Equity Compensation: Definition, How it Works, and Types of Equity

Most startups experience cash difficulties during the pre-seed stages. During this stage, you must save on costs to reinvest more in your startup and ensure it grows faster. Startups, especially tech and biotech companies, often use equity compensation as part of their compensation packages— to supplement their employees' salaries.

So, what is equity compensation, and why should your startup consider this as a compensation option?

What is equity compensation?

Equity compensation is when a startup offers its employee ownership stake in the organization as part of its compensation package. This structure improves your startup's investment portfolio by saving on salary costs.

Equity compensation serves as an employee perk with potential future benefits. Here's how it works:

How does equity compensation work?

There are various equity compensation models. Your startup could offer equity compensation instead of standard employee benefits, or you can offer it as the cherry on top. Research shows that more than a third of private companies and 43% of publicly traded companies have an employee equity compensation plan.

How do companies benefit from equity-based compensation?

Equity incentive compensation is a more affordable alternative for a cash-deficient startup than cash employee benefits. So, you can offer company equity compensation to attract new talent.

Established companies with comprehensive benefits packages can also adopt an equity-based compensation plan to retain employees. Your employees will likely be more motivated to keep working in your startup until they gain equity rewards.

Equity vs. cash compensation for employees

There are many debates on which is better for employees between cash and equity compensation. Well, the standard cash compensation is less risky for employees.
The compensation in equity option is not guaranteed as it relies on the company's stock value appreciating— which is not always the case!

Even so, offering equity as compensation could offer your employees long-term benefits, including discounted shares and tax breaks. They could also choose to sell the shares once they have vested.

What are some types of equity compensation?

1. Stock options- They fall under two categories:
- Incentive stock options (ISOs) allow employees to purchase discounted stock shares and receive tax breaks if they maintain them for a specific period.
- Non-qualified options (NSOs)- Employees do not receive tax breaks with this option.

2. Restricted stock units- Startup leaders that offer these equity compensation plans do not require an employee to buy anything. Rather, the startup gives its employees stock shares or cash equivalent after they achieve particular milestones.

3. Employee stock purchase plans (ESPPs)- ESSPs allow your employees to buy shares of company stock at a discounted fair market value— often through automatic payroll deductions.

What are the benefits and drawbacks of startup equity compensation?

As a startup leader, you may be worried that your limited cash will only partially cover your employees' compensation.

Here are some reasons why we should look into private equity compensation as an alternative:

- Improves employee motivation as employee interests align with that of the startup.
- Facilitates employee retention.
- Gives the company a competitive advantage since it improves employees' value proposition.

Nonetheless, you should also be careful of some drawbacks of offering equity compensation:

- Some founders surrender too much ownership to their workers, so you should use equity compensation software to develop an effective strategy for offering these compensations.

The bottom line

Equity vs. cash compensation is the biggest confusion for a startup's leader. Equity incentive compensation is a better alternative for your startup since it enables you to save on compensation costs and reinvest them.

You have understood all the aspects of equity compensation for startup employees— what's next? Discover the various tips on how to structure your equity compensation plan!