Case Study

A multinational laboratory solutions provider

Service(s) offered: **Due Diligence & Valuations**

Sector/Industry: **Manufacturing**

Fair Valuation of Restricted Stock Units for an Employee Incentive Plan

Our client is an Indian subsidiary (Company) of a global multinational laboratory solutions provider (Client) specializing in designing, manufacturing, and installing laboratory furniture.

The Global Management decided to incentivize the employees of the Indian subsidiary by instituting a management incentive plan via Restricted Stock Units (RSUs).

The Global Management, in consultation with the Indian Management, appointed Nexdigm to:

1. Value the Company to be able to quantify the management incentive
2. Recommend a suitable management incentive plan that met the Global Management's objective of:
    - Balancing the conflicting needs of incentivizing the Indian Management over the long-term and minimizing the tax burden
    - Retaining full operational and financial control (as the RSUs were to be converted into a different class of equity shares with several restrictions)

3. Implement the most suitable management incentive plan

4. Ascertain the value of the management incentive instruments (RSUs) for financial reporting

Approach

For the purpose of valuing the Company and management incentive instrument, our approach was bifurcated into the following phases:

1. Understanding the Business and Industry Dynamics
2. Valuation of the underlying Equity Instrument
3. Valuation of the selected management incentive instrument

Phase I – Understanding the Business and Industry Dynamics

We started by conducting discussions with the Management while analyzing the business model and operations of the Company. This gave us key insights about the Company's future business plans and helped us understand their product offering, target market, growth opportunities, etc. We started our preliminary understanding of the furniture industry by referring to proprietary databases and research reports. We then adopted a top-down approach to understand the outlook of the Indian Furniture industry. Knowledge of the Company's business model helped us narrow down our analysis of the Laboratory Furniture industry and identify peers who operated with a similar business model.

Phase II – Valuation of the Underlying Equity Instrument

To determine the most efficient management incentive plan, we first had to value the underlying equity instrument.

Based on our understanding of the industry and given the stage of the Company's life cycle, we considered the Discounted Cash Flow method under the Income Approach to be the most appropriate method to value the underlying equity instrument.

As the underlying equity instruments to be issued upon exercise of the RSUs were a different class of equity shares, we had to make suitable adjustments to the per-share value of the existing equity shares based on the terms and conditions of the RSUs.

The important terms for valuations that we identified were:

- The shares to be allotted on exercise of RSUs would not have any voting rights
- The employees can sell their converted equity shares only to the Company through a buyback at fair market value.
- If an employee resigns during the lock-in-period of the RSUs, the Company will buyback the said RSUs at 50% of the fair market value.

We quantified the impact of these restrictions as follows:

- Since the converted RSUs will not have voting rights to participate in the decision-making process, a Discount for Lack of Voting Rights of 5% was applied on the Equity Shares (Non-Voting).
- Since the Company is a private entity and the employees could sell only to the Company by way of a buyback at fair value or during the lock-in-period at 50% of the fair value, a Discount for Lack of Marketability of 10% was applied on the Equity Shares (Non-Voting) of the converted shares.

The RSUs would represent only 5% of the fully diluted share capital post-conversion. This implied that the holders of Equity Shares (Non-Voting) would have minimal control over the Company's operations either individually or collectively. Therefore, a nominal Discount for Lack of Control of 10% was also applied to the Equity Shares (Non-Voting).

Phase III – Valuation of the RSUs

RSUs are a way by which a Company grants its shares to its employees. The grant is 'restricted' as it is subject to a vesting schedule and is based on the employee's performance or tenure of employment, and it is subject to other terms as the Company may deem fit. RSUs, in principle, are like stock options. If traded options with similar terms and conditions do not exist, the fair value of the options granted shall be estimated by applying the Option Pricing Model.

We evaluated the Lattice Model, Monte Carlo Simulation, and Black-Scholes-Merton Model. Based on our analysis of factors such as the Company's unlisted status and lack of significant RSU exercise data, we concluded that the Black-Scholes-Merton Option Pricing Model was the most appropriate valuation model to value the RSUs.

Inputs to Black-Scholes-Merton Model

- **Dividend Yield**: Based on discussions held with the Management, the Company was expected to pay ~5% dividend each year. Hence, we considered a 5% dividend yield for the valuation of RSUs.
- **Stock Price**: Value of Equity Shares (Non-Voting)
- **Exercise/Strike Price**: This was available from the RSUs Scheme and used accordingly.
- **Expected Term**: Based on the vesting period of the RSUs, the expected term was obtained.
- **Risk-Free Yield**: We had considered the Government of India base/par yield based on the relevant terms of the various RSUs as calculated. These yields were then converted to continuously compounded yields as the Black-Scholes-Merton model requires continuously compounded returns.

Impact

The valuation of the Company helped formulate the incentive plan and gain approval from the Board of Directors. The RSUs were thereafter swiftly granted to the employees and the valuation of the RSUs assisted in the timely accounting and closure of books.

For more information on this case study, please write to us at:

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You can also visit our website to know how our services resulted in tangible business benefits:

www.nexdigm.com