ESOP opportunities in the meltdown

Current meltdown in the stock markets has had a devastating impact on the value of stock options companies have issued to their employees. Most of the Options issued at market prices, twelve to fifteen months ago, are underwater. Needless to say, the option holders are not excited nor are the issuers viz the employers. However, given the enormous success ESOPs have met with in the last three to five years, this time no one is writing them off as a useful tool in fostering motivation, retention and attraction of talent.

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	Market price	25	28	33	44	
	Exercise price	25	25	25	25	
	Benefit per share				19	157,895
Grant after one year	Market price	25	28	33	44	
	Exercise price		28	28	28	
	Benefit per share				16	187,500
Grant after two years	Market price	25	28	33	44	
	Exercise price			33	33	
	Benefit per share				11	272,727

However not many companies seem to view the current downturn as an opportunity. Employees also seem to give preference to cash incentives over ESOPs.

Among the top reasons for this 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. The fact is that, this it self 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.

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.

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.

The other reason commonly heard is that in the current situation, retention is less of a challenge. There are fewer jobs in the market to lure them and those available will not offer aggressive salaries. While it can be argued that retention at junior levels of management could be less of a challenge in the next couple of years, the same is not true for the managerial staff. 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 managerial staff and not for junior staff, who usually prefer cash incentives. In fact 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.

Lack of employee interest, is also 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. Firstly, the 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.

To be fair to the employees, their dejection is understandable. No one would want to have an option which has potential to go underwater. It is possible to structure an option which will ensure that they are always in-the-money at the time of vesting.

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.

Any option design 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.

Indian 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 motivated workforce.

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