Current Issues in Retirement Benefits

Mumbai

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Widening Our Reach: Actuaries working with Businesses

Helping attraction and retention of employees through the
Design And Implementation Of Long-term Incentive Plans

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Institute of Actuaries of India

India - a thriving start up and business ecosystem

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- India has become the **3rd largest start-up ecosystem in the world** after the US and China.
- **More than 75,000** registered start ups
- Number of start ups expected to witness **YoY growth of 12-15%**
- **44 Indian start ups** made to the coveted Unicorn Club in 2021. As many '*soonicorns*' waiting.
- Several strategic, demographic, political as well as technological reasons for the growth
- Many businesses beyond startups or not registered as startups.

"Many people have said that it's India's decade. I actually think it's India's century"

~ Bob Sternfels, CEO, McKinsey & Co

ESOPs - *employers need it…*

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Aligned interests and shared growth

Align **interest of the employees with long term interest of the shareholders** and, thus, can play a vital role in motivating, retaining and making everyone work towards aligned corporate objectives.

Research shows employee owned companies are **more productive, faster growing, more profitable and have lower turnover** - benefits that accrue to all stakeholders including the accounts of the employee-owners.

Sense of Ownership and retention of best of the best

Saves cash as market rewards performance

Equity settled schemes enable companies to save cash, especially in times like these when capital is scarce, and invest the same into the business whilst ensuring the **employees gain with the consequent growth in company's value**.

3 out of 5 Start ups *are already using ESOPs. More than half adopt ESOPs before external funding.*

Of the remaining (i.e., 2 of 5), ***1 in 3 of these companies intended to set up ESOPs*** *in the next 6 months*

Source: State of ESOPs in India by Saison Capital (2022 survey report)

ESOPs *- employees want it…*

Significant potential for Wealth Creation for employees

FOMO starting to build up amongst employees

Being seen at par with promotion

Not just one off grant, regular and even when changing jobs

ESOPs *- But there may be problems to solve*

Redbus – a cautionary tale.

What had happened was pretty simple. ***With the sale of redBus, a few people, three to be exact, had become millionaires. A lot of people, roughly 600, did not.*** *Except that some of them thought they deserved to. Their contention boiled down to a simple instrument, peddled ever so often in the start-up world—employee stock ownership plans (ESOPs). Those who had them couldn't fathom why the money never showed up in their bank account. Those who didn't have ESOPs were asking why not?*

~ Livemint

Oyo's ESOP costs grow 344% to Rs 680 crore in FY22.

~Moneycontrol.com

Over the past one year, several newly listed tech companies have been criticised for large share-based payments that have dented their profitability.

~Article on Moneycontrol.com

ESOPs *- But there are problems to solve*

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Aligning Interests

Wealth creation for employees (to ensure motivation and retention) vs. Cost to the entity and shareholders

Potential reward vs. Riskiness of Reward

Consideration of stage of entity

***Key Output**: Form of grant, Size of grant, Key terms of grant (vesting period, exercise price, etc)*

Accounting Implications

1. *Ind AS 102 on Share Based Payments (of GN on Share Based Payments)*
2. *Complications in case options issued are on shares of group entity*
3. *Most countries on IFRSs / have similar standards*
4. *Most standards work on Fair Value (or intrinsic value) basis*

Tax Implications

1. *Implications under Income Tax Act, 1961 for both entity and employee*
2. *International tax implications in case options issued are on shares of group entity*
3. *Need to ensure no tax without liquidity / cashing out.*

Legal Implications

1. *Companies Act, 2013 and allied rules*
2. *FEMA, 1999*
3. *SEBI (Share Based Employee Benefit) Regulations, 2014 (Listed entities)*
4. *ICDR Regulations, 2009 (Listed companies)*

- Aligning interests is the key stage in designing of any share based compensation plan.
- Accounting, Tax and Legal factors are important considerations but do not impinge on form, kind and size of grant.
- **Iterative process** and involves considering various scenarios in terms of **Form, Size and Terms of the grant**.

Design and Implementation *- what it entails?*

End to end activities involved in designing, implementation and valuation of all forms of share based payment plans (ESOPs, RSUs, Phantom Stocks etc.) involves the following:

Designing

Objective: Identifying the form of grant linked to stage of Organization

Budgeting: Wealth creation for employees ≠ cost to shareholders, Quantum vs Volatility

Identifying beneficiaries

Setting terms and Conditions: Vesting period, exercise period, exercise price, etc

Financial Implications: Understanding the financial implications in different scenarios

Legal implications: Companies Act, SEBI Regulations, FEMA, etc

Implementation

Drafting: Scheme, grant letters, employee presentation, board presentation, etc.

Compliances: Providing all documentation needed for passing necessary resolutions and ensuring compliances with applicable laws and regulations

Employee Communication: Issuance of grant letters, employee manuals / PPTs, handling employee queries.

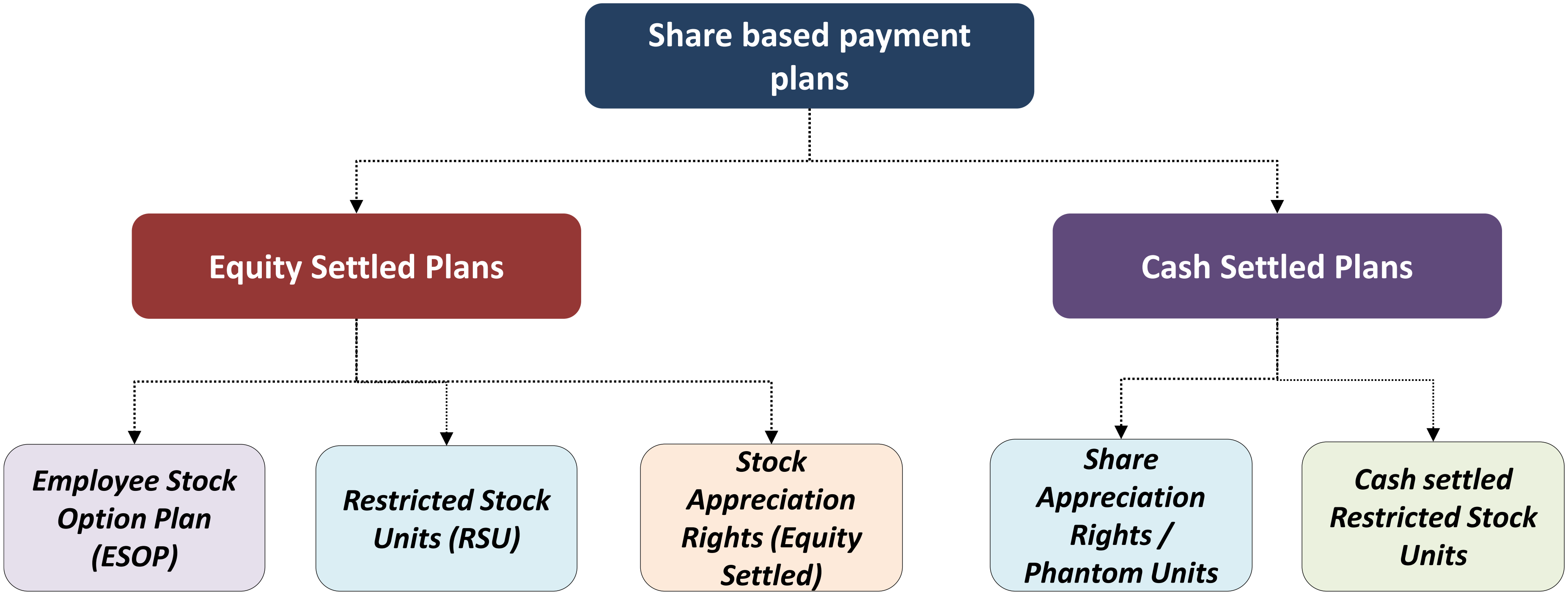
Post Implementation

Accounting and valuations as per Ind AS 102 and Guidance Note on Share based payments issued by ICAI

(Activities required post implementation that typically sit with the Company)

- **Record keeping**
- **On-going compliances**
- **Settlement of benefit:** Issuance of shares or cash payout

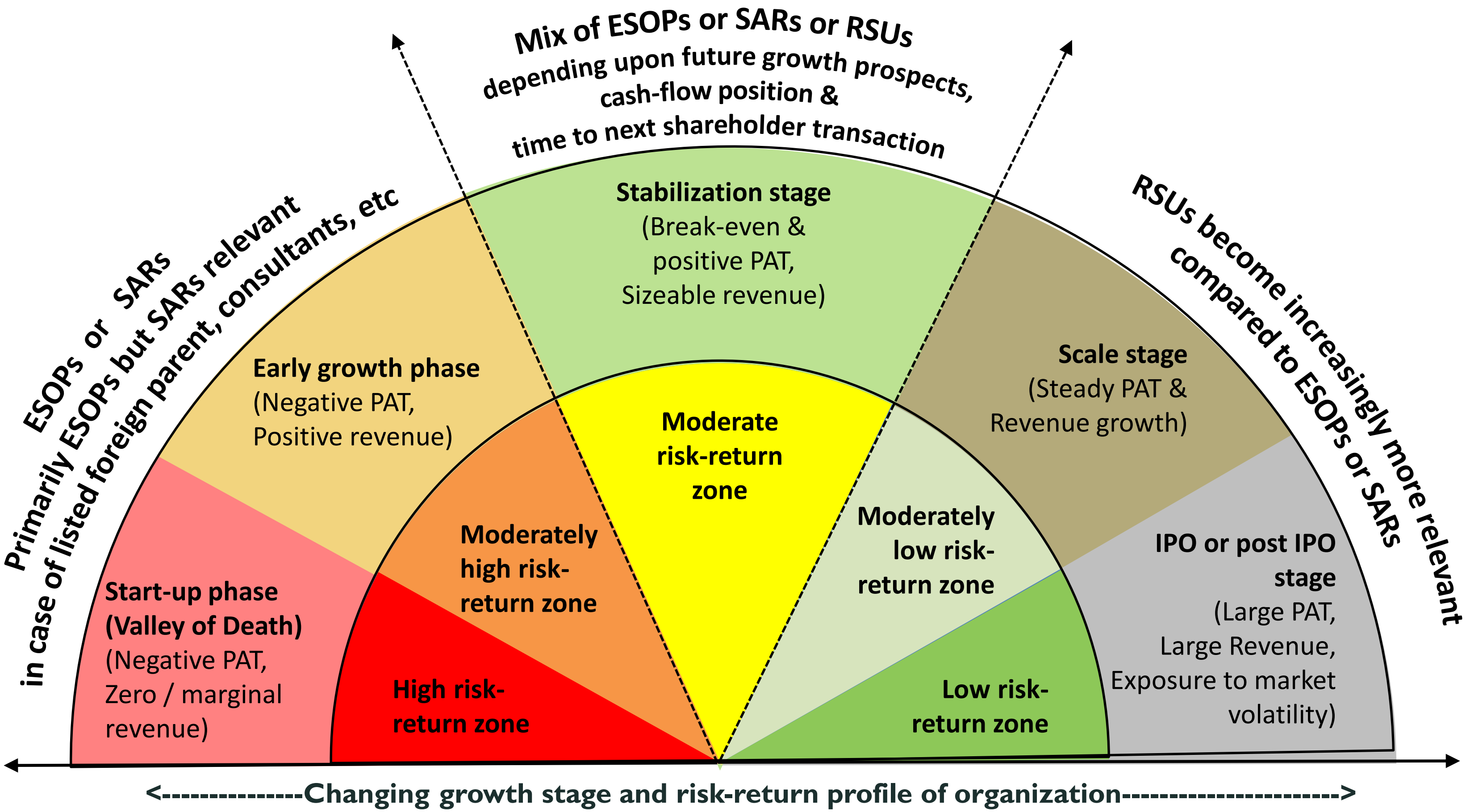
Choosing the right instrument



Each plan varies in its risk-return profile and hence the objective that it helps fulfil.

Companies should choose that plan ***whose risk-return profile matches with that of the Company****. A high level suitability matrix is shared on the next slide.*

Suitability Matrix: *Basis organizational stage*



This is only an indicative matrix and Companies may choose a different one based on specific factors.

Note that **cash settled schemes** (i.e. SARs / Phantom stocks etc.) **involve actual cash outflow** for the Company and should be used after due consideration of the cost and benefit of such schemes.

Cash Settled vs Equity Settled

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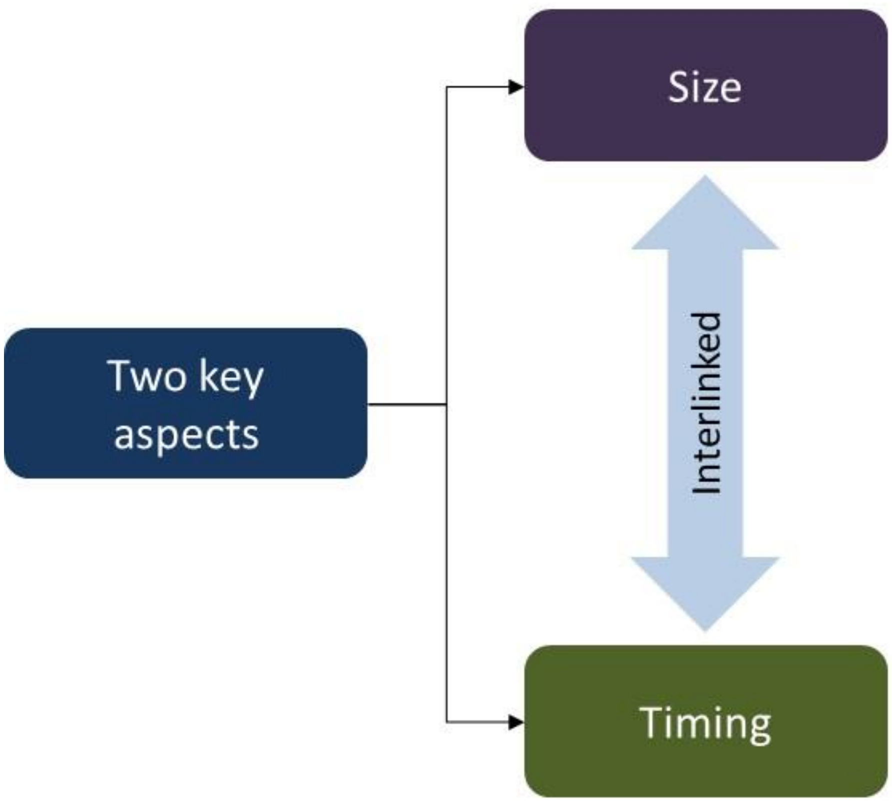
Considerations	Equity Settled Instruments	Cash Settled Instruments
Preference for level of Ownership	Part of the capital table and hence **dilute the ownership** of current shareholders.	Do not form part of capital table and hence **do not dilute ownership** but **achieve same economic outcome** for employees.
Flexibility in designing the scheme	Require **compliance under Companies Act, FEMA and SEBI Regulations**	**Outside the purview of any Act** as do not impact capital structure. Offer **greater flexibility in structuring the instrument**, for instance: 1 SAR can be set equal to 1/10th of a Share, Vesting period can be less than a year etc.
Financial Implications for the Company	Treated as **equity in accounts**, leading to a non cash charge recognized over vesting period.	Treated as a **Liability in accounts**, leading to creation of provision which is remeasured at marked to market basis until settled. Understanding **expected future provision** important in designing such schemes.

Pool Size: *Level of Dilution and overall size of grant*



Large enough to potentially create sufficient wealth for employees

Small enough to ensure shareholder dilution is within limits

Need to be smart and get the math right! Do not rely on external benchmarks!

Immediate enough to cater to immediate needs of current employees and grants

Deferred enough to limit dilution of existing shareholders & to leave enough for future grants

Pitfall to avoid:

Diluting too much, too soon!

Financial Terms of Grant

- Terms of Grant
  - Vesting Criteria
    - **Performance or service based** or both
    - Graded or bullet vesting
    - Uniform, front-ended, back-ended
    - Performance criteria recommended for senior employees
    - Distinction for different divisions / departments
  - Exercise Price
    - **Current share price vis-à-vis discount** to be offered
    - Impact on cost to company and wealth creation
  - Exercise Conditions
    - Length of exercise period
    - **Linkage or not to happening of corporate event**
    - Flexibility to Board for buy back (including implications)
    - Flexibilities to board to enable early exits / liquidity

Working at employee level

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Employee Level Grants

Who?

- Eligibility criteria – **broad based vs selective?**
- Senior Management or founding team only
- Middle management employees to be considered?
- Any **past tenure or performance criteria?**

How?

- **Methodology** for grants basis compensation philosophy
  - CTC Replacement
  - CTC Replacement using future wealth
  - CTC Multiple approach

When?

- **Triggers** for future grants
- Promotions, milestones, etc
- Criteria for grants to new joinees, if needed

Optimizing results

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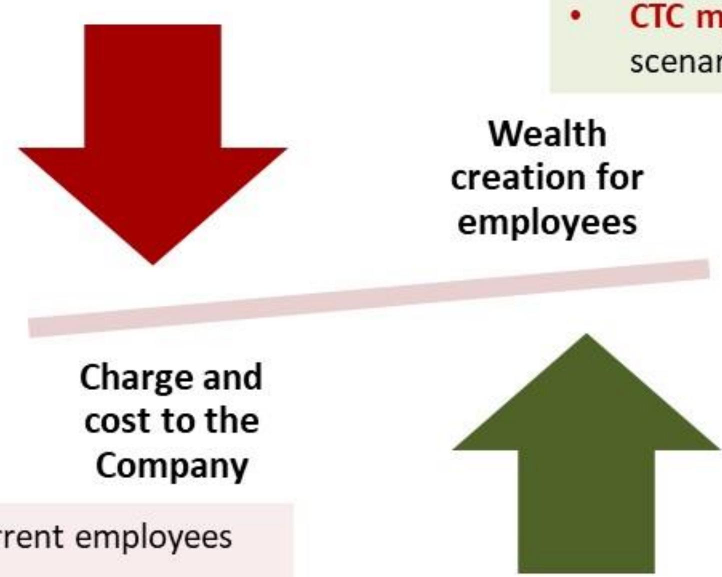
- **Expected wealth creation** basis business plan projections of Company
- **CTC multiples** for various share price scenarios



- **Cost to Income statement** for current employees and key hires
- **Fair market value** - more dilution, no / less accounting charge
- **Discount** - less dilution, benefit buffer with accounting charge

Various **scenarios / simulations** for different options should be considered.

Optimizing cost to Company for given level of wealth creation

Non-financial terms of grant

Minimizing Cash-flow strain for Employees

- Choose scheme rules which aim to **match cash inflow & cash outflow** for employees
- Consider **linking exercise only with Liquidity Event**

How will your cap-table look over time?

- View of **level of dilution expected over time**
- Preference for having **individual employees on cap-table** as shareholders?

Treatment of vested options of ex-employees

- **Compulsory exercise of options** in a short period; or
- Allowing employees to **continue holding vested options** post leaving

Other Scheme Aspects

- **Flexibility to Board** to decide exact terms of Exercise at a later date
- **Accelerate vesting for key employees**, if needed
- **Listing** considerations

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Conclusion

More consulting, less valuations

Need to significantly invest in building capacity

Need to offer end to end solutions

Guidance notes and practice standards can help

Scope to significantly enhance revenue base

Profession should actively position the skill sets