THE ESOP PLAYBOOK FOR FOUNDERS

A GUIDE TO STRUCTURING AN EQUITY PROGRAM TO BUILD GREAT TEAMS

2022

CONTEXT & CONCEPT

LET US START WITH THE "WHY" QUESTION.

Employee equity is all set to be a key enabler of wealth creation and distribution in the Start-up ecosystem in India and SE Asia. This region is now creating world beaters in many sectors such as EdTech, SaaS and Fintech to name a few. Trillions of dollars of economic value and millions of jobs are going to generated by these businesses in the next decade. Several great organizations will be built in this process and employee equity ownership is a key enabler in attracting and retaining talent. It is also an instrument of wider distribution of wealth created in this process enabling the virtuous cycle of reinvestment and more entrepreneurship.

The notion, scale, and scope of employee equity ownership via ESOPs has been changing rapidly and is significantly different from a decade ago. With an abundance of funding many start-ups and Founders are vying for talent from the same pool. With success stories from exits (e.g., Flipkart, Freshworks, Zomato), prospective employees are discerning with respect to ESOP schemes and programs of potential employers. Hence, we believe it is extremely important for founders, finance leaders and HR leaders to create an incentive plan that strategically aligns the larger purpose and objectives of the company with that of the employee's aspirations and incentives.

This Playbook co-created by Matrix Partners and Qapita aims to provide the right inputs, guidelines and industry best practices to create an equity incentive program that enables them to stand-out and attract and retain the right talent to grow their companies.

That being said, this Playbook will be a living document and will be periodically revised to reflect the contemporary practices and insights from time to time.

THEME & TOPICS

The following is a list of topics we have covered in the below playbook.

Theme		Short Description
1 / 10	Changing trends and mindsets	Why Founders' need a clear and scalable ESOP game plan
2 / 10	Right-sizing the ESOP pool	Sizing, creating, deploying, and re-sizing the ESOP pool
3 /10	Employee friendly scheme	What does an employee friendly ESOP scheme look like?
4 /10	The buyback factor	Trends in ESOP buybacks and liquidity programs
5/10	Finance Function Impact	The CFO lens on ESOPs: Accounting, Tax and Compliance
6/10	The CHRO lens	The CHRO perspective - total rewards, engagement, and retention
7/10	Employee Trust Vehicles	ESOP Trust Vehicles – Why, When and How
8/10	Alternative Instruments	The case for Phantom shares and Stock appreciation rights
9/10	Exercise and Taxation	Exercise events and communicating Tax impact to stakeholders
10/10	Employee Lens	Communication, transparency, and engagement with employees

1/10 Changing trends and mindsets

Why Founders need a clear and scalable ESOP game plan

The scope and scale of employee equity incentive schemes has been changing rapidly in the last few years. From being a mandatory precedent to venture funding rounds, it has become a strategic instrument for enabling hyper-scaling of start-ups. The need to attract the best people to build large, purposeful organizations in a market hungry for talent necessitates that Founders' have a game plan that is unambiguous and scalable. The type of instrument and the associated economics have also evolved with the stage of growth of the business.

Observations:

As ESOPs have become a strategic instrument to build rockstar teams, structuring an ESOP program is no longer a formality left to the finance and HR teams, but a strategic exercise driven by founders. Be it structuring the right equity program or engaging the employees frequently or deciding on offering liquidity to employees at regular intervals – all these actions are receiving a larger amount of founder and board level interest.

On the other hand, as tens of thousands of employees are reaping the benefits of ESOPs in the Indian startup ecosystem, there is a larger awareness amongst prospective employees about ESOPs and the potential they carry. This also sets a basic expectation around clear communication, adequate transparency and regularly ascertaining value of ESOPs from time to time.

Takeaways:

- ESOPs are no longer a lottery ticket that only a few win, but a credible instrument that aligns employee wealth with company's value creation.
- There is no one-size-fits-all ESOP Plan. Founders need to bring in their originality – philosophy, purpose and intent, and marry it with contemporary industry practices to create an ESOP Policy that enables them to stand-out in the market.
- An ESOP Program is a dynamic scheme. While it is instituted keeping in mind the prevailing standards and company objectives, these tend to change over period of time and hence there is a constant need to revisit and reinvent the policy to attract and retain talent.
- Timing: Founders should think of setting up an ESOP Scheme when they plan to build their core teams. While in most cases this is around a funding event, it is not a necessary condition!
- ESOPs also offer an opportunity to founders to build the right narrative and brand in the ecosystem signaling intent with execution. A consistent narrative right from the early stages of the company and following through with corroborative action would go a long way in building an employee-friendly brand in a talent-deficit market.

2/10 Right-sizing the ESOP pool

Sizing, creating, granting, and re-sizing the ESOP pool

What is the right size of ESOP pool that is appropriate for an early-stage start-up? There is no one-size-fits-all solution to this question, but we can highlight a broad framework we have seen founders adopting in creating their initial pools and how they would top it up subsequently to signal the right intent to their employees. There is a delicate balance between the pool size and shareholder dilution that founders need to navigate through.

Observations:

We have seen that on an average founders allocate anywhere between 8% and 15% as part of their first ESOP pool. The median pool size is 10% in most companies.

ESOPs are also regularly topped up subsequently in future rounds. A staggered approach to expanding ESOP pool size makes sense and is also optimal considering dilution impact.

Takeaways:

Founders can consider setting up a pool size on multiple factors:

- The startup's hiring plan for the next 18-24 months (basically enough timeframe when one can make a case for a pool top-up with the investors and the board)
- The philosophy and intent of the founders (larger pool size indicates a greater intent to share and hence considered friendly by employees)
- The composition of the current leadership team (if the company has a solo founder or intends to rope-in several senior management folks, a larger pool size is justified)
- Industry benchmarks.

3/10 Employee friendly scheme

What does an employee friendly ESOP scheme look like?

Balancing multiple stakeholder interests while making the ESOP plan as employee friendly as possible implies a nuanced understanding. It's imperative for founders and startup leaders to view their policy from the employee's perspective and align the key strategic parameters of the scheme with the employee's interest.

Some of the key strategic parameters include: Pool Size, ESOP Coverage amongst employees, Vesting Schedule and Period, Exercise regime post separation, lock-in periods, liquidity programs.

Observations:

Of-late we have seen several practices with regard to ESOPs to benefit the employees largely. Here are a few examples of employee friendly practices that founders could consider:

- **Coverage**: A 100% coverage meaning ESOPs to all employees is considered extremely employee friendly
- **Pool size**: Any pool size above 10% is considered friendly. While the most generous startups have also considered pool size in the range of 20%-30%
- **Strike Price**: As low as possible, Zero or Face Value indicates the upfront unrealized value the employee makes on the day of grant
- **Vesting Period and Schedule**: 4 years is considered both fair and employee friendly vesting period. While most schemes have annual vesting, nowadays, due to existence of software platforms, quarterly or monthly vesting schedules is considered more friendly to employees.
- **Exercise Restrictions**: While an option to exercise is friendly to employees, many companies limit exercise of ESOPs in the early and growth stages of startups to avoid unnecessary compliance and procedures involving issuance of shares to employees. This is a well observed practice in many startups. Most exercise events are linked to company liquidity.
- **Separation Rules**: This is the most important parameter that determines employee friendliness. The shorter the post separation exercise period is, the harsher it is for employees. An Employee friendly plan would have a long enough exercise period or in some cases indefinite/infinite as well.
- **Liquidity programs**: Programs that signals the intent of conducting frequent liquidity programs is considered friendly
- **Employee Engagement and Communication**: Companies that focus on engagement and frequent communication, especially through software platforms are considered more serious about implementing ESOPs and having an intent to provide regular liquidity programs for employees to participate.

Takeaways:

To create an ESOP plan that one's employees love, founders need to carefully consider each decision parameter as above and signal the intent of being fair and friendly to employees who decide to join their companies.

4/10 The buyback factor

Trends in ESOP buybacks and liquidity programs

Availability of liquidity for ESOP holders and beneficiaries is emerging to be a key factor. ESOP liquidity programs enables employees to liquidate their options or exercised shares to cash at the prevailing fair value of the shares of the company. Associated with value distribution, financial independence, and ownership; this has become a key factor in employer branding.

Observations:

There has been a significant uptrend in recent times among startups in India and SEA in offering buyback and liquidity opportunities to employees. 2021 has been a record year for ESOP buyback programs (~$400 million+ impacting 10,000+ employees) in this region.

From doing one-time, adhoc liquidity programs, startups are also announcing innovative programs such as 'structured liquidity' and 'anytime liquidity' to ensure employees get liquidity for their ESOPs when they require.

Founders are also considering offering lending and other financing solutions for exercising one's ESOPs or borrowing cash against ESOPs as a collateral.

Takeaways:

- There is a need to signal the intent to offer frequent liquidity programs to one's employees. This is important for employees to unlock their ESOPs into cash.
- Startups can consider announcing structured liquidity programs as well as anytime-liquidity programs to enable employees to enjoy predictable liquidity very close to what one experiences in public markets.
- Apart from company led buybacks, companies can also choose to offer secondary programs to offer liquidity to one's employees and stakeholders.

5/10 Finance function impact

The CFO lens on ESOPs: Accounting, Tax and Compliance

The CFO / Finance controller lens on ESOPs extends across accounting, compliance, and taxation.

Accounting: In accordance to the accounting standards, the cost of services received in share based payment needs to be recognized over the vesting period as a P&L expense in the books of the company. The cost of service received is calculated as the fair value of the options as calculated by option pricing models like Black Scholes, Binomial Lattice etc.

Stock compensation amortization expense requires reporting and filing processes to be in place and may also involve external certification to meet audit requirements.

Compliance: Compliance requirements start from creation of pool, to granting as well as taxation. To being with, at the time of policy creation necessary board and shareholder approvals need to be taken to institute the ESOP scheme. Requisite filings also need to be done to regulatory authorities, eg: MCA in India, ACRA in Singapore etc. On an ongoing basis, based on jurisdictions, necessary board approvals need to be taken at the time of issuing grants as well making amends to the ESOP Policy.

Tax: In jurisdictions, where tax needs to be deducted at source there is an obligation on finance and HR functions to withhold this.

Last but not the least, ESOPs create a CapTable impact too. The finance function can manage this efficiently with awareness, planning and most importantly with systems.

6/10 The CHRO lens

The CHRO perspective - total rewards, engagement, and retention

ESOPs now form a key part of 'total compensation' awarded to employees and increasingly negotiated at the time of recruitment. ESOPs offer a key instrument for the CHRO for hiring, engagement, retention, and overall employer branding. HR Leaders and founders are increasingly becoming vocal about ESOP policies in the company highlighting the key employee-friendly aspects, be it a larger pool size, regular top-ups, frequent vesting, longer exercise periods or structured liquidity events.

Internally, HR Leaders have several structured engagements with employees on ESOPs. Be it regular townhalls to clarify open questions and demystify ESOPs as an instrument as well on-demand enquiry service on aspects related to vesting, exercise, liquidity and taxation.

Many startups have also adopted tech platforms to implement and communicate ESOPs with their employees. Systems offer unique ways in which company management can communicate details with regard to ESOPs and the value that they accrue.

7/10 Employee Trust Vehicles

ESOP Trust Vehicles – Why, When and How

ESOP Trusts help companies carve out an actual pool of shares into an SPV vs. a nominal pool that is created within the company. While ESOP Trusts provide a certain degree of flexibility and advantage, it is generally preferred under certain specific circumstances and at a particular stage of the company. The most important factor is helping the finance and compliance functions in managing fewer number of shareholders w.r.t corporate action and shareholder voting.

8/10 Alternative Instruments

The case for Restricted Stock Units, Phantom shares and Stock appreciation rights

While ESOPs are the most frequently used employee incentive schemes, there are also other category of incentive schemes like Restricted Stock units, Phantom Stocks, and Stock Appreciation Rights (SARs). While these provide certain flexibility to companies, they also add certain obligations.

The case for Restricted Stock Units: It is a stock option which is given to employees at a deep discount or at face value.

Pros: Lesser investment from the employee and also less dilution for the shareholders. The employee is protected from the downside risk.

Cons; A RSU has a high accounting charge that can be advantageous to the employee even when the business is struggling. It is typically applied to extend the life of the ESOP reserve and lessen dilution.

The case for SARs (cash settled) /Phantom: They form a type of cash settled incentive schemes that reward cash payouts to employees pegged to the share price appreciation.

Pros: SARs (cash settled)/Phantom are a form of non-dilutive equity linked incentive instruments. Another advantage of SARs ((cash settled)//Phantom is that they can be offered to non-employees as well in jurisdictions like India (where traditional ESOPs cannot be given to non-employees). This includes consultants, advisors, gig workers etc.

Cons: One of the main disadvantages of SARs (cash settled)//Phantom is the obligation to provide liquidity in the future rests on the company. Hence requisite provisions need to be made in P&L to execute liquidity programs. In case of ESOPs, company could also explore a secondary liquidity opportunity without burdening company's balance sheet. Secondly, in case of SARs (cash settled)/Phantom, employees might not be able to benefit from capital gain tax advantage, especially in IPO bound companies.

Observations: We see prevalence of SARs (cash settled)/Phantom schemes mostly in bootstrapped and profitable companies as well as growth stage startups which require to offer equity incentives to non-employees.

9/10 Exercise and Taxation

Exercise events and communicating Tax impact to stakeholders

Taxation involving ESOPs is often a misunderstood aspect among employees and occasionally, founders. While taxation is a jurisdictional matter, there is a broad approach to taxation that both founders and employees need to understand.

Finance teams also need to be aware of the taxation impact on employees and withhold requisite amounts as mandated by the law. There are two kinds of taxation impact on ESOPs:

a) At the time of exercise/surrender: The difference between FMV and exercise price is recognized as an income to the employee and required income tax needs to be withheld.
b) At the time of sale of shares: The difference between the sale price and FMV at exercise event is considered a value appreciation of shares and taxed based on capital gains. There is no employer obligation here.

10/10 Employee Lens

Communication, transparency, and engagement with employees

Employers are covering a larger share of employees and ESOPs are becoming a ubiquitous instrument of attracting and retaining employees in startups. This has necessitated having an effective communication and engagement plan to drive awareness and also periodically communicate the value accrued. Structured liquidity programs and proactive communication go a long way in earning the trust of current and prospective employees.

HR Leaders are considering innovative approaches to engage and communicate with their employees using ESOPs:

- ESOP communication at the time of recruitment. Founders and HR Leaders often explain the value of ESOPs simulating future scenarios for the prospective employee.
- Companies are increasingly instituting an effective ESOP communication and engagement strategy by conducting regular townhalls, AMA sessions and helpline support to clarify key queries with regard to ESOPs and taxation.
- Software tools are frequently used for an ongoing, real-time engagement. These systems provide tools such as value calculators, tax estimators etc.
- Frequent Signaling and leadership cues around the importance of ESOPs to the business in terms of internal memos to the organization, thought leadership articles, media interviews etc.