



## Did You Know?

### Equity dilution has many definitions

#### Main Data Group's equity dilution report


Many executives ascend to leadership positions without substantial equity ownership in the firms they lead. Providing equity grants of a significant size, and on a sustained basis, helps to ensure that the economic interests of corporation and executive are closely aligned. The rationale for these grants is widely accepted, but the pool of equity resources used to fund them comes at a price: The dilution of ownership among existing shareholders who may express resistance for this tradeoff by voting down future funding requests for new share allocations.

Companies must seek shareholder approval for equity incentive plans in order to satisfy various tax, accounting, and securities law provisions, so they are understandably reluctant to test the boundaries of investor forbearance. This sets up a "Goldilocks" conundrum: If companies are too stingy with equity grants, they may fail to achieve the objective of aligning economic interests; if too generous, they risk the dreaded prospect of a failed shareholder vote.

Consequently, few pay-related issues approach the scrutiny that shareholders and companies alike give to share utilization, making it even more surprising that a single, authoritative way to measure it does not exist. While the Financial Accounting Standards Board requires companies to apply a standard methodology for the calculation of diluted earnings per share, this metric has little value for purposes of measuring share utilization in equity incentives because it also incorporates other (and potentially much larger) sources of dilution such as convertible bonds and warrants to suppliers.

In the absence of an "official" methodology that isolates the dilutive impact of equity incentives, shareholders and governance watchdogs have created several varieties of their own. Here are some common characteristics:

- **They generally measure equity usage in the aggregate.** All forms of incentive equity (options, stock appreciation rights [SARs], restricted stock, restricted stock units [RSUs], performance shares/units, and deferred shares/units) are included. Some analysts give full-value vehicles like restricted stock a heavier weighting than incremental-value vehicles such as options, but others count options and restricted shares on a one-for-one basis.

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- **They always compare incentive equity to total equity.** Equity usage is a ratio, with the numerator being the aggregate number of incentive shares and the denominator being some form of total shares outstanding.

Analysts focus on three basic measures of share utilization:

- **Dilution and Overhang:** Dilution measures the aggregate number of plan-based award shares outstanding, in any form. Overhang typically measures the aggregate number of shares outstanding, plus the number of ungranted shares remaining for issue from qualified equity plans. Overhang may also include shares that are subject to an upcoming proxy vote. Dilution and overhang are measured at a specific point in time—typically the end of the most recent fiscal year.
- **Burn Rate:** Measures the aggregate number of plan-based award shares granted in a given year, in any form.

MDG's equity dilution report gives users a multitude of choices and permits users to compare their company's dilution and overhang for the most recent year and burn rate for each of the most recent three years against a user-defined set of peers—an essential part of the "Goldilocks" test, since share utilization tends to correlate strongly with industry, size, maturity stage, and other characteristics of a well-constructed peer group. The Setup page offers a wide range of choices for calculating these metrics:

- Include or exclude equity incentives that are required to be settled in cash;
- Specify the type of equity incentives to include in dilution, overhang and burn rate calculations;
- Include or exclude ungranted shares remaining for issue from qualified equity plans;
- Include or exclude shares that are subject to an upcoming proxy vote;
- Specify one of three ways to define outstanding shares (common shares outstanding, basic diluted-average shares outstanding, or fully diluted-average shares outstanding);
- Adjust the burn rate to reflect options or SARs that were assumed, exchanged, forfeited, or repurchased; and
- Create different weightings for whole-value shares and options.

### About Main Data Group

Main Data Group is a provider of executive compensation benchmarking and corporate governance analytics. Its mission is to empower executive compensation professionals with comprehensive total rewards and corporate governance information in an affordable, easy-to-use online service. For more information contact us at [info@maindatagroup.com](mailto:info@maindatagroup.com) or by filling out our contact form at [www.maindatagroup.com](http://www.maindatagroup.com).