Founders’ Guide to Startup Equity

“Investing is the intersection of economics and psychology.” Seth Klarman

The Founders of a company face one of the most foretelling discussions regarding the future of their enterprise. Who owns how much of the business and when?

There are several factors that are pivotal such as whose idea was the product or service? Who will carry the largest burden of risk in building the company? Which Founder or Founders will work the hardest to make the entity successful? Who is in for the long-haul?

Many times Founders are friends, family or colleagues. This can make the questions above emotionally charged and potentially divisive. If the Founding Team holds their equity too tight, people may not want to work with them. If they give too much equity away too soon, they dilute the value for everyone involved.

Equity Structure for Startups

One of the most stable and long-lasting forms of equity structure is called the “Layered Approach.” It involves three main layers of ownership based on the premise that as the business grows it must add more team members to build on its success. Those layers are the “Founding Layer,” “Executive Layer” and the “Employee Layer.”

Founding Layer

This layer consists of the Founder or Founders. These are the people with the original business idea. They created the vision and are the first evangelists for the enterprise. Founders typically are Strategists by nature.

They must grapple with who will get what equity percentage based on their commitment to the success of the business. The guiding principle is risk versus reward. People willing to assume the largest amount of risk are entitled to the greatest share of the rewards.

Executive Layer

Strategy is ineffective without execution. Someone has to do the hard work of making the Founders’ dreams a reality. Building the business is what drives value. This is the job of the Executives. Their role is critical. They are normally brought onboard after the business has received money from the Founders, Investors or revenue from the business itself.

Executives are not required to assume as much risk as the Founders because the business was brought into existence before they arrived. As a result, they are typically not awarded as much

ownership of the company.

Employee Layer

The first layer of employees is vital to the sustainability of the firm. Without them, the business cannot survive. They are responsible for performing the work of the business. Employees do the largest share of the heavy lifting to move the organization forward.

Successive layers of employees must be added as demand for the company's products and services continue to grow. Managers are hired to direct sales, production and operation teams.

Growth Timeline

Each layer is normally one year or more in length. Research shows the most successful enterprises build three layers or more depending on the industry they are in. The layers consist of the Founders, Executives and multiple levels of employees.

Each added layer strengthens the foundation. For example, there may be two Founders in layer one, four Executives in layer two, and ten or more employees in layer three. Each layer takes on a lesser amount of risk as the business grows and is therefore entitled to less ownership.

Vesting Rights

The most common form of ownership is corporate stock shares. In order to maximize the investment of each individual, stock ownership must vest over time. Four to five years is ideal because it generally takes at least that long to achieve full profitability. No one should receive vesting rights until after their first year of service.

A popular vesting formula is twenty-five percent after the first year and two percent every month thereafter until the person is fully vested. Vesting is essential for optimizing stability, inspiring growth, and maximizing participation in the venture as it matures.

Investor Ownership

Whenever the corporation sells stock to an investor, the investment dilutes the ownership of all the previous owners. This can be a good thing if the money is used properly to expand the business. It can be a disaster if the money is not used wisely because it can lead to major stakeholders selling their percentages if they think the company is moving in the wrong direction.

There is no one single panacea to what we call the "Founders' Dilemma" of trading equity for capital. However, careful business planning and forethought can help steer the organization to make the best possible decisions early in its development.

How We Can Help You

Pacific Crest Group (PCG) provides professional services that keep your business focused on your critical objectives. We provide strategic Accounting and Human Resource (HR) services created specifically to help you meet your goals. Through exemplary customer service, clearly defined policies and procedures as well as a forward-looking perspective, we provide the outsourced solutions your business needs to grow. A PCG professional is happy to meet with you to discuss solutions for your unique requirements designed to maximize all of your business opportunities.