Equity Fundamentals

A plain English guide to how equity works for UK companies

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Introduction

Our mission at Vestd is to help as many founders as possible to use equity as a lever for growth, and to build better businesses.

We wrote this guide to give you the foundational knowledge you need to share ownership and motivate key people in the right way.

Reading this guide will help you understand your options - no pun intended - in order to eliminate the risks of taking a wrong step.

The answers we provide are based on real questions we are regularly asked by founders, CEOs and CFOs.

We help hundreds of UK companies every month and would love to get to know more about you, your company and your goals.

If you need any assistance then don't hesitate to book a free, no-obligation consultation with one of our equity specialists.

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Founder & CEO of Vestd

What are shares?

Let's start from the beginning.

Every limited company in the UK is split into a certain number of shares, as decided by the directors on incorporation of the company. Imagine a large pie sliced into many equal pieces.

These shares and details of their holders are kept by the company in a share register, which is often referred to as the 'cap table'.

A company can have any number of shares. Most are incorporated with either 100 or 1,000 shares. But **one million** shares is best (we'll reveal why that is later on).

The holders of these shares then have certain rights, as laid out by the Articles of Association of the company.

The Articles also determine how the company is run and how its income and assets are split.

Each share is priced at a nominal value, which is established when the company is set up.

What does ‘nominal value’ mean?

Nominal value

At the time of incorporation, the directors determine the nominal value of each share, which the shareholder must pay to the company.

This nominal value can be literally anything, but typically ranges from £0.000001p per share to £1 per share.

There’s no minimum capital amount that must be put into a company incorporated in the UK.

The initial capital in the company is simply the number of shares multiplied by the nominal value of each share.

As time progresses and more of these shares are issued, they’ll have the same nominal value but **may be issued at a premium** to that, reflecting an increase in the overall value of the company.

How many shares should I have?

It doesn't really matter how many shares a company is incorporated with, as they can be relatively easily subdivided at a later date.

Subdivision simply means dividing those original pie slices into multiple smaller pieces.

Technically, you do this by submitting a form (SH02) to Companies House and passing a shareholder resolution.

Having said that, it is much easier just to **set up your company with a large amount of shares.** With one million shares as a starting point, you will have more flexibility going forward.

Let's consider an example...

- You want to be able to issue 1% of your equity to someone in the future. So how many shares do you need now and what nominal value should they have?
- If you have only 10 shares then you can't give someone just 1% – that doesn't equal a whole share. When you issue a new share (making the total 11 shares) that share will equal almost 10% of your whole business.

But if you start with one million shares...

- 1% of 1,000,000 is 10,000 shares. As such you avoid giving away too much of the total shareholding.

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If you've started with a low nominal value, say £0.001, then you don't need to put much capital into the business at the outset (total number of shares multiplied by nominal value = 10,000 x £0.001 = £10 in this example).

The main reasons you're likely to issue more shares is if **investors** are putting money into your company in return for shares, or **distribute shares to team members**, to incentivise them to help develop the business.

What types of shares are there?

There are at least 10 different ways of sharing ownership, broadly clustered into two distinct groups: **shares and options**.

We'll talk about shares first. The next chapter will focus on options.

Shares give people actual ownership immediately, and there are three main variations to choose from:

01. Ordinary shares

02. Preferred shares

03. Growth shares (a special type of ordinary share)

Ordinary shares and preferred shares are commonly used. Growth shares are becoming increasingly popular as more founders are made aware of their interesting characteristics.

Within these share types, you may see a number of varying 'classes' with minor differences (like ordinary A, ordinary B, etc), which we deal with in the last section.

Let's now explore each of these share types in a bit more detail, so you can learn when to use them.

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01. Ordinary shares

Ordinary shares are what most people have. At their simplest, they give the holder of each share the same rights to dividends, capital and voting in the company.

Many companies are founded with and issue only ordinary shares but there are other methods of sharing equity that may be a better fit, depending on what you are trying to do.

02. Preferred shares

Preferred shares (often known as 'prefs') typically give their holders rights to specific dividends ahead of all ordinary shareholders.

They also give them rights to a specific amount of the capital at a winding up of the company ahead of any ordinary shareholders.

As stated above, companies normally just have ordinary shares, so all shareholders have the same rights to any value created by the business, whether it succeeds or fails.

When seeking additional investment in the business, however, it may well be that new (or existing) investors may only be willing to put in money if they have a preferential right to the cash flows from the business. These would be preferred shares.

This may seem unfair to the existing shareholders, but if that's the only way the company can get additional funds to allow its expansion or survival then they may well vote to accept such a change.

The new investment will give them a better chance of seeing a return on their existing shareholding than if there were no new investment at all.

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03. Growth shares

Growth shares are issued at a ‘hurdle price’ that represents the value of the company at that time plus a small premium to reflect ‘hope value’. Recipients share in the capital appreciation in the business from that point on. Hence ‘growth’ share.

These are attractive for a company to issue as they don’t dilute value for the existing shareholders.

Growth shares can be issued out at nominal value to new shareholders without incurring any income tax for the recipient, who will only be liable to pay Capital Gains Tax on any sale.

They are typically used as rewards for people joining a company to incentivise them to grow value. Our Beginner’s Guide to Growth Shares explains all.

What are options?

[Options](#) are the most popular way of [sharing ownership when rewarding employees](#) with equity. You can also issue certain types of [options to non-employees](#), such as consultants, advisors and contractors.

Options allow recipients to buy shares at a later date, at a pre-approved price, so long as certain conditions have been met.

The three types of options most commonly used are EMI options, CSOP options and unapproved options.

- **EMI**
  EMI schemes are by far the most tax efficient way to reward people with equity, though there are eligibility criteria that must be met and maintained by employers and employees.

- **CSOPs**
  CSOPs are the next best thing after EMI, benefitting from excellent tax exemptions too (providing certain rules are adhered to). And unlike EMIs, CSOPs aren't limited to companies of a specific size.

- **Unapproved options**
  Unapproved options are incredibly flexible and can be issued quickly to anyone, but they don't offer the same tax advantages as the other two.

  On exercise of the unapproved options the recipient will incur Income Tax on any difference between the price they pay and the market value of the shares at the time.

  EMI options and CSOP options are treated differently and are much more favourable from a tax standpoint.

What kind of conditions can I set?

Conditional shares require the recipient to achieve some kind of pre-set goal, before some or all of the allocated equity is made available to them.

Conditions are almost always time-based but can also be anchored to key goals and milestones.

Time-based conditions

When you award options to employees they don't become available to them immediately. Instead, the options go through a 'vesting' period, and become available over time.

The usual vesting period is four or five years, but that's entirely up to you.

Options come in two forms: exit-only or exercisable. We are huge fans of the latter for all sorts of reasons, but most companies choose the former, which requires some kind of liquidity event to occur before recipients can exercise their options.

Exercisable options can be exercised when the vesting schedule and / or milestones have been completed.

75% of Vestd customers include time-based vesting in their scheme design.

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Goal-based conditions

In addition to (or in place of) a vesting schedule, performance milestones can be set.

Goals can be anchored around performance, such as reaching sales targets, or delivering a project under budget and before a deadline.

When it comes to conditions, it's wise to keep things simple. We explore the pros and cons in more detail in this guide. But essentially, **adding too many performance-based conditions to your scheme can impact its effectiveness**; confuse or demotivate folk, or worse, encourage overly-competitive behaviours not in the company's best interests.

Option schemes that allow you to set conditions and milestones that govern the release of equity includes EMI option schemes, CSOPs and unapproved option schemes.

As an alternative to options, Growth Shares can also be anchored to performance milestones and other conditions that determine how much equity is given to the recipient.

What rights can shares and shareholders have?

We've discussed preferential rights to dividends and capital. Aside from that, there are a number of common rights that are varied from class to class of Ordinary, Preferred or Growth Shares.

Voting or non-voting shares

Although the standard approach is that all shares have equal voting rights, it's very common that certain classes of the shares don't.

This may be **to ensure that voting control sits with a certain section of the shareholders**, or to limit the administrative burden of dealing with numerous shareholders in a particular class.

Dividend rights

Again, usually all shares have equal rights to dividends, but it's not unusual that certain classes will be excluded from them for a particular reason.

Although the rights of the shares are usually set out in the Articles of Association, **they can be changed by a Shareholder Resolution** (including a majority of the holders of that particular class of share), and the subsequent submission of a form (SH08) to Companies House.

What is equity dilution?

As part of the incorporation process the company has to decide how the shares are split between the founders of the company.

When new shares are issued, for whatever reason, dilution will occur. That means that existing shareholders will effectively own a reduced percentage share of the company.

As an example, let us assume that a company has 100 shares and they are split between Jane who has 60 shares (60%), and Dave who has 40 shares (40%).

The company decides to issue 25 new shares to Rachel in return for a £20k investment. This means that:

- Rachel then has 25 out of a new total of 125 shares, so 20% of the business. This also implies that the business, post investment, is worth £100k.
- Jane's share will now be 60 out of 125 shares, or 48% of the business.
- Dave's share will be 40 out of 125 shares, or 32% of the business.

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Each time more ordinary shares are issued, the same dilution process happens and the stakes of existing shareholders in the company reduce accordingly.

The important thing to understand is the value of those shares, rather than the ownership percentage.

Owning a smaller proportion of a business shouldn't matter if the overall value increases.

In Rachel and Dave's case, they now have a business valued at £100k. When they started it may have been worth considerably less than that, as would their shareholdings.

Dilution is not to be feared!

Why would a company issue new shares?

A company's equity is a very powerful thing and is increasingly being used for a number of different purposes.

In all cases issuing new shares leads to equity dilution as explained in the previous chapter. The critical question for any founder is whether the company is better off with or without the benefits that this dilution enables.

The two most common reasons for new share issuance are:

01. In return for financial investment.

02. To reward the support of the people who are helping to build and grow the business.

Let's explore this in a little bit more detail.

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01. Equity in return for investment

Unless a company can get access to loans to help it through its progress towards revenue and then cash generation, it is likely to need capital to fund this stage of its life.

This capital typically comes from founders at first, then friends and families, and then maybe angel investors and venture capital as the business matures and shows traction.

It is important to understand the cumulative effect of investment on dilution when planning how to do this.

Using our earlier example:

- A founder has 100% of the company at the start, and needs three rounds of external investment.
- Each of these rounds takes 20% of the business (post investment).
- After the third round the founder's stake has dropped to 51.2%.
- If it were 30% equity given each time the founder's share would have dropped to 34.3%.

The challenge is that at an early stage the level of risk associated with the business is very high, so the amount of equity that needs to be given for the investment also tends to be high - but without it the business cannot develop.

It is crucial for founders to sensibly manage the issuance of new shares, particularly in early funding rounds.

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02. Equity to reward support

There is no doubt that giving a person a share of a company dramatically changes their relationship with it.

Recipients want the company to succeed because they have a vested interest in its success. They become an advocate rather than just having a transactional relationship.

The support that can be given can take many forms:

- **Intellectual support,** such as advice or contribution to business development.
- **Ambassadorial support,** such as presenting and supporting the company and its products to a person's networks).
- **Revenue support,** such as committing to be a customer for a certain period.

Many companies now give - or intend to give - their team shares as a reward for contributing to its success.

Team members are usually employees, but other people can be incentivised in this manner too, such as contractors, advisors and consultants.

How much equity should I give people?

The percentages of the business that people give varies enormously.

A critical foundational team member who is not yet an employee may be worth 5% or 10%, but an occasional supporting contractor could be just fractions of 1%.

It is also worth considering whether it could make a difference to award small portions of your equity to other people who are key to your company's success. These people could be ambassadors, partners or early stage customers.

In all cases you can create a powerful alignment with key contributors to your growth by giving them a reason to help you succeed.

The amounts awarded to each person are likely to be small, as the intent is to create alignment and emotional connection, rather than necessarily a major financial incentive.

As soon as it's appropriate, openly communicate the likelihood and potential timeline of an exit. A comms vacuum will often open the door to rumour and panic, so keep people informed.

You might think about appointing a go-to person (usually from the HR or leadership team) to field questions from employees about the exit process, and to keep everybody informed about milestones or delays.

Use our calculator to work out how many shares to give to your team.

What are the alternative ways of issuing shares?

Once a company has decided that it wants to issue shares there are a number of ways of going about it.

For ease of explanation we have split this into:

- Unconditional share issuance
- Share issuance on set terms
- Options (covered on page 11)

01. Unconditional share issuance

If a company is issuing shares in return for investment, issuing **unconditional** shares (aka ordinary shares) will almost certainly be the route that is followed.

This means that the recipient will have **immediate and irrevocable legal and beneficial ownership** of the shares.

These new **ordinary shares** are issued and fully paid for at a premium that reflects the potential worth of the company at the time.

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The company can also choose to issue unconditional shares for people who are part of building the business, but there are two things to be aware of:

- Once issued, **they can't be taken back** - there are no strings attached.
- If the company has value at the point of issuing the shares, and the recipient does not pay that per share value for them, then they will be **liable for Income Tax** on the difference between what they have paid and the market value at the time.

02. Share issuance on set terms

So while unconditional shares can't be taken back once they're given, it is possible to issue shares that are **conditional.**

This provides the recipient with irrevocable ownership but only when certain requirements are met.

As we explained earlier, these could be **time-based or milestone-based,** before the shares become unconditionally owned by the recipient.

This is a very attractive option for a company that wants to **eliminate the risk** of someone walking away with a chunk of the business before contributing fully.

For a company to be able to do this, it would need to include a number of specific clauses within its Articles of Association. In addition, if a company were to adopt specific Articles, it can also address the second issue mentioned above (the Income Tax implications that come with not paying full market value for shares).

It can do this by ensuring that any shares issued are **growth shares**, and so do not cause the recipient to have to pay Income Tax upon receipt of them.

How much equity should I set aside for a share scheme?

As with many facets of business, there is no one-size-fits-all approach. What is right for your company might not be ideal for another.

For example, early-stage business with no funding and a small team will be in a very different place to an established corporate-sized firm with hundreds of employees. No doubt their respective equity pools will be different too.

That said, there are some benchmarks to explore, to give you an idea of what other businesses tend to do when creating their share schemes.

So what does an average share scheme look like?

In the UK the total equity set aside for the team will typically be in the range of 5-20%.

This normally comes in the form of an option pool that will be used in the share scheme. Options are granted to employees and typically vest over a number of years.

Employees normally need to stick around before their options can be exercised, at which point they become actual shares.

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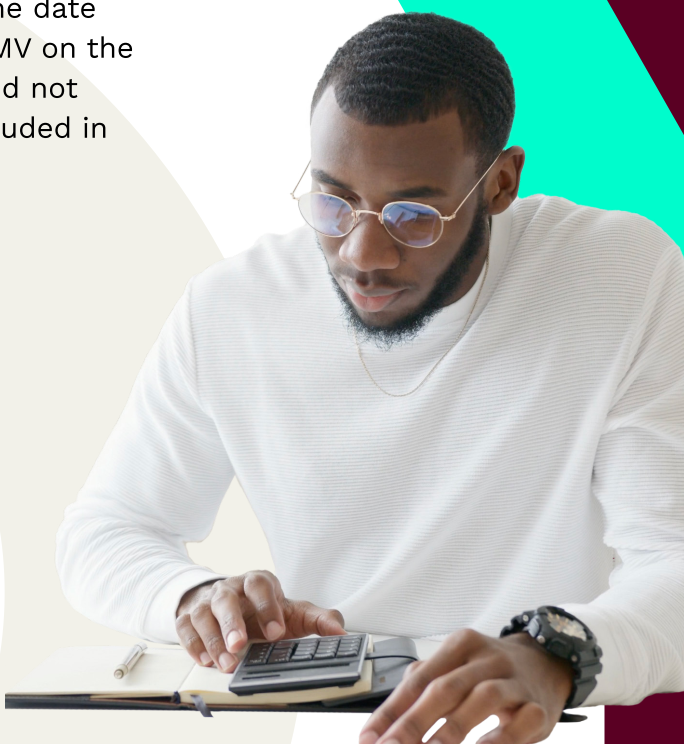
16.7% is the average option pool size among our customers

Before deciding on how much equity to ring-fence for your scheme, consider the following:

- **Founder dilution**
  If you are a sole founder, setting aside 15% equity for your employees means you'll retain 85%. That's easy enough to grasp, but what happens if you have two co-founders who also own a slice of the action? Issuing employee equity will dilute each of their stakes too.
- **External investors**
  Perhaps you have some angel or seed investors onboard? In that case, you will have already issued equity, and their shares will be diluted by your employee option pool. Future share issues – either to employees, or new investors – will further dilute everyone's stakes.
- **Company valuation**
  To give your team tax certainty, you'll need a company valuation, which then goes off to HMRC for approval. For CSOPs, the exercise price of the share options must be set at the fair market value of the shares on the date the options are granted - referred to as the UMV on the HMRC valuation. If not, then it's not a CSOP and not eligible for the tax benefits. Valuations are included in the price of our share scheme plans.

Now let's look at your employees...



How much equity should I give to each employee?

Employees are normally rewarded in relation to their anticipated **contribution**, but also in line with **risk**.

With this in mind, the first thing to think about is the nature of your business. Are you running an early-stage business, or has it progressed to the growth phase?

People who join a business in the initial phase are taking on more risk – and often do more foundational work – than those who join later, when the business is more stable.

As such, the equity offered to early 'foundational' hires may be considerably higher than to those who join in the future.

The first five people hired are often each awarded a percentage point grant of the available equity pool (normally up to the 5% mark). However, it may be that you need to push the boat out for pivotal hires.

If you're opening up the scheme to all employees, then you may have two tiers: one for 'foundational' and senior roles, and another for non-foundational hires.

Remember to keep some equity aside for future hires.
Avoid depleting the option pool if you plan on doubling your headcount or bringing in experienced C-level folk anytime soon.

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Valuing people's contribution, your business... and their stake

In order to dangle an appropriately-sized carrot in front of people you'll need to think about what they will bring to the party, and also the value of what you are offering. Equity rewards proportionate to people's actual contributions are possible with our Agile Partnerships™ framework.

For most growing businesses it is wise to agree on a meaningful amount of equity for an individual based on a value aspiration over the medium term.

For example, you might consider what the business is worth today and where it might be in two or three years time. That kind of timescale will resonate with the recipient. It helps to align goals.

Valuing equity is reasonably straightforward. A share price is determined by the value of your business divided by the number of shares in circulation. Multiply that by the amount of shares you're distributing to someone.

The tricky bit may be in valuing your business. Our valuations team will take care of this for you, or you can ask your accountant for help.

Further reading

- The Complete Guide to Share Schemes
- Equity Sharing Calculator
- The Joy of EMI Option Schemes
- CSOP Essentials: Your Guide to Company Share Option Plans
- A Beginner's Guide to Growth Shares
- How to design a vesting schedule for your EMI scheme
- Exercisable vs exit-only schemes
- What to do when someone leaves the business

Let’s talk equity!

If you need any help understanding how to get the best from your equity then book a free discovery call.

We will explore:

- Your company structure
- What you are looking to achieve
- The best scheme types for your needs
- Setting conditions and milestones
- How to protect existing shareholders
- The costs and tax implications

We’ll also answer any questions you have about sharing ownership with your team. There’s no obligation to use Vestd, though naturally we hope you’ll become one of our happy customers.

About Vestd

Vestd is the first and only regulated share scheme platform for SMEs in the UK. Thousands of people use it to manage and monitor their equity.

The platform was specifically designed and built to help SMEs launch and manage share and option schemes. Our customers also benefit from ongoing access to our in-house team of equity specialists.

Why choose Vestd?

01. Choose from a range of share / option schemes (EMI schemes, CSOPs, Unapproved Options, Growth Shares, Ordinary Shares and Agile Partnerships™).

02. Guided setup and five-star support from our team of specialists.

03. Full two-way Companies House integration. Issue shares and options immediately via the platform.

04. 100% accurate real time and historic cap tables.

05. Regular company valuations from our analysts (no need for accountants) and industry standard legal docs provided (no need for lawyers).

06. A personal dashboard for all of your shareholders.

High Performer
SPRING
2024

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Vestd is the platform of choice for UK SMEs issuing shares and options. We help businesses create, execute and manage shares & options schemes simply and affordably.

Vestd Ltd is authorised and regulated by the Financial Conduct Authority (685992).