

Equity Compensation*

Rules of thumb, guidelines, conventional wisdom & other considerations

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**Several slides are “hidden.” You may want to review them.*

Why do you care about equity compensation?

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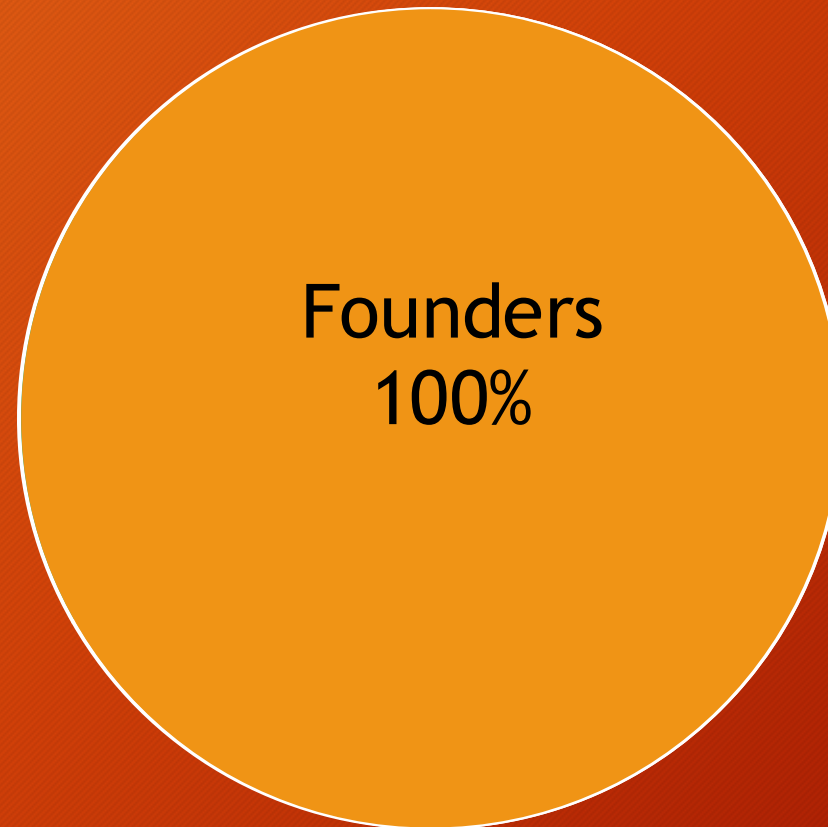
- If you are a founder, you have to decide how to share the “Founders’ Pie”
- If you are recruiting someone, you must decide how many stock options to offer a prospective hire
- If you are a prospective hire, you must evaluate the number of stock options you’ve been offered
- If you are an employee, stock options are usually tied to annual incentive compensation
- The creation of a stock option pool impacts valuation and ownership percentage

Equity Compensation (2 of 8) The Founders' Pie

Getting started correctly is critical!

When you start a company, you have to decide who owns what

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Founders' Pie

Conventional Wisdom

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- 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%

Conventional wisdom is wrong,
and could be FATAL!

Think about 2 founders, what if?

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- One jumps into the company & the other keeps her “day” job, “helping” at night & on weekends
- One wants to lease company cars for the founders & and the other doesn't
- The company is doing well
 - One founder wants more current income
 - The other wants to leave the money in the company & change the world

Equity Compensation (3 of 8)
Slicing the Founders' Pie

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Slicing the Founders' Pie

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- How much stock ownership should go to whom?
- Contributions to date
- Contributions in the future
- Incentive alignment

Considerations of Value

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

Idea

Commitment and Risk

Skills,
experience,
track record,
contacts

Business
model

Responsibility

How Important Is Each Element?

On a Scale of 1-10

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Absolute Scores (1-10)

	<i>Weight</i>
Idea	7
Business Plan	2
Domain Expertise	5
Commitment & Risk	7
Responsibilities	6

Relative Contributions of Founders' Importance of Each Component

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Absolute Scores (1-10)

	<i>Founder 1</i>	<i>Founder 2</i>	<i>Founder 3</i>	<i>Founder 4</i>
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

Relative Contributions of Founders

Weighted Scores

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Absolute Scores (1-10)

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

Relative Contributions of Founders

Preliminary Founders' Pie Estimates

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Absolute Scores (1-10)

	Founder 1	Founder 2	Founder 3	Founder 4	
Idea	70	21	21	0	
Business Model	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%

Only use for guidance. Do not use the calculated values.

Equity Compensation (4 of 8) Stock Options

What's the big deal?

A Stock Option Is

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- The right to buy a share of stock sometime in the future
- At a price established at the time of grant, i.e. the exercise price
- A typical option expires on the 10th anniversary (possibly the 2nd or 5th anniversary) of the grant if it hasn't been exercised

What's the Big Deal about Stock Options?

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- It is the "proverbial pot of gold!"
- For example, you are granted 100,000 stock options with a \$1 exercise price
- Company is acquired in 5 years for \$10 per share
 - Buy 100,000 shares of stock at \$1 per share
 - = \$100,000 is paid out
 - Immediately sell 100,000 shares at \$10 per share
 - = \$1,000,000 is received
 - Gain: **\$900,000**

How many options is enough?

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- Depends on total shares on a fully diluted basis
- You **MUST** know how many fully-diluted shares exist to evaluate an offer of options

Options	Fully-diluted Shares	Ownership %
1,000	100,000	1.00%
10,000	1,000,000	1.00%
100,000	10,000,000	1.00%

Equity Compensation (5 of 8) Vesting

Now you see it, now you don't!

Vesting Schedule

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- A grant of options does not mean you own those options
- You earn those options over time - vesting
- Purpose: to keep the employee motivated to stay with the company
- Typical schedule: 4-year vesting period
 - 25% of options cliff vest on the first anniversary
 - $1/36^{\text{th}}$ of the balance per month over the next 3 years

Equity Compensation (6 of 8) Small Piece of a Large Pie

What does that mean?

The Way It's Supposed to Work

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	Start		Series A		Series B		Series C		IPO	
	Shares	%	Shares	%	Shares	%	Shares	%	Shares	%
Founders	100,000	100.00%	100,000	30.00%	100,000	11.25%	100,000	7.27%	100,000	5.81%
Option Pool 1			66,667	20.00%	66,667	7.50%	66,667	4.84%	66,667	3.88%
Option Pool 2					111,111	12.50%	111,111	8.07%	111,111	6.46%
Option Pool 3							28,674	2.08%	28,674	1.67%
Total Options	0	0.00%	66,667	20.00%	177,778	20.00%	206,452	15.00%	206,452	12.00%
Investor 1			166,667	50.00%	166,667	18.75%	166,667	12.11%	166,667	9.69%
Investor 2					444,444	50.00%	444,444	32.29%	444,444	25.83%
Investor 3							458,781	33.33%	458,781	26.67%
IPO									344,000	20.00%
Total Investors	0	0.00%	166,667	50.00%	611,111	68.75%	1,069,892	77.73%		
Total	100,000	100.00%	333,333	100.00%	888,889	100.00%	1,376,344	100.00%		
Pre-financing value			\$ 1,000,000		\$ 5,000,000		\$ 20,000,000			
Post-financing value			\$ 2,000,000		\$ 10,000,000		\$ 30,000,000			
Investment			\$ 1,000,000		\$ 5,000,000		\$ 10,000,000			
Price per share			\$ 6.000		\$ 11.250		\$ 21.797			
Value of Founders' Shares			\$ 600,000		\$ 1,125,000		\$ 2,179,688		\$ 10,898,438	

5.81%
\$10,898,438

Final thoughts

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- 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 & level the playing field when seeking funding
- **Don't do anything without strong professional assistance**