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Rewards in family offices

Catherine Grum

Edward Groves

The challenge

Although family offices are established for a variety of reasons, many are expected to manage the wealth of the family in some way, shape or form. This can often be achieved with a relatively small employee base and services outsourced to various providers. However, where wealth creation still forms one of the central aims of the family office and/or the wealth is of such a sufficient scale, you can find some quite sophisticated operations. Where these include actively managing financial portfolios or direct investments in particular, they require the family office to hire specialist expertise in order to execute the family's objectives successfully.

We see family offices increasingly finding themselves needing to compete in order to hire and retain the talent required to run their operations. In doing so they face a number of challenges. The first is often to find potential employees who not only have the required expertise but also understand the unique environment they will be operating in, which is likely to be quite different from a large corporate or financial services firm. For the right candidate this may be one of the incentives for making the move but it can also present challenges, particularly as the infrastructure and support are likely to be significantly leaner with even very senior employees expected to 'roll their sleeves up' from time to time.

In order to attract the best talent, family offices need to consider how they can offer an attractive incentive package to recruit and then crucially retain key employees. Expectations will vary and salary, bonus and potentially also pension arrangements (depending on location) are likely to be core components. However, senior executives coming from a banking, private equity or corporate background will have come from an environment where long-term incentive plans (LTIPs) were likely to have been in operation, often forming a substantial proportion of their overall package. These reward systems are intended to retain employees over a longer period by offering some form of compensation that provides an additional and more lucrative potential return, provided certain conditions are met, thereby aligning the employee with the organisation's success. Common examples might include share plans or carried interest entitlements.

There are some particular challenges for family offices when considering the inclusion of an LTIP arrangement as part of their overall approach to reward. For example, replicating a share arrangement may not be appropriate given that most family offices manage a wide portfolio of assets from investment portfolios and direct investments to real estate as well as the family's personal assets such as their homes, yachts, planes, artwork and classic cars. It would be usual to expect these assets to be owned exclusively by family members and there may be specific terms to this effect written into the structure. This issue can cause particular tension where family members play an active role in the family office alongside non-family members as they will have different entitlements and expectations. It is therefore highly unlikely that any LTIP will focus on the overall portfolio.

Even when the focus is narrowed to the financial investments, the family office's objectives may vary quite considerably from commercial enterprises making it harder to select an appropriate measure. For example, a very conservative wealth preservation approach may be taken in relation to the financial portfolio or social impact investments included so that a focus solely on growth in value may incentivise the wrong behaviour.

This article sets out some of the key considerations that family offices must consider when setting their reward policy, and provides a more detailed overview of the use and structure of some common LTIPs.

Overall approach to reward

When any business is setting or reviewing its employee reward strategy, it is important that the business views reward at a holistic level, rather than considering each of the separate elements in isolation.

Any review should consider both the financial and non-financial elements of reward, as employees are increasingly sophisticated in considering not just the immediate financial returns, but also in evaluating the non-financial benefits, including the value of their time and the experience they will take from the role. While broader detailed consideration of this area is outside the scope of this article, a family office should seek to leverage the other benefits that it can provide over and above financial aspects when considering the reward package.

A family office will therefore need to consider each of the different elements that can make up a balanced reward policy and consider the potential application of these to their business and the role that they are seeking to fill.

It is also important to consider that the balance and elements of the reward policy offered to employees may vary dependent on their role – LTIP awards are likely to be more relevant to and valued by employees holding or considering senior positions which can directly influence performance and their corresponding returns. Conversely, those employees at a more junior level may place more importance on non-financial elements such as flexible working which may better align with their immediate needs or goals.

When setting its policies, there is a lack of market data available to family offices about what other similar family offices do, not least because each is different. While it can be helpful to look at the approach being taken by comparable businesses, particularly where they are competing for employees, it is more important to consider the specific goals and corporate values of the family office. Setting a reward policy which accurately reflects and reinforces these should optimise their ability to recruit and retain the best talent for their operation.

This is particularly important when seeking to recruit at a senior level where an LTIP award may be expected as part of an incentive package. However, the use and structure of an LTIP should be given detailed consideration before any awards are made, as the existence of an LTIP can directly influence behaviours and expectations. An LTIP which is poorly communicated or out of line with the overall aims of the family office, for example where it is tied to the realisation of assets that the family intends to hold indefinitely, can lead to tensions between the employee and the family.

Short-term pay

Overview

Short-term or annual pay generally comprises of salary, annual bonuses and any allowances that may be offered by the employer (such as location or pension allowances).

When considering salary and bonus, our advice to employers is usually that they should be aware of how their offerings are placed against the market that they are competing with – both on a stand-alone basis and when considered together with any longer-term or non-financial elements of an incentive package.

As before, the availability of data is much more limited in the family office context, particularly outside the United States, although a few recruitment agencies in places such as the United Kingdom and Switzerland are starting to try and collate this. Many firms in adjacent industries produce market data however, which can provide an overview of compensation levels broken down by a number of different metrics (an example of a recent KPMG survey can be found at https://home.kpmg.com/uk/en/home/insights/2016/11/kpmgs-guide-to-directors-remuneration-2016.html). These firms also provide bespoke 'benchmarking' services to assist employers in understanding pay levels in their particular market (these services cover not just short-term pay, but also the wider benefit package as a whole).

Bonuses

When considering annual bonus structures, payouts are often linked to the achievement of operational and tactical targets over the performance period (generally the previous financial year) and will include an element of discretion and/or judgment from the employer to determine the extent to which such targets have been achieved. It is increasingly prevalent for employers to consider a balanced scorecard of factors including, for example, risk management, customer satisfaction and an underlying financial performance underpin when setting performance targets for annual bonuses and this fits well with the approach of many family offices. Not all have clearly defined objectives or key performance indices (KPIs), however, and it is much harder in these circumstances to align employee bonuses to anything meaningful.

In line with a shift in approach in the corporate world, family offices should also consider whether bonuses should be delivered over a deferred period and/or be subject to malus (the forfeiture of a bonus or LTIP entitlement before it has vested) and clawback provisions (the repayment of remuneration after it has been paid). These are now market standard in financial services and increasingly are being seen in other sectors to allow employers to reduce bonus levels down post-award where appropriate; for example where there has been a material mis-statement or adjustment of a company's accounts.

Allowances

Family offices should also consider where their talent

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pool is being drawn from in an increasingly global and mobile economy, and how that may impact upon their role.

The location of the family office and any required travel may influence whether relocation or living allowances should be considered in order to attract and retain key talent.

These allowances can vary from the direct and quantifiable payment of moving expenses or contribution towards housing, to more complex areas such as cost of schooling or assistance with tax obligations (either in relation to professional adviser costs, or potentially 'tax equalisation' policies). Appropriate advice should be obtained to make sure that the most is made of tax relief on such allowances where provided.

Interaction with LTIP

When setting short-term pay it is advisable to consider the interaction with any LTIP being offered, and when doing this it is particularly important to assess and articulate to potential employees (at a high level) how the LTIP is structured as they can operate in a number of different ways and deliver very different returns to employees.

This consideration, in light of some of the particular challenges facing family offices in this area, highlighted in the introduction, may mean that it is necessary to offer base salary or bonuses at more competitive levels to the market to compensate for the potential returns under the LTIP. The level of communication required to ensure that employees understand and appreciate the value of any differential may depend on the sector from which the employee is being hired.

These issues are considered further below in the 'Consideration of LTIPs' section.

Consideration of pensions

While pensions can be seen simply as another element of short-term pay, the use and structure of any pension offering should be carefully considered given the complexity of, and different approaches that can be taken to, pension arrangements, and the material impact that these can have on an employer.

Historically, a pension could be offered either as a 'defined benefit' or 'defined contribution' plan. For UK businesses, there has been a strong shift to defined contribution arrangements (where the pension is calculated based on the amounts contributed to the scheme by the employee and employer, and the subsequent performance of the investment of those contributions). This is due to the potentially open-ended cost and burdensome administration requirements of defined benefit arrangements (where an employee is broadly entitled to receive a pension based on his or her pre-retirement salary).

Family offices should also consider whether they wish to promote and encourage employee saving behaviours, perhaps in line with the family's own long-term approach. This may influence the types of pension arrangements offered to employees, and the level of employer contribution which is made to employee pensions (which may vary depending on employee contribution levels).

An additional element to be considered is the tax, legal and regulatory complexity of pension arrangements that often do not necessarily align consistently between jurisdictions and may change regularly. Family offices may therefore benefit from considering the relevant regimes in their key locations to understand their legal obligations and determine whether pension savings do offer the possibility for tax efficiencies for employees or the employer. In the United Kingdom, for example, employers are required to 'auto-enrol' all employees into a pension scheme at the same time as the potential tax benefits of pensions savings for high earners are being scaled back. Urgent review is therefore required for family offices with UK employees if this has not been previously addressed. For individuals who move between tax jurisdictions, considerations around the international aspects of pensions should be borne in mind.

Consideration of LTIPs

Overview of LTIPs

As noted above, LTIPs are often a key element of the incentive package offered to senior employees in a number of different sectors. However, it is important to note that, at its most basic level, 'LTIP' simply means a long-term incentive plan and both the structuring and potential returns offered under an LTIP can vary significantly even from business to business in the same sector.

LTIPs are something that, at their best, can act as a strong incentive to senior employees to produce high performance over the long term, but, at their worst, can damage the relationship between them and stakeholders due to a lack of understanding or alignment. This can be a particular issue in the family office world where optimistic promises are made at the outset that ultimately prove too challenging to implement in practice.

It is therefore crucial that where a family office is considering the introduction of an LTIP, it takes time to consider how it should be structured and communicated in order to seek to ensure that it is an effective motivational tool.

An effective LTIP is a plan which incentivises the participants to drive the behaviours and performance of a business in a manner which is consistent with the aims and interests of its stakeholders. In the context of a family office, this means that the terms of the LTIP need to be carefully aligned with the interests of the family.

For a family office to implement an LTIP which acts as an effective hiring and retention tool, it is important for the family office to consider the pool of talent which they are hiring from, and how that talent may be incentivised in their current roles.

As noted above, the structure of LTIPs can vary from business to business. However, set out below is a high-level summary of how LTIPs are structured in different fields from which family offices may be seeking to attract talent or draw from in terms of approach.

Private equity and fund management

Investment executives are often incentivised via the allocation of 'carried interest' or 'promote' types of award which are linked to the increase in value of the assets under management over time. These awards are generally structured to provide the investment team with a percentage share in any return to investors over and above a specified level, often based on a specified rate of return for the investor or multiples of money invested. In these circumstances, the time frame over which the LTIP operates is therefore tied to the life of the fund being utilised by the investment professionals.

To the extent the value of the underlying assets are realised and the return is in excess of this specified level, the investment managers share in a portion of those returns at the time of realisation. In the case of a private equity investor, this may be at the time one or more of the portfolio companies is disposed of, although more typically this is aligned to the return of the overall fund. In the case of a real estate investor, this may be at the time the real estate is commercialised or refinanced (although, again, returns are generally aligned to the overall fund).

To the extent the assets do not perform in a manner which allows investors to realise their specified level of return, the award will not deliver any value to the investment manager.

It should be noted that, in addition to 'carry' or 'promote' which is generally awarded to investment managers within the funds for low or nil upfront cost, they are often also offered the opportunity to 'co-invest' and contribute their own funds to participate in the investment on the same basis as other investors (albeit without the same minimum level of investment that may be required for outside investors).

The establishment of in-house venture capital or private equity fund-style structures is a growing trend we are seeing with larger family offices. However, when it comes to retaining employees, simply replicating incentive arrangements from the fund industry is being met with mixed success. One key issue to consider in advance with this type of incentive is the likely timeframe that the family office intends to invest for. Often family offices have a particularly long-term horizon. This is proving successful in terms of winning bids, particularly with mid-market companies which are attracted to the more flexible approach and the fact their investors are not focused on 'exiting' within a particular timeframe. However, it also means that the rewards available to the senior employees under the LTIP may be much more unpredictable and, far from aligning interests, this can create situations in which the employees' interests begin to conflict with those of the family.

Private companies (including private equity backed and family-owned companies)

Private companies generally offer LTIPs with the value of an employee's award linked to the increase of the company (or a specific business unit) value over time, or the achievement of certain long-term strategic or financial objectives.

These arrangements are generally not subject to significant performance conditions over and above the requirement to increase the value of the business by more than a certain level or achieve the specified strategic or financial objectives, and consideration of whether the employee remains employed at the time of realisation of the LTIP. The time of realisation of a return for employees is likely to depend on the ownership structure of the company and the motives of the underlying shareholders.

For private companies which have private equity investors, the position is relatively straightforward and LTIPs are often designed as 'exit only' arrangements, which are intended to deliver value to employees at the same time as value is realised for its shareholders – generally on a sale of a controlling interest in the company or a listing of the company to a public market – and the value attributable to the LTIP is based on the return the private equity investor hopes to achieve on realisation. While employees therefore do not have certainty as to when the LTIP may deliver value, they will generally have an awareness that private equity models assume that interests will be held for a certain length of time before being realised (typically between three and seven years from the point of acquisition).

Similar to private equity and fund management structures, in addition to an LTIP incentive, employees can also be offered the opportunity to invest in the company, or may be required to 're-invest' any LTIP gains into the new ownership structure of the company following an 'exit' event.

For private companies that are either family or founder owned, the structure of the LTIP is likely to very much depend on the intentions of the owners, as in the case of most family offices. To the extent the

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aim of the owners is to dispose of the business, the LTIP may be structured in a similar manner as that of a private equity backed company.

However, for many family and founder-owned businesses, their aims can be very different to those of a private equity investor, as they may well have no intention of disposing of some or all of the business to a third party in the short to medium term. In those circumstances, the LTIP may be structured to deliver value to employees over a specified time period, to the extent the conditions of the LTIP have been achieved over that period. This type of structure can increase complexity as it requires the owners to consider how the realisation of the LTIP will be funded in the absence of a third party investor. This consideration should not generally prejudice the ability of a company to operate an LTIP (as there are various ways of addressing this) but it is important that this cost of funding is considered as part of the design of the LTIP, rather than being something that is not considered until the point of realisation.

Listed companies

Listed company LTIPs are generally operated over shares in the company and the award quantum is determined not solely by the increase in the company value over time, but instead based on a specified number of shares under award and the satisfaction of certain performance conditions which may not be directly tied to the underlying share price.

These LTIP structures generally operate to grant employees awards on a regular basis (often annually) and the performance of the award will be measured over a fixed period (typically three to five years), following which point the satisfaction of the performance conditions shall be measured and the award shall deliver value (in the form of cash or company shares which can be sold on the markets) to the extent the conditions have been satisfied. Increasingly, investors are expecting there to be a further two-year deferral period at the end of the performance period.

Performance conditions are often based on a combination of financial metrics such as ‘earnings per share’ or ‘total shareholder return’ (either absolute or relative) and non-financial metrics such as risk management or the achievement of strategic goals, the satisfaction of which is determined by a remuneration committee made up of non-executive directors (although investors can treat non-financial conditions which are difficult to calibrate with scepticism).

Listed company LTIPs, specifically at executive level, are also subject to detailed disclosure obligations and external shareholder review and expectation. Various investor bodies publish guidelines as to what shareholders expect to see in listed company LTIPs and executive pay is often in the financial – or at times mainstream – news. The structure of any listed company LTIP is therefore strongly influenced by market practice and requirements of investors and it is not common for listed companies to deviate from these types of arrangements – particularly at the executive level. This trend of increased scrutiny seems likely to continue or even increase, with discussion around matters such as employee board representation, annual binding pay votes and details of CEO pay multiples all being debated.

Application to family offices

When considering the use of an LTIP, family offices must therefore consider:

- the arenas from which they will be recruiting talent;
- the aims and motivations of the family office; and
- the types of assets in which the family office will be investing.

While a family office may not operate in the same manner as a fund manager or private equity house in being required to deliver value for third-party investors over a very specific period of time, the aims of a family office are likely to be closely aligned to those of other investment managers and/or private companies in that they shall be seeking to increase the value of their assets over time – value creation could therefore be a suitable objective for senior employees to align their interests to those of the family.

While potentially drawing talent from listed businesses, it is more likely that family offices should consider implementing LTIP arrangements which are more closely aligned with these industries rather than with listed company LTIP structures.

Family offices should also consider what the long-term aims are in respect of the assets it holds, and whether it is likely that assets will be realised in the short to medium term (ie, three to seven years). To the extent this is not likely, family offices should consider utilising similar arrangements to those used by private companies to deliver value to senior employees in the absence of a 'liquidity' or 'exit' event. In particular, this will require family offices to consider sources of cash funding (such as realisation of assets, or third party borrowings) in order to satisfy awards.

Family offices should also consider whether it is appropriate to implement an LTIP not at the family office level, but at a subsidiary level, so the employees associated with specific types of asset are appropriately incentivised, and to appropriately ring-fence any 'family assets' from the LTIP. For example, a different structure may be operated for a captive fund of direct investments versus a real estate team.

Key considerations for family offices

Where a family office is considering implementing an LTIP, the following points should be considered as part of its design:

- The aim – how does the LTIP align the interests of participants with those of the family, and will the terms of the plan motivate them? It will be crucial for the scheme parameters to be set at levels which are both sufficiently challenging and incentivising for employees (ie, if targets are perceived as unachievable, they may demotivate employees).
- How value is measured and determined – how are award values calculated and how are any non-financial performance targets measured? In the absence of third party transactions, an assessment of value may require an independent valuation from a professional valuer. If there is sufficient scale, would a remuneration committee add rigour and independence to this process?
- Quantum of award – to the extent the business performs as intended, what level of value will the LTIP deliver to employees and how will this vary with over- or under-performance? Does this quantum seem appropriate in the context of the wider values of the family office?
- How and when value is delivered – should participants realise value at the same time as the family, or should their returns be based on specific time periods or the achievement of milestone events?
- Incentive or reward – is the LTIP designed to incentivise employees to grow the value of the family's assets going forward, or reward them for their performance to date? The answer to this question may impact upon the value profile of the LTIP and any performance conditions that apply to it.
- How widely to be used among staff – should participants in the LTIP be offered to all staff, or only those at a senior level who may feel that they can directly influence the value of the awards through driving the growth in value of the family office assets?
- Cash-based or equity-based incentive – cash-based incentives may be more straightforward to administer, particularly in light of some of the challenges highlighted but are unlikely to offer material tax efficiencies. Equity-based incentives may be more complex and require detailed consideration of the tax and legal implications, but are likely to offer more scope for awards to grow in a tax-efficient manner.
- How to administer the scheme – what will the cost be, how often are grants made and what happens if participants cease employment?
- The importance of tax – how much consideration should be given to the tax efficiency of the arrangements? The ability to implement a tax-efficient LTIP will be subject to legal and commercial constraints and may increase complexity. Do the benefits outweigh the added complexity, administration and costs?
- The market – how does the proposed LTIP (and wider incentive package) align with the incentives being offered by competitors in terms of potential quantum?

Conclusion

LTIPs can be a very effective method of recruiting, retaining and incentivising the key talent needed to support the more complex activities of larger family offices. However, a poorly designed or badly communicated LTIP can also lead to friction between stakeholders (the family) and participants (senior employees).

LTIPs can be implemented in a wide variety of ways, and it is important that attention is given to the specific aims and values of the family office as part of its design.

Particular consideration should be given to the complexity and administrative workability of any potential incentive, as overly complex arrangements can lead to misunderstandings among participants, which can create tensions and destroy value in the eyes of an employee.

Once stakeholders have designed the LTIP parameters, effective communication with potential participants and timely implementation of the LTIP are key to its successful use in a family office setting.

Finally, space has not permitted consideration of the alternatives to hiring an extensive team within the family office, such as outsourcing. However, if the considerations discussed are already enough to provoke a headache, these alternatives should be fully reviewed in advance of making any expensive hiring decisions.

KPMG

KPMG's People Consulting team has a wide range of experience advising businesses on the incentivisation of their employees and developing an appropriate reward strategy, from assistance with the introduction and communication of non-financial benefit options to the design and implementation of LTIPs and pension arrangements.

KPMG takes a multi-disciplinary approach and can assist on the advisory, tax, legal and accounting elements of the design and implementation of an LTIP supporting shareholders and management teams of all sizes (from start-ups to FTSE-listed businesses) across geographies to introduce and operate LTIPs.

KPMG's Family Office Services is another example of this multi-disciplinary approach, bringing together the best team to assist family offices from across KPMG's network of specialists and tailoring these to the specific needs of the family office industry.

Catherine Grum is KPMG's UK Head of Family Office Services. She helps enterprising families establish and run their family offices, acting as a sounding board and trusted adviser to family members and senior family office executives.

Edward Groves is a senior manager in KPMG's People Services practice. His focus is on the legal, tax and employee communications elements of reward and he has extensive experience of designing, implementing and advising upon key management and all-employee arrangements for companies ranging from start-ups to FTSE100s.

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