# ‘Slump in markets, right time for ESOPs'

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*The value of ESOPs can be significantly higher than a person's annual income, the investment does not require an immediate cash commitment from the company and it carries no downside risk.*

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How best can you build wealth through ESOPs? With many sectors using ESOPs to compensate employees, this is a question that many would like answered. To answer this and other questions, Business Line spoke with Mr Harshu Ghate, co-founder and CEO of ESOP Direct, a firm that offers solutions on equity-based compensation to over 400 clients including Axis Bank, Aditya Birla Group, DLF, Bharti Airtel, Tech Mahindra and MindTree. He outlined, in his simple and straight style, the implications of IFRS standards, as pertaining to ESOPs, once they are implemented next fiscal.

Excerpts from the interview:

How important are ESOPs as an ingredient in a person's portfolio? Can it really substitute for hard cash?

ESOPs cannot substitute for cash, especially when they are not vested. Vested options are as good as shares, though not as liquid (it usually takes 2-3 weeks from the date of exercise to get tradable shares credited in the employee's demat account). ESOPs are, however, an important ingredient in a person's portfolio mainly for three reasons – first, the value of ESOPs can be significantly higher than a person's annual income / investible funds. It depends on the hierarchy. For a CEO, over a longer timeframe, the ESOP component could be much higher than his cash compensation. Even for other employees, the proportion would increase significantly over a 3-5 year time-frame.

Second, this is an investment that does not require cash commitment (from the company) till an employee wants to exercise his options. The appreciation in option value happens even without investing funds or taking market risk.

Third, there is no downside risk for this component. If the stock price is below the exercise price the employee can defer his exercise and if it is still not high enough he can allow the options to lapse without any cash investment.

How important is timing in exercising options, buying shares and subsequently selling them?

Timing of exercise is important from a tax perspective. If the exercise happens when the difference between the market price and the exercise price is less, the perquisite tax liability will be lower and the subsequent appreciation in stock price and the resultant gain will be taxed as capital gains — short-term or long-term depending on the holding period. Since currently there is no long-term capital gains tax on listed shares, timing the exercise right could lead to better tax management.

Companies have a time window within which employees can exercise options. Does this limit the benefits in terms of the best time in which to sell or buy?

The scope for active management through buying and selling shares is limited. There are two reasons why companies limit the time window. One is to avoid the administrative hassles of frequent issue and listing of shares, and second is the compliance with insider trading code. Both these do hamper the employee's ability to time the exercise and sale of shares and maximise the gains.

Companies could use the Trust route to park the shares, thereby reducing the frequent share allotments. SEBI has clarified that exercise of options by the employees, even though they are classified as insiders, in the blackout period is permissible and the subsequent sale of ESOP shares by the employee within six months is also permissible.

We find that companies go quiet on ESOPs when the market falls and start in full swing when the market is bullish? Does it make for a case of missed opportunities?

Absolutely. Any slump in the market is the right time to grant options, for two reasons. First, companies need to give lesser number of options (since the potential benefit per option will be high). This will also suit the shareholders as the dilution is lower. Second it also works well for the employee, since his downside risk is lower. Not many companies realise this.

But isn't the equity dilution miniscule in most cases?

It is not true that the dilution is that low in all cases. It would be significantly higher in companies that have been running ESOP programmes for the past 5-6 years.

What price do employees pay while availing options, the exercise price or a nominal amount now and the exercise price later?

They do not pay anything at the time of grant of options. Exercise price is paid only when the options are exercised.

Is tax recovered from employees while granting options or while it is exercised?

Tax accrues at the time of exercise of options.

How are long-term and short-term capital gains treated in the case of ESOPs?

It is treated in a way similar to any other share investments. Cost of acquisition in both the cases is taken as the market price on the date of exercise. Shares held for more than a year and sold are long-term capital gains and are tax-exempt. If, after exercising, the shares are held for less than one year, they would be treated as short-term capital gains and would be taxed accordingly.

When companies that are listed overseas offer ESOPs to employees in India, what are the tax implications?

If the employee is based in India, he is liable to pay perquisite tax on the date of exercise and the capital gains on sale. Employer is responsible to recover the perquisite tax and pay to the exchequer.

What would be the impact of transitioning to IFRS accounting standards on ESOPs for a company's P&L? What should companies do to keep the charges under control?

IFRS would make the expensing of ESOPs mandatory using the fair value method. Currently, Indian GAAP allows companies to use intrinsic value if they so prefer but disclosure of the impact on profits, if the fair value was used, is mandatory. So the change would be that what was appearing in the notes to accounts would now be a part of the P&L statement.

It is, however, important to note that the charge to P&L is notional since there is no liability created. The impact of the notional charge is credited to reserves. As such the book value or the net worth of the company does not change. The EPS would be impacted. It is, however, observed that some analysts adjust the impact of this notional cost in the EPS, others often ignore it, since there is no cash payout.

Companies will experiment with different variants of options, such as RSUs or stock settled SARs (stock appreciation rights). We do not foresee companies replacing ESOPs with cash payouts, because the payouts will be huge and will impact business operations.

In sectors such as IT and Financial services, attrition is high and employees may not stay around long enough to gain from the benefits of ESOP. What should such persons do?

ESOPs are long-term instruments and not for those who want to jump jobs frequently. Unless a person continues with a company for a 4-5 year period he will not be able to get the maximum from his ESOPs.

Is there a significant difference between RSUs (restricted stock units) and ESOPs? Which one is better?

RSUs as implemented in India are nothing but deep discounted ESOPs. Restricted stock, by definition, means that stock with restrictions on voting rights, transferability and right to dividend. The companies that have granted RSUs in India, Wipro and recently M&M, have issued options at par value. RSUs could be better choice in the IFRS environment to optimise the accounting cost. Under the current Indian GAAP, ESOPs (at market price) are better because they do not involve any accounting cost. Employees also prefer RSUs because there is no risk of them going underwater in case of bad market situation.

How would employees of unlisted companies get a fair value for their ESOPs?

ESOPs in unlisted companies have been a case of mixed successes. There are some companies that granted ESOPs while they were unlisted and employees made a bounty when the company went public – recent success stories are SKS, VA Tech Wabag, Persistent Systems. There are also cases where employees have been able to encash their value (buyback by existing/ incoming investors) even if the company has not gone public – cases in instance are ICICI Prudential and VA Tech Wabag. On the other hand, there have also been companies which neither managed to go public nor provided exit to the option-holders. It depends on the company's management and their outlook towards ESOPs as a tool.