Launching ESOPs: Let’s get the Vesting Criteria Right!

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Introduction

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- Employee Stock Option Plans (ESOPs) are the **NEW AGE compensation tool** widely used by Companies to **align shareholders' and employees' interest**.

- However, just implementing an ESOP scheme does not in itself result in alignment of interests. Achieving the right alignment **requires getting the Terms of Grant** (i.e., Vesting criteria, Exercise Price and Exercise conditions) **right** for different grants as well as across different grades.

- **Vesting Criteria** is the biggest lever available to the Companies to **drive the right employee behavior** in this respect, whether is it promoting retention or incentivizing to drive the next leg of growth for the Company.

- This in-turn often requires **varying the vesting criteria for different grades as well as by growth stage of companies and having explicit linkage to the business plan targets of the Company**. However, majority of the Companies **adopt the standard 4-year time-based vesting schedule** for all their grants, across grades as well across various points of their growth journey.

- In our view, at each growth stage of Company, you need to **revisit the Vesting schedule** for different grades and have the **right linkages with service, individual performance as well business performance** to get the alignment right. In addition, you can use vesting criteria as a tool to **optimize the pattern of charge to be recognized in your Income Statement**.

- In this article, we discuss:

  - Why the Vesting criteria matters?
  - What are the various option available for setting Vesting Criteria?
  - Suitability of Vesting Criteria by Grade
  - Suitability of the various options available

Why Vesting Matters?

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Vesting Criteria Impacts

Employee Behavior

Aligning interest requires driving employee behavior in a manner that best meets the Company's objectives. This in turn requires having **vesting criteria which encourages both employee retention as well as drives Company's performance**.

Service based vesting, specifically back-ended vesting, will help **promote retention** whilst **performance-based vesting** linked to right KPIs* will help **drive employee performance** to achieve these targets.

Pattern of charge to Income statement

Granting ESOP results in non-cash charge recognized in the Income statement over the vesting period. Company's can thus use vesting criteria as a lever to **optimize the charge recognition pattern**.

- **Shorter or front ended vesting** results in **early recognition** of charge vis-a-vis **back-ended vesting** schedule which results in relatively **smooth spread**.
- **Performance linkage** helps ensure charge is recognized only to the extent **KPIs* are expected to be met.**

**KPI - Key Performance Indicators*

Options Available

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Vesting Criteria: Options Available

Time Based Vesting

- **Bullet Vesting** (e.g., 100% at end of Year 4)
- **Graded Vesting** (e.g., 25% at end of each year)
  - Front ended
  - Back ended
  - Proportionate

Performance Based Vesting

- **Market Linked**
  - Target share price
  - Target Market cap
  - Target IRR on exit of Investors/ Promoter
- **Non-Market Linked**
  - Achievement of Company KPI*
  - Achievement of Individual KPI*
  - Event based (such as on happening of IPO or fund raise etc.)
  - Combination of above

Hybrid Vesting

Various combinations of Time based as well as Performance based vesting

Subject to minimum legal requirement of 1-year vesting (known as cliff period), the vesting criteria can be chosen in any of the manner as shown above.

**KPI - Key Performance Indicators*

Time (or Service) based Vesting

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Below are **examples of different types** of time-based vesting schedules, **along with their estimated pattern of charge recognition** in the Income statement:

Completed Years of Service	Proportion Vesting		Front Ended Vesting		Back Ended Vesting		Bullet Vesting	
	% of options vesting	% of total charge recognized Y-o-Y	% of options vesting	% of total charge recognized Y-o-Y	% of options vesting	% of total charge recognized Y-o-Y	% of options vesting	% of total charge recognized Y-o-Y
1	25%	52%	50%	69%	15%	44%	0%	25%
2	25%	27%	20%	19%	20%	29%	0%	25%
3	25%	15%	15%	9%	30%	19%	0%	25%
4	25%	6%	15%	4%	35%	9%	100%	25%

**This is an example of 4-year vesting schedule and the percentage of charge recognized each year has been estimated assuming options vest at end of the period. **Y-o-Y means year on year*

- As can be seen, vesting schedule **directly impacts the pattern of charge recognition** in the Income statement. For instance, **proportionate vesting** results in more **upfront recognition of charge** vis-à-vis bullet vesting which results in more uniform recognition of charge.

- Further, Time based vesting, typically used in 'Copy-Paste Schemes' lacks linkage with company specific targets, focusing solely on tenure. To that extent, **time-based vesting, if used without any performance criteria, it may encourage Rest and Vest behavior** wherein employees coast along in a job they may potentially dislike or not be good at, just to wait for their options to vest.

Performance based Vesting

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Performance based vesting links vesting to achievement of **specified target or milestone**, with no defined timeline, subject to **1 year cliff** being met. Performance based vesting can be **market linked** or **non-market linked**:

Market linked factors

- Links vesting to company's share price target or market capitalization or shareholder IRR such as:
  - Vesting on **achievement of share price of INR 1000**
  - Vesting on achievement of **market capitalization of INR 1000 crores**
  - Vesting if **IRR on exit is at least 25%**

Non market linked factors

- Links vesting to company or individual KPIs, such as:
  - Company **achieving specified Revenue or EBITDA targets**
  - Individuals achieving specified milestone, **rating or KPI**
- Event based vesting such as on **product launch, IPO, etc.**

- Under this vesting choice, the pattern of recognition of charge in Income statement depends on **management expectation** of when **business targets** will be **achieved** and the same is **trued-up to reflect actual achievement** against targets.
- Performance based vesting enables having **explicit linkage with performance**, thereby, helping in achievement of business targets. This may be beneficial for **newly incorporated companies** looking to grow through corporate transactions
- For easy administration of schemes, it is advisable to keep KPIs as quantifiable and objective as possible.

**KPI - Key Performance Indicators*

Suitability across Grades

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Below is snapshot of proposed vesting schedule for different grades/ level of seniority

C-Suite

- Primarily performance-based vesting linked to **Company KPI* Targets with minimum time criteria**
- Linkage with achieving **desired level of IRR on exit** of promoters or investors or on **happening of IPO** etc. also common to ensure these targets are met.
- Simple service-based vesting less advisable at this grade given grant size tends to be sizeable.

Senior Level / Department Heads

- Primarily performance-based vesting linked to **Department level KPIs** as well as **Company KPIs Targets**.
- Simple time or service-based vesting less advisable at this grade as grant size tend to be reasonably high.

Middle Level

- Primarily **service-based vesting** with **linkage with individual performance** / rating.
- Some companies include linkage with overall Department KPIs being achieved.

Junior Level

- Primarily time of **service based vesting criteria** advisable.
- If no performance criteria is included, then **minimum rating requirement** may be included to ensure employees continue to perform.

**KPI - Key Performance Indicators*

In a nutshell...

- In recent years, alternatives to this traditional model have emerged because the time-based formula has failed to get longer-term retention & motivate performance.

- The stock options granted needs to be structured to encourage long-term retention as well as **keeping employees' skin in the game**.

- Balancing vesting structures to provide the right short-term and longer-term incentives along with **explicit linkage to business plan targets** can also avoid phenomenon known as "**rest and vest"** (where employees coasting along in a job, they dislike just to wait for their options to vest).

- It is a fine balance to get these incentives right, as the wrong vesting structures could unintentionally impact employee engagement or their perception of the ESOP plan.

- Thus, If you want your employees to stay with the company for a period of time and commit to building success, then **GET YOUR VESTING CRITERIA RIGHT!!**

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.

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