Equity, Vesting, & Valuation

What Is The Gap?

The grand canyon size gap between where you’re at right now and where you need to be before you become ubiquitously financeable. As in, you have enough traction to qualify for outside financing such as angel investors, VCs, and banks. To cross that gap we often have to use our equity as poker chips to pay for the people and things we need.

What Is A Fixed Equity Split?

When you give a co-founder or vendor equity without any tool for clawing it back. Meaning the percentage stays the same, regardless of circumstance.

The percentage won’t go down if they leave; stop providing value; or are even fired.

Why Is Equity Sometimes Referred To As Splitting Pie?

- It represents a pie chart showcasing what percentage of the business everyone owns. For the purposes of this class, a more ominous and jaded answer to this question is: once equity is distributed, it’s eaten, and you can’t get it back.

- When we say a pie is baking, in the context of startups, what do we mean?

- Why is it dangerous to split pie before we bake it?

- Why is it dangerous to split pie after we’ve baked it?

What Is Dead Equity And Why Is It So Problematic?

- Equity owned by a co-founder or partner who didn't provide the value you thought they agreed to, and now they're gone. Either because they quit, or were fired, and you have little-to-zero legal ramifications for getting it back.

- Not to be confused with someone (or money), that came in, did a job to completion, and left. This is either called, vested (if they're a human) or invested (if it's cash or some other injection of capital).

- Dead equity demotivates you, the founder.

- It signals to later stage investors there was an entrepreneurial mismanagement. Which makes them ask, how many other mistakes were made. It also makes them ask themselves how much of your motivation was lost with their equity.

What Is A Vesting Schedule?

- A pre-negotiated stock percentage ownership by a co-founder or vendor.
- It is not earned upfront, but a little bit at a time, over a negotiated amount of time.
- An example might be:
    - Sarah gives her friend 25% of her business to be her co-founder
    - She puts her on a five year vesting schedule.
    - Every year she continues to do her job as a co-founder, she earns another 5%.
    - If she quits after a year, she keeps 5%. After two years, 10%, etc. After five years, she's maxed out the amount of equity she can earn in the company (25%).
    - Hopefully by that point she stays because of her love for the company and it's mission….AND….by that time the company should be strong enough to motivate its people the way normal humans are motivated (salaries, raises, perks, etc.)

The Advantages Of A Vesting Schedule

- Gives the person you’re courting more equity because you the founder have more confidence that they’ll be there for the distance.

- Protects you in-case they are in it for the wrong reason.

- It forces the aspiring co-founder to ask themselves if they can really get away with providing the value that they’re promising. Because if they can’t, their compensation can be taken away. This is clearly different than an employment role where a person can hide & stall within a company until they’re fired.

- Portrays a level of sophistication to later-stage investors.

- Protects you from dead equity.

- Every business attorney worth their salt has written vesting schedules, so they’re very easy modules to add to an operating agreement.

What Is A Cliff?

- A cliff is another variable that changes the structure of the deal.
- It protects the founder from having to give any equity at all until a certain minimum amount of work/value time has been showcased.
- For example, if we're still Sarah, giving our co-founder 25% of our business, on a five year vesting schedule (5% every year)….a cliff would protect us from having to give her anything if she only lasts a month.
- This is mainly to prevent people from saying yes, doing nothing, and earning the clip of equity. In this case (without a cliff), she could sign the deal, never do anything, and earn 5%.

Mirroring A Vesting Schedule's Variables To Both Your Motivations & That Of Your New Partner

- Total time of vesting
- Cliff
- Total amount of equity up for grabs

Why Is It Important To Understand Valuation?

- Entrepreneurs need to do a better job understanding that they're the biggest investor in their business by far, and that your business is an investment asset. One needs to be able to track how inputs translate into value.

- It's a crucial step in raising money.

- It's a crucial step in splitting equity with co-founders or partners.

Valuing A Startup Is More Like Valuing Art Than It Is Valuing A Business.

You are what the market says you are.

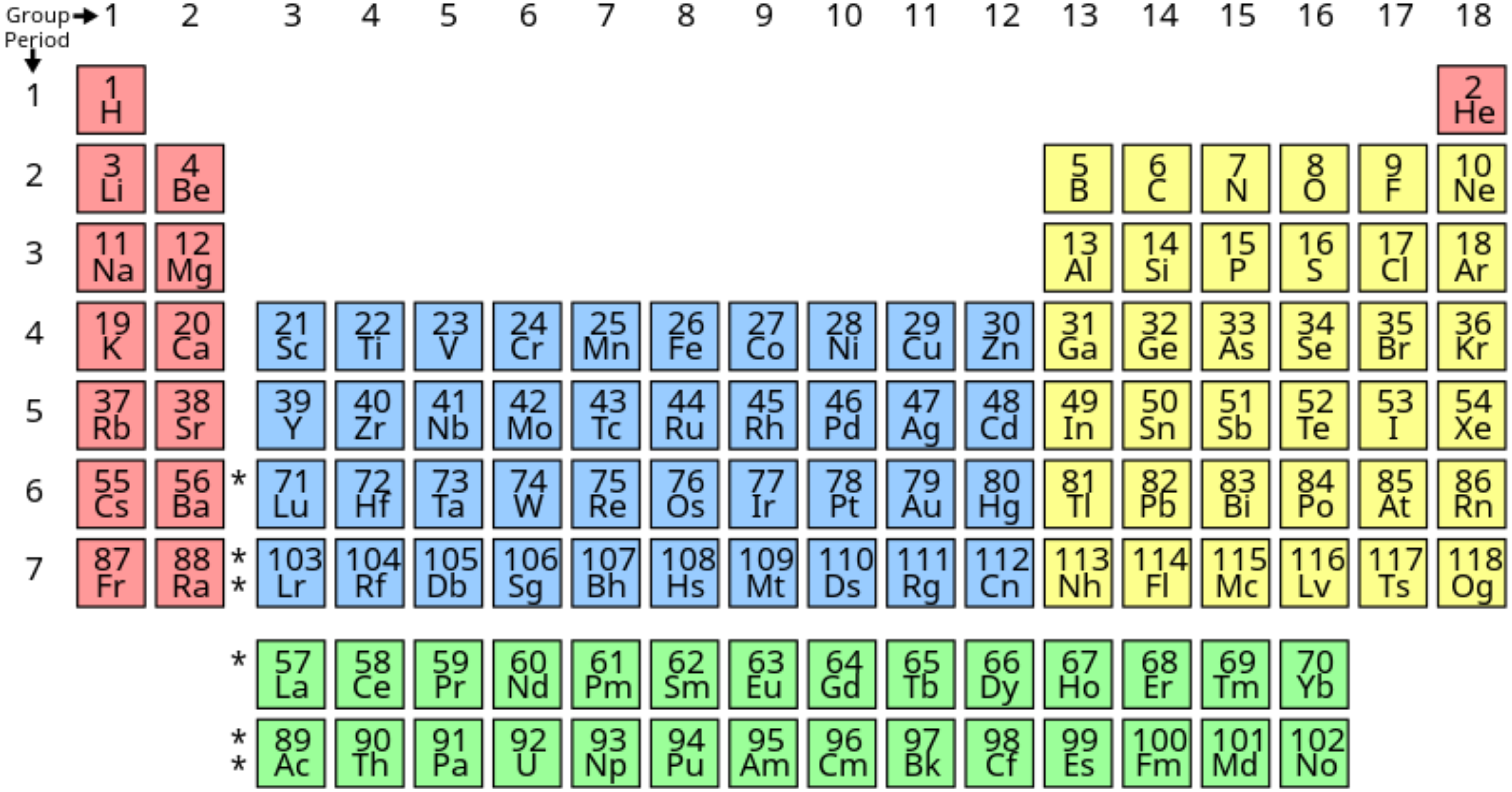
What Is A Multiple?

- A multiple is a quick and oversimplification of valuing your business on the fly by taking a “multiple” of your earnings.
    - So if your business is making $1M a year, and you have a multiple of 3, your business is worth $3M.
    - “Earnings” was a purposely vague word. Half of investors think a multiple is of profit, half think it’s of revenue.

What Increases A Multiple?

- How SAFELY you can PROTECT your earnings into the future
- The scalability of the business model
- The billion tangible and intangible variables to be discussed throughout the rest of this class.

Think of the variables an investor or acquirer will be tallying like points on a rubric, or period table. Meaning there are different categories in which one can score points, and within those categories there are different items that are worth different amounts.



What Are The Main Variables Being Assessed?

- Comparables (geographic, stage, industry, recency)
- Traction (revenue/profit, downloads, users, repeat usage)
- Money spent (total and quality)
- Patents & technology
- Owned media/lists
- Hard to come by partnerships
- Innovation accounting metrics that imply (a) value and (b) growth
- Advisors and aligned entities
- Purchase orders
- Sex appeal of the business
- Reviews/testimonials/social proof/buzz

The Team & Founder

- Startup experience
    - Stage experience
    - Industry experience
- Wow factor of the founder
- Perceived value of the team and their dynamic
- Bootstrapper’s story
- How well do you play the game