The Power Of Equity

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Equity is the currency that makes the world go around. Let me explain this statement in the context of companies using equity capital to grow, scale, and ultimately monetize the business. Companies report equity in the form of paid-in founder capital, investor capital, retained earnings, and converted debt capital, which lenders may own out of a conversion event.

The important point is not that the equity exists, but what management does with the equity. How is the equity employed? Smartly-employed equity capital leads to higher returns on that equity and happy shareholders. And managers have the responsibility to smartly deploy the equity capital of the company.

But managers also need incentives to be aligned with owners and other stakeholders to pursue longer term sustainable growth. Short of assuming some altruistic golden rule guides behavior, how may the owner of a company align the interests of other investors, managers, service providers, employees, and lenders?

This dichotomy between divergent interests is the subject of this article. Economists would refer to the classic moral hazard problem, using incentives to guide behavior once parties contract with one another. In fact, aligning the interests between the parties may be one of the most important factors guiding success or failure of a company.
One method to align incentives involves the three critical elements of any project, which are time, money and quality. Time and again, the old adage survives – that every leg of the three legged stool (time, money, quality) must be connected to the seat, or the stool falls to the floor. One key to incentive alignment that may address each of the three legs of the stool involves equity. The power of equity cannot be overstated, if balanced by other incentives to do the right thing and treat people fairly, which creates a culture with a longer term perspective.

Think of the housing market. The borrower-lender analogy aligns interests by helping to solve the classic moral hazard problem. Once the lender advances the money to the home purchaser/borrower, how does the lender assure the purchaser/borrower maintains the home and pays the mortgage? The answer is the home equity in the form of a down payment. The less equity, the larger incentive to simply treat the property as a rental. Of course, home owners/borrowers must demonstrate other characteristics such as gainful employment, timely debt payment history and prudent debt management among other credit quality factors.

Classic management theory also cites the use of equity, in the form of compensation to motivate employees and executives. The literature supports equity as a motivational tool, balanced by suitable vesting periods, a collaborative culture, and other monetary and non-monetary incentives, such as employees placed in the right job with the right skill set. The same equity compensation, balanced with cash, and a good cultural fit motivates management to align interests with other stakeholders.

As such, tools available to the owner to align interests in the corporate setting generally revolve around the equity in the business. Some of the uses associated with equity as an incentive alignment tool and a substitute for cash include:

- use of equity as a partial substitute for cash when working capital constrained
- reduce churn and the administrative costs of multiple consulting arrangements by paying a portion of advisory / consulting fees with equity
- motivate management with a mix of cash, equity, and non-cash incentives
- align interests with investors through capital raises in exchange for equity, or convertible debt, rather than straight debt, to enable a longer term view
Given the importance of equity to incentivize homeowners, and classic management theory regarding incentives for executives to align the interests of managers with the companies they manage (why else give managers restricted stock units and options that vest over time?), why do other transactions exclude equity? In some cases, regulatory restrictions may prevent the exchange of equity for services, for example under Securities and Exchange Commission and other guidelines for auditor independence. Or, a large publicly traded company may need board approval and formal disclosure to public shareholders to address the dilutive nature of share and option grants outside of a traditional employee stock ownership plan.

However, when possible to incentivize different parties with equity in a less regulated private company environment, the equity compensation (balanced in a broader package of cash and non-cash incentives), may be viewed as a payment for the longer term value created by the arrangement.

I admit, equity compensation is complicated, both from an administrative side (think the tax, accounting, and investor dilution issues), as well as a motivational side (what if an under-performing employee or advisor with equity is incentivized to stay with the company?). As with every compensation arrangement, executives must strike a balance to manage the perverse incentives. Even so, the power of equity to incentivize a longer term view with appropriate checks and balances cannot be understated. In other words, equity, when smartly deployed, is the currency that makes the world go around.

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