Regions Wealth Podcast

Episode 12: Know Your Stock Options
So, you've received employee stock options or sweat equity as part of your compensation package — now what? In this episode, Chief Investment Officer Alan McKnight joins us to discuss what every employee should know about holding, selling, and exercising stock options.

Episode Transcript

Anne Johnsos:
Welcome to Regions Wealth Podcast, the podcast that tackles life's challenges with financial experience. I'm your host, Anne Johnsos. Frequently, companies give employees stock or stock options as part of their compensation packages. The problem is, roughly half the people with stock options don't know what to do with them and end up making mistakes. How do you know when to hold, when to sell, and when to exercise those options? Joining me in studio is Alan McKnight. He's the chief investment officer at Regions Bank. Alan, thanks for being here.

Alan McKnight, Chief Investment Officer, Regions Bank
Thanks for having me today.

Anne:
In this episode we are talking about knowing your stock options. We've taken frequently asked questions from a bunch of people and developed a character who needs your advice. Let's listen.

Jessica:
My name is Jessica, and I'm 34. Last year, I had a pretty bad experience with employee stock options. I guess I should start at the beginning. In 2013, I took a job at an early-stage startup. I was employee number two, and I had a hand in building pretty much everything. Because I'd played a key role in creating our product and growing the company, I was given equity. I knew my male coworkers had all received way more equity...most received double, a few received even more than that. I should've negotiated, but I didn't. My CEO was constantly making comments about how I'd probably get rich off my equity. It was totally his guilty conscience talking.

Anne:

Let’s pause right there. First off, what questions should an employee like Jessica ask when accepting stock options as a form of compensation?

Alan:
It really starts with the document, and understanding what exactly are they entitled to, and understanding what their rights are as it relates to those options. In many cases that will go through the HR group at the organization. But at times you may not be able to get a clear answer, or they may not even know. Reaching out for legal advice can be helpful to understand what it may be today, but more importantly over the course of those options, when you vest what they are worth, what the rights and regs are around those vesting periods, and ultimately what the company might be able to do that could change that may not necessarily be in your best interest, but in their best interest. That's not always the case. But going into it with that mindset of “am I being covered? Do I have all the appropriate channels checked? Do I know exactly what the outcome could be?” is critical, because particularly for smaller companies, things can change dramatically in a very short period of time.

Anne:
Alright. We talk about equity and how much equity is offered, what the options might mean. Can employees negotiate for more equity, or should they?

Alan:
They can. This gets back to earlier our discussions related to risk, it's an illiquid investment. It's an illiquid option. It doesn't mean that you are necessarily going to be, as she notes, rich. It could be that it's worth nothing. And that's the challenge of a for-profit company, and particularly a startup, because certain things can change, and despite what people tell you, or you hear executives say, it may be worth nothing someday, or you are diluted, just meaning they have to bring in so many more investors to make the business work, that your ownership of that company is so small that it's not anywhere near what you would have thought. The concept that's always worth a certain amount is much more fluid than in a public market company. You can ask for more, but commensurately it could be worth less.

Anne:
Jessica doesn't specify what type of stock options she received, but at a high level what are the most common types of stock options granted to employees, or other means of compensation?

Alan:

Right. There really are a multitude of incentive compensation plans, of which stock options are one. They are a variety which really run the continuum from a straight cash compensation, incentive compensation system, whereby you receive that cash at time of receipt, meaning you had a great performance review, you received cash for that work, versus a longer term incentive compensation plan, which would be stock options, restricted stock units, performance stock units, cash restricted stock units. Literally the list goes on in terms of what those options may be. Every company is different. Majority of companies think of it as a total compensation opportunity. They want to align you with your salary, with your bonus opportunity, and what that may mean in the short term. Then finally that long term incentive compensation piece, which would be any of these restricted units, and the restrictions that are placed on them are numerable.

There is a host of these different options and different incentive compensation plans, and because of that it's really born by the employee to solve for what it is, and what it means to their financial picture. The challenge will be if folks place too much -- particularly in a private company -- emphasis on some of those restricted units of some sort or long term incentive plans and they aren't putting enough capital and savings in other retirement plans, because you really have wedded yourself to one company. That can be great when it works out well. It can also be problematic if the company faces challenges despite all of your hard work and great performance.

Anne:
Explain the difference between options, and restricted stock.

Alan:
Options are the opportunity to purchase a stock, either public or private, versus a restricted stock, or a vested stock, in which the stock is actually -- you own that stock at a certain time. As an example, you can have restricted stock that in three years you own outright. You don't have to pay anything for it, it is yours at that point in time in a three-year vest. Conversely, you can have an option, whereby you have the opportunity to purchase it in three years. So as long as it has gone up, the difference between where the stock is, and where you received it will be your benefit in the gain that you receive. Now, if it goes down, then you have to determine, “why would I exercise these options, when in fact it's actually worth less than what I thought it would be worth originally?”

Anne:

Got it. So let's hear more from Jessica on what happened at her company.

Jessica:
Anyway. About a year later, we were getting ready for Series A funding. The CEO advised me and a few other employees to exercise our options -- he said it was in our best interest to do so before the A round took place. I'm still not sure if that was actually in our best interest... or his. I guess I sort of looked at my equity like a lottery ticket. I figured I probably wouldn't get anything from it, but if I did, great. I guess that's why I never spoke up about it. I really believed in what we'd built, and we were getting a ton of great press, but I just didn't foresee anyone spending millions to acquire us. To me, the biggest payoff was the creative freedom and ownership I'd been given. Unfortunately, as time passed, things began to go south. It felt like more successful we were, the more volatile our CEO became. The other two co-founders quit pretty abruptly. Without anyone left to rein him in, the CEO started making really bad decisions. He blew through money like crazy. Then one day, he just stopped paying us -- no warning, nothing. I held out for a month, then decided it was time to leave. I thought about doing something with my equity but wasn't sure if that was even an option. The company was basically dead, and I wasn't even fully vested.

Anne:
So this speaks to the point you made that the burden is borne by the employee to figure out how to benefit from stock options. What questions should people ask themselves before deciding to exercise options?

Alan:
First and foremost, they should determine their confidence level in the company, where the company stands. And more importantly, how much they really know about the company and the owners, and the other investors, and what that might look like. That's hard to do at a really large company, but in this case a small company, you likely are very close to these folks. You know who they are, what they do, and so really get an appreciation for that.

Second, it's knowing the underlying facts and figures for the company. What are our revenues? Can I see that? Do I understand what kind of profits we may or may not be generating? Do I understand what new investors, what kind of deal they are going to get in purchasing this stock? Finally, after I've exercised this stock, what are the specifics of this type of stock? As I alluded to earlier with series A funding, each stock can look different. It's not all one and the same. There can be different caveats, restrictions placed on a particular type of security. So understanding how yours may

differ from a new investor, and who has rights to patents, to assets, all that type of thing can change over time. There is a lot to learn, there is a lot to go into, and in many cases, no one is sitting there explaining it to you. Trying to get some counsel around it, even if it's within the company, other folks you trust, a financial advisor, a legal advisor, someone who can at least look through it from an outsider's perspective, because there can also be an emotional tie, and there can be an emotional pull of other members of the company who prompt you to want to move forward even though you may be a little hesitant.

Anne:
Stock options are a popular employee benefit at many tech startups. But an estimated 70% of startups fail within the first 20 months. Can recipients rely on employee stock options as a means to help support their future?

Alan:
They are a way to support the future, and they are a way to think about additional financial planning, and the attainment of financial goals, but there is more risk associated with them, because you are concentrating your assets in one particular security. Whether that's a tech startup, an industrial manufacturer, a consumer company, whatever it is, ultimately you are going to have a larger percentage of your portfolio that is one company, what we call single security risk. It's more concentrated, and you may know that company really well, but that doesn't mean that there can't be challenges, and the vast majority of employees only have so much control even in a smaller company of what the outcome is going to be. What we counsel folks is look at this holistically over your total portfolio. If you have a diversified portfolio, how much would you want to hold in one stock? What is the impact of holding that stock? How much are you receiving? How much of it is your total compensation? Because it may be a smaller component of it, and you are not as worried about it. Conversely, it may be a very large component and they say, you are getting almost no salary or other incentives, we are paying you all in options. That's a much riskier proposition, and you really are assuming the best and that things are going to work out for that company and it's not going to fail.

Anne:
Right, so it’s important to be clear-headed about how many eggs you’re putting in one basket—and whether they’re good eggs. Let’s go back to Jessica for more of her story.

Jessica:

Last year, I discovered they'd been acquired by a large European company. I received a vague email from some lawyer telling me that I had 24 hours to read, sign and return 108 pages of legal documents pertaining to my equity. They gave me no time to consult a lawyer, which felt like a huge red flag. I stayed up late that night reading all 108 pages. I discovered that the CEO had diluted everyone's shares by multiplying his own shares four times over. He also doubled the shares of his friend, who had joined the company as CFO one month before we ran out of money. My equity was now worth next to nothing. I was furious, but what could I do? I signed the paperwork and accepted my small payout. The whole thing really took a toll on me. I'd love to work with another early stage startup, but I'm scared of getting burned with sweat equity yet again. My dad received stock options from the publicly traded company he worked for, and it worked out well for him. With sweat equity, it feels totally different. It feels like there's zero oversight and no recourse when things go bad."

Anne:
OK, the company Jessica received her stock options from was acquired. What should Jessica's next steps have been once she received that paperwork from the company's attorney?

Alan:
Don't sign on the dotted line.

Anne:
Don't sign.

Alan:
The first thing she should do is review the document, and do it in a thorough manner, where she can truly understand everything that it entails. In most cases she can't be forced to sign at any given time. She may hold out and there may be other repercussions to that, but until she feels very comfortable, and confident in terms of what she will receive and why. She should wait, she should get financial counsel on the securities that she owns. She should get legal counsel if possible to better understand what her rights are, but don't just sign because you get a vague email, and they threaten that you have to do something, because in many cases that's a signal that there is more going on than you might realize. As an investor, you should never assume best intent by whoever may be providing that to you. Sit down, review, take your time, speak to legal counsel, speak to a financial advisor, better understand what that document really says, and what you may be able to do, and then set the next steps.

Anne:
She mentions her shares have been diluted quite a bit. Is there anything she could do about that now or is that just done?

Alan:
It really depends on the situation. In this case there is not enough data to really state that she could have done something different. I think the best thing to do would be to understand how they were diluted, in what manner? Did they come post her original purchase? Did they come before? If they were provided or exercised by other individuals, what did that look like? That's then building the case for if she feels something was actually wrong, or that was illegal, that she can build the case around it, and understand what her rights are as a shareholder, as an investor in the company, but it will very much depend on the way in which those options or additional shares were issued, and that's going to be different for every company in terms of what that looks like in the program, the issuance, what the price was, all those type of things will be detailed within their offering structures, but it's not necessarily automatic of every other company, it will depend.

Anne:
So it requires research, investigation and time?

Alan:
And time.

Anne:
Alright. Okay. Jessica talks about the difference between the stock options her father received from a publicly traded company, and the equity she received from the startup. How do the stocks options provided by private companies differ from those provided by public ones?

Alan:
It comes down to the type of company. A public company is better capitalized typically—has a longer history of operations, and revenues and expenses. So you have more information, it's a public company, they have to file certain piece of information, as an investor, whether you are an employee or just an outside investor, you can go through and determine what it's worth, what are the operating expenses, how do I think the company is doing? What are the benefits of their business, the mote, the industry? All that type of thing. With a private company that's not so obvious, they

don't have to file the same amount of information. They don't have to provide you as an investor or an employee with the same levels of information. It's not necessarily that the options are different in terms of how you exercise them, and what they do. What's different is the company and understanding that company requires a lot more work on a private company than it does on a public one. Before you, one, accept options, two, exercise options, you should really understand what the business opportunity is for that company.

Anne:
At the end of these podcasts we like to ask for a couple of takeaways. Something that maybe an audience member can share with a friend. What would you say to those listening are some key takeaways?

Alan:
I think it comes down to knowing yourself and understanding how much risk you are willing to bear both in your career with compensation, and with investments, and understanding the intersection of those three, because they are critical. Many people want to divest them, and say they are different, it's my career, my compensation, my investment and savings. But they are so intertwined, that if you don't have a good appreciation for that, and knowing yourself around risk, and that risk assessment, and understanding what your objectives are, it's going to be really hard to find success over the long term.

Anne:
Thanks again Alan McKnight, chief investment officer at Regions Bank. We've learned a lot. Thanks for joining us.

Alan:
Thanks so much for having me.

Anne:
And thank you for listening to Regions Wealth Podcast. Every episode we explore a different financial topic with the help of a Regions advisor. Join us again and consider sharing the wealth by recommending this podcast to a friend.

Copyright 2019 Regions Bank, member FDIC, Equal Housing Lender. This information is general education or marketing in nature and is not intended to be accounting, legal, tax, investment or financial advice. Statements of individuals are their own—not Regions'. Consult an appropriate professional concerning your specific situation. This podcast is intended for

educational and marketing purposes only. The people and events are fictional but represent real issues. No identification with actual persons is intended or should be inferred.

Investments, Annuities and Insurance Products Are Not FDIC Insured, Are Not Bank Guaranteed, May Lose Value, Are Not Deposits. Are Not Insured by Any Federal Government Agency. Are Not a Condition of Any Banking Activity.

Copyright 2019 Regions Bank, member FDIC, Equal Housing Lender.

All non-Regions' owned apps, websites, company names, and product names are trademarks or registered trademarks of their respective owners. Their mention does not imply any affiliation with or endorsement by Regions of them or their products and services. They are merely used as examples of the many available apps, companies and websites that offer similar services. Before using any app or website you should carefully review the terms of use, data collection and privacy policies. Apps may have an initial cost or in-app purchase features.

This information is general in nature and is not intended to be legal, tax, or financial advice. Although Regions believes this information to be accurate, it cannot ensure that it will remain up to date. Statements or opinions of individuals referenced herein are their own—not Regions'. Consult an appropriate professional concerning your specific situation and irs.gov for current tax rules. Regions, the Regions logo, and the LifeGreen bike are registered trademarks of Regions Bank. The LifeGreen color is a trademark of Regions Bank.