IMPACT OF COVID-19 ON ESOPS: RECOMMENDATIONS FOR COMPENSATION COMMITTEE

The Compensation Committee is bestowed with the powers and responsibility to administer the Equity compensation policy of the Company. All the decisions with respect to the ESOP Plans of the Company are initiated, debated and approved by this Committee before they go to the Board or Shareholders for their approval. It is a common practice though, to empower the Committee to take all Operational decisions relating to implementation, minor modifications and even making exceptions in some genuine cases. The Board and Shareholders usually approve a broad policy framework and give authority to the Compensation Committee to handle the specifics.

The onslaught of COVID, has made the Compensation Committees revisit their Compensation strategies to align it with the changed business models and goals. Some of the key issues before the Committee with respect to the ESOPs are discussed here.

Should ESOPs be used more aggressively?

With almost all businesses feeling the heat, a major upheaval in the growth estimates, business model, viability of some of the business lines, is expected by all the stakeholders. Investors have demonstrated it in the volatile markets. Corporates have shown it by preparing contingency Plans, re-structuring the organizations. Employees also are bracing up to turbulence in their careers, postponement of increments and in some cases even layoffs.

While the businesses go though restructuring, importance of key talent to navigate through the tough times will only get more pronounced. Committed employees who will think in line with the shareholders and make the revised Business Plans work would be needed more than ever before. Lower stock prices, in this case would be a blessing in disguise as potential benefits for employees will be higher and dilution for shareholders be lower. Win-win for both.

In cases where lay offs are imperative, boosting the morale for those retained will be crucial to ensure the recovery is achieved as planned. In such situations, we see companies even resorting to covering larger employee base for ESOPs, to conserve cash without compromising the overall compensation.

We see ESOPs being used more aggressively by the Companies in the post COVID scenario.

ESOP Direct

Does the existing Policy framework need any tweaking?

ESOP policy consists of several decision points such as – employee coverage, vesting conditions, vesting period, exercise period, exercise price, impact of separations under different modes, etc. Each of these need not be revisited. However, the more relevant ones which need close re-evaluation are:

- **Vesting period:** Companies would be justified in looking at a longer vesting period, given the time taken to recovery may be longer than normal. We see the typical vesting period of 3-4 years getting extended to 4-5 years. In case companies do not see an early recovery, the first vesting could be planned beyond 12 months, say 15-18 months.

- **Vesting conditions:** Companies which earlier used Performance based vesting conditions would need to relook at their assumptions, especially where the Performance conditions were linked to Operating parameters like, Top line or Bottom line growth. It may be worth while to look at Peer group comparison as a Performance condition. This may eliminate the need for any adjustment in situations like now, where the entire industry is impacted and if your business does better in the given situation, the Options could still vest.

- **Exercise price:** If the impact is seen to persist for the next 2-3 quarters and beyond, granting at today's prices may not achieve any purpose, since the prices may still go down further. In such a case either the Grants can be deferred to a date where the bottom is scratched or grant earlier at a discounted price to absorb any short term shocks.

- **Exercise period:** Given the turbulence in the market prices and longer time to recovery, we see more and more companies choosing to offer a longer period to employees to exercise. Employees also would prefer to delay investment and preserve cash with them till the uncertainty is over. This may also be necessitated because not many lenders to be keen to offer loans to employees in a turbulent market. The Committee should however be conscious of the fact that longer exercise periods would result in higher Options cost (wherever companies are following IND AS standards).

- **Impact of Separations:** In view of the turbulence and continuous restructuring, companies would do well to look at Separations more compassionately than before. For instance, separations due to lay-offs can be considered for acceleration of vesting.

Is this the time to evaluate any new instrument?

The Compensation Committees may evaluate other comparable instruments in the following situations:

- **Severe long-term impact:** The market value ESOPs may not make sense in this situation. An RSU or a Discounted option can be evaluated. Concerns of the shareholders and Proxy firms would need to be addressed. ESOPs could be used as currency rather than using cash.

- **Uncertainty about the revival of stock price:** If the company is confident of its revival but not of the stock market sentiment, it may look at a SAR (Stock Appreciation Right) with an option with the Company to settle in cash if the stocks do not revive but company performance does.

How do we get a buy-in from the employees for the new Grant?

In midst of the turmoil, the employee morale on the whole is likely to be quite low. The news about lay-offs within the organization would aggravate this feeling further. In situations like these, the most advisable approach is to communicate extensively with the retained talent and explain them the need for restructuring and the Plan to recover the lost ground. Their confidence about the stable future of the company is critical. Apart from communication, some boosters in the instrument design such as discounted price, longer exercise periods, cashless exercise feature, option to convert to cash settlement would go a long way in bolstering their faith in the company.

How do we deal with the existing outstanding Options?

- **Underwater Options:** This would be the most common demand from the Company management, in view of the fall in stock prices. However, this is a quite complex decision to take. Stakeholders have very strong views on this subject. If the CEO / CXO level employees are pushing for it, since they have a lot at stake, Corporate Governance angle also creeps in. There are also Accounting implications which Company cannot ignore. Investors would insist that employees should also feel the brunt just as they themselves are. It is, however, possible to optimize on all these concerns and implement a Value-for-Value exchange of options, which should please all.

- **Performance conditions unlikely to be met:** If the company is unable to meet Performance conditions such as Top line/ Bottom line growth; market price, etc. the options may lapse. Given the uncontrollable situation, the Committees would be justified in revising the Performance conditions. This could also be done by allowing the spill over or carry over feature so that employees can catch up with the performance over the next couple of years. The Committees should also seriously look at inserting the Peer group comparison as a Performance condition. This will eliminate the individual company performance criteria and bring in focus the company's comparative performance vis-à-vis the Peers.

ESOP Direct