Orchestra

Employee Share Schemes

An overview of Employee Share Schemes (ESS) and how Orchestra can help you administer your plan

Prepared with the assistance of Oxygen Advisors

oxygen advisors

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Orchestra is the smart way to track equity and streamline investor relations in an intuitive platform.

We believe private companies are the driving force behind economic growth, innovation, and job creation, and we understand the challenges that all business leaders face: having the time to be effective in execution and having a committed team on the journey with you.

Orchestra is the trusted platform making light work of equity ownership, creating harmony and multiplying success.

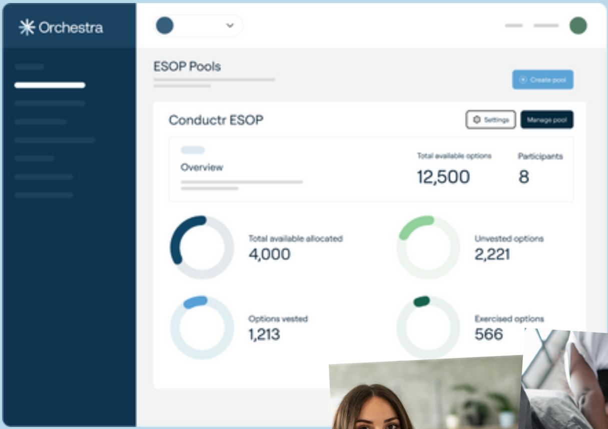
Oxygen Advisors is a team of passionate, highly-skilled Virtual CFOs and management accountants who specialise in lifting the weight of financial worries off your shoulders. From providing accurate, reliable monthly reporting and metric dashboards to strategic support while raising capital, our tailored approach is specifically catered for early-stage and high-growth companies and ensures you get the service best suited to your business.

Overview

Employee share schemes (ESS) can create a powerful arrangement between a business and its employees. Businesses will normally offer to give or sell shares to their employees or, in some instances, may set up bonus schemes based on the company's performance.

Benefits of a well-structured and administered employee share schemes include:

- An excellent way to attract and retain key talent within your business
- A way to substitute some cash salary costs in early-stage companies
- Create an 'ownership mindset' and common goal amongst key team members
- Incentivising long term and strategic thinking, helping employees understand business decisions
- Tax and cashflow efficient way to incentivise staff that may not otherwise be able to afford to buy equity
- Can be used as part of a potential exit or sales strategy for current owners
- Flexible structures that can be catered to a range of business needs



Types of **Employee Share Schemes (ESS)**

Different types of Employee Share Schemes will suit different businesses. The main types of plans include:

1. **Call option plans (often called employee share option plans or ESOP):**

Option plans create a contract between the company and the employee, which obliges the company to issue new shares to the employee in the future at a specific price and timeframe specified by the contract.

This type of contract can benefit employees by allowing them to participate in the upside of share price increases without outlaying the capital to purchase the shares. Option plans are also common where the company's future is still hard to predict.

It benefits the company by aligning the employees to the objective, which will increase the share price, provide remuneration that doesn't require cash and provides some risk mitigation, as shares are unlikely to be issued when there has been no share price appreciation.

To create an option plan, the Company will sign an 'Employee Share Option Deed'. This will set out the terms of the scheme, who may participate and how the scheme will be operated. Participants will acquire their options by signing an invitation letter sent by the Company.

Share options are traditionally earned through longevity in the company and/or performance milestones. Share options will normally defer the tax payable by the employee until the point the options convert to shares. Eventual tax implications for the employee can be aligned with the employee's opportunity to sell the shares when it is easier to find any tax payment.

Early-stage investors often request that an option plan be implemented before investing, as they recognise their potential value for the company. More mature companies can also benefit from an option plan when they are heading toward a sale or liquidity event.

2. Loan-to-purchase

A loan-to-purchase scheme will typically be used to immediately 'sell' ownership of shares to employees. Often favoured by more established companies, a trust entity could also be established to hold shares for employees in the parent company.

Typically, businesses will offer a low or no-interest loan (or a bonus payment) to fund the purchase of the shares. Loans will often not require repayment until an eventual liquidity event in the company.

3. Phantom or Bonus Share Schemes

A phantom share scheme will provide participants with a contractual right to a monetary amount on certain events occurring or certain KPIs being achieved.

"Phantom" share schemes create some benefits of formal share ownership without requiring the physical transfer of shares or options. Often favoured in businesses with strong profit share focus, Phantom schemes allocate 'shares' to employees who will get a cash bonus based on their 'ownership' when dividends are calculated, and/or a liquidity event occurs.

4. Management Buy-outs

Whilst not always classed as an ESOP, management (or managed) buy-outs can create an ownership mindset within your key staff, particularly in more long-standing or profit-driven companies. A management buy-out scheme creates transactions where the company's management team or senior staff purchase the assets and operations of their business. However, these transactions may not always happen on one date, so management buy-outs can be classified as an ESOP.

How can **Orchestra** help?

Regardless of which employee share scheme you choose, Orchestra will help you to establish and administer your chosen scheme. If businesses and employees cannot understand and engage with your plan, then it won't have the intended benefits.

Over time, employee share schemes can become burdensome to manage manually, so you'll want a platform to save your business time and money. In addition, Orchestra will:

- Work with you to digitise your current employee share scheme agreements or packages, which include legal documents, through our network of trusted advisors.
- Create an easy-to-manage cloud-based share and options registry to facilitate compliance, record-keeping and reporting for your plan. Share registries are integrated with the NZ Companies Office, creating a single source of truth for your company.
- Provide an easily understood process for creating and managing your vesting schedules and conditions using templates. These are vital to an employee fully benefiting from any plan.
- Provide an online app for all employees to view their portfolio and securely access and store documentation related to their offer.
- Digitally sign and secure documents like offer letters with an option grant.
- Provide access to an online share trading platform that allows employees to periodically buy or sell their shares amongst themselves if the company allows them.
- Orchestra can also provide employee share schemes for listed companies. Please get in touch if you would like to discuss this.

How to **get started**

It’s easy to get started with Orchestra. We offer different plans to suit growing businesses. We can support you to manage your existing scheme or work with our network of advisors (legal and financial) to get a new plan administered for your team.

We provide onboarding and ongoing support with our team of experts.

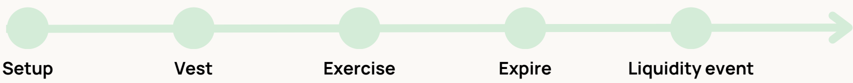
- Secure an appointment to talk to one of our sales reps.
- Explore use cases based on your industry.
- Learn how Orchestra can save you time and motivate your team and investors.

www.orchestra.io/request-a-demo

ESOP **deep dive**

The Call Options or ESOP lifecycle

All Call Options plans typically run through the same lifecycle, which is explained step-by-step below.



1. **Setup**

Under an option plan, a business will create an 'option pool' where is sets aside options that can be allocated to employees. The standard option pool size will vary between 5 and 15% of the fully diluted capital in the Company, but it can vary. Companies will typically work with their lawyers to create:

- Option plan deed containing the core rules
- Offer letters for employees containing vesting rules
- Potentially a Director's Deed authorising the option plan creation and offers

During the setup phase, the business (often in conjunction with the employees) needs to confirm:

- The amount of shares being issued
- The exercise price
- The vesting period
- The expiry date
- What happens if an employee leaves
- What happens in a liquidity/sale event

Once all information is confirmed, it can be entered into Orchestra so all stakeholders can be made fully aware of all relevant details and conditions.

It is important to also note that an option plan will create obligations for a company once created. A company will be obliged to sell those shares to the employee if the criteria are met. But there is also compliance matters, such as providing a valuation when shares are exercised, certain director resolutions, and communications with current investors.

2. Vesting

Under an option plan, an employee is not able to 'exercise' the option until that option 'vests'. This means that the option cannot be converted into a share, until the option has vested. Vesting normally takes the form of:

- Automatic time-based vesting and/or
- Manual/performance-based vesting

Automatic/time-based vesting:
Automatic or time-based vesting can either occur by way of 'periodic vesting' the use of a cliff or both. Orchestra facilitates this to make it easy to understand in an intuitive app.

- Under a 'cliff', a certain amount of options vest after an initial period has passed i.e. if an employee is new to the company, they may experience a six-month 'cliff' meaning their options will only vest after this 'cliff' of six months from their start date.
- Under 'periodic' vesting, the options vest gradually over a period of time (generally monthly, quarterly or yearly).

Manual/performance-based vesting:
Options will vest on the achievement of some defined milestones or performance hurdles. If the options don't vest (i.e. because the milestone isn't achieved), they lapse. This means they can no longer be vested or exercised by that employee. They will be recycled back into the option pool, where they can be allocated for other employees or offers.

2. Exercise

Vested options can be exercised and then purchased by the employee at the price agreed upon in the offer documents. Orchestra can easily facilitate the transfer of options into ordinary shares in your official cap table.

Once an employee exercises options they become a shareholder in the business and are entitled to the same rights as other shareholders.

Tax considerations when exercising shares*

The granting of share options is generally not a taxable event. However, in New Zealand, taxable income may be created for the option holder when options are exercised.

The amount of taxable income is the difference between the exercise price and the market price at the time the shares are purchased. For example, if an employee exercises 1,000 options with an exercise price of $1.00, and at that time the shares are worth $2.00, this has created a taxable income for the option holder of $1,000 (1,000 x $2.00 - 1,000 x $1.00).

The business can be entitled to a deductible expense equal to the employee income and must disclose this in PAYE returns. However, paying PAYE on behalf of employees is optional. If the PAYE is not paid on behalf of the employee, the employee will need to pay this tax directly to the IRD.

*Orchestra is not, by means of this information, rendering tax or other professional advice or services. This information is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business or interests. Before making any decision or taking any action that may affect your business or interests, you should consult a qualified professional advisor. This information is not intended as a recommendation, offer or solicitation for the purchase or sale of any options or shares.

4. Expiry

If the share options expire without employees exercising they can then be recycled back into the option pool, where they can be allocated for other employees or other offers.

5. Liquidity events

What happens in a company exit? Your initial option plan deed will contain information relating to what happens in a liquidity event for your business, including whether unvested options automatically vest or expire.

Glossary of **employee share scheme** terms

Of all the ESS types available to businesses the majority of questions will normally relate to option plans. If you need more information on these terms below, please get in touch with us.

ESOP means Employee Share Option Plan.

ESS means Employee Share Scheme.

Exercise means the process of converting a vested option into an ordinary share. An option can be exercised when the option has vested and the Exercise Price is paid.

Exercise Price also called the 'strike price', is what the employee will eventually pay if they choose to exercise their options. The lower the price, the more valuable the options are to the employee due to tax being applied on the upside between the Exercise Price and market value of the shares being acquired versus having to pay a higher exercise price in its entirety.

Exercise Period means the period in which an employee can exercise the options. Often, an employee won't exercise the options straight after vesting and may even wait for an eventual liquidity event in business.

Expiry Date means when an option is no longer valid to be exercised. Considerations need to be made around the time taken to reach a liquidity event versus having a range of unexercised options in your business. Expiry dates also need to take into account rules for employees who may leave your business.

Grant Date means the date the options are granted to the employee or contractor under the Offer

Offer means an offer for options is made to an employee or contractor through an ESOP offer letter, which will normally be attached to an ESOP Deed all employees must agree to. Options create a contract between the company and the employee, which obliges the company to issue new shares to the employee in the future at a specific price and time frame specified by the contract.

Plan Rules mean the rules that accompany each offer. The rules set out all the terms in relation to the ESOP, including the process for employees who may leave a business and what happens in the event of a business sale.

Vesting is a concept that restricts an employee's access to exercise their options based on a set of criteria. These could be as simple as a certain amount of time passing or a set of KPIs or company milestones.

Vesting Cliff is a common vesting criterion that requires a set amount of time before any options become available to the employee to exercise. For example, options may vest monthly over four years, with a one-year cliff, meaning no options vest until after the first year.

Vesting Period means the time from the start of the offer through to when all share options have been vested or fortified. A vesting period may include a cliff or other conditions that need to be met before vesting can begin.

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