



## The Impact of Performance on Equity Utilization

By David Knopping and Matthew Lopez

**AS GOVERNANCE STANDARDS HAVE TIGHTENED OVER THE PAST SEVERAL YEARS, COMPANIES HAVE WORKED TO**

create a sustainable balance between managing shareholder dilution and maintaining a strong pay-for-performance culture through their equity compensation programs. In 2000, the median gross burn rate (see list of definitions at the end of this paper) for all high-technology companies was 5.9 percent compared to approximately 3.2 percent.<sup>1</sup> While this marked decrease in stock utilization has presented challenges for companies relying on equity to build ownership cultures that drive value creation, Radford analysis shows that some companies are realizing the best of both worlds: lower utilization and higher share price appreciation.

In pay-for-performance cultures, a significant portion of employee compensation is variable (i.e. cash bonuses and equity), and based on the achievement of organizational and individual goals. Given the heavy emphasis high-technology companies place on pay-for-performance in general and equity compensation in particular, the expectation is that higher-performing companies would issue more equity to employees as a reflection of the company's success. In other words, if companies believe that equity grants reinforce an ownership mentality that further drives share price performance, higher-performing companies would thus

be granting more equity to reward employees for growing the company's, and shareholders' value.

To determine if this was in fact the case, Radford evaluated the historical stock price performance and equity gross burn rates of approximately 40 high-technology companies with revenue greater than \$5 billion, representing a broad cross-section of industry subsectors (see Figure 1). For the purpose of analysis, companies were divided into those with positive and negative share price movement over a three-year period. In the analysis, the stock performance period covered fiscal years 2004 to 2006; gross and net equity burn rates were compiled from fiscal years 2005 to 2007. We examined equity burn rates for the year following the performance period to determine if companies were increasing or decreasing their equity usage based on performance, thereby creating a more direct link between stock price performance and the percent of company allocated to employee programs.

**Higher performing companies were in fact using less equity on an annual basis than their lower-performing peers**

**Figure 1: Companies with Positive Stock Price**

Three-Year Performance Period				
Percentile	Revenue	Employees	Market Cap	Three-Year Stock Price Growth
75th	\$36,622.0	83,500	\$43,721.7	18%
50th	\$17,246.0	58,500	\$11,932.0	10%
Average	\$30,322.2	74,423	\$41,943.2	14%
25th	\$8,871.0	17,100	\$4,789.0	6%

**Companies with Negative Stock Price Performance**

Three-Year Performance Period				
Percentile	Revenue	Employees	Market Cap	Three-Year Stock Price Growth
75th	\$14,354.0	56,804	\$36,833.0	-2%
50 <sup>th</sup>	\$13,230.2	34,200	\$29,248	-4%
Average	\$16,369.0	40,283	\$40,644.0	-8%
25 <sup>th</sup>	\$10,666.1	23,588	\$7,492.6	-12%

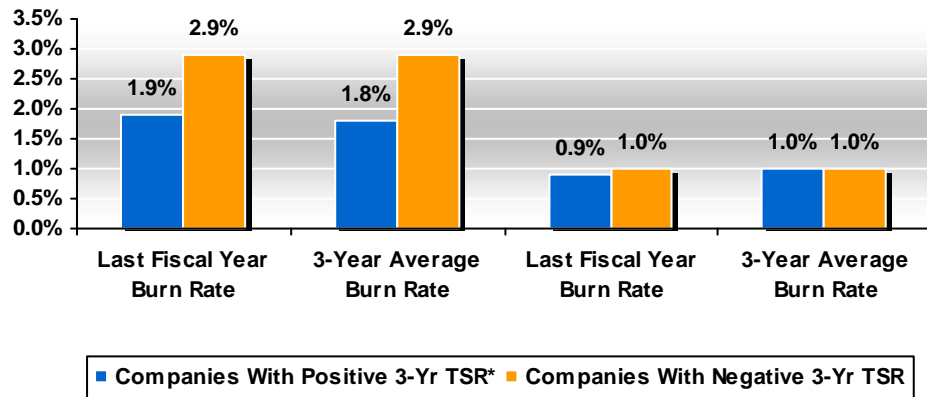
*Findings and Considerations*

After comparing the three-year average gross burn rates of companies with positive share price growth to the three-year average gross burn rates of companies with negative share price growth, Radford found that higher-performing companies were in fact using less equity on an annual basis than their lower-performing peers.

As Figure 2 below depicts, companies with positive share price appreciation during the three-year period had average gross burn rates approximately 40 percent lower than those

companies with negative shareholder return (1.8 percent and 3.1 percent, respectively). It is also worth noting that the higher-performing companies were able to manage to a lower burn rate even with, at the median, somewhat larger employee bases.

**Figure 2: Stock Utilization Practices**



**Presenting employees with less equity in the wake of high company performance can present a communication challenge**

\*Total Shareholder Return

The most logical explanation for these findings is that companies with increases in share price can deliver more equity value to employees with fewer shares. This would imply that companies are formulating their equity grant levels based on competitive practices for delivering a target equity grant value in the broader market, then looking at the total equity pool granted as a percent of company to balance this value-based methodology for determining equity grant sizes.

However, companies that focus solely on setting actual grant levels based on value in the market and do not consider historical company performance could face employee morale issues. Presenting employees with less equity (in number of shares/options) in the wake of high company performance can present, at the least, a communication challenge, and at worst, attraction and retention risks. While most shareholder interests groups focus on the value of the equity grant, employees are, by and large, still inclined to associate competitiveness with actual number of shares granted or realized value (stock price – strike price X number of shares) rather than Black-Scholes or Net Present Value at time of grant.

Meanwhile, those companies that have experienced negative stock price performance year-over-year are likely to have a significant portion of their outstanding option holdings underwater, creating additional retention concerns. In these cases, companies may need to issue more shares to employees to offset the limited retention value of past equity grants; these “supplemental” grants increase a company’s gross equity burn rate. Also interesting to note is that the net burn rates among the companies with negative stock price performance are very similar to that of the companies with positive stock price performance. Net burn rate takes into account shares cancelled in addition to shares granted, and tends to rise with increased turnover. Companies with high turnover rates experience higher gross burn rates because they must issue grants to attract new employees, and those “new-hire” grants are typically larger than the standard ongoing grant.

Additional analysis is required to determine the extent to which these data are representative of companies with revenue below \$5 billion, as well as the extent to which other factors, such as industry subsector and/or specific, narrow revenue ranges, impact the influence of share price movement on utilization (for example, software companies between \$1 billion and \$5 billion in revenue).

Figure 3 below illustrates the relationship between company share performance and the mix of stock options and restricted stock at those companies. Organizations in the upper quartile granted 85 percent of their total equity pool in the form of stock options and 15 percent in restricted stock. By comparison, companies at the low end of the performance spectrum granted about 60 percent of their equity pool in the form of stock options and 40 percent in restricted stock. These findings are to be expected, given that in a higher-growth environment, employees stand to recognize more value from stock options than full-value shares as a result of the typical conversion ratio at play. For example, rather than receiving 3,000 options an employee would receive 1,000 restricted shares (assuming a 3:1 ratio). Using this common conversion ratio, employees begin to realize more value via stock options once the stock appreciates by more than 50 percent, which if measured over the typical vesting schedule of four years represents approximately 11 percent annual stock price growth.

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**Figure 3: Utilization by Level of Performance**

Performance Rank	Percentage of Total Pool Delivered in Options LFY	Percentage of Total Pool Delivered in FVS LFY
Upper Quartile	85%	15%
3rd Quartile	70%	30%
2nd Quartile	70%	30%
Lower Quartile	59%	41%

### Summary

Large high-technology companies with positive stock price growth show a clear pattern of significantly lower equity utilization rates than is the case with their negative-growth counterparts. While additional analysis is required in order to better understand the connection between performance and equity utilization across a cross-section of company sizes, growth stages, and industry subsectors, Radford has found that many companies are clearly taking advantage of their stock price growth to deliver an equivalent amount of value to the employees, while minimizing dilution to shareholders.

This leads to the next question: is this truly reflective of a pay-for-performance philosophy, and what are high-technology companies seeking to create with ownership cultures? Based on the conclusions of this analysis, it seems imperative that companies begin to broaden their assessment of market practices to include not only direct talent and product competitors, but the best practices for equity compensation at top-performing companies. These analyses can help

companies ensure that their go-forward total rewards and equity strategies send the appropriate messages and deliver appropriate compensation to employees for their role in creating shareholder value.

## Footnotes

<sup>1</sup> 2007 Radford Advisory Services Equity Trends Analysis/2001-2006 Radford Overall Practices Report – Technology Editions

Company List		
Advanced Micro Devices	eBay	Oracle
Affiliated Computer Services	Electronic Data Systems	Pitney Bowes
Amazon.com	EMC	Qualcomm
Apple	Flextronics	Qwest Communications
Applied Materials	General Dynamics	Sanmina–SCI Corp.
Arrow Electronics	Hewlett-Packard	Seagate
AT&T	IBM	Sprint Nextel
Avnet	Intel	Sun Microsystems
Cisco Systems	Jabil	Symantec
Comcast	Micron	Synnex
Computer Sciences	Microsoft	Texas Instruments
Dell	Motorola	Yahoo!
DirectTV	Nokia	
Eastman Kodak Company	Nortel	

Terminology	Definition
<b>Net Burn Rate:</b>	Total options and restricted stock/restricted stock units granted (applying the ISS full-value share multiplier) minus total options and restricted stock/restricted stock units cancelled divided by weighted average shares outstanding
<b>Gross Burn Rate</b>	Total options and restricted stock/restricted stock units granted (applying the ISS full-value share multiplier) divided by weighted average shares outstanding
<b>ISS Full-Value Share Multiplier</b>	ISS applies a multiplier on full-value awards for the past three fiscal years based on the company's annual stock price volatility. (Source: RiskMetrics ISS Governance Services US Corporate Governance Policy 2008 Updates)
<b>Net Present Value</b>	A model used to calculate the value of a stock option based on the expected increase or growth in the price of the stock, assuming growth at a constant percentage rate, for an assumed period of years, and discounted back to the present at an assumed discount rate
<b>Black-Scholes</b>	A model used to calculate the value of an option by considering the company's stock price, strike price, expiration date, risk-free return, and dividend yield
<b>LFY</b>	Last fiscal year
<b>FVS ADD TOTAL SHAREHOLDER RETURN (TSR)</b>	Full-value shares (e.g., restricted stock, restricted stock units)

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David Knopping has nearly 10 years of compensation consulting experience on a variety of issues. Areas of focus include executive and broad-based compensation strategies, employment contract development, Board of Director pay, and short- and long-term incentive plan design. David's primary consulting projects cover various sectors of the high technology industry, including software products/services, semiconductors and Internet/e-commerce. He also has significant experience working with life sciences and pharmaceutical companies.

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## About Radford

For more than 30 years, Radford has provided compensation market intelligence to the technology and life sciences industries. Global survey databases, which include three million incumbents, offer current, reliable data to 2,000+ clients. Leveraging Radford survey data, our thought-leading global Radford Consulting team creates tailored solutions for the toughest global business and compensation challenges facing companies at all stages of development. In addition to our consulting team, we also offer equity valuation assistance via Radford Valuation Services, and leading-edge market analyses and survey services with Radford Advisory Services. For more information on Radford, please visit [www.radford.com](http://www.radford.com).

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