Tailoring Compensation to Start-Up Stage Companies
by Kartik Balaram

The number one question we are asked by venture capital and private equity firms is “when should our portfolio companies work with a compensation advisor?”

The truth is that addressing compensation issues in a thoughtful, process-oriented way often falls to the bottom of the priority list. Many investors and senior leaders at these organizations must wear multiple hats and compensation decisions can unfortunately be ad-hoc.

The fluid and dynamic approach that is both common and effective in quickly advancing the product, marketing and sales functions does not necessarily translate as well to compensation decision making. Rather than taking the “learn as we go” approach, leaders are better served to “learn, then go” when it comes to compensation issues by investing time early on to better understand compensation processes and develop the toolkits and structures that can be referenced as the organization scales. This approach pays dividends down the road with respect to efficiency and consistency.

In our experience, common compensation issues arise at different start-up stages:

Seed Funding or Forming of the Entity

At the founding of the company, entrepreneurs receive capital to get their business idea off the ground. Due to the fluidity of the business at this stage, compensation strategy and decisions are particularly ad-hoc.

Investor Profile	Friends & family, incubators, angel investors
Typical Funding	Ranges from $100K to $2M
Business Issues	Product development and management; corporate development (capital, partnerships, etc.)
Compensation Issues	Hire executives, establish capitalization table

At the start of the business, every penny matters. Hiring the right people while managing cost is crucial, and pre-IPO equity incentives – which offer significant wealth creation opportunity with company success – are the crown jewel. Investors and founders need to understand competitive pay levels for both salaries (very modest) and equity incentives (a higher percentage of the cap table than will be the case in later rounds) to hire the experienced talent that can help build the organization. This usually starts with gaining access to compensation databases/surveys to understand typical pay levels at organizations with similar capital and is typically limited to one-off items, such as founder/senior executive compensation and setting the structure for the company capitalization table. Some over the shoulder outside counsel may be involved as well.

Series A Funding

Financing initial product development and launch are the priority are in aggressive build out phase for the product/solution offering. Aggressive goals are set across the team to work towards specific product/solution milestones. This is the true “start-up” phase of the company and is typically the ideal time for companies to wrap their mind around what is “best practice” with respect to compensation levels and decisions.

Investor Profile	Venture capital, angel investors
Typical Funding	Between $2M to $10M
Business Issues	Product innovation and milestone achievement
Compensation Issues	Compensation benchmarking, new hire equity grant sizing, cap table and pool management

The desired end point of Series A funding is market validation of the company’s product/solution offering. Seasoned individual contributor talent is needed to progress against key company milestones. This requires extensive talent acquisition, so systems and structure to deliver new hire equity grants in a competitive and consistent manner are incredibly beneficial. Companies must also manage the available equity pool to ensure enough dry powder remains in the available share reserve to fuel an intense hiring and performance management cycle.

Series B Funding

Scaling the business is the new focus. The company’s product has reached the broader community and investors are monitoring business and talent growth. Compensation strategy becomes more holistic, less ad-hoc and more process focused. With this comes the opportunity to gain structure in the compensation strategy and programs, universally.

Investor Profile	Venture capital, private investors
Typical Funding	Approximately $25M to $50M
Business Issues	Talent acquisition, product roadmap clarity, strategic investments
Compensation Issues	Compensation benchmarking, equity guideline framework and strategy, cap table and pool management, senior employee equity refreshes

Companies typically engage compensation consultants directly at this stage. With the significant capital coming in and the perceived maturity within the organization, there is a desire to gain more process and structure within the compensation programs. It is an opportunity to explore the implementation of a formal annual incentive plan (bonus plan), a significant refresh of the available equity pool, conduct an audit of compensation competitiveness and build out cash and equity related frameworks to manage pay.

In light of the significant dilution realized by leadership, executive compensation benchmarking should be a point of focus. The organization has likely found itself competing in a new “talent market” populated by more established companies. There is work to be done on determining the appropriate market comparator scope and the magnitude of equity adjustments that need to occur to incent leadership as well as the broader employee population. This includes an audit of pay programs, cost modeling of pay adjustments, and the development of a formal set of new hire and refresh equity grant guidelines, including scenario modeling to ensure that the share pool can support the hiring plan and performance management process.

In addition to equity frameworks, investors and management teams can benefit from having set salary ranges and bonus targets (if there is a formal plan) that are aligned with the company's leveling system.

Series C+ Funding (Late Stage)

These are companies that have proven to be successful businesses and require capital to help expedite the growth of the business. Investors hope to see top line metric progress that boosts company valuation in anticipation of a potential go-public transaction or M&A. External parties (i.e., investors, prospective employees) expect a streamlined process and around total rewards.

Investor Profile	Venture capital, private equity, hedge funds
Typical Funding	Approximately $50M to $100M+
Business Issues	Go-public event, M&A, human capital management, strategic investments
Compensation Issues	Establishing process (e.g., Compensation Committee calendar), public company compensation awareness, IPO readiness, founder compensation

For late stage, private companies, many organizations adopt a public company annual Compensation Committee agenda to address pay decisions. The process helps establish credibility internally that compensation decisions are process-oriented and allows for a smooth transition to public company practices should an organization go public.

In addition to covering cash adjustments at the annual performance cycle, equity compensation is also addressed formally. While refresh grant activity at earlier stage companies is less frequent, later stage/public companies tend to have an annual equity refresh for most employees to reward employees for prior year performance and ensure equity holdings offer adequate retention. This also is helpful from an employee expectation perspective as the talent market for companies in this stage is public company focused, and equity grants are issued to employees on an annual basis.

At this stage (or even at Series B), founders are close to, or are, fully vested in their equity holdings and in many cases expect a meaningful equity grant as an incentive to continue forward. The Compensation Committee and Board are likely to invest a lot of time and effort into determining the quantum of refresh and whether performance criteria should be attached to the grant in some capacity. This process takes a few months to address and usually requires trade-offs from both parties.

Finally, there is preparation for an IPO, where a private company sells shares to the public to raise capital, reward investors and build brand awareness. This requires a tremendous amount of preparation and support from outside attorneys, bankers and compensation consultants. It is a long and complicated process and can take months of prep work to get alignment from both the Board and the management team. Common issues addressed at this juncture are developing a public company peer group for benchmarking purposes, aligning on a transition strategy for executive pay, setting a Board of Director compensation policy, and setting the public company equity incentive plan share pool and other key provisions (e.g., evergreen pool refresh, ESPP). An entirely separate issue is implementing IPO-related equity grants, which can also be a time intensive process.

Conclusion

Implementing compensation structure and process is ideally tackled when the Board and management teams have an ideal mix of experience and bandwidth. The level of involvement is akin to a crescendo; the more mature a start-up becomes, the more opportunity there is for process and structure. We are hopeful the capital markets cooperate as 2024 comes to a close, and anticipate investors and management teams will be aggressively proactive on these matters.