Pre-IPO Share Usage for Equity Compensation

Over the years, equity grants to employees before a company goes public has become quite common. This can be attributed to various reasons such as:

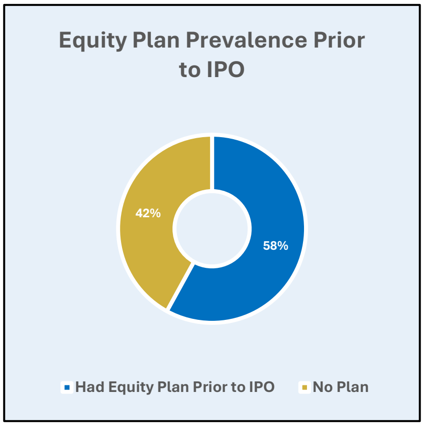
Sources of Capital: Over the last decade, private equity and VCs have played an important role in providing initial and growth capital. When investments take place in an unlisted company, the way investors approach equity compensation for portfolio companies is quite different from that of already listed companies. Often, an equity option pool is earmarked for the executives whereby the vesting is linked to both continued employment and performance (linked to investor returns upon exit and / or fundamental performance metrics).

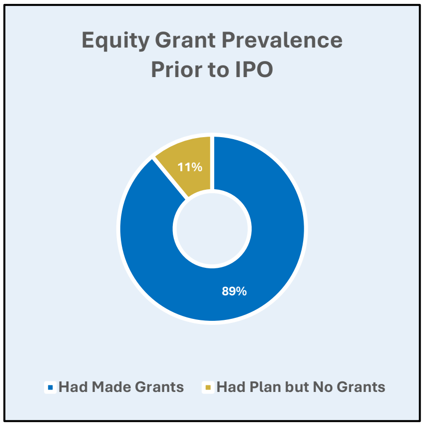
Attracting Talent: Equity compensation has played an important role in attracting executive talent in early-stage companies. Given that the capacity to be aggressive on cash compensation is limited, there has been a significant reliance on equity compensation to fill the gap

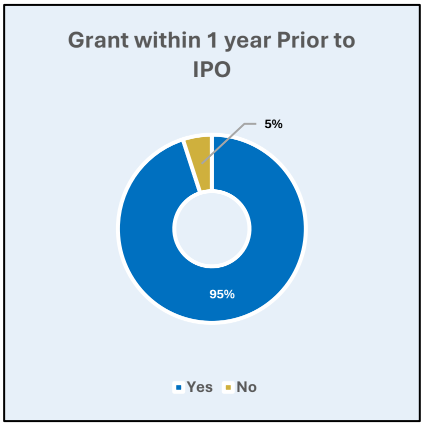
Investor Comfort Post-IPO: Potential investors have a keen interest in equity programs to ensure continuity of the leadership team post IPO. An equity plan where the vesting extends beyond IPO provide potential investors with this comfort

Flexibility: Equity compensation plans in listed companies go through considerable scrutiny by institutional shareholder advisory bodies as well as investors. Even if a scheme is formulated Pre-IPO, grants under the scheme after the company is listed, can only be made once the scheme is ratified by the shareholders post the IPO[1]. Making the grants Pre-IPO, hence gives significant flexibility to companies in structuring the program.

To understand the share usage Pre-IPO, we studied "Final Offer Documents filed with ROC[2]" by 179 companies from 1st April 2021 till 22nd June 2024. **58% Companies** formulated equity compensation plan(s) prior to the IPO. Out of the companies having equity compensation plan(s), **89% Companies** had made grant(s) while **11% Companies** had a plan but did not make grants. It is also interesting to see that while many companies had made grants earlier in the business life cycle, **95% companies had also made a grant within one year prior to the IPO**.







[1] Applicable for companies listing on Indian Stock Exchanges under SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021
[2] Registrar of Companies

For companies that had an equity compensation plan prior to their IPO, we have calculated the share usage basis the pre-issue capital as reported in the final offer document filed with ROC. It is however important to appreciate that companies may have made grants for many years under various plans and the percentage of equity available for grant would have varied at that point. This percentage may have come down due to subsequent rounds of private capital raise and / or conversion of other securities to equity. In order to bring consistency in our analysis our “Total Pool” definitions is:

$$\text{Total Pool} = \frac{\text{Maximum Shares Under All Plans in Company}}{\text{Total Pre-Issue Equity Shares}}$$

Note: The Maximum Number of Shares are adjusted for all splits, bonus issues and conversions

We also analysed the Pre-IPO pool size basis nature of the issue i.e., if a company had Offer for Sale (OFS) component in the issue. Further, if the IPO had an OFS component, we analysed if there are any differences if OFS gave an exit to PE/VC/Investor shareholders.

Table 1: Pool Size Analysis

Pool	All Companies	Companies with OFS Component	Companies with PE/VC Exit in OFS	Companies w/o PE/VC Exit in OFS
25th Percentile	2.00%	2.00%	2.25%	1.62%
Median	3.89%	3.92%	4.52%	2.29%
Average	4.70%	4.74%	5.34%	3.50%
75th Percentile	5.44%	5.66%	6.52%	4.80%

We discussed high prevalence of equity compensation plans in companies backed by PE/VC investors and how a significant equity compensation pool is earmarked for the leadership team. The theme plays out in Table 1 where we can see that pool size is much higher where the OFS had an exit from the investor shareholders. We also analysed the Pool Utilization rate which is defined as:

$$\text{Pool Utilization} = \frac{\text{Total Number Granted under All Plans}}{\text{Pool Size}}$$

Table 2: Pool Utilization

Pool	All Companies	Companies with OFS Component	Companies with PE/VC Exit in OFS	Companies w/o PE/VC Exit in OFS
25th Percentile	39.39%	41.36%	57.15%	16.28%
Median	62.56%	73.12%	81.08%	50.43%
Average	62.24%	64.32%	71.33%	49.85%
75th Percentile	96.59%	96.69%	97.73%	88.91%

The Pre-IPO pool utilization rates are high across the board. Given that the any new grants post IPO can be made only when the Pre-IPO schemes are ratified by the shareholders post-IPO, a large proportion of the pool is utilized before the company is listed. This is primarily due to flexibility in the plan structure prior to the listing. Companies find it easier to implement structures like time-based RSU, prior to the IPO compared to post listing where the scrutiny around plan structures is relatively high. Post-IPO, companies generally get a new scheme in place which is aligned to compensation philosophy followed by a listed company. Less commonly, pre-IPO schemes are ratified with enhanced share pool for equity compensation.

Our analysis also shows that on an average approx. 79% of the total options granted are outstanding at the time of IPO i.e., options that have not yet being exercised (vested and unvested combined). There are two primary reasons for this – firstly, employees tend to wait for a liquidity event to cash-in (although some companies do buy back options / shares from employees). Secondly, we saw earlier, that 95% of the companies made a grant one year prior to the IPO, given the rules regarding minimum vesting period, the entire grant would have been outstanding at the time of IPO.

The Conclusion

The Pre-IPO equity compensation structure can vary significantly compared to how companies will look at the same, post-IPO. The objectives of the plan often change post-IPO and a realignment of scheme is most often required. If there is a considerable portion of equity awards which is unvested at the time of IPO and will remain unvested for 2-3 years post IPO, it gives investors confidence on the stability of leadership team post IPO.

Exec-Rem

Office #1103, Regus, Level 11, Platina, G Block, C-59, Bandra Kurla Complex (BKC), Bandra(East), Mumbai – 400051, India

www.exec-rem.com

info@exec-rem.com