# IMPACT OF COVID-19 ON ESOPS AND YOUR RESPONSE

COVID-19 has jolted everything that concerns us – our psychology, way of handling crisis, mindset towards business, profits, employees, colleagues at work, and everything else. It is also teaching us several lessons of real life. One major impact which is evident but everyone is unsure of, is its depth and tenure. How the businesses are going to deal with the severe and long-term impact on the economy in general? As businesses scramble to save themselves and fight for survival, a major cost that would be scanned minutely is the employee compensation.

The focus of this article is on the impact COVID-19 will have on the Equity based compensation and how should Corporate managements react in this chaotic situation. The impacts and responses would vary depending on

whether the company already has an active ESOP Plan or whether they are contemplating it in future. The other axis of the impact is on how will the employers be impacted and how will the Option holder employees feel the pinch.



## THE IMPACT

First, let us look at the impact on the existing Plans and Outstanding options on the employer and the employees.

### Underwater Options

With the sharp fall in the stock prices, most of the outstanding options issued by the company in recent months must have turned underwater. Depending on how steep the fall is, it is likely that it could take a few quarters before the options turn in-the-money. For some businesses which need to pivot or completely transform themselves, the recovery may take longer. This is not the first time that companies have faced underwater options and there are alternative approaches to handle them.

The response would depend on the nature of impact and the expected time of recovery. The response will also be guided by the fact that while Underwater options do not serve the purpose of Compensation and reward, they still carry the Accounting charge till they vest. For the recent Grants, this charge would be significant.

## Need to Conserve Cash

While companies struggle to recover, they would look at all possible ways to conserve cash. ESOPs being a non-cash compensation could be seen as an alternative. If the business model of the company is otherwise good and not impacted and it is a matter to time to recover the lost ground, then employees would also not mind getting a part of their compensation in this form.

## Options with Performance Conditions

Companies who have certain Performance conditions as a pre requisite for vesting, will face cancellation of all the options since these conditions are not likely to be met. While this will have a negative impact on the employee morale, the cancellation would bring back the options to the Pool and would be available for fresh grants at current prices. Companies would be required to re visit the Performance thresholds for future vests.

## Continuing with future Grants

Usually the Annual grants of companies are linked to the Increment cycle – around May-June. Given the current turmoil and uncertainty, companies would be forced to relook at this timing and may defer the Grants. This will also be driven by the impact on the overall reward policy of the company. However, where the impact is not much (there are some sectors which will do better in this crisis), the companies would use this opportunity to Grant at lower prices and provide opportunity for larger gains for employees.

## Employees may not have cash to Exercise and pay tax

In cases where either the fall in prices is not steep or where Options were granted at deep discounts (RSUs), the Options would still be in the money. However, in these uncertain times, the employees would prefer holding on to all the cash they have and not invest in company's shares or pay taxes. For the companies who have not granted so far but are contemplating using this form of Reward, this crisis gives them an opportunity to leverage the lower prices. This is also an opportunity to convey to the employees how critical they are in charting the path to recovery. Employees are likely to be more circumspect and cautious. They may prefer cash incentives than equity, except for those who also see this as an opportunity to be a part of company's growth story at lower cost.

# THE RESPONSE

Just like the impact, the response also cannot be generalized and it will depend on the nature of impact. However, with this rider, the suggested generic response to the impacts mentioned above would be on the following lines.

## Underwater Options

Cancelling underwater options is costly, hence, if the Options are underwater by up to 30-40%, companies would be advised to continue as-is and wait for the prices to recover. Companies can extend their exercise periods to give more time to employees to exercise. However, if the extent of underwater is beyond 40 -50%, alternatives such as cancellation, re-pricing, etc. could be evaluated. Varying the exercise price, however, is a complex decision to implement from a Regulatory, Corporate Governance and Accounting perspective and needs deeper assessment.

## Conserve Cash

In case of companies whose business is temporarily impacted and would recover in due course, this is an excellent opportunity to Grant options in lieu of Cash increments and conserve cash. For those for whom the change is going to be fundamental and transformational, need to retain the top talent that will enable the transformation will be key to success and ESOPs can be a good tool to ensure retention as well as attracting new talent.

## Performance Conditions

Mostly Performance conditions are defined in terms of Top line and Profitability. These can be revisited with revised goals. Where Performance conditions are linked to Peer group TSR, these may not change, since the target of outperforming the peers can still exist in a challenging market.

## Lack of Investible Cash with Employees

Extending the exercise period would be a good alternative to evaluate. If employees are provided low interest loans, some may prefer exercising in order to reduce the Tax impact.

## Appropriate timing of action

Uncertainty as to curbing the contagion locally and globally throws uncertainties of timing of business stabilization. The best time for action would be when stabilization is foreseen.

The challenge of COVID-19 is seen to be one with much wider coverage and global impact. It will test the resilience of economies and businesses. It is hoped that the society and organizations will come out of it only to be more humane and humbler because this is one phenomenon that is equally lethal for rich and poor, strong and weak, powerful and powerless, old and young.



> While business re-organizations may lead to some downsizing, need to retain and attract the core talent would only get stronger.



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