

# **Analysis on How to Improve the Equity Incentive System of High-tech Industry in China: Taking Tencent as an Example**

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**Abstract.** With the rapid development of economy and the intensification of competition, the competition of high-tech industry is particularly fierce in the information age. As the equity incentive is a necessary factor in the development of any company including high-tech industry, this study will take Tencent as a sample to analyze the feasibility and hidden problems of Equity incentive policies of high-tech companies, and propose suggestions based on the analysis of hidden problems.

## **1. Introduction**

In China, the listed high-tech companies share many characteristics in common, such as high intelligence, high investment and high risk. Because of its particularity, the industry has become the industry with the most Equity incentives. So far, 61.85% of the hi-tech companies have implemented Equity incentive plans. and are also growing rapidly. This paper takes Tencent, the industry leader, as an example to analyze that how to improve the Equity incentive system of high-tech companies in China. The paper measures the trend of the owner's investment return by comparing the annual net return on equity from 2004 to 2017. Asset-liability ratio, current ratio, stock price trends will be analyzed. At the end of this paper, some potential problems will be listed, and some suggestions will be proposed.

## **2. Overview of Equity incentive plan of Tencent**

### **2.1 Equity Incentive Plan Process**

Shenzhen Tencent Computer System Co., Ltd. was founded in November 1998 by Ma Huateng, Zhang Zhidong, Xu Chenye, Chen Yidan and Zeng Liqing. Tencent is one of the largest Internet integrated service providers and one of the Internet enterprises with the largest number of service users in China.

On November 11, 2017, in celebration of Tencent's 18th anniversary, Ma Huateng announced that 300 shares of Tencent stock would be awarded to employees as a special commemoration. The total value of the shares awarded is estimated to be about HK\$1.7 billion (about 1.5 billion RMB). Tencent has brought more than one surprise to employees' equity. Since 2007, there has been a long-term and sustained Equity incentive plan: Provide company stock options to key long-term employees with continuous excellent performance, so that employees can share the company's performance growth. In December 2007, Tencent announced an Equity incentive plan. According to the plan, the shares will be purchased by independent trustees and the fee will be paid by Tencent. The plan will take effect on the date of adoption (December 13) and will be valid for ten years. From 2008 to 2012, Tencent issued 18.875 million shares to qualified employees. In 2013, Tencent announced a new share incentive scheme, which raised upper bound from 2% to 3% of the issued equity and expanded the scope of the reward.

### **2.2 Equity Incentive Forms**

The first step of in the incentive to issue new shares is to raise funds first, subscribe for new shares issued by Tencent or buy shares from the secondary market, so as to establish a stock pool from which to distribute incentives for relevant persons. The total number of shares in the pool does not exceed 3%

of the issued equity. In Tencent's public disclosure, restricted stock units have been one of the main ways to motivate employees for many times. RSU (Restricted Stock Unit), is a promise that the incentive object will grant the stock in a certain period in the future. The incentive object who meets the service term or performance conditions stipulated in the Equity incentive plan can obtain a certain number of stocks. Or if employees fail to meet the target, then they can't obtain the rewarding stocks.

### 3. Profits brought by Equity incentive plan

Tencent launched the equity incentive plan before and after, whether there is a significant change in its operating conditions, and how effective the implementation of the Equity incentive plan is, we use the following criteria to judge.

#### 3.1 Tencent net assets&net assets growth rate trend

First, let's look at the change of net asset value, which is the most important financial indicator to measure shareholder value. Tencent net asset value has always been in the growth trend (Fig. 1), but the growth rate has been low before the introduction of the Equity incentive plan. After the release of the Equity incentive plan at the end of 2007, the growth rate of Tencent net asset has exploded, and in 2010, the growth rate was even close to 80% (Fig. 2). In 2011, it was a significant decline, but the figure after 2011 was still significantly higher than that of the years before the issuance of Equity incentive plan. In the short ten years, from 2007 to 2017, net assets increased from 5,275 million yuan to 27,703 million yuan, an increase of more than 50 times. Thus, the conclusion is that the introduction of equity incentive plan makes the value of Tencent shareholders grow rapidly. On the basis of the rapid development of enterprises, the rights and interests of shareholders are also guaranteed.

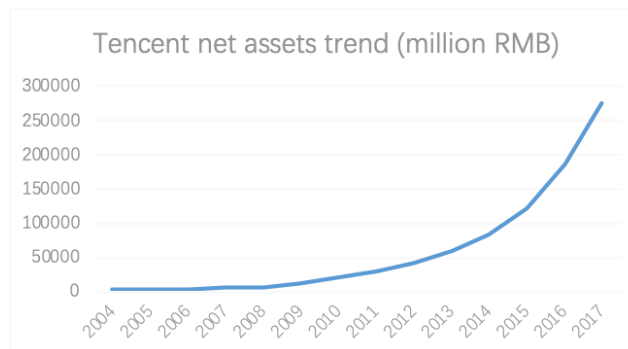


Fig. 1. Tencent net assets trend

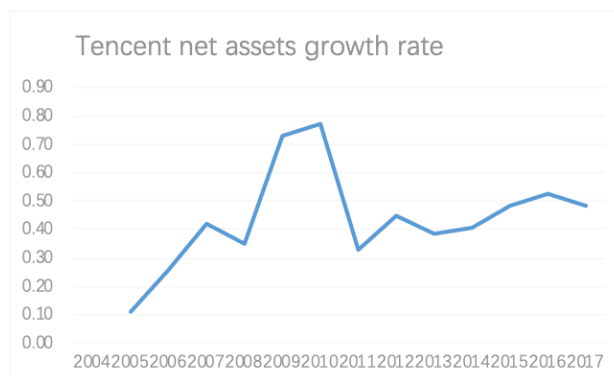


Fig. 2. Tencent net assets growth rate

#### 3.2 Tencent net profits&net profits growth rate trend

Then the following chart shows the impact of equity incentive plan on Tencent profitability. According to the change of Tencent net profit, Tencent net profit shows an increasing trend year by year (Fig. 3). After the Equity incentive plan was issued at the end of 2007, the net profit growth rate remained at a high level. Although Tencent has expanded its sales scale and developed its

e-commerce advertising business since 2010, the growth rate of net profit has declined due to the obvious increase in expenditure during the period. However in 2015, because of both Tencent business restructuring which abandoned its poorer business and the advent of "the King Glory", Tencent net profit growth rate was able to increase year by year and returned to a relatively high level in 2017 (see Fig. 4).

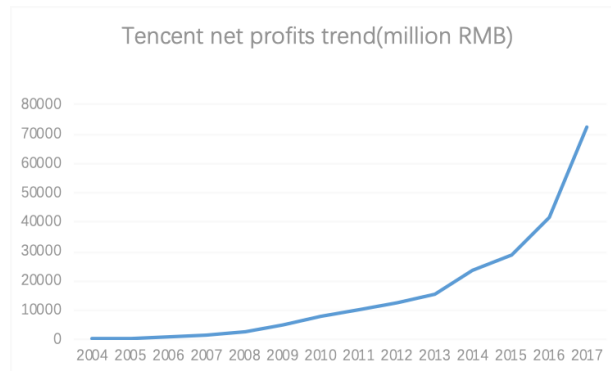


Fig. 3. Tencent net profits trend

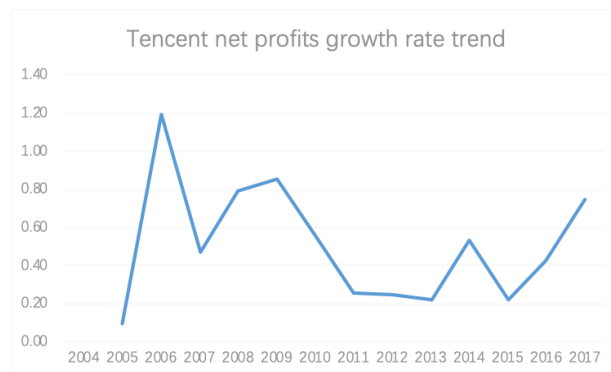


Fig. 4. Tencent net profits growth rate trend

### 3.3 Tencent return on net assets trend

In addition, from the perspective of return on net assets, after the issuance of Equity incentive plan, it has significantly increased, which reflects the role of Equity incentive on the profitability of the company. Under the influence of the economic crisis and Tencent strategic adjustment, the return on net assets in 2009-2016 is in a downward trend, but this unfavorable trend was alleviated in 2017, and the effect of Equity incentive plan has been reflected in Tencent (Fig. 5).

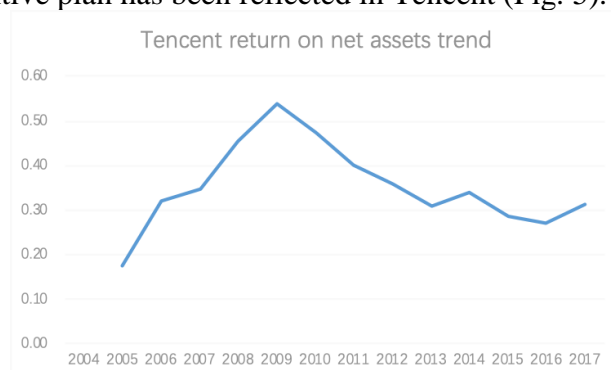


Fig. 5. Tencent return on net assets trend

### 3.4 Tencent asset-liability ratio&current ratio trend

The following figure displays Tencent's performance in terms of solvency. Tencent asset-liability ratio has been rising from less than 0.1 in 2004 to a peak of 0.6 in 2015 (Fig. 6). After the release of the Equity incentive plan, it has been in a period of rapid growth for about three years. It can be seen that the high cost of the Equity incentive plan will increase the company's cost in the short term, but as

long as the company's long-term development is stable, the impact will not be too long. Tencent's liquidity ratio has also been in a downward trend. And the liquidity ratio has not decreased in the past two years after the launch of the Equity incentive plan. The ratio has remained stable while rising slightly, indicating that the implementation of the initial Equity incentive plan has improved the company's short-term solvency (see Fig. 7). With the expansion of Tencent business system, the proportion of high-margin game business has been reduced, the huge investment in video field is still in the loss, while comic and other financial fields are in the embryonic stage, so the liquidity ratio has been declining, and it is difficult to pay off debts in the short term. However, this difficulty is only temporary. Tencent is committed to building a complete network Empire and has great potential for future development.

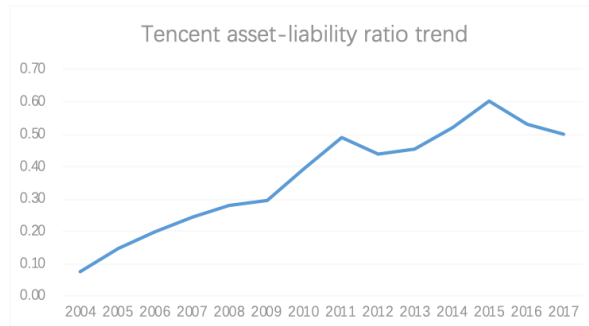


Fig. 6. Tencent asset-liability ratio trend

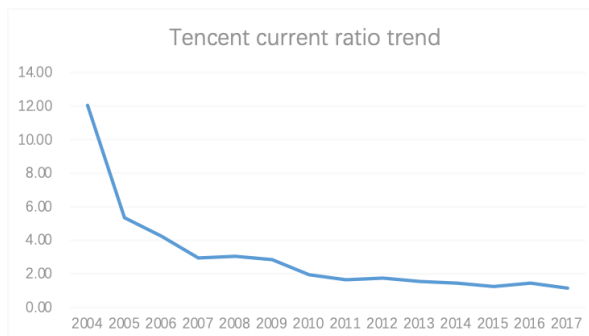


Fig. 7. Tencent current ratio trend

### 3.5 Tencent stock price

After the introduction of the Equity incentive plan, whether shareholders or managers are most concerned about the stock price of the enterprise can effectively reflect the value of the enterprise. Therefore, the stock price is also a criterion to reflect whether the implementation of the Equity incentive plan is effective. Before 2017, Tencent's stock price has been relatively stable. After the introduction of Equity incentive plan at the end of 2017, with the continuous improvement of the company's operating capacity, the stock price has steadily grown, and entered a period of rapid growth in 2014. Since then, despite fluctuations, the stock price has maintained a high level, which shows that Tencent's business has been relatively stable and successful and it has been approved by investors (see Fig. 8).



Fig. 8. Tencent stock price increase

## 4. Potential problems

Although Tencent's Equity incentive plan has achieved good results, it is not perfect. There are also some potential problems in the plan.

### 4.1 Short-term equity incentive effect

As can be seen from the chart, Tencent's net asset growth rate, net profit growth rate and net asset return rate significantly increased when the Equity incentive plan was issued at the end of 2007. However, the effect will disappear within 1-2 years. Equity incentive plan has no impact of long-term sustainability on performance promotion., Performance has not maintained growth after 1-2 years.

### 4.2 Inadequate motivation of early employees

Tencent has been carrying out Equity incentives for a long time. For the early employees who have accumulated considerable wealth, the work motivation has been insufficient. Tencent urgently needs to find driving force to keep the enterprise growing at a high speed.

### 4.3 Real "fairness" is hard to achieve

The stock awarded to each employee is not evenly distributed, but linked to the performance of the department. In 2017, the Equity incentive plan announced that about 34% of Tencent's employees were rewarded, and almost everyone in the Wechat (one of the Tencent most popular social software products) team was rewarded. In view of the huge profits brought by Wechat, it is no wonder that everyone was rewarded, but it inevitably affected the enthusiasm of the hard-working employees in other departments whose performance is not outstanding. As a result, employees want to squeeze into the departments with outstanding performance rather than work hard for the their departments.

## 5. Suggestions for improvement

### 5.1 Extending the Equity Incentive Period

The new restricted shares issued by Tencent in 2017 have a three-year period, which is proposed to be extended to 5-10 years. From the shareholder's point of view, the longer the period of validity, the better; However, from the manager's point of view, the longer the period of validity, the greater the unpredictability of the future, the smaller the present value of future income discount to the current period, the smaller the incentive effect on managers. Therefore, the validity period of exercise should seek a balance between shareholders and managers. According to American practice, options are valid for 5-10 years. In addition, for high-tech companies, Equity incentives include R&D personnel who are helpful to the growth of enterprises. But R&D work can not be completed overnight, it may take a long time, years or decades. Their work may lag behind company performance. Shorter incentive period is not fair for R&D personnel, nor can it play a long-term and effective role.

Therefore, prolonging the validity period of Equity incentive can fully take into account the interests of all aspects and help to improve the effectiveness of Equity incentive.

## **5.2 Strengthening Effective Equity Incentive for New Employees**

Because of the high-tech industry with faster updating speed, the staff's "metabolism" speed is fast. It is important for a high-tech company to inject young blood in time. Early employees contributed to the start-up of the company, and at the same time, they also received generous returns. However, early employees are often difficult to be stimulated by the general Equity incentives. Compared with early employees, new employees are the key driving force for hi-tech companies, like Tencent, to maintain high-speed growth. Therefore, hi-tech companies are supposed to focus on strengthening effective Equity incentives for young new employees and building up balance between new and old employees. Only by balancing the equity allocation can Tencent maintain high morale and combat power in the future, and develop better step by step.

## **5.3 Establishing and Perfecting Equity Incentive Distribution Mechanism**

According to its own development situation, Tencent is supposed to continue to expand the distribution scope, from core managers to grass-roots managers including project managers and directors, and finally to ordinary employees. Moreover, the number of stocks awarded to each employee should be more related to the information of the company's development, the position and rank of employees, and the contribution made by these people, rather than simply based on the performance of their departments. Because there are many factors that affect the performance indicators of different departments. If the products that the Department is responsible for are already old-fashioned, it may be useless for employees to make further efforts. Or if the whole industry is in a depressed stage, it may not be able to make a big improvement in performance in a short period of time. Therefore, hi-tech companies including Tencent should improve the performance evaluation system and establish a sound Equity incentive distribution mechanism.

## **6. Conclusion**

Through the above research, it proves that Tencent's Equity incentive has a certain impact on improving their company's performance, but at the same time, the current Equity incentive plan also has shortcomings. At present, there are some drawbacks in this study, such as the single subject of analysis toward Tencent. Therefore, the author will do follow-up research on other companies in high-tech industry.

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