



## **ESOP Strategy:**

Why the same should be in sync with the **Business Plan** and **Appraisal Cycle** of the Company?

K P A C

# Introduction

- Employee Stock Option Plans (ESOPs\*) have emerged as the **NEW AGE compensation tool**.
- Record level of funding and ESOP buybacks in 2021 have not only proven stock compensation to be the right medium for long term wealth creation for employees but created a FOMO\*\* amongst them who don't receive these benefits.
- Employees not only expect but demand ESOPs, and Founders can no longer ignore stock compensation.
- In a bid to attract and retain resources, we see many founders take a **reactive approach to stock compensation** with no real ESOP strategy in place. This often results in **grant of too much equity, too soon**, with a high-income statement charge and often no real impact on retention.
- What companies need is an **ESOP Strategy** which best aligns the interests of different stakeholders, not once but CONTINUALLY! In our view, this can only be achieved if the ESOP Strategy is **embedded in both** the Company's **business planning process and appraisal cycle**.
- Doing this shall ensure that the ESOP Strategy evolves as the business and Company grows. In this article, we discuss:
  - Why do you need an ESOP Strategy?
  - How to ensure your ESOP Strategy remains effective?
  - Stages in embedding ESOPs in business planning and appraisal cycle.

\* Reference to ESOPs includes reference to any other form of stock compensation

\*\* FOMO - Fear Of Missing Out

# Why do we need an ESOP strategy?

## Helps optimize outcomes

- 1 Ensures **competitive wealth creation** for employees vis-à-vis the income statement charge for granting ESOPs.

## Aligns Interests

- 3 Ensures terms (vesting criteria, exercise price etc.) which **create wealth only if the business plan / other KRAs are met.**

## Better Governance & Administrative Ease

- 5 Orderly grant of ESOPs eases governance and ensures better management.

*A well-defined ESOP strategy considers interests of all stakeholders and creates a compensation mechanism which continually aligns the shareholder and employee interests.*

## Manages Dilution

- 2 Ensures ESOP Pool is actively managed at the optimum level and helps **keep shareholders dilution at reasonable levels.**

## Creates exceptional opportunities to earn more

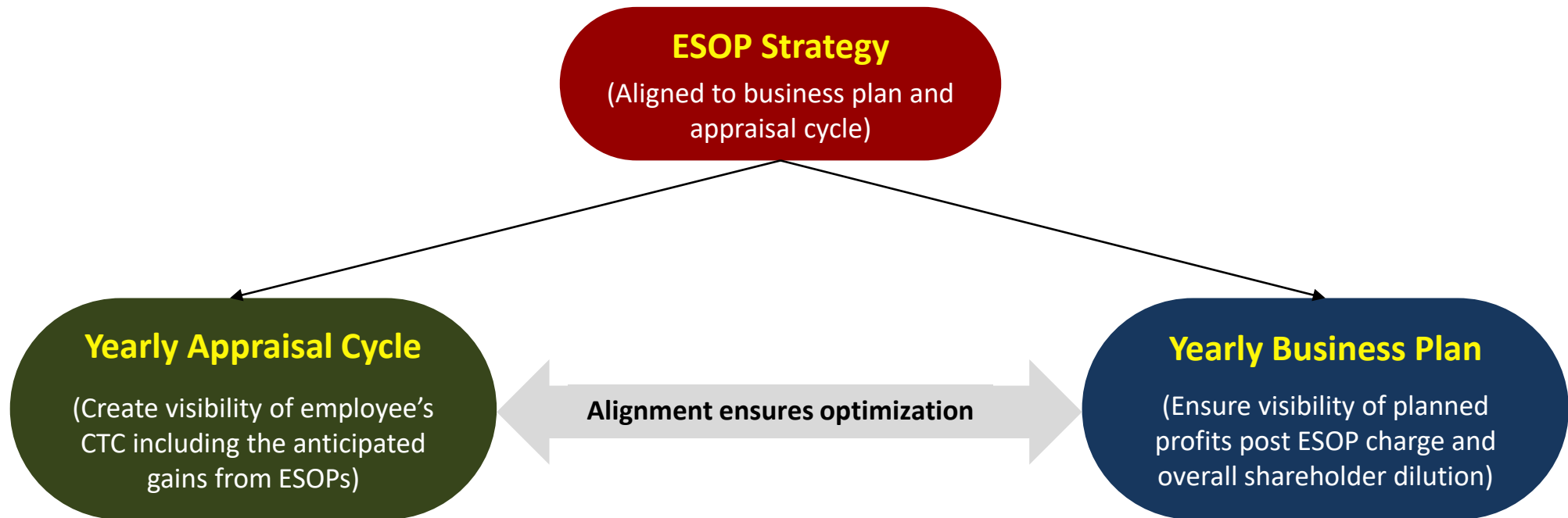
- 4 **Triggers for future grants or higher vesting** in case of exceptional performance can be set in a sound financial manner.

## Creates ESOP Recall and delivers intended value

- 6 Systematic approach on ESOPs ensures employees understand the value of the instrument.

# Creating an effective ESOP Strategy

Key to creating an effective ESOP strategy is to ensure that the same is in sync with and is embedded into the Company's business plan and appraisal cycle. This ensures that the ESOP Strategy is relevant to the business and continues to remain so as the business develops.



- Embedding of ESOP outcomes within Business Planning Cycle ensures **control on shareholder and company outcomes** (i.e., dilution, P&L charge).
- Embedding with Appraisal cycle **ensures employee's interest are protected** and ESOPs become part of every compensation / appraisal conversation.
- **ESOP Strategy** brings **both aspects together** to achieve the right balance.

## Create Budgets

- **Shareholders' Budget:** Set ESOP Budget by setting aside an adequate ESOP Pool to meet the planned allocation.
- **Company's Budget:** Determine the maximum charge and cash outflow (in case of cash settled schemes) the Company can afford.
- **Employees' Budget:** Set initial eligibility criteria and identify eligible employees. Also, assess Hiring Plans to identify new hires eligible for ESOPs on joining.

## Optimise Outcomes

- **Assess expected level of wealth creation** for employees at end of vesting period under different business plan scenarios.
- **Determine ESOP allocation methodology** based on your goals (i.e., cash conservation vs. rewarding performance and retention)
- **Set grant terms** - vesting criteria, performance linkages and exercise price based on strategy adopted.
- **Assess financial statement** impact over the business planning horizon.
- **Optimize results** by changing allocation methodology or grant terms or both. Often an **iterative process**.

## Engage, implement

- Ensure scheme documentation **allows adequate flexibility** to cater to various scenarios in which the business may develop.
- Demonstrate expected wealth creation and ensure **all appraisal / CTC conversations** include **discussion on ESOPs**.
- Roll out grant letters and scheme detailing all terms.
- Undertake **company wide employee communication** every year as a recall on ESOP scheme of Company.

# In a nutshell..

- ESOPs have now become an **integral part of compensation**, especially at senior grades. Having an **ESOP strategy** can help you launch an effective ESOP Program, whilst managing the interests of different stakeholders.
- And if this **strategy is aligned to both business plan and appraisal cycle**, the results can really be optimized for all those around. In fact, for us , this is the only way to do it.
- If you approach **ESOPs without a proper strategy** in place, you run the **risk of doling out equity** without achieving the desired effect on employee morale and retention.
- Thus, If you want your strategy to evolve as your business grows, **don't make this a one-time activity**.
- Instead, **embed your ESOP strategy within the business planning and appraisal cycle** of the Company to ensure there is impetus to continually achieve the right balance for all stakeholders.



**GET IT  
RIGHT**



# 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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