Equity Compensation

Rules of thumb, guidelines, conventional wisdom & other considerations

Frank Demmler

Founders’ Pie

Getting started correctly is critical!

Founders' Pie

Conventional Wisdom

- Count the number of founders
- Divide the number of founders into 100
- That's the "fair" percentage for each founder

Founders	Percent
2	50.0%
3	33.3%
4	25.0%

Founders' Pie

Conventional wisdom is wrong, and could be fatal

Think about 2 founders, what if?

- One jumps into the company & the other keeps his job, “helping” at night & on weekends
- Company is doing well. One founder happy with current income, the other wants to change the world.
- Company needs money. One founder puts it in, the other doesn’t.

Think about 2 founders, what if?

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Just imagine 3 or more founders!

Slicing the Founders’ Pie

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Slicing the Founders' Pie

- How much stock ownership should go to whom?
  - Share the wealth with those who help to create the value and thus the wealth
  - Realize a harvest of at least 5 to 10 times the original investment
  - Make sure the company prospers and grows thus creating a huge, shared pie

Distribution Issues

- Differentiation
  - Reward system recognizes differences in contributions among team members
- Performance
  - Reward is a function of performance (as opposed to effort)
- Flexibility
  - Reward system acknowledges and accounts for changes in contributions of team members

Considerations of Value

Contributions in certain areas are of particular value to a venture.

- Idea
- Commitment and Risk
- Skills, experience, track record, or contacts
- Business plan preparation
- Responsibility

Stock-Vesting Agreement

- Stock-vesting agreement—agreement between venture and team member used to guard against the event that some portion of the stock has been earned and some portion will remain unearned, as when a team member quits or dies; the venture places the stock purchased by team members in escrow to be released over a two- or three-year period

Stock-Vesting Agreement

- Fosters longer-term commitment to the success of the venture
- Provides a method for a civilized, no-fault corporate divorce if things do not work out
- Establishes a period of years, often four or more, where founding stockholders can "earn out" their shares

Founder Relative Contribution

Absolute Scores (1-10)

	Weight	Founder 1	Founder 2	Founder 3	Founder 4
Idea					
Business Plan					
Domain Expertise					
Commitment & Risk					
Responsibilities					

Founder Relative Contribution

Weighted Scores (1-10)

	Founder 1	Founder 2	Founder 3	Founder 4	
Idea					
Business Plan					
Domain Expertise					
Commitment & Risk					
Responsibilities					
Total Points					
% of Total					100.0%

Suppose: University Spinout – 4 founders

- Inventor – senior faculty, won't leave the university
- Business guy (MBA?) – jumps in and responsible for getting things done
- Post-doc – knows how to make the technology work, jumps into the company
- Lab tech – happened to be in the right place at the right time

Founder Relative Contribution

Absolute Scores (1-10)

	Weight	Founder 1	Founder 2	Founder 3	Founder 4
Idea	7				
Business Plan	2				
Domain Expertise	5				
Commitment & Risk	7				
Responsibilities	6				

Founder Relative Contribution

Absolute Scores (1-10)

	Weight	Founder 1	Founder 2	Founder 3	Founder 4
Idea		10	3	3	0
Business Plan		3	8	1	0
Domain Expertise		6	4	6	4
Commitment & Risk		0	7	0	0
Responsibilities		0	6	0	0

Founder Relative Contribution

Absolute Scores (1-10)

	Weight	Founder 1	Founder 2	Founder 3	Founder 4
Idea	7	10	3	3	0
Business Plan	2	3	8	1	0
Domain Expertise	5	6	4	6	4
Commitment & Risk	7	0	7	0	0
Responsibilities	6	0	6	0	0

Founder Relative Contribution

Weighted Scores (1-10)

	Founder 1	Founder 2	Founder 3	Founder 4
Idea	70	21	21	0
Business Plan	6	16	2	0
Domain Expertise	30	20	30	20
Commitment & Risk	0	49	0	0
Responsibilities	0	36	0	0

Founder Relative Contribution

Weighted Scores (1-10)

	Founder 1	Founder 2	Founder 3	Founder 4	
Idea	70	21	21	0	
Business Plan	6	16	2	0	
Domain Expertise	30	20	30	20	
Commitment & Risk	0	49	0	0	
Responsibilities	0	36	0	0	
Total Points	106	142	53	20	321
% of Total	33.0%	44.2%	16.5%	6.2%	100.0%

Rules of Thumb

Frameworks for thinking about equity compensation

Perspectives

- Timing issues
  - Today
  - At exit
  - Somewhere in between
- Incentive value
  - Percentages
  - Value
  - Parity/fairness

From 30,000 feet

- At the end of the day, founders and management will own 20% - 33% of the company (at the time of an exit)
- During the early stages of the company, stock option pools are likely to be in the 10% - 25% range. Pools are replenished with each round. <u>Making people "whole" is not automatic.</u>

Small Piece of a Large Pie

What does that mean?

The Way It's Supposed to Work

	Start Shares	Start %	Seed Round Shares	Seed Round %	Round 2 Shares	Round 2 %	Round 3 Shares	Round 3 %	IPO Shares	IPO %
Founders	100,000	100.00%	100,000.00	30.00%	100,000.00	11.25%	100,000.00	7.27%	100,000.00	5.81%
Option Pool 1			66,666.67	20.00%	66,666.67	7.50%	66,666.67	4.84%	66,666.67	3.88%
Option Pool 2					111,111.11	12.50%	111,111.11	8.07%	111,111.11	6.46%
Option Pool 3							28,673.83	2.08%	28,673.83	1.67%
Investor 1			166,666.67	50.00%	166,666.67	18.75%	166,666.67	12.11%	166,666.67	9.69%
Investor 2					444,444.44	50.00%	444,444.44	32.29%	444,444.44	25.83%
Investor 3							458,781.35	33.33%	458,781.35	26.67%
IPO									344,086.02	20.00%
Total	100,000	100.00%	333,333.33	100.00%	888,888.89	100.00%	1,376,344.08	100.00%	1,720,430.10	100.00%
Pre-financing value			$ 1,000,000		$ 5,000,000		$ 20,000,000		$ 150,000,002	
Post-financing value			$ 2,000,000		$ 10,000,000		$ 30,000,000		$ 187,500,002	
Investment			$ 1,000,000		$ 5,000,000		$ 10,000,000		$ 37,500,000	
Price per share			$ 6.000		$ 11.250		$ 21.797		$ 108.984	
Value of Founders' Share			$ 600,000		$ 1,125,000		$ 2,179,688		$ 10,898,438	

Frank’s Rules of Thumb

when considering a single employment offer

CEO	“rainmaker”	8.0%-12.0%
COO	“the business guy”	4.0%-8.0%
VPs	1-2 “key” players	2.0%-3.5%
VPs	Other	1.0%-2.5%
CFO	“supply & demand”	0.5%-1.0%

Per Brad Feld, askthevc blog, 1-16-08

Title	Cash Comp	Cash Median	Bonus	% Co Equity	% Co. Median
CEO - Founder	100k-250k	200k	0-100k	5-20%	9.0%
President / COO - Founder	100k-200k	175k	0-50k	3-8%	5.0%
CFO - Founder	100k-170k	150k	0-20k	1-5%	2.5%
CTO - Founder	120k-200k	160k	0-30k	2-10%	4.0%
VP Engineering - Founder	150k-185k	160k	0-30k	1.5-5%	2.5%
VP Sales - Founder	175k-200k	175k	0-60k	1.2-5%	3.5%
VP Business Dev - Founder	150k-180k	170k	0-35k	1.5-5%	3.0%
VP Marketing - Founder	140k-180k	160k	0-30k	1.3-7%	3.0%

Founders

Per Brad Feld, askthevc blog, 1-16-08

Title		% Co Equity	% Co. Median
CEO - Founder		5-20%	9.0%
President / COO - Founder		3-8%	5.0%
CFO - Founder		1-5%	2.5%
CTO - Founder		2-10%	4.0%
VP Engineering - Founder		1.5-5%	2.5%
VP Sales - Founder		1.2-5%	3.5%
VP Business Dev - Founder		1.5-5%	3.0%
VP Marketing - Founder		1.3-7%	3.0%

Title	Median
CEO - Founder	%
President / COO - Founder	%
CFO - Founder	%
CTO - Founder	%
VP Engineering - Founder	%
VP Sales - Founder	%
VP Business Dev - Founder	%
VP Marketing - Founder	%

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Title	Cash Comp	Cash Median	Bonus	% Co Equity	% Co. Median
CEO - Non-Founder	180k-260k	225k	0-150k	3-7%	5.0%
President / COO - Non-Founder	150k-230k	200k	0-75k	1-3%	1.5%
CFO - Non-Founder	100k-200k	160k	0-50k	0.5-1.5%	1.0%
CTO - Non-Founder	125k-200k	160k	0-50k	0.5-2%	1.0%
VP Engineering - Non-Founder	150k-200k	175k	0-50k	0.7-1.5%	1.0%
VP Sales - Non-Founder	160k-200k	175k	20-150k	0.7-1.3%	1.0%
VP Business Development - Non-Founder	150k-190k	175k	0-70k	0.5-1.3%	0.75%
VP Marketing - Non-Founder	160k-190k	175k	0-50k	0.5-1.2%	0.8%

Non-Founders

Per Brad Feld, askthevc blog, 1-16-08

Title	% Co Equity	% Co. Median
CEO - Non-Founder	3-7%	5.0%
President / COO - Non-Founder	1-3%	1.5%
CFO - Non-Founder	0.5-1.5%	1.0%
CTO - Non-Founder	0.5-2%	1.0%
VP Engineering - Non-Founder	0.7-1.5%	1.0%
VP Sales - Non-Founder	0.7-1.3%	1.0%
VP Business Development - Non-Founder	0.5-1.3%	0.75%
VP Marketing - Non-Founder	0.5-1.2%	0.8%

Title	Co. Median
CEO - Non-Founder	5.0%
President / COO - Non	1.5%
CFO - Non-Founder	1.0%
CTO - Non-Founder	1.0%
VP Engineering - Non-	1.0%
VP Sales - Non-Found	1.0%
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Founders vs. Non-Founders

Per Brad Feld, askthevc blog, 1-16-08

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CEO - Non-Founder	225k	5.0%
President / COO - Founder	175k	5.0%
President / COO - Non-Founder	200k	1.5%

Founders vs. Non-Founders

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CTO - Founder	120k-200k	160k	0-30k	2-10%	4.0%
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End-Game Arithmetic
Who owns what at liquidity event?

Per Don Dodge, The Next Big Thing Blog

Title	% Equity	Number	Total Equity
CEO	4.00%	1	4.00%
Vice President	1.00%	6	6.00%
Director	0.50%	5	2.50%
Manager	0.25%	10	2.50%
Others	0.05%	100	5.00%
			20.00%

Other Rules of Thumb

- Directors 0.50% – 1.00%
- Advisors 0.25% – 0.50%
- Founder vesting
  - 25% at closing + $^{1}/_{36}$ per month for 3 years
- Vesting acceleration at change of control
  - Management-friendly: double trigger
  - Investor-friendly: no acceleration

Considerations

- Founders vs. Non-Founders
- Stock options
  - Non-qualified options
  - Incentive stock options
- NQO can be dangerous
  - Tax on difference between exercise price & FMV
  - Price can go down after purchase – oops!!!
- Stock options vs. restricted stock
- Pre-financing vs. post-financing
- Within the company vs. compared to other companies

Exercise Price

serious tax & securities issues related to what follows

- Exercise price is tied to the company valuation
- Preferred stock is superior to common stock
- Preferred stock share price should be higher than common stock
- The difference between common stock and preferred stock diminishes over time & as commercial traction takes hold
- Common may be as low as 10% of preferred

Other Clichés

with some elements of truth

- Focus on the share price. As long as it's going up, you're OK.
- Cosmetics matter. Option grants of tens-of-thousands of shares can be persuasive, even if the actual value is miniscule.
- It is the CEO's job to sell the vision. Candidates must be excited about opportunity and their role in realizing it. "Compensation is secondary."

Final thoughts

- Budget your equity distribution over a reasonable time frame
- Don't do anything without strong professional assistance
- Develop a network of mentors and advisors who can help you design something appropriate for you and your company
- ***<u>Don't do anything without strong professional assistance</u>***

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