Equity incentives in the Netherlands

Does your equity plan motivate your key employees?
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1. About this report

With this report we would like to share our knowledge and insights in market trends of equity incentives. The questions what kind, why and how companies use equity incentives to trigger their key employees will be the focus in this report. We have made a distinction between different market segments, i.e. listed companies, middle market/family businesses and start up/scale up companies.

Insights and market trends

In our annual report “Executive Remuneration in the Netherlands 2017”, EY provides insights on trends in executive remuneration within listed companies. The 2017 analysis (based on annual reports of 2014, 2015 and 2016) shows that in the Netherlands, performances at the largest listed companies have improved over the last 3 years, while at the same time there is a lot of uncertainty on future performance. New opportunities and potential threats to economic stability are more diverse than ever before. In light of these developments, remuneration committees are continuously challenged to properly balance executive remuneration packages for sustainable growth. As a further deepening on equity remuneration, in this report “Equity incentives in the Netherlands” we focus on the part of the remuneration for executives which is related to the company’s share value. We analyzed the type of equity plans issued, its relation to the fixed salary and performance measures.

Besides the listed companies on one side of the spectrum we see a lot of middle market companies and also family businesses who make use of equity incentives schemes to attract and keep key employees. We describe a recent business case in which all different stages will be discussed, e.g. from the design stage to discussion with the Dutch tax authorities regarding the valuation method.

Also within startups it is popular to grant equity remuneration to employees. Partially the same logics apply for startups as well as for the other companies: employee retention and alignment of employee interests with those of the company. Interesting differences are the type of equity plans issued and the company’s available budget to do so, which can also affect the choice for the type of equity plans issued.

A properly working equity instrument is strengthening the business. In this report you will find examples of properly working situations. You will also find information on market practices. Having insight in market practices can be useful, but not more than one of the (many) considerations. At the end, your goals are leading when deciding on type, conditions and size of the equity plan.

We hope you will enjoy reading the report. We will be happy to discuss it with you in more detail and to (re)consider with you whether equity remuneration is an effective remuneration instrument for your company.
2. Why equity? Is sharing caring?

Alignment, tax benefits, creating income, rewarding your employees while one do not have direct cash available, increase employee engagement, retention, keeping up with competitors, self-esteem for employees, etc. All possible and fair answers to the question: why equity.

Sometimes it feels like there is more research about the usefulness and necessity of equity plans, than the number of existing equity plans itself. As advisors, we challenge our clients always to consider the following first: what is your goal when implementing an equity plan?

Large, listed entities have other goals than family businesses. Start-ups know what they want to achieve, however they face a lack of available cash so that (sometimes erroneously) an equity plan seems to be the only way to hire or retain excellent staff.

In the merger and acquisitions practice and for private equity funds other considerations apply. An optimal motivation of key employees with quick wins and minimal taxation is far more important. Often used instruments are called ‘sweet equity’ for a reason.

General rule: keep it simple

Can we give one general answer? There is never a single reason to introduce an equity plan. If the only reason would be rewarding employees, then taxation should have a significant impact when designing the plan. The (non-)availability of a corporate tax deduction should be offset against direct cash out for employees. In the Netherlands, share plans would then be more logical than employee option plans. However, if retention is key, in practice amongst part of our clients we see a revival of employee option plans. It is not the most tax efficient plan, however it is a flexible instrument.

The general rule is: keep it simple. Complex plans that are not understood by the employees, will not motivate people as much as possible. Goals are only reached if the employees understand the plan and their potential benefits. If tax optimization is leading, a plan can be more complex, as long as the employee still understands what is in it for him and what to do to reach this.

What is often missing? Generally speaking there is a lot of attention for execution and implementation of a new equity plan. We however encourage companies to evaluate when employees leave or did not meet the performance criteria. Did the plan work and what can we learn from it?
3. Market trends listed companies

In our report ‘Executive Remuneration in the Netherlands 2017’ EY analyzed the annual reports of Dutch listed companies for the years 2014 - 2016. The report is intended to provide insight in trends in executive remuneration levels and practices for those companies. This publicly free information has been gathered, analyzed and summarized by EY’s remuneration experts. Please find herewith some highlights of the report related to long term incentive plans.

3.1 Remuneration mix

With ‘Remuneration mix’ we typically mean a mix of base salary, short term incentives and long term incentives. The emphasis on variable pay tends to be higher for more senior position positions in a company, as those positions are assumed to have more influence on company performance. From our research on the pay mix in 2016, we learned that the relative importance on variable pay is highest in the AEX. The percentage of variable pay for CFO and other Board Members in the AEX is even higher than for the CEO position in the AMX.

The CEO Mix of fixed salary, STI and LTI is roughly 30:30:40 in the AEX, roughly 40:25:35 in the AMX and roughly 50:25:25 in the AScX.

All remuneration types have their own specific goals. Short term incentives generally relate to incentives with a performance period of maximum 1 year. This type of incentive is generally focusing on maximizing profit, whereby a number of performance measures is used to determine the STI to be granted to the executive. However, such a focus on short term measures can have adverse consequences on the long term, for sustainable profitability. Therefore, most companies try to mitigate these risks by combining short term incentives with long term incentives. Also, companies tend to place more emphasis on non-financial measures over the last years. In this report we will focus on Long Term Incentives.

Total remuneration pay mix

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Equity incentives in the Netherlands
3.2 Long term incentives
Long term incentives are offered to executives to increase focus on the longer term and align the interest of executives with those of the companies’ shareholders. With ‘long term’ incentives, we refer to share based plans (either settled in shares or in cash) with a vesting period of more than one year. From EY’s analysis we learn that almost all long term incentives are granted conditionally at the beginning of a 3 year performance period, and become unconditional after 3 years based on the performance over these 3 years. In most cases an additional lock-up or holding period of 2 years applies before executives can actually sell or cash their LTI rights. So, the most common cycle for LTI pans from grant to cash is 5 years, which is in accordance with the Dutch Corporate Governance Code.

The use of shareholding requirements has increased

There is a wide variety of possible long term incentive types. The types can roughly be divided in 3 types, being:

1. **Stock Options** - whereby the executive can purchase shares after a certain period
2. **Share based incentives** - for example Restricted Shares (Units), share matching rights, deferred shares, Employee Stock Purchase Plan, etc., whereby the executive receives or purchases shares in the company
3. **Cash incentives** - including Phantom Stock / Stock Appreciation Rights, whereby the cash-settled benefit for the executive depends on the value of the company’s shares.

![Chart showing the use of shareholding requirements from 2014 to 2016]

3.3 Type of LTI performance measures
The type of performances measured in order to determine the LTI benefits can vary over companies. The below chart shows for the Dutch indices the percentage of companies that are using one of the listed performance measures in their LTI plan in 2016:
3.4 Number of LTI performance measures

The table below shows the average number of performance measures used in LTI plans and the average percentage of which depends on financial measures.

The table shows that the average number of performance measures has slightly increased over the years for all 3 indices. Even though, generally companies take 2 – 3 measures to determine the individual’s performance. Interesting to note is the substantial increase in financial measures in the AMX. Further, the table shows that companies in the AEX use more performance measures than companies in the AMX and the AScX.

3.5 Shareholding requirements

Most companies offer LTI grants every year in order to provide long term incentives continuously. This prevents that focus on the longer term is reduced if performance targets of previous grants might have become or might seem unattainable.

An alternative to strengthen the executives’ focus on the longer term is the use of shareholding requirements. Executives are then required to hold at least a certain amount of shares, often expressed in value as a percentage of fixed salary, in the company. From the analysis made by EY we learn that shareholding requirements are most predominant at AEX-companies, where approximately 67% of the companies have a shareholding requirement in place. In the AMX index this is approximately 30% and in the AScX only approximately 10%.
4. Business case

The company BTCBV is doing well. It is a three-generations-old business. The family is still majority shareholder, however also independent investors own shares of BTCBV. In the economic environment, some branches early respond to economic recovery, while for other branches these effects are delayed. BTCBV belongs to the latest category. It means that the economic crisis affected the company later, and the economic recovery will only now become effective for BTCBV.

**Equity plan used for retention of key employees**

The previous years have been exiting ones, and there was no room to truly improve the remuneration policy, though there was a challenge to keep the high performing employees. Those employees are being recruited by other companies that are already in a better economic environment, which makes it difficult to compete. Therefore, BTCBV felt compelled to anticipate on future growth, by allocating (part of) the expected growth to employees in advance. Main reason is retention, and to keep away high performers from competitors.

BTCBV considered a few alternatives. Cash payments have its advantages. BTCBV could offer a retention premium to its employees, whereby the employee receives a cash amount if on a predetermined date he is still an employee of the company. Disadvantage of such payment is full taxation at employee level. Advantages are flexibility for BTCBV; the company can add all kinds of conditions to the settlement of the payment. Also, the payment is tax deductible for corporate tax purposes. Hence, BTCBV considered the cash payment not as satisfying. An employee who can receive a higher salary elsewhere can easily outweigh this higher salary against the future cash payment. One can make this more challenging: let the payment be conditional based on value increase of the company.

However BTCBV considers that the wish to stay will be experienced even better if the employee can directly benefit from the company’s value increase. This also means that the employee can further benefit from value increase after the predetermined date.

The clients’ considerations can be caught in an employee share plan, with a lock-up period. During the lock-up period the employee cannot trade the shares. Combining this with the obligation to pay back the gain if the employee leaves early, various employer’s goals are met.

- **Retention**, since the employee only receives the benefit if he stays with BTCBV during the lock-up period;
- **Tax friendly**, since under Dutch tax law, under conditions a tax deduction is available for shares with a lock-up period;
- **Alignment of interests**, as the employee will also benefit if the company’s value increase;
- **Simplicity**, as this remuneration type is an easy to understand instrument for retention and rewarding.
The shares with lock-up has its pros and cons.

- **BTCBV** has decided to issue new shares. As a result, the participation of all shareholders changes proportionally by adding the employee-shareholders. The family has no objections, however the independent investors do not want the employees to become influential via shares with voting rights. Therefore, a trust is set up holding the actual shares, and depositary receipts are issued to the employees, so the employees does not have voting rights during the general meeting of shareholders. However, the holders of depositary receipts should be well informed, not only as this is an obligation, but also to reach the goals of retention and alignment, which can only be met if the employee understands the participation and the concrete benefits.

- Company valuation: an annual valuation of the company is complex. Employer, employee, shareholders, new shareholders and the tax authorities do have an interest in a clear valuation method. A simple formula (like: 7 times the average EBITDA for the previous 3 years) can be a solution, however it is difficult to get an unconditional approval upfront from the Dutch tax authorities on such a formula. In this case, the tax authorities noticed the valuation method and indicated ‘to have no single reason to doubt the correctness’ of the method. So no full certainty, but second best.

Downside of such a simple valuation method is that it should by applied for both purchase and sale. If in the meanwhile the company is acquired by a third party, the formula is in principle still leading. The employee can then be dissatisfied when he sells against the price following from the formula, while in the meanwhile it is known that the company’s fair market is above this price. This has been discussed with the tax inspector, who understood the problem and kindly asked what would happen in an opposite situation: what if the company’s fair market value is below the price following from the formula? This discussion finally lead to a fair and complete valuation
agreement. Thereafter it was quite a challenge to prepare clear and necessary communications to the employees in this respect.

Company valuation of non-listed entities always requires special attention

- Next problem is how to finance the plan. Under this employee should purchase the shares including consideration of the discount. If the employee pays less, taxable wage is recognized. In order to facilitate the employees, the grant of the depositary receipts is scheduled in the same month as the bonus payment. Further BTCBV granted an additional discount, whereby BTCBV used the tax free amount of the work related cost scheme, in order to avoid taxable wage to be recognized at employee level.

- Most important point of attention is the settlement. After the end of the lock-up period, at a certain moment the employee wants to take the gain. However, the company is not listed at the exchange market, so the shares are not freely tradable. Finally the existing shareholders concluded an agreement about who will repurchase the depositary receipts and the ratio for this purchase.

Of course the design of the plan required discussion about many other details, however BTCBV managed to do so.

Currently, a few years after introduction of the plan, staff turnover has reduced drastically. Employees realize that in their branch the economic effects are delayed. This originally weakness on the job market has now proven to be a strength of this remuneration instrument: the company’s value increase has yet to come, and employees are happy to have started their participation already.
5. Startups: Grant share based incentives to key employees

Via our EYnovation™ program we are extensively involved with startup- and scale up companies in the Netherlands. Share based incentives is one of the essential topics a startup company should take into consideration at an early stage.

This consideration relates to the possibility to grant share participation plans to key employees. We divide share participation plans into two types:

1. Individual employee share participation below 5% of any type of the shares of a startup company;
2. Individual employee share participation above 5% of any type of the shares of a startup company.

The division described above is mainly based on Dutch tax rules. In this article we will focus on the first type of employee share participation plans, so below 5% of any type of the shares. We will generally answer the frequently asked questions: Why, How, and What. In addition, we will describe the market practice based on our experience with startup companies which are part of the EYnovation™ program and the start-up/scale up companies who completed our People Advisory Services survey.

WHY should startups grant share based incentives to key employees

Why should an owner of a startup company already consider to give a part of the company to key employee at an early stage? The founder is the one with the, hopefully, brilliant idea so why should he/she give a part of the company to key employees. The answer is quite simple: key employees are necessary to execute the brilliant idea to an actual product, service, application, platform or anything else.

In addition startup companies often have challenges with respect to their financial situation. There are no sufficient funds to pay a competitive salary for highly qualified people. One of the methods which can be used is the remuneration mix. With the remuneration mix we mean the split between base salary, short term incentives (cash bonus) and long term incentives (share based incentives). The remuneration mix is totally different at a startup company compared to a mature company. At a “mature” company the base salary is likely higher and employees are commonly offered a short term incentive. Long term incentives are normally only offered to the company’s executives. At startup companies, with a lack of cash, it is difficult to compete from a base salary perspective, however startups could offer long term incentives. This basically has two benefits: the share based incentives could function as a retention method of the key employees and the company does not have to pay any cash at the early stage.

Finally, the potential future investors, VCs, angels, etc. would also expect that part of the shares, (normally between 5%-10%) are somehow granted to key employees for retention purposes, in order to successfully grow into a scale-up company and further on.
HOW should start-ups grant share based incentives

The way how a company should grant share based incentives is strongly based on personal preference of the founder(s). Key questions a founder should answer is:

- Do I want to grant actual shares or do I want to provide cash (based on the value of the shares)?
- Do I want to give the full rights of the shares including voting rights or should the voting rights stay with the founder(s)?
- How much do I want to grant and how often?
- When are employees able to sell the shares?
- When should the employee pay tax (if any)?

All these questions, amongst many others, are relevant to design the share based incentive plan that suits best to the company.

As the decisions are mainly based on individual preferences, there is no “best” share based incentive plan which suits all companies.

Think upfront why, how and what you want to grant to your employees

WHAT type of share based incentives should start-ups give to their key employees

After the determination what elements should be part of the share based incentive plan, the type of share awards can be determined.

Based on our experience and based on our survey amongst startup and scale up companies we see that the most commonly used types by startup companies are:

- share purchase plans,
- stock options, and
- stock appreciation rights (SARs).

With a share purchase plan we mean all plans which offer employees the possibility to buy shares in the company (with or without a discount). This will strengthen the company’s cash position as well as increase employee commitment as a result of his personal investment. Stock options offer the right to buy shares in the future for a fixed price which is determined at the moment of grant. SARs are comparable to a stock option but the “spread”, the value between the value at exercise and the “purchase” price, will be paid out in cash.

There is no share plan identical due to the specific preferences of the founder(s), although main plan rules could be similar. The way of settlement, shares or cash, could also differ based on the actual plan rules. A third settlement method, the settlement via depository receipts (in Dutch “certificaten”) is also commonly used by startup companies in the Netherlands.

The different types of incentives are used for different reasons but based on our survey, attraction of (key) employees, retention and motivation are main reasons to offer share based incentives.

Finally, we would like to note that it is critical for startup companies to think upfront why, how and what they want to grant to their employees. Carefully write down the plan rules as it will be very difficult to change the share plan rules along the ride!
6. Tax considerations

Different type of share plans may lead to different tax consequences. The taxable moment and the taxable benefit are of importance to determine the final net benefit for the employee. So besides various performance-related criteria, also the tax consequences can play a role in choosing the most suitable plan type. However, what is the most efficient plan type?

Unfortunately there is no straight forward answer to this question, as it depends on the plan characteristics and its tax consequences, and above all, the development of the share price.

We would like to demonstrate this in the below comparison between restricted stock, restricted stock units, market shares and stock options.

In the below example we have compared the value of the named incentive types based on the below assumptions:

- Market price at grant date: 10
- Granted incentives:
  - 50 Restricted Stock; or
  - 50 Restricted Stock Units; or
  - 50 Market shares
  - 200 Stock options

There is a difference in the number of granted Restricted Stock (Units), market shares and the granted number of Stock Options, which we often see in the market. This difference can be explained as when an employee receives Restricted Stock (Units) or purchases market shares (MS), the employee actually receives (a right to receive) a share with a certain value, while in case of a Stock Option this will only receive the right to buy a share. This will only have value for the employee if the share value increases. To compensate this difference, more stock options are usually awarded.

- **Restricted Stock** are free shares granted and directly made available to the employee, however with a restriction to sell the shares for a certain period.

- **Restricted Stock Units** is the entitlement to receive free shares once conditions are fulfilled.

- **Market shares** are common shares purchased by the employee from net salary against market value.

- **Stock Options** is the right to acquire shares against a specified price (typically equal to the market price of the shares at the date of grant) at the end of a specified period of time.
6.1 Value of the incentive
The below graphic shows the development of the value of a package of RS(U)’s, market shares and Stock Options.

For RS(U)’s and market shares we see that the value of the package has a linear relation with the value of the underlying shares. The value of the package equals the number of RS(U)’s granted multiplied with the share value. Same applies to market shares the employee has bought.

This is different for stock options. A stock option only has value if and insofar the value of the underlying share exceeds the exercise price (normally speaking the value of the share at grant date). So in the above example, stock options only have value for the employee if the share price is above €10. If so, the value of the package consists of the value of the underlying share minus the exercise price. The result is multiplied with the number of stock options granted.

Value of the package

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RS/RSU/MS Options
6.2 Net benefit
Below we see a graphic indicating the net benefit of RS, RSU’s, market shares and Stock Options, assuming a Dutch marginal tax rate of 51.95%. We now see that the different tax treatment of the 4 equity types lead to different net benefits for the participant.

Restricted stock is typically taxed upon grant of the package. This is beneficial if the share value is increasing after the date of grant, as the value increase is not considered as taxable employment income. However, in case of a decrease in share value, this will have a negative impact on the net result, as this disadvantage cannot be deducted from the taxable benefit.

Restricted Stock Units are taxable at the moment of vesting (i.e. the right to receive the shares is unconditional). When receiving RSU’s you will pay taxes on the actual package received. So until the moment of vest, RSU’s will not give the opportunity to have an untaxed value increase.
After vesting date, the shares can still be held by the employee and as from that moment value developments are not considered as taxable employment income.

Market shares are not taxable, assuming that no discount is granted to the employees. The employee purchases the shares from his net income, so the development of the value is not taxed as employment income. Therefore we see a straight line.

Stock options are taxed once the options are exercised, i.e. when the participant uses its rights to purchase shares against the price agreed upon on grant (assumed to equal the share value at grant). Stock option holders will only exercise the options if the share value exceeds the value at grant. In case of a share value increase, also given the number of options granted, the net benefit will increase fast.

The most effective equity type from a net employee’s perspective strongly depends on the expected share value development.

From the graphic, it may look like that from a tax perspective, stock options are most attractive for the participant. However this largely depends on the expected value development of the company’s shares. In the example, stock options are more beneficial than all other plan types if the value exceeds roughly 15. For a start-up it may be doable to have a share value increase higher than 50%, however for a listed company or family businesses, such an increase might be very challenging.

So, the most effective equity type from a net employee’s perspective, depends on the expected share value development for approximately 5 years from the grant date. However, besides the net benefit for the participant, there are many other considerations to decide on the equity type to be granted to employees.
7. Team overview

At EY we are convinced that a multidisciplinary team is the best way to serve our clients. In relation to equity plan design, review and execution, we work together with a mix of specialists in the field of Reward and Taxation. Depending on the client’s needs, we can easily extend the team with legal experts. Our clients benefit from fully integrated advice.

This report is drafted by the following equity expert team:

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