**ESOP Practices in India – An Overview**

The survey report, in the following chapters, addresses the finer aspects of ESOP Design practices in India. It would however be useful to take a macro view of the overall trends that seem to be emerging in this relatively new phenomenon in India.

In the subsequent paragraphs we have made an attempt to identify and analyze the macro trends. We have tried to interpret the findings vis-à-vis sectors (IT Vs Non-IT) and also within the sectors, in terms of whether companies are looking at structures unique to their requirements or is everyone following each other. We have also tried to analyze the impact of the SEBI guidelines on ESOP and benchmarked the findings versus global trends, particularly in the US.

- **Coverage of employees:**

  There is a noticeable difference in terms of coverage, if one compares the IT and non-IT companies. While around 43% of the IT companies have given ESOPs to more than 90% of the employees, only 17% of the Non-IT companies have done so. A related finding is that more than 75% of the Non-IT companies offer ESOPs only to the senior and middle management employees.

  This is a predictable trend. We believe that apart from the willingness of the management to offer ESOPs, it is also the preference of the employees, which influences the decision about coverage. While a worker employee in a manufacturing company would prefer a cash incentive to a stock option, a fresh software developer
would go for a stock option. It has to be seen how the employees in the IT sector react to the slump in the stock prices.

It is however interesting that within the IT companies, while only 23% of the large companies offer ESOPs to more than 90% of the employees, the number is as high as 60% in case of smaller companies. A significant 54% of the large IT companies offer ESOPs to less than 25% of their employees.

This clearly brings out that smaller companies offer options to the junior employees also to ensure retention and attracting them from larger companies.

- **Legal structure:**

  It is interesting to find that there is no uniform legal structure followed by the companies. While around 58% of the companies have preferred a direct route (Without an ESOP trust) a significant number (42%) of companies have preferred a Trust route.

  Also interestingly there is no major shift in the post 1999 (after SEBI guidelines) period. It was expected that the accounting treatment suggested by SEBI would force companies to opt for a direct route.

- **Term of options:**

  There appears to be no difference in the practices followed by IT and Non-IT companies with respect to the term of the options. More than 78% of the IT companies have a term of less than 4 years and the percentage is identical for the Non-IT companies.
It was expected that the tenure in the non IT companies would be longer since the attrition rates there are much less than in the IT sector. If the Non-IT companies look at longer terms, they could optimize by diluting less equity without affecting the attractiveness of ESOPs. Interestingly no remarkable difference is noticed between large and small IT companies. It was expected that small IT companies would have shorter term of options than the larger companies, to attract and retain talent. However it does not appear to be so.

- **Frequency of grants:**

  Here again there is similarity in the practices followed by the IT and Non-IT companies. Around 57% of the IT companies grant on a yearly basis whereas around 50% of the Non-IT companies do so.

  We expect that as a response to volatility in stock prices, more and more companies would now go for frequent grants. This would facilitate pricing the options at close to market price.

- **Entitlement:**

  Noticeably large number of companies (77%) give more weightage to individual performance when it comes deciding the number of options granted. Relatively less importance is given to Salary grade, Position/title. Here again the trends are similar in the IT and non-IT companies.
• **Conditional vesting:**

A significant portion (25%) of the companies provide for vesting linked to individual performance. A comparable figure in the US is around 5%. An apparent trend in the US is more towards only time-based vesting because performance-based vesting requires compliance with variable plan accounting.

As more and more Indian companies start following US GAAP, they are also likely to follow time-based vesting. Other US features such as performance accelerated vesting (which avoid variable plan accounting) are also likely to feature in Indian plans.

Another interesting trend is that while in around 90% of the IT companies the vesting is time based, the figure is only 67% in the non-IT sector. Significantly large number (33%) of Non-IT companies link the vesting to individual performance.

• **Vesting schedule:**

Almost all the companies (98%) prefer uniform vesting schedule for all the options. It seems that companies are not looking at differentiating between say options given to senior management and junior team. We believe that options could be made more effective if the vesting schedule (both the term as well as graded schedule) is fine-tuned based on the target employee segment.

• **Exercise price:**

This is an important factor in the design of an option. Only around 42% of the companies offer options at the fair market value. The global figure is almost 100%.
The trend is no different between the IT and non IT companies, except that a fair portion (17%) of the Non-IT companies offer options at a fixed price.

We believe that as ESOP practices mature in India, we will see more and more companies offering options at the market price.

I. We do not see companies using differential exercise prices to optimize on the extent of dilution. This is presumably to avoid the accounting impact.

- **Provision for facilitating exercise:**

  Significantly large number of companies (60%) leave it to the employees to make arrangements for financing the exercise of options. As many as 20% provide for broker-assisted cash less exercise. An equal portion (20%) provides loans to fund the exercise.

  The global picture is that almost every company offers broker assisted cashless exercise of options, as a facility to employees.

  It is expected that with the new (draft) Insider trading guidelines more and more companies would provide for broker assisted exercise (through a designated broker). With more and more banks offering loans against shares, financing of options is also likely to surge.

- **Change in Control, Rights, Bonus:**

  An alarmingly large number of companies have not addressed situations such as impact of change in control (more than 55%), Rights issue (50%) and Bonus issue (27%).

  It appears that these companies would leave it to the compensation committees to decide on the impact as and when such situations arise.
We believe that change in control (through takeovers, mergers and de mergers) are no longer stray incidences. They happen every now and then. So also the occasions when companies issue Right and Bonus shares. These events have significant impact on the underlying value of the options and as such should addressed up front in the scheme document.

It is noticeable that even larger companies (IT as well as non-IT) have been equally ignorant about this (especially change in control) in their schemes. Globally companies provide for accelerated vesting in case of change in control and suitably change the number of options and the exercise price in case of Bonus issues.

Even though more than 73% companies have addressed the issue of treatment to be given on issue of bonus shares, there is no uniformity in the nature of treatment. More than 37% of the companies offer bonus options for vested as well as unvested options.

In order to be fair to the shareholders, option holders should be entitled to bonus options only on the unvested options. For the vested options, employees should exercise them to be eligible for bonus. A significant portion (22%) of the companies do not give bonus options on the unvested options. Considering that the issue of bonus shares directly influences the price of the shares and hence the value of the options, it is only fair that the option holders are offered bonus on the unvested options.

A significant proportion of companies (32%) which grant bonus options, have kept the exercise price of the bonus options as nil. This could lead to a situation where an
option holder would be able to exercise the bonus options (without exercising the original options) without paying any exercise price.

It should also be noted that SEBI Guidelines requires that situations such as change in control, right issues and bonus issues are addressed by the compensation committee in a fair and reasonable manner.

- **Response to the slump in stock prices:**

  It is no secret that after the stock market crash most of the options are under-water and no longer attractive. Interestingly, the companies have not found it necessary yet to respond to this situation. More than 92% of the companies have left their schemes untouched.

  We believe that this is the first time IT companies are experiencing the phenomenon of crashing prices and under-water options. It will take some time for them to react. We are likely to witness much more on re-pricing, new schemes to swap the earlier grants, etc.

**Concluding remarks:**

ESOPs are yet evolving in India, we are yet to see companies differentiating on the basis of the sector they belong to, the category of target employee, etc. While in the US responses are faster (more than 30 % of the hi tech companies have re priced their options), the Indian companies are taking time to react.

We believe that this survey would mark a beginning of information and experience sharing and help the companies in making their Stock option Plans more responsive and effective.
Survey on
ESOP Design Practices 2001

In case you need access to the complete Survey report please write to info@esopdirect.com or contact Sabita Wadhwa at our Pune(India) office at 91 20 5284615 / 6 or fax 91 20 5284786