Educating and Inspiring the World at Work
FEBRUARY 2019
WORKSPAN

THE KEY TO ENGAGEMENT

Designing an ESPP to Drive Your People Strategy

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Employee stock purchase plans (ESPPs) are more than just compensation. They're an important tool for creating an ownership culture while potentially delivering outsized financial gains at a (usually) modest cost. In some industries, an ESPP is table stakes for competing in a tight labor market. In others, it can be a genuine strategic differentiator.

But ESPPs are not created equal. Even in industries where they're common, it's possible to design a program that stands out and delivers greater impact. In this article, we'll discuss the different flavors of ESPPs and ways to help you determine which type is right for your organization. Along the way, we'll show why ESPPs just might be the most versatile — and underutilized — compensation and employee engagement instrument.

A Brief Primer on ESPPs

ESPPs allow employees to purchase the company's shares at a discount, usually through payroll deductions. For example, employees may choose upfront (at the offering date) to withhold 5% of their earnings during a six-month period. At the end of this subscription window (the purchase date), the dollars withheld are used to buy shares at a particular price.

And that's just one way to structure an ESPP. There are at least a dozen others. In fact, chances are there's an ESPP to match whatever goals you pursue.

Figure 1 | An ESPP Plan Where the Stock Price Rises over Six Months

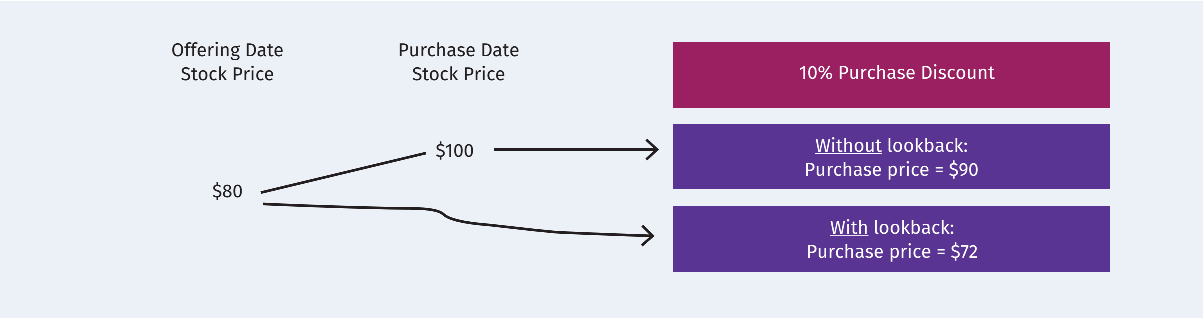


Figure 2 | An ESPP Plan Where the Stock Price Declines over Six Months

Let's look at a couple of ESPP scenarios in action. Figure 1 shows a basic six-month plan that offers a 10% purchase price discount. If the stock price is currently $100, an employee who contributes $900 to the plan can purchase 10 shares at a discounted price of $90 per share, netting an immediate 10% gain.

One of the most basic, but valuable, strategies is to add a lookback provision to this same plan. This allows employees to purchase shares at the offering-date price or purchase-date price, whichever is lower. Using the example in Figure 1, this means that the discounted purchase price is even lower at $72/share — even though the stock price has risen to $100 by the purchase date. So the same $900 employee contribution buys 12.5 shares, yielding an immediate 40% gain compared to 10% from the purchase price discount alone.

Now suppose the purchase date stock price is still $100, but the offering date stock price was $120 (see Figure 2). The employee is insulated from this decline by being able to purchase shares at the lower discounted price of $90 per share.

With these examples, we hope we've shown why an employee might be eager to put part of his or her paycheck into an ESPP. Better yet, a purchase discount and a lookback feature are just two of the many levers that employers can pull to craft a valuable and popular plan.

More on that later. First, let's examine why ESPPs are so relevant today.

Where Compensation Meets Ownership Culture

CEOs and boards must foster a strong corporate culture, high levels of employee engagement and ways for top talent to think and act as business owners. The modern gig economy, with its emphasis on highly transactional employer-employee relationships, makes these challenges tougher than ever — and yet more important than ever.

As with any complex problem, there's rarely a single answer. However, ESPPs play a unique role in advancing an ownership culture. We consistently hear from CHROs that employees value their ESPP more than even full-value awards. Why? Because of the direct link between personal investment and downstream wealth. Creative ESPP design features can multiply the wealth of every dollar that employees invest. This amplifies the perceived value in a way that other instruments can be hard-pressed to touch.

Consider stock awards. They might cultivate ownership, but their cost — and their impact on dilution — discourage employers from issuing them beyond a small group of senior executives. In our 2018 "Executive Compensation and Decision Support Survey," for instance, 80% of respondents say no more than 20% of their workforce is eligible for the company's long-term incentive plan (LTIP). When they are issued broadly, the per-person quantities are often too low to have a meaningful impact. Moreover, stock awards are (and feel like) pure compensation, which doesn't cleanly advance an ownership sentiment because there isn't skin in the game.

Table 1 | A Checklist of ESPP Program Objectives

Perspective	Questions to ask	Answers that suggest a... Less lucrative ESPP	Answers that suggest a... More lucrative ESPP
External competitive view	What are competitors in the labor market doing? • How many have ESPPs? • What features do they offer?	Very few competitors have ESPPs of any merit	ESPPs are common and many highly attractive ones exist
Talent retention view	How difficult is it to attract and retain talent? • Are business leaders complaining that talent is turning over too quickly? • Do key mid-level positions take too long to fill?	Talent is easy to retain and when turnover occurs replacement is quick	Retention is extremely difficult and key positions sit open for long periods
Culture diffusion view	Do employees feel connected and engaged? • How well are existing programs facilitating an ownership culture? • To what extent are employees skeptical of owning stock?	Engagement is already high or stock ownership will be resisted	Engagement is low and with the right ESPP employees may be open to buying stock
Strategic compensation view	How does equity fit into overall compensation? • Has equity been a key driver of compensation? • Has the role of equity changed? • Has there been a reduction in the levels eligible for equity grants?	Equity has never been core to compensation and most people don't receive it	Equity has been core to compensation or grant levels are declining
Organizational transformation view	Is the organization going through a macro transformation? • Are there strategy changes on the horizon? • Is the competitive landscape changing?	Few to no changes: business as usual	Major changes underway in the business and competitive landscape
Cost view	What accounting cost constraints does a program design need to work within? • If existing grants are being scaled back, could the savings there more than offset a new ESPP?	Limited to no budget exists for any equity programs	Budget exists for an equity program either organically or by reducing a current program

ESPPs are another story. By contributing a portion of their paychecks, employees can put skin in the game, thereby staking out their own financial position in the company. However, effective ESPP designs insulate participants from share price declines during the subscription window that are outside their control. In our experience, even employees who liquidate their ESPP shares after purchase feel a stronger connection and ownership sentiment because they look at the proceeds as something their sacrifice helped create.

Yet, only 51% of the 230 companies we recently surveyed said they have an ESPP.

Part of this is fallout from the 2006 onset of stock option expensing. When the accounting rules changed, many companies curtailed or eliminated their ESPPs — despite ESPPs being much kinder to the balance sheet than stock options. With more than 10 years of hindsight to learn from, it's becoming clear that for many companies it was an unintentional case of throwing the baby out with the bathwater.

Another factor is that many companies struggle to connect ESPPs to their talent attraction, engagement and retention strategies. This is accomplished through a design process that explicitly considers those strategies in light of cost and dilution constraints. We'll show you how to do that next.

Designing the Right ESPP for You

Designing an effective ESPP begins with understanding the program levers available and what happens when any given lever is pulled. The goal is to match the ESPP design to the outcomes you need to drive along the lines of motivational impact and cost management.

Let's break this into three parts. First, we'll show a framework for capturing your program objectives. Second, we'll review the basic design levers available. And third, we'll show how to pick design attributes based on your objectives.

Defining Program Objectives

Table 1 offers a way to think about your program goals in the context of constraints and

Table 2 | ESPP Design Features

Design feature	What it does	Benefit
Employer share match	Employer matches shares purchased from employees' contributions, typically offered in lieu of a discount	Provides immediate dollar gains at purchase, but is only available for nonqualified plans
Length of offering period	Period during which employees contribute payroll deductions toward the purchase of shares, typically up to 27 months for tax-qualified plans	Allows more time for price appreciation, and can provide substantial gains when combined with a lookback feature
Lookback provision	Shares are purchased based on the lower of purchase-date or offering-date price	Allows employees to enjoy gains in a rising stock price environment, while shielding employees from potential losses when negative shocks that are largely outside employees' control causes the price to decline
Number of purchase periods	Number of times that purchases occur during an offering	More purchases within an offering provide more liquidity, especially for plans with lengthy offering periods
Purchase price discount	Shares are purchased at a discount, typically 5-15% for tax-qualified plans	Provides immediate dollar gains at purchase, with potential for favorable tax treatment under qualified plans
Reset feature	For plans with multiple purchase periods, the offering price is reset to a lower stock price when the stock price declines	Protects employees against stock price declines because the lookback price is reset
Rollover feature	For plans with multiple purchase periods, the offering is restarted at the lower price if the stock price declines	Locks in larger gains for employees in a declining price environment
Variable contributions	Allow employees to increase and/or decrease their contribution rate during an offering period	Provide flexibility to employees, but may lead companies to continue recognizing expense based on a higher contribution rate (if decreases are allowed) or trigger modification accounting (if contribution rate increases are allowed)
Variable number of shares	More shares may be purchased when the price declines (instead of locking in the maximum number of shares based on the offering-date price and simply refunding excess payroll deductions)	Enables hedging against stock price declines

opportunities you may face. There are six vantage points from which to approach the decision. Within each vantage point are questions to consider. Your response to each will suggest how lucrative your ESPP needs to be.

Keep in mind that this is a checklist, not a scorecard. It's meant to guide a conversation about what an ESPP should look like, rather than provide any conclusions. For example, if there are few to no changes in an organization's strategy and competitive landscape, then this might support a less lucrative ESPP. Maybe, but not always. Perhaps the lack of change itself is a problem and an ESPP would inject useful novelty. In fact, the cliché "part art, part science" applies here.

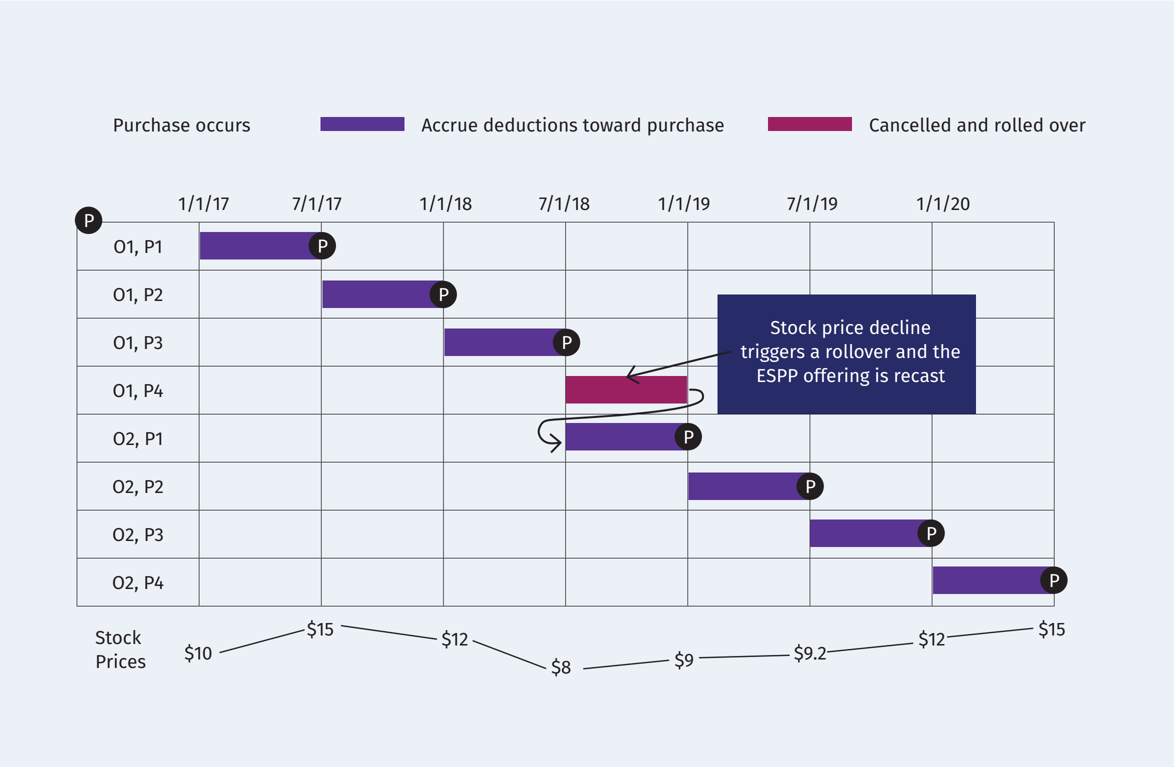
Understanding ESPP Design Features

Next, let's look at our options for design features. Table 2 shows some popular features that allow stock purchases to be insulated from price declines, to occur at discounts and to be adjusted based on how the stock is faring during the ESPP period.

As you can see, there are many distinct provisions that can alter an ESPP's economics and appeal. Four features are particularly important:

- **Lookback provision.** The ability to purchase shares at the lower of the offering-date or the purchase-date price creates huge upside to employees and mitigates downside risk if the stock price declines.

Figure 3 | A Rollover Provision in Action



Employee stock purchase plans could inject useful novelty into your organization's strategy. In fact, the cliché "part art, part science" applies here.

- **Offering length.** A longer offering period, when combined with a lookback provision, offers higher upside potential in the same way that an option with a longer contractual term is more valuable. Appropriate communications can help employees understand the value of this benefit.

- **Purchase price discount**. This is one of the most visible features of an ESPP. If the objective is to create an employee-friendly plan, then offering a higher discount rate is a powerful way of signaling value to employees and encouraging participation.

- **Reset or rollover feature.** For plans with longer offering lengths and multiple purchase periods, a reset or rollover is particularly appealing as the lookback price restarts when the stock price goes down. These features do add complexity to the program, but they also provide material insulation to employees against stock price declines. Figure 3 shows how a rollover provision looks in practice.

Making Design Decisions

You've completed the first step of analyzing your program objectives and needs. You now also understand the design levers available. The final step is to decide which program works best for you. Here we recommend a four-step process.

1. Build the short list. In our experience, good decision making occurs amid forced tradeoffs. Based on the needs assessment, pick three to four design alternatives — including one lucrative design and at least one simpler, more cost-effective design — that could fit the bill.

2. Model each alternative. The key variables to model are the expected participation rate, financial cost and

The benefit of ESPP scenario analysis is that it very clearly illustrates how sensitive cost and dilution are to the unknowns at stake: participation and the stock price.

dilution. Start with expected participation since this is the most subjective and will influence the cost and dilution projections. We generally use industry and survey data as a starting point.

3. Weigh the alternatives and form a recommendation. With strong analytics in hand, it becomes easier to form a recommendation. For a more lucrative design, some questions to ask include:

- *Is it that much more expensive than the next best design?* Often, the cost differential isn't very large. Be sure to point to the relative costs of competing designs, not just the absolute cost.
- *Will participation rates be satisfactory?* It's usually not worth it to roll out an ESPP that garners low participation. While participation rate data are not comparable from company to company, they can provide some indication to support one design over another.
- *What are competitors doing?* If you're trying to justify a more advanced ESPP, asking this question can help in multiple ways. If competitors already have similar ESPPs, then you might need a lucrative ESPP just to maintain parity. If competitors don't have attractive ESPPs, then you might find the extra cost of surpassing theirs is worth it in order to create a unique message.

Modeling Different ESPP Scenarios

A scenario-analysis framework is necessary to model the cost and dilution of an ESPP. The key variables are participation and expected stock price. As a result, it's common to set a favorable, moderate and unfavorable scenario for each and run six scenarios for each design alternative.

The benefit of scenario analysis is that it very clearly illustrates how sensitive cost and dilution are to the unknowns at stake: participation and the stock price. Forward-testing of this nature lets you answer a handful of important questions:

- What's the most this program could cost?
- Is there a combination of participation rates and stock prices that would be unpalatable to our financials?
- If we drive higher participation, how much more cost are we incurring for that participation?
- Should we roll the ESPP out internationally or keep it just in the United States?

It can also be helpful to back-test designs using actual stock prices and hypothetical participant counts. If you have an ESPP, you can use actual participation rates as one scenario and hypothetical rates as additional scenarios. Back-testing helps executives understand the numbers.

4. Package the analysis and obtain approval. By this stage, you've formed a strong point of view and it's time to present one or two potential designs to senior management. In our experience, the CEO and CFO are very interested in the details and will have a wide array of questions. To avoid surprises, it's a good idea to socialize your progress with the executive team. Even so, plan for a litany of questions and concerns.

Your models will be very important to this conversation. Avoid focusing on cost. Make sure you have a concrete way to explain the benefits. For example, we've gleaned statistical relationships between ESPP participation and employee turnover. Avoid presenting the ESPP simply as another "nice to have" amenity because the business case can be much stronger and concrete than that.

Implementation

At this point, you've garnered approval and are getting ready to roll out your new ESPP. Whether an enhancement to an existing program or an altogether new one, an ESPP — even a rich one — needs to be promoted in order to raise internal awareness. Beyond that, to really create a stronger ownership

Table 3 | Communication Techniques for Rolling Out an ESPP

Design feature	What it does	Benefit
Standard collateral	Hard and soft-copy brochures, booklets and other explanatory materials	• Provides study materials for how the program works • Can offer examples of the program payouts under different scenarios
Total rewards statements	ESPP gains (usually realizable or realized value) embedded in total rewards statements	• Keep the program top-of-mind • Prompt employees to weigh it in light of overall compensation
Webcasts	Prerecorded or live presentations explaining the program with concrete examples	• Offer another way to engage with the content and ask questions
Town halls and live workshops	Live, in-person sessions (small or large group) where employees can drop in to ask questions	• Provide a grassroots and personalized means of explaining the program • Offer insight back to HR on how well people understand the program
Videos	Brief explainers using animation to break down technical content	• Offer a different way to explain a complex subject

culture, you need people to be excited by the opportunity being presented. Table 3 offers a roundup of communications techniques.

Don't forget that after you've designed a robust communications program and rolled out an ESPP, track the program's specified success metrics and report these to senior management. If the program isn't meeting its goals, the sooner you glean this, the sooner you can take action.

Closing Thoughts

ESPPs have emerged as a cost-effective tool for cultivating an ownership mindset among employees. Beyond that, a well-crafted program can be a powerful addition to a talent attraction and retention strategy.

Whether you're thinking about introducing a new ESPP or revitalizing one you already have, here are some design and implementation questions to consider:

- What are the primary objectives of the program?
- What is the target participation rate?
- Which design features are critical in achieving program objectives and target participation?
- How much will the plan cost? What is the incremental expense associated with adding more attractive features?
- How much benefit will each design alternative provide to employees?
- What are the downstream administration and financial reporting implications of the selected design?
- What is the best way to effectively communicate the plan to employees?

A thoughtful approach, alongside scenario-based design modeling, can yield the insights you need to build a program that works for your company. **ws**

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