

# Equity Compensation

*Rules of thumb, guidelines, conventional wisdom & other considerations*

Frank Demmler

# Frank Demmler

- **Professional**

- Managing Director, Riverfront Ventures (2013-2018)
- Vice President, Entrepreneurial Services, Innovation Works (2005-2018)
- President & CEO, Future Fund Inc. (1999-2003)
- Co-founder & Investment Advisor, Western PA Adventure Capital Fund, (1996-1998)
- General Partner, Pittsburgh Seed Fund (1985-1998)
- Start up consultant, The Enterprise Corporation of Pittsburgh (1984-1998)
- Fortune 200 job, right-sized out of job (pre-1984)

- **Academic**

- Adjunct Professor of Entrepreneurship, CMU (1987 - present) (full-time 2003-2005)

- **Education**

- Princeton, UCLA & Harvard Business School

- **Awards & Recognition**

- Lifetime Achievement Award from the Pittsburgh Venture Capital Association
- Finalist, Ernst & Young Entrepreneur of the Year, Supporter of Entrepreneurship
- Gerald E. McGinnis Adjunct Professor of Entrepreneurship at CMU

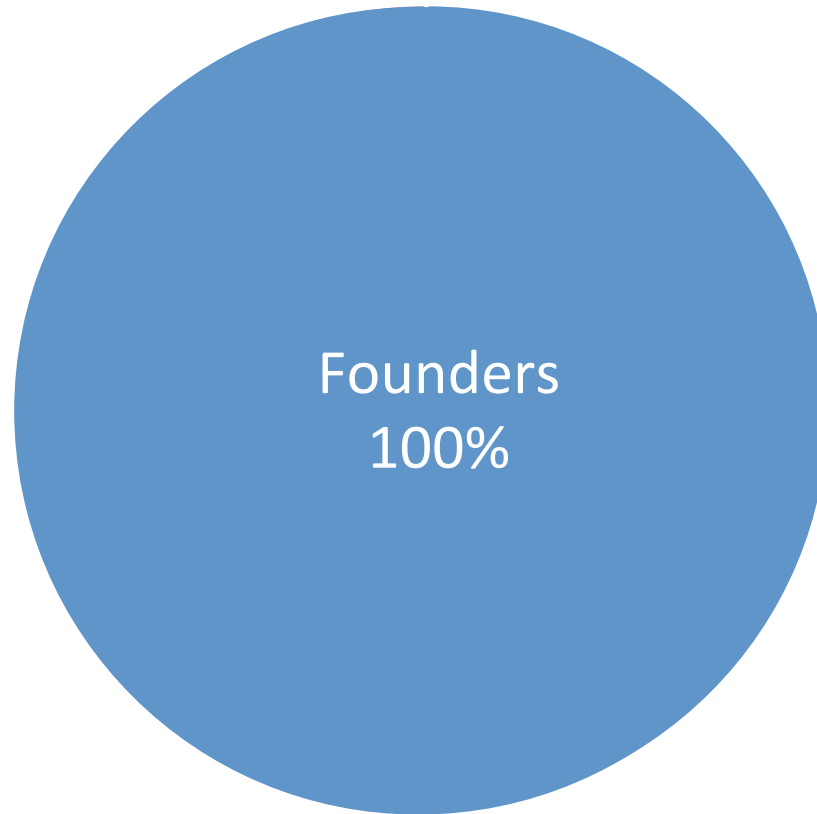
# Why do I care about equity compensation?

- If you are a founder, you have to decide how to share the “Founders’ Pie”
- If you are recruiting someone, you have to decide how many stock options to offer a prospective hire
- If you are a prospective hire, you have to evaluate the number of stock options you’ve been offered
- If you are an employee, stock options are usually tied to incentive compensation

# 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

<b>Founders</b>	<b>Percent</b>
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.



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**Just imagine 3 or more founders!**

# Slicing the Founders' Pie

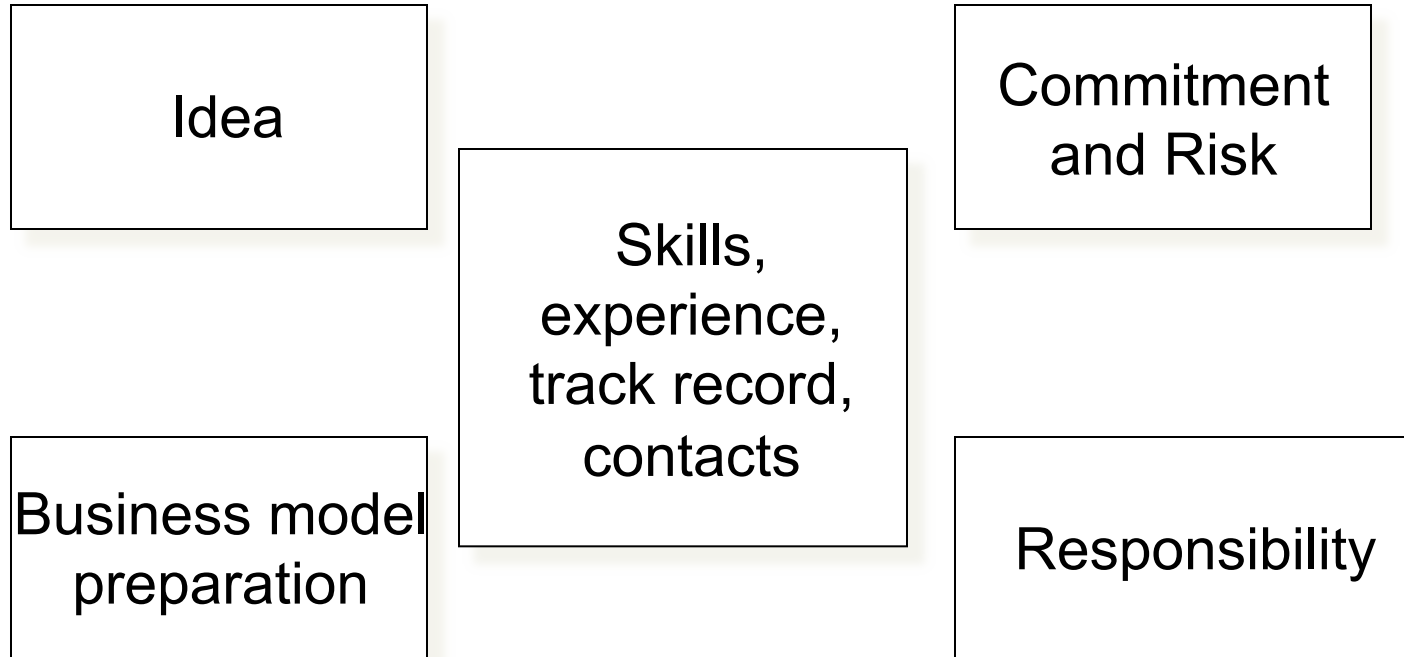
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# Slicing the Founders' Pie

- How much stock ownership should go to whom?
- Contributions to date
- Contributions in the future
- Incentive alignment so that the company prospers and grows thus creating a huge, shared pie

# Considerations of Value

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



# Suppose: 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 responsible for getting things done
- **Founder #3:** Post-doc – knows how to make the technology work, joins the company when funded
- **Founder #4:** Lab tech – happened to be in the right place at the right time

# Founder Relative Contribution

***Absolute Scores (1-10)***

<b>Idea</b>					
<b>Business Model</b>					
<b>Domain Expertise</b>					
<b>Commitment &amp; Risk</b>					
<b>Responsibilities</b>					

# Founder Relative Contribution Importance of Each Component

***Absolute Scores (1-10)***

	<i>Weight</i>				
<b>Idea</b>	7				
<b>Business Model</b>	2				
<b>Domain Expertise</b>	5				
<b>Commitment &amp; Risk</b>	7				
<b>Responsibilities</b>	6				

# Founder Relative Contribution

## Founder Contribution to Each

### *Absolute Scores (1-10)*

		Founder 1	Founder 2	Founder 3	Founder 4
<b>Idea</b>		10	3	3	0
<b>Business Model</b>		3	8	1	0
<b>Domain Expertise</b>		6	4	6	4
<b>Commitment &amp; Risk</b>		0	7	0	0
<b>Responsibilities</b>		0	6	0	0



# Founder Relative Contribution

## Compiled Assessments

### *Absolute Scores (1-10)*

	<i>Weight</i>	<i>Founder 1</i>	<i>Founder 2</i>	<i>Founder 3</i>	<i>Founder 4</i>
<b>Idea</b>	7	10	3	3	0
<b>Business Model</b>	2	3	8	1	0
<b>Domain Expertise</b>	5	6	4	6	4
<b>Commitment &amp; Risk</b>	7	0	7	0	0
<b>Responsibilities</b>	6	0	6	0	0

# Founder Relative Contribution

## Founder Score per Component

### *Weighted Scores (1-10)*

		Founder 1	Founder 2	Founder 3	Founder 4
<b>Idea</b>		70	21	21	0
<b>Business Model</b>		21	56	7	0
<b>Domain Expertise</b>		42	28	42	28
<b>Commitment &amp; Risk</b>		0	49	0	0
<b>Responsibilities</b>		0	42	0	0

# Founder Relative Contribution

## Founders' Weighted Contributions

*Weighted Scores (1-10)*

	Founder 1	Founder 2	Founder 3	Founder 4	
<b>Idea</b>	70	21	21	0	
<b>Business Model</b>	6	16	2	0	
<b>Domain Expertise</b>	30	20	30	20	
<b>Commitment &amp; Risk</b>	0	49	0	0	
<b>Responsibilities</b>	0	36	0	0	
<b>Total Points</b>	106	142	53	20	321
<b>% of Total</b>	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 a trade of equity for something else, i.e., accelerated vesting; consulting agreement; ...?
- Facilitate a new round of investment and let the new investors “fix” things
- Threaten to leave
- Leave

# 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.

# Stock Options

What's the big deal?

# What a Stock Option Isn't

A Stock Option is not Stock



# 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
- For a specific length of time (2 years, 5 years, 10 years?)

# What's the Big Deal about Stock Options?

- An example:
  - 50,000 stock options with a \$1 exercise price
  - Company is acquired in 5 years for \$10 per share
    - Buy 50,000 shares of stock at \$1 per share
      - = \$50,000 is paid out
    - Immediately sell 50,000 shares at \$10 per share
      - = \$500,000 is received
    - Gain: \$450,000
      - Caution: it's ordinary income

# How many options is enough?

- Depends on total number of company shares on a fully diluted basis
  - 100 options with total of 10,000 shares equals
  - 10,000 options on 1,000,000 shares equals
  - 100,000 options on 10,000,000 shares equals
  - 1% fully-diluted equity
- **They are all equal, but what number is most impressive?**

# How many options is enough?

From another perspective:  
You've been offered 5,000 options

Fully-diluted shares	% ownership
10,000	50.00%
100,000	5.00%
1,000,000	0.50%
10,000,000	0.05%

- You **MUST** know how many fully-diluted shares exist to evaluate an offer of options

# Vesting

Now you see it, now you don't!

# Vesting Schedule

- 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 shares cliff vest on the first anniversary
  - $1/36^{\text{th}}$  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

# Small Piece of a Large Pie

What does that mean?



# The Way It's Supposed to Work

	Start		Seed Round		Round 2		Round 3		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 Option Pool	-	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 Investor	0	0.00%	166,667	50.00%	611,111	68.75%	1,069,892	77.73%	1,413,978	82.19%
Total	100,000	100.00%	333,333	100.00%	888,889	100.00%	1,376,344	100.00%	1,720,430	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 Price per share			\$1,000,000 \$6.000		\$5,000,000 \$11.250		\$10,000,000 \$21.797		\$37,500,000 \$108.984	
Value of Founders' Shares			\$600,000		\$1,125,000		\$2,179,688		\$10,898,438	

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Price per share			\$6.000		\$11.250		\$21.797		\$108.984	
Value of Founders' Shares	???		\$600,000		\$1,125,000		\$2,179,688		\$10,898,438	

5.81% → \$10,898,436

# 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%

# Founders vs. Non-Founders\*

Title	Median Cash	Median Equity
CEO - Founder	\$200,000	9.0%
CEO – Non-Founder	\$225,000	5.0%
President / COO - Founder	\$175,000	5.0%
President / COO – Non-Founder	\$200,000	1.5%

\*Per Brad Feld, askthefvc blog

# 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%
			<hr/> 20.00%

# Other Rules of Thumb

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

# Considerations

- Founders vs. Non-Founders
  - When do you bring someone on board?
  - % equity may vary by a factor of 3
- Fairness: role of comparables
  - Within the company
  - Compared to other companies
- Stock options can come in many different “flavors”
  - Non-qualified options
  - Incentive stock options
- Each “flavor” may have very different tax consequences
- Stock options vs. restricted stock
- Pre-financing vs. post-financing – can be an enormous consideration

# 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 **could be considered** 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 25% of preferred (at least at the last time I asked about this)



# 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
- **Don't do anything without strong professional assistance**