A Study on the Correlation Between Equity Incentives and Business Growth

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Abstract. With the establishment of the equity incentive mechanism in China, more and more enterprises are beginning to explore incentive systems in depth. Equity incentive systems have attracted widespread attention and discussion because they can both increase enterprise value and reduce agency costs. If a company can find an equity incentive plan suitable for its own daily economic activities, it can gain an absolute advantage in the competitive market among peers. This paper uses a case study method, focusing on Midea and Haier, to conduct a comparative analysis of the equity incentive plans implemented by two different enterprises in the same home appliance industry. It analyzes the impact of different equity incentive mechanisms on corporate development and proposes relevant suggestions to enable equity incentives to play a better role in promoting corporate development.

Keywords: Equity Incentives; Midea; Haier; corporate development.

1. Introduction

Equity incentives are a long-term incentive method provided by enterprises to incentive targets, which requires the targets to meet certain standards in order to obtain certain rights. It mainly grants a certain amount of shareholders' rights to core employees through the implementation of stock options, enabling them to have a sense of belonging and participate in economic decisions as shareholders, jointly bear the risks of the enterprise, thereby enhancing the value of shares and encouraging operators to fulfill their responsibilities.

Currently, equity incentives have become a powerful means of corporate strategy and business development. On one hand, equity incentives should focus on core talents with strategic value; on the other hand, they should be aligned with the company's major strategic nodes, based on the premise of the company's performance growth. The design of equity incentive plans should primarily be performance-oriented, ensuring stability and attractiveness to employees, balancing both motivation and constraints.

In the nearly 40-year development history of China's manufacturing industry, Midea and Haier are undoubtedly two of the most shining stars. Midea has invigorated the organization and employees with its "Decentralized Management" model; Haier has made each employee the protagonist of the market with its "One Person, One Unit" model. Although these two models have different paths, they share a common goal-sustainable development aimed at the market and maintaining industry leadership. This paper will explore the management styles and equity incentive methods of Midea and Haier, analyze the different impacts of equity incentive mechanisms on corporate development, and provide relevant suggestions to better utilize equity incentives in enterprises and promote corporate growth.

2. Literature Review

Equity incentives first appeared in the United States and have now become a trend in motivation. Research on equity incentives in academia has a long history and various perspectives. Generally speaking, it mainly includes several aspects: theoretical foundation research of equity incentives, research on the effectiveness of equity incentives, research on standards for the effectiveness of equity incentives, and research on factors influencing the effectiveness of equity incentives. Scholars hold different views on these research areas, with some even being quite divergent.

In terms of research on the effectiveness of equity incentives, the majority of current studies are empirical. The results of these studies can be divided into two camps. One camp believes that equity incentives are correlated with enterprise value, arguing that allowing executives to hold stock through equity incentives can enhance enterprise value and increase shareholder utility [1,2]. Many scholars have strictly defined the range of the executive stock holding ratio through empirical analysis, finding that within this ratio range, the executive stock holding ratio positively correlates with enterprise value, while in other ranges, this positive correlation weakens and may even turn negative [3-5]. The other camp, however, believes that equity incentives do not correlate with enterprise value for two main reasons: first, the independence of the board of directors that formulates the equity incentive plans is not strong; second, the incentive ratio is relatively low, making it difficult to produce motivating effects on the incentivized individuals [6-7].

3. Comparison of the Equity Incentive Mechanisms of Midea and Haier

3.1. Midea

Midea’s management innovation is reflected in its organizational structure and operational mechanisms. Midea has achieved a transition from a centralized to a decentralized management model by implementing decentralized management, which grants greater autonomy to its business units and invigorates the organization’s vitality. Midea’s decentralized management operates on the principles of “centralization with reason, decentralization in order” allocating decision-making and execution powers to the business units, enabling them to react quickly to market changes. This decentralization not only improves decision-making efficiency but also enhances employees’ sense of responsibility and belonging. Midea’s equity incentive plan integrates long-term and short-term incentives and restrictions, forming a multi-layered incentive ecosystem unique to Midea.

The partner shareholding plan is specifically aimed at senior management. This plan is essentially performance shares, mainly targeting the president and general manager-level executives of the company. The company buys stocks in the secondary market and distributes them to core executives based on evaluation results. This approach effectively drives the transformation of the company from “managers” to “partners”, making the results of long-term incentives significant. Before implementing this plan, core management team’s compensation structure was relatively simple and lacked long-term incentives; however, in the face of increasingly fierce competition, it found a suitable way to stabilize itself in the ever-changing industry market.

The restricted stock incentive plan is specifically aimed at middle managers. This plan involves a total of 140 people, mainly comprising senior executives and other managers deemed to have a direct impact on the company's development by the board of directors. These individuals are looking for substantial income that can be seen annually. It involves a targeted equity issuance, allowing employees to purchase shares at half price. Thus, compared to partner stock, restricted stock can intensify incentives while also perfecting Midea’s equity incentive system.

The stock option incentive plan is specifically aimed at core staff. This plan is a relatively popular method of stock-based incentives among enterprises and is also one of the earliest methods introduced by Midea. The option plan focuses on R&D, manufacturing, quality, and other essential business personnel, with 1476 participants. It is also a targeted equity issuance, but unlike restricted stock, employees need to purchase shares at full price. The stock option plan has been implemented the longest and has a more inclusive nature. The changes among these five phases of the plan show the close integration of Midea Group's option plan with its strategy.

3.2. Haier

Haier’s “One Person, One Unit” model represents a profound transformation from a traditional manufacturing company to an enterprise of the internet age. The core of this model is to shift employees from passive executors to active creators, enabling each employee to directly face the market and quickly respond to user demands. This model has brought significant changes to Haier's operations, transforming employees from executors into creators. At Haier, "One Person, One Unit" is not just a management model; it is a culture. Employees are no longer simple order executors but have become autonomous decision-makers and self-driven creators, motivating them to create greater user value and achieve mutual growth between employees and the company.

Between 2006 and 2014, Haier announced five stock incentive plans, of which the plan in 2006 was not implemented, while the other four plans were approved by the company's shareholders' meetings, and three of them have been officially implemented. Before the implementation of the stock incentive plan, the shareholding ratio of the company's senior executives was relatively low. Therefore, in the first incentive plan announced in May 2009, the company particularly emphasized that this stock incentive plan was designed to meet the strategic development needs of the company, while balancing the company's long-term and short-term interests, in order to better attract, motivate, and stabilize the core management and key personnel required by the company, thereby promoting the company's development. Although the number of executives in the 2009 stock incentive plan slightly decreased, the proportion of shares held by management within the total shares of the incentive plan significantly increased. Meanwhile, the 2009 stock incentive plan also imposed higher performance requirements, demanding not only a return on net assets of no less than 10% but also a compound annual growth rate of net profit reaching or exceeding 18%, which was far higher than the 10% requirement specified in the 2006 incentive plan.

After 2018, in response to the economic crisis, to expand domestic demand, and to promote stable and rapid economic development, the Chinese government decided to promote the "Home Appliance Going to the Countryside" initiative nationwide. These stimulus policies effectively stimulated domestic market demand, resulting in a favorable growth situation in the domestic appliance market in 2009. The exercise conditions established in the 2009 Haier stock incentive plan had been met, and to boost morale through stock incentives, while also placing "golden handcuffs" on benefiting employees, Haier announced its second stock incentive plan in September 2010. This second plan expanded the scope of the incentive objects, with the number of incentivized individuals growing by nearly 70%. In this plan, core employees became the main incentive target, accounting for 97.6% of the total incentives, with their shareholding also accounting for 70.74% of the total shares.

In 2012, Haier announced its third stock incentive plan, which focused on mid-level core technical personnel, mainly aimed at expanding the scope of the incentive objects. None of the company's senior executives were included in this round of incentives, with 26 million stock options representing 0.97% of the company's equity wholly used to incentivize key employees. Additionally, the exercise conditions in this incentive plan saw significant adjustments compared to the previous two rounds, with profit growth rates in 2011 required to reach or exceed 12% and 28.8%, far below the 18% compound annual growth rate stipulated in the first two rounds. In April 2014, the company announced its fourth stock incentive plan. Influenced by strategic investors, the fourth stock incentive plan was more robust than the previous three plans, with stock options accounting for 1.75% of the company's total equity, totaling 47.64 million shares, and the incentive scope was very broad, including five senior executives among a total of 455 individuals.

4. Equity Incentives and Corporate Development

Since Haier implemented its equity incentive plan in 2009, the company's stock price has shown a generally upward trend, and various financial indicators have increased year by year. This indicates that the equity incentive plan has a positive impact on the enhancement of Haier's value and is overall successful. Before Haier implemented the equity incentive plan, the proportion of shares held by senior executives was relatively low, which directly led to a loss of personnel within the company. In Haier's first equity incentive plan, it specifically emphasized this point by increasing the proportion of the management in the total shares of the incentive plan. This not only better promotes corporate development but also ensures the long-term interests of the company are realized. However, Haier's incentive plan differs from Midea's in that it does not have specific policies aimed at core senior executives. Haier's equity incentive policies have generally targeted hundreds to thousands of people, where both executives and employees purchase shares with their own money. This helps maintain the stability of the management team while also stimulating the enthusiasm of all employees, aligning the interests of senior management with those of ordinary employees. While this is a positive aspect, the incentive for management in terms of the number of shares held and performance requirements is clearly lower than that of Midea.

Midea's equity incentive plan is more distinctive compared to Haier's. It establishes different policies based on varying levels and positions when formulating plans. Its partner shareholding plan is mainly applicable to core senior executives, the restricted stock plan mainly to unit or department heads, and the stock option plan primarily to key business backbones. Moreover, Midea also executed different types of policies. Core senior executives are fully covered by the company, middle and senior management can buy at half price, while business backbones must finance their own shares. Midea uses return on net assets as the performance evaluation metric for core senior executives, while net profit serves as the performance evaluation metric for middle management and ordinary employees. The governing standard for evaluating managers' performance is net profit, increasing the likelihood of such managers engaging in short-term behavior.

During the implementation of the equity incentive plan, Midea's profitability has been significantly improved, especially the return on equity and net profit directly related to equity incentives have increased significantly. However, Midea's operating capacity has generally declined, and although it has increased in the first year of the equity incentive plan, it is not optimistic overall. The long-term solvency of Midea did not show significant changes during the introduction of equity incentives, remaining basically stable, while the short-term solvency has improved. Under the influence of the equity incentive plan, Midea has maintained a good growth momentum and has strong development potential in the industry. Overall, in the years following the introduction of the equity incentive plan, Midea's performance has shown significant improvement [8].

Since the announcement and implementation of the company's equity incentive plan, Haier's performance has been continuously rising. The company's net profit growth rate in 2009 and 2010 was over 45%, with a weighted average return on net assets increasing by 4.11 and 5.04 percentage respectively. After relevant policies were withdrawn, the company's net profit growth was somewhat affected, but from 2011 to 2013, the net profit growth rate still remained above 20%, with the weighted average return on net assets also maintaining a level above 30%. Furthermore, when compared with Midea, in 2008, Haier's net profit and weighted average return on net assets were slightly lower than Midea's. The comparison and analysis of the profitability metrics of the two companies indicate that the implementation of Haier's equity incentives ensured rapid growth in the company's profitability.

5. Suggestions for Improving the Equity Incentive Mechanism

5.1. Choose Appropriate Incentive Methods to Ensure Long-term Effectiveness

If the validity period of the incentive plan is short, those who are incentivized are likely to make decisions that profit them in the short term at the expense of the company's long-term interests to quickly obtain these benefits. Once the waiting period is over, they can leave for another company with the stocks obtained at a low price. Therefore, the effectiveness of the incentive depends on whether the incentivized individuals are able to think long-term for the benefit of the company. If the core talent and key managers within the company truly have a sense of ownership and consider the company's interests seriously, generating more returns for the company, then it constitutes an effective incentive plan. Stock options use the appreciation potential of the stock price as an incentive method. For listed companies in China, the company's stocks can participate in market circulation, making the stock option model relatively suitable. Additionally, for companies listed on the Shanghai and Shenzhen stock exchanges, the mainland capital market is gradually maturing, and a company's stock price can relatively accurately reflect its value. Midea, a white goods company, relies heavily on research and development capabilities and sales abilities as its core competitive strengths, making the stability of core personnel particularly important. Granting employees shares can effectively motivate their enthusiasm, while time limitations can reduce employee turnover and ensure the stability of the company's talent. Meanwhile, the development of white goods companies is relatively stable and predictable, making it easier and more accurate to determine stock option assessment targets. Therefore, stock options are more suitable for Midea Group.

5.2. Strengthen Internal Supervision During the Implementation of the Equity Incentive Plan

If the internal supervision system is incomplete or inadequate, it can easily lead to managers exploiting legal loopholes for personal gain, which not only harms shareholder interests but also undermines the company's long-term development. Therefore, companies should continuously enhance internal supervision levels, clarify penalties for violations during the implementation of the equity incentive plan, and punish those who violate the plan's regulations or the company's management rules, ensuring that equity incentives can truly play their role and guarantee the long-term healthy development of the company. This not only benefits the company and shareholders but also safeguards the interests of the incentivized individuals, achieving a win-win situation. Additionally, companies should regularly disclose the status of their equity incentive plan implementations and the conditions for achieving performance and exercise rights, enabling external investors to actively participate. A sound internal supervision system can effectively prevent management surplus management behaviors after implementing the equity incentive plan, avoiding operators acting on their surplus management motives and prompting them to consider the healthy development of the enterprise. This improves the rationality of their decision-making and leads to a more rational daily management and operation process, linking personal achievements and wealth with the future of the enterprise, and maximizing efforts to realize both. A well-established internal supervision mechanism will effectively constrain operators, ensuring that incentivized individuals do not harm the company's interests for personal gains, thereby fully leveraging the effectiveness of the equity incentive plan.

5.3. Adoption of Diverse Assessment Indicators

Midea's equity incentive assessment indicators include non-recurring gains and losses must not be lower than the average of the past three years before the grant; the net profit growth rate attributable to the parent company and the weighted average return on net assets must reach 15% and 20%, respectively. Overall, these indicators are singular and not very difficult to achieve. Midea should, based on net profit growth rate and weighted average return on net assets, consider the company's value positioning, growth potential, strategic goals, and other dimensions to establish a comprehensive and diverse assessment indicator system. As Midea's business scale expands, important non-financial indicators such as market share, employee satisfaction rate, and customer loyalty should also be included in the assessment system. Due to the quantifiability of financial indicators, management may embellish reports and manipulate profits for their own benefit, which makes a singular financial evaluation indicator disadvantageous for the implementation of plans and may also harm the company's long-term interests. When designing the equity incentive plan, Midea Group can refer to industry development trends to reasonably set performance indicators. For example, as a leader in the home appliance industry, the attainability of indicators should be higher than the industry average, and the net profit growth rate and weighted average return on net assets should be set significantly higher than the industry average to serve as effective incentives.

6. Summary

At present, competition among various industries is becoming increasingly fierce. Chinese enterprises are faced with both opportunities and challenges. If they can overcome these challenges and seize the opportunities, they will experience rapid development. Therefore, it is particularly important to establish and improve a reasonable equity incentive mechanism for listed companies in China, which can mobilize their enthusiasm and creativity. Equity incentives can bring good effects to enterprises, but they may also lead to expanded risks or blind development by entrepreneurs, bringing various problems to the companies.

A comparative analysis of the equity incentive plans of Haier and Midea clearly shows that there are still many loopholes in the institutional framework of the incentive mechanisms launched by listed companies in China. For example, both companies use overly simplistic performance indicators when assessing performance, which do not comprehensively evaluate the performance of the incentivized individuals. Therefore, while providing sufficient incentives to incentivized individuals, companies must also set corresponding constraints to guide these individuals to have a strategic perspective and long-term thinking. Companies should also adopt targeted incentive models and constraint mechanisms based on different incentivized individuals. This paper suggests that Midea establish a reasonable equity incentive period based on its actual situation, strengthen internal controls, and diversify assessment indicators at multiple levels, while also providing reference value for corporate governance and enterprise development.

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