CultureAmp among the first to grasp new employee share scheme opportunity

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CultureAmp co-founder and chief executive Didier Elzinga says the software startup intends to have its ESS set up within weeks.

Startups are seizing the opportunity to implement employee share option schemes since the law changed on July 1, with Melbourne-based CultureAmp one of the first on board.

Herbert Smith Freehills partner Peter Dunne, who advised CultureAmp through the process, says he is assisting five other startups to set up schemes and is in discussions with at least two others.

Dunne says it is “categorically” becoming a trend for technology and tech-enabled startups, because share options are becoming the norm around the world.

“Increasingly the employees are having regard to what’s available to them in and global market and the currency is that they get stock options,” Dunne says. “I’ve seen an increase in the number of companies interested in doing this and I don’t think that will abate any time soon.”

CultureAmp co-founder and chief executive Didier Elzinga says the software startup intends to have its ESS set up within weeks and the delay was actually on the US side.

“We’re still going through the final steps of rolling it out,” Elzinga says. “Ironically the thing holding us up is sorting out the US side because we have staff in the US too. The view going in was that it was going to be much harder here than in the US but the changes in legislation mean there’s a fairly good process here.”

CultureAmp has grown from 14 to 39 staff since January this year, on the back of $US6.3 million in venture capital investment. Most staff are in Melbourne, but 10 are in San Francisco.

Elzinga says he first looked at developing an employee share scheme a year ago, but it was too complicated and the difference now is “night and day”. The new legislation is for companies with under $50 million in revenue, a fact that some technology entrepreneurs have criticised. Freelancer.com chief executive Matt Barrie has described it as “tricky” and Campaign Monitor co-founder Dave Greiner as “disappointing”.

However, Elzinga says he is comfortable with the limit, despite CultureAmp’s high growth (currently about 10 per cent month on month).

“We’re in a window, we’re not going to be able to continue to do this forever,” Elzinga says. “The bigger the company gets, the more mature it gets, there are other ways you can incentivise people. At this stage when it’s just a dream, you need to get people to buy into it.”

Elzinga says CultureAmp and startups in general are less likely to be making large equity grants once they have $50 million in revenue. He adds there are already suitable structures for bigger companies to implement employee share schemes that involved small chunks of equity to large groups of people.

Dunne, along with colleagues from Herbert Smith Freehills and its sister tax practice, helped advise the government on establishing the new regime. He says the new scheme provides clarity of tax treatment and pro forma forms to simplify the process.

“It’s really good initiative ... but it’s true the legislation is targeted at startup community,” Dunne says. “Once you fall outside that, you can have a share scheme but need to structure it differently.”

Motivation for offering employee share options

CultureAmp has decided to offer the share options to all staff, but the amount each individual is offered would vary according to the role, their skills, and how early they join the company. The startup is using the common US formula of a four-year vesting period with a one-year cliff, meaning the employees get nothing if they leave in the first year, 25 per cent after one year, and then monthly vesting for the remainder.

Elzinga says the main reason to offer shares is to create a sense of ownership rather than to compete on salary.

“We still want to be competitive in the market in terms of the salaries we pay; we’re not saying ‘come and work for nothing and we’ll give you some shares’,” he says. “But in a technology startup, the concept of the shares and how this can be valuable for every individual is really powerful. Most importantly you’re now an owner, you’re looking at something that is yours when you walk in, and it’s hard to underestimate the power of that especially if you can build that in early.”

Dunne suggests founders considering setting up an employee share option scheme should run through different growth and funding scenarios to determine how much equity to give away.

“Early on founders can give too much away to the first people who help the company in the early stages when it’s hard, even if they’re not around for a long time,” Dunne says. “You need to have regard to the fact that equity is valuable and as you do capital raising, the equity pool for the original founders will be reduced. Yet as the company grows you’ll need key roles to facilitate that growth, a chief marketing officer or a chief product officer for example would expect good remuneration packages and often expect equity. That picture is distorted if too much equity is given away early on because it sets the benchmark.”

In the US, there has been a trend for startup employees to become savvier about equity in startups, because not all equity is treated equally and venture capital investors often negotiate preferential terms. For example, a downside preference clause means that investors get their money back ahead of other stakeholders if the company is sold for less than its valuation.

Dunne says there is a need for startups to educate employees about how the share option schemes will work, especially in Australia. He says the reality is that institutional investment such as venture capital impacts pre-existing equity and usually ranks first in a liquidity event, but it’s irrelevant if the investment drives growth in the way that it should.

“Employees need to be taken through this and the great thing is that the ESS changes the relationship so that employees are now quasi owners of the business,” Dunne says. “It’s incumbent on any company that puts this in place - and the CultureAmp guys do this well - to take people through how the plan works so it’s seen as a good offering, and not something clouded in mystique and uncertainty.”

Elzinga says CultureAmp tries to be very transparent, and is “lucky” because its fundraising to date has been fairly standard.

“The deal is fairly vanilla and there are not many things that could change everything,” Elzinga says. “I’m lucky in a way because I used to work in film and I don’t know if you’ve ever read a film contract but film financing is an arcane art … and it can become bewilderingly complicated. You do need to be able to have those conversations and one of the challenges is that the concept of equity is not that well understood here, so there is a bit of an education process.”

Elzinga left the film business, where he specialised in special effects, after 13 years, partly because he was inspired by his friendship with Atlassian co-founders Mike Cannon-Brookes and Scott Farquhar.

He sits on the Atlassian Foundation board, which assists charities such as Room to Read with an endowment that includes 1 per cent of Atlassian’s equity and profit. Elzinga says the CultureAmp founders are considering joining the Pledge 1% movement, where founders commit to giving 1 per cent of equity, product, employee time or all three. Farquhar has been advocating Pledge 1% in Australia, along with Salesforce.com.

“Scott and I have talked about that; there are quite a few things to be worked out, but we’re actively looking at it,” Elzinga says. “At this point in the process, we’re philosophically committed to the idea, but working through what that means in practice so it’s more than just words. Once you have investors on board, you can’t unilaterally send the shares, so there’s also the question of 1 per cent of what.”