

The Impact of Equity Incentives on Enterprise Business Performance

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Abstract. In the framework of modern enterprise system, the "principal-agent" relationship between the shareholders and the proprietor is clear in terms of property rights and responsibilities, but there is also a factor that the proprietor is driven by short-term personal interests against the long-term interests of the enterprise. As a kind of innovation in corporate governance, the equity incentives enable the proprietors to hold a certain amount of equity in the enterprise, so that proprietors can directly obtain the growth return of the enterprise while exercising the management right of the enterprise, and then consider the long-term development of the enterprise from the perspective of enterprise development.

1 Introduction

The emergence of equity incentive is due to the separation of ownership and operation in the present time when shareholding system is prevalent, which will generate moral hazard of executives. Therefore, the implementation of equity incentive programs has become an important measure for many companies to solve this problem in this process.

With the continuous improvement of relevant legal system and regulations in China, many large-scale companies have joined the team to implement the equity incentive plan. However, in the specific implementation process, the implementation effect of equity incentive varies greatly among different companies. This study takes Huawei as the research sample to analyse the equity incentive plan of enterprises, and discusses the influence of the equity incentive plan on the company business performance as well as its positive significance and shortcomings, which is especially necessary for enterprises to implement scientific and effective equity incentive plan.

2 Development History of Equity Incentives

Equity incentive plan is an incentive method that gives proprietors certain economic rights in the form of company equity, so that they can share profits and bear risks as shareholders and diligently serve the long-term development of the company.

The development of equity incentive in China could be traced back to the implementation of "labour-sharing system" by Jin merchants, i.e. shareholders contributed money and managers contributed effort and were responsible for the shareholders' capital. The

shareholders allowed the managers to replace a certain amount of labour shares with their personal abilities, and both silver and labour shares enjoyed the same right to dividends [1]. Regarding the development of modern equity incentive plan in China, it could specifically be divided into the following three stages: pilot stage, standardized development stage and mature stage.

2.1. Pilot Stage

The period from 1992 to 1998 was pilot stage. Around 1990, employee stock ownership was introduced as a means to address the shareholding reform of state-owned enterprises. However, the focus at that time was not on incentives, but on diversifying the single shareholding of state-owned enterprises and achieving the diversification of enterprise property rights. Later, China Securities Regulatory Commission called a halt to employee shareholding in 1998 because of compulsory employee shareholding in local practice and other irregularities in operation.

In May 1992, the State Commission for Restructuring the Economic System, the State Development Planning Commission, the Ministry of Finance, the People's Bank of China, and the Production Office of the State Council jointly issued the Pilot Measures for Joint-Equity Enterprise, which allowed the pilot of "internal employee shares" from "targeted sources". In April 1993, the General Office of the State Council forwarded the Urgent Notice on the Immediate Suppression of Irregularities in the Issuance of Internal Staff Shares issued jointly by the State Commission for Restructuring the Economic System and other departments. In 1997, Shanghai Yidian Holding Group Company took the lead in implementing the stock option system. In 1998, Tianjin Teda Incorporated Company also began to explore the implementation of stock options. During this period,

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since the domestic capital market in China was only in its initial stage, the laws and regulations matching with the equity incentive basically did not exist yet, and it was in the exploratory stage of equity incentive plan in China [2].

2.2. Standardized Development Stage

The period from 1998 to 2005 was the standardized development stage. According to the relevant laws and regulations before 1998, the company employees were allowed to hold part of the corporate stock. However, as the relevant constraints were not yet sound, there was a negative impact of turning into short-term benefits in the process of implementation. In November 1998, the China Securities Regulatory Commission (CSRC) issued the Notice on Stopping the Issuance of Company Employee Shares, calling a halt to the issuance of company employee shares.

It was not until October 2005 that the newly revised Company Law of the People's Republic of China made breakthroughs in the registered capital system, the buyback of company shares and the transfer of shares during the tenure of senior management, thus filling the legal gap for companies to implement equity incentives. It laid the foundation of legal regulations and provided the possibility for the implementation of equity incentive.

2.3. Mature Stage

From 2006 to the present, the development of the equity incentive plan in China has entered into a mature period. With the introduction of the new Company Law and Securities Law on January 1, 2006, and the laws and regulations promulgated by the CSRC, Ministry of Finance and SASAC in 2006, namely, the Measures for the Administration of Equity Incentives for Listed Companies and the Trial Measures for the Implementation of Equity Incentives for State-owned Listed Companies (Domestic), the equity incentive system was more formally confirmed and the conditions and methods for the implementation of the equity incentive system were clarified. Since then, the equity incentive market in China has officially entered a mature stage.

By the end of 2020, a total of 1,716 listed companies in China's A-share market had disclosed the implementation of equity incentives, accounting for 41.53% of the total number of listed companies. Equity incentives have become an important corporate governance mechanism in China's capital market [3].

3 Common Methods for Evaluating Business Performance of Enterprises

The so-called enterprise performance evaluation refers to an objective, fair and accurate comprehensive judgment of the asset status, profitability level, cash flow and other aspects of enterprise in a certain accounting period with the use of mathematical and statistical and operational research principles, considering a specific index system,

a unified standard and certain procedures, and carrying out quantitative and qualitative comparative analysis [4].

Enterprise performance evaluation can be divided into two types: traditional type and new type. The difference between the two is that the traditional type of enterprise performance evaluation focuses only on financial indicators, while the new type of enterprise performance rating combines financial and non-financial indicators to provide a comprehensive analysis of the target company.

3.1 Traditional Type of Enterprise Performance Evaluation Methods

The traditional type of enterprise performance evaluation methods are represented by the DuPont analysis and the economic value added method. DuPont analysis is a classical method proposed by DuPont Company to evaluate the performance of a company from a financial perspective by analysing the financial data indicators of the company and using the relationship between several major financial ratios to analyse the financial situation of the company in a comprehensive manner. The basic idea is to decompose the return on net assets into a number of financial ratio products, which helps to analyse and compare the business performance in depth.

Economic value added is a set of financial management and decision-making as well as managerial incentive compensation and performance appraisal management system based on the concept of economic value added proposed by the American scholar Stewart and implemented by the famous Stern Stewart Company in the United States [5]. EVA is applied in more areas, and it can not only measure the real business situation of the company, but also evaluate and account for the performance of the company and provide a basis for the decision making of the shareholders [6].

3.2 New Type of Enterprise Performance Evaluation Methods

The Balanced Scorecard evaluates business performance from two main perspectives of financial and non-financial indicators, with financial indicators linked to traditional business performance and non-financial indicators closely aligned with corporate development strategies. The Balanced Scorecard breaks down corporate strategy in four dimensions, taking into account the financial situation, non-financial status, long- and short-term operations, and internal and external environment of the company.

Compared with traditional evaluation methods such as EVA, the application of balanced scorecard in performance analysis has the advantages of being more comprehensive, diverse, objective and scientific [7]. Traditional evaluation methods focus on financial indicators, rely on accounting profit and shareholders' equity in excess, and ignore key factors of non-financial dimensions, leading to incomplete and uneven development of the company [8]. In contrast, the balanced scorecard is more objective and can evaluate

the operation and future development of the enterprises from multiple dimensions, and effectively prevent the bad behaviour of business operators by understanding customer satisfaction and internal process dimensions [9].

4 Case Study

There are various models of equity incentives, and most of them are formed based on three main models, including stock options, restricted stock and employee stock ownership plans.

In 2005, the equity division reform solved the source of shares needed for equity incentive; China Securities Regulatory Commission and State-owned Assets Supervision and Administration Commission of the State Council issued a series of policies in 2006, which regulated the legal environment of equity incentive system; and the Ministry of Finance and State Administration of Taxation of China issued the policies in 2009, which improved the legal environment of equity incentive system. And equity incentive in China has gradually matured and become more and more important. Especially, for high-tech tech enterprises, equity incentive is regarded as the winning strategy to enhance employees' motivation, improve employees' loyalty and make the enterprise bigger and stronger. This study takes Huawei as an example and explores the influence and significance of equity incentive on Huawei's performance by analysing and studying Huawei's equity incentive plan.

4.1 Enterprise Background and Staff Structure

Founded in 1987 in Shenzhen by founder Ren Zhengfei, Huawei is a world-leading information and communications technology (ICT) solutions provider that has built end-to-end solution advantages in the areas of telecom operators, enterprises, terminals and cloud computing, providing competitive ICT solutions, products and services for consumers and working to realize the future information society and build a better, fully connected world. Huawei products and solutions are currently used in more than 170 countries around the world, serving 45 of the top 50 global operators and one third of the world's population.

By the end of 2018, Huawei had 188,000 employees, more than 90% of whom had received a university education, with an average age of 33 years old and 166 employee nationalities, dominated by young talents with higher education in science and technology innovation. In terms of personnel structure, technical research and development personnel occupy the largest share of 46%, and retaining these high-tech talents through the equity incentive plan is one of the important factors that enable Huawei to develop successfully.

4.2 Equity Incentive Plan of Huawei

Huawei has implemented different equity incentive plans at different times, which can be divided into five development stages of equity incentive.

4.2.1 Equity Incentive During the Start-up Stage (1990-2000)

At the early stage of the start-up, Huawei had a large amount of equity available for allocation. From the normal business financing process, the initial company desperately needed a lot of financing due to the expansion of market business and the development and growth of its own scale, while Ren Zhengfei increased the initial research investment in order to quickly establish the market share of the brand, but it was limited by the difficulty of finding bank loans for private SMEs around 1990.

Therefore, Huawei chose to rely on internal financing. In 1990, Huawei first proposed the model of employee stock ownership. The price of employee participation at that time was RMB 10 Yuan per share, with 15% of the company's after-tax profit as an equity dividend. In the early days, Huawei employees' compensation consisted of salary, bonus and stock dividends. One of the main conditions used for stock placement was that after employees had to work for one year, shares were allocated based on various assessment indicators of the employees. Some of the employees' salaries and bonuses formed internal financing in this form. [10]

4.2.2 Equity Incentives During the Internet Bubble (2000-2003)

During the Internet bubble period, the communications industry, represented by Huawei, was greatly impacted. Huawei experienced unprecedented difficulties in financing. At this time, Huawei implemented virtual restricted shares, a stock option, in order to weather the crisis.

Virtual restricted stock was a kind of virtual stock granted by the company to incentive recipients, which was very different from the traditional sense of stock. The incentive recipients only enjoyed the right to dividends brought by the restricted stock and the right to appreciation brought by the change of the fair value of the share price, but had no ownership rights. The company strictly stipulated that the restricted shares could not be transferred or sold. In order to restrain the employees, the company also stipulated that the restricted shares should automatically expire when the employees left the company. In the income structure of restricted shares, the major part of Huawei employees' income from share options was no longer the early fixed dividends, but the appreciation part from the option shares, which was mainly derived from the company performance and business scale volume, thus further motivating Huawei's employees. [11]

4.2.3 Equity Incentives During the SARS Period (2003-2008)

In view of the impact of SARS in 2003, Huawei's export market was seriously affected, and external property rights lawsuits also seriously affected Huawei's

international market, resulting in that Huawei had to launch a new round of equity placement.

This time, the placement was different from previous placements and was a bottom-up placement. Employees were encouraged to voluntarily keep their salaries within Huawei and purchase equity in the form of salary reduction, while the company's pricing also dropped significantly to meet the share purchase needs of the incentive recipients. This share placement had a serious core bias, focusing on core management, as evidenced by the fact that the number of shares placed for core-level employees far exceeded that of ordinary incentive employees. After learning the lessons from the previous share allotment, this allotment set a 3-year lock-up period, which prohibited cashing in within 3 years after the purchase of shares, and the shares allotted would be invalid if the incentivized employees left the company within 3 years. [12]

4.2.4 Equity Incentives During the New Economic Crisis (2008-2013)

The global economic crisis caused by the U.S. subprime mortgage crisis in 2008 caused a world-class crisis, and Huawei was not spared at the same time.

Faced with the impact of the 2008 economic crisis and the bottleneck in the development of new technologies, Huawei adopted new equity incentives to achieve financing and weather the economic crisis. Huawei set up different levels of shareholding according to employees' work levels, varying from 13 level to 23 level, with three levels under each level, and the main difference between the different levels was the salary income. The number of shares that could be allocated varied with the level of the employee, which was an implicit incentive to motivate the employee to work hard and achieve higher business results. [13]

4.2.5 Reward Equity Incentives after 4G License Issuance (2013 - Present)

In 2013, China's 4G license was officially issued, major operators successfully got the qualification of 4G commercialization, and Huawei launched the Time Unit Plan (TUP) in response.

The TUP mainly allocated a corresponding number of stock options with a five-year term based on the employee's corresponding rank, position and performance, and the employee could receive corresponding appreciation rights and dividends with the stock options held by themselves, which would be zeroed out after five years. With the implementation of the TUP plan, it's impossible for the old employees who already held virtual shares to sit back and enjoy the benefits, while the new employees would have more room for upward mobility and could potentially earn the same benefits as the old employees as long as they put in the effort. [14]

4.3 The Impact of the Equity Incentive Plan on Huawei

The equity incentive has brought the following three impacts to Huawei.

The first is to solve the problem of a single financing channel for non-listed companies. Compared with listed companies, non-listed companies have a single financing channel and difficulty in financing. Non-listed companies offer equity incentives to their employees, which can not only highly unify the interests of employees and themselves, but also solve part of the financing problem. In the early stage, Huawei had very little registered capital, and the financing was rebuffed. In 1990, the first employee stock ownership was proposed to encourage employees to buy Huawei's shares, thus solving the problem of shortage of capital in the early stage of the company. It can be seen that equity incentive can solve financing difficulties to a certain extent, especially for those enterprises in the growth stage. [15]

The second is to increase corporate value and discipline employees to prevent brain drain. The primary effect of equity incentives is to motivate, but there is also a hidden effect of disciplining employees through seniority and performance attainment. The specific performance is risk sharing. Employees cannot leave the company easily, should integrate the personal interests with the company's interests and weight the long-term interests of the company with the short-term interests of individuals. In short, it plays a restraining role.

The third is to prevent the problem of equity dilution, avoid malicious takeover, and protect the rights and interests of all. There is always a problem to face when implementing equity incentives in listed companies. Although the shares used for equity incentives have a certain blocking period, once the blocking period expires, most executives choose to sell their holdings in the capital market to liquidate them, thus leading to equity dispersion. Although Huawei's equity has basically been used for equity incentives, Huawei sells "virtual equity" to its employees, which is a kind of employee equity that Huawei unilaterally recognizes, not a legal equity that employees have ownership. Even if some employees have equity ownership, this equity is basically in the hands of the employees and is not circulated in the market, not held by competitors or acquirers. In addition, once a Huawei employee leaves, the labour union will buy back the equity in the hands of the departing employee. Therefore, the control of Huawei is still in the hands of Ren Zhengfei, avoiding the risk of malicious takeover due to the fragmentation of equity. [16]

5 Conclusion

As one of the leading high-tech enterprises in China, Huawei has a great demand for talents, which is the driving force of Huawei.

In order to retain more talents, it is necessary for companies to actively and effectively implement an equity incentive system. It is not enough for domestic

enterprises to focus only on technology development, but also on motivating talents. Through the equity incentive system, the employees who have contributed can get the benefits brought by the rapid development of the company, so as to stimulate their work enthusiasm and potential and achieve the common development and progress of individuals and enterprises.

In the development of the enterprise, enterprises should have the concept of sharing benefits with employees and establish the mechanism of "common prosperity and disgrace", which will provide a strong guarantee and source of power for the future development of the enterprise.

With the use of its unique wolf culture and the great influence of Ren Zhengfei, Huawei forms a unique corporate culture, which is very different from other companies. In communications industry of China, talent is the most valuable and hardest to keep, especially core corporate talent and research talent.

Highly qualified talents determine whether a company can innovate technology and develop rapidly, and what's most important is to improve the enterprise performance. By sharing the benefits of future development, enterprises attract and retain talents, so as to maintain the foundation and power of development.

Through the implementation of the equity incentive system, Huawei has achieved significant growth in revenue and a huge increase in brand effect and realized the growth in most important aspects of the operation revenue and net profit.

With its rapid development in the past few years, Huawei has become the benchmark and leader of the industry, and the key to its stable performance growth lies in its own efficient management mechanism, with little connection to the external market environment. Therefore, it is suggested to study and understand management mechanism and philosophy of Huawei as much as possible, so that other companies can develop their own equity incentive system that suits their conditions. However, Huawei's success is unique and difficult to copy, and the situation of each industry is very different, so that Huawei's incentive model and management mechanism cannot be copied in full. It is important to be realistic, and it is necessary for other companies to make a suitable incentive system after fully understanding and learning from the actual market and changes. In conclusion, Huawei model has good reference value for the implementation of equity incentive system in China, and also has high practical significance in terms of universal application and research development.

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