

Using Equity as Compensation

Equity. n. Shares in a business enterprise which the foolish giver undervalues, the crafty giver overvalues and the recipient doesn't understand.

Many companies use equity as a way to recruit senior-level talent into cash-strapped but growing companies. Many times this arrangement leads to surprises for both giver and recipient. Here's the typical play in three acts.

Act I - Scene I: Company founders present a glowing picture of the future and the future value of the stock. Senior executives wax eloquent about the market, future sales, growth and make a suitable offer.

Act I - Scene II: New employee wants to believe the vision. New hire speaks about what strength, skills, and devotion they bring to the new company. In light of this the employee wants more stock than is originally offered. A compromise is reached.

Act II: Six months later employee is weary from 100,000 air miles and 80 hour weeks. Forthcoming raise is canceled due to slower-than-expected sales ramp-up. Reality engulfs all concerned. Grumbling noises heard off stage.

Final Act: Value of the stock starts to recede from view. Employee almost ready to quit. Large customer knocks at the door. Words from a distance: "OEM deal", "possible acquisition" are heard. A spark of hope.

The curtain falls leaving the audience -- you -- wondering whether stock was the right thing for the company to use or for the employee to take in lieu of cash compensation.

In this *Entrepreneurial Focus*, I'd like to share with you some of my personal observations as being on both sides of the table (giver and receiver). Stock does have its place in employee compensation and motivation but must be used very carefully because of the legal implications.

The thoughts presented here deal with stock in a "full" corporation (a "C" Corp." as it is called). Proprietorships and "S" corporations are outside the scope of the discussion about equity.

A. Why People Want Stock in a Company

Many people believe stock is inherently valuable because of what they read in the financial pages of the newspaper. Stock is only paper. It only has cash value when there is a buyer who will pay cash on terms that are acceptable to the seller.

Therefore, if you own or want to own stock in a small privately held company, you must understand a). who will want to buy stock in the company b). how *you* will dispose of your shares and c). at what price .

Even if you can find a buyer, your stock is still worthless if you cannot sell because of legal restrictions regarding the buyer or restrictions placed on your stock by the company. If

you cannot find a buyer inside or outside the company, your stock is worthless.

If you want to increase your net worth -- the only reason for having stock -- make sure your stock is in a company which creates value for shareholders. In these companies, shares may be sold on the public market or to potential acquiring companies.

In either case, there is a buyer to whom you can sell and there is some incentive to pay you a "fair" price for the shares you own. Along the way, outside investors are involved which means there is a market of sorts for the stock and a value can be established.

"Lifestyle companies" may also disburse stock to key employees. But these companies tend to create a lifestyle desirable to the company founders or employees. Stock in these companies may serve a more symbolic purpose since these companies have limited appeal as candidates for acquisition or for a public stock offering.

Members of successful lifestyle companies can take home comfortable (and occasionally outrageous) salaries but the value of the company in general and stock owned by an employee, in particular, may be heavily discounted.

Although there are several examples of public companies that resemble lifestyle companies (e.g., single major shareholder, little outside capital, run like a one-person show, etc.), don't bank on your stock being worth something.

If you want to build your net worth through increased value of your stockholdings, join a company that must answer to outside, professional investors. If you are joining or starting a company that is likely to remain a lifestyle company, stock has a symbolic value.

B. Why Offer Stock to Employees

I have never seen a company (i.e. the founders of a company) give stock to employees so they will become rich. The typical reason for giving stock to employees is the message: "You're an important member of the team".

In one company, all employees received stock to make them feel part of the team. When the company went public, a number of employees found their net worth had increased by several hundred thousand dollars.

One person was the company's first receptionist. This person (a capable, talented person who would do more than answer phones) viewed the capital gains as "found money". Key members of the development team that came in late made the same amount of money but felt their contributions affected the company's success far more than the receptionist. (They were probably right to some extent).

While I think it is desirable for all employees to be treated fairly, this does not mean they must be treated the same. You can offer stock to senior people as a reward or motivator. But for managers, supervisors and other persons in the company, try using "phantom stock" or "stock appreciation rights" which behave like stock but can be less cumbersome to deal with.

Try and use stock sparingly because it is complicated and is an investment of your company time and money. Make sure

the investment pays off and is not spread around willy-nilly. Since stock carries with it a certain amount of legal baggage, don't use it if another form of reward will work as well.

You can also use one-time bonuses, profit-sharing, beer-blasts and other motivators. If you use non-stock as financial or psychic rewards, avoid the appearance of greed or need to maintain control.

Save equity for people that understand the value of the equity and are long term contributors to the company's success. Use other forms of non-equity compensation for people outside this group.

C. Outside Investors As An Indicator

Some companies have outside investors. The investors may be related to the founders/principals or they may be individuals or institutions that are unrelated. If a company has unrelated outside investors, there is a good chance the company will be managed for the benefit of the shareholders -- not just the founders.

Although everyone wants the company to succeed, "financial" investors want the company to succeed quickly so they can exit (cash out) quickly. Informal investors ("angels") may also want to exit but they are sometimes more patient.

If your company has outside investors, this is a strong selling point and enhances the perceived value of the equity or equity-like incentives.

If your company has no outside investors and has seen increasing sales, maybe you want to consider outside investors so you can make your company more attractive to senior level people. If you do not want outside investors for whatever reason, think about non-equity incentives. These can be attractive to many executives.

D. How Much to Give/How Much to Get?

Before you give or get stock in a company, think about company valuation because it drives the economic value of the shares.

The amount of equity granted to an employee is subject to negotiation. There are no firm guidelines. However, I think a reasonable starting point is the value of the equity given/received for the stage of the company's development.

Early stage companies are most risky so the stock amounts should be more generous. Later stage companies have less risk so the amount of equity compensation should be limited.

If someone gets X thousand shares which are 10% of the total shares outstanding, the person will "own" (in some sense) 10% of the value of the company. Obviously, the shares have value if the company has value to someone other than current shareholders.

The value of shareholdings is the share price times the number of shares. However, the stock price and valuation are related (valuation = total shares X price per share). If a company is valued at \$5M with 2M shares out, each share is worth \$2.50. Owning 25,000 shares means the shares are worth \$62,500. Viewed another way, these 25,000 shares are

1.25% of 5M shares which means the shares are worth 1.25% of the \$5M valuation or \$62,500.

The trick is to estimate the *future* value of the shares. This means you must estimate the percent of total you will hold after attracting other investors *and* the valuation of the company when the shares become liquid (by IPO or sale of the company).

Recently VentureOne, a financial consulting firm in San Francisco studied the valuations of more than 1000 deals. The table below shows the average total valuations and my calculation of the equity amount held by the original founder's.

Stage of Growth	Total Valuation	Founder's	
		Percent after funding	Valuation
Start-up	\$3.7M	49%	\$1.8M
In development	14.7	35%	5.2
Beta versions	23.9	28%	6.6
Shipping	20.8	22%	4.6
Profitable	42.7	19%	8.3

Suppose you held 5% of the founders shares as a member of the original team of a company that followed the averages above. Through all the financing rounds (5 in this case -- most companies go through 3 or 4) you would still hold 5% of the founders slice of the pie. Although the founders' slice of the pie gets smaller, the size of the pie -- and the value of the stock -- increases.

At the start up stage your 5% would be worth 5% of the founder's value of \$1.8M or \$90,000. At the last round where the company has a \$42.7M valuation, you would own 5% of the \$8.3M that is owned by the founders or \$415,000. On top of this may be stock options, additional shares of stock so the value of a person's holding may be higher.

In general stock is used to encourage people to stay with the company. Thus stock is earned over a period of time (the vesting period) usually 3-5 years. Options may be vested or granted outright.

In summary, equity in a company that has acquisition or IPO potential can increase a person's net worth. Using stock (and excitement), a small company can attract top-notch talent.

Make sure everyone understands that equity is not "money in the bank". And make sure the shareholders understand that future value is created by the cumulative effect of current efforts.

Jim Geisman is President of Marketshare, Inc. a Wayland, Mass.-based business development consulting firm that helps software companies increase sales in the US or in Japan. Jim can be reached at 508-647-0330 (telephone) or 508-647-4876 (fax) or by e-mail at jimg@softwarepricing.com.