Allocating and Granting Equity in Start-Up Companies

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TOPICS TO BE COVERED:

- Overview of key terms and concepts
- How should equity be allocated and/or granted in a start-up?
- Overview of equity agreements

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THE BIG PICTURE

Equity generally refers to an ownership interest in a business enterprise

- can be thought of as the value remaining after all of the company's debts and liabilities are paid off (aka *equity value* or *residual value*)
- often used to refer to stock or membership units that represent an ownership interest in a company (i.e., *equity security* or *equity interest*)
- in accounting, *equity* refers to the amount of funds contributed by the owners plus the retained earnings (aka *shareholders' equity*)

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Balance Sheet of Newco, Inc.

As of December 31, 2011

ASSETS		LIABILITIES AND SHAREHOLDERS' EQUITY	
Cash and cash equivalents	$100,000	LIABILITIES:	
Accounts receivable	20,000	Accounts payable	$150,000
Equipment	500,000	Accrued compensation	10,000
Intangible assets	80,000	Notes payable	340,000
		Total liabilities	500,000
		SHAREHOLDERS' EQUITY	
		Common stock, par value $.01 (1,000,000 shares authorized; 50,000 issued and outstanding)	150,000
		Retained Earnings	50,000
		Total shareholders' equity	200,000
TOTAL ASSETS	**$700,000**	**TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY**	**$700,000**

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KEY DISTINCTIONS

- Corporation versus Limited Liability Company
- Stock (shares) versus Membership Interest (units)
- Board of Directors versus Board of Managers

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IMPORTANT TERMINOLOGY

- Authorized stock/authorized shares
- Issued and outstanding shares
- Options/warrants
- Fully diluted shares
- Par value
- Capitalization
- Capitalization table (aka *equity table*)

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Capitalization Table of Newco, Inc.
As of December 31, 2011

Shareholder	Issued and Outstanding Shares of Common Stock	Shares Underlying Options/Warrants	Fully Diluted Shares
Founder #1	20,000	-	20,000
Founder #2	20,000	-	20,000
Seed Investor	10,000	1,000	11,000
Director #1	-	3,000	3,000
Director #2	-	3,000	3,000
TOTAL	**50,000**	**7,000**	**57,000**

Authorized Shares: 1,000,000 shares of common stock, par value $.01 per share

Issued and Outstanding Shares: 50,000 shares of common stock

Fully Diluted Shares: 57,000 shares of common stock

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THINGS TO REMEMBER:

- There is no magic to share numbers; actual share numbers don't tell you anything by themselves
- Ownership percentage is more significant than share numbers, but even ownership percentage doesn't indicate value

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VALUATION IS EVERYTHING!

- Equity is worthless unless there is ultimately an *exit event* or *liquidity event*, such as a sale of the company or an IPO (or if the company makes and distributes significant cash flow)
- An *exit event* or *liquidity event* will presumably be priced based on valuation principles that investors and investment bankers utilize
- *Ergo*, it is important to have a general sense of valuation principles and concepts when discussing equity grants and allocations (even if a valuation event is far off)

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CRASH COURSE IN VALUATION

"Fair market value" is generally defined as what a willing buyer would pay a willing seller in a voluntary transaction in which neither is under a compulsion or obligation to buy or sell

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CRASH COURSE IN VALUATION (Cont'd)

Several possible ways to value a company:

- Net book value
- Net asset value
- Discounted cash flow (DCF)
- Market comparables

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CRASH COURSE IN VALUATION (Cont'd)

Terms that investors use:

- Pre-money valuation
- Post-money valuation
- Value per share
- Value per fully diluted share
- Founder stock
- Incentive equity
- Incentive pool (or option pool)

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CRASH COURSE IN VALUATION (Cont'd)

Question: How much equity would an investor get in Newco if the parties agreed that Newco had a total pre-money valuation of $12.0 million and the amount of the investment is $3.5 million?

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Purchase Price Calculation for Newco, Inc.

Shareholder	Issued and Outstanding Shares of Common Stock	Shares Underlying Options/Warrants	Fully Diluted Shares
Founder #1	20,000	-	20,000
Founder #2	20,000	-	20,000
Seed Investor	10,000	1,000	11,000
Director #1	-	3,000	3,000
Director #2	-	3,000	3,000
TOTAL	**50,000**	**7,000**	**57,000**

Pre-Money Valuation: $12,000,000
Fully Diluted Shares: 57,000
Value per fully diluted share: $ 210.53 per share

Amount of investment: $ 3,500,000
Price per share: $ 210.53
Total number o f shares issued: 16,625 shares

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CRASH COURSE IN VALUATION (Cont'd)

Valuation of Start-Ups:

- Market-comps often aren't available or helpful
- Projections are often a wild guess (and are often meaningless for life science and high-tech companies)
- Sometimes (maybe most of the time) the purchase price will have no relation to valuation principles
- Parties often back into a valuation based on "gut" feelings regarding desired percentage ownership
- Nevertheless, the resulting valuation potentially becomes a baseline

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ALLOCATION OF STOCK AMONG FOUNDERS

- Should generally be allocated based on relative value of contributions
- Should address what happens if a founder doesn't "stick around" or otherwise contribute what is expected
  - Vesting provisions
  - Buyback provisions
- For tax reasons, need to be careful about distinction between capital contributions and subsequent equity grants

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GRANTING EQUITY TO KEY TEAM MEMBERS

- Generally referred to as "incentive equity"
- Often granted to employees, contractors, directors, and sometimes vendors
- Need to clearly define and document what is expected of the grantee
- Don't forget that equity grants are taxable income in year of grant (or, if later, in year of vesting)
  - Use of options granted at FMV may help
  - In LLC, use of "profits interests" may help

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GRANTING EQUITY TO KEY TEAM MEMBERS (cont'd)

How much equity should I give someone such as a CEO, a Director, or a Chief Scientific Officer?

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GRANTING EQUITY TO KEY TEAM MEMBERS (cont'd)

- Equity should be "issued" by the company, not "given" by the founders
- Even though incentive equity grants result in a percentage ownership shift from founders to grantees, these grants should come from company (not from founders)
- Because of tax considerations, equity should generally be granted early but with vesting conditions to prevent the "over-grant" of equity

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ISSUING EQUITY TO INVESTORS

- Investors will often want some sort of preferred security, like convertible preferred stock or convertible debt
- Such securities will usually involve *preferred returns/dividends*, *liquidation preferences* and *distribution preferences*
- Beware of anti-dilution rights
- Many investors will want to limit the ability to grant incentive equity without triggering anti-dilution rights

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THE "D" WORD

Dilution is one of the most oft-discussed but least understood topics

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DILUTION

Potential different meanings of the word *dilution*:

- Dilution in ownership percentage
- Dilution in net book value per share
- Dilution in net asset value per share
- Dilution in earnings per share
- Dilution in economic value per share (*i.e.*, price dilution)

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DILUTION (cont'd)

- "Anti-dilution rights" that investors seek are usually intended to protect against dilution in economic value per share
- They are really worried about subsequent investors receiving equity at a per-share value less than what they paid, meaning that they overpaid
- "Price protection" is probably a more accurate term than "anti-dilution rights"

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DILUTION (cont'd)

Two general types of "price protection" anti-dilution rights:

- **"Full-ratchet" Anti-Dilution Rights**: If shares are issued at a price lower than my price, I get the lower price (even if only one share is issued).
- **"Weighted-Average" Anti-Dilution Rights**: If shares are issued at a lower price, I get a reduction in my price based on the relative amounts of equity issued in the two rounds.

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DILUTION (cont'd)

- Anti-dilution rights are typically implemented by adjustment to the conversion price of preferred stock or convertible debt, or by issuing new shares of common stock to the right holder
- These provisions are usually set forth directly in the investment agreements
- There are typically "exceptions" to the triggering of such rights, such as the issuance of incentive equity grants up to a certain percentage of the company's fully diluted outstanding shares or shares issued in certain non-financing transactions

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DILUTION (cont’d)

Protection against dilution in percentage ownership generally doesn’t make sense (and is unfair) except in limited circumstances:

- Certain seed-stage money and technology licensors
- Should generally be capped out

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EQUITY AGREEMENTS

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EQUITY AGREEMENTS

- Often also called by other names, such as "Shareholder Agreements" or "Investor Rights' Agreements"
- In LLCs, these matters are typically included directly in the Operating Agreement
- While such agreements are often required by investors (including universities), founders may want to have a separate agreement or may want to include provisions that the investors don't require

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Equity Agreements: Provisions relating to stock transfers

- Rights of first refusal
- Other transfer restrictions (i.e., transfers to competitors)
- Buyback rights upon involuntary transfers
- Buyback rights upon other triggering events

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EQUITY AGREEMENTS: PROVISIONS RELATING TO EQUITY ISSUANCES

- Anti-dilution Rights (full-ratchet or weighted-average)
- Preemptive Rights
- Registration Rights

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EQUITY AGREEMENTS: VOTING AND GOVERNANCE PROVISIONS

- Provisions that establish board size and composition
- Provisions that require shareholders to vote in favor of certain board members or in favor of other matters
- Provisions requiring a supermajority vote or investor consent for certain major items (often called *protective provisions*)

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EQUITY AGREEMENTS: DRAG-ALONGS AND TAG-ALONGS

- *Drag-along* provisions generally require shareholders to agree to sell their equity to a third party if certain investors or a majority of the shareholders want to sell the company.
- *Tag-along* provisions generally give minority shareholders a right to sell their equity to a third party if the majority shareholders want to sell out.

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Q&A

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