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Balderton Essentials

Guide to Employee Equity

Updated January 2019

What Do We Address Here?

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Why Give Equity to Employees?

Why is Employee Equity Important?

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Equity is important for…

- **Compensation**, especially in early days when cash is scarce
- **Recruiting rockstars** (and everyone else!)
- **Retention** and continued enthusiasm from the team
- **Incentivising** future successes
- **Rewarding** past performance
- **Culture** and engendering a sense of collectiveness

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What is Employee Equity?

Common Types of Equity for Employees

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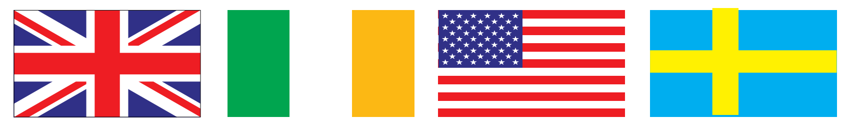
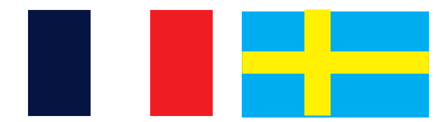
Options (ESOs)

- Most commonly used in: 
- Offer the holder the right (but not the obligation) to buy company shares at a predetermined price over a specific timeframe. They benefit from a tax efficient structure.
- In Sweden, QESO (Qualified Employee Stock Options) are restricted to companies under 50 employees. For bigger companies preferred scheme is warrants.

Virtual shares (VSPs)

- Most commonly used in: 
- Also known as 'Phantom Shares' or 'Shadow Stock'. Provide a contractual right to the employee that mimics an ESO without the real option
- Like ESOs, granted at a predetermined price, and upon exit (when the shareholder sells the real shares), the employee is treated as if he or she had sold the real shares
- Unlike ESOs, do not provide employees with voting rights or the other rights of traditional shareholders upon exercise

Warrants

- Used in: 
- Like ESOs, offer the holder the right to buy company shares at a predetermined price over a specific timeframe in the future. In specific jurisdictions, warrants have more favourable tax treatment than ESOs
- 'BSPCE' warrants are considered most tax-efficient type in France
- In some jurisdictions, such as Sweden, warrants and other types of equity are much more complex (e.g. employees may have to pay a 'premium' upfront) and tax advantages seen in other jurisdictions may not apply.

Key Events in the Life of an Option

Vesting Period

Time over which options become exercisable by employee

Exercise

Employee exercises option to purchase shares at the strike price. May occur any time after vesting. If an employee leaves the company before an exit, he or she is often required to exercise any vested options within a specified window (i.e. 90 days).

Sale

Grant

Employee receives promise of future option

Cliff

Employee earns right to exercise first portion of granted options

Fully Vested

Employee has earned right to exercise all options

This may be very short, as when an employee works for the company at the time of an exit and exercises and sells on the same day. Alternatively, this may also be long due to tax reasons, as when an employee exercises at a low strike price and intends to hold the options so that the gain from sale is taxed as long-term capital gains.

Other Key Terms in Equity

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- **Employee Stock Option Plan:** A programme that sets out the terms of employee equity
- **Employee option pool:** The percentage of a company's total shares outstanding set aside to be offered to employees as a tool for recruitment and / or retention
- **Strike price:** Also known as an exercise price. The price (determined at the time of grant) at which an employee can purchase the shares of the grant
- **Exercise window:** The timeframe over which an employee may purchase options. This window typically begins on the date of departure from a company and ends after a pre-determined number of days
- **Refresh:** A grant given to an employee after his or her initial hire
- **Types:** For additional equity types / structures, especially for other countries or jurisdictions, see Section VIII

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How Much Equity is Needed for the ESOP Pool and How Does it Evolve?

How Big Should an ESOP Pool Be?

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How much am I setting aside for my employees in aggregate?
This is an important decision made in conjunction with your investors and with your board.

We recommend growing your ESOP pool size to approximately match the below:

	Seed – Series A	Series B	Series C	Thereafter
Size of employee pool as % of total equity (allocated + unallocated)	7.5 – 10%	9 –12%	12 – 15%	15%+

» Note: Founder shares are separate from the ESOP pool and should not be included here

» The size of the pool should be reviewed annually in conjunction with hiring plans—financing rounds also offer good opportunities for this

» Typically, after any financing round through Series B, a company should aim to have an unallocated pool of ~7.5%. After Series C, the unallocated pool should represent roughly 5%

It is crucial to remember that while employee equity pools can be expanded over the company's financing journey, the pool should not expand infinitely. For example, once a company becomes public, other incentive programmes (like LTIPs) may be more appropriate.

How does the pool evolve?

Illustrative Example* of ESOP Evolution

	Pre-ESOP	Seed	Series A	Series B	Series C	Series D	IPO
Company Valuation		$3M	$25M	$75M	$200M	$450M	$750M
Total Shares in Company	10M	12.5M	15M	20M	25M	30M	40M
ESOP – Total	1.9%	7.5%	10.0%	11.0%	13.5%	15.0%	18.0%
Allocated	1.9%	3.1%	5.9%	7.1%	9.0%	11.7%	15.0%
Unallocated		4.4%	4.1%	3.9%	4.5%	2.9%	3.0%

**Note: companies should be evaluated on a case-by-case basis. Example is illustrative.*

How does the pool evolve?

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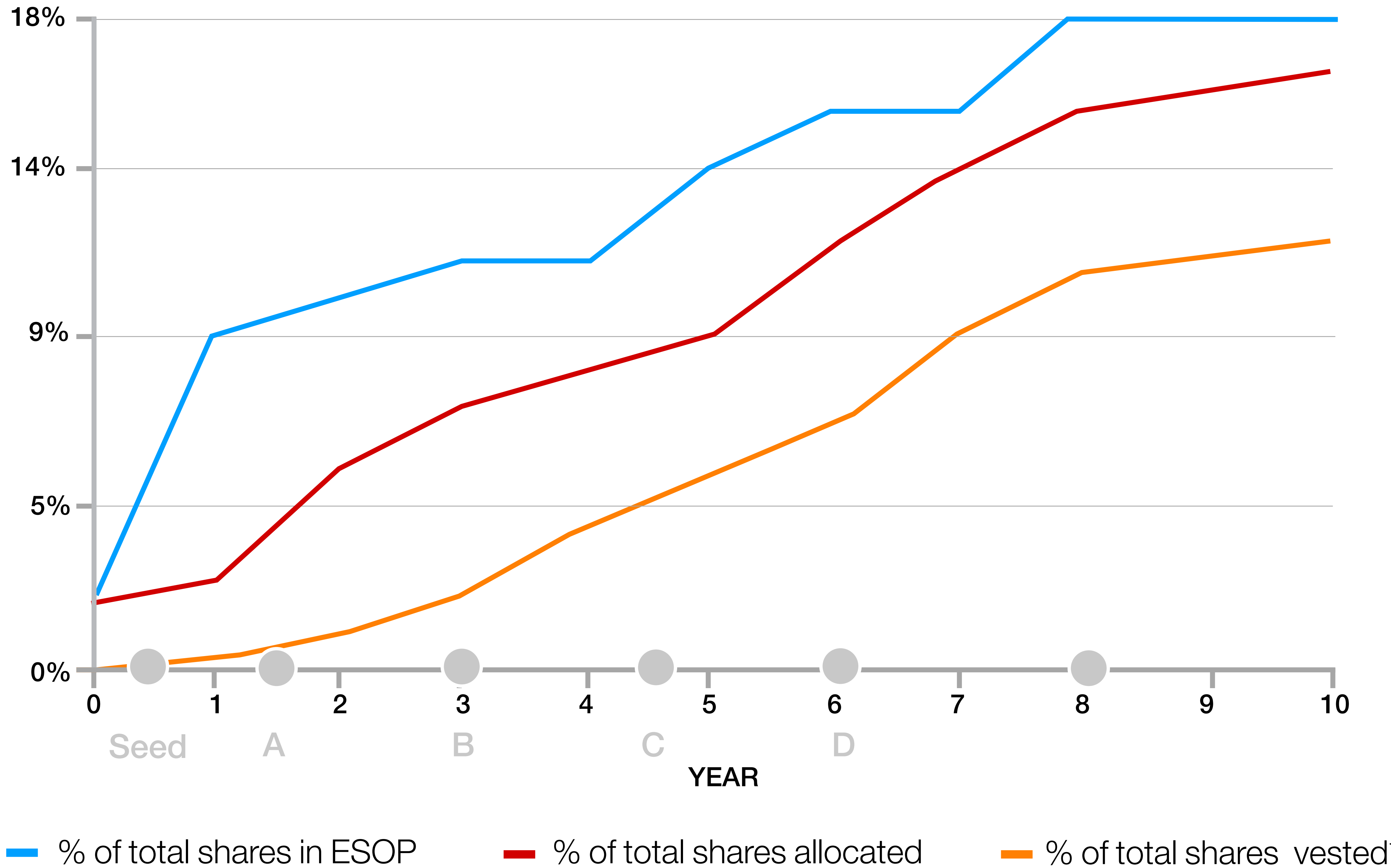
Illustrative Example ESOP Pool Growth & Vesting



Cumulative. *Assumes all allocated shares vest

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How Much Equity Should I Give an Employee?

How Do Grants Change Over Time?

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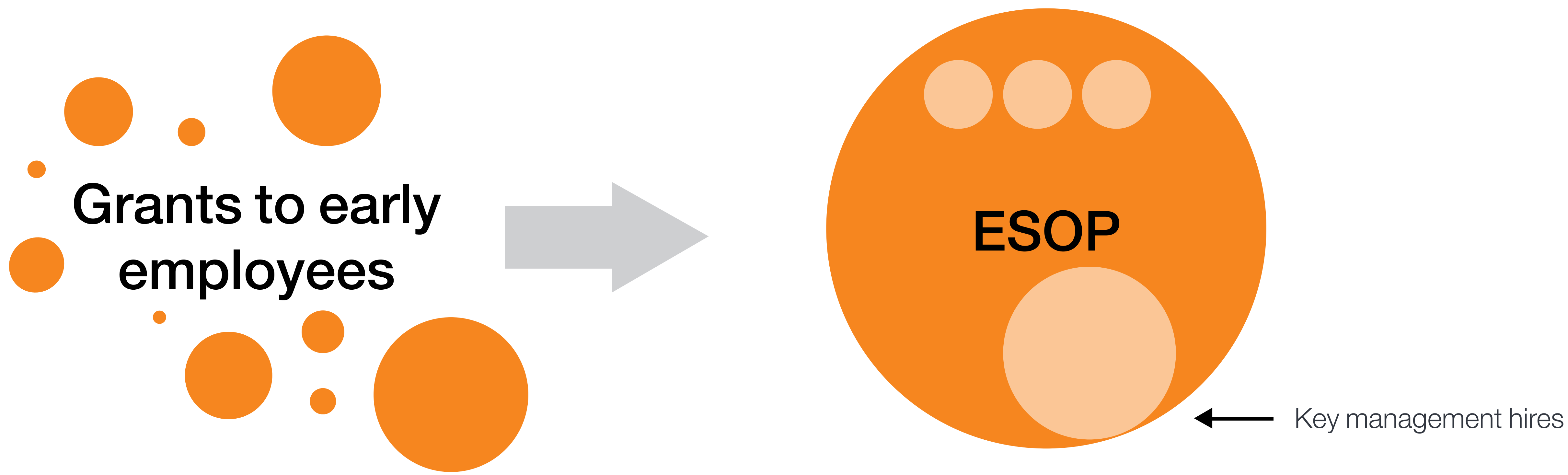
It’s okay for grants to start off as more art than science, but it will always require a balance between the two



Early on, equity helps to attract and incentivize team members who are vital to the initial success of the company (engineering, product development, etc.)

These grants vary in size, according to the candidate and resources.

By Series B, most grants should be systematic and fairly transparent, within an employee stock option plan.

Recruiting the C-level management team will still likely require tailored grants.

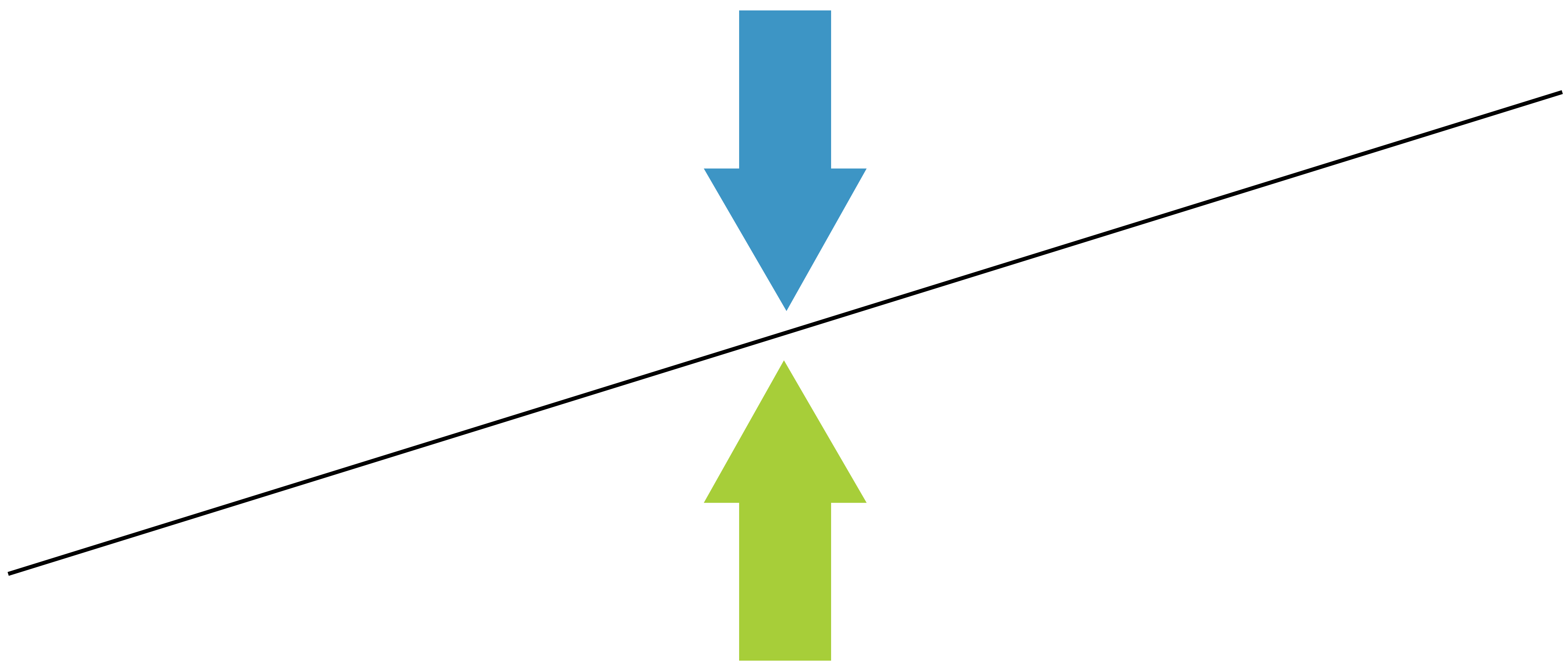
Should All Employees Get Equity?

- Giving equity to all employees can be a powerful cultural tool. While this has many advantages, it's important to be thoughtful in granting options
- Giving options to all employees helps ensure everyone feels a part of the vision and a sense of ownership within the company—which can be an incredibly powerful motivator
- Even junior employees? Yes, grants can be relatively small for junior employees
- Equity is not a limitless resource. However you allocate it, ensure you have enough to compensate rockstars and leaders
- Founders may find that employees, especially in Europe, may not value equity as highly as a cash equivalent. In such cases, small equity grants or cash awards can be suitable

Planning the Size of Employee Grants

Plan with a view on both the top-down and bottom-up!

How much equity is available in the employee option pool?



What is the value of this person to us and what is a competitive offer?

What are the Steps of Planning Grants?

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To plan equity for near-term hires:

1 Create a hiring plan for the next ~18 months

2 Estimate how much equity you anticipate needing for each new hire
  a Start planning with senior hires, as their grants will likely be the largest
  b Include a buffer for negotiation!

3 **Before Series B:** Determine appropriate grant size based on:
  a Amount of employee option pool
  b Role / experience of the individual, and
  c Market / competitor offers

or

1 **Series B+:** Confirm grant size and total equity needed based on ESOP scheme
  a Include a buffer for exceptions

2 Identify existing employees to be awarded refresh or reward grants
3 Consider how these grants inform future expectations
4 Update ESOP scheme as appropriate

How do ESOP Grant Sizes Differ by Stage?

# of Employees	< 15	15 – 50	50 +
Typical cash compensation	Minimal	Below market	Close to market
Corresponding Equity	**Up to** 1% per employee (typical in U.S. startups)	By seniority	Based on ESOP scheme (typically multiple of salary)
Bottom Line	Be generous!	Move away from individual grants	Stick to the scheme!

What are Typical Grants for Early Employees?

Grant size for early (first 1-10) employees is determined by role and experience, but should reflect the early stage at which they joined

In the U.S., the earliest few hires might expect up to **1% each**. Expectations are somewhat **lower in Europe**, but this is **adjusting upward**

Incentivizing your first 10 employees via equity is **more art than science.** It's helpful at this stage to step back and think about how much you want allocated by your seed round, and to set compensation expectations for your early hires based on **realistic and ambitious** upside potential

You can find a more detailed tool in planning for an individual grants here.
You can find further reading about grant sizes and benchmarks here.

What are Typical Grants at Different Levels?

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By Series B and beyond, a structured ESOP scheme should **determine grant size by applying a multiple to the employee's base salary**

- Levels can be used to coordinate grant sizes as a proportion of base salary across roles and functions
- As company valuation grows, upside falls and you may have to offer multiples at the higher end of the ranges in the table below
- In places where salaries are lower, multiples may also be higher

For example, If a Manager earns a salary of €80,000, his grant could be **0.5 x €80,000 = €40,000**. The number of shares in the grant is determined by the delta between the most recent valuation and strike price of the options

You can find a more detailed tool in planning for an individual grants here.

You can find further reading about grant sizes and benchmarks here.

Role	Level	Salary Mult.
C-Level	1	See next slide
VP	2	0.7x – 2.0x
Director	3	0.5x – 1.0x
Manager	4	0.3x – 0.7x
Key Functions*	5	0.2x – 0.5x
All Others	5+	0.0x – 0.2x

*Key Functions might include strong individual contributors (tech or otherwise) that will have to be incentivized proportional to the value they bring the business

What are Typical Grants for C-Level?

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Management team hires will likely expect to negotiate larger grants, regardless of stage

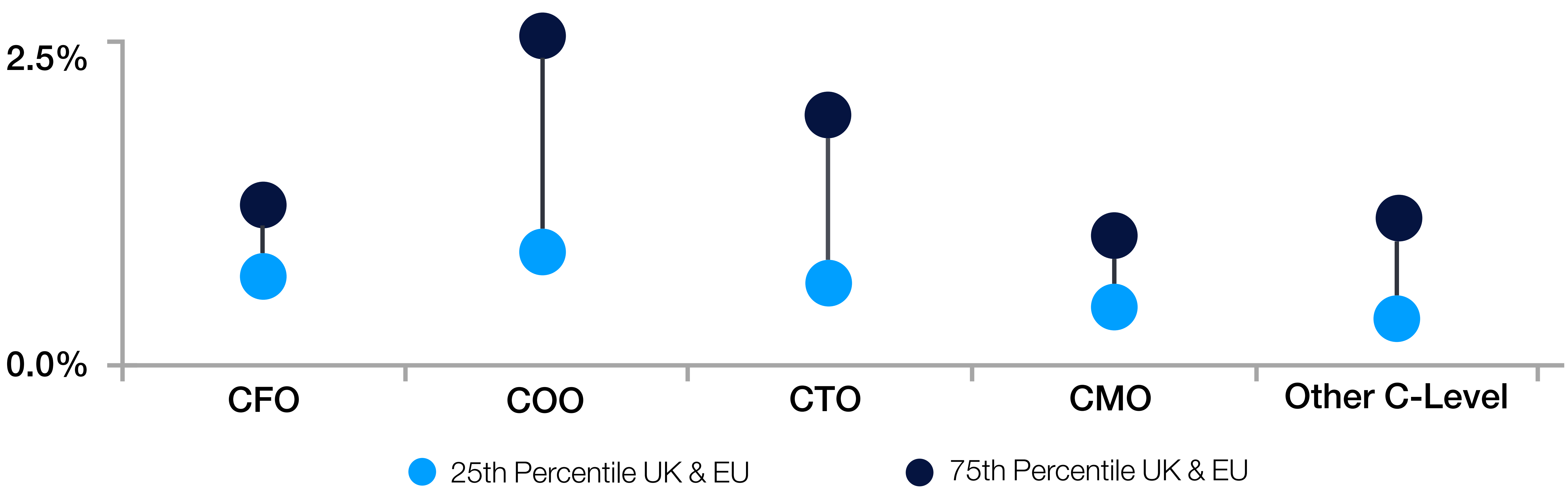
» These grants will remain highly individualized

» It is rarely necessary to give even critical senior hires more than 1-2% (with the exception of CEO hires). Think carefully, and discuss with your board, before you make an initial grant of more than 1%

» At later stages, you should also examine the size of this grant relative to the individual's salary

European Executive Equity Stakes By role

Source: 2018 VC ECS survey, reflects non-founders only



Case Study: ‘Pied Piper’

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This hypothetical case study is meant to help illustrate the planning process that a company may go through for early employee grants

- ‘Pied Piper’ was founded three years ago by two co-founders
- ‘Pied Piper’ first hired a talented and experienced engineer, and offered him 1% of the company as part of his compensation. He was essential in the company’s early days and is still with the company today
- Another great engineer joined shortly thereafter, and was also offered a similar grant
- The early grants for the whole team can be seen in the table below

Original Team & Grants	# shares	% of company
ESOP		
Allocated		
Engineer 1 (first hire)	125,000	1.00%
Engineer 2 (second hire)	112,500	0.90%
Product 1	87,500	0.70%
Total ESOP	**325,000**	**2.60%**

Original Team & Grants	# shares	% of company
Total company	12,500,000	100.0%
Target ESOP	937,500	7.50%

Case Study: 'Pied Piper'

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Post-Series A	# shares	% of company
ESOP		
Allocated		
Engineer 1 (first hire)	125,000	0.83%
Engineer 2 (second hire)	112,500	0.75%
Engineer 3	15,000	0.10%
Engineer 4	15,000	0.10%
Product 1	87,500	0.58%
Sales /Biz Dev 1	3,000	0.02%
Sales / Big Dev 2	3,000	0.02%
Marketing Mgr 1	4,000	0.03%
Unallocated	*1,135,000*	*7.57%*
Total ESOP	**1,500,000**	**10.00%**

Post-Series A	# shares	% of company
Total company	15,000,000	100.0%
Target ESOP	1,500,000	10,00%

- 'Pied Piper' is now post-Series A. The co-founders have established an ESOP, and the pool represents 9% of all outstanding equity (allocated and unallocated)
- The current team allocations can be seen in the table below

Case Study: 'Pied Piper'

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- The co-founders have decided to continue giving grants to all employees going forward
- There are key hires to be made over the next 18 months, including:
- COO, who will also act as Head of Sales; VP of Marketing; and VP of Finance
- The founders' plan anticipates the following grants :

Post-Series A	# shares	% of company
Total company	15,000,000	100.00%
Target ESOP	1,500,000	10%
ESOP		
Allocated – Existing		
Engineer 1 (first hire)	125,000	0.83%
Engineer 2 (second hire)	112,500	0.75%
Engineer 3	15,000	0.10%
Engineer 4	15,000	0.10%
Product 1	87,500	0.58%
Sales /Biz Dev 1	3,000	0.02%
Sales / Big Dev 2	3,000	0.02%
Marketing Mgr 1	4,000	0.03%

This is a refresh grant for the first Engineer

Allocated – New		
COO / Head of Sales	300,000	2.00%
VP Finance	75,000	0.50%
VP Marketing	60,000	0.40%
Engineer 5	22,500	0.15%
Engineer 6	22,500	0.15%
Product 2	6,000	0.04%
Sales / Biz Dev 3	1,500	0.01%
Sales / Biz Dev 4	1,500	0.01%
Allocated – Refreshes		
Engineer 1	18,750	0.13%
Unallocated	627,250	4.18%
Total ESOP	**1,500,000**	**10.00%**

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How do I Set a Strike Price for Employee Options?

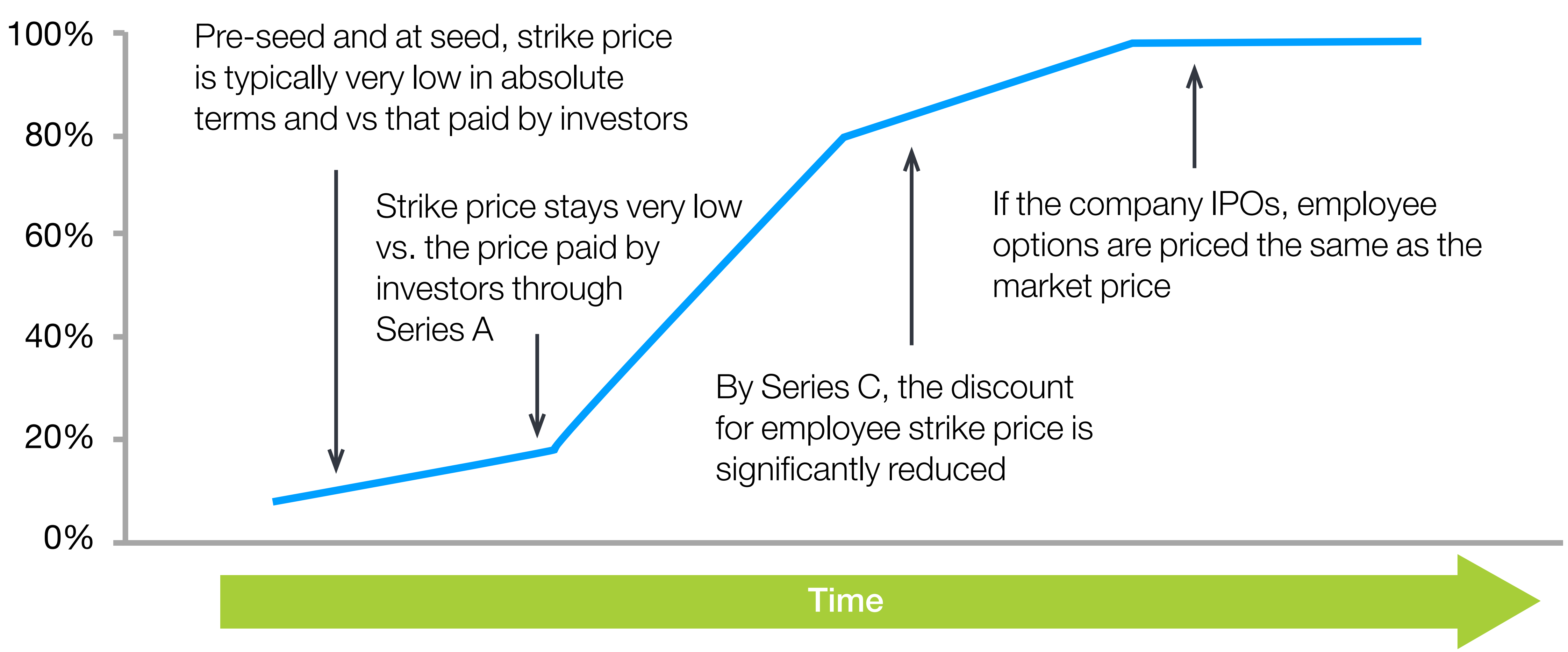
What Strike Price Should Options Have?

The strike price of employee options generally increases over time, both in absolute terms and as a percentage of the corresponding price paid by investors.

Why?

- Taxes are typically optimised for both the company and employee by keeping the strike price as low as possible during the earliest stages of the company
- Lower strike prices for early employees helps to appropriately incentivize them
- Be sure to discuss all tax implications with your tax expert!

Employee Strike Price vs Share Price of Latest Round



Why are Employee Options Priced Differently than Those of Investors?

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Fair Market Value

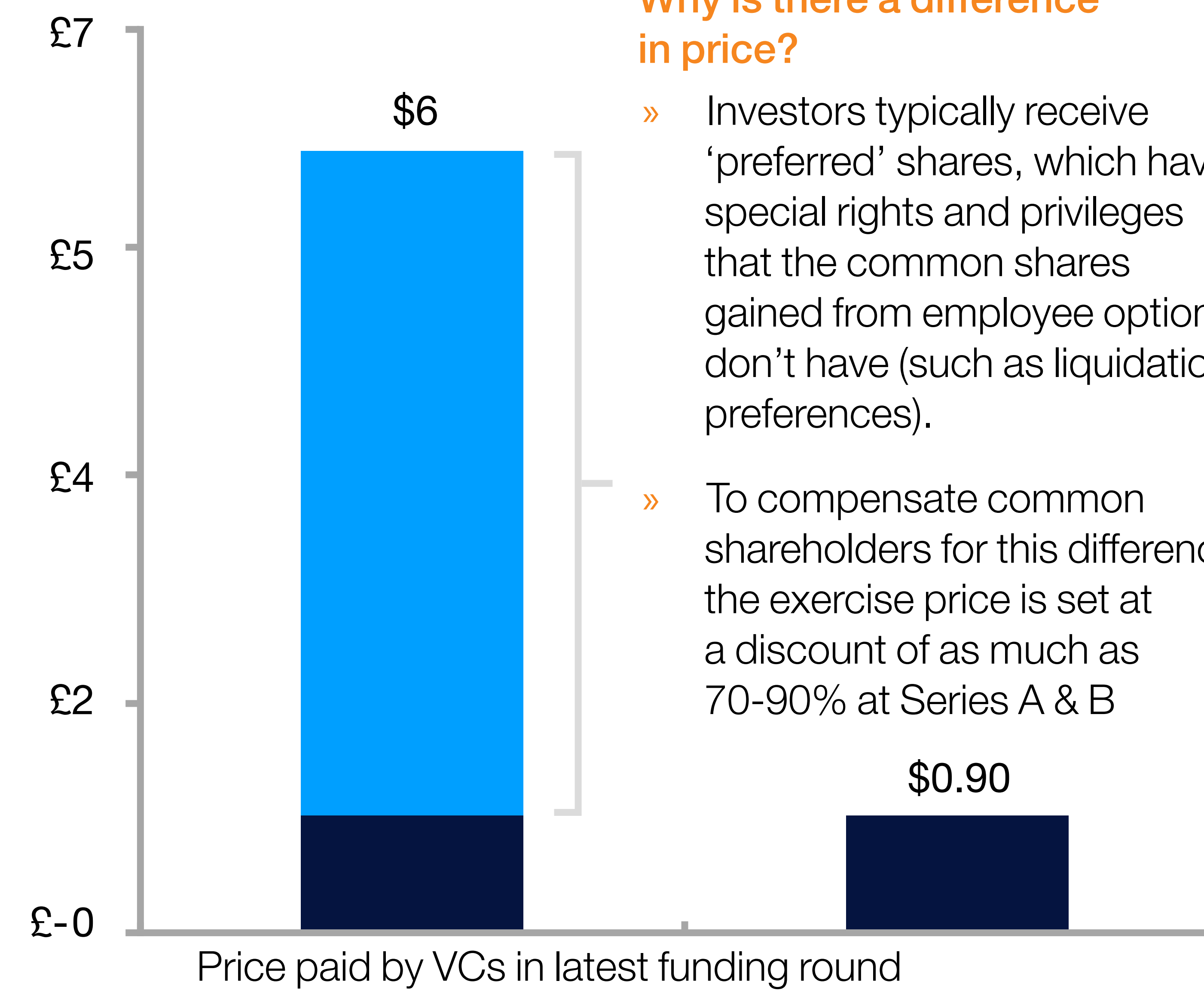
A company will often determine the appropriate exercise price for options based on the fair market value (generally lower than the valuation agreed upon by VCs and other investors) to ensure favourable tax treatment on exercise

***Important note:** If the exercise price for options is set lower than the appropriate fair market value, employees may face tax consequences at exercise.

In some jurisdictions, this process is required of companies of a certain size or stage, and often must be completed or validated by a third party

- UK: HMRC Shares and Assets Valuations (SAV) offers some flexibility in pricing
- US: 409A valuation

***Important note:** Balderton is not, and does not claim to be, qualified to provide the fair market value of a company or to set corresponding strike prices for employee options. Please ensure you seek advice from qualified financial, legal, and tax advisors to understand the requirements and nuances of this process in your jurisdiction(s).



Why is there a difference in price?

- Investors typically receive ‘preferred’ shares, which have special rights and privileges that the common shares gained from employee options don’t have (such as liquidation preferences).
- To compensate common shareholders for this difference, the exercise price is set at a discount of as much as 70-90% at Series A & B

When Should I consider a Stock Split?

The number of shares in the company impacts the value of each share, and thus the strike price for employee options:

» If the company is valued at $10M and there are 1,000 total shares outstanding, each has a value of $10,000, whereas if there are 10M total shares outstanding, each has a value of $1

» If employee options are priced at an 85% discount to the investor value, the strike price the of each of the higher-valued options is $1,500, where the strike price of each of the 10M shares is $0.15

Through **Series B,** you should aim to keep the share price **no higher than $1-$2.**

We find that employees respond more favourably to grant offers that reflect a greater number of options at a lower strike price both because this enables them to potentially exercise smaller portions of their grant at different times, and because it emotionally 'feels' like a more significant grant with a greater number of options

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How do I help employees understand and value their equity?

How do I Communicate the Size of a Grant?

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There are a few ways to articulate the size of an equity grant. In different contexts, it's useful to know how to communicate that value in alternative ways.

% of company

» Often used in framing grants to first handful of employees and management team (or experienced) hires

» **Caution:** don't anchor most employees to a % ownership, as this will change over time due to dilution

Number of shares

» We recommend using this as the fundamental way to think about and communicate all grants

Monetary value (£,$,€)

» Illustrates what the shares are worth today

» Facilitates a discussion around the potential upside for the employee if the company achieves an exit — Sell the dream, but with realistic expectations!

How do I Express the Value of a Grant to Experienced or C-level Hires?

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Key management team members and experienced hires will often think about grants in terms of **% of the company**. It's important to **be prepared to communicate their grants as such**

You should:

1. Know the number of fully diluted shares outstanding for the company
2. Articulate the grant in terms of % of company and number of shares
   i.e. If the company has 10M shares outstanding, and you grant a COO 2% at hiring, the grant is 200,000 shares
3. Present what the value of the grant today by using the employee's strike price and most recent company valuation by investors i.e. If the COO's strike price is \$0.15 but the most recent fundraising with investors was \$10M (or \$1/share), the value of the options to the COO **today** is 200,000 x (\$1- \$0.15) = \$170,000
4. Communicate your vision for the company in terms of a realistic potential future valuation to illustrate the potential upside for the employee, taking into account anticipated dilution. Dilution occurs as a result of new financing rounds or the issuance and subsequent exercise of new options (see slide 33 for an example of dilution). i.e. If you believe the company will **potentially** achieve an exit at \$500M and assume 30% dilution, the **potential** value of the shares to the COO **in the future** is 200,000 x (\$35 - \$0.15) = \$6,970,000, representing an upside of \$6.8M
5. Know the detailed terms of the grant. It may be helpful to prepare a summary sheet that includes **grant date, number of shares, strike price,** and **vesting schedule** for the grant for clarity. Do not include percent of company or potential upside unless you've clearly stated that these are current and potential, respectively
6. Keep any contracts or documents regarding options grants separate from employment contracts
7. Be transparent! It is essential to be clear and accurate when communicating grants to employees

How do I Express the Value of a Grant to General Employee Hires?

For other employees you should sell the current value of the grants, as well as potential upside

You should:

1. Articulate the grant in terms of number of shares and monetary value, using the employee's strike price and most recent company valuation by investors. i.e. If you grant an employee 5,000 options at a strike price of $0.15, but the most recent fundraising with investors was $10M (or $1/share), the value of the shares to the employee **today** is 5,000 x ($1 - $0.15) = $4,250
2. Communicate your vision for the company in terms of a **realistic** potential future valuation to illustrate the potential upside for the employee, taking into account anticipated dilution i.e. If you believe the company will potentially achieve an exit at $500M with an assumed 30% dilution, the **potential** value of the shares to the employee **in the future** is 5,000 x ($35 - $0.15) = $174,250
3. Know the detailed terms of the grant. It may be helpful to prepare a summary sheet that includes **grant date, number of shares, strike price,** and **vesting schedule** for the grant for clarity. Do not include percent of company or potential upside unless you've clearly stated that these are current and potential, respectively
4. Keep any contracts or documents regarding options grants separate from employment contracts
5. Be transparent! It is essential to be clear and accurate when communicating grants to employees

How Does Dilution Work?

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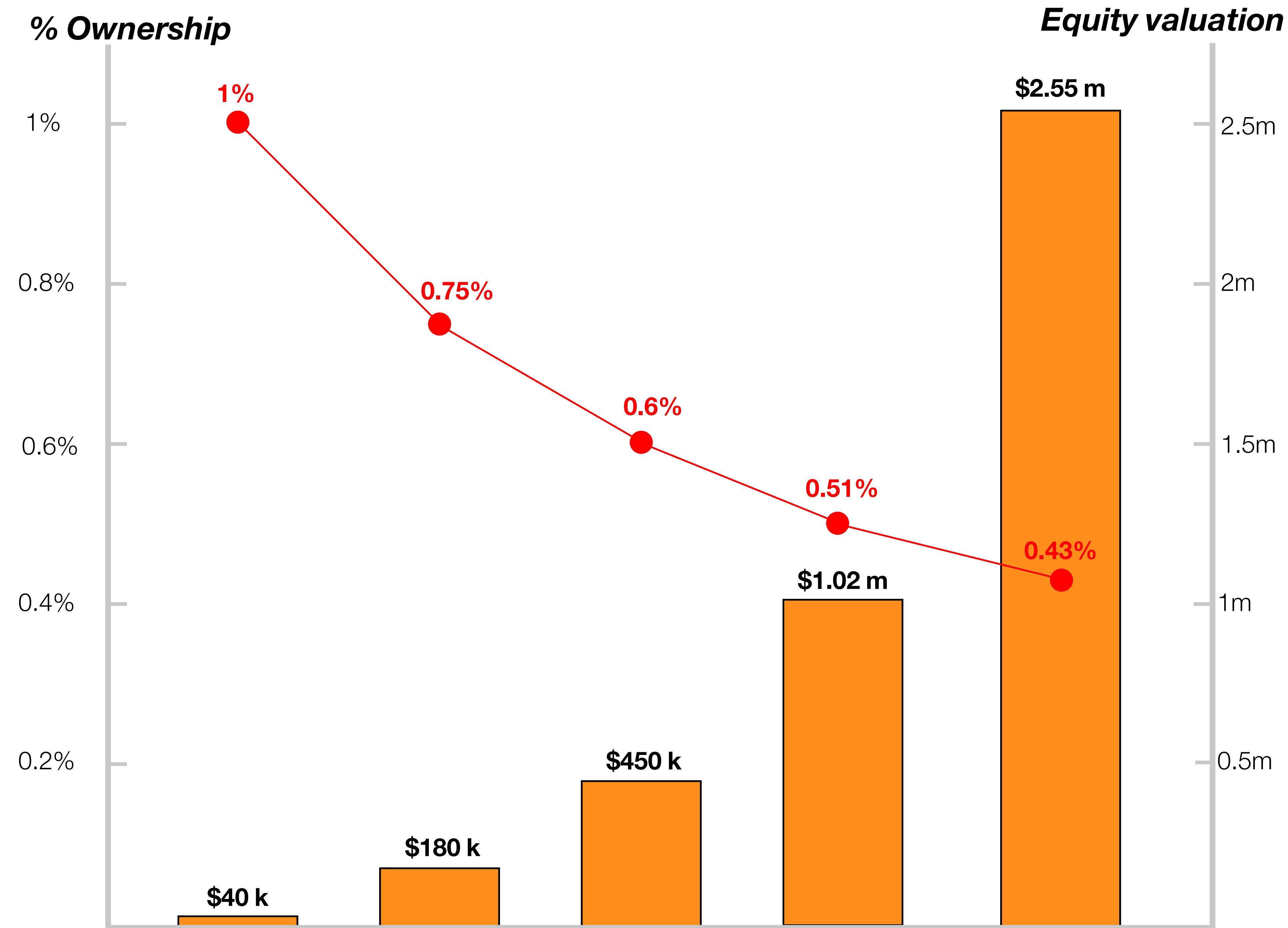

Rounds	Seed	Series A	Series B	Series C	IPO
Raised	$ 0.8m	$ 6m	$ 15m	$ 30m	$ 100m
Pre-money	$ 3.2m	$ 18m	$ 60m	$ 170m	$ 500m

» **What is it?** Dilution is a reduction in the relative ownership of a company for existing shareholders due to the creation of new shares. It occurs, for example, as a result of a new financing round or the issuance and subsequent exercise of new options

» We take the example of an early employee that gets 1% of fully diluted grants after the Seed round. You can observe dilution over subsequent rounds and the increase of equity valuation.

What's an Example of a Grant Summary Sheet?

Sample ESOP Terms of Option Summary

Date of Grant: 1 January 2017

Vesting Commencement Date: 31 January 2017

Number of Options: 5,000

Exercise Price: $0.15

Timetable under which the Options will Vest: These Option Shares shall vest over 4 years, 25% of the total grant on the first anniversary of the Vesting Commencement Date, and the remainder in equal instalments of 1/36 every month for the subsequent 3 years.

Exercise and expiry conditions (if relevant):

All terms subject to board approval.

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What are the Details of Vesting, Exercise, and Refresh?

What Vesting Schedule Should I Use?

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Typical Terms

» Balderton recommends: **4-year vesting period, one year cliff, monthly vesting thereafter**

Why?

» Follows industry standard–used by most tech start-ups

» Offers balance between meaningful initial grant size and incentive for employee to stay at the company

» Is understood by, and is likely consistent with, acquirers

Typical Criticisms

» Employees receive a chunk of equity at end of month 12, but earned it in the preceding 12 months

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Alternative Schedules

» 4 year vesting period, one year cliff, quarterly vesting thereafter; used by Facebook

» 6-year vesting period, one year cliff, monthly vesting thereafter; used by AngelList

» 4 year vesting period, back-weighted vesting (ie. 10% / 20% / 30% / 40% in each year); used by Snapchat

What Does a Vesting Schedule Look Like in Practice?

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Monthly Vesting Schedule													
End of Month		1	2	3	12	13	14	15	24	36	47	48
Initial Grant	10,000											
Monthly Vesting		-	-	-	2,500	208	208	208	208	208	208	208
Total Vested		-	-	-	2,500	2,708	2,917	3,125	5,000	7,500	9,792	10,000
% Vested		0%	0%	0%	25%	27%	29%	31%	50%	75%	98%	100%
Total Unvested	10,000	10,000	10,000	10,000	7,500	7,292	7,083	6,875	5,000	2,500	208	-
% Unvested	100%	100%	100%	100%	75%	73%	71%	69%	50%	25%	2%	0%

Note: See additional materials for an example of employee vesting schedules under different terms.

Exercise Window

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» **What is it?** When an employee departs from a company, they may exercise, or purchase their vested options at the strike price, within a specified amount of time. (Because this window does not start until departure, employees that remain at the company are not impacted by this term.)

Typical Terms

Balderton recommends: 90 days after employee departure

Why?

» Provides enough time for most employees to collect the liquidity to exercise their options as desired

» Also provides the company with a reasonable expiry date for planning purposes, the ability to make bespoke exceptions for retention or hiring purposes, and the ability to roll any expired options back into the pool

» Increasingly, this is the industry standard

Typical Criticisms

» (Still) Too short:

» Unduly penalizes employees for agreeing to have less liquidity due to lower salary compensation in early days

Alternative Windows

» 30 to 60 days: shorter; can be viewed as harsher for employee

» 1-10 years: seen as way to not penalize employees who have foregone liquidity in the form of reduced compensation, especially in early days. However, long windows extend a period of uncertainty around unexercised options, making it difficult for the company to plan and manage the pool. Longer windows also reduce the grant's retention power and shift the advantage to ex-employees, who can wait for further indications of potential upside instead of mandating the financial decision of paying the exercise price immediately upon on leaving

Should I Give Employees Acceleration Clauses?

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Acceleration Clauses

Balderton does not recommend acceleration clauses for most employees

» Where we see acceleration clauses for C-level executives, they typically provide acceleration for 50-100% of unvested options when the criteria of a double trigger clause are met

What is it?

» Enables options to vest before the scheduled date due to the achievement of a milestone, or to a company event (exit, etc.), called a ‘trigger’

Why is it not recommended?

» Can be less attractive to an acquirer in the case of sale, as it requires the acquirer to re-incentivize talent with new equity

What kinds of triggers occur?

» Single trigger: A type of acceleration achieved through accomplishment of single criterion (most typically the sale of the company). This is not very common.

» Double trigger: Acceleration achieved through the accomplishment of a combination of two criteria (most typically the sale of the company and the involuntary termination of the employee within 12-24 months after sale). This is found more commonly than single-trigger acceleration.

» Board discretion: A type of acceleration that is not automatic, but decided by the Board. This can be used to reward some employees selectively.

Should I Have a Bad Leaver Clause?

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Good leaver vs. Bad leaver

Balderton does not recommend bad leaver clauses for employees

What is it?

» Allows the company to reclaim vested options from an employee who leaves under terms designated as those of a 'bad leaver'

Why is it not recommended?

» *Tone:* Starting your relationship with a new hire by negotiating the conditions under which they could lose their equity sets the wrong tone for their future at the company

» *Reputation:* Reclaiming 'bad leaver' equity will nearly always be discussed both internally and externally, and can cause concern in existing and prospective employees about the security of their own stakes

» *Competition:* Your competitors may impose bad leaver provisions in their options schemes, so avoiding this could be a competitive edge in hiring

» *Objectivity:* Employees should retain their earned part of the company's success regardless of the circumstances of their departure

» For specific circumstances, companies **should** consider clauses for 'super' bad leavers (e.g. fraud, criminal behaviour against the company, etc.)

When and Why Should I Give Subsequent Grants to Employees?

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Retention

Evergreen / Refresh: Additional shares awarded on a regular basis beginning **3-5 years** after an employee's initial grant, to help mitigate the decrease in still-unvested options

» May be another single, large grant, or repeating grants of **25-50%** the size of a grant the employee would receive if hired today (depending on length of vesting and grant cadence)

Incentive

Performance-based: Awarded as part of a bonus package, linked to target performance metrics of the individual, team, or company

» Typically determined as a **percent of base salary, then multiplier based on performance levels**

Reward

Discretionary / outstanding performance: Awarded to reward unique contributions

» These grants should be for **non-executives**

» The size of these grants might be as large as **50%** of the size of the grant the employee would receive if hired today

We believe every company should use equity for retention and / or incentives. Some companies (e.g. LinkedIn) successfully use equity for rewards.

Why Give Refresh Grants?

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» As time goes on, the amount of unvested options from an initial grant declines

Vesting Schedule									
Year		1	2	3	4	5	6	7	8
Grant	10,000								
Yearly Vesting		2,500	2,500	2,500	2,500	-	-	-	-
Total vested at YE		2,500	5,000	7,500	10,000	10,000	10,000	10,000	10,000
% vested		25%	50%	75%	100%	100%	100%	100%	100%
Total unvested at YE		7,500	5,000	2,500	-	-	-	-	-
% unvested		75%	50%	25%	0%	0%	0%	0%	0%

» As the amount of vested options increases, those that remain unvested become less meaningful in incentivising the employee to stay with the company

» Many companies begin to see turnover from employees as the date of their full vesting approaches

What Vesting Schedule Should I Use for Refresh Grants?

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Refresh grants see more variability in their vesting structure than initial grants

Typical Terms

- Smaller, annual refresh grants or second large grant
- Granted year 4 after initial grant, no delay before vesting begins, 25% / 25% / 25% / 25% annual vesting schedule

Typical Criticisms

- Despite a range of potential schedules, none perfectly smooth the drop in outstanding unvested options
- Refresh grants, especially to early employees, are rarely meaningful in size and value relative the initial grant

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Alternative Schedules

- Back weighted: Granted year 4 after initial grant, no delay before vesting begins, 10% / 30% / 30% / 30% annual vesting schedule
- Two-year: Granted year 4 after initial grant, 0% / 50% / 50% / 0% annual vesting schedule

You can find a more detailed planning tool for the size and vesting period of refresh grants here.

How do Refresh Grants Work?

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- » To mitigate the decline of unvested options, 'refresh' grants can be issued to provide additional options to the employee
- » The new unvested options increase and extend retention incentives for the employee

One possible refresh grant structure:

Small annual grants made beginning in Year 4:

Vesting Schedule									
Year		1	2	3	4	5	6	7	8
Grant	10,000				2,500	2,500	2,500	2,500	
Initial Grant Vesting		2,500	2,500	2,500	2,500	-	-	-	-
Refresh 1		-	-	-	625	625	625	625	-
Refresh 2		-	-	-	-	625	625	625	625
Refresh 3		-	-	-	-	-	625	625	625
Refresh 4		-	-	-	-	-	-	625	625
Total Yearly Vesting		2,500	2,500	2,500	3,125	1,250	1,875	2,500	1,875
Total vested at YE		2,500	5,000	7,500	10,625	11,875	13,750	16,250	18,125
% vested		25%	50%	75%	85%	79%	79%	81%	91%
Total unvested at YE		7,500	5,000	2,500	1,875	3,125	3,750	3,750	1,875
% unvested		75%	50%	25%	15%	21%	21%	19%	9%

- » The size of these grants should be based on the employee's current value to the company (as if you were hiring him or her at the time of the refresh)

You can find a more detailed planning tool for the size and vesting period of refresh grants here.

How do Refresh Grants Work?

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Another typical refresh grant structure:

Second large grant made at the end of Year 4 (to begin vesting in Year 5):

Vesting Schedule									
Year		1	2	3	4	5	6	7	8
Grant	10,000				10,000				
Initial Grant Vesting		2,500	2,500	2,500	2,500	-	-	-	-
Refresh 1		-	-	-	-	2,500	2,500	2,500	2,500
Total Yearly Vesting		2,500	2,500	2,500	2,500	2,500	2,500	2,500	2,500
Total vested at YE		2,500	5,000	7,500	10,000	12,500	15,000	17,500	20,000
% vested		25%	50%	75%	100%	63%	75%	88%	100%
Total unvested at YE		7,500	5,000	2,500	-	7,500	5,000	2,500	-
% unvested		75%	50%	25%	0%	38%	25%	13%	0%

- While made at the end of Year 4, conversations around this type of grant begin earlier so that the employee is aware the grant will be awarded as the unvested portion of his or her initial grant decreases
- May be preferred because it offers clean refresh structure that mimics initial grant, does not set precedent for annual grants, and makes the refresh grant the largest possible size optically
- Does not mitigate turnover in later stages of vesting without early, proactive communication

You can find a more detailed planning tool for the size and vesting period of refresh grants here

How do Alternative Structures Work?

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Example of alternative refresh grant structure:

Small annual grants with 10% / 30% / 30% / 30% vesting schedule:

Vesting Schedule									
Year		1	2	3	4	5	6	7	8
Grant	10,000				2,500	2,500	2,500	2,500	
Initial Grant Vesting		2,500	2,500	2,500	2,500	-	-	-	-
Refresh 1		-	-	-	250	750	750	750	-
Refresh 2		-	-	-	-	250	750	750	750
Refresh 3		-	-	-	-	-	250	750	750
Refresh 4		-	-	-	-	-	-	250	750
Total Yearly Vesting		2,500	2,500	2,500	2,750	1,000	1,750	2,500	2,250
Total Granted		10,000	10,000	10,000	12,500	15,000	17,500	20,000	20,000
Total vested at YE		2,500	5,000	7,500	10,250	11,250	13,000	15,5000	17,750
% vested		25%	50%	75%	82%	75%	74%	78%	89%
Total unvested at YE		7,500	5,000	2,500	2,250	3,750	4,500	4,500	2,250
% unvested		75%	50%	25%	18%	25%	26%	23%	11%

» May be preferred because it smooths % unvested over time, and backweighting incentivizes retention through later stages of refresh vesting

» Takes longer time to build in terms of number of refresh options vesting each year, and potential dip in number of options vesting in Year 5 may present retention risk

You can find a more detailed planning tool for the size and vesting period of refresh grants here

How do Alternative Structures Work?

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Example of alternative refresh grant structure:

Small annual grants with 0% / 50% / 50% / 0% vesting schedule:

Vesting Schedule									
Year		1	2	3	4	5	6	7	8
Grant	10,000				2,500	2,500	2,500	2,500	
Initial Grant Vesting		2,500	2,500	2,500	2,500	-	-	-	-
Refresh 1		-	-	-	-	1,250	1,250	-	-
Refresh 2		-	-	-	-	-	1,250	1,250	-
Refresh 3		-	-	-	-	-		1,250	1,250
Refresh 4		-	-	-	-	-	-	-	1,250
Yearly Vesting		2,500	2,500	2,500	2,500	1,250	2,500	2,500	2,500
Total Granted		10,000	10,000	10,000	12,500	15,000	17,500	20,000	20,000
Total vested at YE		2,500	5,000	7,500	10,000	11,250	13,750	16,250	18,750
% vested		25%	50%	75%	80%	75%	79%	81%	94%
Total unvested at YE		7,500	5,000	2,500	2,500	3,750	3,750	3,750	1,250
% unvested		75%	50%	25%	20%	25%	21%	19%	6%

» May be preferred because it smooths % unvested over time, and quickly builds in terms of number of refresh options vesting each year

» Shortens retention power of each individual refresh grant as effective vesting period is two years, and potential dip in number of options vesting in Year 5 may present retention risk

You can find a more detailed planning tool for the size and vesting period of refresh grants here

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What are Variations on Stock Options?

Why are Alternative Types of Equity Used?

The type and structure of equity you offer is usually driven by tax considerations relevant to the country in which it is issued, as these may significantly impact its value to employees.

In many countries, the tax considerations continue to change and evolve.

We are not your tax experts, but you should talk to one if you have questions! We can help you find local advisers or precedents to guide you through this.

What Structures of Equity are Most Common in Specific Countries or Jurisdictions?

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Country	Most common form(s)	Reason(s)
	ESO, mainly EMI	» Tax efficient structures in UK: if EMI strike price set at market value, no tax to employee on exercise (up to £250K) » Company should obtain a valuation agreed with HMRC before options are granted
	VSP	» Options are not tax efficient for employees » VSP mimics economic benefits for employees without providing voting rights, etc. of other shareholders
	BSPCE 'Founder Warrants', AGA 'Free Shares'	» Both are free to employee up front » BSPCE taxed as income; Free shares taxed as capital gains, depending on time held (+ social charges) » BSPCE strike price based on share price
	Depository rights provided through STAK	» More tax efficient than options » Mimics economic benefits for employees without providing voting rights, etc. of other shareholders
	Options (QESO), Warrants	» QESO (Qualified employee stock options) are tax efficient (25-30%) but restricted to startups below 50 people » For 50+ employees, warrants are the favoured scheme and employee must pay a small amount upfront

Note: Please seek advice from qualified financial, legal, and tax advisors to understand the specific tax considerations of your jurisdiction(s).

What are the Other Types of Equity Used in Other Situations?

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Restricted stock units (RSUs)

» **What are they?** RSUs represent a promise to issue common stock (or the cash value of common stock) at a later date at the fair market value of the shares on that date

» **Are they recommended?** They are **not generally advisable** for, or used in, early-stage companies due to their less favourable tax treatment in most jurisdictions, more limited upside (but also limited risk), and their inability to be offered in secondary sales
  – RSUs typically are not attractive for company or employee until the company is public, expect in specific cases or jurisdictions where RSUs may be used for tax purposes
  – Employees are typically taxed upon delivery of the units (vesting, not exercise)
  – Note: RSU ≠ restricted stock

Growth Shares

» **What are they?** A separate class of shares that reward employees (typically management or key employees) for growth company above a “threshold” or “hurdle”, specified at issue

» **Are they recommended?** Although growth shares can be more tax-efficient than options in rewarding key team members for achieving specific goals, they are generally unnecessarily complicated for early-stage teams. However, they may be a good solution in the U.K. for later stage companies.

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How do I Present This to the Board?

Am I Required to Share Employee Grant Details with the Board?

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- **Yes**, most shareholder agreements **require** you to share the ESOP scheme with your board and to get board approval for employee equity grants
- At a minimum, the board must generally approve any ‘exceptional’ grants
- Employee grant approvals typically happen on at least a quarterly basis
- After **Series A**, a Compensation Committee should be formed as a subcommittee of the board, responsible for approving employee equity grants

What Should I Tell the Board About ESOP?

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1. **It is helpful to present the employee options pool to the board in the context of all existing shares outstanding**

   Build a summary cap table that includes a summary of vested and unvested employee shares, as well as what remains ungranted to employees within the pool

Company A - Summary Cap Table			
Founders' shares	#Shares	% of Class	% Fully Diluted
Founder 1	2,500,000	50.0%	16.7%
Founder 2	2,500,000	50.0%	16.7%
Total	**5,000,000**	**100.0%**	**33.3%**
Employee options pool			
Granted, vested	320,000	21.3%	2.1%
Granted, unvested	548,050	36.5%	3.7%
Proposal for approval	16,950	1.1%	0.1%
Ungranted ESOP	615,000	41.0%	4.1%
Total	**1,5000,000**	**100.0%**	**10.0%**
Preferred			
Investor 1	1,100,000	12.9%	7.3%
Investor 2	600,000	7.1%	4.0%
Investor 3	3,000,000	35.3%	20.0%
Investor 4	1,750,000	20.6%	11.7%
Investor 5	2,050,000	24.1%	13.7%
Total	**8,500,000**	**100.0%**	**56.7%**
Total Shares	**15,000,000**		**100%**

What Should I Tell the Board About ESOP?

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2. **Create an ESOP grant plan and get approval from the board**

See below for an illustrative example of what you can present to the board on an annual basis to outline expected hires in the year to come

Company B - ESOP Grant Plan					
Role	Standard Grant	Standard % Equity	Planned Hires	Total Options	Total % Equity
CFO	150,000	0.50%	1	150,000	0.50%
VP WW Sales	125,000	0.42%	1	125,000	0.42%
Sales Manager	10,000	0.03%	3	30,000	0.10%
Account Executive	3,000	0.01%	12	36,000	0.12%
Inside Sales Rep	1,500	0.01%	12	18,000	0.06%
Pre-sales Rep	1,500	0.01%	4	6,000	0.02%
Engineering Manager	10,000	0.03%	2	20,000	0.07%
Senior Tech Lead	4,000	0.01%	4	16,000	0.05%
Senior Engineer	3,000	0.01%	8	24,000	0.08%
Junior Engineer	2,000	0.01%	12	24,000	0.08%
Others			25	50,000	0.17%
Annual Total			**84**	**499,000**	**1.66%**

What Detail Should I Show About Individual Grants?

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3. **Provide a summary of all grants for which you are seeking approval**

   Highlight any exceptions to established ESOP plan and clearly articulate why.

   See below for a specific example, unrelated

Company A - ESOP Grant Summary for Board Approval - 30-Jun-2017

Name	Role	Proposed Grant (# shares)	Type of Grant / Approval Needed For	Exception ?	Reason for Exception / Notes	Strike Price ($)	Date Vesting From
R.Geller	VP	7,500	Refresh	Y	One-time reward	4.15	30-Jun-17
J. Tribbiani	Jr. Associate	800	First grant	N		4.37	30-Jun-17
R. Green	Sales Mgr	1,000	Refresh	N		4.37	30-Jun-17
C. Bing	Director	5,000	First Grant	N		4.37	30-Jun-17
M. Geller	Director	1,250	Uplift for high performance	Y	Outside performance expectations	4.37	30-Jun-17
J. Gunther	Sales Associate	800	First grant	Y		4.37	30-Jun-17
P. Buffay	Jr. Associate	600	First Grant	Y	Risky hire	4.37	30-Jun-17
Total to be approved		**16,950**					
% of Total ESOP		**1.1%**					

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Where Can I Find More Information?

Does Balderton Have any Other Tools?

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Balderton has created a workbook to help you better understand some of the topics discussed in this deck. It offers worksheets for:

- **Grant Value Summary** to express the size of an individual grant in different ways, and to show its size relative to the rest of the budget in a given round
- **Initial Grant Vesting** to show the quarterly vesting of an initial grant based on different vesting schedules
- **Refresh Vesting** to show the vesting of refresh grants based on different vesting schedules, and how they impact the number of forward vesting shares for an employee
- **Board Summary Example:** sample tables to summarize proposed grants for Board approval

Where Can I Read and Learn More?

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Key resources:

- Sources and additional resources: Employee Equity Resources
- AVC (Fred Wilson's blog): series on employee equity
- Thomson Reuters Practical Law: overview of tax / legal structures by region
- Wealthfront equity plan and blog
- Accion: overview of ESOPs and general education