Equity Compensation*

Rules of thumb, guidelines, conventional wisdom & other considerations

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

Equity Compensation Topics (1 of 8)

1. Overview
2. Founders’ Pie
3. Slicing the Founders’ Pie
4. Stock Options
5. Vesting
6. Small Piece of a Large Pie
7. Rules of Thumb & Clichés
8. Final Thoughts

Why do you care about equity compensation?

- 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 Securities

- Common stock
  - Founders’ stock and exercised options
- Restricted common stock
  - Recruitment incentives considered better than stock options by the recruit
- Stock options
  - Primary recruitment & retention incentive
- Warrants
  - Vendor payment instead of cash

Equity Compensation Vesting

- Common stock
  - Company's buyback rights of founders' stock over four years
- Restricted common stock
  - Company's buyback rights over four years
- Stock options
  - Right to buy shares in the future at a price established when granted
  - Outright ownership vests over four years
- Warrants
  - No vesting, owned outright when granted

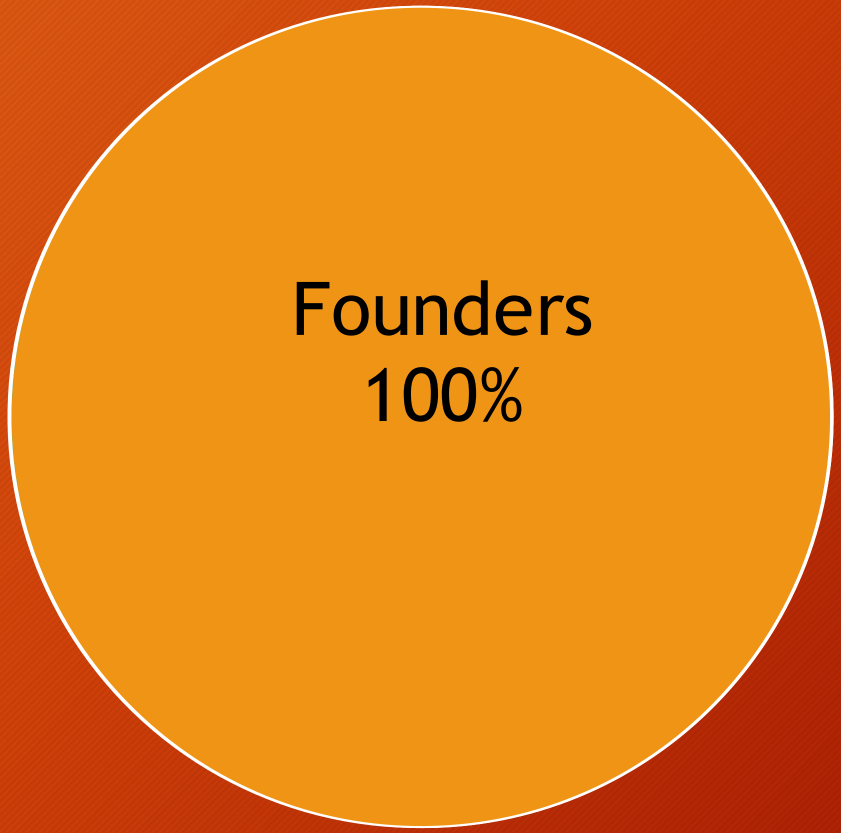
Equity Compensation Vesting Mechanics

- Most frequently used vesting schedule
  - 25% vest on first anniversary (cliff vesting)
  - $^{1}/_{36}$th of the balance vests per month over three years
- Stock options
  - Ownership of the options vests over four years
- Owned shares of founders & restricted stock of recruits
  - The company's right to buyback expires over four years
- Accelerated vesting
  - Specific senior positions may have acceleration at a liquidity event

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



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 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 more current income
  - The other wants to leave the money in the company & change the world

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Just imagine 3 or more founders!

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

Frank Demmler

Slicing the Founders' Pie

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

University Spinout – 4 Founders

- **Founder #1**: Inventor – senior faculty, won't leave the university, created university-patented IP
- **Founder #2**: Business guy (MBA?) – jumps in and is responsible for getting things done
- **Founder #3**: Post-doc – knows how to make the technology work, joins the company
- **Founder #4**: Lab tech – happened to be in the right place at the right time

Considerations of Value

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

- Idea
- Skills, experience, track record, contacts
- Commitment and Risk
- Business model
- Responsibility

How Important Is Each Element?

On a Scale of 1-10

7	Idea
5	Skills, experience, track record, contacts
7	Commitment and Risk
2	Business model
6	Responsibility

How Important Is Each Element?
On a Scale of 1-10

Absolute Scores (1-10)

	Weight
Idea	7
Business Plan	2
Domain Expertise	5
Commitment & Risk	7
Responsibilities	6

Relative Contributions of Founders' Importance of Each Component

Absolute Scores (1-10)

	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

Relative Contributions of Founders' Both Factors Combined

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

Relative Contributions of Founders Weighted Scores

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 Compiled

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%

Relative Contributions of Founders Preliminary Founders' Pie Estimates

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.

What if you got it wrong?

- Vesting of founders' shares can be a partial solution
- Can you get founders to consider a "do-over"?
  - Use the Founders' Shares Calculator
- If not, can you barter an equity trade for something else?
  - accelerated vesting, consulting agreement, health care coverage extended
- Threaten to leave
- Leave
- Raise a new round of investment and let the new investors "fix" things

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- Leave
- ~~Raise a new round of investment and let the new investors "fix" things~~

DO NOT DO THIS!

Equity Compensation (4 of 8)
Stock Options

What's the big deal?

A Stock Option Is

- 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 10^{th} anniversary of the grant

What’s the Big Deal about Stock Options?

- 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?

- 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

- A grant of options **<u>does not mean you own those options</u>**
- 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
  - 1/36th of the balance per month over the next 3 years

Vesting Schedule Considerations

- Cliff vest means lump sum vests (a year’s worth)
- One year cliff vest means, in essence, that you’re on probation for the first year
- Monthly vesting thereafter tethers you to the company for an additional 3 years
- Similarly, if the company is acquired, unvested options tether you to the acquiring company

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

What does that mean?

The Way It's Supposed to Work

	Start Shares	%
Founders	100,000	100.00%
Option Pool 1		
Option Pool 2		
Option Pool 3		
Total Options	0	0.00%
Investor 1		
Investor 2		
Investor 3		
IPO		
Total Investors	0	0.00%
Total	100,000	100.00%
Pre-financing value		
Post-financing value		
Investment		
Price per share		
Value of Founders' Shares		

The Way It's Supposed to Work

	Start Shares	Start %	Series A Shares	Series A %
Founders	100,000	100.00%	100,000	30.00%
Option Pool 1			66,667	20.00%
Option Pool 2				
Option Pool 3				
Total Options	0	0.00%	66,667	20.00%
Investor 1			166,667	50.00%
Investor 2				
Investor 3				
IPO				
Total Investors	0	0.00%	166,667	50.00%
Total	100,000	100.00%	333,333	100.00%
Pre-financing value			$ 1,000,000	
Post-financing value			$ 2,000,000	
Investment			$ 1,000,000	
Price per share			$ 6.000	
Value of Founders' Shares			$ 600,000	

The Way It's Supposed to Work

	Start		Series A		Series B	
	Shares	%	Shares	%	Shares	%
Founders	100,000	100.00%	100,000	30.00%	100,000	11.25%
Option Pool 1			66,667	20.00%	66,667	7.50%
Option Pool 2					111,111	12.50%
Option Pool 3						
Total Options	0	0.00%	66,667	20.00%	177,778	20.00%
Investor 1			166,667	50.00%	166,667	18.75%
Investor 2					444,444	50.00%
Investor 3						
IPO						
Total Investors	0	0.00%	166,667	50.00%	611,111	68.75%
Total	100,000	100.00%	333,333	100.00%	888,889	100.00%
Pre-financing value			$ 1,000,000		$ 5,000,000	
Post-financing value			$ 2,000,000		$ 10,000,000	
Investment			$ 1,000,000		$ 5,000,000	
Price per share			$ 6.000		$ 11.250	
Value of Founders' Shares			$ 600,000		$ 1,125,000	

The Way It's Supposed to Work

	Start		Series A		Series B		Series C	
	Shares	%	Shares	%	Shares	%	Shares	%
Founders	100,000	100.00%	100,000	30.00%	100,000	11.25%	100,000	7.27%
Option Pool 1			66,667	20.00%	66,667	7.50%	66,667	4.84%
Option Pool 2					111,111	12.50%	111,111	8.07%
Option Pool 3							28,674	2.08%
Total Options	0	0.00%	66,667	20.00%	177,778	20.00%	206,452	15.00%
Investor 1			166,667	50.00%	166,667	18.75%	166,667	12.11%
Investor 2					444,444	50.00%	444,444	32.29%
Investor 3							458,781	33.33%
IPO								
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	

The Way It's Supposed to Work

	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									344,086	20.00%
Total Investors	0	0.00%	166,667	50.00%	611,111	68.75%	1,069,892	77.73%	[illegible]	[illegible]
Total	100,000	100.00%	333,333	100.00%	888,889	100.00%	1,376,344	[illegible]	[illegible]	[illegible]
Pre-financing value			$ 1,000,000		$ 5,000,000		$ 20,000,000		[illegible]	
Post-financing value			$ 2,000,000		$ 10,000,000		$ 30,000,000		[illegible]	
Investment			$ 1,000,000		$ 5,000,000		$ 10,000,000		[illegible]	
Price per share			$ 6.000		$ 11.250		$ 21.797		[illegible]	
Value of Founders' Shares			$ 600,000		$ 1,125,000		$ 2,179,688		$ 10,898,438	

5.81%
$10,898,438

Equity Compensation (7 of 8)
Rules of Thumb

Frameworks for thinking about equity compensation

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 often replenished with each round.

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%

Other Rules of Thumb

- Directors 0.50% – 1.00%
- Advisors 0.25% – 0.50%
- Founder vesting
  - 25% cliff at first anniversary + $^{1}/_{36}$ per month for 3 years
- Vesting acceleration at change of control
  - Management-friendly: double trigger
  - Investor-friendly: no acceleration (remember the earlier tethering comment?)

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."

Equity Compensation (8 of 8)
Final Thoughts

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
- ***Don’t do anything without strong professional assistance***