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EQUITIESFIRST™ Progressive Capital

# EMPLOYEE STOCK OWNERSHIP PLANS (ESOP)

**Companies often use ESOP to align interests with their employees. Many early employees of listed companies have accumulated majority of their wealth through stock rewards. When short-term capital needs arise, rather than selling the shares in the market (which create share price pressure), pledging the shares to EquitiesFirst is an alternative for upside retention and alignment of interests.**

## BACKDROP

- Companies often use ESOP (employee stock ownership plans) to align the interests of their employees with those of shareholders
- Most of the listed companies have a group of early employees who have been working in the company since the start-up stage. After years of hard work, the company gets listed, and the early employees get rewarded through stock options
- When an employee may have a capital need, the key options include:
  1) selling the shares in the market;
  2) obtain margin lending services from private banks;
  3) pledge the shares to private lenders like EquitiesFirst

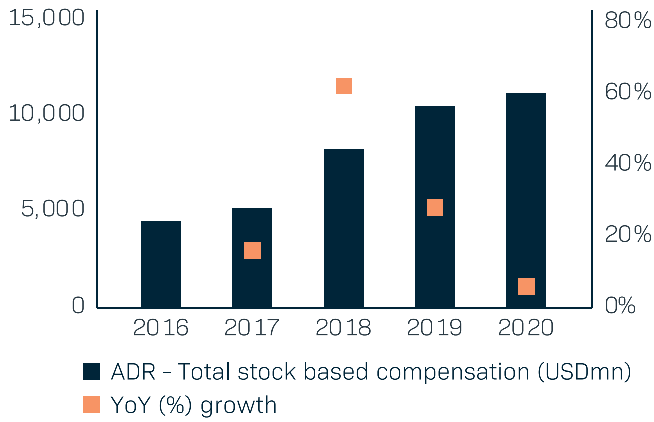
## KEY TAKEAWAYS

- If the shares are sold in the market, the employee will lose the upside in the stock and vested interest in the company. This also risks creating selling pressure on the share price
- If the shares are pledged to the private banks, the funding needs to stay within the private bank and cannot be used for personal purposes (e.g. buying a house)
- An alternative would be pledging the shares to EquitiesFirst which provides:
  1) non-purpose funding;
  2) full exposure to the upside of the shares; and
  3) no share price pressure.

## ALIGNMENT OF INTEREST WITH EMPLOYEES THROUGH ESOP

- There has been increasing number of companies (especially within Chinese ADRs) which use ESOP to incentivize their employees and align their interest with those of their shareholders.
  - A PwC survey of 337 public Chinese companies that listed in the US or Hong Kong from January 2016 to July 2019 showed that 52% of these companies have adopted equity incentive plans following an initial public offering (IPO)
- Accounting for stock-based compensation (SBC) is recognized as a non-cash expense on the income statement under US GAAP. SBC is an operating expense and is allocated to the relevant operating line items:
  - Cost of goods sold
  - Research and development expenses
  - Selling, general and administrative expenses
- We note that the total share-based compensations for China ADR have been on an uptrend as companies increasingly use stock options to incentive the employees

**TOTAL SHARE-BASED COMPENSATION FOR CHINA ADRs (USD mn)**

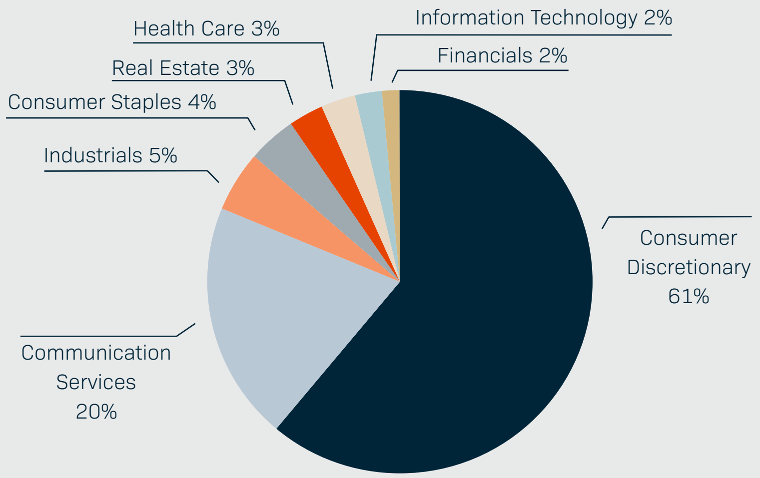



Note: In China, depending on the background of the shareholder with shares from ESOP program, there may be tax considerations in the conversion from options to shares and any changes (temporary/permanent) in beneficial ownership of the shares. For details, shareholders should seek advice from independent advisors, including tax advisors.

Source: Bloomberg (August 2021)

## INCREASING SBC AMONG CHINA ADRs

**BREAKDOWN OF TOTAL SHARE-BASED COMPENSATION BY SECTOR (2020)**




- On a secular basis, we note that consumer discretionary and communication services are the largest sectors offering share-based compensation, which combined account for >80% of the total share-based compensation offered by China ADRs in 2020. We note that a subsection of these are, in fact, technology companies. For example, BABA, JD and PDD are all classified as "consumer discretionary".

## SHORT-TERM LIQUIDITY NEEDS FOR EARLY EMPLOYEES

- Most listed companies have a group of early employees who have been working in the company since it was a start-up. After years of hard work, the company gets listed and they have accumulated majority of their wealth through stock rewards. They typically have a bullish view in the company and are committed to its people, business, culture and objectives.

- When they have short term liquidity needs, the key options include:
  1) Sell the shares in the market;
  2) Obtain margin lending services from private banks;
  3) Pledge the shares to private lenders such as EquitiesFirst

### ACCESSING SHORT-TERM LIQUIDITY

**OPTION 1** — **Selling the shares in the market**

KEY FEATURES

The employee will lose all the upside of the stock, and this will also create pressure to the share price.

**OPTION 2** — **Obtain margin lending services**

KEY FEATURES

If the shares are pledged to private banks, the funding needs to stay within the private bank and cannot be used for other external purposes (e.g. buying real estate, refinancing debts, etc.)

**OPTION 3** — **Pledge the shares to EquitiesFirst**

KEY FEATURES

Allows the employee to retain upside exposure and economic alignment with their employer. There is no pressure to the share price. The funding is non-purpose allowing the employees to use the capital as they see fit.

## PERSPECTIVE FROM THE LISTED COMPANY'S CFO

- Corporate CFOs are focused on avoiding pressure in their share price, including from minority shareholders selling shares in the market. Significant minority shareholders are often early employees who tend to be loyal, "sticky" investors who understand the company best and prefer to retain their shares. However, these shareholders may still have liquidity and financing needs.

- Pledging the shares to EquitiesFirst as a financing partner allows shareholders to access funding without needing to sell their shares. From the perspective of a CFO this is preferrable to selling pressure and the loss of otherwise loyal shareholders.

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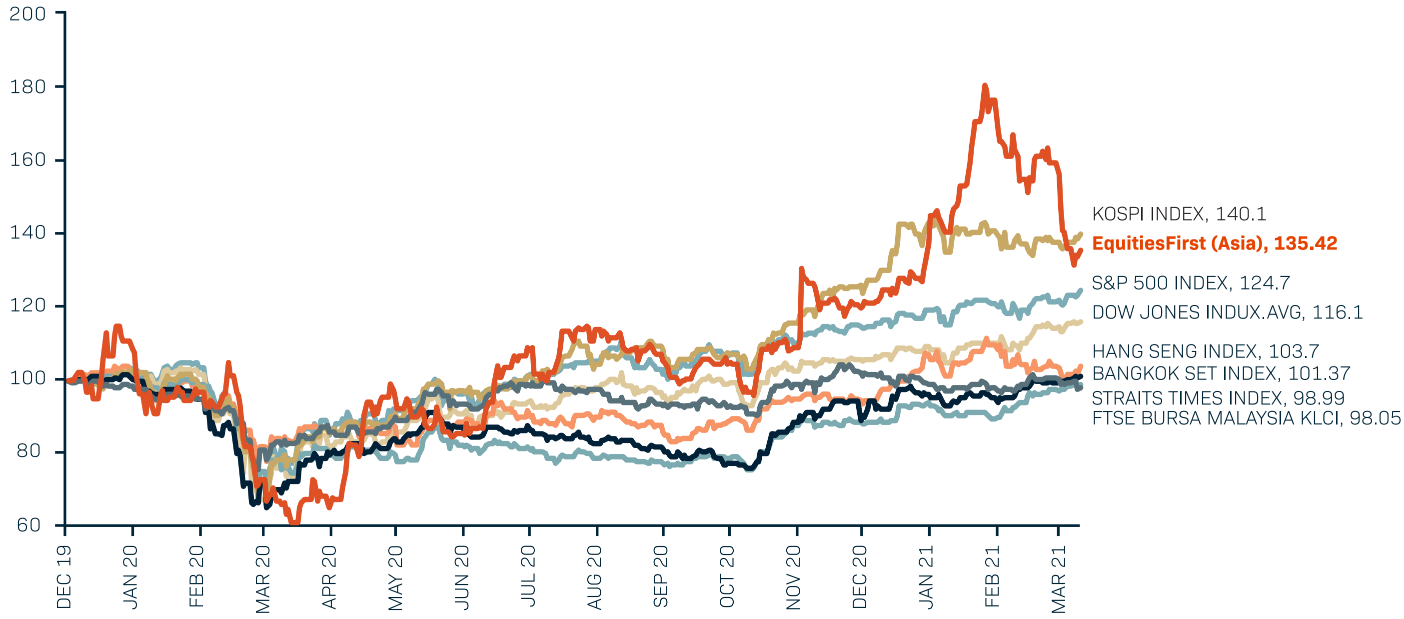
Source: Bloomberg (August 2021)

## RETURN COMPARISON (REBASED)

We conducted an analysis of all the transactions completed by EquitiesFirst in Asia over the course of 2020 and through to 1 April 2021. We indexed all of the transactions on an equally-weighted basis and compared the performance with major indices globally:




## CASE STUDY: ONE OF THE CHINA ADR

The chart below details one case in which EquitiesFirst has helped a number of employees of a China ADR with their funding needs. The interest has been aligned because there is no impact to share price and the funding is non-purpose. As a result of opting for the share-backed financing instead of liquidation, minority shareholders A, B and C have retained 67%, 30% and 84% upside of the stock to date, respectively.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Source: Bloomberg (August 2021)

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