

The Equity Stack: How Ownership Structures Define Wealth

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Venture-backed startups have created some of the largest personal fortunes in modern history, particularly in the technology sector, where founder ownership levels at the time of an IPO typically average between 15% and 20%.¹ The financial results we see today were by no means random. Instead, they reflect the ownership structure that was put into place as soon as the company started, and how that ownership structure dictates the distribution of all future value created by the company.² The venture capital model illustrates a larger concept within Corporate Finance: Wealth is distributed largely based upon equity ownership versus contribution of labor.³

Venture-backed firms' equity structures determine which parties receive the benefits from their successes, since equity holders are entitled to any surplus value created by a business, and equity owners therefore enjoy any increase in Enterprise Value, while wage earners do not.⁴ Ergo, the equity structure of a venture-backed company is very important for deciding which party will end up with a larger share of the wealth as the company grows or succeeds.⁵

The venture-capital-funded startup has an equity base with numerous participants, such as employees, venture capital investors, and founders.⁶ Typically, the founder(s) are granted a significant percentage of the equity at the time of formation in consideration of their creation of the company, assumption of risk associated with starting the business, and other efforts involved in developing the company.⁷ The venture capital firm receives equity in exchange for funding the growth of the company using the money they invested, and in most cases, this funding is provided by purchasing preferred stock, which provides additional protections in addition to those available under the standard equity stake.⁸ In addition to receiving equity in consideration for their work, employees may also be granted equity as part of their total compensation package, often in the

¹ <https://www.blossomstreetventures.com/post/founder-ownership-at-exit>

² https://www.nber.org/system/files/working_papers/w27296/working_papers/w27296.rev1.pdf

³ https://anderson-review.ucla.edu/wp-content/uploads/2021/03/Sorenson-et-al_StartupEmployees_Final_preprint2019.pdf

⁴ <https://www.investopedia.com/terms/s/stockholdersequity.asp?>

⁵ <https://www.svb.com/startup-insights/startup-equity/managing-startup-equity/>

⁶ <https://about.crunchbase.com/blog/venture-capitalist-percentage-ownership>; <https://www.svb.com/startup-insights/startup-equity/managing-startup-equity/>

⁷ <https://scholarship.law.vanderbilt.edu/vlr/vol76/iss5/1/>.

⁸ <https://nvca.org/model-legal-documents/>; <https://eqvista.com/equity/equity-compensation-vs-salary-startup/>

form of stock options.⁹ While there is considerable equity ownership participation by all parties, the equity “stack” is structured in a way that financial results can differ significantly based upon the timing and terms of acquiring ownership.¹⁰

Timing of equity ownership is one of the most important factors that determine financial performance for companies with venture capital backing. The convex payoff structure of equity—where returns grow exponentially with the growth of company value—benefits early equity holders.¹¹ Founders and early investors often obtain equity when their companies have lower valuations than later investors, which means that a smaller equity ownership can result in significantly greater wealth for the founder/early investor if they ultimately sell the company for a high value.¹² By comparison, all other participants (i.e., those who enter after the first group) will typically buy equity at a higher valuation than earlier participants. Therefore, an identical equity percentage will correspond to less of an absolute gain to each participant compared to the first group of participants.¹³ The reason for this disparity has to do with the underlying principles of finance; i.e., returns on investments are heavily influenced by both entry prices and timing.¹⁴

Venture Capital Investors also benefit from contractual arrangements such as liquidation preference, which will allow Venture Capital Investors to better protect their investment and define how they would be distributed when an exit occurs.¹⁵ Preferred Stock is often issued by venture capital firms to the investors who purchase it. The Preferred Stockholders have the right to be repaid their investment prior to all other stockholders being paid when a sale or liquidation occurs.¹⁶ Liquidation Preference has become a ubiquitous part of venture capital deals and is generally recognized as a method to reduce the potential loss of investment on the part of the investor.¹⁷ The Investor's ability to contractually reduce its risk in less favorable exit scenarios through liquidation preference provides the Investor with protection in terms of recovering its invested capital, and the risk associated with shareholder dilution is borne by common shareholders (founders, employees, etc.).¹⁸

A major but underappreciated part of the equity stack is the Option Pool Shuffle – Investors will take an option pool out of the pre-money valuation; in essence, they are diluting the founders

⁹ <https://eqvista.com/equity/equity-compensation-vs-salary-startup/>

¹⁰ <https://scaleup.mofo.com/guidance/ask-a-mofo-common-provisions-in-venture-capital-term-sheets-liquidation-preference>

¹¹ <https://www.nber.org/papers/w19347>

¹² <https://www.svb.com/startup-insights/startup-equity/managing-startup-equity/>

¹³ <https://www.joinwarp.com/blog/startup-equity-dilution-what-founders-need-to-know-before-their-next-round>

¹⁴ <https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/equity-valuation-concepts-basic-tools>

¹⁵ <https://www.angellist.com/learn/liquidation-preference>

¹⁶ <https://venturecapitalcareers.com/blog/liquidation-preference>

¹⁷ <https://www.ashfords.co.uk/insights/blog/liquidation-preferences-breaking-down-the-payout-dynamics>

¹⁸ <https://www.svb.com/startup-insights/startup-equity/startup-equity-dilution/>

before they invest.¹⁹ During a down round, the equity stack can also be adjusted as part of a recapitalization, which could result in Common Stock holders being heavily diluted to accommodate additional capital.²⁰ The equity ownership splits post-funding can also be changed significantly by price protection provisions, including anti-dilution provisions (e.g., founder-friendly broad-based weighted average to the extreme full ratchet provisions), among others.²¹

The Venture Capital Model represents an even larger truth in corporate finance: it is the possession of ownership, and not just involvement, which creates value for owners (wealth). Economists studying financial markets have noted that equity (or stock) allows its owners to capitalize on increases in value of their equity, but generally wage agreements limit employee compensation through contracts.²² Ergo, the reason why startup founders and early investors often end up with a significant amount of wealth as a result of the success of their business ventures—even if later employees play a major role in the company's growth—is because they are owners of the business venture.²³

More importantly, there are also inequities in access to early equity ownership across geographically dispersed and professionally connected networks. Venture capital investments occur disproportionately within a few geographically focused areas, like Silicon Valley, which contain a high density of both investors and founders, creating an opportunity for entrepreneurs to be financed at early stages in their development.²⁴ Over 50% of all U.S. venture capital investments have been found to be concentrated in only three areas: The San Francisco Bay area, New York, and Boston.²⁵ These are the same areas that contribute most to the existing inequities in the ability of individuals to access equity ownership opportunities and to build wealth.²⁶

Ultimately, the Venture Capital Model reveals a fundamental aspect of Corporate Finance: that wealth generation is a function not simply of one's "effort," but also of "ownership." The Equity Stack defines, at an early stage of a company's life cycle, which parties (to what degree) can expect to receive a portion of the upside in terms of financial reward. In other words, the founders/early investors benefit from their timing of investment (the earlier they invest), their level of equity ownership, and contractual provisions; thus, these parties have a greater opportunity to capture a significant portion of the value generated by a growing company. In contrast, later participants (i.e., employees of a company whose contributions of time, talent and/or labor are critical to growing a business) are constrained by the equity structures of corporate finance (liquidation preferences, dilution, option pool, etc.) to capture similar levels of financial returns,

¹⁹ <https://www.ipohub.org/article/dilution-stock-option-pools>

²⁰ <https://www.cooleygo.com/down-round-financings>

²¹ <https://esinli.com/knowledge-base/startup-finance/full-ratchet-anti-dilution/>

²² <https://www.nber.org/papers/w19347>

²³ <https://www.nber.org/papers/w19347>

²⁴ <https://www.hbs.edu/ris/Publication%20Files/09-143.pdf>

²⁵ <https://elevate.vc/the-unequal-geographic-distribution-of-venture-capital/>

²⁶ <https://www.journals.uchicago.edu/doi/10.1086/321301>

regardless of their individual level of contribution to the growth of the company. The equity-based financial rewards realized by later-stage participants are not a result of random or unjustifiable inequalities of treatment, but rather are an inevitable result of the structural features of the corporate finance system.

In addition to funding innovation, the Venture Capital Ecosystem highlights how participation in ownership opportunities significantly influences the distribution of wealth. Because early-stage equity is generally owned by individuals within a small subset of geographic, educationally, and professionally networked communities, there exists a disparate level of access to ownership opportunities which influence wealth generation.²⁷ Therefore, the Venture Capital Model contributes to the establishment of a financial structure where ownership, timing, and access to ownership opportunities directly impact economic outcomes. An understanding of the dynamics described above is key to understanding the wealth-distributing functions of contemporary financial systems, which are influenced by both the contribution to the financial success of companies and the participant's position within the ownership structure of those companies.

²⁷ https://www.nber.org/system/files/working_papers/w15102/w15102.pdf