All about startup equity

by Paige Omura

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Equity can be a huge incentive for joining a startup early, but knowing when to exercise your options, how to get paid out, how much you'll make, and how much you'll get taxed is not at all obvious. It's important to have a solid understanding of how options work, because the way you use them can have huge financial consequences.

What is a Stock Option?

A stock option is a contract that gives you the right, but not obligation, to buy a stock at an agreed-upon price and date. The price at which you can purchase the stock is called the exercise price, or strike price. So if your employer grants you 100 options, you do not own 100 shares. Rather, you have the option to buy 100 shares at the aforementioned strike price. Doing so is called exercising your option.

Most startups give employees Incentive Stock Options (ISOs), though some use Non-qualified Stock Options (NSOs). For this post we'll assume that we're only dealing with ISOs.

Understanding the Equity Component of an Offer

There are a few key components to an equity offer that you should always look for.

- **Number of Options.** The number of shares you have the right to purchase.
- **Percentage Ownership.** Your percentage ownership of the company's total outstanding equity, assuming that you exercise all of your options. This is calculated as (number of options) / (total outstanding shares issued by the company).
- **Strike Price.** The per-share price that you pay to exercise your options.
- **Vesting Schedule.** Typically your equity grant will be subject to vesting, which means that you don't receive all your options right away, but that you'll receive them over time. A typical vesting schedule is four years with a one-year cliff. This means that if you leave the company within your first year, you'll walk away with nothing. If you stay, 1/4th of your shares will vest on your one-year anniversary, after which 1/48th of your shares will vest monthly. There are plenty of other vesting schedules too. Some companies have a five-year vest with a six month

cliff. At Amazon, 5% of your shares vest after year one, 15% after year two, then 40% after years three and four.

- **Post-Termination Exercise (PTE) Window.** If you leave your job, you'll often have just 90 days to decide if you want to exercise your options. Once those 90 days are up you forfeit all your options, causing many employees to find themselves in "golden handcuffs". Luckily, some companies like Pinterest and Asana are starting to do 5, 7, or 10 year PTE windows. Be aware, though, that even if your PTE window is more than 90 days, your ISOs will convert into NSOs after 90 days.

When should I exercise my options?

Exercising your options can be expensive, so deciding when to exercise is going to depend on your personal financial situation. However, it's important to understand all possibilities and the enormous tax implications that come with each one.

Exercising one year before IPO

One of the best times to exercise your options is one year before the IPO, as described by Wealthfront here. If you exercise your options one year before selling and your grant date was at least two years prior to the date you sell, you'll only have to pay long term capital gains tax on your profit, rather than the much higher typical income tax rate.

If the fair market value (determined by the most recent 409a valuation) of your company's shares has risen above your strike price, you may also have to pay Alternative Minimum Tax (AMT) at the time you exercise your options. The federal AMT rate is 28% of the spread between the fair market value of your shares and the value of your shares at your strike price.

The problem preventing many people from using this approach is that it often requires fronting a significant amount of cash to exercise your options. If that's the case, you can wait until after the IPO to exercise your options.

Exercising and Selling Post-IPO

If you can't afford to exercise your stock options, but your company has already gone public, you can arrange a cashless exercise. In a cashless exercise, your employer or a brokerage firm will give you a loan to exercise the options, then sell the stock at market price immediately. You then use the proceeds from the sale to repay the loan. This is quite common at startups where employees can't afford to exercise their options. Typically the mechanics of the process of receiving the loan, selling the stock, and repaying the loan is hidden from the employee, and he or she will simply receive the proceeds after the whole transaction is complete. The downside to this approach is that your gain from selling the stock will be taxed as ordinary income because you've held the stock for less than a year.

Early Exercising

Many startups allow their employees to exercise their options before they've vested, which is referred to as early exercising. Early exercising is a good idea when you either have high confidence that the company will have a successful exit or the total cost to exercise is affordable. This approach has 2 major advantages:

1. You'll owe zero AMT at the time you exercise your options if your strike is equal to the company's last 409a valuation.
2. The 1-year countdown to qualify for long term capital gains tax starts ticking.

Keep in mind, though, that early exercising is risky. You should only early exercise if you are comfortable losing your entire investment.

The cost to early exercise varies drastically depending on the stage of the company. If you're at a seed stage startup, your strike price could be $0.01. In this case, early exercising 50,000 options would cost you $500. At a Series A stage company, however, your strike price could be around $0.50. Early exercising 50,000 options at that price would cost you $25,000.

If you choose to early exercise **it is absolutely crucial that you file an 83(b) election within 30 days** to inform the IRS of your decision. If you don't file an 83(b) election form, you'll be hit with additional taxes when your options vest.

What happens if you leave before your options have vested?

If you early exercise your options and leave before they've all vested, the company typically has 90 days to repurchase any of your unvested shares at the same price you paid. If they fail to do so after 90 days, all the unvested shares are yours. This can vary across companies though, so you should check your option grant letter or ask your employer.

A lot of the advice we give startups is tactical; meant to be helpful on a day to day or week to week basis. But some advice is more fundamental. We've collected here what we at YC consider the most important, most transformative advice for startups. Whether common sense or counter-intuitive, the guidance below will help most startups find their path to success.

The first thing we always tell founders is to launch their product right away; for the simple reason that this is the only way to fully understand customers' problems and whether the product meets their needs. Surprisingly, launching a mediocre product as soon as possible, and then talking to customers and iterating, is much better than waiting to build the "perfect" product. This is true as long as the product contains a "quantum of utility" for customers whose value overwhelms problems any warts might present.

Once launched, we suggest founders do things that don't scale (Do Things That Don't Scale by Paul Graham[1]). Many startup advisors persuade startups to scale way too early. This will require the building of technology and processes to support that scaling, which, if premature, will be a waste of time and effort. This strategy often leads to failure and even startup death. Rather, we tell startups to get their first customer by any means necessary, even by manual work that couldn't be managed for more than ten, much less 100 or 1000 customers. At this stage, founders are still trying to figure out what needs to be built and the best way to do that is talk directly to customers. For example, the Airbnb founders originally offered to "professionally" photograph the homes and apartments of their earliest customers in order to make their listings more attractive to renters. Then, they went and took the photographs themselves. The listings on their site improved, conversions improved, and they had amazing conversations with their customers. This was entirely unscalable, yet proved essential in learning how to build a vibrant marketplace.

Talking to users usually yields a long, complicated list of features to build. One piece of advice that YC partner Paul Buchheit (PB) always gives in this case is to look for the "90/10 solution". That is, look for a way in which you can accomplish 90% of what you want with only 10% of the work/effort/time. If you search hard for it, there is almost always a 90/10 solution available. Most importantly, a 90% solution to a real customer problem which is available right away, is much better than a 100% solution that takes ages to build.

As companies begin to grow there are often tons of potential distractions. Conferences, dinners, meeting with venture capitalists or large company corporate development types (Don't Talk to Corp Dev by Paul Graham[2]), chasing after press coverage and so on. (YC co-founder Jessica Livingston created a pretty comprehensive list of the wrong things on which to focus [How Not To Fail by Jessica Livingston [3].]) We always remind founders not to lose sight that the most important tasks for an early stage company are to write code and talk to users. For any company, software or otherwise, this means that in order to make something people want: you must launch something, talk to your users to see if it serves their needs, and then take their feedback and iterate. These tasks should occupy almost all of your time/focus. For great companies this cycle never ends. Similarly, as your company evolves there will be many times where founders are forced to choose between multiple directions for their company. Sam Altman always points out that it is nearly always better to take the more ambitious path. It is actually extraordinary how often founders manage to avoid tackling these sorts of problems and focus on other things. Sam calls this "fake work", because it tends to be more fun than real work (The Post YC Slump by Sam Altman[4]).

What is Y Combinator?

We're an accelerator that funds startups — like Coinbase, Instacart, Reddit, Doordash — at their earliest stages. Starting a company? Even if it feels early, 40% of our companies joined with just an idea.

Apply

When it comes to customers most founders don't realize that they get to choose customers as much as customers get to choose them. We often say that a small group of customers who love you is better than a large group who kind of like you. In other words, recruiting 10 customers who have a burning problem is much better than 1000 customers who have a passing annoyance. It is easy to make mistakes when choosing your customers so sometimes it's also critical for startups to fire their customers[5]. Some customers can cost way more than they provide in either revenue or learning. For example, Justin.tv/Twitch only became a breakout success when they focused their efforts toward video game broadcasters and away from people trying to stream copy written content (Users You Don't Want by Michael Seibel[5].)

Growth is always a focus for startups, since a startup without growth is usually a failure. However, how and when to grow is often misunderstood. YC is sometimes criticised for pushing companies to grow at all costs, but in fact we push companies to talk to their users, build what they want, and iterate quickly. Growth is a natural result of doing these three things successfully. Yet, growth is not always the right choice. If you have not yet made something your customers want - in other words, have found product market fit, it makes little sense to grow (The Real Product Market Fit by Michael Seibel[6]). Poor retention is always the result. Also, if you have an unprofitable product, growth merely drains cash from the company. As PB likes to say, it never makes sense to take 80 cents from a customer and then hand them a dollar back. The fact that unit economics really matter shouldn't come as a surprise, but too many startups seem to forget this basic fact (Unit Economics by Sam Altman[7]).

Startup founders' intuition will always be to do more whereas usually the best strategy is almost always to do less, really well. For example, founders are frequently tempted to chase big deals with large companies which represent amazing, company validating relationships. However, deals between large companies and tiny startups seldom end well for the startup. They take too long, cost too much, and often fail completely. One of the hardest things about doing a startup is choosing what to do, since you will always have an infinite list of things that could be done (Startup Priorities by Geoff Ralston[8]). It is vital that very early a startup choose the one or two key metrics it will use to measure success, then founders should choose what to do based nearly exclusively on how the task will impact those metrics. When your early stage product isn't working it's often tempting to immediately build new features in order to solve every problem the customer seems to have instead of talking to the customer and focusing only on the most acute problem they have.

Founders often find it surprising to hear that they shouldn't worry if their company seems badly broken. It turns out that nearly every startup has deep, fundamental issues, even those that will end up being billion dollar companies. Success is not determined by whether you are broken at the beginning, but rather what the founders do about the inevitable problems. Your job as a founder will often seem to be continuously righting a capsized ship. This is normal.

It is very difficult as a new startup founder not to obsess about competition, actual and potential. It turns out that spending any time worrying about your competitors is nearly always a very bad idea. We like to say that startup companies always die of suicide not murder. There will come a time when competitive dynamics are intensely important to the success or failure of your company, but it is highly unlikely to be true in the first year or two.

A few words on fundraising (A Guide to Seed Fundraising by Geoff Ralston[9]). The first, best bit of advice is to raise money as quickly as possible and then get back to work. It is often easy to actually see when a company is fundraising by looking at their growth curve and when it flattens out they are raising money. Equally important is to understand that valuation is not equal to success or even probability of success (Fundraising Rounds are not Milestones by Michael Seibel[10]). Some of Y Combinator's very best companies raised on tiny initial valuations (Airbnb, Dropbox, Twitch, are all good examples). By the way, it is vital to remember that the money you raise IS NOT your money. You have a fiduciary and ethical/moral duty to spend the money only to improve the prospects of your company.

It is also important to stay sane during the inevitable craziness of startup life. So we always tell founders to make sure they take breaks, spend time with friends and family, get enough sleep and exercise in between bouts of extraordinarily intense, focused work. Lastly, a brief word on failure. It turns out most companies fail fast because founders fall out. The relationships with your cofounders matter more than you think and open, honest communications between founders makes future debacles much less likely. In fact, it turns out that one of the best things you can do to make your startup successful, in fact, to be successful in life, is to simply be nice (Mean People Fail by Paul Graham[11].)

The Pocket Guide of Essential YC Advice

- Launch now
- Build something people want
- Do things that don't scale
- Find the 90 / 10 solution
- Find 10-100 customers who love your product
- All startups are badly broken at some point
- Write code - talk to users
- "It's not your money"
- Growth is the result of a great product not the precursor
- Don't scale your team/product until you have built something people want
- Valuation is not equal to success or even probability of success
- Avoid long negotiated deals with big customers if you can
- Avoid big company corporate development queries - they will only waste time
- Avoid conferences unless they are the best way to get customers
- Pre-product market fit - do things that don't scale: remain small/nimble
- Startups can only solve one problem well at any given time
- Founder relationships matter more than you think
- Sometimes you need to fire your customers (they might be killing you)
- Ignore your competitors, you will more likely die of suicide than murder
- Most companies don't die because they run out of money
- Be nice! Or at least don't be a jerk
- Get sleep and exercise - take care of yourself