An Employee's Guide to **Share Options and ESOPs**

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Introduction

Welcome! If you're reading this, you might just have accepted a new job at a startup – a job that gives you equity in a growing company. Or, you might already own share options in a startup, and you're wondering exactly how to make sense of your equity stake.

Share options give work a whole new meaning. You're not just taking home a salary each month: you're working towards owning a piece of your company. But for many people, their equity means lots of new questions about your compensation. When do my share options turn into shares? Why do my share options 'vest'? What happens if and when I leave the company?

This one-stop guide to share options and employee share option plans (ESOPs) will help you answer these questions, and many more besides. Remember: this is just a guide. You should always check with your employer to find out exactly what your company's ESOP and equity policy means for your compensation.

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What's a share option?

Shares and share options are not the same. A share is a unit of ownership in a company; it almost always costs money to acquire shares. A share option is the right to buy a share at a point in the future. Companies can give share options to employees without any money changing hands. Share options turn into shares once the options have vested and an exercise window has opened (more on those later).

You might see people talk about 'share options' and 'stock options'. These terms refer to the same thing: share options are more commonly used in Europe, while stock options are more often used in the US.

Share classes and voting rights

Companies often have different classes of share represented on their cap tables. You're likely to have the right to acquire **common shares** in your company. Common shares differ from **preferred shares**, which are usually the class of share held by investors. In case you're wondering, it's typical for founders to also hold common stock.

In most companies, shareholders get to vote in annual general meetings and when there are particular events that are important to the company, like when board members and/or company directors change. Share options don't come with voting rights, and even when you convert your options into shares, it's rare for common stockholders to have the right to vote on these kinds of resolutions.

Inside ESOPs

Your share options will be part of your company's employee share option plan (ESOP). Company directors can choose who is granted access to share options under the terms of the ESOP. Some companies choose to grant equity to all employees, while others restrict share option awards to select groups of employees.

ESOPs are useful for startups because younger companies rarely have the cash on hand to compete against much larger businesses for top talent. Instead, equity rewards employees for the long-term effort they put in helping to build the business.

Share options aren't the only way companies distribute equity stakes to the team: some types of ESOP award actual shares rather than share options (like growth share schemes in the UK). In some countries, most prominently Germany, it's more common to award virtual shares.

While investors acquire shares with cash, ESOPs allow you to earn your right to share options over time and pay a discounted price to turn those options into shares. If the company's share price increases over time, so too will the amount of profit you can make when you sell your shares.

Companies can opt to set up ESOPs without any agreements with the tax authorities. But many companies choose to set up ESOPs that are 'approved' by the relevant market's tax authority. This means the company valuation, and the strike price you need to pay to exercise your options and turn them into shares, have been judged to be fair. Approved ESOPs – such as enterprise management incentive (EMI) schemes in the UK – come with tax advantages for employees: if you sell your shares at a profit, your profits will be taxed as capital gains rather than as income, meaning you'll keep more of your earnings.

ESOPs across Europe

Decades ago, tech companies in the US popularized the practice of including equity as part of employees' compensation packages. Companies in Europe saw equity as a 'nice to have' rather than a must-have until relatively recently, but adoption is increasing rapidly. 44% of the European companies surveyed in Ledgy's 2023 State of Equity and Ownership report gave share options to at least some employees.

The bad news is that when it comes to share options, there is little standardization across geographies. Different countries operate different government-approved ESOPs. For early-stage companies in the UK, for instance, the most popular type of ESOP is the EMI scheme. France operates a similar scheme known as bons de souscription de parts de créateurs d'entreprise (BSPCE). More than 50% of the French companies that award share options to employees use BSPCE schemes to do so.

However, not every country has caught up. Companies find it very difficult to issue ESOPs in Germany due to the administrative overhead. To make matters worse, when you sell your share options using an ESOP in Germany, your tax burden can be very high (over 60%). German companies have turned to virtual share option plans (VSOPs) as a way around the complexities of setting up ESOPs.

The value of your equity

It seems like a simple question: how much is my equity actually worth? But too often, employees find it difficult to understand the value of their share options. So what information do you need in order to understand the monetary value of your ownership stake?

The data you need to value your equity

- **The number of share options you're being granted.** You should find this in the share option agreement between you and your employer.
- **The latest company valuation.** Companies with approved ESOPs should be able to share an up-to-date valuation with you, which will have been vetted by the relevant tax authority. Factors that influence the company valuation can include the rate of revenue growth, margin and profitability, and macroeconomic conditions affecting the sector.
- **Your ownership percentage.** It's important to know what percentage of the company's fully diluted share capital you'll own when your options are converted into shares.
- **The strike price you'll need to pay to turn your options into shares.** Again, companies with approved ESOPs should have agreed the strike price you'll be asked to pay to exercise your share options and become a shareholder.

How does your share option turn into a share, and then into cash, over time?

At each stage, your equity means something slightly different. Initially, you have an agreement to own a stake in your company at some point in the future. Then, over time, you acquire a real slice of the business. And finally, depending on what you choose to do in a liquidity event, your shares turn into cash.

Share option agreement signed, you're an option holder!
Usually when you join your new company, or when your company sets up its ESOP

Share options vest
Happens over time, often over a four-year period

Exercise your vested options – become a shareholder
Occurs when your company opens an exercise window. You'll pay the strike price per share option to turn your options into shares

Cash out
Usually takes place at a liquidity event such as an IPO or acquisition

But you need a liquidity event to happen first: without a secondary share sale, tender offer, IPO or acquisition, your equity won't turn into money in your bank account. And at each stage prior to the liquidity event, the value of your equity will only ever be a guide.

There are a couple of things it's important to remember. Firstly, stock options often have expiration dates, meaning that if they are not exercised within a certain period (for example, 10 years from the date they were granted), your options may no longer be worth anything. You need to be aware of this deadline if it exists.

And finally, don't forget that you're acquiring a stake in a young, 'high-risk' business. If the share price increases, your financial gain from your equity will increase too. But if the company valuation or share price falls, your shares could end up being worth less than you agreed to pay for them. We'll also cover the impact taxes have on your financial outcome later on.

How vesting works

If you have a share option agreement with your company, you'll see that you don't get awarded all your shares immediately after signing the contract. Instead, your share options vest over time.

Equity is designed to reward employees for their efforts over time, unlike, let's say, bonuses which are paid out as a lump sum. Your company will set out in your contract how many of your share options will vest each month, quarter or year (vesting normally happens in monthly increments). But pay attention, because you'll only start to see these regular vesting milestones once you've passed your cliff...

What's a cliff?

A cliff is the period of time you have to work before being granted rights over any of your share options. The cliff is designed to prevent people qualifying for equity without making a significant contribution to the growth of the business.

It's becoming normal for share options to vest over a period of four years with a 12-month cliff at the start of the vesting schedule.

78%

of companies in the US have at least some shares vesting over four years with a 12-month cliff.

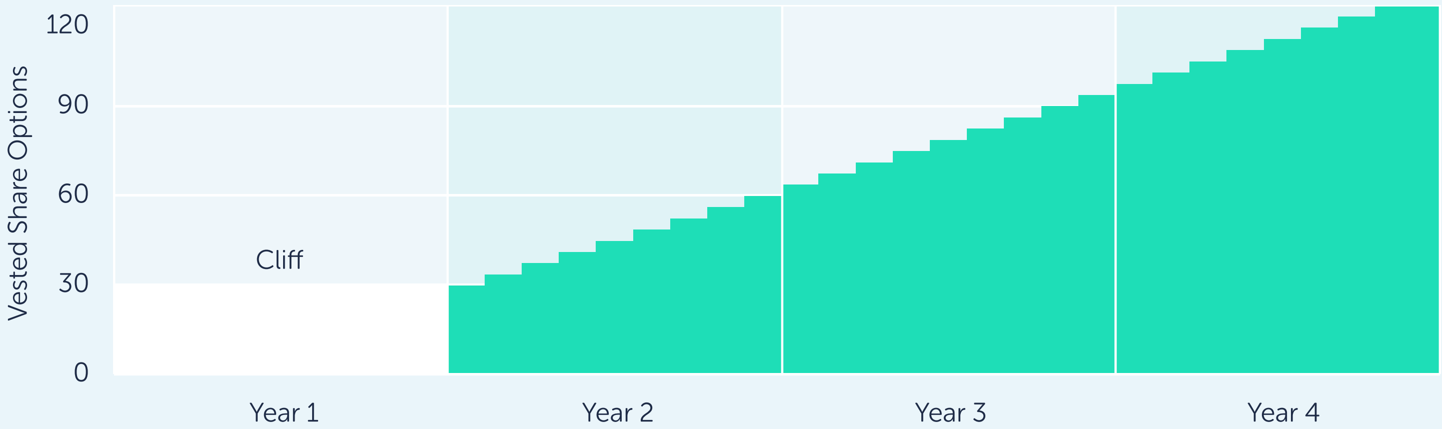
67%

of companies use this vesting model on average in the UK, Germany and France.

How vesting works (cont.)

Following this schedule, you'd have 25% of your shares vesting in one go after one year, with the rest of your options vesting in regular increments over the next three years:

Example 4 year vesting schedule with a 1 year cliff



Your original share option grant is one thing, but some companies also offer new grants to employees when they get to the end of their four-year vesting schedule, or when people reach professional mile-stones like promotions. This means you may have multiple grants vesting on different schedules.

Exercising share options

Exercising is the process by which share options turn into shares. Put simply, you buy your vested shares from your employer by paying the 'strike price' per share. The strike price is the agreed price employees have to pay to convert options into shares. Your strike price per share will usually be lower than the share price, meaning you acquire your shares at a discount compared to what investors might pay.

It's up to companies to set the strike price per share for employees. Ledgy data suggests that between 40% and 50% of companies choose to keep their strike prices 'nominal', which generally means lower than €1 / £1. Other companies elect to have the strike price increase in proportion to any increases in the share price.

It's up to the company to decide when you can exercise your options. The directors decide to open up a window for exercising options – a short period of time in which you can decide whether or not to pay the strike price per share and turn your options into shares. Exercise windows don't come along all the time: typically, exercise windows open every couple of years, or at milestone events like funding rounds.

It's worth noting that you have to have enough cash on hand to actually exercise your share options. Although many companies seek to keep strike prices low, this can still represent a significant cash commitment depending on how many options you're exercising and the strike price you're paying. For example, if you wanted to exercise 10,000 vested shares and the strike price is £1, that would mean a £10,000 upfront payment to your company.

The decision to exercise your options is down to you. Using your own judgment and the information on strike prices etc provided by your employer, you'll need to weigh up whether any future financial gain is worth the upfront cash commitment.

Secondaries

Usually, you'll need to wait for a liquidity event like an initial public offering (IPO) or an acquisition to turn your shares into cash. But more and more companies are opting to let some employees sell part of their stakes in secondary share sales. Most common in late-stage companies, a secondary share sale sees private investors acquire other shareholders' options at the latest share price. They are often used to provide some liquidity to founders and/or long-serving employees without having to sell the company or go public.

Fundraising, exits and taxes

When companies raise money, there are a number of knock-on effects for your equity stake. Dilution happens when new shareholders acquire stakes in a business, reducing the ownership percentages of the pre-existing shareholders. Although the number of share options each employee owns remains stable (outside of top-up grants), the percentage of the company those share options represent is reduced as the company issues additional shares to new investors.

A liquidation preference clause dictates that investors with preferred shares get paid some, all, or a multiple of their investment before common shareholders (such as founders and/or employees) get payouts in the event of a liquidity event such as a sale or public listing.

However, if new investment comes with a higher company valuation, the value of employee share options can still increase.

For example, let's say Alice, an engineer at flight search engine Flewgle, has been granted 15,000 shares of her company's fully diluted share capital. If Flewgle has 600,000 shares in total, that represents 2.5% of the company. When Alice is granted her shares Flewgle is valued at £3 million, making Alice's stake worth £75,000.

Then, in the next fundraising round, Flewgle raises £400,000 and issues 100,000 new shares to Bigg Capital, the company's new investor. Alice's 15,000 shares now represent 2.1% of fully diluted share capital. If the company valuation had remained at £3 million, the value of her stake would slip down to £63,000. However, Bigg Capital invested at a new, higher valuation. After the funding round, Flewgle is worth £5 million – making Alice's 2.1% stake worth £105,000.

It's not always that simple, though. Investors often have anti-dilution clauses in their contracts designed to protect the value of their shares. These include liquidation preferences, which ensure that the investor receives a minimum return on their investment. This can have a significant knock-on effect for other shareholders. Ask your company whether any investors on the cap table have these clauses.

Fundraising, exits and taxes (cont.)

The exit – cashing out

At some point, every shareholder will look to realize a cash profit from their investment. As we've already covered, this usually requires a liquidity event, which gives investors the opportunity to sell or exchange their shares for cash.

Usually, a liquidity event means an acquisition, merger, or IPO. During acquisitions and mergers, the acquirer typically buys out shareholders, receiving some or all of their shares in exchange for cash. An IPO means the company lists on a stock exchange, making it much easier for employees and investors to sell shares.

Taxes

Of course, where there's profit, there are taxes. With most ESOPs, you don't have any tax to pay until you sell your shares. Many ESOPs, like EMI in the UK and BSPCE in France, are designed to reduce your tax burden when you sell shares by treating profits as capital gains rather than income. In the UK, for example, this means paying between 10% and 20% tax when you sell your shares, rather than 40% or 45%.

Other ESOPs don't have the tax authority approval, which means you might have a higher tax bill to pay. Ask your employer if you're not sure what type of ESOP your company uses. In other countries, notably Germany, tax is paid when employees exercise their options and when shares are sold, making total tax obligations much higher.

Moving on: what happens to your share options?

Almost all of us will move on from businesses at some point. But how much of your equity stake you keep when you move on depends on the circumstances under which you leave the company, as policies often change depending on whether you've chosen to leave the company or if your role is being made redundant.

Good and bad leaver clauses

What makes someone a **good** or **bad leaver**?

Companies can define good and bad leavers however they choose, usually drawing on the advice of their lawyers.

The most common cases that see employees defined as a **good leaver**, and hold on to their vested share options after they leave the business, are:

- Retirement;
- Serious illness or death (in which circumstance the employee's share options would transfer to the next of kin);
- Being made redundant through no fault oftheir own, e.g. as a result of a merger, or because the role is no longer necessary.

In contrast, **bad leavers** lose the right to retain any shares or share options after moving on. Bad leavers often include employees who:

- Commit gross misconduct;
- Are convicted of a crime, such as committing fraud or embezzlement;
- Break a noncompete clause or violate the terms of a shareholders' agreement;
- Voluntarily resign, or before reaching a certain milestone, e.g. before all their shares have fully vested.

Ask your company whether they treat people who voluntarily resign as good leavers or bad leavers. If you're treated as a bad leaver when you resign, that means you'll lose your rights to your share options – even those that have vested.

Exercise windows are usually opened for people who move on from the business. If you are able to keep hold of your equity after you leave, it's worth asking how long your exercise window will be open for. Often, leavers are given just 90 days to exercise their options or lose them forever. This potentially means coming up with a significant amount of money in a short amount of time in order to buy your options from the company. More companies are extending exercise windows to several years, giving you more time to decide whether or not you want to pay to become a shareholder in the business.

Final thoughts

We designed this guide to help anyone who's ever read a clause in their share option agreement and thought 'What on earth does that mean?' Whether you've been granted share options for the first time, or learning more about what your equity means for you, we hope you found our overview insightful.

As the tech ecosystem creates more category-defining companies, more and more people are being compensated with share options, which we love to see. But too often, the important 'fine print' of equity is too opaque or too technical for people to quickly understand.

The solution demands input from companies and team members. Companies need to be transparent with their people, giving them the information they need to understand their equity stakes and make sound financial decisions. And you should feel confident that your package is commensurate with market standards and that you're being compensated fairly. Because when you're up to speed with your equity, you can get to work in the knowledge that you're contributing to something great.

Ledgy is the equity management platform built for scaling companies. We work with more than 2,500 businesses in over 40 countries around the world, including many of Europe's fastest-growing and most innovative scaleups:

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