Is the Startup Compensation Model Broken?

by Travis Howell, Assistant Professor of Strategy, Paul Merage School of Business, University of California, Irvine

Executive Summary

- Startups often offer a relatively lower cash salary, but combine it with generous stock options. The expectation is that if everyone in the organization works hard and the company grows, the employee will receive a significant cash-out at a near-term liquidity event (e.g., an IPO).
- This compensation model has certain historical advantages, but more recently, disadvantages have been observed, leading many to wonder if the current compensation model is broken.
- Instead of emphasizing compensation, startups should focus on helping employees feel a sense of purpose in the work, and on building a company culture that makes people want to stay.

Advantages of Using Stock-Based Compensation in Startups

Most ventures have little to no financial capital when they first start out. As a result, they are generally unable to offer employees the same level of salary and benefits relative to other, more well-established companies in the same industry. As such, startups must get creative when compensating employees.

Historically, stock-based compensation has been a key way for startups to compete with larger companies for talent. Through stock-based compensation, startups are able to hire people who are willing to accept a lower salary for the possibility of making money on the stock options. Also, before accounting rules changed, tax deductions were sometimes associated with those stock options, providing additional value for employees.

In addition, stock options are thought to align the incentives of employees with the organization. Employees essentially become owners, meaning it is "their" company and they are thus motivated to work hard and take a long-term perspective.

Disadvantages of Using Stock-Based Compensation in Startups

Although the advantages of stock-based compensation in startups have been touted for a long time, recently the disadvantages have received more attention. Some argue that stock-based compensation is virtually akin to receiving a lottery ticket in exchange for a lower salary.[1] Very few employees win the "lottery," because it is so dependent on timing. If employees are lucky enough to be hired and be granted their stock options at the right time, the tradeoff is worth it. But for most employees, this is not the case. For example, shortly after Microsoft ended their stock-based compensation program, Bill Gates spoke about how he wished the company had never adopted that compensation model. He explained that, although some employees got rich from their stock, most received no value. Or, as he put it, "either you can buy 10 homes or none at all."[2]

A further problem with stock-based compensation is that, as the company raises more money, the value of employees' stock options becomes diluted by the new funding. As Blank explains, employees typically do not have pro-rata rights to keep their percentage intact (whereas VCs do), meaning that employees are hurt far more than investors when new money comes in.[3]

Yet another problem with stock-based compensation is that it can sometimes create undesirable incentives. Stock options usually have a vesting period attached to them (often around four years). Employees have little incentive to stay after their options are vested, so they often leave as at that point and go to work for another company, where they start vesting that company's stock options. As a result, it can be difficult to retain talent with stock-based compensation.

Another factor that has made many wonder whether stock-based compensation is currently "broken" is the fact that startups are staying private longer. Many companies are delaying IPOs and other liquidity events much longer than in the past. As a result, employees generally have to wait longer to receive their expected payout, meaning it is less attractive and less valuable for them, and also creates more uncertainty.

Finally, another issue with stock-based compensation is that it may not be as much of a differentiator now as it was in the past. Many of the large technology companies today (Apple, Google, Facebook, Microsoft, Amazon, etc.) offer both a competitive salary *and* stock-based compensation, along with a wide variety of other perks and benefits.[4] Given that these firms' stocks are already valuable, the value of the stock options is much less risky. As a result, many startups are having trouble competing for top technical talent, as the big technology companies hoard that talent.

So how can startups attract talent?

Given the challenges associated with stock-based compensation, what should startups do to attract talent? Several insights were offered at the 2020 Kenan Institute Frontiers of Entrepreneurship conference in West Palm Beach, Florida. For example, Sangeeta Badal, principal scientist of entrepreneurship and job creation at Gallup, argued that hiring and retaining talent is less about compensation and more about meeting the psychological needs of the individual. Badal argued that the new workforce is concerned less about total compensation (though some minimum threshold is always required) and more concerned about purpose. People want to derive meaning from their work. When they derive this meaning, they are more likely to stay at a job, even if they receive offers with higher compensation packages from other companies. Thus, employers need to create purpose by helping employees see how their individual contributions contribute to the bigger picture. This is harder to do in large firms, and thus startups have an advantage here.

Related thoughts were shared by L.J. Brock, chief People Officer at Coinbase. Brock explained that while Coinbase's employees are being poached every day by the large technology companies, the employees who stay are the ones who care most about culture and mission. This group of employees is less concerned about how much Coinbase pays in compensation and more concerned about the people around them and the work they are doing. A similar sentiment was echoed by DeLisa Alexander, EVP and chief people officer at Red Hat. Alexander explained that, although they were losing many of their employees to the big technology companies, they are starting to see many of them return because they like the culture better at Red Hat.

In addition to meaning and culture, there are other ways that startups can differentiate themselves from larger companies and attract talent. For example, Amy Nelson, director of Venture for America, explained how many of the students they place in startups are not there for the compensation, but rather for the chance to move up the ranks more quickly than in larger companies. In startups, employees are often given much more responsibility than they would otherwise be given, and this is attractive to many people.

Overall, the best way for startups to hire and retain talent is likely not through compensation, because it will be hard to win on that front relative to larger companies. Instead, startups should help employees feel a sense of purpose in the work, and should build a company culture that makes people want to stay.

Practitioner Takeaways

- Stock-based compensation in startups is not as attractive as it once was. Disadvantages revolve around the timing of when employees receive their stock options, the dilution of stocks' value due to new funding, the inadvertent creation of undesirable incentives by vesting terms and the fact that many employers can now offer both stock options and a competitive salary.
- Startups can retain employees by focusing less on compensation and more on creating meaning purpose for employees.
- Culture is an attraction for many employees, and startups may have an advantage over larger, more mature firms in establishing an attractive culture.
- Some employees are also attracted to startups because of greater opportunity to take on additional responsibilities and move more quickly up the ranks.

Contributing Experts

- Amy Nelson, Director, Venture for America
- DeLisa Alexander, EVP and Chief People Officer, *Red Hat*
- Sangeeta Badal, Principal Scientist, Entrepreneurship and Job Creation, *Gallup, Inc.*
- L.J. Brock, Chief People Officer, *Coinbase*

References

[1]Blank, S. (2019). How to Make Startup Stock Options a Better Deal for Employees. *Harvard Business Review*, April 3, 2019 edition.

[2]Stock Options — Why It's Time for Startups to Replace Them (2018). *Medium*, August 8, 2019 edition.

[3]Blank, S. (2019). How to Make Startup Stock Options a Better Deal for Employees. *Harvard Business Review*, April 3, 2019 edition.

[4] Tech firms shell out to hire and hoard talent (2016). *The Economist*, November 5, 2016 edition.