Buying the Hype:
Understanding Equity and Stock Offers

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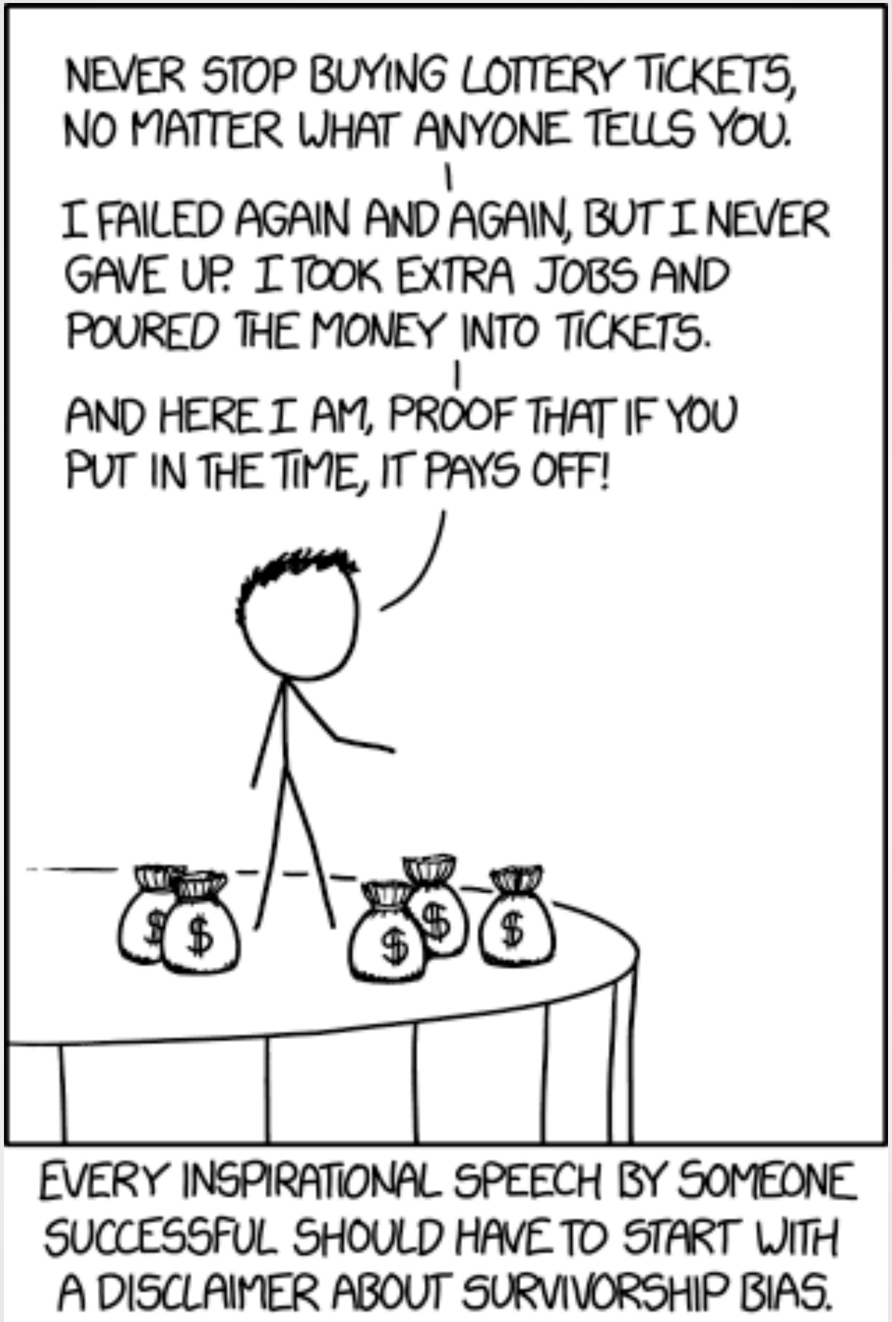
slides.com/verythorough/buying-the-hype

Status update: I'm rich! Facebook flotation to create 1,000 millionaires among company's rank and file

Google Options Make Masseuse a Multimillionaire

Instagram's 13 employees share $100m as CEO set to make $400m


NEVER STOP BUYING LOTTERY TICKETS, NO MATTER WHAT ANYONE TELLS YOU.
I FAILED AGAIN AND AGAIN, BUT I NEVER GAVE UP. I TOOK EXTRA JOBS AND POURED THE MONEY INTO TICKETS.
AND HERE I AM, PROOF THAT IF YOU PUT IN THE TIME, IT PAYS OFF!
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EVERY INSPIRATIONAL SPEECH BY SOMEONE SUCCESSFUL SHOULD HAVE TO START WITH A DISCLAIMER ABOUT SURVIVORSHIP BIAS.

source: xkcd

Defining Terms

Stock Options: An *option* to buy a certain amount of stock at a certain price

Grant

Legally binding agreement of terms for your options

Vesting

Gradually gives you access to your options

Exercise

The act of purchasing your actual stock

Sale

The act of selling your stock

Important Grant Info

Grant date: date when your grant begins

Quantity: number of shares you can buy when fully vested

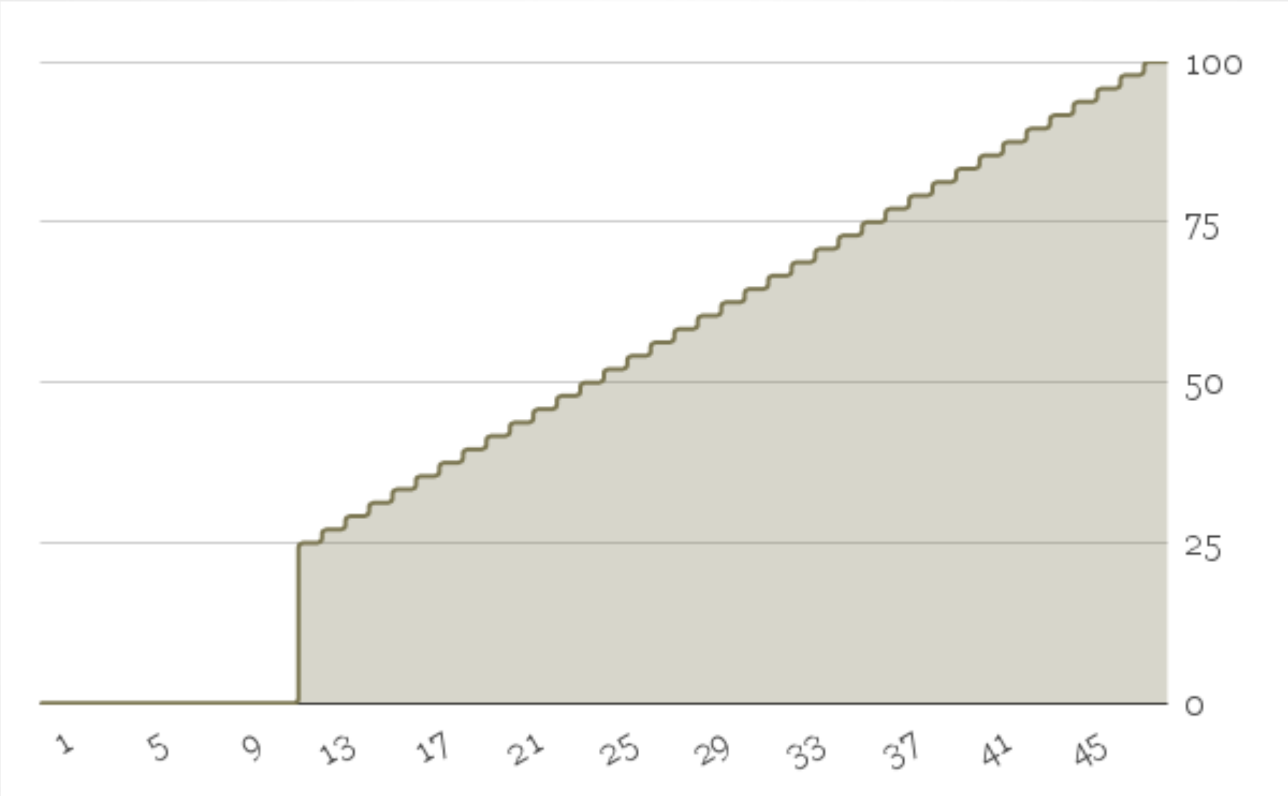
Strike/exercise price: the price you pay for your shares (usually 'fair market value' on the grant date)

Expiration date: date when you can no longer buy your options (usually 10 years after grant date)

Post-termination period: window when you can still buy after you leave (usually 90 days, more for death, etc.)

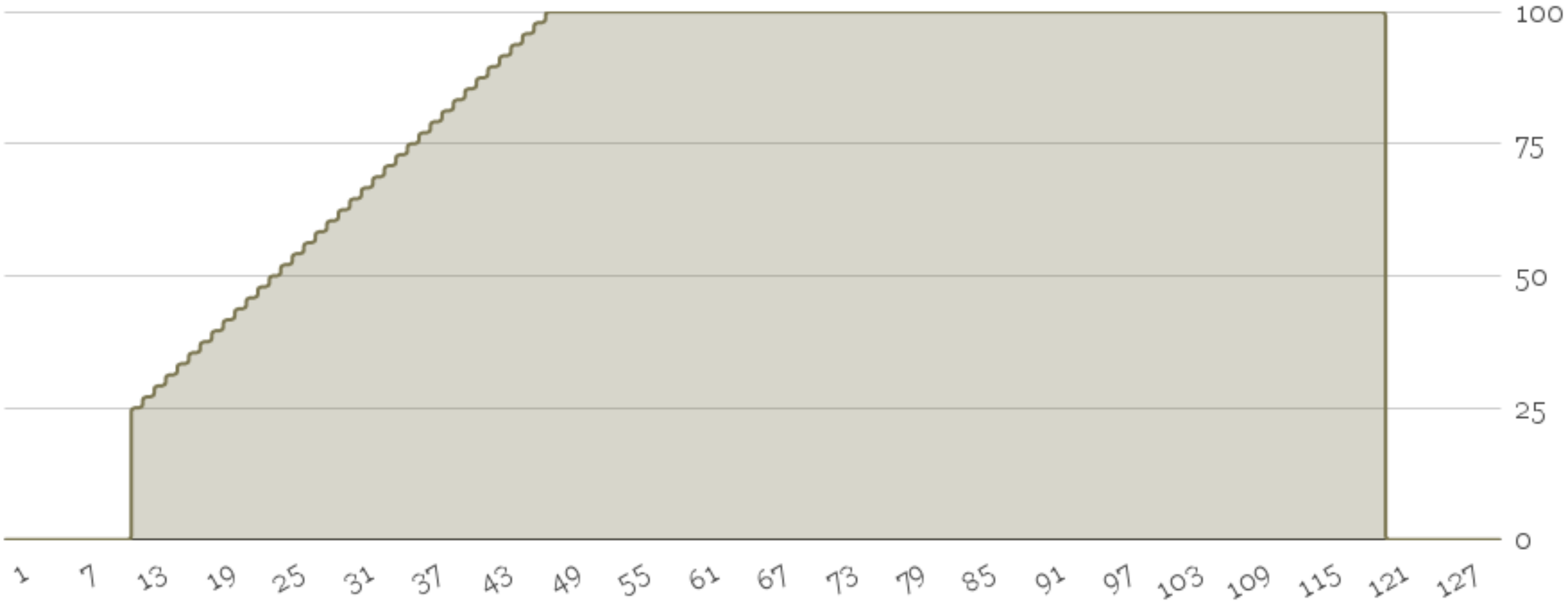
Vesting Schedule

"Four-year monthly vesting with a one-year cliff"



Vesting Schedule

"... and a ten-year expiration"



Exercise Terms

of shares x strike price = cost basis

1000 x \$0.10 = \$100

# of shares x (current fair market value - strike price) =

1000 x (\$1.00 - \$0.10) =

bargain element

\$900

Sale Terms

of shares x current market price = gross proceeds

1000 x $2.00 = $2000

gross proceeds - cost basis = net proceeds

$2000 - $100 = $1900*

* $900 of this is the bargain element

Types of Equity

Restricted stock award: actual stock granted to you, with no purchase required (granted all at once, but control is usually vested)

RSUs (restricted stock units): "units" of stock (or cash value of stock) given to you over a vesting schedule

NSOs (non-qualifying stock options): options where bargain element is taxed as ordinary income at exercise (usually used for contractors)

ISOs (incentive stock options): options with special tax benefits (only available to employees)

Publicly-Traded Company ISOs

Same-day exercise & sell

1000 shares Strike price $0.10 Market price $2

Cost basis = 1000 x $0.10 = $100

Bargain element = 1000 x ($2 - $0.10) = $1900

Gross proceeds = 1000 x $2 = $2000

Net proceeds = $2000 - $100 = $1900

Net proceeds = Bargain element = $1900 ordinary income

Publicly-Traded Company ISOs

Buy & hold for < 1 year

1000 shares Strike price $0.10 Exercise price $1 Sale price $2

Cost basis = 1000 x $0.10 = $100

Bargain element = 1000 x ($1 - $0.10) = $900

Gross proceeds = 1000 x $2 = $2000

Net proceeds = $2000 - $100 = $1900

Bargain element = $900 ordinary income

Net proceeds - bargain element = $1000 capital gains

Publicly-Traded Company ISOs

Buy & hold for > 1 year

1000 shares | Strike price \$0.10 | Exercise price \$1 | Sale price \$2

Cost basis = 1000 x \$0.10 = \$100

Bargain element = 1000 x (\$1 - \$0.10) = \$900

Gross proceeds = 1000 x \$2 = \$2000

Net proceeds = \$2000 - \$100 = \$1900

Special to ISOs:

Same tax for all net proceeds = \$1900 capital gains

AMT

Alternative Minimum Tax

Counts the bargain element as income

at exercise

but it's complicated ...

Private Company ISOs

Buy & hold for ... ever?

1000 shares Strike price $0.10 Exercise price $1

Cost basis = 1000 x $0.10 = $100

Bargain element = 1000 x ($1 - $0.10) = $900

Can't sell until there's an exit:

acquisition ~ or ~ IPO

Lots of upfront cost that may never pay off

Private Company ISOs

AMT can be huge

10,000 shares   Strike price $0.10   Exercise price $5

Cost basis = 10,000 x $0.10 = $1000

Bargain element = 10,000 x ($5 - $0.10) =

$49,000

taxable "income"

Waiting for an exit

Schedule limitations

Termination *(voluntary or involuntary)*

Quit/fire/layoff is usually 90 days

(but some are offering much longer)

Death or disability may have a longer window

(like 12-18 months)

Expiration

10 years after grant date

Evaluating an Offer

General Considerations

- Are you taking a cut in salary?
  - How much?
  - When will you reach market value?
- If you made the higher salary, would you save it?
- Do you *need* for this to pay out big?

- What stage is the company in?
- How are its prospects?

- What type of equity is offered?

Evaluating an Offer

Questions to ask the company

- What % of the company are the options worth?
- What is the 409a valuation?

- How much has the company raised?
- When do you plan to raise more? How much are you aiming for?

- What are your exit dreams for the company? Acquisition? IPO? When do you hope this will happen?

Evaluating an Offer

How does your percentage compare?

- Check rough estimates based on position or hire #
- Check AngelList for similar positions at similar companies.

Calculating Possible Exits

Dilution and Preferred Shares

Dilution

Your option/share count stays the same, but your percentage will decrease as more investors join

Preferred Shares

Investors typically have preferred shares, which *usually* includes **liquidation preference**, which means investors get back what they put in, first.

So if a company raises $100M and sells for $100M, your shares are worth $0

Calculating Possible Exits

See what info you can get from the company

- Can I see a waterfall table of different exit scenarios? (unlikely, but possible)
- Let's say my stock is fully vested today, and the company sells for <current value>. What would I gain?
  - What about at 2x? 3x? 10x?
- What is the **liquidation overhang**?
- How much has the company raised?
  - Is all of that preferred with liquidation preference?
  - Do any investors have multipliers or participation rights? (This amplifies the liquidation preference.)

Calculating Possible Exits

Generate possible minimums

- How much would the company have to 'sell' for before your stock is worth anything?
- How much before you get back your lost salary?
- How much before it really gets interesting?

(Be sure to consider future funding in your calculations.)

How likely is this to happen? How long will it take?

Negotiation Points

Minimize upfront costs

Early exercise

Buy shares before vesting to eliminate bargain element

10,000 shares   Strike price $0.10   Exercise price $0.10

Cost basis = 10,000 x $0.10 = $1000

Bargain element = 10,000 x ($0.10 - $0.10) = $0

Restricted Stock *Award (not RSUs!)*

Similar benefits, except there's no purchase price - you're given the stock outright

(In both cases, you'll lose unvested shares if you leave early)

but don't forget ...

archival photo, Silicon Valley circa 2015

Negotiation Points

Keep your options on the table

Extended exercise period

Keep your options for years after you leave, so you can wait for an exit. Some may scoff, but companies are doing it.

Follow-on stock grants

See if the company has a policy for granting more stock over time, to curb dilution and get options with later expiration.

Accelerated vesting on acquisition

Avoid losing unvested options if the company is acquired (single-trigger) and lays you off (double-trigger).

After Accepting

Gotchas to watch out for

Get your grant

This is not your offer letter! It may be months before you get it, especially in a new startup. Try to ensure you get it before the company's valuation goes up.

Look before you leap

Before exercising options (especially buy & hold), make sure you know the tax implications. Get professional help!

Check for take-backs

Ask if the company has the right to repurchase vested shares. This can hurt (or sometimes help) you.

After Accepting

Reality Check

Money isn't everything

And stock options may never be money! Remember there are many reasons to join a company.

Satisfaction is perception

Wondering if you could have negotiated a better deal will not bring you more money or happiness. Celebrate what you achieved and move on!

(and new funding rounds are a great time to renegotiate!)