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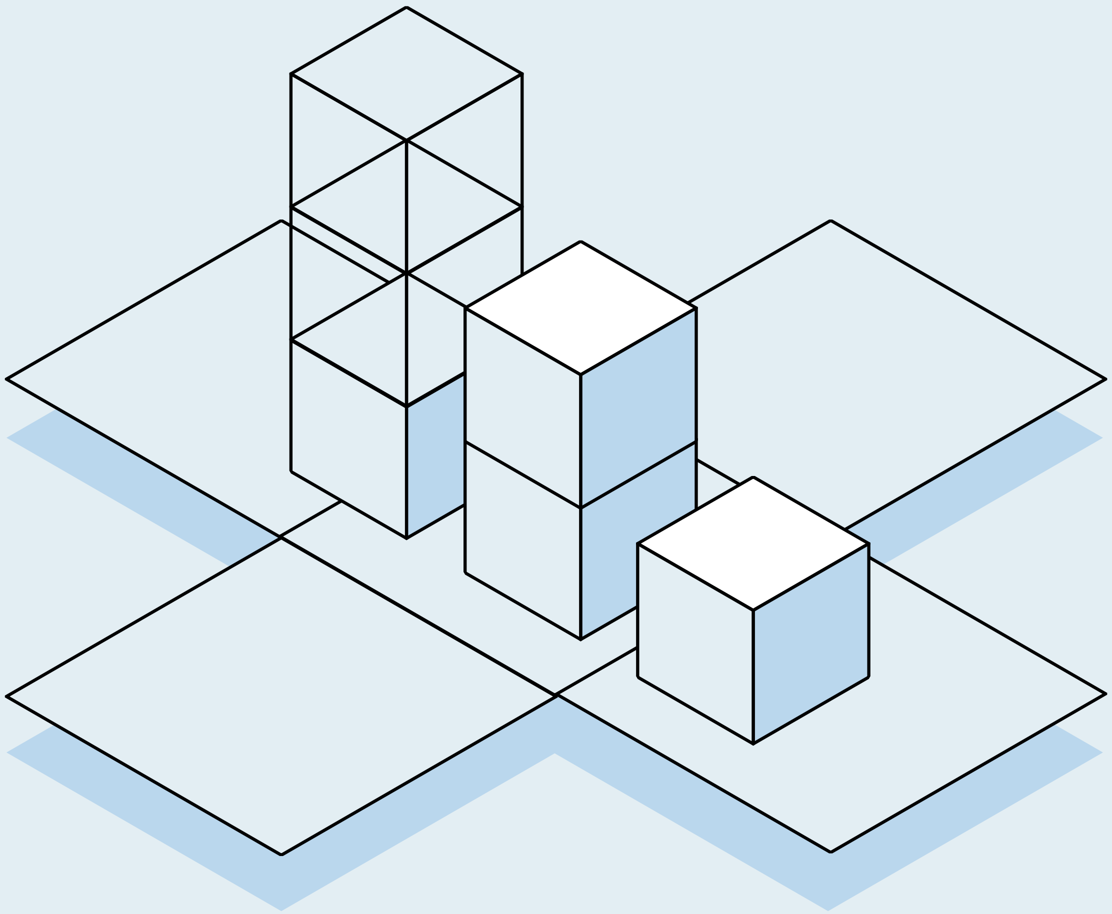
Unpacking ESOP for startups playbook

Strategies, Trends, and Best Practices for Employee Equity



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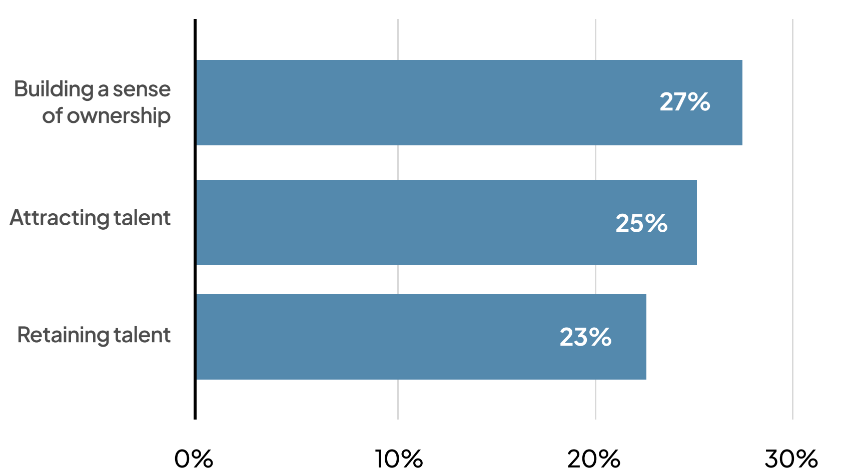
Introduction

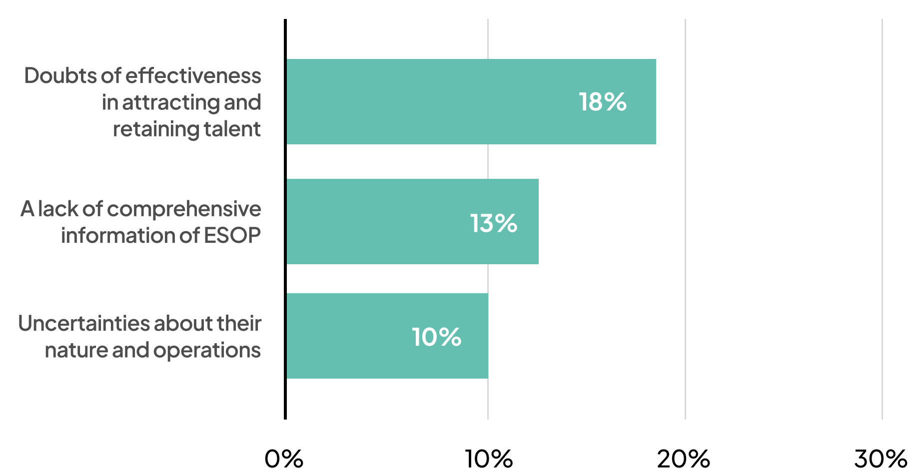
In 2023, AC Ventures undertook a benchmarking study across its portfolio companies to evaluate the adoption and impact of Employee Stock Ownership Plans (ESOPs).

The study pinpointed the main reasons for implementing ESOPs: building a sense of ownership (27%), attracting talent (25%), and retaining talent (23%). However, it also uncovered several challenges, including doubts about the effectiveness of ESOPs in attracting and retaining talent (18%), a lack of comprehensive information about ESOPs (13%), and uncertainties about their nature and operation (10%).

Main Reasons of Implementing ESOP



Challenges of Implementing ESOP



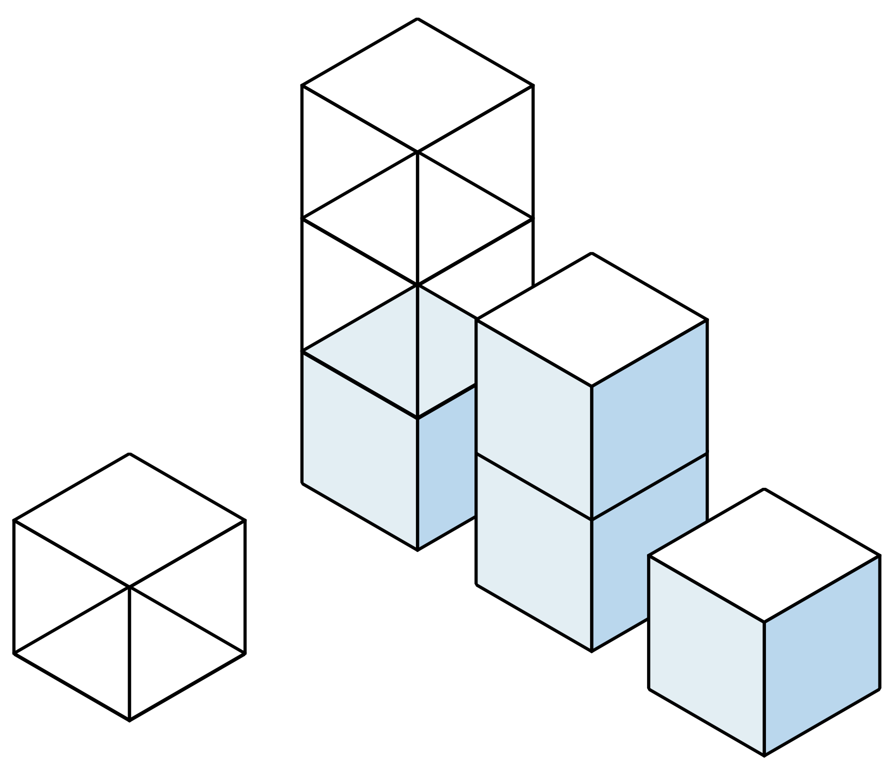
Source: AC Ventures' internal benchmarking study on ESOPs adoption across AC Ventures portfolio companies (AC Ventures, 2023).

In response to this, AC Ventures developed this playbook on ESOPs for our portfolio companies, in collaboration with Carta. This guide aims to streamline the ESOP implementation process with a clear and structured approach. By clarifying the creation and management of ESOPs, the initiative intends to provide companies with the necessary knowledge and tools for successful implementation. Our ultimate goal is to cultivate an environment where employees feel a strong sense of belonging and alignment with the company's objectives and growth.

Importance of ESOP Practice

As Indonesia's startup ecosystem evolves, the demand for top-tier talent intensifies, especially for startups aiming for rapid growth. The e-Conomy SEA joint report by Google, Temasek, and Bain & Company (2023) highlights talent scarcity as a key challenge in Indonesia's digital landscape. Offering competitive remuneration packages, including ESOPs, is crucial for attracting and retaining skilled talent, particularly when competing with larger, established companies.

The beauty of ESOPs lies in its dual role as a corporate finance strategy and an employee benefits plan. When employees leave the company, retire, or otherwise become vested, the ESOP buys back the shares at their current market value, offering a form of retirement savings based on the company's performance. Startups that overlook ESOPs risk missing out on their substantial benefits. ESOPs are not just tools for talent retention and attraction – they are instrumental in building an engaged and positive workplace culture, making them a strategic imperative for forward-thinking organizations.



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What are ESOPs?

What are ESOPs? ESOP is a type of equity compensation. Simply put, ESOPs are specialized plans that primarily invest in the shares of the sponsoring company, granting employees an ownership stake in their workplace.

ESOPs are designed to be win-win: they offer employees a stake in the company, potentially leading to enhanced employee motivation and retention, and they provide companies with a mechanism to finance themselves or to buy out existing owners. As employees accumulate years of service, they gradually gain full rights to the shares in their ESOP account, a process known as vesting.

The 4 Common Types of Equity Compensation

Stock Options

Rights for employee to purchase shares at a future date.

Employees gain the right to buy a set number of company shares at a fixed price within a certain period.

Restricted Stock Award (RSA)

Shares that can be purchased on grant date.

Employees receive actual company stock shares on the grant date, subject to a vesting period.

Restricted Stock Unit (RSU)

Shares that are promised to deliver at a future date.

Employees are promised a certain number of shares or their cash equivalent in the future, contingent upon meeting vesting conditions.

Stock Appreciation Rights (SAR)

Right to appreciation in market value of shares over a specific time.

Employees have the right to the increase in the company's stock value, without the need to own the shares.

Options | Shares | Cash

Exercised/Purchased by Employee | Issued to employee | Not equity

Source: ESOP Masterclass for Early-Stage Startup Founders (Carta, 2023).

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ESOP Implementation Timeline

While a start-up may not have the means to develop a comprehensive ESOP program yet when its first legal entity is set up, the company needs to prepare to do so at a point in time it is considering pursuing an equity fundraising involving institutional investors.

Implementing an ESOP comprehensively is beneficial when the company has a clear understanding of its financial and strategic objectives and therefore can strengthen its growth trajectory through more productive and empowered employees.

Timeline

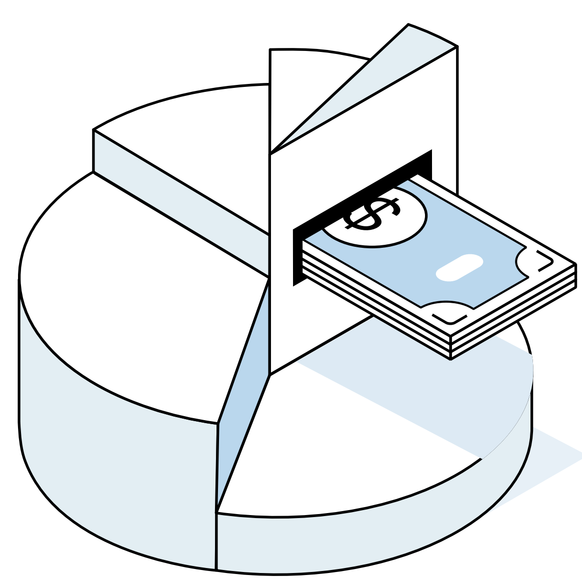
1. Creation of ESOP Pool
   - → Deciding the size of ESOP
   - → Implementing ESOP structure & regulations

2. Determine Awardees
   - → Performance Achievement - based criteria
   - → Incentive for contribution

3. Issuing of Option Grants to Awardees
   - → Process of awarding and acceptance

4. Vesting Schedules
   - → Time-based vesting
   - → One-year cliff

5. Employee Liquidity Opportunities
   - → Secondaries
   - → Acquisitions



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1 Deciding the size of ESOP

According to a survey by AC Ventures among its portfolio companies, half of those implementing an ESOP allocate 5–10% of the company's shares to this program. These companies are primarily in the early-stage category, with valuations typically up to around $100M.

Typically, early-stage firms tend to allocate a higher percentage of equity, often around 10–20% of outstanding equity, for ESOP purposes to attract and retain top talent. This allocation generally occurs before the first major funding round (Series A or pre-Series A), as incoming investors prefer founders to create an ESOP pool from their equity to prevent dilution. Over time, this percentage tends to decrease as new shares are issued for fresh capital.

Critical in this process is devising a 12-to-18-month organizational plan for ESOP issuances. This involves estimating the required compensation for current and anticipated employees and key management individuals during that period. It's essential to tailor the Equity Pool size precisely to these needs. Should the need arise, a company can expand the Equity Pool later on.

Implementing ESOP structure & regulations

Once the ESOP pool has been established, the necessary legal framework comes into play, guiding the company to define ESOP rules. These rules will oversee the allocation of ESOPs to employees and any agreements concerning ESOPs between the company and participating employees.

Some crucial aspects outlined in the ESOP rules include:

Criteria determining eligibility for employee option participation

Eligibility for ESOP participation hinges on various factors such as an employee's role, tenure, and performance.

Vesting schedule

Outlines the timeline over which employees gradually acquire ownership of the shares.

Exercise period

The time frame during which employees can exercise their stock options by purchasing the allocated shares at the predetermined price (i.e., strike price).

Company's right to repurchase employee shares (buyback):

Provision within ESOP that enables the company to reacquire these shares under specific conditions or circumstances.

Rights and responsibilities of employee option participants

The entitlements and obligations held by employees who are part of the stock option plan.

Initially, it's advisable to establish a standardized ESOP structure with a 4-year vesting period and a 1-year cliff, allowing for potential adjustments later. Additionally, to encourage greater employee engagement, companies may consider more frequent vesting schedules, like monthly vesting, fostering a consistent and tangible link between effort and reward.

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2 Determine Awardees

Considering the sensitive nature of preserving cash and safeguarding the equity plan during the early stage, companies need to determine awardees of such equity shares very carefully.

Extending ESOPs to a broad employee base might foster inclusivity and teamwork. Meanwhile, restricting access to select staff may serve as an extra motivator for retaining top talent. It's vital to communicate eligibility criteria clearly to maintain fairness and transparency.

To align with the company's prudent and fair approach to incentivizing its people, the consideration of performance achievement-based criteria in granting ESOPs could be explored. This translates to a prerequisite condition where an employee is eligible to receive ESOPs only if they have successfully achieved their Objectives and Key Results (OKR) within a specified timeframe. In essence, the allocation of ESOPs is tied to the accomplishment of predetermined performance goals, ensuring a direct correlation between individual achievements and participation in the stock option program.

Therefore, although it is common to provide ESOPs to the senior management team to supplement the cash component in their comparatively higher compensation, ESOPs could also be contemplated as an incentive for a broader category of employees, acknowledging their significant contributions to the company. This approach fosters a meritocratic system that is both equitable and motivating.

3 Issuing of Option Grants to Awardees

The process of granting employee options within the company typically follows these procedural steps:

Firstly

The Board of Directors (BOD) or an ESOP committee, if established by the BOD, will invite eligible employees to receive employee options. They will determine the number of employee options allocated to each eligible employee.

Secondly

within a specified period governed by the ESOP rules, the employee must formally accept the offered employee option. This usually involves completing, signing, and returning an acceptance form to the company within the designated time frame.

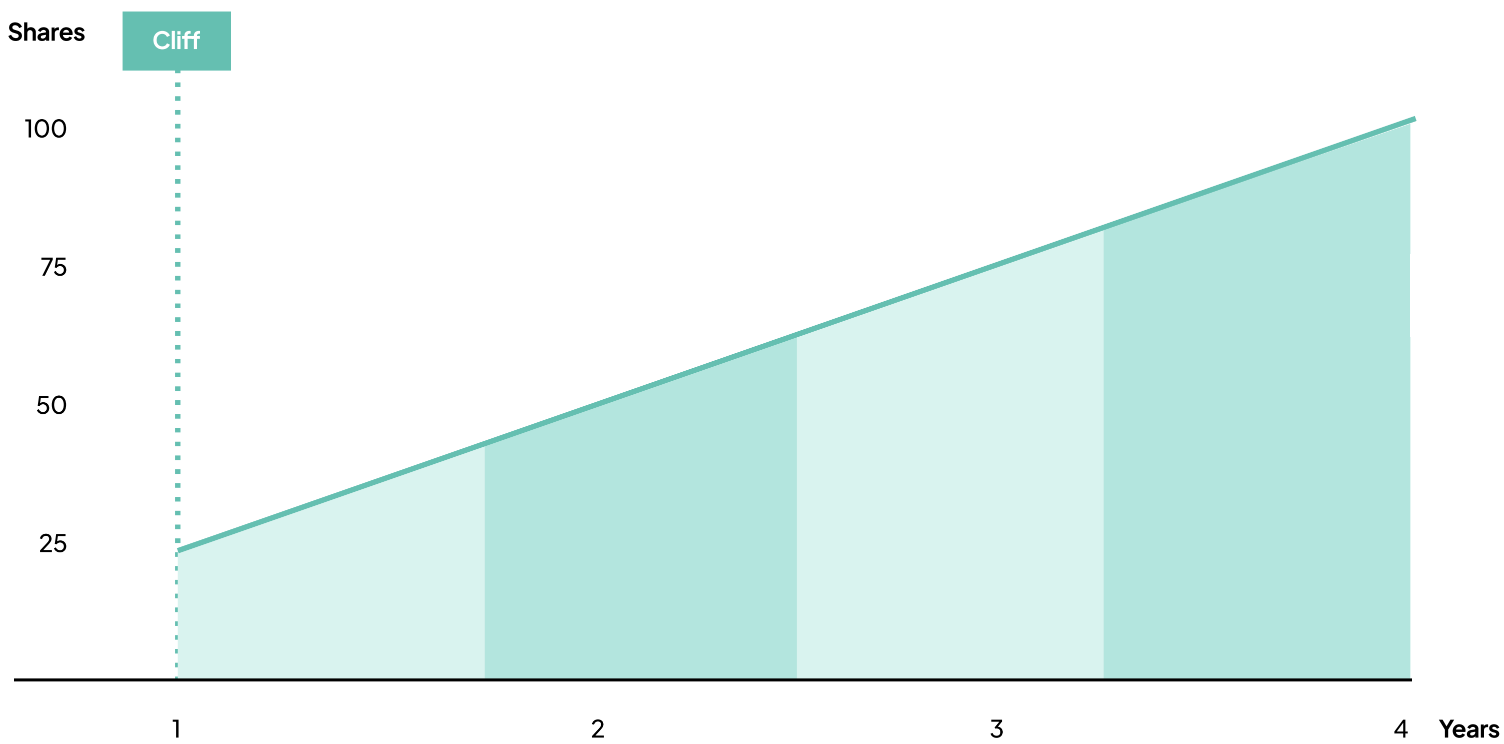
Finally

an employee who has accepted an employee option can exercise the employee shares outlined in the invitation. This exercise usually occurs at specified vesting dates, complying with the vesting period as outlined in the ESOP rules.

It's essential to note that ESOP rules can differ among companies, and an ESOP is typically discretionary, meaning it's optional and solely at the discretion of the issuing company, as long as it aligns with applicable laws and regulations.

4 Vesting Schedules

Vesting typically adheres to a schedule outlined in the stock option agreement, which is time-based. Many companies implement a vesting schedule spanning four years, often initiating with a standard one-year "cliff." This cliff is a period that must pass before any vested options become accessible to you.



Source: What are stock options and how do they work? (Carta, 2023).

In addition to the common four-year vesting schedule, which includes a one-year cliff and monthly vesting thereafter, there are other types of vesting. These can be based on performance or specific events, tailored to either company-wide or individual objectives. In the marketplace, refresh or promotion grants typically offer more favorable vesting schedules, featuring shorter durations without a cliff.

5 Employee Liquidity Opportunities

Secondaries

In the dynamic tech world where companies often choose to stay private longer, it's essential to provide employees with a pathway to liquidity. A secondary transaction occurs when a shareholder of a company sells their existing shares to another party. Primary transactions, on the other hand, occur when a company sells its equity and ownership (usually in the form of newly issued shares) to other parties, such as investors, to raise capital.

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Secondary transactions in APAC

-	Primary transactions	Secondary transactions
Who sells the equity?	Company	Shareholder of company
Who receives the cash from the transaction, otherwise known as the sale proceeds?	The company, with the cash typically going into such things as building, growing, and scaling of the company	The sellers/shareholders, who participated in a company sponsored transaction. Usually the sale proceeds are considered a form of income or capital gains
Who buys the equity	Typically institutional investors found by the company, such as angels, venture capital firms, family offices or private equity firms	Any third party, individual or institutional, including the company itself who participate in sponsored transaction
Otherwise known as:	A funding round; fundraising	A liquidity program; company buyback or third party purchase

Source: Secondary transactions in APAC: How employees can unlock equity comp rewards (Carta, 2023).

In this region, secondaries are typically organized by the company, providing a well-structured approach to extending the benefits of equity participation. By organizing secondaries, your company takes the reins in facilitating the sale of existing shares which then allows you to ensure that the process aligns seamlessly with your growth strategy.

Another form of secondaries are when companies repurchase shares directly from employees.

In most situations, the company takes the lead in organizing these buybacks, offering a structured way for employees to cash in on their hard-earned equity. This not only enhances employee satisfaction but also reinforces a sense of ownership in the company's success.

Buybacks can be orchestrated individually or as part of a mass buyback scheme. Some companies may consider periodic buybacks to align with growth milestones, ensuring that employees are rewarded as the company progresses.

Companies typically fund buybacks off their balance sheet or negotiate it as part of a primary funding round whereby new investors fund the buyback transaction.

Acquisitions

In the APAC tech ecosystem, where acquisitions often serve as a common exit strategy, the impact on ESOPs is relatively straightforward. Typically, acquisitions involve the acquiring entity buying out all shareholders at an agreed valuation or price. As a founder, communication is key during this process, keeping your team informed about the acquisition's implications on their ESOPs fosters transparency and reassures employees amid the transition.

Valuation and conversion mechanisms play pivotal roles in this context. Collaborating with financial experts, founders should reassess the valuation of existing ESOPs to ensure a fair and accurate representation of their team's contributions. Simultaneously, exploring seamless conversion options, such as transitioning ESOPs into the acquiring company's stock or providing alternative equity instruments, helps align employee interests with the acquiring entity.

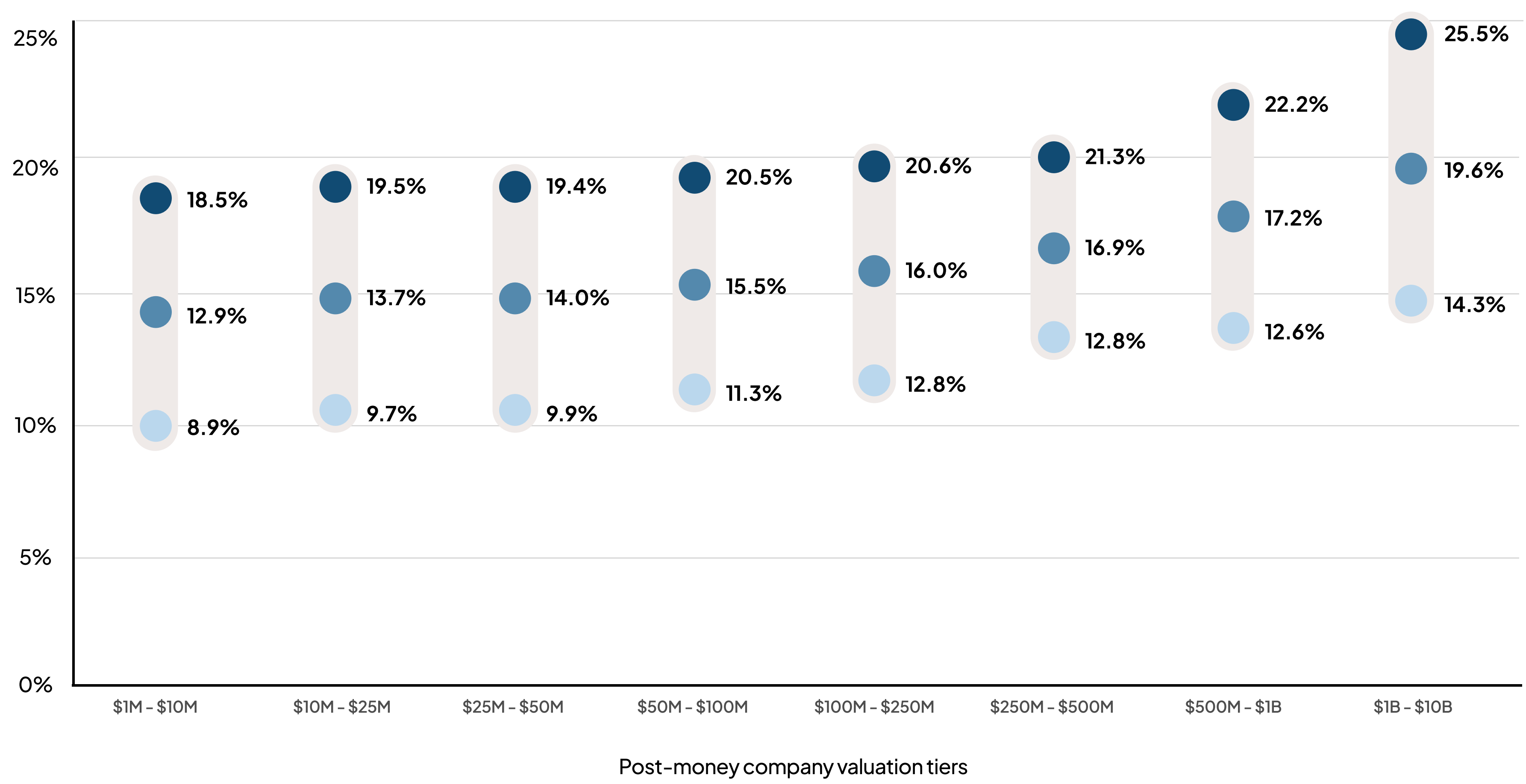
Market Trends in ESOP Practice

Overall, there are positive developments in how ESOPs are being implemented and utilized within companies. This improvement could involve factors such as better structuring of plans, increased transparency, or more favorable terms for employees. We would like to draw attention to specific trends in ESOPs that founders of start-up companies should consider as benchmarks or points of reference.

Globally, we see that startups allocate approximately 13–20% of company equity to their ESOP program. In APAC specifically, it's slightly less but still significant at 10–12%.

The median ESOP is between 13–20% of company equity

25th, 50th and 75th percentile figures for employee option pool size (percent of fully diluted equity)



Source: ESOP portion of company equity globally based on post-money valuation (Carta, 2023)

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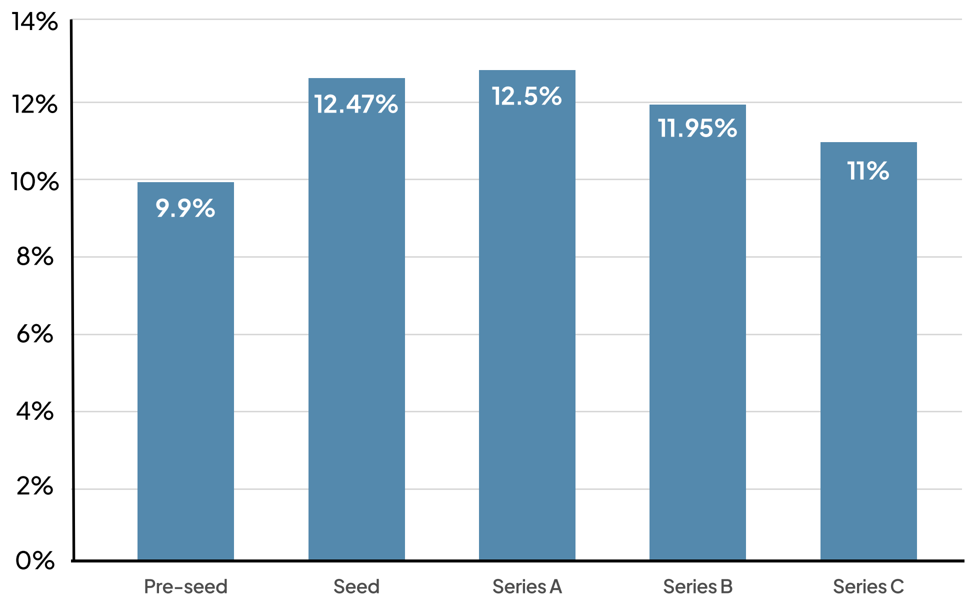
Startups in APAC reserve 10 - 12% of equity for employees

Median employee option pool size (percent of fully diluted company equity) by stage for APAC companies on Carta

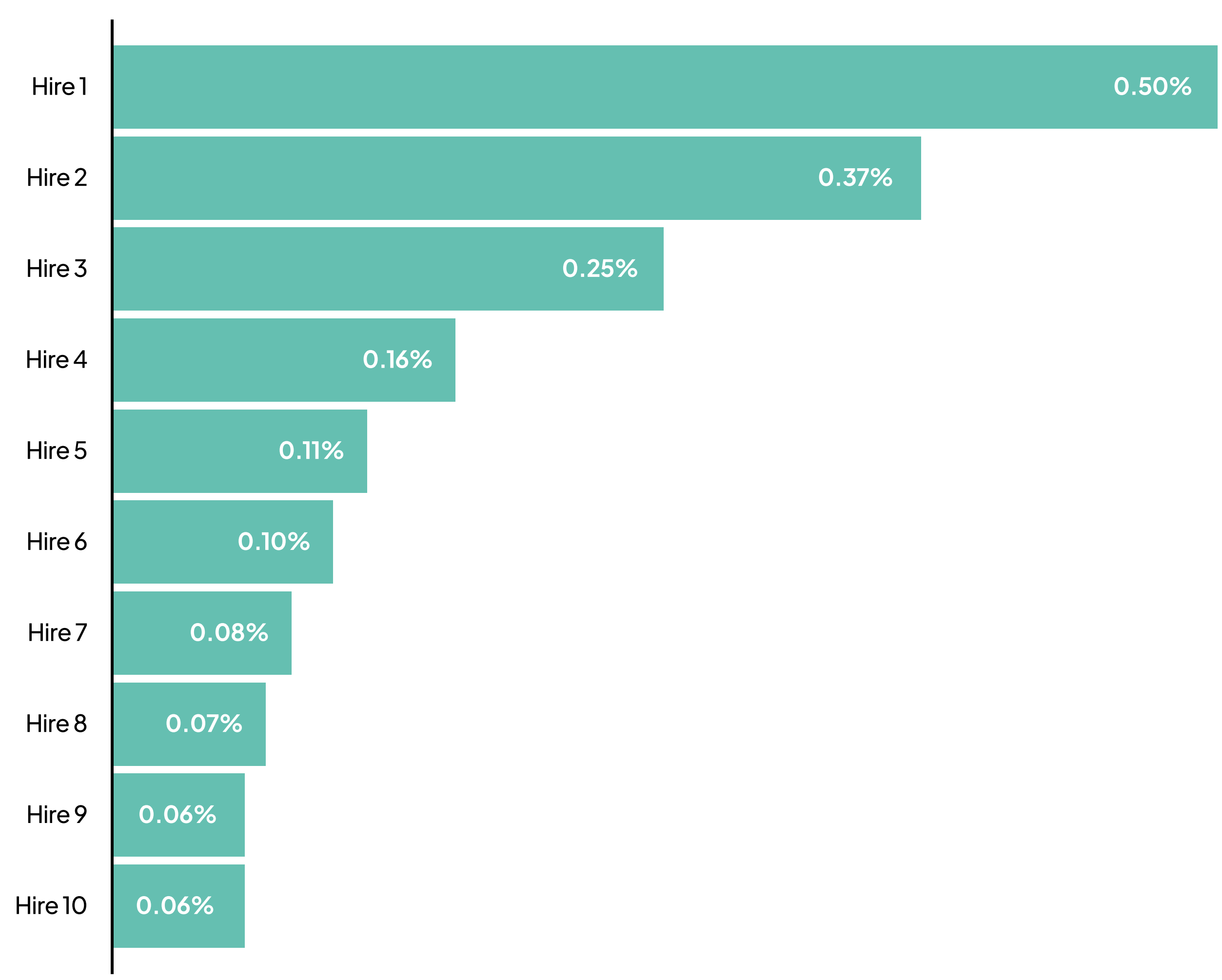


Source: ESOP portion of company equity in APAC based on funding stage (Carta, 2023)

Additionally, the first significant hire in the APAC region usually receives approximately 0.5% ownership share in the company. The following chart provides a helpful framework for allocating equity among your initial 10 significant hires. It's important to emphasize that these "key hires" refer to the valuable talent you aim to recruit and retain, deserving of being offered ESOPs.

The median first hire in APAC received 0.5% ownership

Median percent of fully diluted company equity granted to each of the first 10 hires | Grants over 20% excluded



Source: Stock ownership for first ten hires in APAC (Carta, 2023)

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ESOP for Corporate Management Purposes

As the company grows, scaling ESOPs becomes essential.

Therefore, it is imperative to plan for the expansion of ESOPs in tandem with subsequent fundraising rounds. As well, conducting ongoing education about ESOPs is crucial; explain them to potential employees before they accept job offers.

As companies navigate the intricate landscape of equity management, it becomes increasingly important to establish clear best practices for corporate governance. This holds not only for operational aspects but is especially critical considering the impact on employee motivation, investor confidence, and overall corporate reputation.

Ensuring proper governance in equity administration involves a comprehensive approach. From the initiation of equity plans to grant issuances, meticulous documentation is key. This transparency extends through each stage, from the signing of grants to vesting, exercising, or even terminations.

Other key practices to consider:

1 Board Consents and Documentation

→ Best practices include collecting and filing board consents for equity plans and grant issuances. This not only formalizes the approval process but also ensures that all relevant stakeholders are aligned with the company's equity strategy

2 Valuation and Reporting

→ Accurate valuation of share value is critical for both regulatory compliance and maintaining trust among stakeholders. Equally important is the meticulous reporting of expenses related to the ESOP program, contributing to transparent financial disclosures. Furthermore, the ESOP program has to be expensed as non-cash compensation.

3 Compliance with Local Authorities

→ Meeting tax, legal, audit and other compliance needs with local authorities is fundamental. Navigating the complexities of regional regulations ensures that your ESOP program aligns with local requirements, mitigating potential risks.

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Best Practices: Key Success Factors and Key Risk Mitigation

In navigating the complexities of ESOPs, implementing best practices is instrumental in ensuring success while mitigating potential risks. Let's dive into key success factors and risk mitigation strategies for founders venturing into the realm of ESOP administration.

Key Success Factors	Success Factor	Recommendation
Proactive Financial Audit Preparation	Companies undergoing financial audits, whether mandated by government regulations or investor requirements, should prioritize meticulous ESOP valuations and expense reporting. Establishing a future-ready approach for audits is crucial to avoid costly mistakes	Proactively set up accurate ESOP Valuations and Expense Reports from the inception of the ESOP program. Anticipate the increasing scrutiny of auditors on ESOP financial reporting, with some requesting valuations for each year of ESOP issuance. Being well prepared from the start saves time, minimizes errors and prevents financial setbacks
Streamlined ESOP Administration	ESOPs may seem straightforward to implement but can pose administrative challenges due to multiple stages - signing, vesting, exercising, terminations and option returns. Accurate and easily accessible cap tables are imperative for founders	Utilize software solutions that automate updates and streamline communication with stakeholders and employees. Investing in a robust platform ensures accuracy in tracking the intricate lifecycle of ESOPs, enhancing efficiency in administration and maintaining a clear cap table

Key Risk Mitigation	Risk Mitigation	Recommendation
Recognition of Employee Risks	Employees take a significant risk when joining startups, and equity serves as a financial reward for their commitment. Founders can mitigate the risk of talent attrition by considering equity issuance to a broader employee base, acknowledging the shared journey and aligning interests	Issuing equity, even in smaller amounts, to a wider pool of employees recognises their contribution and aligns incentives. This proactive approach fosters a sense of ownership, enhances employee retention, and aligns the team with the company's long-term goals
Strategic ESOP Issuance	Once equity is issued, clawing it back becomes challenging. To manage dilution effectively, founders should adopt a strategic approach to ESOP issuance	Follow the guideline of issuing less equity more frequently. Starting with smaller issuances and gradually increasing them over time is advantageous for the company, allowing flexibility in responding to evolving needs without overcommitting on equity early in the company's lifecycle

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Glossary

Buyback	The process where the company may choose to buy back an employee's stock options before a liquidation event at a mutually agreeable price, so that employees can realize value.
Cliff Period	The lock-in period before employees are entitled to their first portion of vested stock options.
Exercise	Purchasing shares of the issuing company's common stock at the set price defined in the employee's option grant.
Exercise Period	The time period in which the employee can convert the stock option to a share.
Liquidity Event	An event at a company that allows founders and employees to turn their shares into cash. Examples include a tender offer, IPO, or merger.
Secondary Markets	A market where employees sell stock options to other investors, rather than to the company (buyback)
Stock Option	A stock option gives employees the right, but not an obligation, to purchase shares in the company.
Strike Price	The amount to be paid by the employee to exercise an option.
Top Up	Increasing the number of available stock options for current and future employees.
Vesting	The process where employees earn their stock options over time. Vested stock options refer to stock options that have been earned by the employee
Vesting Period	The period for the awarded stock options to be distributed across

Source: State of ESOPs in SEA (SAISON & Svested, 2021).

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AC Ventures

AC Ventures (ACV) is a top Southeast Asian venture capital firm that invests in early-stage startups focused on Indonesia and ASEAN, with over US$500 million in assets under management.

The firm's mission is to empower entrepreneurs with more than just capital by combining operational experience, industry knowledge, deep local networks, and resources. ACV's team has invested in over 120 tech companies in the region since 2012.

With a team of more than 35 professionals led by Adrian Li, Michael Soeriadi, Helen Wong, and Pandu Sjahrir, it has offices in Jakarta and Singapore.

Visit our website at www.acv.vc

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Carta is a platform that helps people manage equity, build businesses, and invest in the companies of tomorrow. Our mission is to create more owners.

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