UNDERWATER OPTIONS : ALTERNATIVE APPROACHES AND LEVERAGING OPPORTUNITIES FOR ADVANTAGE

1. Background

1.1 Companies implement equity-based compensation plans ("Plans") for multiple reasons. However, the primary reasons are employee reward, retention, offering of wealth creation opportunity fastened with corporate growth. However, there is a setback to the stated objectives when stock options / units ("ESOPs" / "Options) granted under a Plan go underwater.

1.2 Underwater Option means where the market price of the underlying share falls below the exercise price of such Option; thereby making the Option program unattractive and ineffective. This underwater situation affects not only the implementing Company but also the concerned employees in various ways:

a) From Company's perspective – The Company has to bear the accounting cost for the underwater Options even though Plan has become ineffective. If the Options were part of the overall compensation package, the value lost has to be restored in one way or the other. Company needs to bring back employee's trust and confidence in the Company.

b) From Employees' perspective – The Plan becomes unattractive and the value notionally earned prior to exercise is lost. The overall compensation gets reduced significantly; this is particularly true when such Options were a part of the total compensation package. Employees' confidence in the Company weakens as opportunity for value creation loses ground.

1.3 The phenomenon of underwater Option gets highlighted in the current turbulent times wherein the business operations have been disrupted due to the Covid-19 pandemic. The market prices of shares of companies across sectors have been affected all over the world because of which the equity based compensation programs implemented in any form have been severely hampered. The only solution is redressal of situation.

1.4 Redressal of underwater situation can be planned in various alternatives where each alternative approach carries its own sets of advantages, statutory requirements and limitations.

2. Alternative Approaches

2.1 <u>Alternative 1: Re-pricing of Options</u>

(a) **Structure**

The exercise price per Option is reduced so that the Option regains its value.
All other grant parameters are kept the same e.g. no change in the vesting period, exercise period, other terms and number of options.
This is expressly allowed under the relevant laws.

(b) **Assessment**

This alternative is suitable where the Options are deeply underwater with almost no, or in adequate life of Options left and the recovery is highly uncertain or would require a time period spilling over the life of the Options, then this alternative can be useful.
In case of a broad-based Plan, this alternative is easy to administer as there is no action required from employees' side; all beneficial adjustments are done and communicated by Company.
Approval requirement – This requires shareholder's approval.

(c) **Impact on stakeholders**

Shareholders – The shareholders generally do not favour as the fall in share price has affected their wealth as well. However, in circumstances such as the Covid-19 where the market prices have been severely impacted, the shareholders may approve this alternative as employees need to be motivated for keeping the business going and growing.
Management – Given the Management's intention to retain growth drivers at any point in time and hence for maintaining the reward and motivation, re-pricing may be favorably considered. The Management will evaluate additional accounting impact on the books of accounts vis-à-vis the benefit offered to employees.
Employees – Restoration of value of Options in hand is appreciated.

2.2 <u>Alternative 2: Compensatory Fresh grants</u>

(a) **Structure**

Status quo is maintained for existing grants.
To compensate for value lost in the existing grants, fresh Options are granted under the existing Plan. New grants can have different parameters as to vesting and other conditions as thought fit.

(b) **Assessment**

This alternative is suitable where there are chances of partial or full recovery in value of underwater Options in due course, prompting for status quo.
There should be enough pool available for making the fresh grant.
The fresh grant should accommodate terms to tackle the turbulence (which caused the existing Options to go underwater) by relatively longer exercise period, front loaded vesting, provision for cash settlement, etc.

(c) **Impact on stakeholders**

Shareholders – Fresh grants will result in equity dilution. However, if fresh grants are made from the existing Plan, no shareholders' approval is required.

Management – Fresh grants will have additional accounting cost and the Option pool will be reduced.

Employees – Fresh grants are beneficial and motivating as these seek to make good the loss by replenishment with additional Options.

2.3 Alternative 3: Option Swap/ Exchange

(a) **Structure**

Underwater Options are swapped against a fresh grant of Options.

Fresh Options granted can be of the same or higher value. The terms of new grant can be tweaked depending upon the value intended to be delivered.

(b) **Assessment**

It is suitable where the Options are deeply underwater with less probability of quick turnaround and when various terms of grant (including vesting period, schedule, exercise period etc.) are sought to be changed.

Lesser number of fresh Options are required as compared to that of underwater Options, as the fair value per fresh Option is would be higher than the underwater options.

This is the most commonly used alternative globally for handling underwater options because it is fair to all stakeholders.

(c) **Impact on stakeholders**

Shareholders – This alternative is appreciated by the shareholders as there is lower dilution or no additional dilution.

Management – Additional accounting impact may be neutral or may be increased in proportion of the intended benefit. The available option pool might increase if equal value is passed on through fresh grants.

Employees – Fresh grants are beneficial for the employees as those come with lower exercise price; however, minimum vesting period of 1 year has to be served again.

2.4 Determining the appropriate approach

Different parameters namely, the remaining life of the Options, the extent to which share prices have fallen down, the probability and period within which value lost could be recouped, etc. are some of the major considerations in arriving at an appropriate alternative. An alternative may have more weight in case it ensures more:

a)Ease of execution, understandability and communication;
b)Trust and confidence of employees in the growth of Company;
c)Effectiveness from P&L account charge point of view; and
d)Win-win for all relevant stakeholders.

3. Leveraging opportunity for advantage

3.1 In the current scenario where all the stakeholders are willing to take a flexible approach for the survival and growth of the business, here are a few opportunities that can be leveraged for ensuring effective redressal of underwater Options resulting in benefit of all the stakeholders:

Stakeholder	Opportunity
Shareholder / Investor	Flexible approach towards incremental accounting charge and equity dilution to keep the business going, growing and to keep the employee morale high
Employee	Willingness to accept: • Deferred compensation; and • Lesser number of in-the-money options
Management	• Achieving Cash conservation and retention of key employees; • Driving performance to sail through tough time; and • Motivating employees to achieve new goals.

3.2 Falling market price of shares though an undesirable outcome of the ongoing pandemic, is always considered a good avenue to have a fresh start. It simply holds good the age old axiom "Grant ESOPs when market price is at bottom" which basically conveys the possibility of huge return with little exercise price and lower accounting cost.

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