Equity Fundamentals

Part 2

The answers you need to start using your equity to grow your business.

Introduction

This guide, the second in a series, will give you fundamental knowledge about how you might use the equity in your UK business.

In part one you learnt what shares are, now discover how you can use them.

The answers we provide are based on real questions we've been asked by businesses looking to get more out of their equity.

If there are still things you want to know at the end of the guide, then look out for our third edition coming out soon. Can't wait until then? Just get in touch with us at hello@vestd.com

Cheers
Ifty Nasir, CEO at Vestd

Average reading time: 10 minutes

Contents

1 What is equity dilution?

2 Why would a company issue new shares?

3 What are the alternative ways of issuing shares?

1

What is equity dilution?

In part one of this series we dealt with what shares and nominal values are, and how many shares, of what class, a company might choose to issue when they incorporate.

As part of the incorporation process the company also has to decide how the shares are split between the founders of the company.

As an example, let us assume that a company has 100 shares and they are split between Jane who has 60 shares (60%), and Dave who has 40 shares (40%).

The company decides to issue 25 new shares to Rachel in return for a £20,000 investment. This means that:

- Rachel then has 25 out of a new total of 125 shares, so 20% of the business (and implies that the business, post investment, is now worth £100,000)
- Jane's share will now be 60 out of 125 shares, or 48%
- Dave's share will be 40 out of 125, shares or 32%

Each time more ordinary shares are issued, the same dilution process happens and the stakes of existing shareholders in the company reduce accordingly.

2

Why would a company issue new shares?

A company's equity is a very powerful thing, and is increasingly being used for a number of different purposes.

In all cases issuing new shares leads to equity dilution as explained above. The critical question for any founder is whether the company is better off with or without the benefits that this dilution enables.

Probably the two most common reasons for issuance are:

- In return for financial investment
- To reward the support of the people who are helping to build and grow the business

Equity in return for investment

Unless a company can get access to loans to help it through its progress towards revenue and then cash generation, it is likely to need capital to fund this stage of its life.

This capital typically comes from founders at first, then friends and families, and then maybe angel investors and venture capital as the business matures and shows traction.

It is important to understand the cumulative effect of investment on dilution when planning how to do this.

Using our earlier example:

- A founder has 100% of the company at the start, and needs three rounds of external investment
- Each of these rounds takes 20% of the business (post investment)
- The founder now has 51.2%
- If it were 30% equity given each time the founder's share would have dropped to 34.3%.

The challenge is that at an early stage the level of risk associated with the business is very high, so the amount of equity that needs to be given for the investment also tends to be high - but without it the business cannot develop.

Equity to reward support

There is no doubt that giving a person a share of a company dramatically changes their relationship with it. They want it to succeed, not just because they work for the company or are a customer, but because they have a vested interest in its success. They become an advocate rather than just having a transactional relationship.

The support that can be given can take many forms:

- Intellectual support (i.e advice or contribution to business development)

- Ambassadorial support (presenting and supporting the company and its products to a person's networks)
- Revenue support (committing to be a customer for a certain period)

Most companies either give, or would like to give, their team shares as a reward for being part of making it a success. This may well be employees, but also can be contractors, advisers or consultants. The percentages of the business that people give varies enormously. A critical team member who is not yet an employee may be worth 5% or 10% , but an occasional supporting contractor could be just fractions of 1%.

It is also worth considering whether it could make a difference to award small portions of your equity to other people who are key to your company's success - these could be ambassadors, partners or early stage customers. In all cases you can create a powerful alignment with key contributors to your growth by giving them a reason to help you succeed. The amounts awarded to each person are likely to be small, as the intent is to create alignment and emotional connection, rather than necessarily a major financial incentive.

3

What are the alternative ways of issuing shares?

Once a company has decided that it wants to issue shares, either for investment or to reward team members and others who are helping to grow the business, there are a number of ways of going about it. For ease of explanation we have split this into:

- Unconditional share issuance
- Share issuance on set terms
- Options

Unconditional share issuance

If a company is issuing shares in return for investment, issuing unconditional shares will almost certainly be the route that is followed. This means that the recipient will have immediate and irrevocable legal and beneficial ownership of the shares.

These new ordinary shares are issued and fully paid for at a premium that reflects the potential worth of the company at the time.

The company can also choose to issue unconditional shares for people who are part of building the business, but there are two things to be aware of:

1. Once issued, they can’t be taken back - there are no “strings attached”
2. If the company has value at the point of issuing the shares, and the recipient does not pay that per share value for them, then they will be liable for income tax on the difference between what they have paid and the “market value” at the time

Share issuance on set terms

So while with unconditional shares can't be taken back once they're given, it is possible to issue shares that are conditional. That is to say, the recipient only has irrevocable ownership once certain requirements are met - these could be time based or milestone based, before the shares become unconditionally owned by the recipient.

This is an attractive option for a company that wants to reward or incentivise someone with real shares but wants to ensure that certain criteria are met for them to be fully handed over.

For a company to be able to do this, it would need to include a number of specific clauses within its Articles of Association.

In addition, if a company were to adopt specific Articles, it can also address the second issue mentioned above (the income tax implications that come with not paying full market value for shares). It can do this by ensuring that any shares issued are growth shares (as described in part one), and so do not cause the recipient to have to pay income tax upon receipt of them.

Options

The other way of issuing shares that have conditions attached to them is via Options.

In this case the recipient does not get any real shares at that point, but does get the right to turn these options into shares by exercising them at a later date once the set criteria are met (whether time or milestone based).

On exercise of the options, the recipient will be due income tax on any difference between the price they pay, and the market value of the shares at the time (unless the options are for employees and are part of an EMI scheme, in which case it is the value of the shares when they were originally awarded).

There is a great deal of detail around qualifying (and maintaining that status) for EMI schemes, and this will be addressed in a subsequent edition.

We can help you do more with your equity

We minimise the cost and complexity through a secure online platform.

Issue equity flexibly and simply on the conditions and timescales you set.

Incentivise and retain your team, share the success of what you build together.

Learn more about your equity opportunities by emailing hello@vestd.com