Fair All Around: Why Performance Based Restricted Stock Units are Gaining Relevance in India

The last decade has seen the nature of employee stock options evolving considerably. What's interesting is that in the last three years, the prevalence of Performance Based Restricted Stock Units (PBRSU) has gone up significantly. According to an article in Business World, 2023 has seen the earlier dominance of classic stock options now dropping to less than 50% for the first time[1].

The reasons for this change are multi-fold. Firstly, the notion of share price reflecting the true value of the company is being challenged in many corners. Increased volatility in the stock market, unfathomable earnings / revenue / story multiples, post-IPO performance of share price of some celebrated new-age companies have supported the challenge to classic stock options – the focus is back on fundamentals.

Secondly, the fair value accounting of employee stock options has become a reality for most industries (there are exceptions, e.g., insurance). With the cost advantage going away, the efficacy of "at the money" options are being challenged. The key question is – if the cost must be incurred anyway, are there other instruments that align with long term incentives better?

Lastly, with traditional stock option programs running for years and with eligibility starting to get more broad-based (thanks to an ESOP revolution by start-ups), the dilutive impact of stock options has started raising some eyebrows amongst investors.

In summary, the focus on Pay for Performance linkage, elimination of so-called accounting advantage, and avoidance of high share burn rate (dilution) are the key reasons why Performance Based RSUs are gaining prevalence.

SHARPENING OF THE PAY AND PERFORMANCE RELATIONSHIP

It's undeniable that linking the outcomes of share-based compensation with specific medium to long-term financial and non-financial performance metrices (that are underlying levers of value creation) helps in building an organization with strong fundamentals. However, adoption of share-based compensation programs is contextual and can vary significantly even in companies within an industry.

The banking industry is a case in point. In the last year, three private sector banks introduced share-based compensation structure akin to PBRSUs, and more may follow. The regulator has played a role in this too.

The Reserve Bank of India (RBI), in its Guidelines on Compensation of Whole Time Directors/ Chief Executive Officers/ Material Risk Takers and Control Function staff[2] highlighted that there should be an effective

[1]https://bwpeople.businessworld.in/article/Insights-And-Trends-On-Executive-Compensation-Benchmarks-Of-CXO-Level-Leaders-Deloitte-Study/24-04-2023-473922/
[2]https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI898C120D41D0E3465B8552E5467EDD7A56.PDF

alignment of compensation with prudent risk taking. Compensation must be adjusted for all types of risks, symmetric with risk outcomes, sensitive to the time horizon of risks and mix of cash, equity and other forms of compensation must be consistent with risk alignment.

A PBRSU program helps meeting these objectives much more effectively relative to classic stock option plans that have an overt focus on share price, which may lead to excessive risk taking. There is however, an argument that classic stock options help in improving the net worth of the company because there is a cash inflow when an employee exercises the options or, in other words, helps in increasing the Tier–I capital in banks -- which helps them better the ratio of Tier–I capital to its total risk-weighted assets. While, the technical argument cannot be refuted, the question to be asked is – is this the objective of a share-based compensation program? Or is the objective to align leadership compensation with strong fundamentals and avoid excessive risks that can do more harm than good in future. A well performing bank can potentially raise capital at higher value using far fewer shares relative to grant of classic stock options.

INCREASED INTEREST IN PAY AND PERFORMANCE

An interesting point to note here is that Insurance Regulatory and Development Authority of India (IRDAI), taking a leaf out of RBI's book, has issued guidelines for insurance companies with similar requirements. It will not be a surprise to see Performance Based RSU structures emerge in insurance companies as well.

The PBRSU structure is finding favour with the manufacturing sector as well. Significant opportunities have opened in manufacturing sector with global multinationals de-risking the supply chains by looking at alternative manufacturing hubs. These are being coupled with initiatives taken by the Indian government to boost manufacturing (PLI schemes are a case in point). The medium to long-term compensation plans are now being structured to link compensation with how well the leadership team can take advantage of these opportunities.

FAIR VALUE EXPENSING IS A BIG FACTOR

Adoption of IND-AS in most industries has made it compulsory to expense employee stock options on a fair value basis. This has raised a very pertinent question i.e., if there is no advantage on expensing, is the stock option the right instrument to drive long-term objectives? We can argue that expensing methodology should not have played a role in selection of instrument. Unfortunately, that was the case with many organizations and was one of the key drivers for selecting "at the money" stock options.

On the other hand, a full value instrument like PBRSU links compensation outcomes with performance outcomes over the medium to long term. If performance metrices are not market linked and are internal to the organization, the expense can be written back in cases where performance conditions are not met and vesting does not happen. Not only does this align with the Pay for Performance philosophy, it also helps contain the cost of programs in case of lower-than-expected performance.

REDUCING SHARE USAGE / CONTAINING SHARE DILUTION

Performance based RSUs also help in containing the share usage. To deliver the same fair value to employees, the number of shares required are significantly lower under Performance Based RSUs (as the fair value of PBRSUs is higher than classic stock options). This helps in lower dilution for shareholders over a period. Most PBRSU programs in India provide an upside in the form of a greater number of shares if the performance targets are exceeded. The upside is generally in a range of 120% to 150%. Even with this upside, the share usage is lower compared to classic stock options.

For now, India remains an "at the money" stock options dominated market, but executive compensation is certainly becoming more contextual. Investors (not traders) like to see compensation aligned with specific outcomes to ensure that the leadership is invested in building an organization with strong fundamentals. In a resurgent economy like India, stock options do make sense. But should it be the only instrument to reward long term performance – this is the question that is coming up for debate more often now.

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