
Employee Stock Option Plans

Determining the Pool Size

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ESOP Pool: An Introduction

Portion of Equity for Employees

ESOP Pool represents portion of equity **reserved by a Company for issuance to employees**, directors and where permissible, advisors and consultants as well.

Percentage of outstanding share capital

It is often denoted as a percentage of the Company's outstanding share capital (on a fully diluted basis), such as an ESOP Pool of 10%.

ESOP Pool **appears as a separate line item** in the cap table.

Leads to dilution, has bearing on cap table

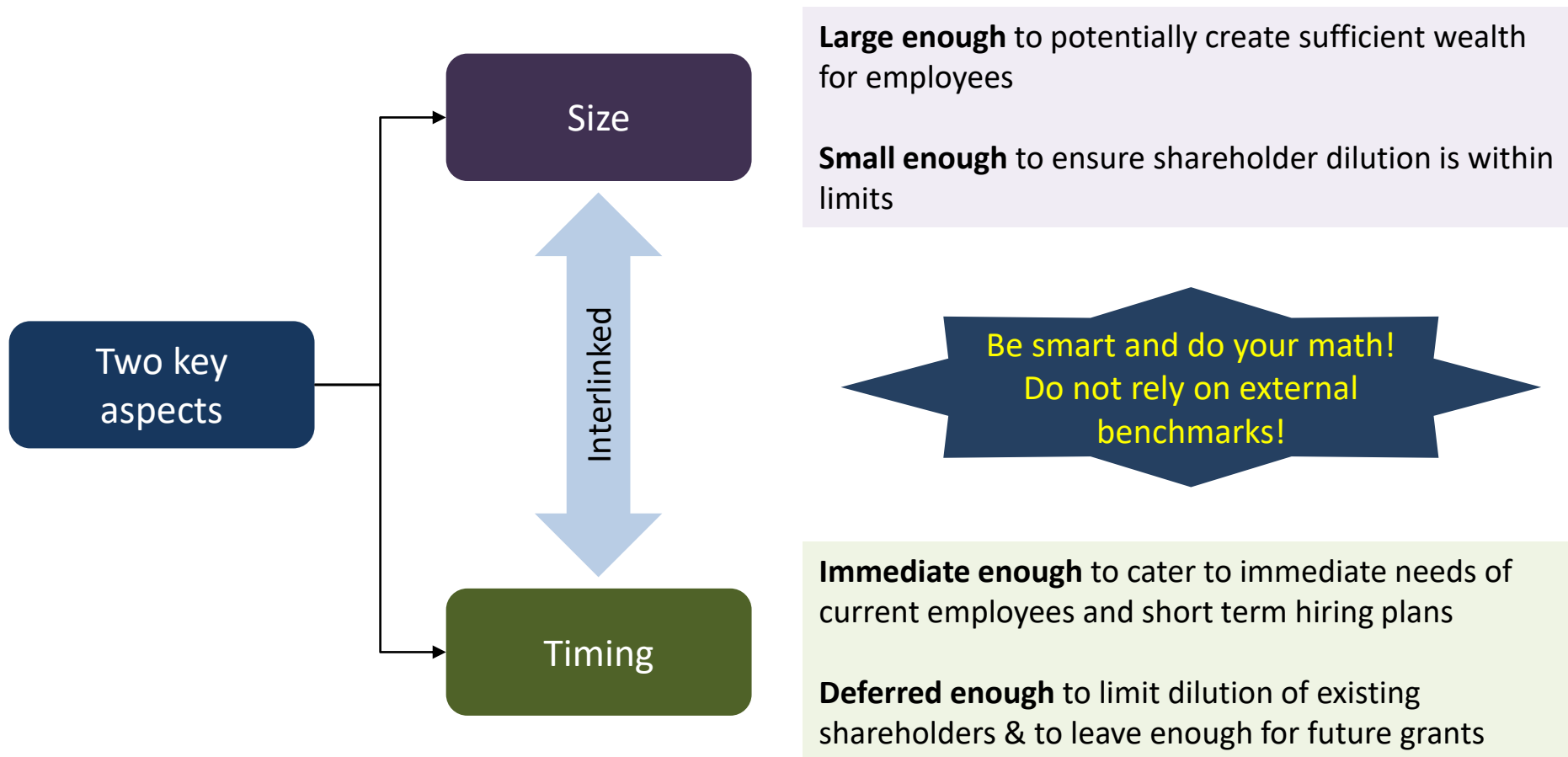
Creation of ESOP Pool leads to immediate **dilution in the percentage holding of existing shareholders**. Thus, it has a direct bearing on your cap table and shareholding pattern.

Getting it right is a balancing act!

Getting the **size of ESOP Pool right and managing the timing of consequent dilution** is therefore essential in striking the right balance between equity compensation for employees and efficient management of cap table.

Creation of ESOP/Equity Pool is a **pre-requisite for issuing ESOPs** or any other equity settled instrument e.g., RSUs and is thus a key decision in the process of issuance of ESOPs.

In this presentation, we explore the **aspects** that a Company should consider **in setting the size of its ESOP Pool as well as consider timing of dilution**.

ESOP Pool: **Aspects to consider**

Above aspects are discussed and explained in the subsequent slides.

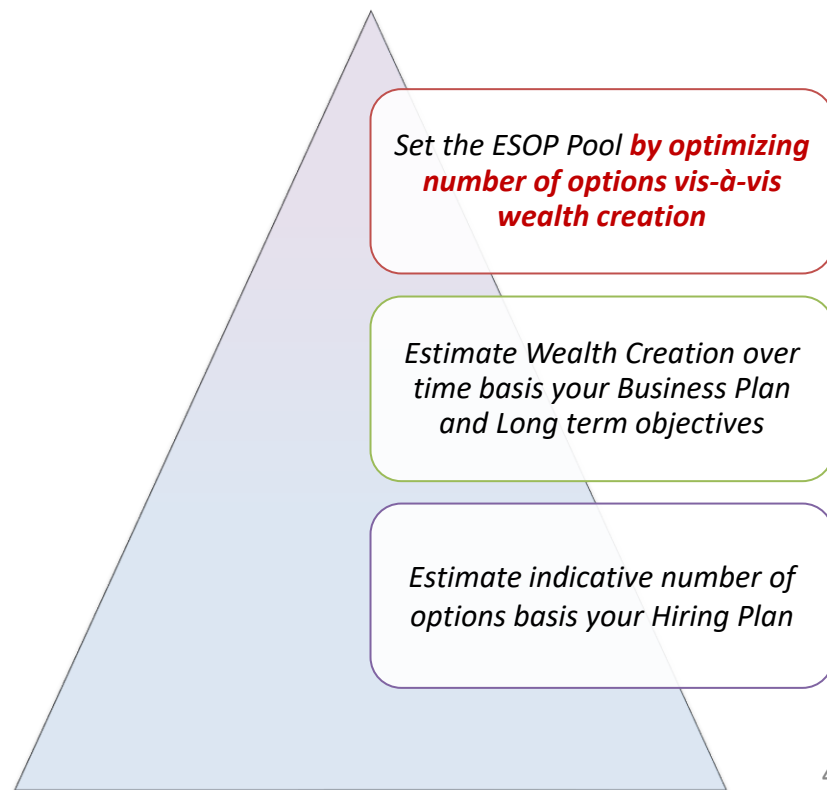
ESOP Pool Size: Practical approach to setting it

- Setting ESOP Pool size is a **board level decision**, involving various strategic factors, company's philosophy on equity compensation and often is a negotiation point between Investors and Founders.
- It is important that the organisation does not rely on the **broach benchmark percentages for ESOP Pool** (e.g. 10%), which may or may not be applicable and **may result in too much dilution too early**.
- Rather, **apply a bottoms-up approach** to assess a reasonable ESOP Pool range to support any board level decision.

Bottoms-up approach involves factoring:

- **Hiring Plans of Company**, budgeting separately for
 - C-Suite hires
 - Existing employees, especially those since inception
 - Future key hires over next 3 to 5 years
- **Business Plans of Company** and projecting estimated **Wealth Creation** for employees categories over time.
- **Optimizing** the overall estimated grants against expected level of wealth creation to set the overall ESOP Pool.

An abridged approach can be adopted for early stage companies, where information may not be readily available.



Timing: Understand impact of dilution over time

As a Company grows and raises further capital, the percentage of ESOP Pool and the underlying value for employees also evolves:

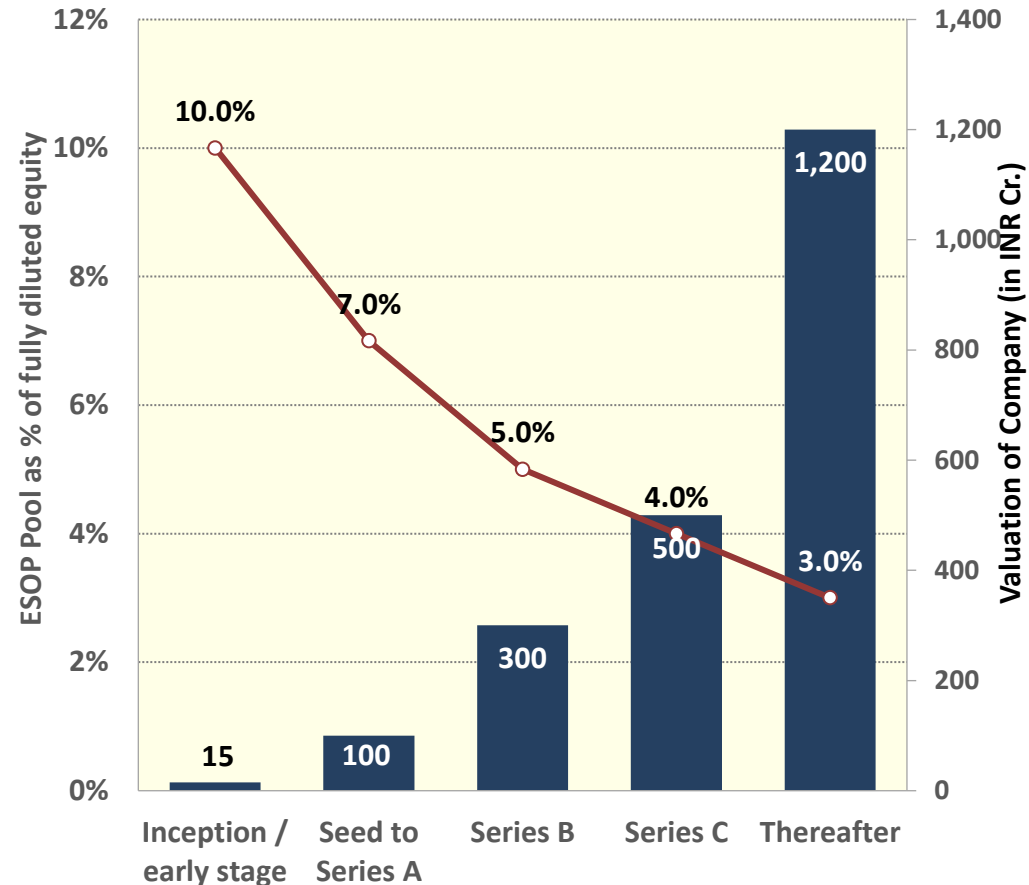
- **Impact of Dilution:** With each fund raise, the percentage of equity reserved under ESOP Pool reduces, unless the ESOP Pool is topped-up.

For instance, a 10% pool created at early stage may reduce to just 3% post Series C. On a standalone basis, the dilution may reduce the attractiveness of the Pool for the employees.

- **Impact of Valuation:** Whilst the percentage allocated to the pool reduces, the value of the Company grows and consequently, the underlying value of ESOP Pool also increases.

Building the above example, assume the Company grows from INR 15 Cr to 1200 Cr over this period. The corresponding value of ESOP Pool, despite the dilution, would increase from INR 1.5 Cr. To INR 36 Cr.

ESOP Pool: How it grows it Cap Table?



Viewing valuation and dilution in conjunction helps assess whether the overall equity compensation package is still attractive for employees.

Timing: Dilute slow to protect Founders

Along with size, organization needs to decide whether the full ESOP Pool should be created right at start, or the desired outcome be reached overtime in a phased manner.

Example below helps illustrate this point:

Particulars	Inception / early stage	Seed to Series A	Series B	Series C	Thereafter
Expected Valuation & Cap Table of Company BEFORE FACTORING ESOPS					
<i>Expected Valuation</i>	15	100	300	700	1200
<i>Expected additional dilution</i>	0%	30%	15%	10%	10%
<i>Investor(s) Holding</i>	0.0%	30.0%	40.5%	46.5%	51.8%
Founder Holding	100.0%	70.0%	59.5%	53.6%	48.2%
Approach I: FULL ESOP POOL CREATED UPFRONT for same level of dilution in each round					
<i>Investor(s) Holding</i>	0.0%	30.0%	40.5%	46.5%	51.8%
Founder Holding	85.0%	59.6%	50.6%	45.5%	41.0%
<i>ESOP Pool</i>	15.0%	10.5%	8.9%	8.0%	7.2%
<i>ESOP Pool (in INR Cr.)</i>	2	11	27	56	87
Approach II: ESOP POOL INCREASED IN A PHASED MANNER for same level of dilution in each round					
<i>Investor(s) Holding</i>	0.0%	29.2%	39.0%	44.6%	49.4%
Founder Holding	95.0%	64.8%	54.0%	47.9%	42.6%
<i>ESOP Pool</i>	5.0%	6.0%	7.0%	7.5%	8.0%
<i>ESOP Pool (in INR Cr.)</i>	1	6	21	52	96

Approach I results in Founder diluting alone for rewarding employees with equity compensation whilst Approach II results in same overall value of ESOP Pool over time with splitting the dilution between both Founders and Investors. All else being equal, Approach II should be chosen.

Conclusion

- Size and timing of ESOP Pool are important decisions in creation of an ESOP scheme and on-going management of it.
- Many organizations take an abstract approach and go with a benchmark or rounded number for the size of ESOP pool. What compounds the issue is that such a pool is created immediately and not over a period of time.
- This not only results in a more than required dilution but also negatively impacts the interests of initial / founding shareholders / promoters.
- Like always, we recommend that the organizations should **move away from templated approach and do their math and decide on the size and timing of ESOP pool** based on their immediate and future needs.
- Decisions around ESOP pool are **essentially balancing acts** and should be taken only after consideration of organization specific factors.



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