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WELCOME TO

**Wednesdays With Redchip**

# Employee Share Schemes

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# Why ESS?

- Key employees
- Motivation
- Act like an owner

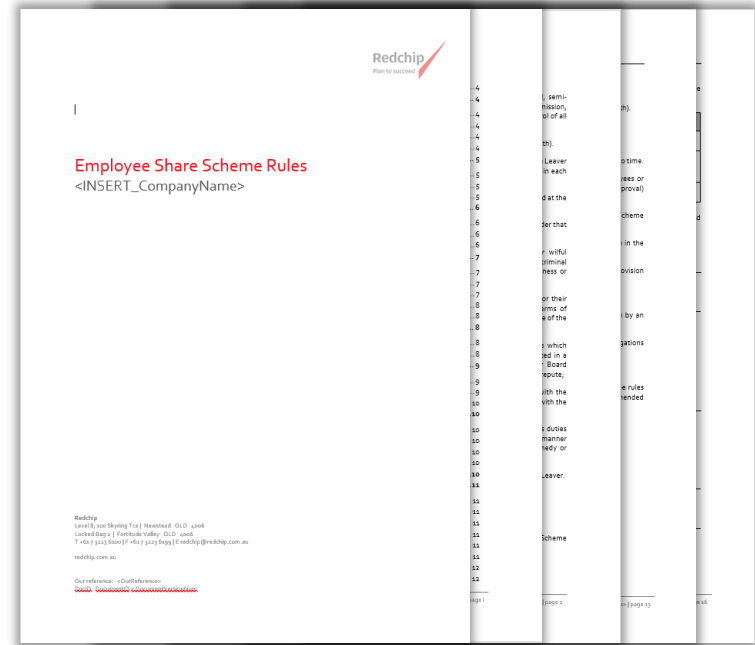
*Is it that simple?*



# Legal stuff

- Scheme rules
- Shares v options v trust interest
- Taxation considerations
  - Revenue versus capital
  - Immediate versus deferred

*Is it that simple?*



# Challenges

- Implemented an ESS
- Queries but not implemented



# Two key questions asked by employees:

- **How much Cash will it cost me?**
  - Upfront – will they back themselves?
    - Can be \$nil
  - Tax
    - Payable when cash available
- **What's in it for me?**
  - Reward for effort



# What's in it for both parties?



- **Salary = employee 'C' pass mark grade**
  - Standard assignment
  - Tangible reward for effort – guaranteed
  
- **ESS = employee 'A' or 'B' grade**
  - Stretch assignment
  - 'Sweat Equity'
  - Intangible reward for effort – no guarantee

# Shares v options

- We see lots of options
- Big issue: What must I do to convert options to shares?
  - Referred to as “vesting”





# Time v performance v both?

## Time

- **Pros:**
  - Easy
  - Concrete
  - Reward for time served
- **Cons:**
  - No need to do extra



# Time v performance v both?

## Performance

- **Pros:**
  - Stretch
  - Value add to company
- **Cons:**
  - Can be useless
  - Worse, demotivator!



# Time v performance v both?

## Considerations:

- **Achievable/realistic**
- **Controllable**
- **Measurable**



# Example

- **\$0 revenue**
- **1 year in the making**
- **Founder + 2 employees**
- **Looking to cap raise**
- **Cost to create:**
  - \$150K excluding 'sweat equity'
  - \$260K including 'sweat equity'
- **Value?**



# Example



- **ESS value - \$minimal NTA**
- **Blue Sky value - \$500K**
  - Target \$100K initial pa profit + 5yrs maintainable earnings

# Example

| Year | ESS Issue | ESS Cumulative | Initial Value<br>\$500K | Stretch<br>Value<br>\$750K | Stretch<br>Value<br>\$1M |
|------|-----------|----------------|-------------------------|----------------------------|--------------------------|
| 0    | 2.5%      | 2.5%           | \$12.5K                 | -                          |                          |
| 1    | 2.5%      | 5.0%           | \$25.0K                 | -                          |                          |
| 2    | 0 - 2.5%  | 5.0 - 7.5%     | \$25.0K                 | \$56.25K                   | -                        |
| 3    | 0 - 2.5%  | 5.0 - 10%      | \$25.0K                 | \$56.25K                   | \$100K                   |

# ESS concessions for start-ups



## Tax basic requirements:

- Company
- Less than \$50M aggregated turnover
- Less than 10 years of incorporation
- Unlisted group
- Not share trading or investment business company
- AU resident employer

# ESS concessions for start-ups



## Tax additional requirements:

- Ordinary shares
- Maximum 10% shareholding & voting power
- Minimum holding period: lesser of three years or employment cessation
- Shares: maximum 15% discount
- Options: exercise price at current market value



# Valuation methodology



## ESS 2015/1: Valuing unlisted shares

- No change of control within 6 months

## Method 1: Net tangible asset value

- 10/12 rule – Max cap raise of \$10M in 12 months
- Max 7 years of incorporation or SBE
- Financial reports per accounting standards

# Valuation methodology



## Method 2 – Knowledgeable person

- CFO or valuer
- **Key considerations:**
  - Value of tangible and intangible assets
  - PV of future cash flow
  - Comparison against similar businesses
  - Uplifts and discounts for control premiums, lack of marketability and key person
- **Board approved**

# Capital Raising & ESS

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# Seed stage financing cycles



## Seed/angel

- Idea or MVP
- Identification of demand
- The three Fs (friends, fools and family)
- Sometimes Angels
- Highest risk (lowest value)
- Company typically not generating any money

# Seed stage financing cycles



## Series A

- MVP or early launch
- Typically Angels
- Sometimes VC's depending on track record of business (first formal round of funding)
- High risk (lower value)
- Company generating no money or very little money

# Seed stage financing cycles



## Series B

- Company has some history
- Typically VCs or private equity (institutional investors bring higher expectations)
- Lower risk (higher value)

# Seed stage financing cycles



## Series C

- Company ready to go for rapid growth – proven success in the market
- Considering acquisitions
- Strategic plans to take market share (advertising)
- Scaling up by developing new products / services

# Seed stage financing cycles



## Series D

- Funding a special situation (merger or acquisition) and preparation for IPO

## IPO

*As a fast growth company you should continually be on the lookout for additional funding. It is critical for growth and is much harder to come by when you most need it (are desperate).*

– Steve Vamos, CEO, Xero



# Before things start



- **Ensure the business:**
  - Has a strong foundation and passes any inspection with flying colours
  - Is set up to handle fast growth, as you might not get a chance to circle back
- **Consider:**
  - Organisation structure
  - IP ownership
  - Realistic IP strategy
  - Mitigating third party commercial risks
  - Mitigating governance risks
  - Mitigating personnel risks
  - Tax

# Where do we begin?



- **Always good to start with the numbers**
- **What is the value of the company?**
  - Consider market size, market potential, industry risk (barriers to entry, volatility and competitors), track record (backed by data), uniqueness/edginess of the business
- **What do you need the capital for?**
  - Prepare a detailed budget that is incorporated into business plan
- **The company can then determine details of the round and prepare a Capitalisation Table**

# ESS timing and capital raising



- No requirement for implementation prior to raising
- A clear and defined framework will improve attractiveness to an investors in Series A round and beyond
- Impact of the ESS needs to be set out in the Capitalisation Table and considered in the Term Sheet

# Capitalisation Table

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**Capitalisation Table**

|                        | Equity (fully diluted) |         | Equity (fully diluted) |         | Equity (fully diluted) |         | Equity (fully diluted) |         |
|------------------------|------------------------|---------|------------------------|---------|------------------------|---------|------------------------|---------|
|                        | Shares                 |         | Shares                 |         | Shares                 |         | Shares                 |         |
| Leonardo               | 3,000,000.00           | 93.750% | 3,000,000.00           | 76.922% | 3,000,000.00           | 72.57%  | 3,000,000.00           | 67.13%  |
| Raphael                | 120,000.00             | 3.750%  | 120,000.00             | 3.077%  | 120,000.00             | 2.90%   | 120,000.00             | 2.69%   |
| Donatello              | 60,000.00              | 1.875%  | 60,000.00              | 1.538%  | 60,000.00              | 1.45%   | 60,000.00              | 1.34%   |
| Michelangelo           | 20,000.00              | 0.625%  | 20,000.00              | 0.513%  | 20,000.00              | 0.48%   | 20,000.00              | 0.45%   |
| Splinter               |                        |         | 390,006.09             | 10.000% | 390,006.09             | 9.43%   | 390,006.09             | 8.73%   |
| Other Investors        |                        |         | 310,054.84             | 7.950%  | 310,054.84             | 7.50%   | 310,054.84             | 6.94%   |
| CCP                    |                        |         |                        |         | 234,003.66             | 5.66%   | 234,003.66             | 5.24%   |
| ESS 2                  |                        |         |                        |         |                        |         | 335,194.43             | 7.50%   |
| <b>TOTAL</b>           |                        |         |                        |         |                        |         |                        |         |
| Shares                 | 3,200,000              |         | 3,900,061              |         | 4,134,065              |         | 4,469,259              |         |
| Equity                 |                        | 100.00% |                        | 100.00% |                        | 100.00% |                        | 100.00% |
| Value                  | \$3,200,000.00         |         | \$ 3,900,060.94        |         | \$ 4,134,064.59        |         | \$ 4,469,259.02        |         |
| Market Value per share | \$ 1.00                |         | \$ 1.00                |         | \$ 1.00                |         | \$ 1.00                |         |

**Distribution of Equity to Leonardo, Raphael and Donatello**

|           | Now (before raise) |                   |                        | Year 1 (after raise) |                  |                        | Year 2 (ESS 1) |                          | Total      |
|-----------|--------------------|-------------------|------------------------|----------------------|------------------|------------------------|----------------|--------------------------|------------|
|           | Shares gifted      | Revocable shares* | Equity (fully diluted) | Shares gifted        | Revocable shares | Equity (fully diluted) | ESS Shares     | Equity (fully diluted)** | Shares     |
| Leonardo  | 89,900.00          | 44,950.00         | 2.84%                  | 89,900.00            | 0                | 2.19%                  | 30,100.00      | 2.69%                    | 120,000.00 |
| Raphael   | 40,000.00          | 20,000.00         | 1.26%                  | 40,000.00            | 0                | 0.97%                  | 20,000.00      | 1.34%                    | 60,000.00  |
| Donatello | 20,000.00          | 10,000.00         | 0.63%                  | 20,000.00            | 0                | 0.48%                  | 0              | 0.45%                    | 20,000.00  |

# Term Sheet



- High level summary of proposed transaction
- Typically not legally binding, except with respect to confidentiality (and exclusivity where applicable)
- **Unique features our Term Sheet:**
  - Structure illustration of the group / organisation
  - Key protection provisions in the Shareholders Agreement (including decision making requirements)
  - Investor detail sheet
  - Capitalisation Table

# Innovation packages

*Getting business right from the start*

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|         |  |
|---------|--|
| Build   | Shape your business for growth and protection                            |
| Engage  | Ensure everyone's on the same page when hiring                           |
| Connect | Be protected when you take your business online                          |
| Protect | Make sure your most valuable assets are all yours                        |
| Fund    | Put your best foot forward when approaching investors                    |
| ELEVATE | All the documents and advice needed to take your business to new heights |

# Questions?

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THANKS FOR ATTENDING

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