

Launching ESOPs: Let's get the Vesting Criteria Right!

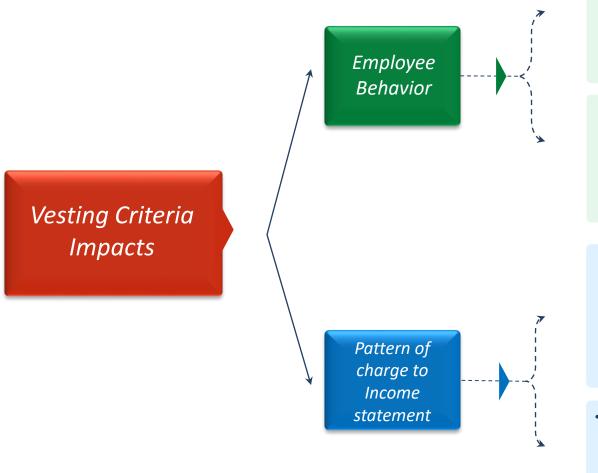


Introduction

- Employee Stock Option Plans (ESOPs) are the NEW AGE compensation tool widely used by Companies to align shareholders' and employees' interest.
- However, just implementing an ESOP scheme does not in itself result in alignment of interests. Achieving the right
 alignment requires getting the Terms of Grant (i.e., Vesting criteria, Exercise Price and Exercise conditions) right for
 different grants as well as across different grades.
- Vesting Criteria is the biggest lever available to the Companies to drive the right employee behavior in this respect, whether is it promoting retention or incentivizing to drive the next leg of growth for the Company.
- This in-turn often requires varying the vesting criteria for different grades as well as by growth stage of companies and having explicit linkage to the business plan targets of the Company. However, majority of the Companies adopt the standard 4-year time-based vesting schedule for all their grants, across grades as well across various points of their growth journey.
- In our view, at each growth stage of Company, you need to revisit the Vesting schedule for different grades and have the right linkages with service, individual performance as well business performance to get the alignment right. In addition, you can use vesting criteria as a tool to optimize the pattern of charge to be recognized in your Income Statement.
- In this article, we discuss:
 - Why the Vesting criteria matters?
 - What are the various option available for setting Vesting Criteria?
 - Suitability of Vesting Criteria by Grade
 - Suitability of the various options available

Why Vesting Matters?





Aligning interest requires driving employee behavior in a manner that best meets the Company's objectives. This in turn requires having vesting criteria which encourages both employee retention as well as drives Company's performance.

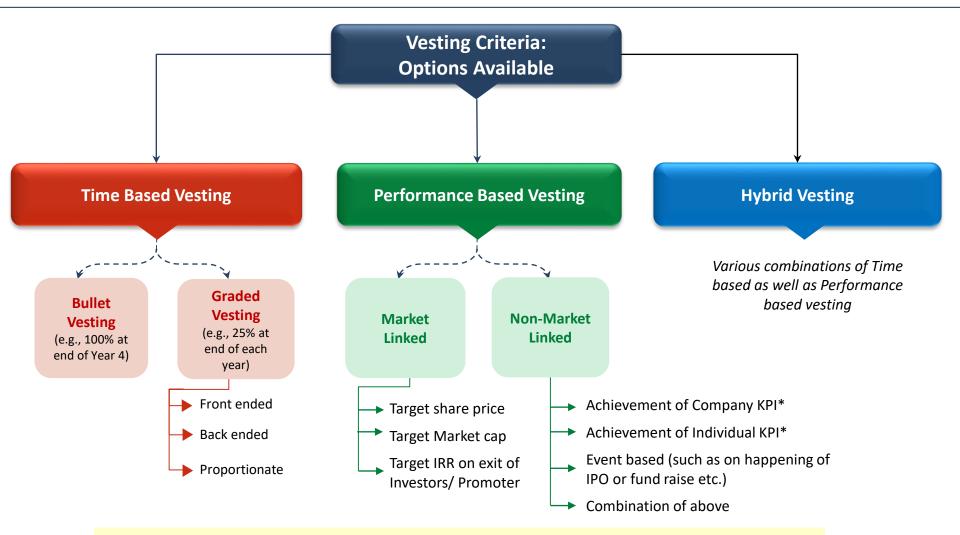
Service based vesting, specifically back-ended vesting, will help promote retention whilst performance-based vesting linked to right KPIs* will help drive employee performance to achieve these targets.

Granting ESOP results in non-cash charge recognized in the Income statement over the vesting period. Company's can thus use vesting criteria as a lever to **optimize the charge recognition pattern**.

- Shorter or front ended vesting results in early recognition of charge vis-a-vis back-ended vesting schedule which results in relatively smooth spread.
- Performance linkage helps ensure charge is recognized only to the extent KPIs* are expected to be met.

Options Available





Subject to minimum legal requirement of 1-year vesting (known as cliff period), the vesting criteria can be chosen in any of the manner as shown above.

Below are **examples of different types** of time-based vesting schedules, **along with their estimated pattern of charge recognition** in the Income statement:

Completed Years of Service	Proportion Vesting		Front Ended Vesting		Back Ended Vesting		Bullet Vesting	
	% of options vesting	% of total charge recognized Y-o-Y						
1	25%	52%	50%	69%	15%	44%	0%	25%
2	25%	27%	20%	19%	20%	29%	0%	25%
3	25%	15%	15%	9%	30%	19%	0%	25%
4	25%	6%	15%	4%	35%	9%	100%	25%

*This is an example of 4-year vesting schedule and the percentage of charge recognized each year has been estimated assuming options vest at end of the period. **Y-o-Y means year on year

- As can be seen, vesting schedule directly impacts the pattern of charge recognition in the Income statement. For instance, proportionate vesting results in more upfront recognition of charge vis-à-vis bullet vesting which results in more uniform recognition of charge.
- Further, Time based vesting, typically used in 'Copy-Paste Schemes' lacks linkage with company specific targets, focusing solely on tenure. To that extent, time-based vesting, if used without any performance criteria, it may encourage Rest and Vest behavior wherein employees coast along in a job they may potentially dislike or not be good at, just to wait for their options to vest.

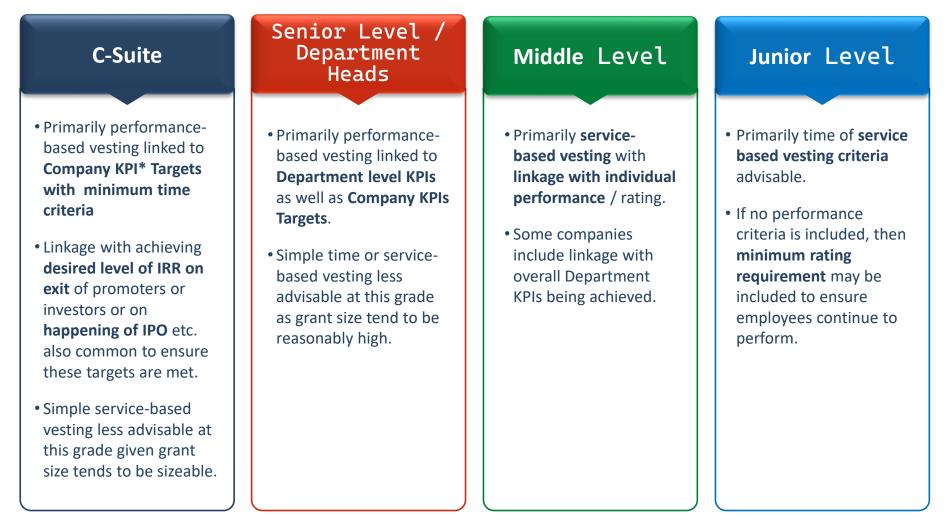
Performance based vesting links vesting to achievement of **specified target or milestone**, with no defined timeline, subject to **1 year cliff** being met. Performance based vesting can be **market linked** or **non-market linked**:

Market linked factors	 Links vesting to company's share price target or market capitalization or shareholder IRR such as: Vesting on achievement of share price of INR 1000 Vesting on achievement of market capitalization of INR 1000 crores Vesting if IRR on exit is at least 25%
Non market linked factors	 Links vesting to company or individual KPIs, such as: Company achieving specified Revenue or EBITDA targets Individuals achieving specified milestone, rating or KPI Event based vesting such as on product launch, IPO, etc.

- Under this vesting choice, the pattern of recognition of charge in Income statement depends on **management expectation** of when **business targets** will be **achieved** and the same is **trued-up to reflect actual achievement** against targets.
- Performance based vesting enables having **explicit linkage with performance**, thereby, helping in achievement of business targets. This may be beneficial for **newly incorporated companies** looking to grow through corporate transactions
- For easy administration of schemes, it is advisable to keep KPIs as quantifiable and objective as possible.

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Below is snapshot of proposed vesting schedule for different grades/ level of seniority

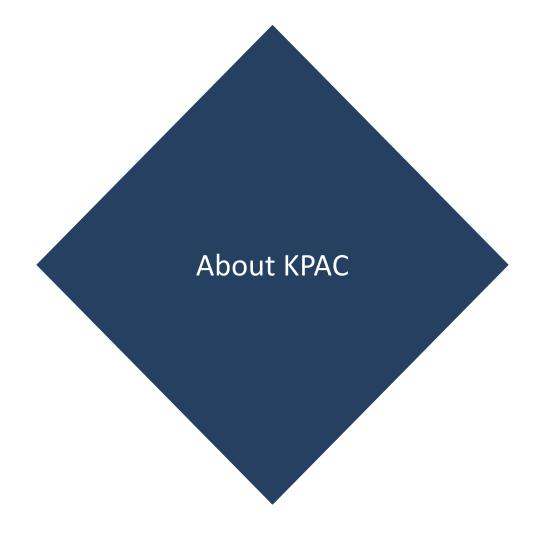


In a nutshell...

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- In recent years, alternatives to this traditional model have emerged because the time-based formula has failed to get longer-term retention & motivate performance.
- The stock options granted needs to be structured to encourage long-term retention as well as **keeping employees' skin in the game**.
- Balancing vesting structures to provide the right short-term and longer-term incentives along with
 explicit linkage to business plan targets can also avoid phenomenon known as "rest and vest"
 (where employees coasting along in a job, they dislike just to wait for their options to vest).
- It is a fine balance to get these incentives right, as the wrong vesting structures could unintentionally impact employee engagement or their perception of the ESOP plan.
- Thus, If you want your employees to stay with the company for a period of time and commit to building success, then **GET YOUR VESTING CRITERIA RIGHT!!**





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Research driven

- KPAC is a research driven actuarial consulting firm **providing actuarial and consulting services** since 2013.
- Empowered by creative thinking and research-oriented approach, we offer solutions that go beyond 'just-compliance'.

Going Beyond Compliance

- KPAC delivers customised solutions with use of data analytics and continuous research, which helps clients in **optimum recognition of liability and better management of expenses**.
- KPAC also helps clients in reducing volatility of expenses through ALM, better planning and budgeting, etc.

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Strong Clientele

- Driven by passion to exceed expectation every single time, KPAC is providing valuation and consulting services to **more than 500 clients** (including large corporate houses and MNCs)
- KPAC's engagements spread across all parts of India and in various other countries like USA, Australia, UK, Middle East, SAARC countries.

- Strong Team
- KPAC has a strong team of consultants and domain experts, who focus on delivering excellence each time.
- Each consultant has experience of handling assignments of large corporate houses and complicated employee benefits. 10

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