

ESOP Direct



ESOP VISTAS

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Editors' Letter

Dear Readers,

We take this opportunity to wish you and all your dear ones a very happy and prosperous new year. We all at ESOP Direct hope and wish that the coming year brings along all the cheer and good news in all your endeavours.

With all the turmoil taking place in the business environment, we believe that, timing was never more appropriate than now for granting ESOPs to your employees. Even though the current recessionary trends are likely to have unusually protracted existence, they still are a part of the normal business cycle. Businesses which sense opportunities in these situations and capitalize on them would be better positioned when things start looking up.

In the domain of Equity based compensation, especially in the Indian context, there are several opportunities one could evaluate and seize, to ensure that as an organization, you continue to have a motivated team to deliver the desired results in these trying times. The same team would form the backbone of your resurgent action when business recovery starts.

To bring-in cheer for you in the coming year, we are glad to present to you **Top 10 Opportunities** to make the most out of the current situation and gear up for the good times to come. Tough times call for innovative approaches and creative actions. We hope that the ten ideas we present here would help you design your ESOP strategies better and help you seize the opportunity.

Please feel free to get in touch with us, if you need any further clarifications on our observations.

Happy Reading!

Team ESOP Direct

You can get in touch with us at consulting@esopdirect.com.

Top 10 ESOP opportunities in the current markets

Unprecedented fall in the stock prices provides an ideal opportunity for the corporate management and shareholders to grant ESOPs to the talented employees of the company. While the current meltdown in the stock markets has had a devastating impact on the value of stock options companies have issued to their employees, the timing was never more apt for issuing fresh options at the lowest possible prices. Even though ESOPs are being used in India for almost two decades now, companies have not yet experimented with different variations that this instrument provides. Thanks to the freedom provided by SEBI guidelines, variations in terms of pricing terms, vesting conditions can now be structured to suite a given situation.

In this paper, we look at what are the opportunities this market provides for the companies who are looking at granting stock options to their employees.

Opportunity # 1: Low dilution - Low downside risk

Quite contrary to the popular belief, most appropriate time to grant ESOPs is when the markets have hit the bottom. The option holders get shares at lowest possible price, with no downside risk and higher potential upside. The shareholders can do with lower dilution, since you will need fewer shares to give the same amount of benefit. The enclosed table shows how companies will have to issue 20% more shares if they delay the grants by a year and 73% more shares if one delays the grant by 2 years.

Scenario		Today	Year 1	Year 2	Year 3	Shares required to give a benefit of Rs 30 lacs
Grant today	Mkt price	25	28	33	44	
	Ex Price	25	25	25	25	
	Benefit per share					19
Grant after one year	Mkt price	25	28	33	44	
	Ex Price		28	28	28	
	Benefit per share					16
Grant after two years	Mkt price	25	28	33	44	
	Ex Price			33	33	
	Benefit per share					11

For those companies who had plans to issue ESOPs, this is *The Opportunity* to roll out options.

Opportunity # 2: Match medium term recovery with medium term instrument like ESOPs

Among the top reasons for the lack of interest among the companies is that they believe that the current meltdown is not just restricted to stock market but is a reflection of an all pervasive recession which is expected to run well into 2010. Given this timeframe, they are not sure if share prices would appreciate significantly enough to make a difference to the value of ESOPs in the coming 18 - 24 months. In fact this itself is an opportunity. ESOPs by their very nature are a medium to long term instrument. Apart from the legal stipulation of minimum one year vesting, typically the vesting spreads over 3-4 years. A company with a sound business model is bound to bounce back in terms of performance and market pricing in the next 2-3 years. All global analysts are unanimous that countries like India will be faster off the ground in overcoming the recessionary impact than the US and Europeans. As the table above shows, the earlier the companies grant, the better for the shareholders and for the employees.

Opportunity # 3: Use floating stock for ESOPs

Current market prices offer an ideal opportunity for the companies to use the floating market stock for ESOPs. Companies could use Trust route to do the market purchase. Companies Act allows companies to give loans to the ESOP Trust to purchase shares from the market. The pool of shares so accumulated could be used over a period to grant Options. Apart from sending strong signal to the market about management confidence and its noble objectives, shareholders would be happy because there is no incremental dilution due of ESOPs.

Opportunity # 4: Mitigate lay off risks by issuing ESOPs to high performers

Several companies are exploring reduction in headcount by relieving its low performing employees. It is likely that in the uncertain atmosphere, even the high performers may be tempted to look out. This will cause severe damage to the on-going operations of the company.

Management skills are still in short supply and these resources could seek greener pastures even in the current scenario. ESOPs are essentially meant for the high performers and managerial staff and not for junior staff, who usually prefer cash incentives. By issuing ESOPs to these categories, the company management will send a strong positive message to them that the company values their association and looks forward to sharing the future growth with them.

Opportunity # 5: Replace Cash incentives with non Cash instruments like ESOPs

In the current environment, **Cash is King**. All companies are looking at conserving all the cash they possibly can. The timing could never be better to replace the variable Cash incentives with Performance linked Stock options. The company would save cash and employees will have an opportunity to make higher returns over the medium term when the stock prices recover. The beauty of ESOPs is that there is no cap on the upside returns. While the cash incentives are an absolute amount, gains from ESOPs are linked to the prices and can be in multiples of the cash incentives. The other big advantage of ESOPs is that the market pays for all the gains and not the company. Thus the company could save valuable cash while the employee has an opportunity to make potentially high returns.

Opportunity # 6: Innovate with variable pricing (Look back / Look forward)

Some of the Promoters are of the opinion that the current valuation is not a true reflection of the company's inherent value and issuing options at that value would mean acceptance of the valuation. Point well taken. Many companies are quoting at less than book value, which certainly is not a correct reflection. However it is possible to structure options wherein the exercise price is decided on the date of vesting with a look back / look forward feature. This will give adequate time for the true valuation to show up in the market prices.

Opportunity # 7: Unlisted companies can link exercise to IPO

Many unlisted companies would want to link their ESOP roll outs to the IPO plans. This will ensure certainty of liquidity for the employees and eliminate cash payouts by the company. In the current situation all IPO plans and hence ESOP roll outs are deferred. It is possible in such cases to link the exercise to the IPO. Here the options will vest but are exercisable on IPO. The employees need to be educated adequately about these terms. They would not mind this since they are not required to invest till the IPO materializes. The exercise period could be kept appropriately longer.

Opportunity # 8: Exercise price linked to market price movements

One of the major grudge of the employees is that Options have a potential to go underwater if the prices go down further. To be fair to the employees, their dejection is understandable. It is possible to structure an option which will ensure that they are always in-the-money at the time of vesting. One of the alternatives is to link the exercise price to the market price on the Vesting date. For instance, the exercise price can be defined as 10% discount to market price on the date of vesting. This would ensure that Options are never underwater on the vesting date. This would have an accounting cost, but then that's a trade off.

Opportunity # 9: Exchange existing Options for new Options

Exchanging existing underwater Options with newly structured Options has several advantages. Canceling the current Options would reduce the impact on the diluted EPS. These Options are not likely to be used (exercised) by the employees hence there is no need to continue with their negative impact on the diluted EPS. In exchange newly structured Options, ideally less in number, would achieve the same benefit to employees at lower dilution and lower impact on EPS. Accounting cost as a result of the exchange can be minimized by appropriately adjusting the number of Options granted fresh.

Opportunity # 10: Re look at the ESOP strategy

There are quite a few companies who have granted options earlier, which are underwater. If they find re-pricing as not the right solution for whatever reasons, they could use the timing to grant options at a lower price so that the employees can average out their cost and still be in-the-money at an aggregate level.

If the company has in the past spread the options thin with larger number of employees, this is an ideal opportunity to amend the allocation and to focus only on those who would be critical to tide over the current recessionary phase.

The ESOP strategy will have to work within the four corners of dilution, benefit, employee coverage and accounting charge. It is possible that if you give more weight to one parameter, the other will get impacted. While it's important to prioritize the parameters, it is necessary and possible to optimize them to achieve buy-in of all the stakeholders.

Employee education is important

Lack of employee interest, is cited as a reason for companies to defer their ESOP initiatives. Employee awareness about ESOPs has been quite low world over, similar to the sense for timing the market among the small investor in the stock markets. Just as the small investor flocks the market to buy in the booming market and sells desperately in the slump, employees also believe that ESOPs make sense when the prices are already high and rising faster. Employees need to be educated that ESOPs are not shares, where you book profits or losses on a daily basis. It would be worth the effort to create this awareness among the employees in order to align their goals with the promoters.

Most of the Options issued at market prices, twelve to fifteen months ago, are underwater. However, given the enormous success ESOPs have met with in the last three to five years, no one is writing them off as a useful tool in fostering motivation, retention and attraction of talent. India Inc has always responded commendably to all the business challenges, be it globalization, rupee valuation or the current meltdown. Here is an opportunity to handle the situation equally ingeniously to ensure that they maintain the edge with a motivated workforce. Let us exploit this opportunity by being more creative and innovative in the way we structure and design our ESOPs ▲