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The storm in ESOPs
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December 11, 2008

The stock market meltdown has hit the wallets of executives of India Inc. and even their retirement plans. Many of them are seeing the value of the stock options getting pummelled. Currently, the market price of stocks is far lower than the option price, making millions of options worthless. Says Harshu Ghate, MD, ESOP Direct, a Pune-based consulting firm: “The value of a stock option is the difference between the stock’s current market price and its option price or the price at which an employee acquires the stock option. Today, numerous ESOPs (Employee Stock Option Plans) have turned unattractive as exercise price of the options are way higher than the market price of their respective stocks.”

Granting stock options is a preferred way of corporate India to attract and retain the best talent in the industry and to reward employees for high performance. But ever since the meltdown began, the wealth creation plans of the jetsetting executive have gone awry. The bellwether Sensex is down 57 per cent this calendar year. In a sample of companies that have ESOPs, the difference between the exercise price and the current price shows an average potential loss of 63 per cent, if the employees choose to exercise their options (see ESOPs Turn Sour). Even as many employees ponder on what to do with their unexercised stock options now, others are sitting on chunks of stocks acquired earlier through options that have plummeted in value in the market carnage. Till sometime ago, ESOPs made many a millionaire in India, but these are trying times for the corporate executive. Your options now depend on whether you are Out of Money (when the company’s market price dips below the exercise price) or In the Money (when the company’s current stock price is higher than the exercise price).

The game plan
Four steps to navigate through the ESOP tangle.

1. Assess your **entire options scenario** thoroughly. If some are not yet exercised and still in the money, exercise them

2. You can **decide whether to sell your stocks** if you need the money. But this can be a part of your long-term holdings

3. If your options are out of money, don’t exercise them. Chances are the **ESOPs could be re-priced** to the current levels

4. Don’t forget to carefully plan your tax liability on **ESOPs as the new fringe benefit tax** will impact your tax outflow immediately

Out of money

If the current value of shares vested in employees has dropped below the exercise price, experts suggest that one should not exercise the option. So, if you are wondering whether you should take your company's ESOP offer, think again. Says Govardhan Purohit, Executive Director, PricewaterhouseCoopers: "It may make more sense to buy the shares directly from the market, if acquiring shares is the objective." Usually, options are vested with executives that have a long association with a company or have achieved certain performance rating parameters. Says Vikas Vasal, Executive Director, KPMG: "Stock options are granted to employees to help them share in the company's growth resulting from capital appreciation. If the current value of the stock options is below than the market value, then the individual may choose not to exercise it, and keep the option open in case the stock price appreciates in the future."

As a practice with most companies in India, options vest for a period of 3-4 years from the date of grant of options and can be exercised anytime within a period of 2-5 years from the date of each vesting. "It is advisable for you to stay around and evaluate the company's potential and its valuations in the stock market for a specific period of time and then take your decision," says Purohit, adding that you could also surrender your stock options. "This will give a genuine chance to your employer to float a new plan or re-price options and make it more attractive," he suggests

ESOPs TURN SOUR

A sample of few companies with ESOPs in 2007.

Company	Options Granted	Exercise Price	Current Price*
Grasim Industries	222,670	1,928	889.25
IL&FS Investsmart	2,500,000	180	83
3i Infotech	1,500,000	140	32.4
Eicher Motors	289,200	462	220.75
NIIT	862,500	121.62	23.75
EID Parry India	116,200	151.4	132.7
Moser Baer	245,200	301.1	54.85
Ramco Systems	401,600	163	56.35
Northgate Technologies	101,000	519.8	56.25

*As on Nov. 28, '08

Exercise and current prices in Rs

In the money

When some of your options are in the money, you still have to act carefully. There are multiple choices available. You could pay cash to your employer and acquire the shares. You could sell them immediately, or could choose not to sell and adopt waitand-watch strategy. Ultimately, it boils down to balancing between your present needs and future goals. Says Purohit: “If you need cash, then sell your shares immediately after purchase even if you are not getting the same price as last year. The current sluggishness will not last indefinitely.”

You can consider exercising your options if the exercise price and the market price are similar, and you want to do some long-term asset accumulation. “Since ESOPs are designed for a reasonably long period, short-term ups and downs can be ignored,” says Vasal. In addition, you can also let your exercise period expire and ask the company to float a new stock option plan. Says Ghate: “Options issued at higher prices and not yet exercised will be cancelled and new options will be issued keeping in mind the current prevailing market prices.”

For those who are already sitting on stocks and have accumulated losses, there’s little anyone can do. One way out is to average down your cost of acquisition. Some employers may float a new option scheme, which executives should consider. Another way out is to ask for cash compensation. “Ask your employer for cash compensation in lieu of loss incurred if you have already exercised the option,” says Vasal.

While the ongoing stock market crash has caused heartburn to a lot of executives, financial analysts believe that the current market situation offers another chance for companies to float fresh ESOPs for employees. “At current rock-bottom prices, new ESOPs present a minimal downside risk to employees. However, an employee has to evaluate the options against any future cash compensation,” adds Vasal. Some companies are in the process of re-issuing stock option schemes. If you are one of them, you can take this opportunity to add to longterm asset creation.

The ESOP primer

What is ESOP?

An ESOP is a kind of employee benefit plan offered by a company to its employees. ESOPs provide an opportunity to employees to acquire a stake in the company. ESOPs confer a right and not an obligation on the employees to buy shares of the company at a future date at a pre-determined price. Whenever a company launches an ESOP, it sets up a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. Shares in the trust are allocated to individual employee accounts. ESOPs are a tool to attract talent and also to retain and compensate employees.

What is vesting?

Vesting is a process whereby the employee acquires the right to exercise the options. It has two components: vesting percentage and vesting period. The former refers to that portion of total options granted, which you will be eligible to exercise. Vesting period is the period on the completion of which the said portion can be exercised.

What is exercise?

The activity of converting the options granted to you into shares by paying the required exercise price is known as exercise of options. In 90-95 per cent of cases, the company fixes exercise price based on the market price of that particular share on the date of grant. Exercise period is the period within which you can decide to exercise your options. This period starts from the date of vesting.

When do options expire?

Due to several reasons, options lose their validity and then cannot be converted into shares. The most common reasons are expiry of the exercise period or when an employee leaves the company.