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Stock Options 101

Understanding and Evaluating Your Compensation Package

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About This Workshop

- I am neither a financial planner nor accountant
- Educational, not financial advice
- Based primarily on:
 - *Stock Options for Dummies*
 - My personal knowledge
- For formal individualized advice :
 - Consult legal advisor before signing the contract
 - Consult HR, financial planner and/or tax accountant before exercising or selling



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Workshop Outline

- Benefits of Employee Stock Options
- Basic Concepts
- Evaluating
 - Yourself and your situation
 - Overall compensation & other factors
 - Company health and future prospects
- Negotiating
- FYI: Topics for the Future
- Questions

This workshop does not address:

- Publicly traded stock options (puts, calls, etc.)
- Employee Stock Purchase Plans (ESPP's)



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How Do Stock Options Benefit Employers?

- Attract employees in competitive labor market
- Allow employer to shift cash from compensation to other corporate priorities
- Having (or the prospect of having) an ownership stake in company increases employee commitment and engagement
- Retain employees
 - Stock option plans are designed for retention (more later)
 - Hooked by *potential* windfall looming in the near future (“golden handcuffs”)
 - May grant additional options so employees always have some money “on the table”
 - Must make Buy/No Buy decision within 30-60 days of leaving organization



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Why Are Stock Options Appealing to Employees?

- Exciting potential
- Have prospect of ownership stake in company
- Shift risk-reward paradigm
 - Increase potential profit if you can buy stock at a discount
 - Eliminate some downside (losing) scenarios
 - May have more information before putting your money at risk
 - Hard (but not impossible) to lose money



Background

Stock:

- Partial ownership of a company
- Ownership stakes (shares) are bought and sold on public stock markets
- Demand for (and market price of) shares rises and falls as investor perceptions and expectations of the company change.
- The amount you invest is at risk
- Unrealized gain/loss (“on paper”) until you sell

Realized gain/loss =

FMV when sold – FMV when bought – broker’s fees – taxes

(FMV = fair market value)

Stock Options: Basic Concept

Option: the *right* (not an obligation) to purchase (or not) a specified number of shares at a contractually specified price (“strike price”) for a set period of time

- ref *Stock Options for Dummies*

Exercise option when current market price $>$ strike price:

- Ensures a gain (on paper) before you risk money out of your pocket

Don't exercise option when current market price $<$ strike price:

- You risk no money out of your pocket

- You neither gain nor lose money

➔ Reduces risk; greater potential upside than downside

➔ Similar to deciding to bet (or not) your own money after watching part of a sporting event

Important Qualifiers

- An assured *paper* gain (at time of exercise) does NOT ensure a *real* gain (at time of sale)

Realized gain/loss =

FMV *when sold* – (strike price X number of shares) – broker's fees – taxes

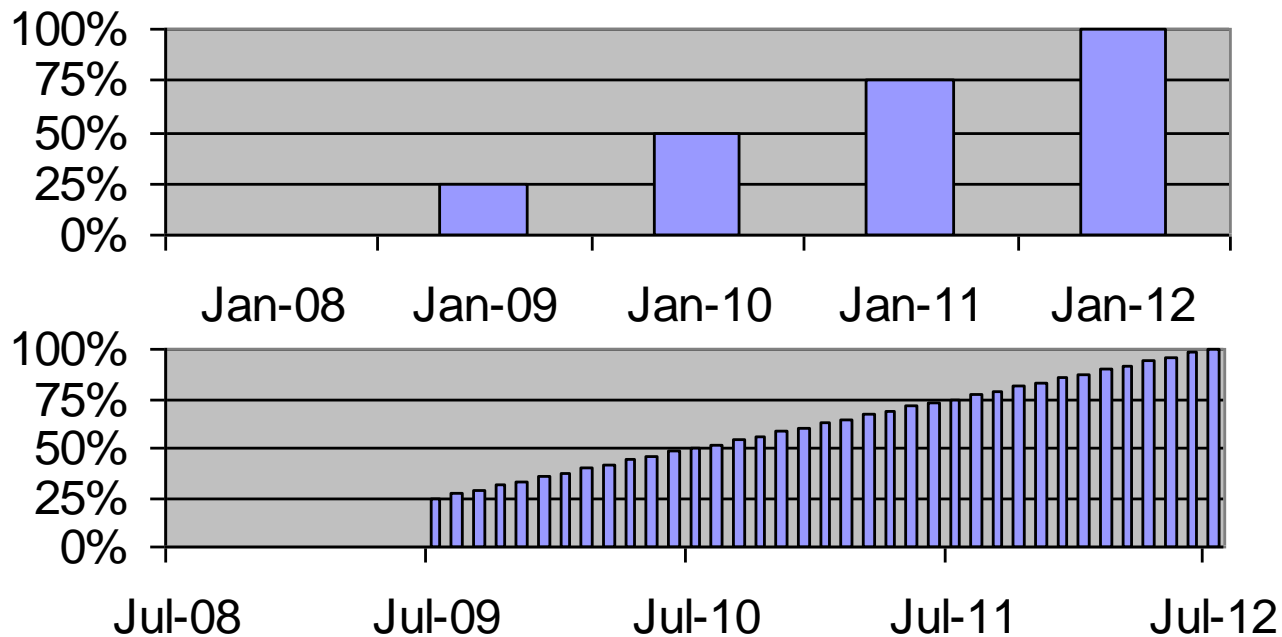
- Less likely (though still possible) to lose money
- Options reduce (but don't eliminate) some types of risk
- No ownership stake or out-of-pocket risk until you exercise your option (buy shares)
- There are restrictions on how, when and if you can exercise your options

Stock Option Essentials

- Type of plan:
 - Incentive Stock Option (ISO) vs. Non-Qualified Stock Option (NQSO)
 - Has important exercise and income tax consequences!
- Date of stock option grant
- Exercise or option price (“strike price”)
 - Fair market value on grant date (if publicly traded company) OR
 - Price set by Board of Directors and I bankers (if private company)
- Maximum number of shares that may be purchased
- Expiration date
 - Typically 10 years after grant

More Stock Option Essentials

- Vesting schedule
 - When are options available for you to exercise?
 - Typically vest 25% of total grant after each year of employment
 - Cliff (annual) vs. staircase (monthly) vesting



Terminology

- “Privately held” “Pre-IPO”
 - New companies owned by a small number of founders, executives and venture capitalists
 - No market exists for buying and selling company shares; FMV = \$0
 - Pre-IPO options have very low strike prices (typically \$0.01 - \$10), offering the greatest potential “upside” as well as the greatest risk
- Initial Public Offering (IPO)
 - A transformational event when company shares are first put on the market for general purchase by the public
- “Publicly traded” “Post-IPO”
 - Describes companies with shares bought & sold on the open market
 - Share price (FMV) is determined by supply & demand
 - Strike price = FMV on grant date
- Post-IPO lock-up and blackout periods
 - Employees cannot buy and/or sell shares for 90 or more days

More Terminology

- “Under water”
 - The market price of company stock < the strike price of your options
 - Your options are worthless 😞
- “In the money”
 - The market price of company stock > the strike price of your options
 - You have a potential windfall—at least on paper. 😊
- “On paper”
 - Until you sell shares of stock, you have *unrealized gains*
 - Critical distinction between a mathematical calculation of your *potential* profit and the *reality* of having money in your bank account
- “Golden handcuffs”
 - Unwillingness to leave job and relinquish options when a *potential* windfall (future IPO? vesting anniversary?) is still “on the table”

Requirements for Realizing a Gain from Stock Options

ALL of the following must occur:

1. Company must be *publicly traded*
2. Have *vested* options available to exercise
3. Current market price > strike price (“*in the money*” but still only “*paper profit*”)
4. *Exercise* some or all options (buy shares)
5. *Sell* shares at a market price > strike price
6. Manage and pay your *tax liability*

Lacking #1, #2 or #3 your stock options are worthless 😊

Worst-case scenarios in #4, #5 or #6 may result in a loss 😞

Historical Perspectives on Risk and Reward

- Between 1995 – 2007, nationwide statistics show:
 - ~5449 companies received VC start-up/seed capital (ref MoneyTree)
 - ~1775 VC-funded companies successfully completed an IPO
(ref J.R. Ritter, U. of Florida, <http://bear.cba.ufl.edu/ritter>)
 - ➔ ~33% of companies had successful IPO
 - ➔ ~67% did not try or were not successful with IPO
- The median age of companies successfully completing IPO's was 7 years (from founding to IPO) (ref J.R. Ritter)
- Average change in stock price over 3 yrs following IPO in . . .

1995 – 1998	+ 36%	
1999 – 2000	- 51%	(ref J.R. Ritter)
2001 – 2005	+ 36%	

Which Compensation Package is Right for You?

Job Offer	#1	#2	#3	#4
Company Stage	Early Stage Seed funding	Pre-IPO Series ABC funding	Public	Large public
Salary	\$70k	\$75k	\$80k	\$80k salary + \$5k perks
# of Stock Options	10,000	2,500	1,000	1,000
Strike Price	\$1	\$5	\$20	\$20

Consider All Elements of Your Employment Package

- Stock options are only one part of compensation package
- Monetary compensation is only one part of overall employment package
- Consider also what you need and want for:
 - Work content, environment, people and company culture
 - Organization, industry and location
 - Travel, work hours and work-life balance
 - Job title, training, advancement opportunity and career path
 - Does it feel like a good fit?

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Evaluate Your Needs

- What are your values? Needs? Wants?
- What is your innate risk tolerance?
 - See Ch. 7 of *Sizing Up a Start-Up*
- Do you have an entrepreneurial attitude?
 - Crave high-risk/high-reward situations
 - Typically in early/out early, seeking big profit within 4-6 yr timeframe (i.e. early or pre-IPO)
- Or are you a long-term employee?
 - Prefer stability & predictability; ~10 yr timeline
 - Stock option profit is a bonus (“icing on cake”)
- Do your current circumstances allow for risk-taking or require risk-management?
 - Bank balance, family, mortgage

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Evaluate the Company!

- Assess company stage, health & potential!
 - How well funded? Is it making money? A profit?
 - Cash, sales, business model, demand, product
 - Stable, qualified management team?
 - Steady growth? Low employee turnover?
 - Competitive landscape?
 - Stock price history or likelihood of IPO
- More important than stock plan details!

References (in CDC Library):

- *Stock Options for Dummies*
- *Sizing Up a Start-Up*



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Evaluate the Options Plan and Package

After you decide which company is best:

- Get & read its stock option plan & contract
 - Get help interpreting it
 - Contact HR/stock administrator re questions
- All essential info should be clear
- Determine your ownership stake (%)
 - How many total shares are outstanding?
 - See HR or EDGAR online for SEC records



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Negotiating

- Press for fair market salary (options = unknown, unpredictable bonus)
- Pre-IPO vs. publicly traded
- Stage & size of company
 - Funding phase



What May Be Negotiable

Company Stage	Early Stage Seed funding	Pre-IPO Series ABC	Public	Large public
ISO vs NQSO	Probably not	No	No	No
Strike Price	No	No	No FMV at grant	No FMV at grant
# of Options	Yes	Probably	Somewhat	Somewhat
Ownership Guidelines	0.1 - 3% (roughly)	0.01 - 0.5% (roughly)	0.001-0.01% (roughly)	<0.001% (roughly)
Vesting Schedule	Maybe	Probably not	No	No

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FYI: Important Future Concerns

- Cashless exercise; same-day exercise and sale
- Split, replacement and “clawback” clauses
- Potential tax pitfalls
 - Tax implications at time of grant?
 - Short-term vs. long-term capital gains
 - Alternative Minimum Tax (AMT)!!
 - Taxes may exceed cash realized from exercise
 - Tax laws change frequently
- Exercising options before IPO or before vesting (Section 83b)?
 - Risky strategy to reduce future tax liability
- **Consult financial planner & tax accountant before exercising or selling!!**

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Additional Resources

- Career Resource Library
 - *Stock Options for Dummies*
 - *Sizing Up a Start-Up*
 - *Stock Options* (more advanced details)
- Stock option websites:
 - www.myStockOptions.com
 - www.stock-options.com
 - National Center for Employee Ownership
www.nceo.org
- Funding levels & IPO status (by company)
 - SEC filings www.edgar-online.com
 - SJ Mercury News VC Survey
www.mercurynews.com/vcsurvey
 - MoneyTree www.pwcmoneytree.com/MTPublic

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Thank You for Attending

- Any questions?
- Please fill out the evaluation form

