QAPITA

Whitepaper

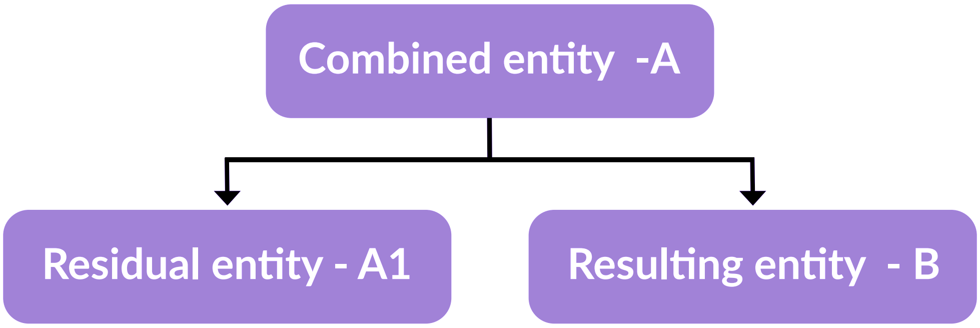
Corporate Actions and their Impact On Esops: Demerger Of Businesses

Corporate ac ons and their impact on ESOPs: Demerger of businesses

Incorrect treatment to ESOPs in case of a Demerger often leads to disproportionate gains to employees at the cost of Shareholders

Nature of Corporate action

• A company having several business lines decides to demerge some of its businesses into a separate company. The objectives of demerger could be several such as re organisation, family allocation, hiving off, seeking strategic investors in specific business, etc.



• The demerger is implemented through slicing out the business to be demerged by way of a vertical split in the Balance sheet as well as Income statement.

• The Share capital also gets split. All the Shareholders of the combined entity become Shareholders of the resulting company in the same holding proportion.

• While the erstwhile entity continues to exist with the residual business, assets and liabilities, there is no Holding / Subsidiary relationship between the two entities. They would however be related parties given the common Promoters.

Impact on employees

In a demerger, employees are aligned with the businesses they work for. Those working for the demerged business get transferred to the resulting entity. The transfer takes place along with their service contract and accumulated benefits (Gratuity, PF, etc).
After the transfer, they cease to be employees of the residual entity.

Impact of demerger on the Value of the ESOPs held by employees

Demerger leads to splitting of the business value and hence value of the Stock Options. In most of the cases, the resulting and residual entities follow a different growth path and trajectory. As such, their respective Share prices also do not follow the same path. One of the businesses may outgrow the other – immediately or over a period.

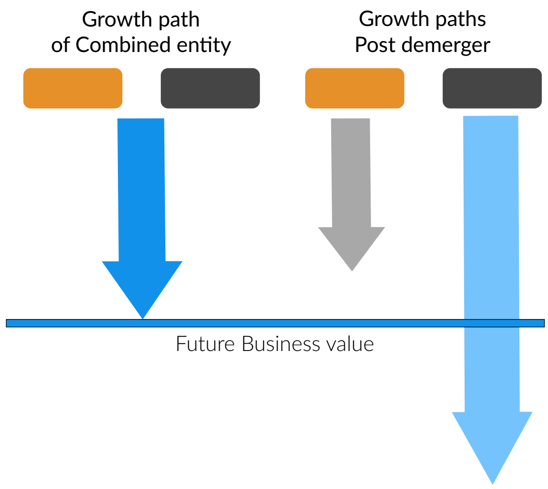
Stock option is a derivative of a Share and its value is linked to the value of the underlying Share. In case of demerger, the value of a combined option is linked to value of two Shares with different growth path. This complicates the assessment of whether the demerger is going to impact the Option holder and if so in which way. Will it enhance the value or diminish it?

Since Option value is different than the value of the underlying share, how can their swap ratios be same?

To put it simplistically, since the employee is holding options of the Combined entity, the value for him should not be impacted if his Options also get split (like Shares) and he gets to hold Options of both entities – Residual as well as Resulting- in some proportion. Unfortunately, it is not as simple as it looks.

What is the Value of an Option – it is the present value of the future benefit the holder will get due to higher price of the underlying Share.

As can be seen, the value for the Option holder pre and post demerger is not the same, even if his options were split and he owned options of both the entities. In the case shown here, the value will increase so he will not mind it. But the situation could also be reverse – the post demerger value of both entities may be lesser than the pre-demerger entity.



Irrespective of what happens post demerger, it is certain the value of the Options will not be the same. Hence, they need to be given due treatment.

Impact on the Options held by the employees

Relevant provisions of the SEBI Regulations (applicable to listed companies) which are also followed by unlisted companies as a best practice, require Companies to do fair and reasonable adjustment to the Options in case of a corporate action. There is no specific treatment recommended for a Demerger.

Post demerger, there are two categories of employees – those who get transferred to the resulting entity and those who remain with the residual entity.

First let us look at the employees getting transferred to the resulting entity. If one were to go by the wording of these Regulations, any employee separating from the company would have to forego his unvested options. There is no exception made for separation due to demerger. As such, unvested options of the employees who get transferred to the resulting entity will lapse thereby leading to reduction in the value of the Options held by him. Regulations require this reduction to be compensated appropriately.

Second category is of employees who stay back in the residual entity. Since they would now hold options of a smaller business, the value in their hands would certainly go down and hence would need appropriate adjustment to make good the diminution.

In other words, appropriate adjustment needs to be done for both the categories of employees.

Fair and Reasonable adjustment

The intent of the Regulations is to ensure that employee's interests are not impacted due to the Corporate action. This can be achieved by ensuring that the value of options pre and post corporate action is the same. Value of the Options is different than the value of the underlying Share. Since the options would vest over different point in time in future, their value varies based on variables such as vesting schedule, exercise period, likely future price, etc. Globally Black Scholes formula is the most popular method used for valuing Options. There are also other less used methods such as Lattice or Monte Carlo model. Regulations allow use of any of these models.

Fair value of the Outstanding Options is calculated (separately for each Grant), pre-demerger and post demerger. Since their values will not be the same, adjustment is made either to the number of Options or the exercise price or both to equate these values.

Practice followed

Almost all the companies in India give the same treatment to Stock Options as the equity Share. For instance, if the Share exchange ratio is 1:1 (1 equity Share in resulting company for every Share in the combined entity) then the same logic is applied to all the outstanding options. This method assumes Intrinsic value of the Option.

Fundamental fallacy in using Intrinsic value is that it assumes all Options would vest immediately (only then can the Options be compared to Shares). However, this is factually incorrect. Options are going to vest at a future date (in fact multiple future dates). Any valuation assuming immediate vesting is bound to give incorrect results. For example, a Shareholder in this case will get 1 Share in the resulting company in addition to the 1 he currently holds. Since these Shares have no lock-in, either or both of these Shares can be sold immediately or whenever he wishes. The Option holder on the other hand, does not have this privilege. Unless the Options have vested he cannot exercise and get Shares. Only then can he sell and realise cash. As such the value realised by the Shareholder from his 1 Share will be different than what an Option holder will realise from his 1 Option. Given this inherent inconsistency, applying the same ratio for Options as for Shares is grossly incorrect and also not in line with what the Regulations expect.

Using Intrinsic value for deciding on Options to be exchanged is neither in line with Regulations nor global best practice

Let us take an example, where an employee has been granted Options on 6 different dates with varying vesting periods and exercise prices. Assuming that the demerger date is some time in 2018, the 6 grants will have different Option values as shown in the table. It is obvious that applying the same exchange ratio for all the grants (which have different Option values) is logically incorrect.

Grant dates: Jan-14 Apr-15 Jan-16 Aug-16 Jan-17

Vesting dates: 2019 2020 2021 2022 2023

Options Granted	Exercise Price	Fair value: Pre Demerger Entity A	Fair value: Post Demerger Entity B	Fair value: Post Demerger Entity A1
1	85	160	200	60
1	133	240	310	90
1	82	150	180	70
1	150	250	320	90
1	52	90	140	40
1	60	110	150	50
6		1000	1300	400

If in this case Share exchange ratio is 1:1 and Option holders are also given Options in the same ratio, Option holder who has been transferred to Entity B will get more value because value of the same options which was Rs 1,000 Pre-demerger has become Rs 1,300 Post de merger. If the same employeeis retained in Entity A1, the value of Options that he will get will stand reduced to Rs 400.

There are two inconsistencies here:

1. Each Grant has a different value, hence applying same ratio of 1:1 for all Grants is incorrect
2. For each Grant, the Post demerger value is higher or lower than the Pre-demerger, it is not in ratio of 1:1. This is because of varying vesting periods of each grants as well as varying potential benefit for Entity B and A1.

To ensure a Value-for-value exchange, the employee transferred to Entity B should be given 77 options (1000/1300 - the ratio should actually be worked out for each grant) for every 100 that he holds in the combined entity. Similarly, the employee retained in Entity A1 should be given 250 Options for every 100 he holds in the combined entity.

Some companies have gone ahead and granted 1 Option in each entity (B and A1) post demerger to all the employees, irrespective of where they are employed. There is a compliance issue here. Since an individual cannot hold options in an entity where he/she is not employed, he/she can hold options of only his employer entity in future. Apart from this, the Value inconsistency continues to exist even in this scenario.

Accounting implications

IND AS (now applicable to all the listed and large unlisted companies) requires that if the Fair value of the Options post demerger is higher than the value pre-demerger then the excess value has to be accounted for as incremental charge. It will be interesting to see how these companies, who have ended up giving higher value to employees have treated it in their books.

The argument being made here is not to suggest that employees would always get more Options. On the contrary, there is high probability that the employees would end up getting lesser Options than before if the value of two demerged entities is going to exceed the combined valuation. As such apart from the employee angle, there is also a Shareholder angle to this treatment. Lesser Options would mean lesser dilution and higher value for the Shareholders.

Globally the best practice is to follow Value for Value exchange as suggested above. Indian Accounting standards (IND AS) have also moved towards Fair value accounting for all assets. There is absolutely no case for using the Intrinsic value for exchanging Options.

Given the high % of outstanding Options (options overhang), in many companies, it is a bit surprising that Shareholders including the Proxy Advisory firms have not looked deeper into this aspect of a demerger scheme. In most of the Merger or De merger cases, employees have benefitted disproportionately in view of the Intrinsic value adjustment method followed by Companies at the cost of the Shareholders.

About Qapita

Qapita is a leading provider of Equity Compensation solutions for startups, unlisted and publicly listed companies. Our service offerings cover the entire life cycle of ESOPs including Plan conceptualization, Design, Documentation, Plan management, Compliance and Reporting. We have serviced over 1800+ clients across all industries, domestic and international, listed and unlisted. Our team consists of experienced professionals specialising in conducting preliminary analysis, planning, designing, and implementing ESOPs. Each of our consulting team members is a qualified Chartered Accountant/ Company Secretary, a market leader in Equity Management and Marketplace solutions for unlisted and listed companies in India and South East Asia.

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