Designing Successful ESOP Program

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Introduction

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- Design and implementation of Employee Stock Option Plans (ESOPs) is **more than just creating a scheme document**. It is the process of setting the whole framework on how the ESOP Program of your Company will run.

- A well thought out framework goes a long way in making ESOPs an effective compensation tool, than just a mere tick-box exercise.

- In fact, Companies with an objective and well set out framework find it easier to explain the value of ESOPs to their employees both at hiring stage as well as part of on-going employee engagement.

- However, we often notice that **Companies focus only on the detailed documentation** around creation of such schemes and in the process **lose sight of the decisions that are most crucial** to the successful design and implementation of the ESOP Scheme.

- This presentation highlights the **key decisions and considerations** involved in designing a successful ESOP Program.

- Whether you are designing and implementing a new ESOP scheme or modifying an existing one or making further grants under an existing scheme, **the considerations listed in this presentation remain relevant**.

- Whilst we do not claim this to be an exhaustive list, we believe careful consideration of these aspects will enable you to get your ESOP Scheme right more often than not!

Design Considerations: **5 Key Areas**

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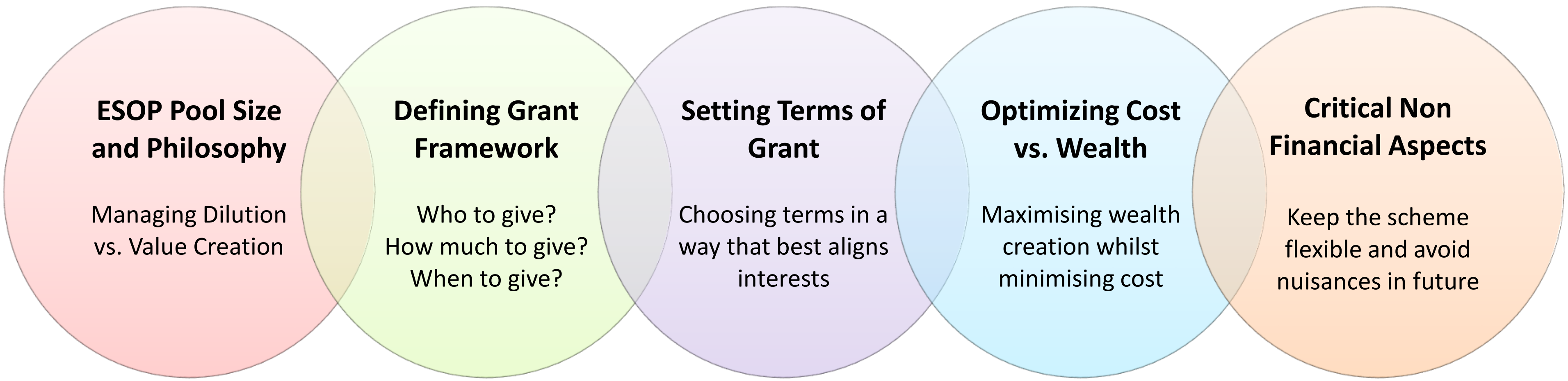
Designing ESOPs requires consideration of many factors and the need to strike a balance between various conflicting objectives.

Key considerations / aspects to be considered are listed below:

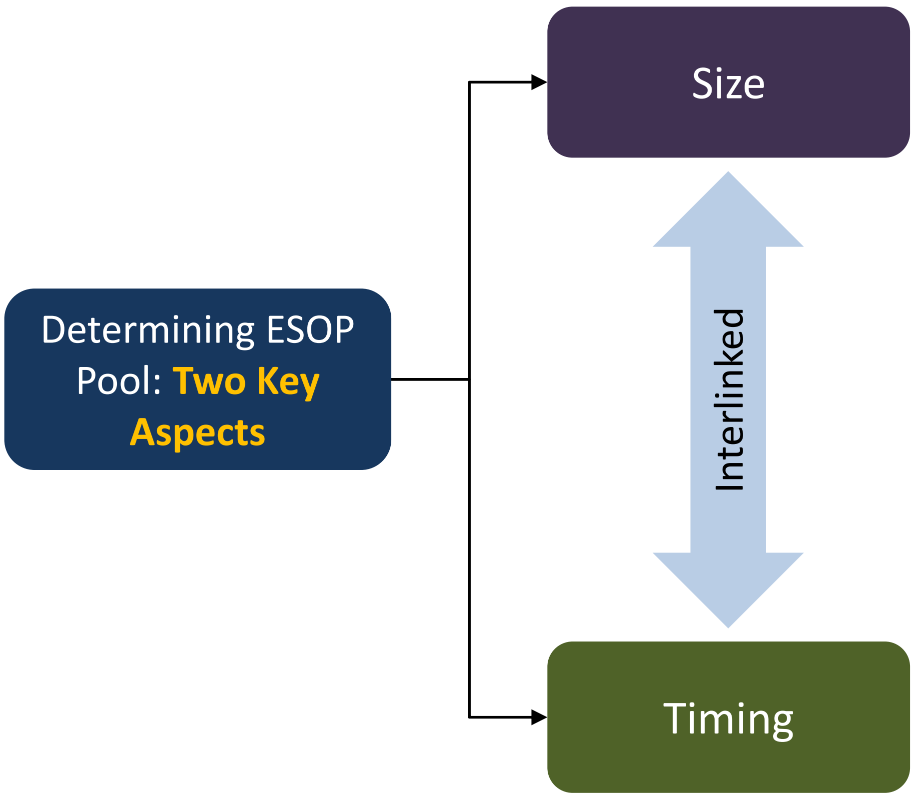


Decision on each of these factors in turn requires understanding the financial implications for the company under different scenarios and alternative design choices, incorporating factors and variables unique to each organisation.

The above decisions are discussed further in subsequent slides.

ESOP Pool Size and Philosophy (1)

ESOP Pool represents the **portion of equity reserved** for employees, directors and where permissible, consultants and advisors of a Company. Creation of ESOP Pool is a strategic decision as it **immediately dilutes the percentage holding** of the existing shareholders.



Large enough to potentially create sufficient wealth for employees

Small enough to ensure shareholder dilution is within limits

Need to be smart and get the math right! Do not rely on external benchmarks!

Immediate enough to cater to immediate needs of current employees and grants

Deferred enough to limit dilution of existing shareholders & to leave enough for future grants

We always recommend Founders to avoid using broad benchmarks and instead assess the size of the Pool needed to **strike a balance between managing their own dilution overtime and the need to offer competitive equity compensation** to retain / attract the right talent. Key considerations in this regard are mentioned on next slide.

ESOP Pool Size and Philosophy (2)

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Key considerations in size and timing related decisions with regards to ESOP Pool:

- **Time frame for which the current ESOP Pool should suffice**
  - ✓ Avoid setting a pool with very long term time horizon. Instead, focus on the pool needed for next 12-18 months or until your next funding round.
  - ✓ You can always top-up / expand the pool as you grow and **manage dilution impact between all shareholders (including future investors)** than just letting the Founder taking the full hit.
- **Expected Employee Coverage**
  - ✓ Factor the founding team, future hires over the chosen time frame and assess how many people are expected to be covered by the current Pool.
  - ✓ Estimate of future hires and their compensation should have linkage to business plan of the Company.
- **Growth in Value of ESOP Pool over time**
  - ✓ Assess the growth expected in the value of your ESOP Pool over the next 4 to 5 years. This is linked to the expected movement in the share price of the Company.
  - ✓ Small pool may also suffice if the Company expects significant growth overtime.

Grant Framework for Employee Level Grants (1)

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Grant Framework sets the **ESOP Policy tone** for the Company by establishing contours for:

Employee Level Grants

Who?

- Eligibility criteria – broad based vs selective?
- Senior Management or founding team only?
- Middle management employees to be considered?
- Any past tenure or performance criteria?

How?

- Methodology for grants basis compensation philosophy
  - CTC Replacement
  - CTC Replacement using future wealth
  - CTC Multiple approach

When?

- Triggers for future grants
- Promotions, milestones, etc
- Criteria for grants to new joinees, if needed

As organizations grow and hire more and more people, it becomes important to standardize the process of granting ESOPs and avoiding last minute surprises. It also helps **embed the ESOP Program** as part of the overall compensation.

A well thought out framework helps employees view the **ESOP Program as a real long term wealth program** wherein they can gain by staying longer with the Company than as a piece of paper offered to them once at the time hiring!

Grant Framework for Employee Level Grants (2)

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Key considerations in determining grant framework for employee level grants include:

- **Setting Participation rules** such as minimum service period, grade, performance rating etc.

- **Choosing Employee level Grant Method**

  This can be based on the Company's compensation philosophy and growth stage. Widely used methods include:

  - **Replacing reduction in CTC** (compared to market levels) with same intrinsic value of ESOPs.

  - **Granting ESOPs** with **future estimated intrinsic value** being a multiple (say 3 to 4 times) of immediate reduction in CTC or of the full immediate CTC.

  - **Granting ESOPs** equivalent to a **multiple of full CTC of employees**, with multiples varying by grade, tenure etc. and back-solved for Company's plan projections.

- **Rules for future grants**, which could include rules for annual grants or granting only on promotion, out-standing performance or long service with Company.

Terms of Grant (1)

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The key terms of grant that need to be determined and the options available for each are given below:

Terms of Grant

Vesting Criteria

- Performance or service based or both
- Graded or bullet vesting
- Uniform, front-ended, back-ended
- Performance criteria recommended for senior employees
- Distinction for different divisions / departments

Exercise Price

- Current share price vis-à-vis discount to be offered
- Impact on cost to company and wealth creation

Exercise Conditions

- Length of exercise period
- Linkage or not to happening of corporate event
- Flexibility to Board for buy back (including implications)
- Flexibilities to board to enable early exits / liquidity

Considerations with regards to above are given in the following slide.

Terms of Grant (2)

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Vesting criteria is the set of requirements (service or performance based) that an employee must fulfil to earn the rights attaching with ESOPs.

Choosing the right vesting criteria for different category of employees involves deciding on:

- Length of vesting period
- Type of vesting - Graded (front ended or back ended) versus bullet vesting?
- Simple service based vesting or linked to individual / company performance milestones.

Exercise price on the other hand denotes the price the employee will eventually pay when buying ESOPs.

ESOPs can be issued **at current market price**, **discount** to current market price (as low as face value) or at **premium** to current market price

Exercise Price **directly influences the level of wealth creation for employees** and help define the level of upside / downside risk shared with employees.

Key Considerations

- **Balance quantum** of equity being granted vis-à-vis the vesting requirements imposed.
- Choose criteria which is **simple and objective** to monitor / administer yet **creates incentive** for employees to work hard for the Company.
- Avoid criteria which creates complacency amongst employees.
- **Set Exercise Price** based on growth stage and compensation offered.
  - **Issuing at market price:** Employees share both upside and downside
  - **Issuing at discount:** Employees gain immediate wealth in addition to share in future upside
  - **Issuing at deep discount:** Employees immune to any fall in share price
  - **Issuing at premium:** Creating incentive to drive share price above a level to earn the upside

Cost vs Wealth Creation for Employees

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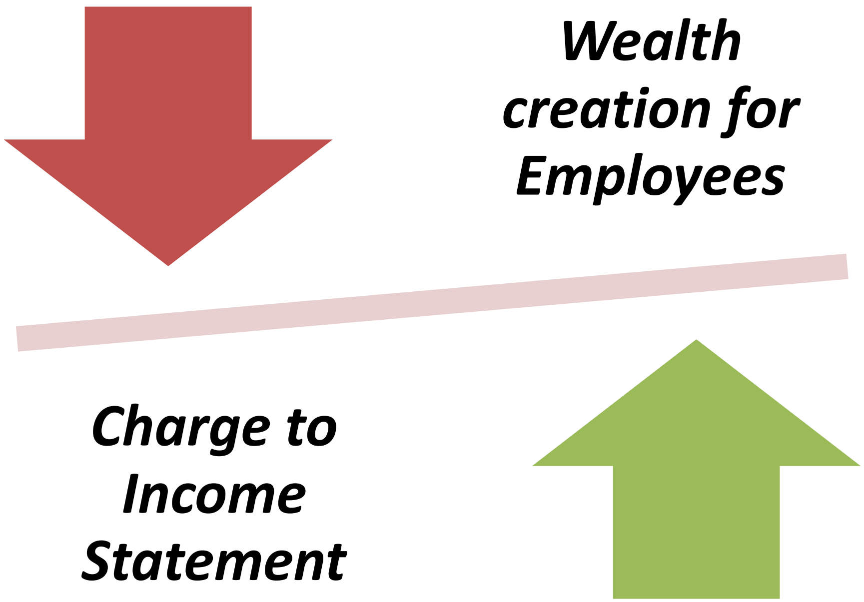
Designing ESOPs is a **balancing act** between managing the Cost to the Company and estimated wealth creation for employees. This step brings together all the chosen design terms to assess the impact on P&L vis-à-vis wealth creation for employees.



ESOPs create a **P&L charge**, which **should be managed**

Whilst Investors may appreciate that this charge is possibly replacing the cash compensation for employees, its important that the cost is managed and not unreasonably high as it depresses reported profits and consequently valuations.

Try to **maximize wealth creation** for employees

Companies should assess the wealth creation at end of Vesting period under different scenarios of business plan to choose terms which best meet the desired employee outcomes.

Each design decision (i.e. exercise price, number of ESOPs granted, vesting criteria etc.) **impacts either P&L cost or wealth creation or both, thus making the design process iterative**.

Its important to assess outcomes in advance and make informed decisions.

Other Critical Non-Financial Aspects

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Minimising Cash-flow strain for Employees	• Choose scheme rules which aim to **match cash inflow and cash outflow** for employees • Consider **linking exercise only with Liquidity Event**
How will your cap-table look over time?	• View of **level of dilution expected over time** • Consider preference for having **individual employees on cap-table** as shareholders?
Treatment of vested options of ex-employees	• Consider what happens to **vested options of employees if they leave the Company** • **Compulsory exercise of options** in a short period; or • Allowing employees to **continue holding vested options** post leaving
Other Scheme Rules	• Ensuring **flexibility to Board** to decide exact terms of Exercise at a later date depending upon how the Company grows • Ensuring flexibility to **accelerate vesting of key employees**, if needed • Not compromising on the **tightness of the scheme rules to avoid mis-interpretation** by employees

About KPAC

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Research driven

- KPAC is a research driven actuarial consulting firm **providing actuarial and consulting services** since 2013.
- Empowered by **creative thinking and research-oriented approach**, we offer solutions that go beyond ‘just-compliance’.

Going Beyond Compliance

- KPAC delivers customised solutions with use of data analytics and continuous research, which helps clients in **optimum recognition of liability and better management of expenses**.
- KPAC also helps clients in reducing volatility of expenses through ALM, better planning and budgeting, etc.

Strong Clientele

- Driven by passion to exceed expectation every single time, KPAC is providing valuation and consulting services to **more than 500 clients** (including large corporate houses and MNCs)
- KPAC’s **engagements spread across all parts of India** and in various other countries like USA, Australia, UK, Middle East, SAARC countries.

Strong Team

- KPAC has a **strong team of consultants** and domain experts, who focus on delivering excellence each time.
- Each consultant has experience of handling assignments of large corporate houses and complicated employee benefits.

Contact Us

Your employees are worth more than a 'cut-copy-paste' scheme taken off the net. Invest in creating the right scheme which will truly align interests and motivate your employees.

Please hire experts who understand all that goes into creating a stock ownership plan and save yourself the hassle, time, and unwarranted risk of trying to figure this out yourself.

Reach out in case you require any further information:

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