Startup Employee Stock Options Plans (ESOPs)

Overview and Best Practices

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Part I

INTRO TO OPTIONS PLANS

What is an ESOP?

- An Employee Stock Options Plan (ESOP)
- An **allocation** of shares that will be granted to employees in the future in the form of **stock options**
  - How much equity should we set aside for employees?
- A **plan** for how these options will be distributed:
  - How many shares will individual employees receive?
  - What terms will govern these grants?
- The plan is as important as the allocation!

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What is an Option?

An option is a right (but not an obligation) to purchase a quantity of a company's stock at a set price for a certain period of time

- **Why do options have intrinsic value?**
  - A effective form of equity ownership
  - A locked-in price for shares
- **How do startups use options?**
  - To bring in founding team members who are not co-founders
  - To recruit, compensate and retain early employees
  - To allow later employees to share in the company's long-term upside

<u>Terminology:</u>

This presentation uses "options" generally to refer to several types of securities that are often issued to startup employees to provide for effective equity ownership, including:

- Stock options (the right to buy common stock a set strike price)
- Restricted stock (common stock issued early on to top employees)
- Restricted stock units (a promise to issue common stock in the future)

Appropriate use of these securities will vary based on local regulatory and tax considerations.

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Lifecycle of a Startup ESOP

- **Founders and early investors** create an ESOP by setting aside a percentage of shares to be granted to future employees
- **Management and the Board of Directors** issue these shares to employees as options packages granted for hiring, promotion and retention
- **Employees** receive all of their options upfront, but the company maintains a right to force forfeit that diminishes over time through a process called “vesting”
- **Options are exercised** by employees when the company is acquired or taken public. The employee pays the “strike price” to acquire the shares, but those shares are now marketable at a higher value

Common Terms in an Options Package

Number of Shares	The total number of options granted to an employee, and therefore the maximum number of shares that employee has access to
Strike Price	The price the employee must pay to purchase each share if and when the employee chooses to exercise the option
Vesting Schedule	The timeline over which the options become wholly owned and exercisable by the employee (no longer subject to repurchase by the company)
Cliff Period	The trial period during which no vesting occurs; in this period vesting accrues, but the total effect of this vesting is realized immediately after the cliff
Expiration Date	The last date on which the options may be exercised and converted into common shares by the employee

We will discuss the mechanics in further detail, but these basic terms are helpful to understanding options grants

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Why Issue Options to Employees?

- **Attract Talent:** options can be used to attract top recruits, particularly engineers, product managers and other technical team members
- **Retain Employees:** options vest over several years, creating strong incentives for employees to remain employees
- **Align Incentives:** by making employees equity owners, options align incentives with the long-term goals of the company
- **Reward Value Creation:** options reward tangible contributions that increase corporate valuation by giving employees a slice of that value
- **Encourage Long-term Thinking**: options typically pay off only in a liquidity event or exit, and thus push employees to build the company for long-term success

A Defining Characteristic of Startup Culture

"The defining difference between Silicon Valley companies and almost every other industry in the U.S. is the virtually universal practice among tech companies of distributing meaningful equity (usually in the form of stock options) to ordinary employees."

Steven Johnson, Technology Writer

- **Startups are a unique case**. Unlike at larger corporations, employee ownership is an essential element of startup communities and culture
  - As high-risk/high-reward enterprises, startups use options to align employee compensation with the risk-prone mentality of the business
  - Startups seeking to achieve a "big exit" use options to align all employees to drive toward this desired outcome

A Necessary Part of the Capital Structure

> *I can't think of a term sheet that we have issued that didn't have a specific provision for employee equity.*
>
> *Fred Wilson, Union Square Ventures*

- **Venture capitalists require ESOPs**. For many VCs, establishing a stock option pool is a prerequisite to closing a deal
  - In an industry where options are ubiquitous, startups are compelled to offer options packages to compete for top talent with other venture-backed companies
  - When operating budgets are tight, competitive compensation packages may not be possible; options can be used to incentivize employees instead of cash

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When to Create an ESOP?

Make employee equity allocations and set up an ESOP sometime between the pre-seed and early-VC stage

Stage	Considerations	Takeaway
Pre-seed	Founders focused on traction (often too busy for an ESOP). Key employees are given equity/options on an ad hoc basis	ESOP not necessary, but it can be helpful to sanity check how much equity you are giving away to early hires
Seed	First outside financing round. Investors either angel or institutional; institutional investors will require an ESOP	Seed rounds can be closed without an ESOP; the benefit to doing so is that seed investors then share in the dilution
Early-VC	The first true VC round. Investors will require an ESOP in place. New hires will be seek large equity grants.	ESOP must be created (to appease investors and to serve as a guideline for the size of new-hire options grants)
Late-VC	Flush with capital, startups at this stage begin to steadily ramp-up hiring, yet employees still want equity	Important to have standardized the ESOP and the amount of equity granted to new hires at each level
Growth	Company is aggressively pursuing growth and hiring; likely to have exhausted most of the ESOP	Most of the ESOP is gone, but shares remaining are more valuable; use them to allow new hires to share in the upside

Communicating Options to Employees: % versus $

Options packages can be communicated either as (1) a percentage of ownership in the company, or (2) a dollar value based on the current valuation; <u>we encourage the latter when possible</u>

%

"We are granting you options equivalent to 0.5% of the company's equity"

<u>Considerations:</u>

- **At an early stage, the only way** to communicate options grants given no true valuation of the company
- **Hard for employees to grasp** what they are really getting ("0.5% seems too little")
- **Invites a negotiation** about what percent of the company an employee really deserves

$

"We are granting you options equivalent to $200,000 of company stock"

<u>Considerations:</u>

- **Once valuation is established, highly effective** way to communicate the true value of an options grant
- **Easy for employees to grasp** what they are really getting ("$200,000 is a lot")
- **Grounds negotiations** in a discussion about concrete dollar amounts, rather than a percent of the company

Note: Although we recommend communicating options packages as a dollar value, we do not suggest refusing employees information about their effective percentage ownership; all options holders are entitled to this information, and to refuse would be unethical.

Part II

HOW MUCH TO GRANT

Two Approaches

Top Down

Decide the total amount of equity to be granted; allocate these shares to employees over time

Bottom Up

Decide the appropriate size of individual equity grants by position; issue these shares as employees are hired

In reality, creating an ESOP will require a combination of top-down and bottom-up planning

The Top-Down Process

1. Determine how much equity to set aside for non-founder employees

2. Create a schedule of how this equity will be distributed over time

1. How Much Equity to Set Aside in the ESOP?

Generally <u>non-founder employees</u> get 15-20% of the company, with some companies issuing up to 25% (and a current trend toward bigger ESOPs)

<15%

- **Founders** are top managers with functional roles that are not redundant
- **DNA** of the company is in a non-technical industry; no technology emphasis
- **Geographic focus** is on a region that is not considered a startup hub
- **Hiring needs** are primarily administrative or back-office team members

20%

- **Founders** are top mangers, but hire others to fill key technical or functional roles
- **DNA** of the company is in applying technology to a non-technical industry
- **Geographic focus** is either wholly or partially in a startup hub
- **Hiring needs** are primarily sales and marketing team members

25%

- **Founders** are not top managers in the business, or plan to step aside
- **DNA** of the company is in technology, engineering, or data science
- **Geographic focus** is in a leading startup hub such as SF, NYC or Boston
- **Hiring needs** are primarily engineering, development, or technical team members

There are no hard and fast rules, but **by looking your company's founders, its DNA, its geographic focus, and its hiring needs** you can begin to benchmark how much equity to set aside for the ESOP

2. A Typical Distribution Schedule

Seniority	Equity Allocation
First 10 Employees	10%
Next 20 Employees	5%
Next 50 Employees	5%

- Early-stage equity grants are always a negotiation, but generally:
  - – CTO: 1-5%
  - – Key Developer or Engineer: 1-2%
  - – Other Functional Team Member: 0.5-1.5%
  - – No non-founding member of the senior team should receive over 10%

The Bottom-Up Process

1. Segment your human resources

2. Create pay multipliers for each job function

3. Determine the dollar value of an options grant

4. Determine the current share price

5. Calculate options grants

1. Segment Your Human Resources

Segment	Roles	Award in % or $?
Founders	Co-Founders	%
Founding Team	Technical & Product	%
Early-Stage Hires	Senior Team (C-Level)	$
	Directors / VPs	$
	Functional / Technical Team	$
	Support Team	$

- Think about the early-stage team in three segments
  - **Founders**: the founding partners in the business
  - **Founding Team**: the people you hire to build your product
  - **Early-Stage Hires**: the team you build as you raise capital
- As early as possible, begin communicating options grants in terms of dollars rather than percentages

2. Establish Pay Multipliers for Each Role

Segment	Roles	Award in % or $?	Options Multiplier (Multiple of Salary)
Founders	Co-Founders	%	--
Founding Team	Technical & Product	%	Negotiated
Early-Stage Hires	Senior Team (C-Level)	$	0.5x – 1.0x base salary
	Directors / VPs	$	0.25x – 0.5x base salary
	Functional / Technical Team	$	0.1x – 0.25x base salary
	Support Team	$	0.0x – 0.1x base salary

- After segmenting the early-stage team, establish a standardized multiple of base salary to be granted as an option package
  - These ranges provide a ballpark grant for each role
  - Get away from actively negotiating packages with employees
  - Be transparent about this methodology

Source: This range of multiples was provided by Fred Wilson of Union Square Ventures, which he created in collaboration with a leading HR consulting firm.

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3. Determine the Dollar Value of the Options Grant

Base Salary as negotiated with the employee at the time of hire or promotion

Dollar Value of Options Grant = **Employee Base Salary** x **Options Multiplier**

Options Multiplier is decided based on the employee's role in the HR segmentation schedule

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4. Determine the Current Share Price

What is the company actually worth today? Or, at what valuation could you raise capital or sell the company? This is an internal valuation (not published). Things to consider:

- The latest financing round
- Any bonafide acquisition offer
- Comparable company valuations / DCF analysis

$$\textbf{Current Share Price} = \frac{\textbf{Latest "True" Valuation}}{\textbf{Fully-Diluted Share Count}}$$

How many shares are outstanding? This should include all shares issued, as well as any dilutive securities:

- Common shares
- Preferred shares
- Shares authorized for issuance
- Options or warrants

5. Calculate the Options Grant

$$\text{Options Grant (Number of Shares)} = \frac{\text{Dollar Value of Options Grant}}{\text{Current Share Price}}$$

An Example: Hiring a CTO

Employee Information

- CTO (Senior Team)
- $100,000 salary
- 0.8x options multiplier

Company Information

- Last valuation round: $5M
- Amount raised: $2M
- Current valuation: $7M
- Diluted share count: 50,000

CALCULATION STEPS

Dollar Value of Options Grant = $100,000 x 0.8 = $80,000

Current Share Price $= \frac{\$7M}{50,000} = \$140$

Options Grant $= \frac{\$80,000}{\$140} =$ **571 shares**

Note that this employee received 1.1% of the diluted shares outstanding; however, the grant is communicated as an $80,000 grant of 571 options, rather than as a percentage ownership stake in the company

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Important Takeaways

- **Top-down planning** (“the allocation”)
  - – Holistically consider what percentage of the company should belong to employees
  - – Allocate these shares to an ESOP
- **Bottom-up planning** (“the plan”)
  - – Specifically consider how much equity each employee should be awarded
  - – Use this framework for individual equity grants
- **Key Takeaway**: Get away from ad hoc equity awards and personal negotiations by standardizing both the amount of equity available to employees and the process by which packages are awarded

Part III

THE FINE PRINT – TERMS

Strike Price

The strike price is the amount that the employee must pay to turn one option into one share of stock. Also known as the "exercise price"

- Options are "struck" at a specific strike price when issued; the holder must pay this amount in order to exercise the option
  - The expectation is that the shares will have significantly increased in value, and the holder will profit from the spread
  - Regulations for how strike prices can be set will vary by region
- However, **it is generally in the best interest of both company and employee if the strike price is set as low as possible**
  - This is because options are typically exercised only after an acquisition or IPO, so while a higher strike price costs the employee more, none of the current shareholders benefit

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Vesting Schedule

The vesting schedule is the timetable over which an employee accrues the right to keep the options that have been awarded

- Vesting protects the company
  - It stages the accrual of options, mitigating the risk that an employee will depart with an undeserved equity stake
  - Continually incentivizes employees as they earn their options package over the course of the vesting period
- **Standard vesting period: 4 years**
  - Alternatively, some companies offer 3-year vesting, although with a shorter vesting period they may offer a smaller options package

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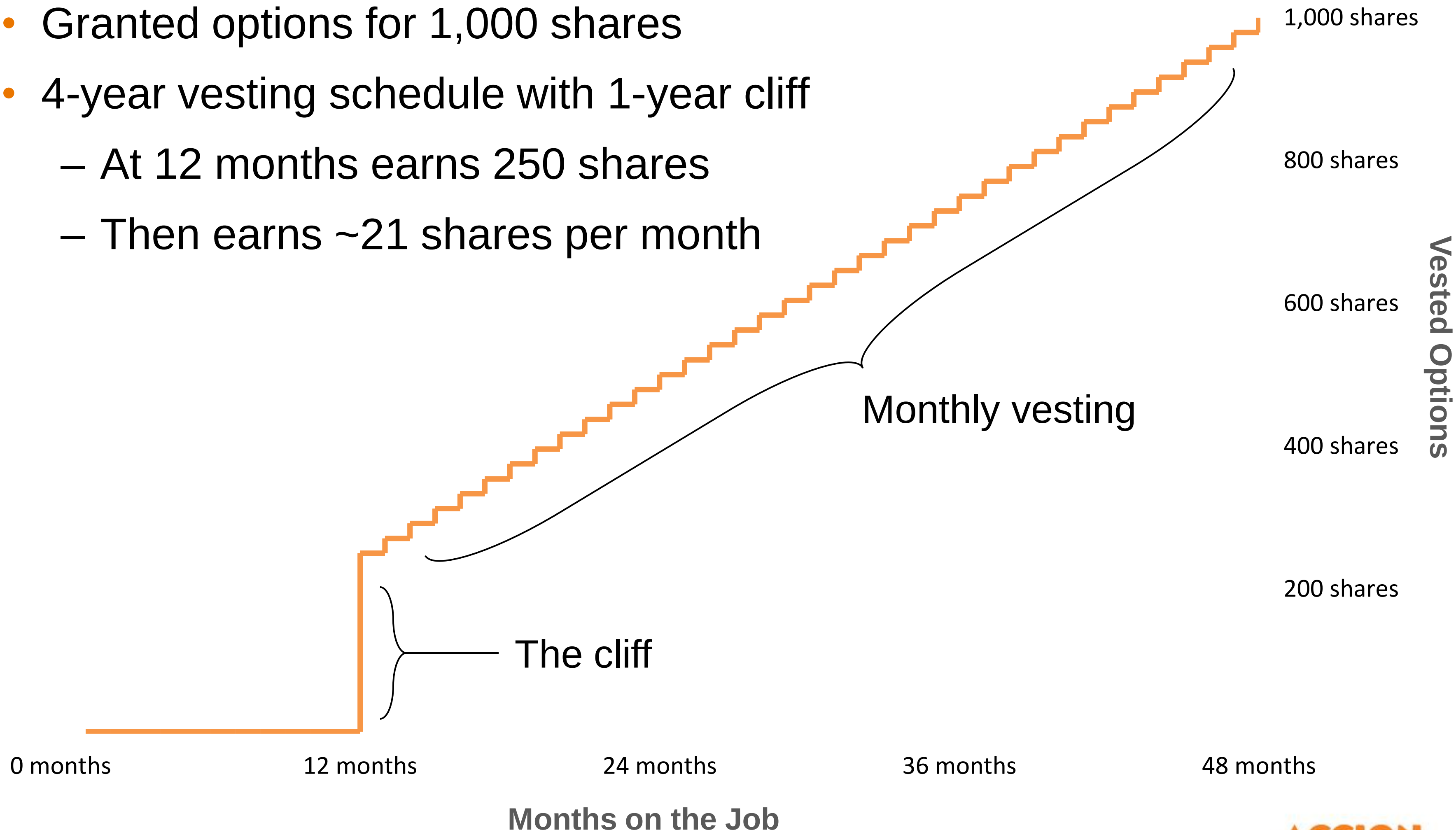
The Cliff

The trial period during which no vesting occurs; in this period vesting accrues, but the accrued shares are earned immediately after the cliff

- The cliff protects the company
- This trial period exists so that the company can avoid giving shares to employees immediately, reserving the opportunity part ways if the employee does not perform well
- **Standard cliff: 1 year**
  - Alternatively, some companies require a 2-year cliff. However, in startup communities where employees know what is “standard” this can cause significant discontent
  - Firing an employee right as their cliff is about to expire is legal, but unethical – begin to communicate discontent as early as possible during the trail period

Example: Standard Vesting with a Cliff

- New hire
- Granted options for 1,000 shares
- 4-year vesting schedule with 1-year cliff
  - At 12 months earns 250 shares
  - Then earns ~21 shares per month



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Vesting in a Liquidity Event

The terms of an options package should specifically address what happens in a liquidity event such as an IPO or acquisition

- Vested options generally become exercisable
- Unvested options can either:
  - Roll over and remain unvested
  - Receive accelerated vesting
    - These options vest automatically upon change of control – not common for everyone, but typical for top employees
  - Receive double-trigger vesting
    - These options vest automatically upon change of control, but only if the employee is terminated – not common for everyone, but typical for employees who may be extraneous in a merger (CFO, General Counsel)

Exercising Options

Options are usually exercised following a liquidity event, but employees can exercise them at any time after they vest

- Options are "in the money" if the share value is above the strike price
- To exercise an option, the employee pays the strike price to the company and receives shares for each option exercised
- If there has been a liquidity event
  - **In the case of an IPO**, the employee can now sell these shares in the public markets
  - **In the case of a cash acquisition**, an employee's shares are bought out at the cash offer price
  - **In the case of a stock acquisition**, an employee's shares are converted to shares in the new company

Tax Considerations

Options can have material tax consequences for employees; startups need to understand the tax implications and be upfront with new hires

- Tax treatment of options will vary by region
- Tax treatment will vary by the type option security issued
- Several possibilities:
  - Taxable event upon grant
  - Taxable event upon leaving company
  - Taxable event upon exercise
  - No effective tax event
- It is important for employees to fully understand the tax implications of the securities they are receiving

Legal Advice

When structuring an ESOP, engage an experienced startup lawyer with regional expertise to standardize the terms and language

Part IV

ESOPS FOR THE LONG TERM

Retention Grants

- Retention grants are used to incentive employees to stay with the company beyond their 4-year vesting period: a “top off”
  - Do not wait until an employee is fully vested to make a retention grant! This creates a natural exit incentive at the end of 4 years
  - Instead, consider making smaller retention grants every 2 years
- A framework for retention grants:

Grant Date	Every 2 years, beginning 2 years after initial package
Options Multiplier:	Use ½ of the employee’s standard options multiplier
Salary Baseline:	Use current salary if employee has received a raise
Valuation & Shares	Use current valuation and share count, if changed

$$\textbf{Retention Grant} = \left(\textbf{Current Salary} \times \textbf{50\% of Options Multiplier}\right) \div \left(\frac{\textbf{New (Latest) Valuation}}{\textbf{Diluted Share Count}}\right)$$

Discretionary Grants

- Bonuses Outstanding Performance
  - These discretionary grants should only be made once per year, and only offered to your top 10-20% of employees whose accomplishments and performance are truly distinguished
- Promotions
  - These discretionary grants should only be made to reward promotion. Bring the employee’s total equity up to the amount you would pay to hire them today.

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Social Impact Considerations

- Companies focused on social impact goals and/or in developing markets may have unique ESOP considerations
- Consider two possible scenarios:
  - **Financial Inclusion Goals**: Employee-friendly hiring practices and ESOPs can help build local financial inclusion. If this is part of your corporate mandate, consider the added social impact value of offering your options program to all levels of employees
  - **Local Ownership Culture**: Conversely, in certain regions stock options may have negligible value to employees, either because of risk aversion, lack of liquidity, or lack of understanding. If this is the case, it is not worth extensively offering options to employees who would rather be paid in cash

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Options Modeling – Overview

- Creating an ESOP has lasting implications on startup capital structure
- While the guidelines provided in this presentation offer a roadmap to implementing an options plan, it can also be helpful to build an options model to understand the long-term effects of this program
- Options models:
  - Forecast hiring needs over time
  - Estimate future valuation and fundraising needs
  - Provide an estimate of employee ownership

Note: There is an accompanying excel file that provides a template for building an options model similar to that described on the following slide

Options Modeling – A Detailed Example

Founding team shares are negotiated as a percentage of the company; all future employees receive grants determined in dollars

The "true" valuation (an internal estimate) increases marginally as the company builds value…

…but increases significantly when the company raises a new round, which also increases the share count and dilutes all equity owners

Employee Stock Options Plan (ESOP) Model

			Year 0		Year 1			Year 2			Year 3		
			Value	Shares	Value	Shares	Shr. Price	Value	Shares	Shr. Price	Value	Shares	Shr. Price
			NA	10,000	$3M	10,000	$300	$5M	10,000	$500	$15M	12,000	$1,250
	Salary	Options Multiplier	Total Options	Equity (%)	Grant Amount	Total Options	Equity (%)	Grant Amount	Total Options	Equity (%)	Grant Amount	Total Options	Equity (%)
Total Non-Founder Employee Ownership				6.50%			9.00%			11.64%			10.20%
Founding Team													
CTO	$120,000	1.00x	400	4.00%		400	4.00%	$60,000	520	5.20%		520	4.33%
Product Manager	$80,000	0.80x	250	2.50%		250	2.50%	$32,000	314	3.14%		314	2.62%
Year 1 Hires													
Lead Engineer	$80,000	0.50x			$40,000	133	1.33%		133	1.33%	$20,000	149	1.24%
Lead Designer	$70,000	0.50x			$35,000	117	1.17%		117	1.17%	$17,500	131	1.09%
Year 2 Hires													
Sales Director	$70,000	0.30x						$21,000	42	0.42%		42	0.35%
Salesperson	$40,000	0.10x						$4,000	8	0.08%		8	0.07%
Engineer	$60,000	0.25x						$15,000	30	0.30%		30	0.25%
Year 3 Hires													
Marketing Director	$60,000	0.30x									$18,000	14	0.12%
Engineer	$50,000	0.25x									$12,500	10	0.08%
Salesperson	$40,000	0.10x									$4,000	3	0.03%
Office Manager	$30,000	0.10x									$3,000	2	0.02%

For all new hires after the founding team, options grants are awarded based on the employee's options multiplier and baseline salary

Retention grants are awarded every two years after an initial options package

Part V

RESOURCES & FURTHER READING

Resources & Further Reading

- Fred Wilson / Union Square Ventures Series on Employee Equity
  - What are options?
  - Structures and allocations
  - How many options to issue?
  - Vesting, cliffs, and change of control
  - Trends in increasing issuance size
  - Dilution
  - Video: Class on Employee Equity

Resources & Further Reading

- Andy Rachleff / Wealthfront materials
  - The Wealthfront startup equity plan
  - The Wealthfront equity tool for benchmarking startup options packages
- Sam Altman and Paul Graham / Y-Combinator
  - Why employees don’t get enough options
  - The “Equity Equation”
- Startup Lawyer
  - Vesting