

Employees' Stock Reward: How Much Equity Do They Deserve?

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STARTING UP: *Practical Advice for Entrepreneurs*

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How much stock should we set aside to give to employees and how do we decide on how much to give to any one employee?"

That's the question, isn't it? People often look for an equation that would solve the problem. Of course, there really isn't any, but there are some metrics you can apply to guide you. To apply these metrics intelligently you should ask a fundamental question: Why are you giving stock to employees? For motivation? Can't afford market salaries? As a risk premium for with a venture that has no track record?

Most likely it is a combination of these, but it is worth thinking this through because you will find it helpful to everyone if you can articulate a "vision" or "philosophy" about your stock. Without such a vision you will be like a ship without a compass; you will have a vague idea of where you are going but you will be unlikely to get there in any reasonable fashion.

How much stock should a particular employee get? This is a matter of negotiation based on how valuable the employee is or may be, how much he or she could receive elsewhere, etc. Be sure to think of the longer term impact of early stock grants. For example, project your staffing growth over the next two or three years. What job will this employee realistically have in two years? Does this initial engineer/programmer have the potential to be head of R&D or software development? If not what amount of stock will I have to issue to the person I hire as my Director of Software Development? It is not unusual for an initial programmer to end up with more stock than the Director of Software Development, after all the initial programmer took more risk. The important point is that you manage perceptions. Like cash compensation, relative stock ownership is a way some people keep score.

So what are some metrics? While I haven't done any systematic research on this, I have noticed that in a typical first-round venture capital deal, between 12 percent and 18 percent of the stock after the investment is set aside for additional stock or option grants. The figure is on the higher end if it is perceived that a critical hire, such as an experienced CEO or marketing person, is necessary. This stock pool is expected to meet the company's need for two or more years.

What about stock allocations before a venture round? After the venture money comes in, usually there is not a problem with paying market or near-market salaries. As a result, the stock allocation after the venture round is used primarily for motivational purposes. Before

the venture round, the stock allocation is most likely fulfilling multiple functions: compensating for salaries, adjusting for risk and motivation.

Here are a few metrics you can apply at the pre-money stage. Take your business plan and look at your projected organizational chart at the end of one year, two years, etc. Now look at your existing team and any currently contemplated new hires. Where will the team members fit in several years out? For instance, does the marketing person have the ability to grow in his or her capacity or will you most likely have to hire someone with more experience and put that person in charge? How much of the limited stock pool might you have to give to the more experienced marketing person?

Now, let's look at the risk and below-market compensation side of the question. Using your business plan, put together a chart. Make the columns the ultimate "value" of the venture at the initial public offering or upon being acquired. Start with a conservative value on the left (say \$5 million) and proceed to a reasonable "home run" scenario (\$100 million). Make the rows the "percentage dilution" which could occur as you raise money at different valuations.

For example, if you raise two rounds totaling \$2 million, assume that you will have to give up anywhere from 30 percent to 70 percent of the company to the investors. By filling in the cells in the table for a given person, you can show what will be the range of ultimate values for that person's initial equity allocation. For example, at a 50 percent dilution, an initial 2 percent interest will become 1 percent, which will be worth \$250,000 if it's sold for \$25 million.

This can provide a focal point for discussions with that person. For example, if her market salary would be \$70,000 and you can only afford to pay her \$35,000, then you can use the table to show that a 2 percent equity interest at a moderate success level will realize \$250,000 -- which is \$75,000 more than the \$35,000 "give-up" in salary over five years.

Be very careful in promising a certain "percentage" of the company. I have seen situations in which a Founder has written a letter which contains language which could be construed as granting an employee a fixed percentage of the company. This is fine if you intend that result. However, most typically what is meant is a percentage of the current issued and outstanding stock and that any further stock issuances will dilute this percentage, just as they dilute the Founder's percentage. So talk in terms of "5,000 shares, which represents 2% of the current issued and outstanding stock."

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