MORE TO IT THAN MEETS THE EYE

Early stage start-ups often hope to grant stock options at the lowest possible price. The motivations are clear especially when an optionee plans to exercise immediately upon the grant. Other situations are not always so clear-cut.

Below are several ways of how lowball valuations can backfire:

- Employees will want stock price to be low when they join the company and high when they leave. Lowball valuations may deprive early employees of their well earned compensation.
- A shrewd optionee understands that strike price represents common stock value, i.e. progress towards successful exits. Stock options granted by a $0.1/share company are 10 times less valuable than a $1.0/share company.
- Strike price evolution overtime shows employees, management and investors how well the company is performing.
- 409A valuations often used by company investors for their own portfolio valuation purposes. Yes, a 409A can affects US GAAP portfolio valuation that your VC reports on their own balance sheet.
- 409A valuations are often basis for pricing secondary transactions.
- The difference between the second market price and the 409A valuation can be viewed is earned income, not capital gain subject to lower tax rate.

COMPLEX STAKEHOLDER ECONYSTEM

Stakeholder	Motivation (High Price)	Motivation (Low Price)
Founders	Avoid dilution	Attract talent (but for a wrong reason read here)
Investors	Avoid dilution	Attract talent (but for a wrong reason read here)
Management	Signals strong company performance	Attract talent (but for a wrong reason read here)
Acquirers	Avoid assuming cheap options	409A often provide favorable valuation data-point
Secondary market buyers/sellers	What is 409a valuation? Is it relevant? Am I entitled to this information? (Winklevoss twins learn hard way)	
Auditors	Conservatism, avoid understated deferred compensation expense	Na
IRS	Avoid understated taxable income	Na

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EMPLOYEES' SENSITIVITIES

<table>
<tr><th>EMPLOYEE</th><th>Motivation
(High Price)</th><th>Motivation
(Low Price)</th></tr>
<tr><td>Initial Grant</td><td>On per-share basis, higher exercise price should signal higher value compensation package (explanation)</td><td rowspan="3">i) Maximize profit from a rare the best case scenario.

ii) Ability to exercise cheaply, as soon as options vest, to lock into long term capital gains.</td></tr>
<tr><td>Future Grants</td><td>i) Shows that company is making progress, ii) have ability to profit from options prior to major exit event, iii) avoid new employees having cheaper options.</td></tr>
<tr><td>Future Employees</td><td>On per-share basis, higher exercise price signals higher value compensation package.</td></tr>
<tr><td>Departing Employees</td><td>Have ability to profit from stock options.</td><td>No incentive to exercise [Was price artificially low, especially if co. sold at high valuation right after I left?]</td></tr>
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