ESOPs in Private Companies

Pitfalls to avoid at each stage

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Introduction

- Employee Stock Option Plans (ESOPs) are the most widely used form of Equity Compensation.

- Driven by the need to conserve capital in times of pandemic, coupled with high attrition and the need to attract good talent, more and more companies are adopting equity-based compensation to offer attractive packages and remain relevant.

- Adopting equity-based compensation is a board level decision requiring consideration of impact on Company's capital structure, compensation philosophy and on-going financials.

- Given the strategic importance of such plans, its **important that Companies get these right from the start**!

- This presentation highlights the **key pitfalls that any Private Company implementing ESOPs should be wary of** at the Design Stage, Implementation Stage and Post Roll-out stage.

- Whilst these have primarily been discussed from perspective of implementing ESOPs, they may well be relevant for any other share-based structure as well.

Pitfalls to avoid: **An Overview**

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Design Stage

1. Diluting Too Much, Too Soon
2. Granting only service linked ESOPs to Senior Hires
3. Undermining Importance of P&L charge of ESOPs

Implementation Stage

4. Creating Cash-flow strain for Employees
5. Lack of flexibility to Board in case of Liquidity Event
6. Not enabling Ex-employees to share in value created

Post Implementation

7. Not enough employee Communication
8. Faltering on accounting and Board Disclosures
9. Lack of ESOP framework beyond first grant

Above points are discussed in subsequent slides..

Pitfalls to avoid: Design Stage

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Diluting too much, too soon

Determining **ESOP Pool size** is a key decision in launch of ESOP scheme.

Setting ESOP pool size at a high level at the beginning results in **Investors diluting too much at an early stage.**

Setting ESOP pool size at a low level at the beginning may result in **inadequate wealth creation** for the employees.

Doing the math and setting ESOP Pool at the level that is **required till your next funding round basis your business plan** helps manage Investor dilution yet offering sufficient pool to attract and retain the right talent.

Granting only service linked ESOPs to senior hires

Attracting Senior / Key Hires requires making **sizeable grants** to offer competitive packages.

With standard service based vesting periods of 4 to 5 years, Founders run **risk of senior team leaving with sizeable equity** before Company achieves its targets.

Performance based vesting linked to **Company milestones as well as Employee level milestones** helps ensure equity is being rightfully earned!

Performance based vesting criteria could be linked to sales targets, profit targets, return of capital employed or other such business metrics. Combination of such factors can also be used.

Undermining importance of P&L charge on ESOPs

Often, Companies do not consider the impact on the P&L when granting ESOPs, only to later realize the hit to their accounts.

ESOPs **result in P&L charge** and impact your **bottom-line**.

Optimizing P&L charge vis-à-vis expected wealth creation for employees helps offer a stable ESOP grant framework, striking balance between charge to P&L and wealth creation for employees.

Various combinations of vesting criteria, exercise price, etc. can be considered, which could result in different charges to Income Statement for similar levels of wealth creation.

Pitfalls to avoid: Implementation Stage

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Creating cash-flow strain for employees

Time bound Exercise Rules require employees to Exercise the ESOPs within a given period, else their options lapse. This results in the employees having to pay exercise price plus tax. However, in case of private companies, there is **often no visibility of whether and when the employees will be able to sell the shares acquired through exercise of ESOPs**.

Lack of properly thought through exercise conditions could thus diminish value of Scheme to the Employees.

Linking Exercise to Liquidity Event as an alternative reduces mismatch between cash outflow and inflow for Employees. It also helps manage Cap Table more efficiently.

Lack of flexibility to Board in case of Liquidity Event

Often companies create Schemes that **do not give adequate flexibility to the Board to cater to varied corporate transactions**, which may arise in reality.

Prescriptive / water-tight rules for treatment of options on happening of Liquidity Event often fall flat as exact nature / terms of future deals can never be predicted in advance.

ESOP Scheme should **focus on creating the right governance structure,** which both empowers Board to protect employees' interests by having clauses such as accelerated vesting option as well as gives them flexibility to define the terms / treatment of ESOPs on happening of such events.

Not enabling ex-employees to share in value created

Many good employees will leave before any Liquidity Event happens. But that should not hold them from participating in the value they helped create!

Standard rules giving a period of 3 to 6 months to exercise vested options do just that!

Companies need to go beyond and consider alternatives such as allowing them to hold vested options post leaving, allowing longer exercise periods or cashing part of their vested options.

Of course, adequate clauses can be added to protect the interests of the Company in the event an employee joins a competitor.

Pitfalls to avoid: **Post Implementation**

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Not communicating enough with employees

One-off communication at time of grant is not enough to keep employees motivated and see value of ESOPs.

Companies need to engage regularly and communicate how the value of their ESOPs has changed and how / when they can look to gain from these.

Faltering on accounting and board disclosures

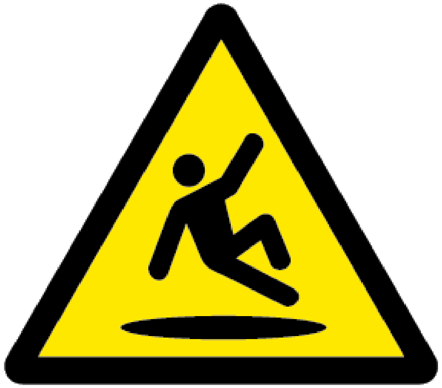
Many companies have made grants in past but never accounted for these or those which have promised grants but don't have a scheme in place.

Avoid these non-compliance pitfalls and ensure you know right from start all the activities that need to be done on an on-going basis.

Lack of ESOP framework beyond first grant

Linked to the first pitfall is the need for clear ESOP Framework going beyond your first grant.

Your framework needs to be thought through from various aspects – how frequently you will make grants, how will you decide who gets the grant and how much, how your exercise price philosophy will change etc.



Conclusion

- The concept of ESOP goes much beyond being a tool of monetary incentivization.
- An efficient ESOP scheme captures and enhances the employee loyalty. Moreover, it retains company legacy and independence.
- Before you decide to implement an ESOP scheme at your company, you must **understand the complexities associated** with the ESOP transaction and implementation process.
- The right steps now can make a big difference later, especially when it comes to a successful implementation.

About KPAC

About KPAC

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.

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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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