STOCK OPTIONS IN POST COVID-19 SCENARIO: A CASE FOR CURRENCY OPTIONS

COVID-19 pandemic has posed a grave danger to the sustainability of the businesses as well as to one of their most critical resources i.e. human resource. In the midst of this turmoil, we are witnessing lockdowns in almost all geographies leading to uncertainties about recovery of economic activities which provide livelihood to people. There are apprehensions amongst employees about stability of their jobs and if the job persists then apprehension builds around compensation. On the counter side, the challenges for an employer company have also become overwhelming as to retention of critical talents and other necessary human resources where conservation of cash is the key.

Equity based compensation ("Stock Options" or "ESOPs" or "ESPPs") in any form had been traditionally regarded as currency for hiring and retention. During time of crisis and particularly when corporate valuation takes a deep dive but having a high probability of bounce back, Equity based compensation attain more relevance as a valuable instrument as if a Currency. The focus of this article is to analyze use of stock options as Currency to compensate employees while maintaining liquidity for primary operations.

Changing Paradigm and Mapping to Currency Options

Conservation of Cash

The fixed and recurring costs for most of the companies which include salaries and other emoluments will continue to be incurred even where no economic activity is undergoing. Until the revenues normalize, saving on cash is critical for all most all companies bearing the brunt of this crisis. One of the ways to conserve cash, would be elimination and/ or deferment of cash component by replacing them with Equity based compensation which would shift the burden of cash payout on the market. Company can grant in-money options having Intrinsic Value at the time of grant, which is attractive to the employees. Companies can also opt for fallback mechanism in the scheme document for settling in cash rather than equity, in case of sufficient cash inflows in future.
From an overall impact perspective, choosing of equity over cash and its effect on equity dilution and EPS when compared with incurring of cash cost upfront, would be less damaging to the survival and sustainability of business in the wake of global economic crisis. And these notional costs are often ignore by the analysts while analyzing the company performance and if exercised these costs are tax deductible expenditure.

Retention of Critical Resources

Significance of retention of critical resources during this time is well understood as they will a play major role in overcoming the challenges this crisis is posing and may continue to pose. Retaining talent with stock options could be an effective strategy as monthly/ periodic cash compensation disbursements are reduced.

CXOs and other senior managerial roles can be considered for higher quantum under equity-based compensation as compared to other resources. An ideal approach towards this issue could be, identification of critical resources across all the levels and committing them equity based compensation for their retention, inclusion of stock grants in exchange of cash components of CTC and compensation for pay cuts, deferment of increments and incentives.

Retention of Critical Resources

In pursuit of motivating employees and securing their compensation at various phases of this crisis, companies may find it useful to adopt different strategies of using stock options which are unique and effective. Being an unprecedented situation with continuing economic ramifications, its consequences in terms of time are also unpredictable. Therefore, strategies may be divided into various phases i.e. short term (immediate steps), medium term (next 12-24 months) and long-term (beyond 24 months). The Management needs to have different strategies for different periods. Short term strategy for this turbulent time, medium- and long-term strategy, when business runs as usual.

Sting of Pay cuts could be minimized by grant of equity-based compensation with front ended vesting or linked to recovery period. Shorter duration of vesting helps in provide much desired liquidity in the hands of employees.

Performance vesting conditions demands revisiting and remeasuring of incentive goals. Unplanned shocks in market and instantaneous change in business operations may dispute the achievement of these goals outlined for vesting.

Given the current turmoil and uncertainty, companies are deliberating on longer exercise period as well. It is likely that longer exercise period may give flexibility to the employees to earn the sumptuous appreciation; longer they wait, higher are the chances of markets recovering the losses. Employees will also get sufficient window for arranging the finance.

Empathizing Regulators

Almost all countries impacted by this Pandemic, have announced or are considering relaxation in compliances, tax deferment, stimulus packages and other measures to aid businesses.
This implies Regulators are now empathizing with the companies and addressing genuine demands of Industries. Representations for relaxations in certain norms to ease operative roadblocks, are being analyzed and considered.

Issuing of equity based compensation as an alternative to cash compensation, is seen as the most obvious route for all businesses, it is therefore expected that regulators will consider making the process seamless and relax some restrictive compliances in the recovery period of the economy.

Currency Options: Different scenario's

The biggest problem statement that arises is that pay cuts are real, but at the same time retention of key employees are equally important and Management must create a balance on both these ends. One of the ways to create this balance is to use equity as Currency options. So that liquidity will be maintained on one hand and the employee retention will also take care.

This can be done by leveraging flexibility in approach of stakeholders, they can take some unconventional measures in structuring currency options.

In Money options – compensating pay cuts

In-Money options can be used as a tool for rewards and retention in current scenario and may compensate pay cuts, which is like companies can transfer their cash cost to notional cost and employee get compensated over the period for pay cuts they are facing now.

In-Money options is cushioned against market volatility and are expected to provide certainty of compensation to employees with minimum investment. Using Stock Options as currency, implies the ease replacement of cash with stock options.
In-Money options are also popularly known as Restricted Stock Units (RSUs) which are granted at face value or in some jurisdiction at nil price. For this, Company can align vesting schedule of such options with business recovery period. Number of options granted can be linked to amount of pay cuts.
Focus of this instrument is "liquidity" rather than "equity dilution" and is completely risk-free for employees but it has an additional equity dilution for the shareholders.

Self-Adjusting exercise price options – giving increments

Employee Stock Options ("ESOPs") / Employee Stock Appreciation Rights ("ESARs") can be designed in a fashion that the exercise price is self-adjusting based on the movement of prices as on date of exercise. Exercise price could be defined as a function of market price on the date of grant and adjustment factor based on returns on the market prices as on date of exercise.
Self-adjusting exercise price options which are cushioned against market volatility and would provide certainty of compensation to employees even if market price falls, they will get benefit with minimum investment.
These Options could be a game changer in employee compensation trends. It requires deep analysis and deliberation on designing various aspects to maximize the intended benefit to employees and minimizing the risk of it becoming an underwater option, by securing it from all ends.

Market price options – taking advantage of lower prices

Companies can also look to grant ESOPs/ ESARs at current market price to take advantage of the lower price. This will work where investor does not favor any discount and management is of the view that Market price will bounce back. In these scenarios, these options could be a best fit. But these (in comparison to RSUs) have relatively higher equity dilution for the shareholders and may not look very attractive for employees if market crashes further after grant is made.

Employee Stock Purchase Plan – Settling Accrued incentives

Company can design an Employee Stock Purchase Plan ("ESPP") preferably at face value for settling accrued incentive which is due and payable in the current year. It can prove to be an opportunity, on recovery of market after the worst phase of this Pandemic is over. The employee can earn much higher returns than that is visible on date of allotment ESPP shares and the Company can shift its cash cost to equity. This is suitable for settling past dues (as there are no chance of forfeiture unlike ESOPs in case of termination) and where large number of employees are covered. But for employees these benefits come with a minimum lock-in for one year and for shareholders it's an immediate equity dilution.

Likely concerns with Currency Options and their responses

There are some of the concerns Management can face while using currency options like

- Can employees be convinced to forgo cash in lieu of equity?
- Will employees have confidence on business plan or on the Management for recovery or sail through this turbulence time?
- How shareholders/ proxy advisors/ investors see In-Money options, when their own investment value has been eroded?
- How fallback cash settlement is different from deferred cash incentives?
- If the Company is planning to give Currency options for covering large number of employees, whether Junior Management would understand the value of equity, whether they appreciate equity in lieu of cash?

From aforesaid points perspectives, it is important that trust needs to be built between employees and the Management. This will resolve employee's apprehensions and create confidence over business recovery. This trust can be established through effective and transparent communication with the employees. Stakeholders also understand that the current situation is not normal and hence are more flexible to adopt different and unconventional approaches for a common good. In current scenario cash deferred is also cash saved.

Conclusion

It has been constantly emphasized that in such challenging times employees need to have utmost trust on their employer companies for any Equity based Plan to work and succeed. Effective communication and adoption of strategies to insulate pay outs from unplanned events, to reinstate trust of employees. As depressed stock options need new lease of life, the new grants need new designing perspective, as these plans will have a greater impact on all stakeholders and in any case must ensure win-win. This unusual situation also gives opportunity to think out of the box or unconventional methods to apply in compensation strategy by stakeholders. In current scenario Currency Options can change outlook of employees and employers on equity-based compensation.

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