Share-based Compensation
More than just ESOPs!

Veritas

Actuaries and Consultants
Benefits - ESOPs and others
Design | Valuations | Reporting

Vichitra Malhotra FIAI, FIA
Founder and Consulting Actuary
v.malhotra@veritas-india.com
www.veritas-india.com

Introduction

- Share-based compensation plans are a valued, beneficial and versatile employee benefit tool for all kinds of organizations, whether they are in the early-stages of development (startups) or are established mid or large sized private and public enterprises.

- Such plans are used by organizations to attract new talent, to motivate employees to achieve performance milestones as well as to retain talented employees.

- Many people think that share-based compensation plans means just ESOPs. However, there is a whole **gamut of options within share-based compensation plans**, and one needs to understand each to see which type is most suitable for your organization.

- The one that's the best fit for your organization will depend on its unique circumstances and on what it hopes to achieve. Stock-based compensation plans can also be (or rather need to be) custom tailored to fit the needs and goals of your organization.

- When structured and utilized properly, the outcomes can work very favorable for both employer and employee. However, when not structured properly and not implemented in a thought through manner, they can be a trap for the unwary.

- This presentation gives an **overview of various types of share-based compensation plans**, covering unique benefits and challenges that they entail.

The *CHOICES* Available!

Veritas

Employee Stock Option Plan

Both plans incentivize if underlying share price moves above certain level (exercise price)

SARs / Phantom Units

Higher wealth creation for given charge to P&L. However, there is possibility of no gain! Suitable for companies expecting significant growth e.g. start ups.

Risk vs Return

Equity vs Cash Settled

Risk vs Return

Guaranteed benefit although lower benefit for given charge to P&L! Suitable for mature organizations expecting stable growth e.g. listed companies.

Restricted Stock
(RS or RSU - equity settled)

Both plans incentivize irrespective of movement in underlying share price

RSUs
(cash settled)

Employee Stock Purchase Plans

Employee Stock Ownership Plans

The ***CHOICES*** *Available!*

Veritas

Equity Settled	Cash Settled
Employee Stock Option Plans (ESOPs)	**Stock Appreciation Rights (SARs)**
Restricted Stock Units	Phantom Stocks
Employee Stock Purchase Plan	Restricted Stock Units (Cash Settled)
Share Appreciation Rights (Equity Settled)	

- Equity settled schemes are **dilutive in nature** whilst cash settled are **anti-dilutive**
- Each scheme varies in its **risk-return profile** and hence the **objective that it helps fulfil.** ESOPs and SARs (highlighted above) are the two most commonly used schemes.
- Companies should choose that plan **whose risk-return profile matches with that of the Company**.

Working, relevance and merits of each of the share based schemes is covered in subsequent slides.

Employee Stock Option Plans ***(ESOPs)***

Employee Stock Option Plans (ESOPs)

ESOPs give employees the option / right (but not an obligation) to buy shares of the Company (i.e. '**Exercise**' the option) during a defined future period ('**Exercise Period**') at a specified price ('**Exercise Price**') determined at the time of grant of ESOPs. Employees earn this option / right by first fulfilling certain conditions over a period of time ('**Vesting Conditions**').

Grant Date → **Vesting Date** → **Expiry Date**

Vesting Period	Exercise Period
Period to satisfy **vesting conditions** and earn the option to buy shares	Period to exercise the option and buy the shares of the Company. Exercise may also be **subject to certain conditions**

Vesting Conditions	Exercise Price	Exercise Conditions
• Can be time based or performance based or both. Can also be bullet as well as graded. • For C-Suite / senior employees, **vesting linked with business targets** advisable. • Vesting period must be determined with reference to business plan of Company.	• Can be lower, higher or equal to the share price as on grant date. • Must be determined by reference to **expected growth trajectory of share price.** • Compensation philosophy of Company also influences level of Exercise Price.	• Consider **linking exercise with happening of corporate transaction** or Liquidity Events. • Adopt conditions which reduce cashflow strain for employees. • Ensure easier cap table management in setting exercise related rules.

Employee Stock Option Plans (ESOPs)

Suitability / Benefits of ESOPs

- **Cash conservation**: Effective way of compensating for lower salaries and relieve pressure on cash flow.
- Effective way for start-ups **to recruit / retain employees** on a broad-based basis.
- Potential for **significant wealth creation** for Employees.
- **Stable P&L Cost year on year**: Can be assessed as part of designing the scheme.
- **Increased sense of 'ownership'** and association with the enterprise.

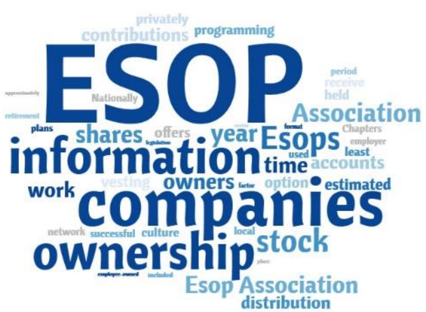
Challenges with ESOPs

- **Dilutive in nature**: As more shares are issued, each share you own becomes a smaller percentage of the company.
- In India, **restrictions exist on issuing ESOPs** to Consultants and Advisors.
- When used as broad-based tool, Employees may feel they have **no control over the share price outcome.**
- In Private Companies, ESOPs may **create cash-flow strain** for employees, unless exercise rules are designed efficiently.

ESOPs are the most used and understood form of equity compensation. Used rightly, ESOPs can not only empower the employees to be partners in the growth of the organization, thereby boasting employee morale, but also help companies in conserving immediate cash outlays.

ESOPs are typically **more relevant in early stages** of an organization **or when** the organization is **expecting a significant increase in the share price**.

To get the issuance of ESOPs right, don't just treat it as a creation of scheme document. Determine the important ingredients of the scheme by **reference to business plan and compensation philosophy** of the organisation.



Stock Appreciation Rights (SARs) Or Phantom Units

SARs / Phantom Stocks (Cash Settled)

Veritas

Cash Settled Stock appreciation rights (SARs) offer cash payments linked to the company's stock price during a predetermined period. SARs are profitable for employees when the company's stock price rises, which makes them similar to ESOPs. However, employees do not have to pay the exercise price with SARs. Instead, they receive the sum of the increase in cash.

Phantom Stock are a variation of Cash Settled SARs, often issued at Strike Price of ZERO!

Grant Date — **Vesting Date** — **Expiry Date**

Vesting Period	**Settlement Period**
Period to satisfy **vesting conditions** and earn the SARs	Period to settle the Vested SARs

Vesting Conditions	Strike Price	Settlement
• Usually tied with service along with performance targets of the Company, similar to ESOPs • Vesting period must be determined with reference to business plan of Company. • Immediate Vesting Possible! Graded as well as bullet vesting possible.	• Works similar to Exercise Price in case of ESOPs • Linkage with Company’s growth trajectory and Compensation philosophy needed	• Unlike ESOPs, no cash flow strain for employees as they directly receive post tax benefit in cash. • Can be fixed date or linked with Liquidity Event • May cause cash flow strain on the entity, unless linked to liquidity event

SARs / Phantom Stocks (Cash Settled)

Suitability / Benefits of ESOPs	Challenges with ESOPs
• **Non-dilutive in nature,** does not impact your Cap Table**.** • **Flexibility:** Big advantage of cash settled schemes is flexibility, given lesser restrictions than in case of ESOPs. • Unlike ESOPs, they **can be offered to Consultants and Advisors (even Promoters)** • **No cash flow strain** for Employees (No Exercise price payment involved) • Works well for subsidiaries where Parent is Listed outside India • Can be **structured as rolling performance-based schemes** in lieu of bonuses	• **P&L Volatility:** Provisions are marked to market (MTM) in case of cash settled schemes, which brings in volatility to P&L. Proper Designing can help optimize and mange this. • **Gearing:** Cash settled schemes are treated as liability from accounting perspective, hence increasing gearing. • **Cash Strain:** Can cause significant cash outflows for the organization, unless linked to liquidity event • **Listed Companies may need to comply** with Stock Exchange requirements for such schemes. • Similar to ESOPs, if the company's stock does not appreciate vis-à-vis Strike Price, **SARs may expire worthless**.

SARs are implemented globally as a means of incentivizing employees. SARs are steadily being recognized in India as an effective mechanism of stock-based compensation and, more notably, as a viable alternative to ESOPs. They offer a lot of flexibility to Companies and with the right designing, the P&L volatility can be better managed.

SARs are typically **more relevant in for Consultants / Advisors** or in case of organization **not looking to dilute equity** or **in case of subsidiaries** when holding company is situated outside of India.

Restricted Stock Units ***(RSUs)***

Restricted Stock Units (RSUs)

Veritas

Restricted Stock Units (RSUs) gives the holders a commitment to receive:

- a certain number of shares (in case of equity settled scheme) or
- value of a certain number of shares (in case of cash settled schemes)

in the future without requiring payment upfront. These units are generally subject to vesting periods and condition (Vesting Conditions).

Grant Date

Vesting date
(Employee Received Shares)

Vesting period

Period to satisfy **vesting conditions** and receives the shares

Employee may sell shares post vesting.

Restrictions on selling can be imposed

Vesting Conditions	Exercise Price	Settlement
• Mostly issued with time / service-based conditions • Besides time-based conditions, RSUs are locked behind performance-based conditions, as shares are being given free of cost. • Vesting can be graded or bullet.	• RSUs don't have an "exercise price", though they may be issued at face value due to legal constraints. • Employees receive shares directly on Vesting. Tax may be applicable at that time.	• No cash flow strain for employees as they directly receive the shares though tax may be payable. • Can be fixed date or linked with Liquidity Event • Can be settled by issuance of fresh shares or purchase of existing shares

Restricted Stock Units (RSUs)

Suitability / Benefits of RSUs

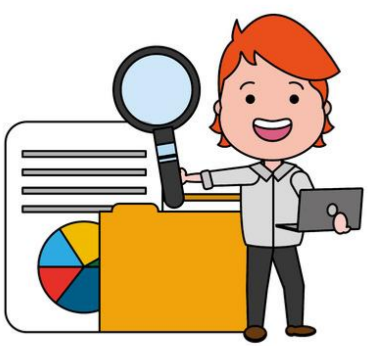
- **Never Under Water**: Offer guaranteed return as Employee receives full value of a stock equivalent for free (or at face value).
- Listed **Companies use this tool to protect employees** from market movements, which may render ESOPs worthless.
- Generally issued with **strong performance-based vesting** conditions, directly aligning with Company's goals.
- Offers replacement for cash component, helping companies **conserve cash.**

Challenges with RSUs

- Employee may have to **pay tax** at time of receiving the shares, irrespective of when he/she sells the shares.
- May **not work as broad-based compensation** tool, especially in Private Companies.
- **If value of stock doesn't appreciate** as expected (or falls), overall benefit to employees may be limited given RSU grants tend to be smaller in size compared to ESOPs.

Restricted stock units have grown in their importance in recent years. Employees find it easier to appreciate a restricted stock grant because its monetary value in their pocket (i.e. the company's stock price) is easier to figure out than a stock option's value.

Although stock options continue as the primary long-term incentive award to attract, motivate, and retain key employees and executives, the role of RSUs is growing. **RSU is widely used by Listed Companies and by companies not expecting significant share price appreciation (compared to start ups)** and forms important part of C-Suite Compensation both in India and outside.



Employee Stock Purchase Plans **(ESPPs)**

Employee Stock Purchase Plan (ESPP)

Veritas

ESPP enables employees to purchase shares of the Company at specified date(s) ("**PURCHASE DATE**"), usually at a **DISCOUNTED PRICE**. Employees accumulate the funds to purchase shares by contributing a fixed percentage of their Salary for fixed period ("**OFFERING PERIOD**").

Enrolment Date	Offering / Grant Date (salary deductions begins)	Purchase Date

Enrolment period	Offering Period
Period to of time where you can choose to either enroll or deny entry into the purchase plan	Period during which the payroll deductions are made

Offering Period	Discounted Price	Purchase Period
• Companies can choose the length of offering period • Usually, 6 months or in multiple of 6 months • Payroll deductions accumulate between the offering date and the purchase date	• Look back provisions are common, where purchase price is lower of market price on two dates • Companies offer further discount on purchase price • The discount can be as much as 15% in some cases	• The purchase period is a subset of the offering period that generally occurs every six months • The purchase date is the final day of the purchasing period • During this period, the payroll contributions are used to buy organizational stocks

Employee Stock Purchase Plan (ESPP)

Suitability / Benefits of ESPP	Challenges with ESPP
• Enables Companies to offer a regular saving scheme to Employees to buy Company's share at discounted price. • Works well as employee benefit scheme for Listed companies as well as Companies planning to list in short period of time. • Increase in share price of Company overtime increases overall employee compensation / benefits. • Greater flexibility to employees as they selects exactly how much they want to contribute—anywhere from 2% to 15% of their eligible compensation—after taxes.	• Administratively complex and requires strong governance to ensure salary contributions / discounts etc. are working appropriately. • Look back provisions may make accounting complex. • Employees may not see advantage of scheme in short run or may view salary contributions negatively. • Ensuring the ESPP follows security and tax law guidelines can be challenging.

ESPPs can provide employees with a regular means of increasing their income over time, especially when the company's stock is in an uptrend. The plan's look-back feature allows you to buy shares at either the market price on the offering date or the purchase date, whichever is lower.

These plans are not very common in India as of now. They are **more relevant in case of listed companies,** particularly listed companies with well traded and liquid shares. This instrument is not relevant in case of start ups or companies that are not listed or are not going to be listed in the near future.

So which one do you choose?

- There are various kinds of share-based compensation plans and it is important to **understand the working, benefits as well as challenges of each** before choosing the 'right' one for your organization.

- The key to getting it right is to ensure your share-based compensation plan matches the **risk and reward profile** of your organization.

- **Get it right** and the share-based compensation plan will help in creating wealth for employees with a reasonable charge to income statement, which is aligned to growth in revenue and profitability.

- **Get it wrong** and the share-based compensation plan will be an unnecessary burden on your financial performance and may create various challenges for both the employer and the employees.

- Finally, remember that **choosing the right plan is only the beginning**. To get it fully right, you must choose the right plan provisions – whether they relate to vesting conditions or settlement rules or treatment of exiting employees.

Remember, ESOPs is not the right answer always!

Contact Us

In case of any queries, please contact:

Vichitra Malhotra
Founder and Consulting Actuary
Email : v.malhotra@veritas-india.com
Phone : +91-9372876627

Our Address

Veritas Actuaries and Consultants
DLH Park, Level 17th,
S V Road, Near Goregaon Flyover,
Goregaon West,
Mumbai - 400064