Why Option Refresh Grants Are Essential for Recruiting and Retention

Employee ownership has always been at the core of the Silicon Valley ethos. From the earliest days of the Valley, startup founders understood that employees who benefit from their company's success will work harder, stay longer, and perform better than those who don't have a meaningful stake.

It's no secret that a thoughtful compensation plan can be a powerful tool for recruiting and retention, particularly in highly competitive markets, but the best way to structure these plans remains controversial. I've been on a bunch of boards where views diverged wildly about refresh grants and I've seen the debate get quite heated.

My goal here is to lay out what I believe to be the best practices with respect to option grants. I'd also like to call out some high-quality articles from the past on this topic including this one by Andy Rachleff and this post by Fred Wilson.

Now, for a bit of context, in the late 1990s and early 2000s, the prevailing strategy was to provide employees with a one-time option grant when they started, but these options would usually not be refreshed after the initial grant. Back then, the time to liquidity was generally shorter than today, it was harder to come by a job, and companies didn't need to be overly generous. Note that I wish we lived in a world where employers were generous all the time but that just isn't the case. All of that said, this one-time grant structure just doesn't make sense anymore for most companies. The time to liquidity has increased over the past 15 years and the overall tech ecosystem has flourished, making the war for talent that much more intense. As a result, employees stay at companies longer and the demand for talent has soared. Transparency around employee compensation both within and across companies has increased dramatically. These factors have resulted in a big positive: employees are better able to advocate for their own compensation.

All of this means that refresh grants make sense; employees can continue to accumulate wealth, and employers can better retain talent.

Despite this trend, some VCs and board members adhere to the old school belief that employees and founders should receive equity only at the time of founding or being hired, and should not receive additional equity on an ongoing basis. It is the debate around this topic, whether employees and founders should get refresh grants, where I've seen significant controversy in board rooms. I've personally seen situations where the VCs only acquiesce to the request for refresh grants after bitter battles with founders and management teams. This short-sighted behavior on the part of VCs fails to recognize the reality of today's environment and can create unneeded acrimony.

At Shasta Ventures, most of our portfolio companies have refresh grant programs in place. The structure of these programs varies from company to company, but the intent is always the same — to provide ongoing reward and incentive for those who continue to help build the companies.

Best Practices for Option Grant Programs

Now let's talk about the best practices for these programs. In my view, employers should offer options to employees in three situations, and consider granting options in a fourth.

Option Grant Scenarios One and Two — New Hires and Promotions

The first two scenarios for option grants are straightforward and uncontroversial. First, employers should grant options to employees when they are hired, and secondly, when they are promoted so that their compensation is commensurate with their new position.

Option Grant Scenario Three — Formal Refresh Program

The third scenario for options grants is whether employers should grant options as part of a formal option refresh program. I believe firmly that most companies should have a formal refresh program in place. For clarity, there are some exceptions such as companies that have a compensation system more focused on cash comp or incentive comp — including sales commissions — but most companies should have a refresh program. The best refresh programs offer an employee a new grant at year two or three, after 50-75% of the employee's initial grant has vested.

Jason Pressman
Managing Director

Jason Pressman is a Managing Director at Shasta Ventures and views himself as a service provider to extraordinary entrepreneurs.

Generally, these types of refresh grants equal 25-50% of a full new hire grant (i.e., the amount of equity that would be required to hire a full time replacement for the role at the current stage of the company's development) and vest in one of two ways: 1) monthly over a continual 48 months or 2) with a boxcar approach where employees receive new options granted serially each year after their second- or third-year anniversary, with vesting tacked on to the end of the existing vesting schedule rather than through parallel grants that overlap in vesting over time. This boxcar structure gives the employee the lower option strike price because they are granted earlier and creates a smooth vesting schedule for employees over time.

Employers, however, must determine which employees receive refresh grants. Are they available to everyone or only to a subset of employees? And then there is the question of whether founders should be eligible for refresh grants. I've seen a broad range of approaches with the topic of founder eligibility for refresh grants and it is often one of the most controversial board level issues in developing compensation programs. Regarding eligibility for employee refresh grants, some companies are completely egalitarian and give them to everyone, but most companies adopt a more meritocratic approach and grant variably depending on performance. In this case, it's up to the discretion of management to determine the contribution and performance of each employee. One approach that works well is to give refresh grants to 75% of employees and vary the value of the grant so that the top quartile receives twice what the bottom quartile receives.

Regarding founders, my view is that founders should be eligible for refresh grants on the same terms as employees. Of course, there are legitimate reasons where the one-size-fits-all approach doesn't work with founders and it's important to look at the big picture including a founder's overall stake, continued level of contribution and whether they've sold any shares and already taken some liquidity. But in almost all scenarios, I believe that founders who are still contributing meaningfully should also be part of the refresh program at their company.

I realize all of this can be bit complicated so let me clarify the program that I think works really well for most companies. I advocate giving refresh grants to founders and employees using annual boxcar grants. When a person reaches their three-year anniversary and is 75% vested, they receive an option grant of approximately 25% of what a new hire would get in that role at that time and the option vests over two years with a one-year cliff so that they vest 1/12th per month in months 13-24 after the option is granted. The employee is eligible for another refresh grant using the same formula in each subsequent year so that there is an ongoing smooth vesting of equity. I think that the size of the grant should be adjusted upwards or downwards based on an employee's performance each year.

As a rule of thumb, the value of annual refresh grants after the third year of employment should equal 25% of the cost of a full-time replacement hire. Since most companies are growing and performing well, the option grants required to hire full-time employees at any given level decreases each year to reflect the lower risk profile of the Company.

Option Grant Scenario Four — Discretionary Performance Grants

Finally, management teams can grant refresh options at their discretion to reward performance. Some firms create an annual option pool for high performers to further incentivize and reward performance. I've seen mixed results with this approach. On the positive side, it can make high performers feel great! On the flip side, it can divide a company into the "haves" and "have nots," create a sense of entitlement and expectation among employees, erode teamwork, and reduce morale among those in the "have not" category. Furthermore, administering performance-based grants is not inconsequential, not just in terms of paperwork and legal bills, but because executives must devote time to rating performance and deciding who gets what. The drawbacks can outweigh the benefits. However, in my experience as a board member, quite a few CEOs love these programs and feel that they work really well to reward exceptional performance. I come out mixed on this one and feel that it really depends on what the CEO and executive team wants to do.

Option Communication — Percentage of Company or Suggested Value

Communicating the value of an option is another subject that can also be a source of controversy in board rooms. Most teams and employees like to talk about ownership percentage (i.e., what percentage of the company does an employee own on a fully diluted basis). Some board members and executives like to switch the discussion to total value per year imputed based on the difference between projected exit value and the strike price of the options. This is particularly relevant for later stage companies where there is more clarity about future value. Honestly, I think both approaches are valid. Later stage companies should talk about both ownership percentage and expected total value based on outcomes. Anyone who is trying to strictly adhere to either approach is likely to find that they need to be a bit more pragmatic, as the views on best practices are wildly divergent, and well-informed new hires will expect to talk about both.

Dilution

Keep in mind that when companies grant equity with refresh grants, they are diluting all existing shareholders as options are not free. Most companies dilute themselves by about 5% per year (although there is a huge range in the amount of annual dilution) based on new hires, promotions and refresh grants. This is a cost of doing business but CEOs and boards need to think about it as the annual dilution really adds up over time. I'm a huge fan of rewarding people who are building the business so I think this annual dilution is a great investment but everyone should go in with their eyes wide open and be thoughtful about how and where to grant options.

Conclusion

Option refresh programs are a valuable tool for recruiting and retaining talent, but must be communicated clearly to employees. The best programs offer refresh options to employees and founders. Management should clearly communicate to employees and founders that while they receive their largest option grant when they join, they will be eligible for more options when they are promoted and when their performance or employment tenure qualify them for the formal refresh program. The clearer you can be with the team, the better!