Analysis of the Impact of Equity Incentives on Corporate Performance

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Abstract. Equity incentive is a long-term incentive mechanism implemented by enterprises to motivate and retain core talents, and is one of the most commonly used methods to motivate employees. Equity incentives have been developed from the beginning of the twentieth century to the present day to form a relatively complete and mature system, and their dynamic evolution and key role in corporate governance (employee loyalty), executive compensation, and investor decision-making make them of far-reaching research significance. Also, the equity incentives of enterprises play a crucial role in their development. The purpose of this paper is to comprehensively summarize and analyze the development and classification of these incentives. In addition, this paper focuses on the equity incentive policies of Tesla and Xiaomi and explores how and why incentivizing two target groups, namely executives and employees, affects corporate performance, as well as making a side-by-side comparison, and gives some suggestions for future equity incentives.

Keywords: Equity Incentives, Corporate Performance Performance, Tesla, Xiaomi.

1. Introduction

1.1. Equity Incentives

The history of equity incentives originates from the need to motivate employees, enhance company performance, and encourage active engagement in company development. In the early 1900s in the United States, companies started exploring ways to reward employees with equity, marking the inception of equity incentives. One early form was the stock option, granting employees the right to buy company stock at a predetermined price. This system aimed to directly align employees' financial interests with the company's success, fostering greater contributions from employees to the company.

1.2. History and Classification of Equity Incentives

Hall and other scholars argue that equity incentives trace back to the early 20th century when corporate management sought ways to attract and motivate employees, particularly executives and key staff, for the company's growth and success [1]. In response, several U.S. companies explored equity-based rewards, with stock options emerging as one of the earliest forms. These options allowed employees to buy company stock at a predetermined price, aiming to establish a direct link between employee interests and company success. Equity incentives developed rapidly in the second half of the 20th century, with Bebchuk arguing that the emergence of start-ups, especially those located in the Silicon Valley region of the United States, which do not have large cash flows, has been a major contributor to attracting senior engineers and executives and other technical talent [2].

Gayle categorizes equity incentives into two main types: stock options and restricted stock awards [3]. Stock options enable executives to buy company stock at a predetermined price, often tied to future growth, emphasizing long-term performance. On the other hand, restricted stock awards involve executives receiving company stock at the grant date but necessitating meeting performance goals and timing requirements to incentivize the attainment of both short- and long-term company objectives.

1.3. Aims and Reasons for Conducting Research

Examining the impact of equity incentives on firm performance is vital, touching on key areas like corporate governance, executive compensation, and investor decision-making. Past studies have limitations and lack comprehensive insights. This paper aims to address these gaps by using Tesla and Xiaomi's equity incentive policies and effects as examples. Through a detailed analysis, it seeks to offer more accurate information to corporate management, investment decision-makers, and academia. The significance of this topic extends beyond academia, impacting corporate, investor, and market sectors alike.

1.4. Previous Studies

Equity incentives are a prominent topic in corporate governance, particularly in China where Ma and other scholars note their implementation since 2006[4]. The goal is to address the agency problem and align the interests of firm owners and operators. Core contractual elements play a crucial role in the effectiveness of equity incentive programs, especially in addressing moral hazard and adverse selection. In academic studies, the relationship between equity incentive models and firm performance is debated. Some argue for the effectiveness of restricted stock models, encouraging careful decision-making by executives, while others favor stock option models for promoting risk-taking in firms.

Controversy arises regarding their connection to corporate financial misreporting and the role of risk. In a focused study by Armstrong, the article "The relation between equity incentives and misreporting: the role of risk-taking incentives" reveals insights into how managers' equity incentives influence misreporting, emphasizing the trade-off between Portfolio Delta and Portfolio Vega, representing wealth sensitivity to stock prices and risk, respectively [5].

Su examines the influence of equity incentives on Chinese firms' performance, showcasing the positive impact on financial metrics like profitability and return on assets. The study underscores the significance of investor protection mechanisms, revealing that regions with stronger safeguards are more likely to benefit from equity incentive plans [6].

Merle Erickson investigates the potential link between executive equity incentives and accounting fraud, focusing on 50 firms accused of fraud by the SEC [7]. Despite concerns about the role of incentives in fraud, the study finds no consistent evidence supporting an association between executive equity incentives and accounting fraud. These results challenge common beliefs and provide valuable insights for further understanding the complex relationship between executive incentives and corporate behavior.

1.5. The Structure of Paper

The article begins by outlining the origins, categorization, evolution, and trends of the U.S. equity incentive system. It states the study's purpose, highlights the importance of equity incentives, and reviews existing research. Moving the data and methodology section, it outlines the formulation strategy, explores the impact on firm performance, and considers potential reasons for this impact. The literature review section distinguishes the study from previous works, emphasizing its significance. In the fourth section, evidence is presented to support and justify the findings. The final part consolidates all findings to conclude.

2. Xiaomi Inc

2.1. Xiaomi's Equity Incentive History and Reasons

Xiaomi has gone through three key stages in terms of equity incentives: the start-up period, the development period, and the post-IPO period. During the start-up period, Lei Jun implemented a business partner system to ensure the deep involvement of the founders and core team. Subsequently, the company launched a universal equity incentive program, covering employees, consultants, directors, and other levels. After listing, Xiaomi has continuously adjusted the incentive targets and increased the incentives for core employees and executives, forming a flexible and diverse equity incentive system.

2.2. Xiaomi Inc's financial performance

Xiaomi's equity incentive program has formed a close "community of destiny" by deeply binding employees and the company, creating a market value of nearly 320 billion Hong Kong dollars in the past 13 years. The company has made frequent equity incentives after listing to provide targeted incentives to core employees, which has further boosted its performance. Up to now, Xiaomi has conducted 17 equity incentives, showing the company's continued focus and importance on equity incentives.

To enhance core talent attraction, Xiaomi, since its inception in 2010, reserved 15% of its shares as an employee stock incentive pool, adopting a diversified flexible compensation model. This model allows all employees to reduce their basic salary to acquire a corresponding proportion of equity. However, whether partners or employees, they are required to contribute to the acquisition of the shares, fostering a more proactive workforce. Starting in 2011, Xiaomi implemented a widespread and long-term equity incentive plan, and as of March 2018, the proportion of company shares held by all Xiaomi employees reached approximately 38%. According to disclosed data on the Hong Kong Stock Exchange, Xiaomi's gross profit margin for its smartphone business increased from 3.25% to 12.69% from 2015 to 2018, and revenue from its diversified businesses grew from 66.8 billion to 174.9 billion, achieving sustained and unexpected growth. XiaomiInc also went public on the Hong Kong Stock Exchange in 2018.

2.3. Suggestions and Insights

Early planning and systematic design: Xiaomi planned its equity incentive system systematically and hierarchically from the very beginning of its business, which provides strategic support for the company's long-term development. Other companies can learn from this and consider the systematic and sustainable nature of incentive programs from the start-up period.

Diversity of incentive tools: Xiaomi has adopted a variety of incentive tools, including stock options, restricted shares, etc., to meet the value pursuit and realization of different workers. Enterprises can better adapt to the needs of employees through the diversity of incentive tools to improve the incentive effect.

The courage to share money: Xiaomi has shown the courage to share money, especially for ordinary employees' equity incentives, to achieve the effect of "wealth gathering and people gathering". Managers should take into account the real needs of employees in equity incentives, and be good at allocating incentive resources, to maximize the motivation and creativity of employees.

Risk prevention and control: After going public, Xiaomi chose a dual shareholding structure to maintain the founder's absolute control over the company. For companies planning to go public, similar risk prevention and control measures can be considered to ensure that the company can maintain control of the business during the financing process.

3. Tesla

3.1. Tesla's Equity Incentive History and Why

Tesla has gone through several equity incentive plans in terms of equity incentives, the most notable of which was the 2018 equity incentive plan. In this plan, Tesla clarified its strategic needs and focused its incentives on market capitalization and performance. Through cascading assessment metrics, Tesla has designed an ambitious incentive plan for Musk to achieve the company's growth goals while also adding to his wealth.

3.2. Tesla's Financial Performance

Tesla's financial performance gradually improved after Elon Musk took over as CEO in 2008. In the early stages of its establishment, Tesla's expenditures were primarily operational, with relatively fewer capital expenditures such as fixed asset investments. Research and development (R&D) expenses, a significant component of operational expenses, increased steadily from 2005 to 2008. In 2007 alone, R&D expenses reached $62.75 million, accumulating to over $100 million. It wasn't until 2008 when Tesla's first mass-produced model, the Roadster, was launched, that the company started generating revenue, surpassing $14 million. The turning point for Tesla's success came with the introduction of the Model S. The production of the Model S not only brought in customer deposits, relieving financial pressure, but its successful mass production also led to consistent financial growth. In 2013, Tesla achieved quarterly profitability for the first time, and by 2020, it achieved profitability for the entire year. The birth of the Model S was made possible by the Musk Stock Incentive Plan approved by the board in 2009. Subsequent targeted incentive plans further solidified the connection between Musk and the company [8-10].

Tesla's financial performance over the past few years has been strong, with not only significant growth in revenue and gross profit but also impressive achievements in market capitalization. Musk has played a key role in Tesla's financial success through its equity incentive program. The continued rise in Tesla's stock price has allowed Musk's wealth to increase rapidly, while also reflecting the company's strong performance.

3.3. Recommendations and Suggestions

Combine incentives with strategic needs: Tesla's equity incentive plan is closely aligned with the company's strategic needs, with incentives targeted at market capitalization and performance. When designing an incentive plan, other companies should think deeply about the company's current stage of development and strategic goals to ensure that the incentive plan can truly serve the company's long-term development.

(1) Flexibility and Goal Orientation of Equity Incentive: Tesla's equity incentive plan reflects flexibility and goal orientation through cascading assessment indicators. The goals of the incentive program should be clear, quantifiable, and adaptable to changes in the company. A flexible equity incentive plan can better motivate executives and drive the company to achieve its long-term goals.

(2) The long-term nature of the equity incentive plan: Tesla's equity incentive plan requires Musk to continue to hold the stock for five years after the exercise of his options, which reflects the focus on long-term goals. When designing an equity incentive plan, companies should focus on the long-term nature of the plan to ensure that executives have a continued focus and commitment to the long-term success of the company.

(3) Equity incentives are aligned with employee values: Tesla's equity incentive program closely links executive rewards to the company's market capitalization and performance, which is consistent with Tesla's mission to promote clean energy and sustainable development. Other companies designing equity incentive plans should ensure that incentives are aligned with the company's core values and mission to better inspire a sense of belonging and passion among employees.

4. Comparison

4.1. Xiaomi's Equity Incentive

Development Stages: Xiaomi has undergone three key stages in equity incentives: start-up, development, and post-IPO. In the start-up phase, Lei Jun implemented a business partner system, ensuring the deep involvement of founders. Later, the company introduced a universal equity incentive program covering employees, consultants, and directors.

Flexibility and Diversity: Xiaomi employs a flexible and diverse equity incentive system, including universal programs and targeted incentives. Employees can reduce their basic salary to acquire corresponding equity proportions, enhancing incentive flexibility.

Tesla's Equity Incentive:

Strategic Focus: Tesla has implemented various equity incentive plans, with the 2018 plan notably focusing on market capitalization and performance. The plan is designed to align with strategic needs, offering incentives tied to market value and specific performance targets.

Tight Integration with Musk: Tesla's clear equity incentive plan has tightly integrated Elon Musk's wealth with the company's interests, ensuring alignment between leadership and overall company objectives.

4.2. Commonalities

Employee Contribution: Both companies require employee contributions to acquire shares through equity incentive plans, fostering a more proactive workforce.

Performance Enhancement: Equity incentive plans have successfully motivated employees, contributing to sustained growth in company performance.

Conclusion: Xiaomi and Tesla employ different strategies in their equity incentive approaches, with Xiaomi emphasizing flexibility and diversity, while Tesla prioritizes market value and performance. Despite these differences, both companies have successfully attracted and motivated key talent through their equity incentive programs, contributing to their overall success.

5. Conclusion

The effectiveness of equity incentives for both Xiaomi and Tesla is rooted in the shaping of common interests, motivation and innovation, talent retention and attraction, and long-term performance orientation. At Xiaomi, employees share in the rewards of the company's growth through equity incentives, which stimulate innovation and enhance loyalty to the company. Tesla's equity incentives focus more on the rewards that executives and employees receive by achieving the company's market capitalization and performance goals, motivating them to work hard for the company's success. Recommendations for future equity incentive policies include personalizing the design of incentives, continuing to focus on market trends, emphasizing sustainability, communicating transparently, and introducing elements of social responsibility. These recommendations are intended to make incentive programs more flexible, adaptable to market changes, and aligned with the Company's strategic vision and sustainability goals in order to motivate employees and executives to better contribute to the Company's long-term success.

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