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Founder Compensation: The Data Only Take You So Far

Robert James

MANAGING DIRECTOR

One of the trickiest exercises in executive pay benchmarking is establishing the "market" for founder compensation, as any available data typically exhibit more variability across pay components than they do for non-founder roles, particularly on equity.

The reasons for this vary and are driven by the unique circumstances in each situation, including the founder's reputation, the number of founders, the ability of she or he to negotiate, and their personality. The perceived value of the product or service being developed and the time and capital required to get to market also play a role, as does the investor profile and the equity philosophies of all parties, to name a few.

The solution is usually not in finding the perfect data because it likely doesn't exist. Rather, recognizing that the data you have—as with any large and normally distributed dataset—represents the average situation for the average founder is key. Understanding how your founder situation differs from this average is at the heart of establishing the right market reference point.

Not all founders are created equally. Some are true subject matter experts responsible for conceiving the original science or technology. Others are less technically oriented, but are leaders or visionaries, capable of building world-class teams and acting as a figurehead to the business. And some founders are both of these (think Steve Jobs).

While a complete discussion of all factors affecting founder compensation is beyond the scope of this post, there are three scenarios that broadly capture most founder situations, each with different considerations for compensation—particularly equity and potential refresh awards.

The Technical Founder Role

As the name implies, a technical founder is a true subject matter expert who conceives the original science or technology. Their contributions to the company are never in doubt, as they are responsible for its very existence. However, their ongoing contributions to the company as an operator involved in the "day-to-day" are somewhat less clear and as a result, so is the structure of their compensation.

Technical founders will often assume a non-CEO position among the executive team or sometimes a non-employee board director role once the product, service, or executive team has reached a certain level of maturity. If then they are still an active executive team member, consider positioning cash pay as it would be for non-founder roles with the same title, despite their equity position.

What matters most for this type of founder is knowing that their contributions continue to be recognized in an objectively fair manner, and the best way to do this is to pay competitively. As one board member put it to me recently, "our biggest competitor for this founder is not another company, it's early retirement, and while there's only so much we can do to prevent that, we must do what we feel is right and fair to keep them engaged."

Be open to the same approach on equity. While not all founder executives of this type will need to be refreshed, some will and a little can go a long way. Examining what non-founder executives in their position might receive on equity is a potential strategy to split the difference if there are mixed opinions about whether this type of founder even needs to be refreshed.

The Operating Founder Role

As the name implies, operating founders continue to have a heavy hand in the strategy and day-to-day operations of the business. These founders tend to be natural leaders capable of motivating and inspiring teams, easily interfacing with investors and the media, and often remaining involved with the product or service. They may or may not be scientists or technologists, but it's clear to everyone involved that this is the person who will lead the organization for the foreseeable future.

Personality plays a large role in compensation for this type of founder. While every great operating founder understands the sacrifice they make to build the team around them, including diluting their own equity position significantly over time, some simply take a more active interest in their own compensation than others. In terms of equity, where the vast majority of founder wealth is derived, this means that some founders forgo refreshes for the sake of sharing more with the team, while others will push hard for competitive equity ownership based on market information or historical factors.

From a benchmarking standpoint, evaluate fully diluted ownership of other founders, understanding that the data likely includes both founder shares and stock options to some degree. Assessing these founder benchmarks, understanding how your founder situation differs from the average, and then seeking to close the gap with a refresh award that passes the sanity check is a reasonable approach to sizing an equity grant.

Lastly, be mindful of founders or board members cherry-picking data points from the public domain in this situation. As mentioned before, no founder situation is the same, despite the similarities in the business, with the answer being what's right for this founder and these shareholders in this situation.

The Multi-Founder Role

Companies with multiple founders and complementary skillsets are fairly common and this situation is arguably the trickiest handle in founder benchmarking, especially if contributions—current or future—are likely to change over time.

However, key factors to keep in mind are equity overhang and the relative split of ownership between founders, non-founder employees, and investors. These factors should be thought of as important guardrails for making equity decisions and should become part of the sanity check process. It's not appropriate to simply benchmark multiple founder roles from the "bottom-up" as it will overstate the market in terms of typical founder ownership. Rather, in this case, decisions should be limited by a "top-down" analysis of founder ownership at a certain percentile (e.g., 75^{th} percentile).

If current or expected contributions between two or more founders with similar titles are expected to change, establishing the right position match for one of them and discounting the other can often be helpful. Assuming that egos will not get in the way, this kind of approach values a lead founder role appropriately but also reflects the expected differences with respect to future involvement. In addition, future events such as an IPO or other transaction can serve as a line in the sand from a compensation standpoint where two founders who were treated similarly before the event will be treated differently afterwards.

In Summary

Founder compensation is nuanced and requires considerable thought. Venture capital and private equity investors are likely to also have strong philosophies around it, and active dialogue with your shareholders is a key component of any founder compensation decision.

Ultimately, founder compensation is usually not a question you can answer with more data. The company's history and founder situation are always unique, and this necessitates a more tailored approach to pay decisions. While time-vested equity remains the most prevalent vehicle at late-stage businesses, boards could consider performance-vested equity for their founders to embed some downside protection and reinforce alignment with shareholder objectives.

Whichever path is taken, it's best to have these conversations with your founders sooner than later. Some due diligence and negotiation is time well-spent, although the law of diminishing returns and angst that comes with lengthy debate can take time and focus away from the business that has a much greater cost in the long-run.

About the Author

Rob James is a managing director with Pearl Meyer with almost 15 years of experience in executive compensation and finance. He serves as a trusted advisor to boards and senior management at public and private firms across North America. He works with companies in all industries, but he has in-depth knowledge and expertise in designing compensations strategies for organizations in life sciences and technology, particularly emerging and high growth companies that are pursuing or have recently completed a M&A transaction or public offering.

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