group
Sherwood International
Skillsgroup
Spring Group
Staffware
Superscape
Synstar
Systems Integrated Research
Torex
Total Systems
Touchstone Group
Trace Computers
Triad Group
Ultima Networks
Vega Group
XKO

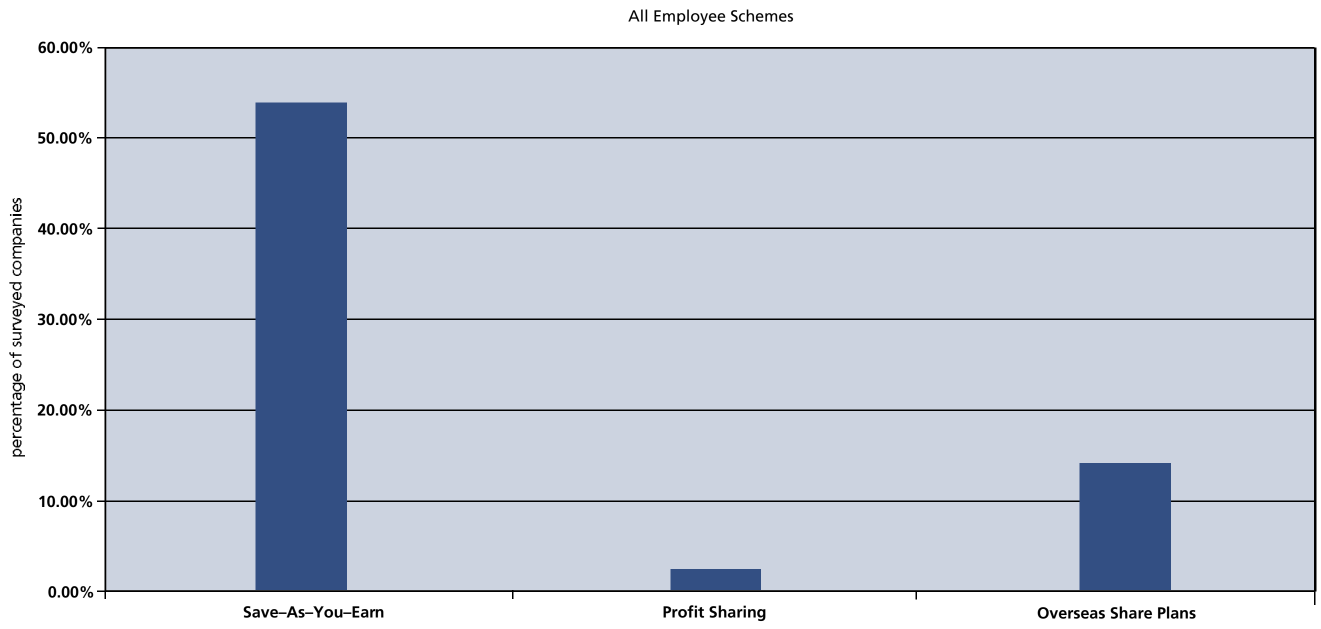
It should be noted of course that by the time this report has been published some of the above companies may no longer be quoted.

For the purposes of our calculations we have used publicly available company information and share price data as at the 31st August 2000.

Equity Incentive Schemes Currently in Operation in the Technology Sector

The following graphs illustrate the current usage of equity incentive schemes by the companies covered. We categorise the schemes into 'Executive Schemes' and 'All Employee Schemes'.





The surveyed companies clearly favour using the Inland Revenue approved Company Share Option Plans (CSOP), Unapproved Share Option Schemes (to provide flexibility beyond the £30,000 threshold of the CSOP), and Save–As–You–Earn schemes. In fact, 42% of them operate all three.

Least favoured are Phantom Share Plans (essentially a cash–based incentive emulating the effect of options without using equity) and Profit Sharing Schemes (involving the grant of free shares to all employees).

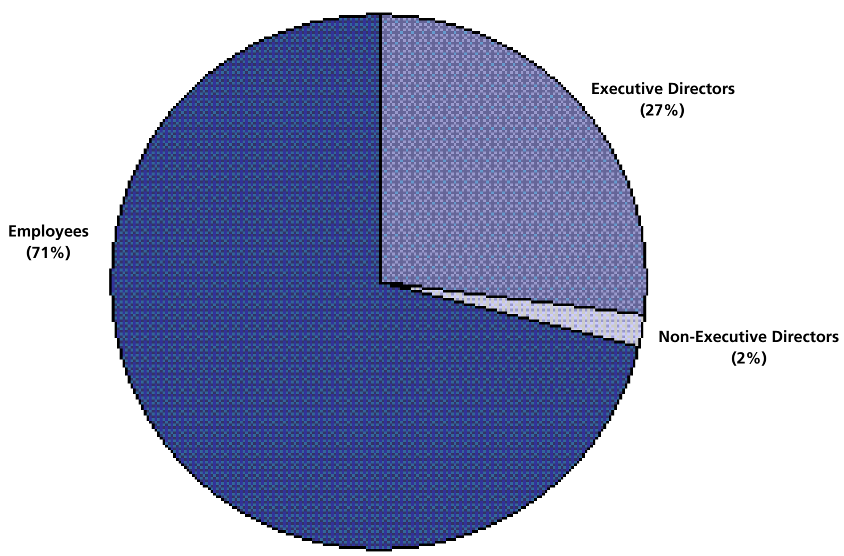
Where all employee plans are not in operation, several firms we spoke to tend to roll out participation in the CSOP and/or unapproved schemes to all staff.

15% of firms operate overseas schemes for all employees.

Option Holdings

The majority (71%) of share options in the surveyed companies are held by non–director employees. On average, executive directors hold 27%, and non–executive directors hold the remaining 2% of share options.

Option Holdings



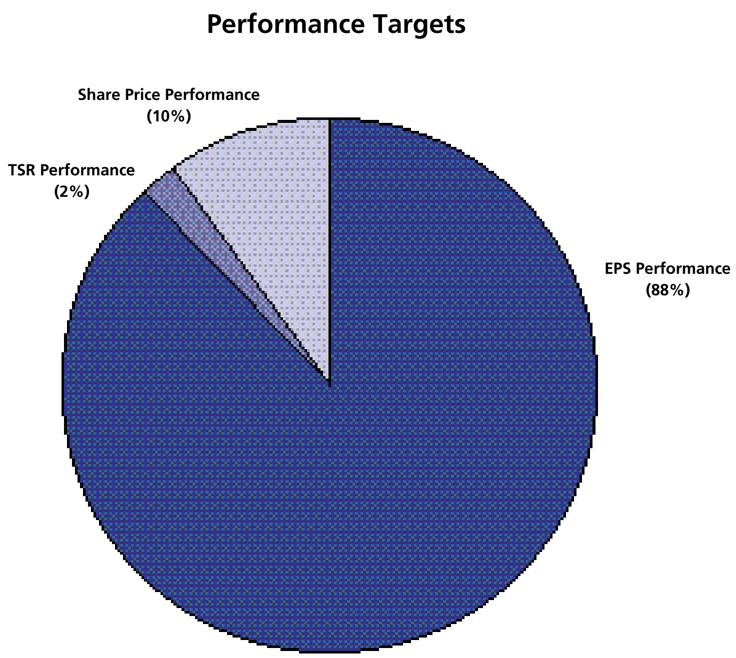
Firms for which this trend does not hold true include Clinical Computing, Eidos, ICM Computer Group, MSB International, Netbenefit, Pegasus Group, Romtec, and SBS Group where, on average, executive directors hold 77% of share options. Firms which have a roughly equal split of share options between executive directors and employees include Anite, Cedar, Harvey Nash, JSB Software Technologies, Kalamazoo and Recognition Systems Software.

Companies in which executive directors do not participate in any share option schemes include AIT, DRS Data and Research Services, Quantica, Synstar and Triad.

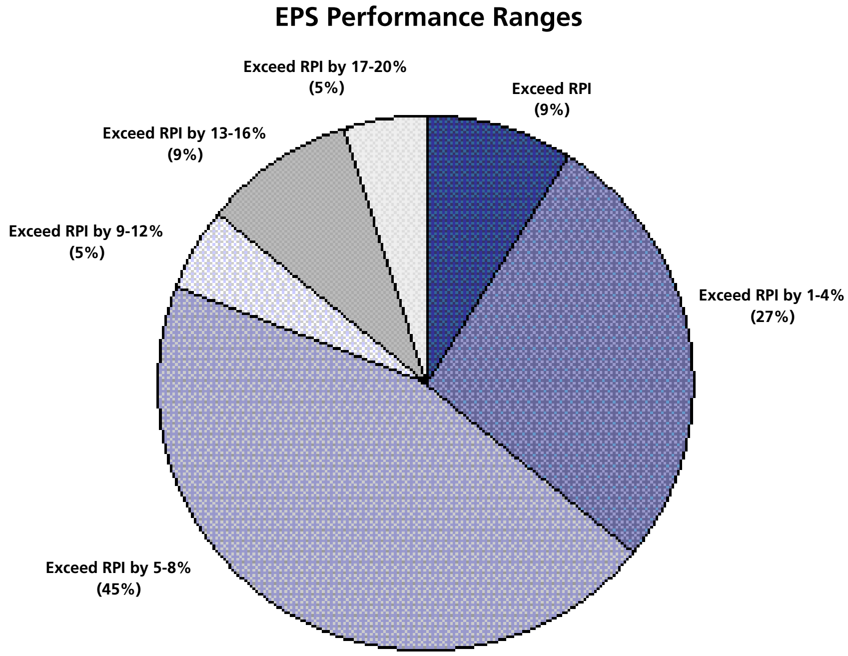
Performance Targets

The vast majority of companies in the sector favour the use of performance targets relating to earnings per share (EPS), total shareholder return (TSR) or straightforward share price performance as a condition for exercise of discretionary share options. Total shareholder returns measure share price growth and dividends.

Where these company performance measures are in use, the split is as follows:



88% of companies have chosen performance targets based on EPS. EPS targets most commonly require a certain percentage increase in EPS over and above that of the RPI over a three year period. Where the potential rewards for executives are substantial, performance is measured over five year periods. Proportional vesting targets are usually utilised so that more options vest the greater the growth in EPS. The less onerous EPS targets in the sector simply require growth in EPS to exceed that of the RPI, the more demanding require growth in EPS to exceed that of the RPI by up to 20%. The following pie-chart illustrates the range of EPS targets in the surveyed companies.



Several firms (10%) have chosen to establish performance criteria based on the share price reaching a certain value for a specified period.

88% of companies have chosen performance targets based on EPS

TSR performance targets are least often employed (2% of firms), and require the company to attain a certain percentile within a comparator group of IT firms for a portion, or for all rewards to be released.

Value of Technology Share Options

To what extent are share options in the researched companies providing the incentive for which they were intended? Or in other words, how much are they worth?

To answer these questions we calculated the average value of shares subject to options held by executive directors and the per employee value of shares subject to UK SAYE share options for each company covered. We also calculated the 'in the money' element – i.e. the difference between the share price (as at 31st August 2000) and the exercise price for each category. For purposes of comparison, we also looked at the average value of shares owned outright by executive directors.

Value of shares subject to options held by executive directors

	Sector Average	Sector Maximum	Sector Minimum
Total value (per person)	£1,623,110	£17,183,141	£7,583
'In the money' element (per person)	£1,043,500 (64%)	£15,004,677	–£15,474,809

Value of shares owned outright by executive directors

	Sector Average	Sector Maximum	Sector Minimum
Total value (per person)	£12,237,672	£195,775,990	£11,000

Per employee value of shares subject to UK SAYE share options

	Sector Average	Sector Maximum	Sector Minimum
Total value (per person)	£16,942	£93,099	£15
'In the money' element (per person)	£13,092 (77%)	£90,005	–£2,501

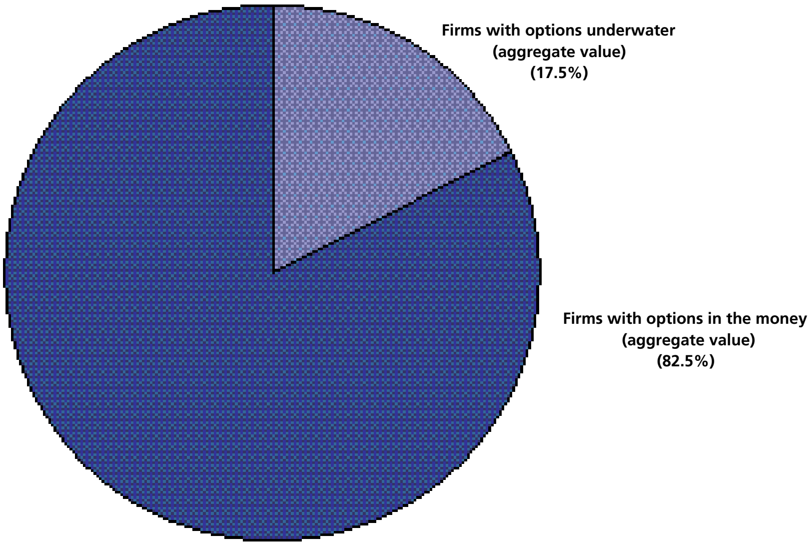
A striking feature is the range of values of options and the 'in the money' elements, illustrating the different growth opportunities within the sector. Share price volatility is also likely to have contributed to the variable worth of technology share options.

The average value of shares held by an executive director is also striking. In many cases, these directors are founders of their companies, and this level of value should not be used as a benchmark for reward for externally hired directors. In many of the surveyed companies, there is a tendency for options to be concentrated in the hands of externally hired directors, acknowledging the need to increase the level of their equity.

Underwater Options

In 17.5% of companies surveyed, the underwater element of options exceeds the 'in the money' element.

Share Options Underwater



It will frequently be hard to persuade shareholders that 'repricing' is a suitable route

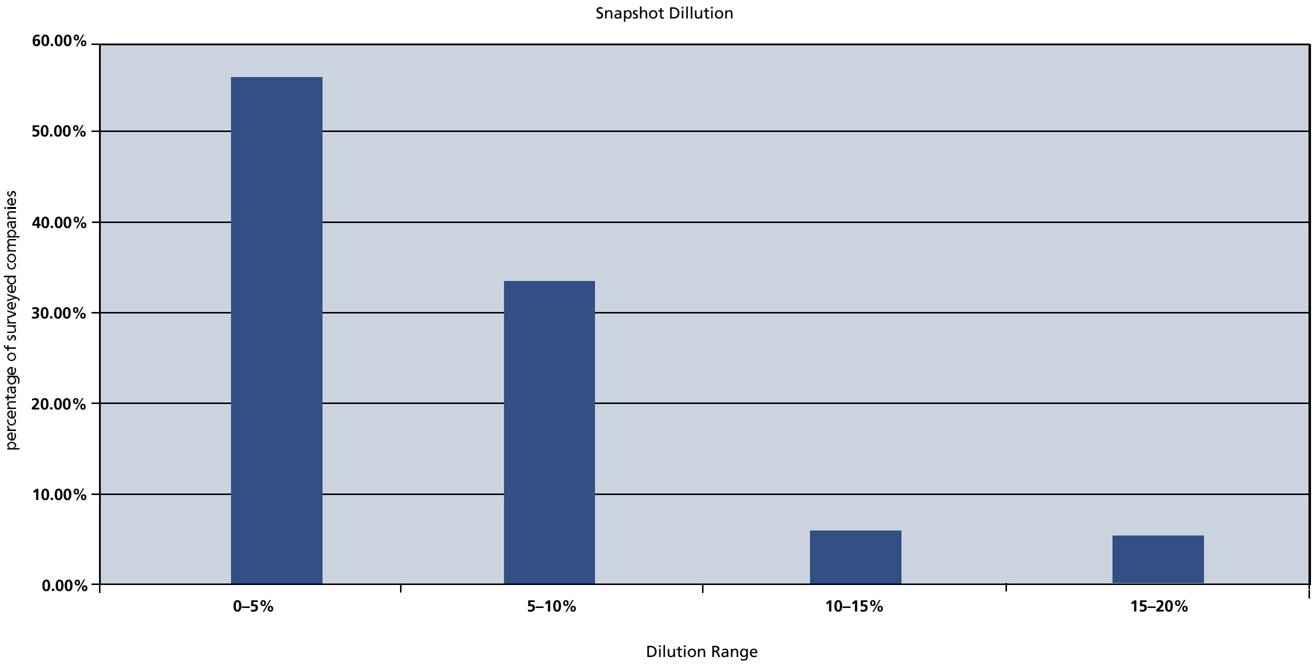
Of course, this does not necessarily mean that the options will remain underwater in the long term and many firms may decide to sit it out. But it may urge some firms to take action to re–incentivise staff in the short–term. Indeed, this has been the reaction of certain of the surveyed firms. For example, in September 1998, the Remuneration and Option Committee of Recognition Systems Group voiced its concern that the incentive value of the majority of existing options was doubtful because their exercise prices were substantially above the prevailing share price. At an Extraordinary General Meeting held on 31st December 1998 a resolution was passed allowing the existing options to be released and new share options to be granted under a new scheme.

It will frequently be hard to persuade shareholders that this 'repricing' is a suitable route. Their view will be that underwater options are a symbol of failure, and new reward is inappropriate. Companies that phase the grant of options, to smooth out fluctuations in exercise price, will either reduce the number of underwater options, or if not, may secure a more sympathetic hearing from investors if they do still need to ultimately reprice.

Dilution

Presented here are two measures of shareholder dilution.

The first is a 'snapshot' dilution measure based on options and grants of shares outstanding reflected as a percentage of the issued share capital. This provides a measure of dilution at one moment in time, but taken alone is of limited use in assessing compliance with ABI guidelines. Nevertheless it provides a useful indication of dilution.



Using this measure of dilution yields the following results:

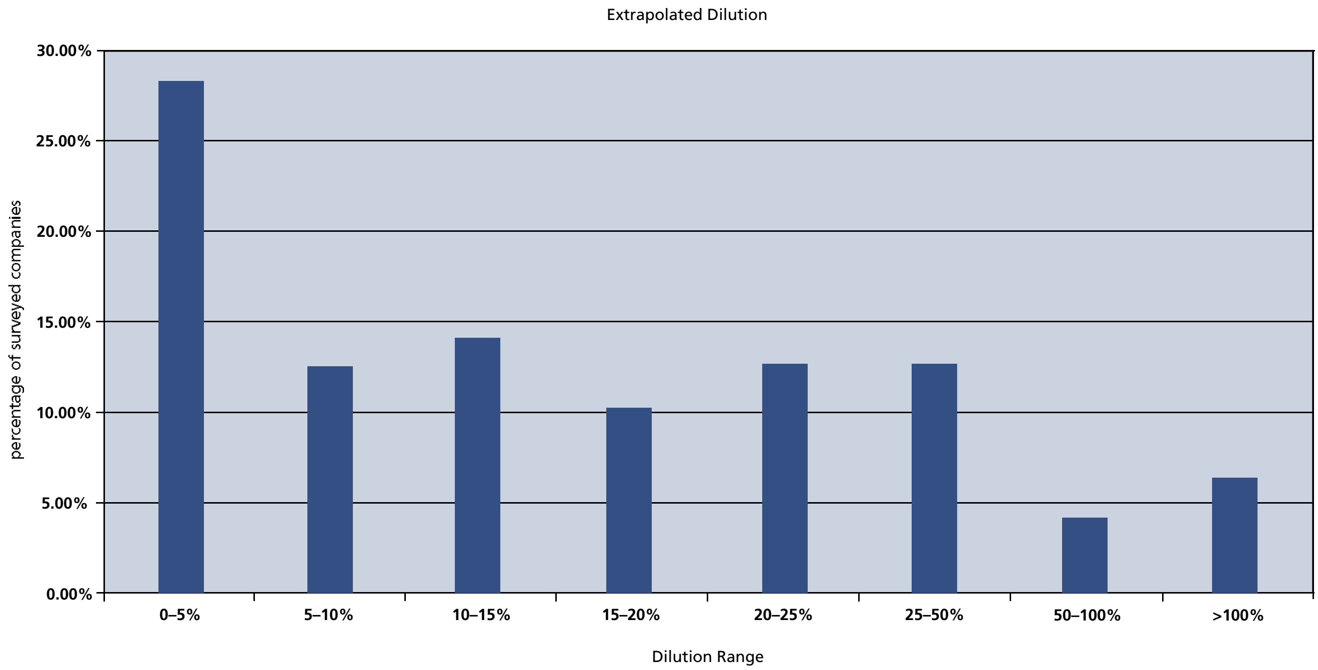
- The average dilution level is 5.59% of issued share capital
- 55% of firms have dilution levels between 0 – 5% of issued share capital
- 33% of firms have dilution levels between 5 – 10% of issued share capital
- 6% of firms have dilution levels between 10 – 15% of issued share capital
- 6% of firms have dilution levels between 15 – 20% of issued share capital

Significantly, the results show that the vast majority of technology companies (88%) currently fall within the 10% range. Of the firms in the 10 – 20% range, 50% have been floated since 1996, and 20% have been floated since 1998.

We have additionally considered the rate at which technology companies are currently issuing option grants and extended that rate into the future over a ten year period. If companies continue to grant options and shares to employees at this same rate will they have exceeded the ABI guidelines after 10 years?

6% of firms have dilution levels between 10 – 15% of issued share capital

The results of this analysis are presented below:



Using this measure of dilution yields the following results:

- The average dilution level is 22.28% of issued share capital
- 29% of firms have dilution levels between 0 – 5% of issued share capital
- 12% of firms have dilution levels between 5 – 10% of issued share capital
- 59% of firms have dilution levels between 10 – 120% of issued share capital

As was the case with the previous measure, the range into which the greatest number of companies fall is 0 – 5%. However, the clear observation here is that only 41% of companies fall into the 10% dilution limit as set by the ABI, with the remaining 59% spread between 10% and 120%. The average dilution level using this "look ahead" approach is four times greater than the average 'snapshot' level for the sector.

Although option grants may not continue to be issued at exactly the same rate each year for ten years the clear signal is that the trend is towards much bigger grants and dilution. Many firms will either have to substantially reduce the rate at which they grant options if they are to comply with the ABI guidelines, or be prepared to exceed them. Given the growing importance of share option grants as part of the remuneration package in the technology sector we anticipate that many will feel they have no choice but to do the latter. As we observe in Section 1, US investor sentiment is relatively sympathetic to higher dilution, and at least one UK company has already expressed an intention to grant significantly higher levels of options where it considers this necessary.

59% of firms have dilution levels between 10 – 120% of issued share capital

3. CASE STUDIES

Eidos

Share Price Performance

Equity Incentive Schemes Employed

- An approved Company Share Option Plan
- An unapproved executive share option scheme
- A SAYE scheme for UK and overseas staff
- 2 US schemes – the US stock option plan and the Crystal Dynamics Inc. stock option plan
- Eidos has received shareholder approval for the new All Employee Share Plan

Performance Targets

No company performance measures are used. Instead personal performance measures are employed.

Data

Percentage of options held by executive directors	76.52%
Percentage of options held by employees	23.48%
Average value of shares subject to options held by executive directors	£3,277,948
Average 'in the money' element of options held by executive directors	£2,405,636
Average value of shares directly held by an executive director	£5,191,031
Average value of shares subject to UK SAYE share options	£3,424
Average 'in the money' element of UK SAYE share options	£1,638
Snapshot dilution	5.02%
Ten year dilution based on most recent option grants	4.76%

Parity

Share Price Performance

Equity Incentive Schemes Employed

- An approved Company Share Option Plan
- An unapproved executive share option scheme
- A SAYE scheme

Performance Targets

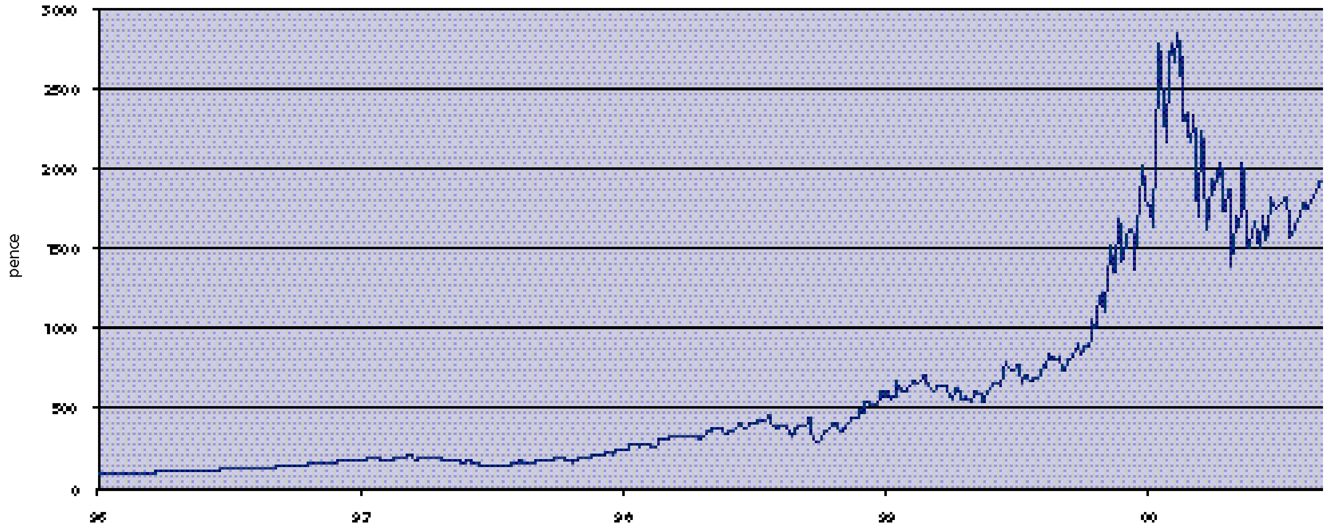
Growth in EPS before goodwill amortisation and exceptional items over the three financial years to 2002 must exceed RPI plus an average of 6% per annum. If growth is lower, there will be one re–test, using the same performance criterion, over the four financial years to 31st December 2003.

Data

Percentage of options held by executive directors	15.04%
Percentage of options held by employees	84.96%
Average value of shares subject to options held by executive directors	£348,450
Average ‘in the money’ element of options held by executive directors	–£45,299
Average value of shares directly held by an executive director	£2,373,688
Average value of shares subject to UK SAYE share options	£54,700
Average ‘in the money’ element of UK SAYE share options	£31,327
Snapshot dilution	3.05%
Ten year dilution based on most recent option grants	12.43%

Logica

Share Price Performance



Equity Incentive Schemes Employed

- An approved Company Share Option Plan
- An unapproved executive share option scheme
- A share related bonus scheme – a 'Phantom' share option scheme, comprising a long–term cash bonus based on the increase in the open market share price over the grant price of long–term bonus units
- A SAYE scheme for UK and overseas staff
- An Executive Equity Participation Plan – a Long–Term Incentive Plan allowing executive directors and other senior executives to invest up to 50% of their after tax annual bonus payment in the company's shares. If they retain the shares for 3 years and the performance criteria is satisfied, Logica will match these shares on a 1:1 gross of tax basis
- An Employee Equity Participation Plan – structured in a similar way to the Executive Equity Participation Plan, with eligible staff being given the opportunity to invest up to £400 per annum in company shares. If after 3 years the employee remains employed by the company and the performance conditions have been satisfied, Logica will award to the employee 1.25 shares for every 1 share purchased as part of their individual investment
- An Employee Stock Purchase Plan for US employees

Performance Targets

For CSOP, unapproved plan, Executive and Employee Equity Partnership Plans, EPS must exceed RPI by at least 7% per annum. for the three year period following the date of grant.

Data

Percentage of options held by executive directors	15.73%
Percentage of options held by employees	84.27%
Average value of shares subject to options held by executive directors	£16,870,229
Average 'in the money' element of options held by executive directors	£15,004,677
Average value of shares directly held by an executive director	£4,422,814
Snapshot dilution	5.04%
Ten year dilution based on most recent option grants	18.44%

4. THE UK EMPLOYEE OWNERSHIP INDEX™

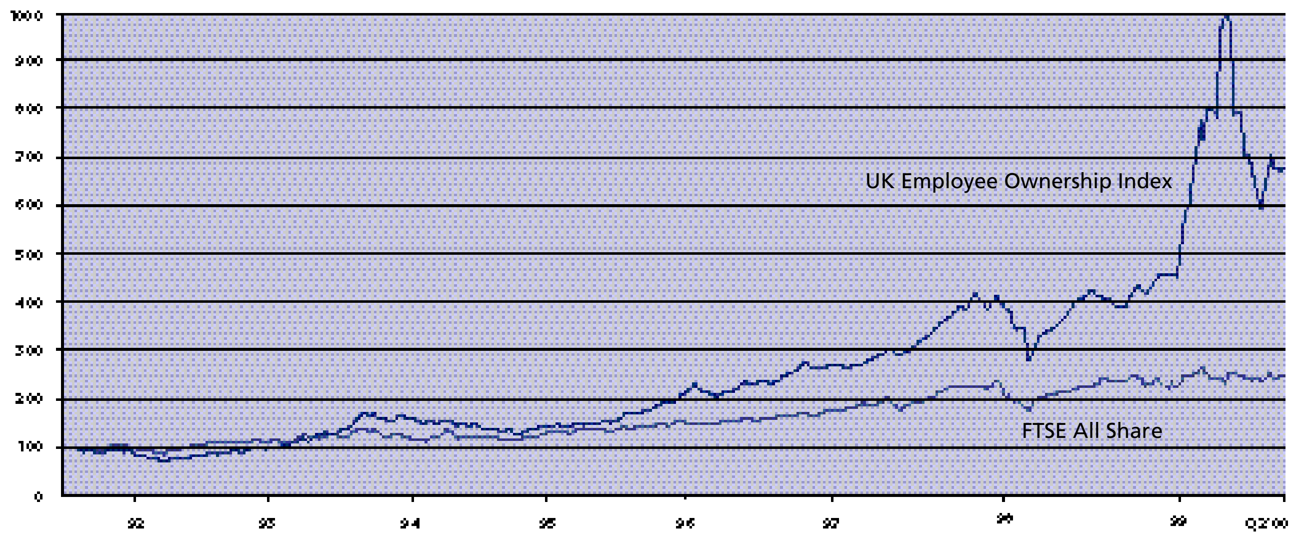
Rewarding your employees with your shares is becoming increasingly common, but what evidence is there that it makes any difference to your company's performance?

It is hard to prove a connection, since there are many factors which have an effect on corporate performance. Nevertheless, considering the share price performance of companies which embrace and encourage employee share ownership is a sensible place to start. And although share price is only one crude measure of corporate performance and not one that always correlates closely with profitability, cashflow or durability, it is clear–cut, unambiguous and readily measurable.

The UK Employee Ownership Index™ (EOI) tracks the relative weekly share price performance of some 30 listed companies with more than 10% of issued capital held by or for employees (other than directors) against the FTSE All Share Index. The index tracks share price movements from January 1992 and is updated quarterly.

The performance of the EOI is presented below together with accompanying data on how the EOI and the All Share indices have faired up to the second quarter of 2000.

Comparison of UK Employee Ownership Index against the FTSE All Share, January 1992 to June 2000



Comparison of EOI, FTSE All Share and Small Cap. Indices over the last quarter, 1, 3 and 5 years

	UK Employee Ownership Index™	FTSE All Share	FTSE Small Cap	FTSE 100
Q2 2000	–16.60%	–2.61%	–0.27%	–3.20%
1 Year	60.75%	0.38%	26.55%	–2.77%
3 Years	143.36%	35.80%	50.25%	33.94%
5 Years	350.01%	84.59%	82.72%	88.23%

It is clear that over the long term, The UK Employee Ownership Index™ has consistently outperformed all the major indices.

The EOI did however have a disappointing second quarter in 2000, falling 16.6% over the period. The FTSE All–Share, FTSE Small Cap, and FTSE 100 indices also slid into negative territory, falling 2.61%, 0.27% and 3.20% respectively. The EOI was affected severely by dramatic share price volatility in the technology sector. The EOI is more vulnerable than other indices to swings in value of just one or two companies. With all the technology firms in the EOI losing between 16% and 65% of their share price over the quarter, the EOI was dragged down to a value of 667 at the end of June 2000.

Excluding technology firms from the EOI gives rise to a 3.33% increase in value of the index over the same quarter.

An investment of £100 in the EOI in 1992 would now be worth £667, while the same investment in the FTSE All Share Index would be worth £244.

There are certain health warnings that need to be issued along with these results – the number of companies within the EOI is relatively small compared to the other indices and it has a bias towards certain sectors: support services, transport and technology. The index also includes more recently floated companies which tend to have significant employee share ownership. However, it is clear that companies with a significant level of employee ownership have outperformed (in stock market terms) those where there is less.

Over the long term, The UK Employee Ownership Index has consistently outperformed all the major indices

And this is the result which we would expect. From Capital Strategies' experience, employee–owned companies tend to feature progressive approaches to management and communication most often associated with best practice and top performing companies. For example:

- there is a more open and informative culture
- employees are educated to a higher level of financial and business literacy
- employees are more involved in the issues facing the company, at all levels of the business
- managers are exposed to a greater degree of scrutiny and accountability

As a result, many companies report incremental improvements in productivity and efficiency and reduced wastage and absenteeism, which can add up to material improvements to 'the bottom line'.

5. THE FUTURE ROLE OF EQUITY INCENTIVES IN TECHNOLOGY COMPANIES

This section looks at equity incentive plans most commonly used in the UK, and some general design considerations that should be borne in mind when choosing a new plan.

When looking at the design of any share incentive plan, it is important to clarify your objectives.

- Do you wish to recruit key, experienced personnel?
- Do you wish to incentivise and retain existing staff, and reduce high staff turnover?
- Should you focus on corporate, team or individual performance?
- Do you want to involve all employees?
- Do you want employees to make their own personal financial contribution?
- What type of equity incentives are your competitors using?
- Do you want to use equity to help create a strong company culture and management style?
- How important is tax efficiency?
- Is your company prepared to finance the purchase of shares for employees?
- Is your company prepared to show the cost of creating employee shares in its profit and loss account?
- Is there sufficient liquidity in your shares to satisfy the demands of a new share plan?
- Are there any other factors that might influence share plan design?

Inland Revenue Approved Schemes

Most Inland Revenue approved schemes must be used to benefit all employees but benefits can be distributed according to objective factors such as salary, length of service, hours worked etc.

Profit Sharing Scheme

This plan involves the establishment of a trust which distributes free shares to all employees, financed by tax–deductible contributions from the company. All employees (subject to a qualifying period of up to five years) must be invited to participate but the number of shares offered to each can be varied on the grounds set out above.

The shares must remain within the trust for at least two years and if the employees leave them in the trust for at least three years, they receive them tax–free.

Profit Sharing Schemes have not been popular among UK quoted companies, mainly because of the direct cost to the company in financing free shares. The Finance Act 2000 is to abolish profit sharing schemes, with 5th April 2001 the last date on which application can be made for approval, 5th April 2002 the last date on which a company can pay money into it, and 31st December 2002 the last date on which shares can be allocated to employees. We do not expect many technology companies to take advantage of this.

Save-As-You-Earn Share Option Scheme

This is the most popular approved scheme and allows employees to save monthly amounts of between £5 and £250 over three or five years. At the beginning of the savings contract, employees are granted a number of share options, at up to a 20% discount from the current market value (at the discretion of the company) based on the amount they have agreed to save, so that the proceeds of the savings contract will enable employees to exercise those options.

At the end of the savings contract, the employees receive a tax free bonus (in lieu of interest) and can use the money to exercise their options but only if they choose to do so. Otherwise they can simply withdraw their savings and tax–free bonus. If the employees do exercise their options with the proceeds, they are not subject to income tax but only to capital gains tax when the shares are sold.

SAYE schemes remain available, and we expect them to retain their popularity among technology companies. However, for employees willing to make a more immediate commitment to share purchase, the New All Employee Share Plan offers greater returns than SAYE, so long as share price does not fall (see New All Employee Share Plan).

QUEST

A QUEST is an Inland Revenue approved trust which can be used to hold shares on behalf of all employees. In quoted companies, it is most commonly used in conjunction with an SAYE scheme, as it can enable a company to receive a tax deduction for the dilution cost to shareholders resulting from exercise of SAYE options. We expect technology companies to continue taking advantage of this.

the New All Employee Share Plan offers greater returns than SAYE, so long as share price does not fall

Company Share Option Plan

This is the only Inland Revenue approved scheme that is 'discretionary' i.e. the company can choose which employees should be granted options and which should not. Options must be granted at no less than market value and any one individual cannot hold options over shares worth more than £30,000. Unlike unapproved options (see later in this section) there is no income tax charge on exercise provided certain time limits are met on exercise.

Because this scheme is discretionary, it is one of the most popular approved schemes. Objective performance targets can be set so a company can ensure that an employee only benefits once the company's performance has improved. It has delivered good service both as an incentive and as a retainer (options normally lapse on leaving the company apart from in special circumstances) and is likely to feature heavily in the incentive plans of most of the surveyed companies.

New All Employee Share Plan

The New All Employee Share Plan is now referred to in the Finance Act as the Employee Share Ownership Plan or ESOP. It is the main weapon in Gordon Brown's armoury in his bid to double the number of companies with all employees holding shares. The ESOP will allow a company to gift free shares worth up to £3,000 every year to all employees ('free shares'). Alternatively, if shareholders are concerned about dilution or directors want to encourage employees to show financial commitment, employees can be allowed to purchase shares worth up to £1,500 each year from pre–tax salary ('Partnership Shares'). Where they do buy Partnership Shares, the company can give further free shares in a maximum ratio of 2:1 ('Matching Shares'). The total value of shares (Free, Partnership and Matching) an employee could both buy and receive under the ESOP each year is £7,500.

The ESOP's flexibility means that it can be complex if companies want to offer partnership shares

One key feature is that the award of free shares can be linked to performance, based on the whole company, a profit centre or simply one individual.

The ESOP's flexibility means that it can be complex if companies want to offer partnership shares. However, the number of new administration providers for the ESOP is set to increase quickly, and NIC savings to the company will usually amply cover any extra administrative cost. And as we show earlier in this report, an employee earning £25,000 investing only in partnership shares would have to suffer a long term 32% decrease in share price before incurring a loss.

How does the new plan compare with the SAYE scheme? Although the two plans are different in nature, they will be the two main alternatives for companies considering a new plan to benefit all employees.

As the illustration set out below shows, the new plan delivers:

- more value into an employee's hands compared with SAYE, so long as the share price does not fall
- significantly more value where the share price rises substantially
- an automatic extra 12.2% saving for the company
- no value dilution to existing shareholders

The assumptions we use in the following illustration are:

- the employee either buys partnership shares with a value of £2,000, or is granted SAYE options over shares worth the same value, with the exercise price discounted by 20%
- capital gains tax annual exemption applies at £7,200
- employee's marginal tax rate is 23%
- SAYE options are sold on exercise
- Partnership shares are sold after five years

	New Plan		SAYE	
	After tax gain to employee	NI saving to company	After tax gain to employee	Dilution cost
Aggregate share value remains at £2,000	£460	£244	£400	£400
Aggregate share value rises to £4,000	£2,460	£244	£2,400	£2,400
Aggregate share value rises to £20,000	£18,460	£244	£15,824	£18,400

If one of the assumptions is changed to cover a higher rate (40%) taxpayer, the results would be as follows:

	New Plan		SAYE	
	After tax gain to employee	NI saving to company	After tax gain to employee	Dilution cost
Aggregate share value remains at £2,000	£800	£244	£400	£400
Aggregate share value rises to £4,000	£2,800	£244	£2,400	£2,400
Aggregate share value rises to £20,000	£18,800	£244	£13,920	£18,400

Enterprise Management Incentives Plan

Like the ESOP, the Enterprise Management Incentive Plan ('EMI') was introduced in the Budget. EMI is a discretionary scheme and the aim is to enable small, 'higher risk' fast growing companies to attract and retain high–flying employees. It is limited to fifteen employees in any one company but allows those fifteen people to hold options over up to £100,000 of shares. The tax treatment is exceptionally generous – shares acquired under an EMI Plan will benefit from the most generous form of capital gains tax taper relief (business assets taper relief), from the period running from the date the options are granted. This can lead to an effective capital gains tax rate on selling the shares acquired under an EMI Plan of just 10% if the shares are sold after only four years from the date the options were granted.

EMI will be the automatic first choice for young technology companies who meet the £15m gross assets maximum size requirement

EMI will be the automatic first choice for young technology companies who meet the £15m gross assets maximum size requirement. It is a hugely flexible plan, quick and straightforward to implement. Our main comment is that companies considering using it will need to check carefully that their trade qualifies (for example, a company whose principal business is licensing of intellectual property developed by other companies may not qualify).

Unapproved Schemes

Unapproved option schemes

These are the most common of all share schemes in the surveyed companies. They are discretionary, highly flexible and not subject to any financial limits (other than those under ABI guidelines limiting the size of annual option grants). Income tax will normally be payable when the employee exercises his right to buy the shares, and is calculated on the difference between the exercise price and the then market value.

We expect that unapproved share option schemes will continue to be used heavily by technology companies. Although employer NIC at a rate of 12.2% is now payable on unapproved options granted after 5th April 1999, the Government's less–than–ideal solution to transfer this liability to employees (with their consent) appears to have placated many of the companies who expressed concern at this. One side–effect, however, is likely to be further upwards pressure on the size of option grants to compensate employees for this extra cost.

Long-term Incentive Plans (LTIPs)

LTIP can refer to many different types of share scheme but they all tend to involve the award of a deferred right or opportunity to receive a set number or value of free shares. Ultimately, employees will receive all or a proportion of those shares depending on their company's performance as measured by a set performance targets (for example, the company's earnings per share must increase by RPI + 3% by the end of a three year period). In addition, some LTIPs can require employees to stay with the company for a further period (normally one to three years) before they can sell the shares.

More technology companies may be prepared to consider an LTIP

Because employees are receiving free shares, they will pay income tax on the value of those shares at the time that they receive them. Employer NIC will normally be payable at the time the shares are transferred to the employees, as with unapproved share options. Until that time, the shares will normally be held in an employees' trust.

LTIPs deliver more value per employee than share options, because an option only gives the employee growth in value, whereas an LTIP delivers both original value and any resulting growth. An LTIP therefore enables a company to use less of its equity to deliver a given level of benefit, and therefore to eat up its headroom for dilution under the ABI guidelines at a slower rate. LTIPs also insulate their participants from share price volatility, and are incapable of going underwater. However, the value delivered under an LTIP must be shown as a cost in the company's profit and loss account, and it may be that this is the main factor in making LTIPs relatively unpopular amongst the surveyed companies.

If the ASB's proposals on accounting for share options are accepted, this disadvantage will be partly removed, and more technology companies may be prepared to consider an LTIP.

6. AN ALTERNATIVE APPROACH

For a technology–based company wishing to foster an entrepreneurial mindset among its key employees, there may be better solutions available than any of those described in the previous section.

In conjunction with some of the UK's leading share plan experts, Equity Incentives has developed a new incentive plan, which:

- provides selected key employees or directors with highly geared rewards in return for personal financial commitment
- avoids charges to profit and loss account and employer national insurance
- charges gains to capital gains tax rather than income tax, with taper relief running from day one; and
- causes no dilution, so does not use any ABI headroom

Equity Incentives Limited 35 Vine Street London EC3N 2AA
Tel: +44 (0)20 7861 4717 Fax: +44 (0)20 7488 0084
E-mail: info@equityincentives.co.uk Website: www.equityincentives.co.uk CDE: 823

Incorporates the equity incentives business of **FIELD FISHER WATERHOUSE** and **CAPITAL STRATEGIES**.

Registered in England No. 4238893. Registered office as above.
A list of the names of the directors and their professional qualifications is open to inspection at the registered office.