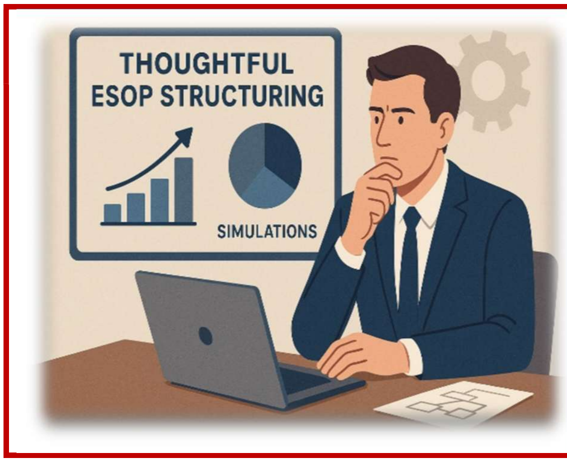

ESOP Structuring Series 2 / 4

ESOP Structuring – Vesting Parameters

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This write-up is a continuation of our ESOP Structuring Series 1 / 4 on structuring of Grant parameters. An ESOP (including all its forms) broadly has 4 key stages/ aspects i.e. (i) Grant, (ii) Vesting (iii) Exercise/ Sale/ Monetisation, and (iv) Effective employee communication ("**ESOP Stages**") which are narrated in separate write-ups.

As the parameters of these ESOP Stages often crisscross/ impact/ influence each other, attempt is made to narrate such linkage at appropriate places in this write-up on structuring of Vesting parameters.

Vesting comes next after Grant of ESOPs. Grant of ESOPs means issue of provisional rights to the employees. This provisional right becomes absolute (or said to be earned by employee) only upon vesting. **Grant of millions of ESOPs carry no value unless some or all such ESOPs vest. This is the importance of Vesting.**

There may be huge employee grievance or there may be eventual failure of the ESOP Plan in case of faulty vesting structure. *E.g., keeping vesting condition 100% linked to company's own financials where the company valuation is traditionally influenced by Sector performance/ outlook, no vesting may happen in case the Sector is not performing well in spite of good efforts by the employees and in spite of company's better performance than its peers. This case may require a portion of vesting linked to company's relative performance with its peers.*

Structuring of vesting parameters can be simple with predictable outcome if all business possibilities are considered.

It may be noted that in case of companies in regulated sectors like Banking and Insurance, the sectoral guidelines on compensation regulate the Vesting parameters. *E.g. for KMPs of private sector insurers and banking companies in India, the minimum vesting deferral is 3 years irrespective whatever is stated in the general ESOP rules/ regulations.* This write-up should be read accordingly.

Vesting parameters are generally structured as under:

Determinants	Details
Vesting period	• Vesting can be allowed subject to a statutory minimum Vesting period of 1 year from the date of Grant (except in case of death or permanent incapacity), subject to maximum Vesting period as decided by the company. • Maximum Vesting period is generally fixed as per ESOP primary objectives like specific retention target, or accomplishment time for business milestones e.g. a target PAT/ EBITDA/ Valuation or IPO. Some companies adopt best practice as well. **Linkage**: ESOP primary objectives
Vesting schedule	• Suppose 100 ESOPs are granted with 4 years vesting period. The next question at what periodic interval these ESOPs should vest. • It is possible to allow Vesting at annual rest, 6 monthly rest, or quarterly rest. *E.g. companies with millennials particularly in IT/ BPO, etc. prefer a 6 monthly or quarterly vesting as vesting is psychologically very frequent and millennials like quick happenings.* **Linkage**: ESOP primary objectives, relevant ESOP regulation
Vesting percentage	• Continuing with example given above, the next question is what percentage of ESOPs to be allowed to vest on each vesting date assuming vesting at annual rest. • The percentage could be 10%-20%-30%-40% (Back-ended), 25%-25%-25%-25% (uniform vesting), 0%-0%-0%-100% (bullet vesting), 40%-30%-20%-10% (front-ended vesting), or any other combination. • Any of these should not be blindly adopted. Each of these styles is highly relevant (or may be highly redundant) depending upon a business case. **Linkage**: ESOP primary objectives, accounting cost, employee benefit
Vesting condition	• Vesting condition is broadly divided into (i) time/ retention basis, (ii) performance basis, or (iii) both. • Time/ retention basis vesting is invisibly present in every vesting as it is a legal requirement. • The debate is centred around Vesting on performance basis or Performance Vesting conditions. Performance has comprehensive meaning and thus, many varieties like Individual performance, Business Unit performance,

	Corporate performance. Further, Corporate performance spans across various qualitative aspects or quantitative numbers like items of financial statements. • For a manufacturing company, corporate performance as vesting condition may be linked to PAT, EBITDA or Turnover. For a Banking company, it may additionally be linked to NPAs. • Corporate performance relative to identified peers is also now-a-days adopted. • The key factors considered for selection of Vesting condition are who are being covered, relevance of their work with such conditions, their understanding of the conditions, etc. • *E.g. blue-collar employees if covered under ESOP should not be tasked to achieve corporate performance. CXOs should not get 100% time basis vesting unless their individual KRAs linked to corporate performance.* **Linkage**: ESOP primary objectives (like employee retention, reward for corporate growth, etc.)

Employee separations

In case of employee separations (due to various reasons) while full or part of a vesting is pending, treatment is given as per applicable ESOP rules/ regulations. Thus, these are not discussed in detail as a company has no much discretion to structure Vesting. The treatments are written in the ESOP Plan as per law.

Basis the Vesting parameters decided, the subsequent parameters on Exercise/ Sale/ Monetization, and Employee Communication are structured in a synchronised manner.

It is important to note that 'a predictable ESOP roadmap' can be obtained when all the parameters of the ESOP Stages are pragmatically determined with appropriate analysis and simulations with reference to applicable laws, practice, accounting, tax, resultant business growth/ valuation and last but not the least is ease of administration.