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# STARTUP LOTTERY

**Your Guide to Navigating  
Risk and Reward**

by

**Gus Bessalel**

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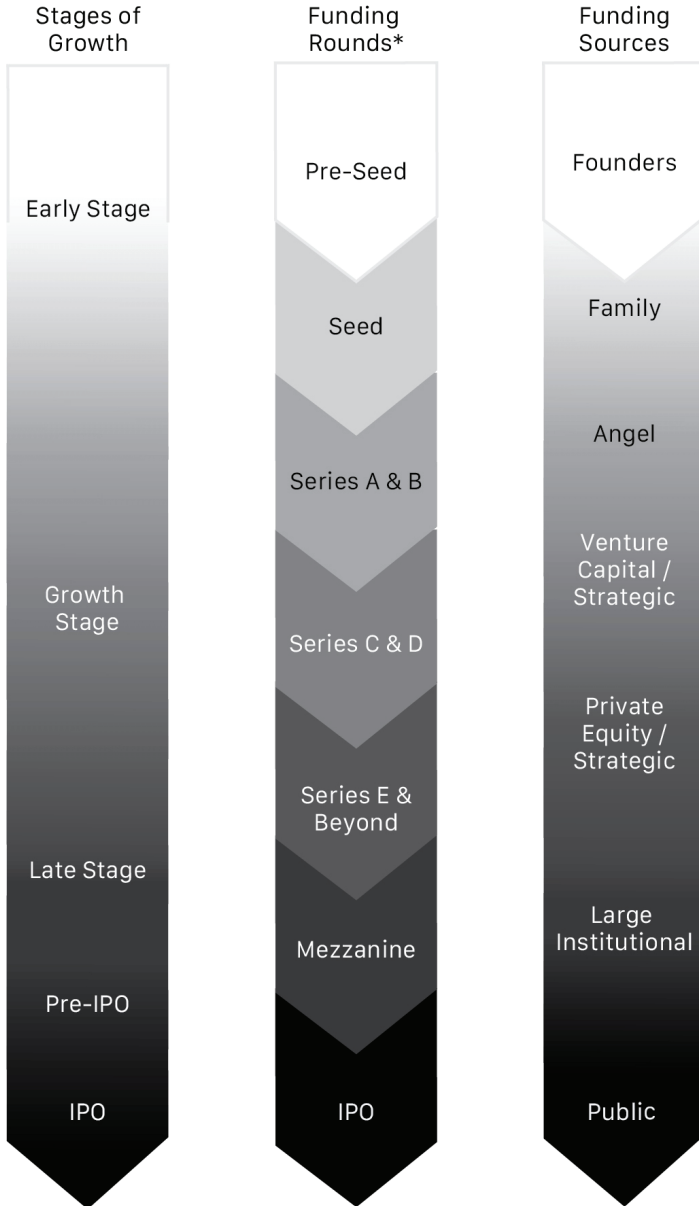
Narrated by Gus Bessalel

# List of Exhibits

Exhibit 1-1: Startup Stages and Funding Rounds . . . . .	8
Exhibit 2-1: The Startup Cast Organizational Structure . . . . .	14
Exhibit 2-2: The Investment/Power Matrix . . . . .	24
Exhibit 3-1: Timelines and The Proof Continuum . . . . .	29
Exhibit 3-2: Relative Risk Along the Proof Continuum . . . . .	34
Exhibit 3-3: Correlating the Proof Continuum with Funding Rounds . . . . .	38
Exhibit 4-1: The U-Curve of Risk Tolerance . . . . .	67
Exhibit 4-2: U-Curve Risk Tolerance vs. Proof Continuum Risk . .	68
Exhibit 5-1: Startup Offer Evaluation Criteria . . . . .	77
Exhibit 6-1: Job Offer Checklist . . . . .	109
Exhibit 8-1 Company Sale Outcomes - Participating versus Non-Participating Preferred Shares . . . . .	140
Exhibit 8-2: Sample Capitalization Table for a Series B Startup . .	146
Exhibit 9-1: Comparison of Options, Restricted Stock, and RSUs . . . . .	156
Exhibit 12-1: Advisor Grant Value Over Time . . . . .	189
Exhibit 13-1: Comparison of ISO Tax Treatment in a Sale Scenario . . . . .	198

Exhibit 13-2: Comparison chart of ISOs and Non-Quals . . . . .	200
Exhibit 14-1: Effect of Company Progress on Option Value . . . . .	214
Exhibit 17-1: The Stairway to Options Payout . . . . .	238
Exhibit 17-2: Options Exercise Possible Outcomes . . . . .	243

8 The Startup Lottery



\*Company exit may happen via a sale at any point in the company's lifecycle.

Exhibit 1-1: Startup Stages and Funding Rounds

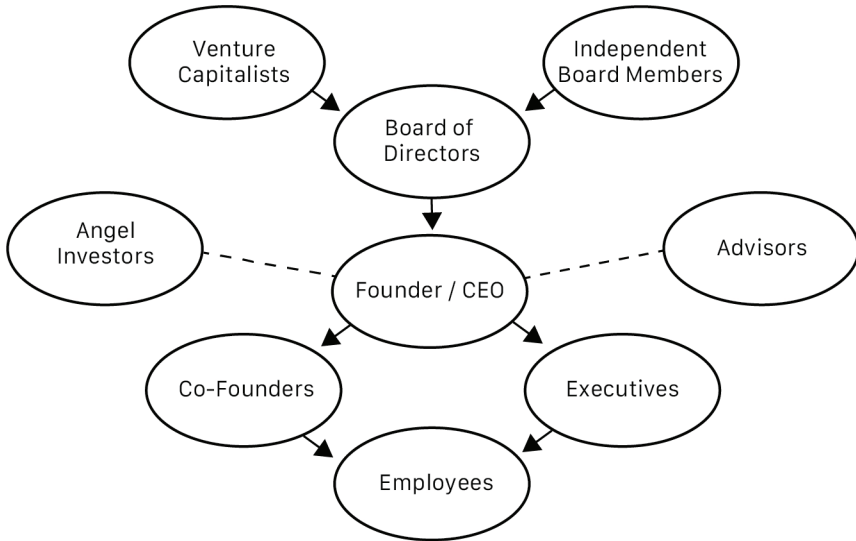


Exhibit 2-1: The Startup Cast Organizational Structure

fundors, rally around and rely on to get the venture off the ground. Until outside investors come in, the principal founder is the largest shareholder in the company.

It is the rare founder who is motivated solely by money. The startup journey is challenging and risky, and there are more certain and direct ways to build wealth. Instead, founders are out to change the world. If they get rich in the process, great. They are evangelical in their zeal and obsessive in their commitment to turning their idea into reality.

The founder has a specific skill set, often technical, without the full breadth of experience building businesses. Successful founders are self-aware enough to recognize their limitations and find ways to attract talent with complementary skills to fill the gaps. They allow others to contribute, innovate, grow, and succeed. Dysfunctional founders exhibit territoriality, arrogance, and controlling behavior that impedes innovation, limits the potential of other employees,

## Leading Actors and Supporting Cast

The players' relative influence may vary slightly by company depending on who invests how much and who owns what percentage of the company's stock. Exhibit 2-2 depicts how the various players typically sit relative to each other on the startup stage. The actors are placed according to their invested capital as well as their power and influence.

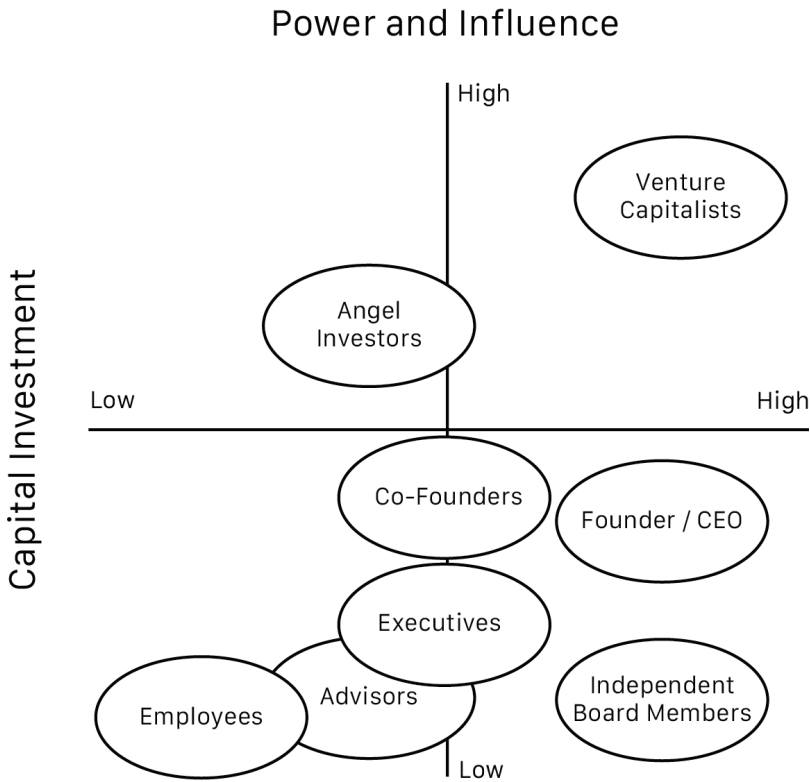


Exhibit 2-2: The Investment/Power Matrix

The players' positioning relative to each other follows a consistent arc over time. Once venture capital investors enter the

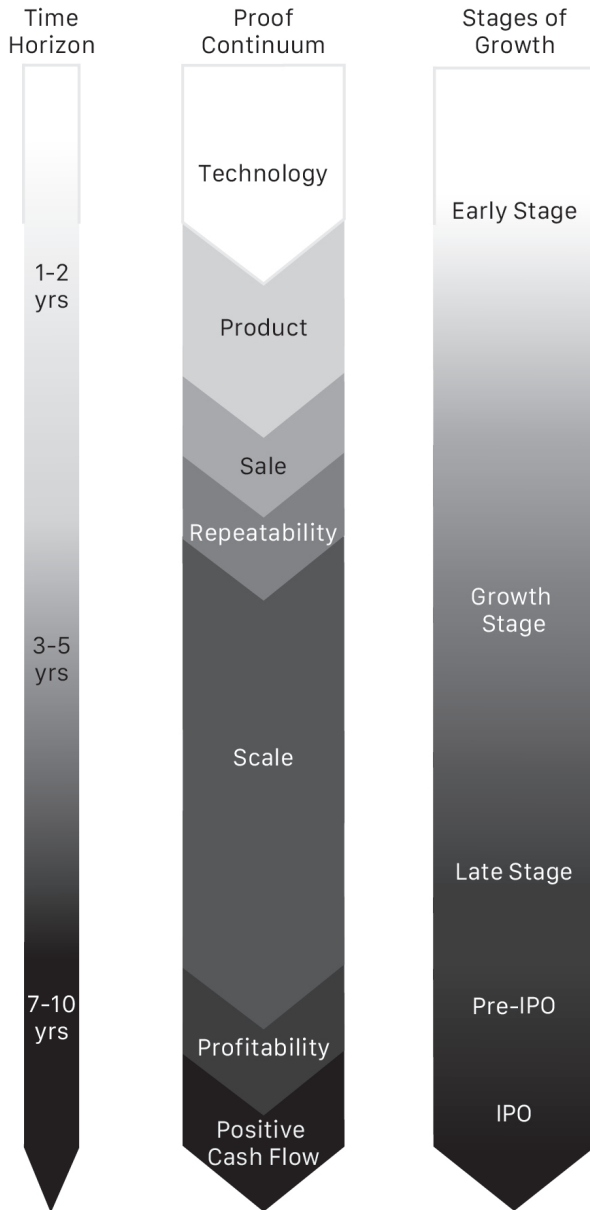


Exhibit 3-1: Timelines and The Proof Continuum

After five long, difficult years, we finally settled on a product formulation and a market to target and began to develop product-market fit and repeatable sales. We spent years burning through tens of millions of dollars in venture funding along the way. It took bringing in senior leaders with product management experience to set the company on the course that eventually led to a meaningful exit.

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## Where Do You Fit?

The risk of startup failure is greatest at the idea phase and diminishes progressively as the company passes through the gates of each proof stage as depicted in Exhibit 3-2. Greater operational progress often coincides with a rise in valuation. Early-stage investors invest at low share prices and stand to reap the greatest rewards. But they also find their companies failing at much higher rates than investors whose portfolio companies have already achieved proof of sale or subsequent stages of the proof continuum.

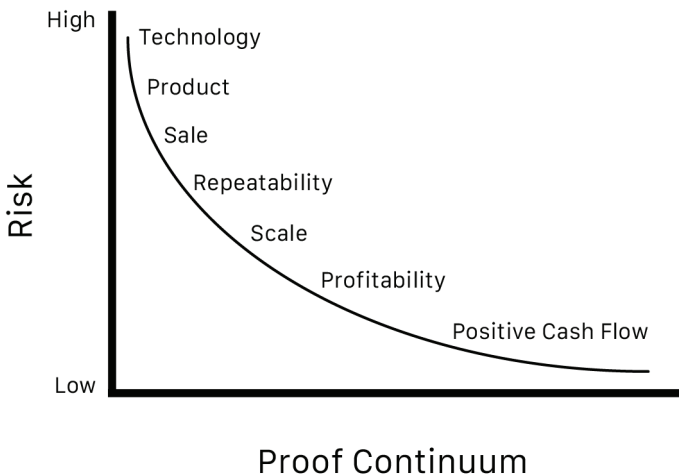
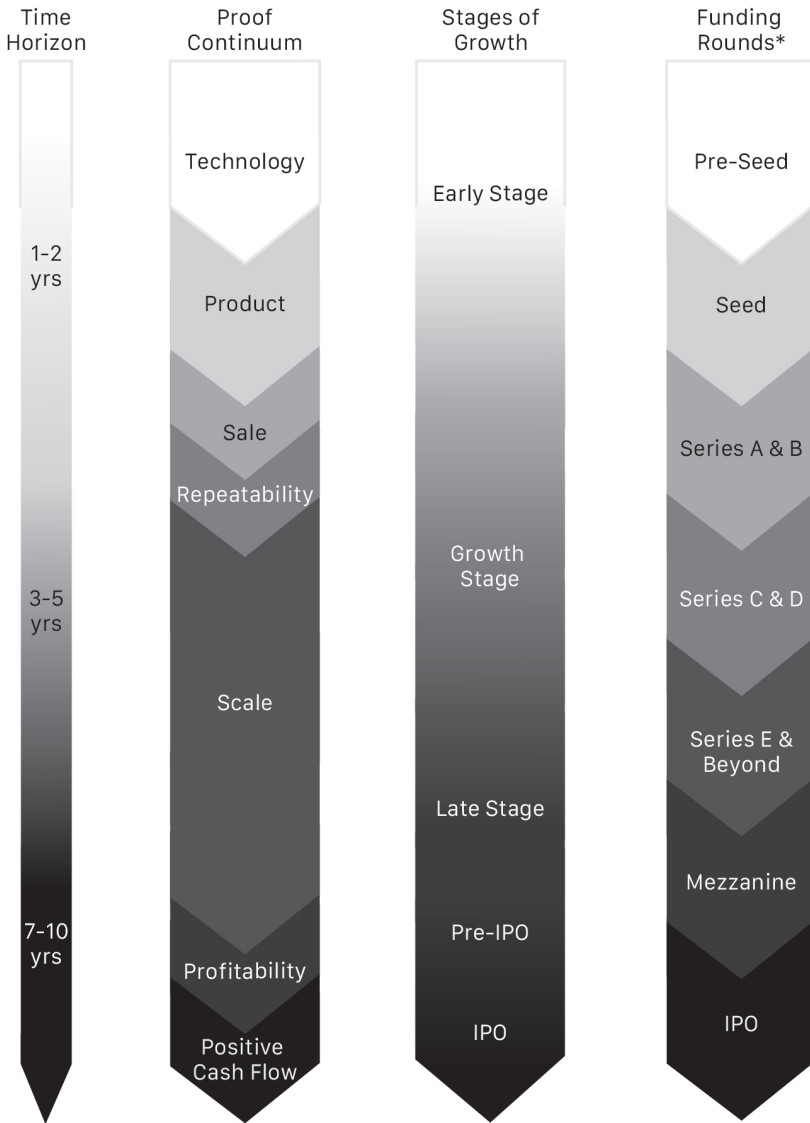


Exhibit 3-2: Relative Risk Along the Proof Continuum



\*Company exit may happen via a sale at any point in the company's lifecycle.

Exhibit 3-3: Correlating the Proof Continuum with Funding Rounds

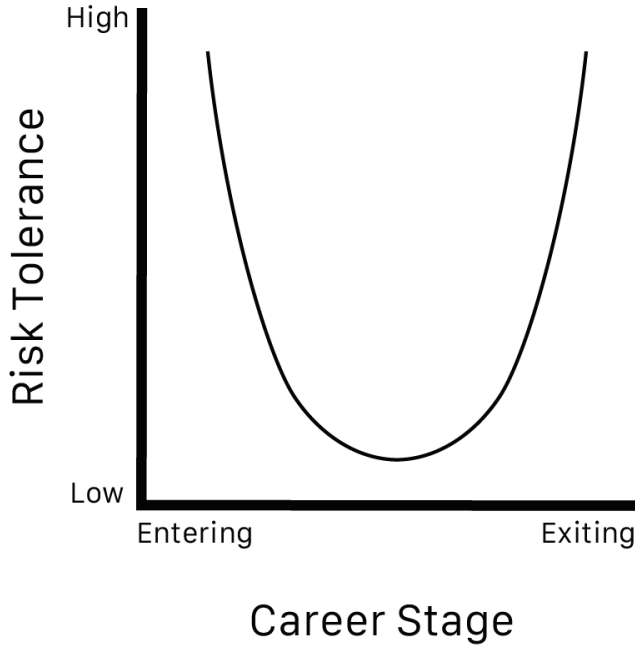


Exhibit 4-1: The U-Curve of Risk Tolerance

join a nascent startup with only \$1 million in revenue seemed too risky. She declined, only to watch the company grow in subsequent years to hundreds of millions of revenue and ultimately get bought for over \$2.5 billion.

Her decision not to join was heavily informed by the fact that we had two young kids at home, and I was already involved in a startup. The risk of jumping ship from her stable position was too great, and the timing for us was wrong. The decision cost us millions in foregone upside, but we couldn't have known that, and it was the right decision for us at the time.

### ***Startup Risk Evolves Over Time***

The factors that should influence your decision are not limited to where you are in your career journey but also include where the startup is along its path through the proof continuum we discussed

in Chapter 3 (Prove It!). The risk associated with a given company evolves. The company may gain great market traction and secure substantial funding. Or progress may be slow, and the company might burn through its cash faster than expected. As companies progress through the growth stage, operational risk declines, which also usually drives financing risk down if the company executes and meets its goals.

Exhibit 4-2 portrays the interplay between personal risk tolerance and the intrinsic risk associated with startups at various stages along the proof continuum. You would consider a situation where your risk tolerance is greater than the intrinsic risk associated with the company a “go-zone,” a situation that you might consider. The reverse is equally true. If intrinsic risk falls below your risk tolerance, that situation is a “no-go.” Of course, risk is difficult to quantify. But conceptually, when you are in a position where your life responsibilities significantly exceed your resources, taking a flier on a startup early on the proof continuum may not be prudent.

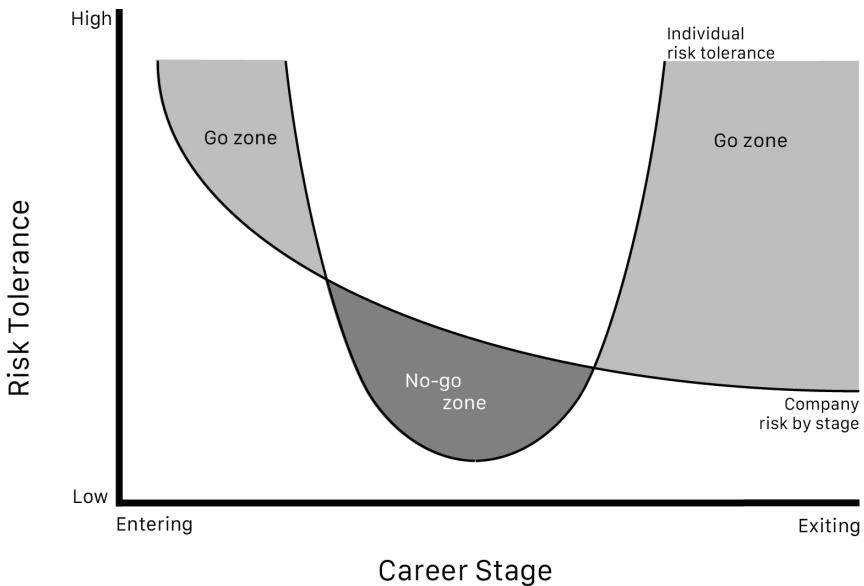


Exhibit 4-2: U-Curve Risk Tolerance vs. Proof Continuum Risk

- Geography (although in a world of remote and hybrid work, that may matter less)
- Sector/Industry
- Size of Company
- Public vs. Private
- If private, stage of company (seed, early stage, growth, pre-IPO)

In Exhibit 5-1, you can see a sample set of criteria and an evaluation of three hypothetical job offers. You should develop customized criteria for yourself, but this list provides a good start. The criteria weights add to 100. Each offer is rated on a scale of 1 to 10, yielding a weighted-average score for each opportunity. The numerical score indicates how each opportunity stacks up (highest to lowest total score), absolutely and relative to other options. Use the numbers as a guide, but also use judgment and common sense before making your decision.

<b>Criteria</b>	<b>Weight</b>	<b>Offer A</b>	<b>Offer B</b>	<b>Offer C</b>
Industry sector	5	9	5	7
Company funding / stability	10	8	6	4
Size of market	5	6	9	5
Strength of management	15	8	7	6
Fit with career goals	10	8	10	7
Advancement opportunities	10	6	8	5
Learning opportunities	10	9	8	4
Geographic location	10	8	10	6
Cultural fit	10	9	6	9
Compensation / Upside potential	15	7	9	7
<b>Weighted Total Score</b>	<b>100</b>	<b>79</b>	<b>76</b>	<b>63</b>

Exhibit 5-1: Startup Offer Evaluation Criteria

	Yes	No
<b>Salary and Position</b>		
Competitive salary	<input type="checkbox"/>	<input type="checkbox"/>
Appropriate title and responsibility	<input type="checkbox"/>	<input type="checkbox"/>
Clear path to salary increases	<input type="checkbox"/>	<input type="checkbox"/>
Clear path to promotions over time	<input type="checkbox"/>	<input type="checkbox"/>
<b>Bonuses</b>		
Presence of bonus	<input type="checkbox"/>	<input type="checkbox"/>
Clarity on bonus determination and structure	<input type="checkbox"/>	<input type="checkbox"/>
Clarity on bonus pay-out	<input type="checkbox"/>	<input type="checkbox"/>
Clear documentation of bonus structure	<input type="checkbox"/>	<input type="checkbox"/>
First-year guaranteed full or partial bonus payout	<input type="checkbox"/>	<input type="checkbox"/>
Bonus opportunities for overperformance	<input type="checkbox"/>	<input type="checkbox"/>
Signing bonus	<input type="checkbox"/>	<input type="checkbox"/>
<b>Commission Structure</b>		
Sales commission	<input type="checkbox"/>	<input type="checkbox"/>
Recruitment commission	<input type="checkbox"/>	<input type="checkbox"/>
<b>Allowances</b>		
Moving allowance	<input type="checkbox"/>	<input type="checkbox"/>
Home office set-up	<input type="checkbox"/>	<input type="checkbox"/>
<b>Equity Offer</b>		
Competitive offer consisting of stock or restricted stock units	<input type="checkbox"/>	<input type="checkbox"/>
Reasonable vesting schedule	<input type="checkbox"/>	<input type="checkbox"/>
Early exercise provision	<input type="checkbox"/>	<input type="checkbox"/>
Extended period to exercise options past 90 days	<input type="checkbox"/>	<input type="checkbox"/>
Accelerated vesting on change of control of the company:		
<i>Full or partial acceleration</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>single-trigger (no termination required)</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>double-trigger (change of control + termination with set period)</i>	<input type="checkbox"/>	<input type="checkbox"/>
<b>Benefits</b>		
Full medical coverage	<input type="checkbox"/>	<input type="checkbox"/>
Dental coverage	<input type="checkbox"/>	<input type="checkbox"/>
Vision coverage	<input type="checkbox"/>	<input type="checkbox"/>
Disability	<input type="checkbox"/>	<input type="checkbox"/>
Retirement plan participation including company match	<input type="checkbox"/>	<input type="checkbox"/>
Paid time off:		
Holidays	<input type="checkbox"/>	<input type="checkbox"/>
Vacation	<input type="checkbox"/>	<input type="checkbox"/>
Sick leave	<input type="checkbox"/>	<input type="checkbox"/>
Maternity/Paternity leave	<input type="checkbox"/>	<input type="checkbox"/>
<b>Severance</b>		
Salary continuation	<input type="checkbox"/>	<input type="checkbox"/>
Accrued bonus payout (full or partial)	<input type="checkbox"/>	<input type="checkbox"/>
Benefits continuation period (COBRA)	<input type="checkbox"/>	<input type="checkbox"/>

Exhibit 6-1: Job Offer Checklist

	<b>Non- Participating Preferred Scenarios (\$ Millions)</b>	<b>Participating Preferred (1x) Scenarios (\$ Millions)</b>
Preferred share investment	10	10
Ownership purchased	50%	50%

#### **\$15 Million Sale Price Scenario**

Preferential payout	10	10
Payout to preferred after conversion	0	2.5
<b>Total payout to preferred</b>	<b>10</b>	<b>12.5</b>
<b>Total payout to common</b>	<b>5</b>	<b>2.5</b>

#### **\$30 Million Sale Price Scenario**

Preferential payout	0	10
Payout to preferred after conversion	15	10
<b>Total payout to preferred</b>	<b>15</b>	<b>20</b>
<b>Total payout to common</b>	<b>15</b>	<b>10</b>

Exhibit 8-1 Company Sale Outcomes - Participating versus  
Non-Participating Preferred Shares

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At Fugue, we struggled to find investors in our last funding round before selling the company. The investors who did come in negotiated for participating preferred with a two times liquidation preference. In other words, upon sale of the company, they would receive payment equal to two times their invested capital and then have the right to convert to common stock and participate proportionately (or “*pro rata*”) in the remaining proceeds. This feature turned out to be very expensive for the common shareholders when the company was sold.

an enlightening picture regarding dilution of ownership for the early shareholders such as founders and angels. In this example, at the formation of the company, the founder and co-founder were issued 1 million shares, with the ownership split 60/40 between them, respectively. After the Series B financing, the combined fully diluted ownership represented by the founder's and co-founders' shares dropped from 100 percent to just under 28 percent. This is due to the sale of shares to investors and the establishment of the option pool from which option grants were issued.

It is common that after several rounds of financing, investors would own a majority of the issued and outstanding shares. In this case, after the Series B, the investors own approximately 55 percent—10 percent in the hands of angels and 45 percent held by venture capitalists. By contrast, non-founder employees hold a small percentage, just over 5 percent. Finally, the unallocated shares in the option pool represent 8 percent available for future option grants, which may or may not ultimately be issued.

<b>Funding Round</b>	<b>Common</b>	<b>Seed</b>	<b>Series A</b>	<b>Series B</b>	<b>Total Shares</b>	<b>Percent Owned</b>	<b>Percent Owned</b>
Security issued	<b>Common</b>	<b>Preferred</b>	<b>Preferred</b>	<b>Preferred</b>		<b>Issued &amp; outs.</b>	<b>Fully diluted</b>
<b>Shareholders</b>							
Founder	600,000				600,000	17.52	16.11
Co-Founder(s)	400,000				400,000	11.68	10.74
Angel investor 1		150,000	45,000		195,000	5.69	5.23
Angel investor 2		100,000	30,000		130,000	3.80	3.49
Angel investor 3		50,000			50,000	1.46	1.34
Venture capitalist 1			500,000	200,000	700,000	20.44	18.79
Venture capitalist 2			250,000	100,000	350,000	10.22	9.40
Venture capitalist 3				700,000	700,000	20.44	18.79
Employee options (issued)	200,000				200,000	5.84	5.37
Warrants (issued)	100,000				100,000	2.92	2.68
Option pool (unallocated)	300,000				300,000		8.05
<b>Total by class (issued and outstanding)</b>	<b>1,300,000</b>	<b>300,000</b>	<b>825,000</b>	<b>1,000,000</b>	<b>3,425,000</b>	<b>100.00</b>	
<b>Percentage (issued and outstanding)</b>	<b>37.96</b>	<b>8.76</b>	<b>24.05</b>	<b>29.20</b>	<b>100.00</b>		
<b>Total by class (fully diluted)</b>	<b>1,600,000</b>	<b>300,000</b>	<b>825,000</b>	<b>1,000,000</b>	<b>3,725,000</b>		<b>100.00</b>
<b>Percentage (fully diluted)</b>	<b>42.65</b>	<b>8.05</b>	<b>22.15</b>	<b>26.85</b>	<b>100.00</b>		

Exhibit 8-2: Sample Capitalization Table for a Series B Startup

	<b>Options</b>	<b>Restricted Stock Units</b>	<b>Restricted Stock</b>
<b>Definition</b>	The right to buy a company's common stock at a set price	Shares of actual stock issued to employee directly	Shares of stock acquired through early exercise before vesting
<b>Vesting</b>	Vest as employee works for company	Vest as employee works for company	Bought before vesting is complete
<b>Taxes</b>	Have to pay taxes on the value of the stock at the time of purchase	Taxed as income on the value of the stock	Has the option to pay taxes on the value of the stock when issued
<b>Voting</b>	No voting	No voting power until vested	Voting power

Exhibit 9-1: Comparison of Options, Restricted Stock, and RSUs

While voting rights and vesting schedules are important, the main issue that affects employees is taxes. Vesting will happen as dictated by the company's incentive stock plan and in accordance with the details of each grant. Employees generally hold a small percentage of company ownership, so whether they get to vote on important company issues probably will have little impact on the outcome. But the tax treatment of equity incentive grants will have a direct and material effect on the value derived from each grant.

When you exercise an option, you pay ordinary income tax rates on the bargain element at the time. When the company's stock

In Exhibit 12-1, you can see the changes in the ownership percentage represented by that initial grant of stock and the corresponding value of the stock over time. By the time Fugue was acquired in February 2022, the ownership percentage of my initial stock grant had plummeted from 0.833 percent to 0.003 percent. After the 67 percent dilution from the initial grant through the Series D, the dilution from the last round caused the percentage ownership of those shares to drop by an additional 99 percent.

Factoring in all of the funding rounds, the ownership percentage represented by those original advisor shares dropped by a whopping 99.96 percent. Putting this in dollar terms, when the shares were issued, they had a nominal value of \$10,000. At their peak, their worth rose to more than \$400,000 on paper. But when the company sold for approximately \$120 million in early 2022, I received proceeds of only \$3,000 for those shares.<sup>37</sup>

	<b>Preferred Round</b>	<b>Capital Raised (\$ Millions)</b>	<b>Post-Money Valuation (\$ Millions)</b>	<b>Post Funding Ownership (Percent)</b>	<b>Value of Shares (\$ Thousands)</b>
<b>May 2013</b>	Initial Grant	-	1.2	0.83	\$10.0
<b>Feb. 2014</b>	Series A	3.8	13.3	0.71	\$94.0
<b>Aug. 2014</b>	Series B	10.0	33.0	0.49	\$162.0
<b>Dec. 2015</b>	Series C	20.0	90.0	0.38	\$342.0
<b>Dec. 2016</b>	Series D	41.0	161.0	0.28	\$451.0
<b>Jul. 2021</b>	Series A-1 <sup>*</sup>	10.4	20.4	0.003	\$0.6
<b>Feb. 2022</b>	Exit <sup>**</sup>	-	120.0	0.003	\$3.0

<sup>\*</sup>The Series A-1 round was part of a recapitalization of the company through which all prior preferred shares received anti-dilution treatment and then were forced to convert to common shares in a significant down round.

<sup>\*\*</sup>The value of shares at exit were calculated after payments of the participating preferred shares held by investors.

### Exhibit 12-1: Advisor Grant Value Over Time

<sup>37</sup>The shares were worth \$10,000 when originally issued and \$3,000 when sold, so I could claim a capital loss of \$7,000 on my taxes, recouping a portion of my loss.

Shares	1,000	1,000
Exercise price per share	\$1	\$1
Exercised?	Yes	No
Cost of Exercising	\$1,000	\$0
Sale price per share	\$5	\$5
Profit per share	\$4	\$4
Profit from sale	\$4,000	\$4,000
Tax treatment	Capital gains tax	Ordinary income tax
Tax rate paid	15%	35%
Taxes paid	\$600	\$1,400
<b>Net</b>	<b>\$3,400</b>	<b>\$2,600</b>

Exhibit 13-1: Comparison of ISO Tax Treatment in a Sale Scenario

In the example, we assumed you held the exercised shares for more than a year before the liquidity event. What happens if you don't meet the holding period? The ISO simply reverts to an NSO. Ordinary income taxes are due retroactively on the difference between the exercise price and the 409A valuation when you exercised. You owe capital gains taxes on further appreciation beyond that at the time of sale, just like with an NSO. You just need to keep good records to calculate the taxes correctly after the fact.

ISOs have one final complication. To avoid creating excess incentives for senior executives, ISO treatment is limited to \$100,000 of vesting options yearly. Companies must multiply the exercise price per share by the shares that vest each calendar year. If the calculation exceeds \$100,000, the excess reverts to being an NSO, usually automatically as a rollover provision in the incentive stock plan. This automatic provision prevents the company and employees from running afoul of the tax laws. Most employees do not vest enough options annually to trigger the \$100,000 ceiling on

	<b>Non-Qualified Options</b>	<b>Incentive Stock Options</b>
Eligible recipients	Employees, board members, and contractors	Employees only
Tax treatment upon exercise	Ordinary income plus payroll taxes on bargain element upon exercise  New basis established at 409A price upon exercise	Tax on gain deferred until stock sold  May be subject to alternative minimum
Tax treatment if unexercised	Short-term capital gains on difference between sale price and price of 409A at time of exercise	Ordinary income tax plus payroll taxes
Tax treatment if exercised and held less than 1 year	Short-term capital gains on difference between sale price and price of 409A at time of exercise	Short-term capital gains on difference between sale price and exercise price
Tax treatment if exercised and held more than 1 year	Long-term capital gain on difference between sale price and 409A price at time of exercise	Long-term capital gain on difference between sale price and exercise price

Exhibit 13-2: Comparison chart of ISOs and Non-Quals

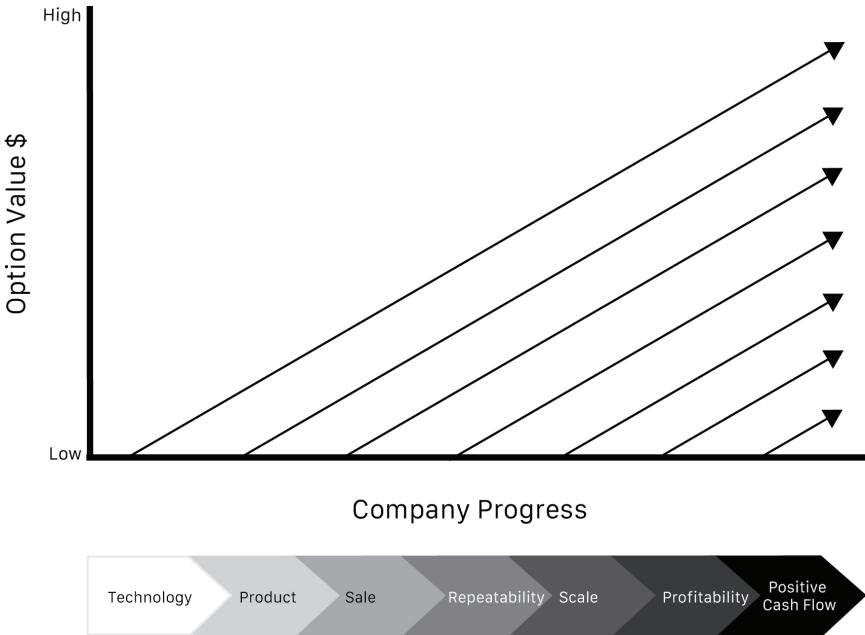


Exhibit 14-1: Effect of Company Progress on Option Value

### ***The Bottom Line***

Whether you have options or RSUs, the value of your holdings and the percentage those holdings are vested affect your decision-making. Failing to understand the value of your holdings may cause you to make uninformed decisions that you may regret later. Recognize that valuing your grants is somewhat challenging and do your best to get a rough idea of their worth; then think critically about what it means to your current situation and potential future opportunities.

Consider the value of your grants today and how they will grow from additional vesting. Assess whether your company is on a growth trajectory, treading water, or even going downhill. Evaluate what impact that trajectory will have on its stock price. Think about the company's waterfall and its effect on your option value.

liquidation preferences. Whatever the reason, the result is the same—no payout.

The turning point is whether you stay at your company until the exit or leave. Choosing to leave is the only time you are forced to decide whether to exercise your options or lose them. At any other point in your journey with your company, you can ride the wave, leave your options unexercised, and wait to see what happens.

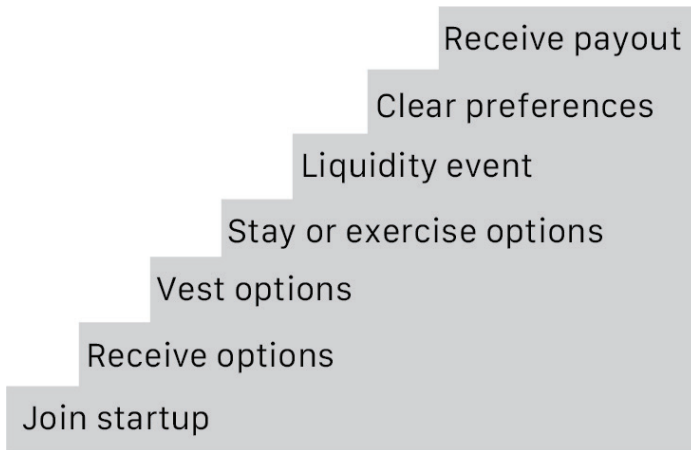


Exhibit 17-1: The Stairway to Options Payout

## Why Employees Don't Exercise Options

Throughout my career, I have observed that few private company employees proactively exercise their options. During my time as CFO at Fugue, we hired about 150 people. When the company was bought, our employee count was just under fifty. Of the hundred or so employees who came and went before Fugue was acquired, fewer than ten ever exercised their options.

There are several good reasons employees don't exercise options:

1. Options vest over time, so exercising requires multiple active decisions during the period they are vesting.

to vote with their wallets and have great incentives to look out for their best interests. Nevertheless, rather than blindly following the crowd, you should think carefully about this decision.

There are four possible outcomes based on whether you exercise or not and what happens to the company as shown in Exhibit 17-2. In some cases, you win. In some, you lose. If you exercise and your company fails, you will wish you hadn't. If your company succeeds, you can cash in on your vested options without exercising, but you will pay higher taxes. And if you have left your company before that successful outcome and didn't exercise, you would have missed out.

		<b>Company Outcome</b>	
		Fail	Succeed
<b>Exercise Options</b>	Yes	You lose	You win
	No	Dodged a bullet	Missed opportunity

Exhibit 17-2: Options Exercise Possible Outcomes