Session 1: Equity distribution and how to plan your captable

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Value and stock

Equity distribution and how to plan your captable

Start-ups

Value is in the future, illiquid and tied to ownership (equity)

- Temptation to use equity as monopoly money.
- Equity implies control and is expensive in the long term.
- Need to restrict its use to acquire critical resources or skills.
- What are the critical resources or skills in your startup?

Everybody wants equity!

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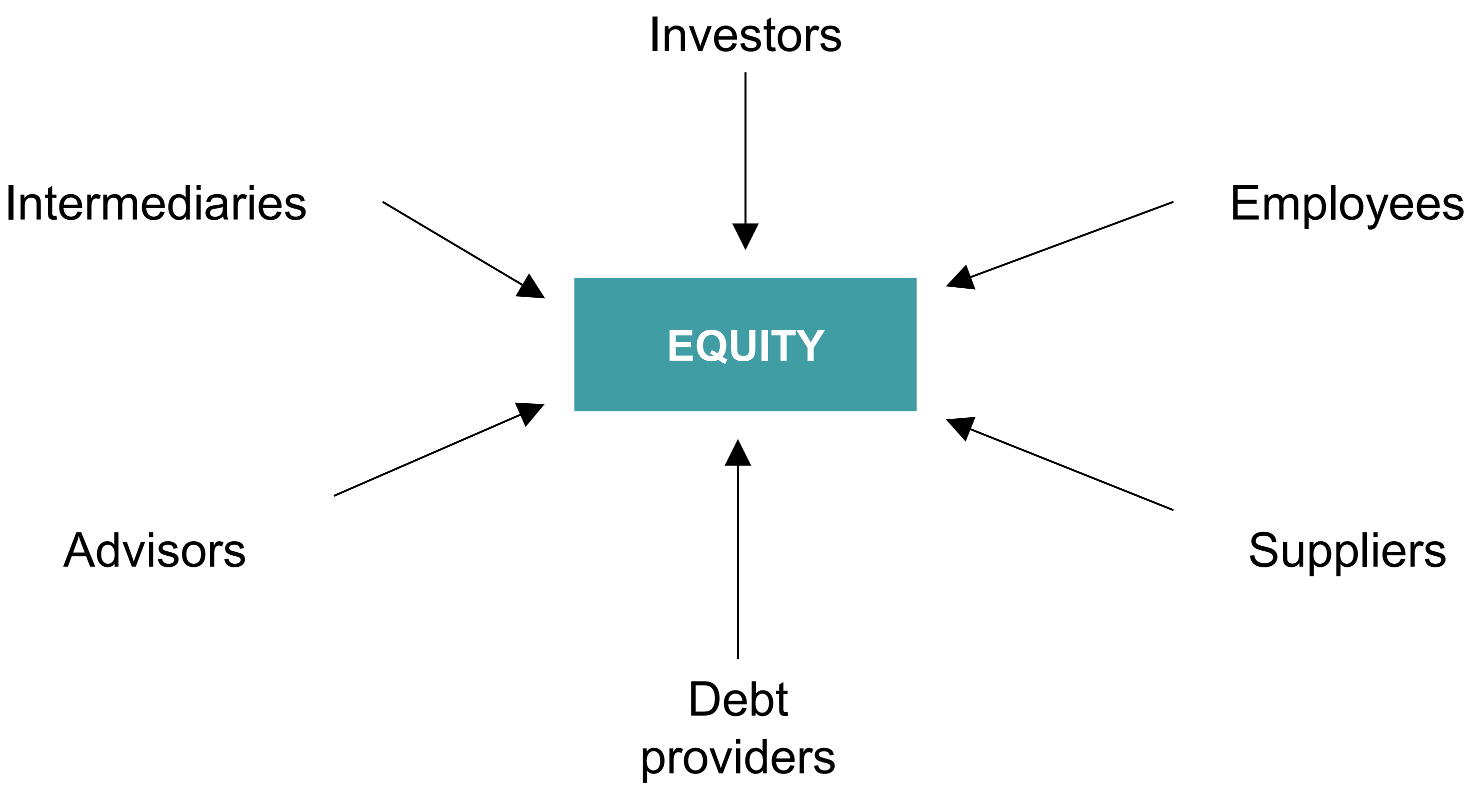

There is overdemand so we must establish some rules

Prioritizing resources and skills

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Which critical resources/skills do we need?

1. List the resources/skills
   - What do I need to achieve my final goal?
   - Money, yes, but what else?

2. Rank the resources/skills depending on how critical they are
   - How important is that for the startup success?
   - Are there alternatives? Can we do without?
   - How scarce is that resource/ skill?

3. Determine whether that resource/skill is eligible for equity distribution
   - Is that a resource/skill I will need during a long time?
   - What is the standard practice on the market?
   - What is the market price of that resource/skill?

10-15' work to develop your list of critical resources/skills

Tools for equity distribution

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SHARES	Normal equity Dual share classes
OPTIONS ON SHARES	Stock options Anti-dilution and other clauses in SHA
SINTHETIC EQUITY	Phantom shares Other bonuses linked to equity valuation

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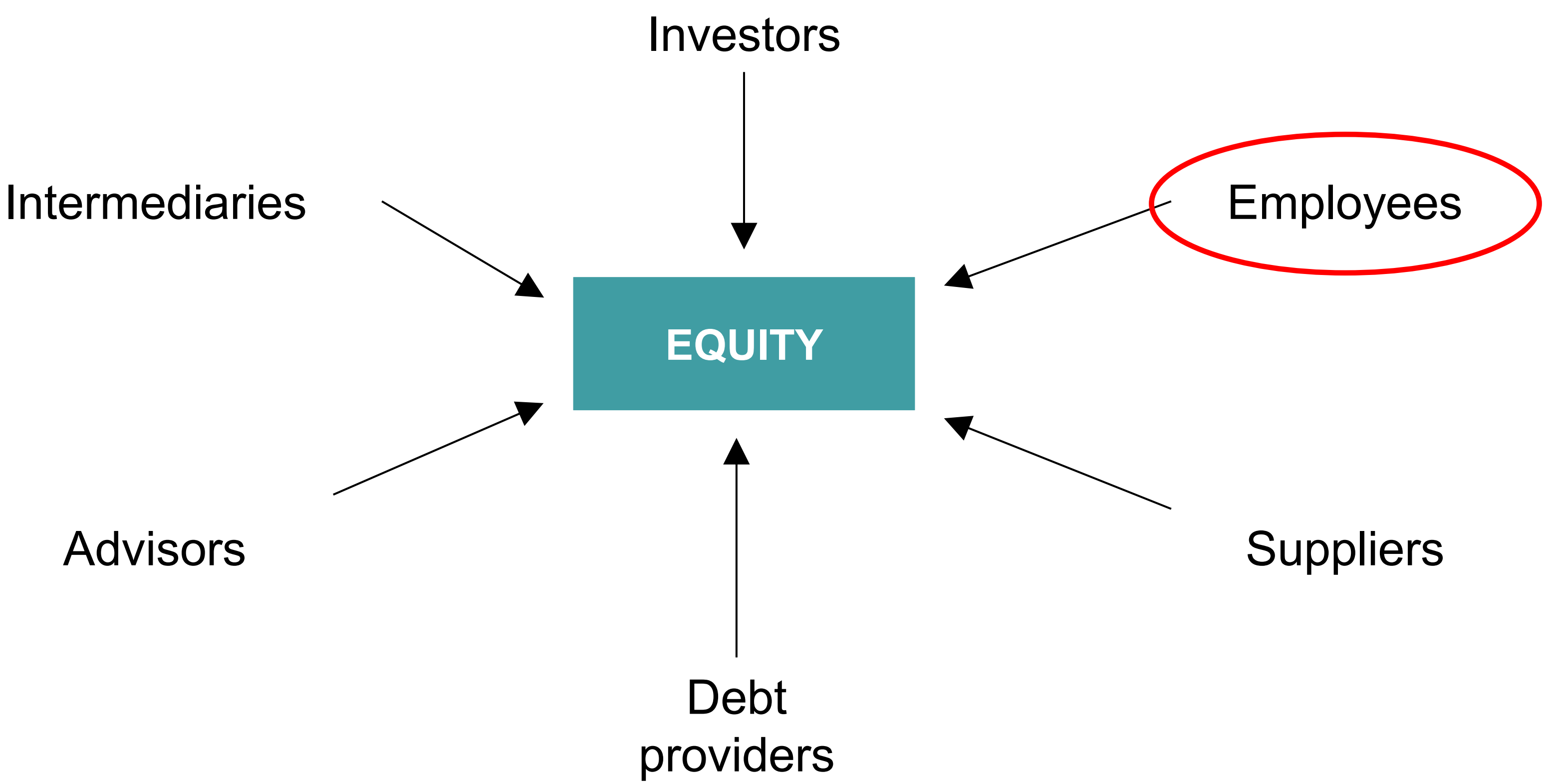

There is overdemand so we must establish some rules

- What are the objectives of stock-based compensation?

1. Align objectives and incentives between employees and company
2. Minimize cash outflows in launch and growth phase
3. Encourage employees to stay with the company

Definitions

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- Some definitions

- **Stock options**, a derivative contract that allows someone to buy shares in the future at a certain price (strike) and upon fulfilment of certain conditions

- **Phantom shares**, economic rights that mimic the economic behavior of actual shares, under several limitations and upon fulfilment of certain conditions

- **Vesting**, is when granted stock options or phantom shares are earned. That is conditional on certain events. Usually the passage of time, in some cases can be the achievement of milestones

- **Cliff**, initial period after granting during which rights are not vested. Typically, one year

- **Strike price**, the price at which stock options can be redeemed (converted into shares).

Stock options

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Employee X is eligible for 1500 stock options for $10 each
Vesting period is 3 years with 1 year cliff

Month 0: company includes employee X in the program

Month 12: 1 year cliff. 500 options are vested on 1st anniversary

Months 13-36: every month 41.7 stock options are vested

Month 36: all stock options vested

Months 12-120: employee X can exercise the stock options as they are vested. To exercise, the employee must pay $15.000 and will receive the shares than can sell afterwards

Month 120: limit to exercise option

If the company shares are worth $20 in year 8, how much will the employee make?

- Exercise stock options 10*1500 = (15.000)
- Sell shares 20*1500 = 30.000, net 15.000

Issues with Stock options

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- Stock options are a mechanism that works well for companies with a reasonable IPO expectation. This is not the case for most startups

	Publicly traded	Private
Liquidity	Options are liquid, they can be exercised, converted into shares and sold	Options can be exercised and converted but selling may prove difficult
Pricing	Stock quote provides instant pricing	No instant pricing. Reference of previous round or comparables Illiquidity discount
Investment	Any broker will allow the employee to exercise the shares and get the difference without advancing the strike price	Employee needs to pay the strike price upfront and sell shares later

- From a company point of view, stock options may lead to a complex cap table
  - Deterrence for new investors
  - Shareholder agreements
  - …

Phantom shares

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- They behave like shares (economic rights) but cannot be converted into shares (no political rights)
  - Phantom shares are not an option, employees possess them or don't
- The company grants phantom shares to employees
  - Granting is similar to stock options (vesting period, cliff,...)
  - Can be 'appreciation only' or 'full value'
- Phantom shares can be cashed in certain conditions
  - Liquidity event: sale of the company, capital increases,
  - Valuation: subject to a minimum threshold sometimes.
- Compared to stock options...

Liquid	**Fair valuation**	**No upfront**	**Cap table**
They are activated at liquidity event	Liquidity event provides a market valuation	Do not require employees to advance cash	Do not change the existing cap table

Principles for stock-based compensation

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- Do not mix with compensation. It is not a variable or a bonus, it's an upside in case something outstanding happens.
- Restricted to people with a direct influence on performance.
- Avoid treating it as Monopoly money. It has to be paid eventually.
- Beware of political rights, make sure there is a good shareholders agreement to avoid temptations to block.
- Take into account tax environment (capital gains whenever possible instead of general income tax).
- Define rules and plan. Be fair.

10-15' work to fit list of critical resources/skills with stock-based compensation tools (or not)

Everybody wants equity!

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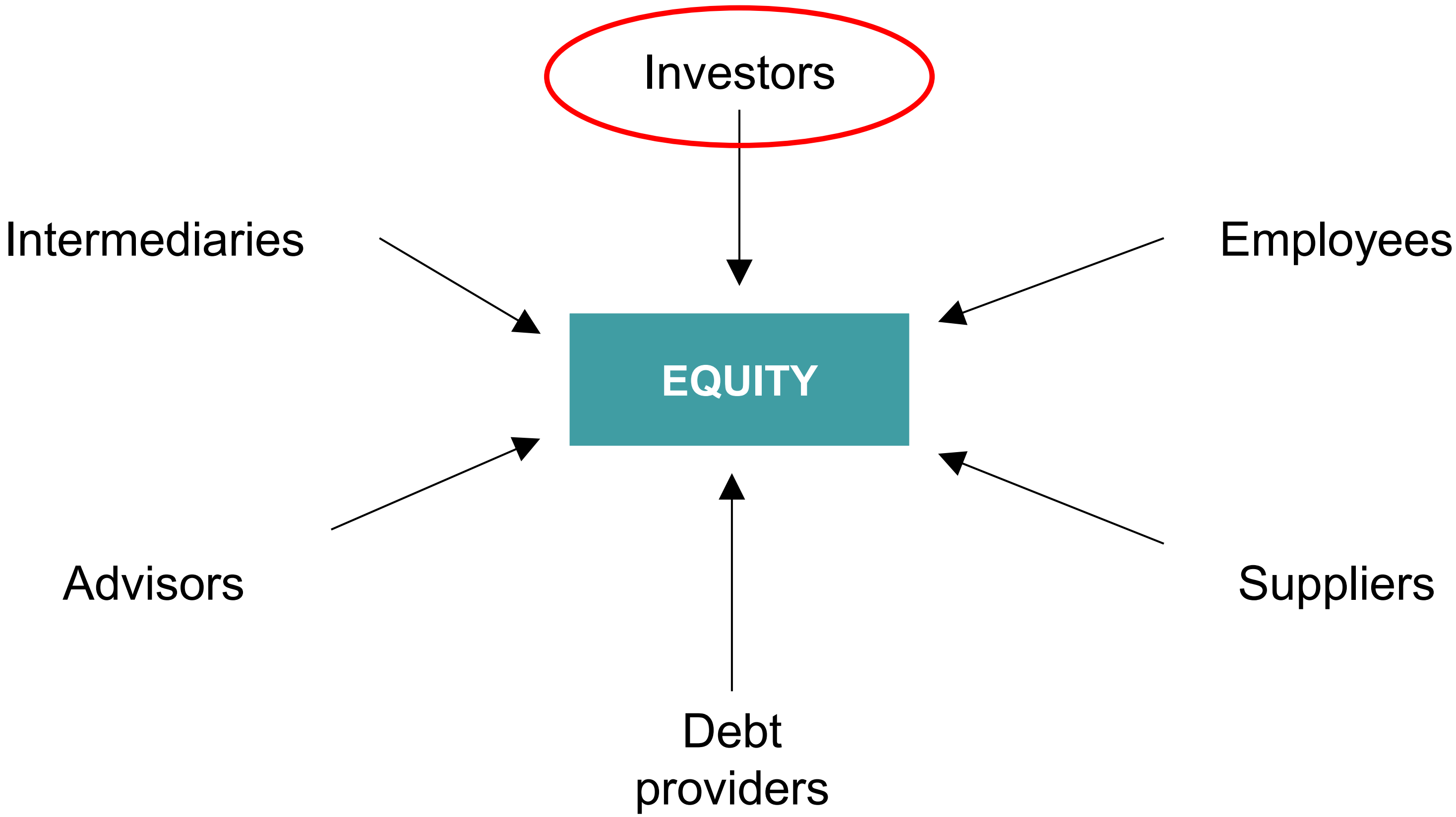

There is overdemand so we must establish some rules

Minimize capital raised

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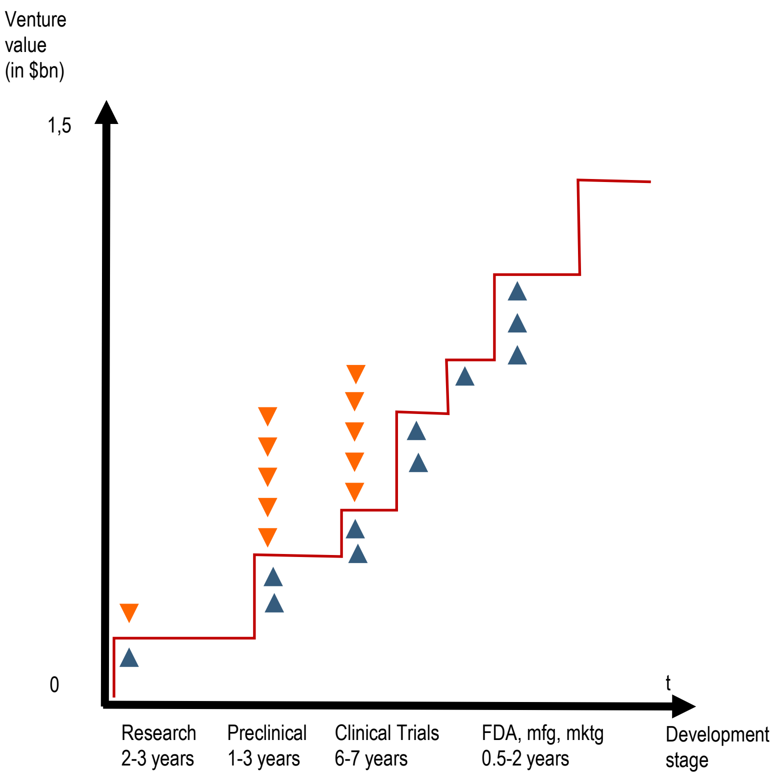
Example: venture needs $10 million to complete development

Hare approach

Raises **$0.2m** in seed round
Raises a further **$4.0m** in preclinical
Finally gets **$5.0m** in phase I-II
Complements this with **$0.8m** in public funds
TOTAL $10m

Tortoise approach

Raises **$0.2m** in seed round
Obtains **$0.4m** in grants for research
Raises **$1.0m** in preclinical
Complements round with a further **$1.0m** in soft loans and **$0.6m** grants
Raises **$2.0m** in phase I, partners with research institution to cut testing costs by **$1.0m** and obtains **$2.0m** in government support
Raises **$2.6m** in FDA phase.
TOTAL $10m



Minimize capital raised

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Hare approach

($mo.)	Pre-money	Funds raised	Post-money	Ownership
Seed round	**1,8**	**0,2**	**2,0**	
Founders	1,8		1,8	90%
Seed investors		0,2	0,2	10%
A series	**3,0**	**4,0**	**7,0**	
Founders	2,7		2,7	39%
Seed investors	0,3		0,3	4%
A series investors		4,0	4,0	57%
B series	**10,0**	**5,0**	**15,0**	
Founders	3,9		3,9	26%
Seed investors	0,4		0,4	3%
A series investors	5,7		5,7	38%
B series investors		5,0	5,0	33%

Tortoise approach

($mo.)	Pre-money	Funds raised	Post-money	Ownership
Seed round	**1,8**	**0,2**	**2,0**	
Founders	1,8		1,8	90%
Seed investors		0,2	0,2	10%
A series	**3,4**	**1,0**	**4,4**	
Founders	3,1		3,1	70%
Seed investors	0,3		0,3	8%
A series investors		1,0	1,0	23%
B series	**11,0**	**2,0**	**13,0**	
Founders	7,7		7,7	59%
Seed investors	0,9		0,9	7%
A series investors	2,5		2,5	19%
B series investors		2,0	2,0	15%
C series	**27,6**	**2,4**	**30,0**	
Founders	16,2		16,2	54%
Seed investors	1,8		1,8	6%
A series investors	5,3		5,3	18%
B series investors	4,2		4,2	14%
C series investors		2,4	2,4	8%

Equity funding is expensive if you consider opportunity cost
Raise as little and as late as possible and complement equity $ with other "soft sources" (1-1 at least)
Use alliances, cost cutting, WC deals to bring cost as low as possible. Keep structure at minimum.
Avoid post financing round spending hangovers

Some guidance

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EQUITY

Investors
Maximize valuation, minimize dilution

Intermediaries
Very restricted. Refer to suppliers

Employees
Only C-level, never more than 5% of cap table. Clear rules

Advisors
Never

Debt providers
Venture debt when capital increase route is blocked

Suppliers
Try to keep to normal payments or royalties if needed. Keep an eye on prices and conversion

What would be your rules?

Q&A

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