



# How Many Shares Your Company Grants This Year Depends on How Its Stock Performed Last Year, But That's Not the Complete Picture

## Insights from MDG's New Analysis of Share Utilization in the S&P 500

By Ted Jarvis, Director of Product Design

In 2018, 84 companies in the S&P 500 received approval via shareholder vote to replenish the pool of authorized shares reserved for equity incentives. These requests typically pass, but ensuring a positive vote may require engaging third-party proxy advisors in a cumbersome process including pay-for-performance and governance tests that have little relation to share utilization per se. Consequently, companies try to avoid going to the trough too often. Monitoring their annual share usage—burn rate<sup>1</sup>—helps to ensure that the remaining pool is used to the best advantage.

For the third consecutive year, the median annual burn rate declined, from 0.8% in 2016 to 0.7% in 2017 and 0.6% in 2018. The rate varied widely among industries (see Exhibit I).

In 2018, the median decrease in burn rate was 8.7%. All market sectors except communication services cut their usage (see Exhibit II).

### ***Why did this happen?***

The change in burn rate was strongly influenced by stock performance over the preceding year, during which the S&P 500 index logged a total return of 12.3%.<sup>2</sup> The energy and communication services sectors lagged significantly while returns in the information technology sector soared (see Exhibit III).

Consider that a company's stock price has an inverse relationship to its burn rate. The information technology industry, for example, reduced its burn rate more than any other sector and had the highest price appreciation; communication services, on the other hand, had to increase its share usage to counteract a falling stock price. When the value of a share rises, fewer shares are necessary to provide a competitive level of compensation; all else being equal, these shares represent a smaller portion of total outstanding equity. The opposite also applies: if the value of a share falls, more shares must be granted. Exhibit IV tracks the relationship between each market sector's 2017-18 total return (X axis) and the 2017-18 median change in burn rate (Y axis). The R-squared for this relationship was 59.8%.<sup>3</sup>

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<sup>1</sup> In this study, burn rate is the aggregate number of options and full-value shares granted in a year, regardless of form (stock options, stock appreciation rights, restricted shares or units, and performance shares or units) and settlement type (cash or equity), divided by the number of basic weighted-average common shares outstanding during the year. MDG's Equity Dilution report permits users easily to customize the definition of burn rate for their own purposes.

<sup>2</sup> For the period March 1, 2017 to March 1, 2018.

<sup>3</sup> The energy sector was removed as an outlier.

### ***Is this a good thing?***

That depends. As a base case, consider a company that granted a million restricted shares with a fair market value of \$10 per share on the date of grant, for a total economic spend of \$10 million. If 100 million common shares were outstanding that year, the burn rate was one percent:

$$1,000,000 \text{ shares} / 100,000,000 \text{ basic average common shares outstanding} = 1.00\%$$

Now assume the stock price rises 20%, a bit over the median appreciation for the S&P 500 in 2017. All else being equal, the company will require only 833,333 restricted shares the following year to provide the same economic spend of \$10 million—a savings of 166,667 shares. If the company's outstanding shares remains constant at 100 million, this decrease causes the burn rate to fall:

$$833,333 \text{ shares} / 100,000,000 \text{ basic average common shares outstanding} = 0.83\%$$

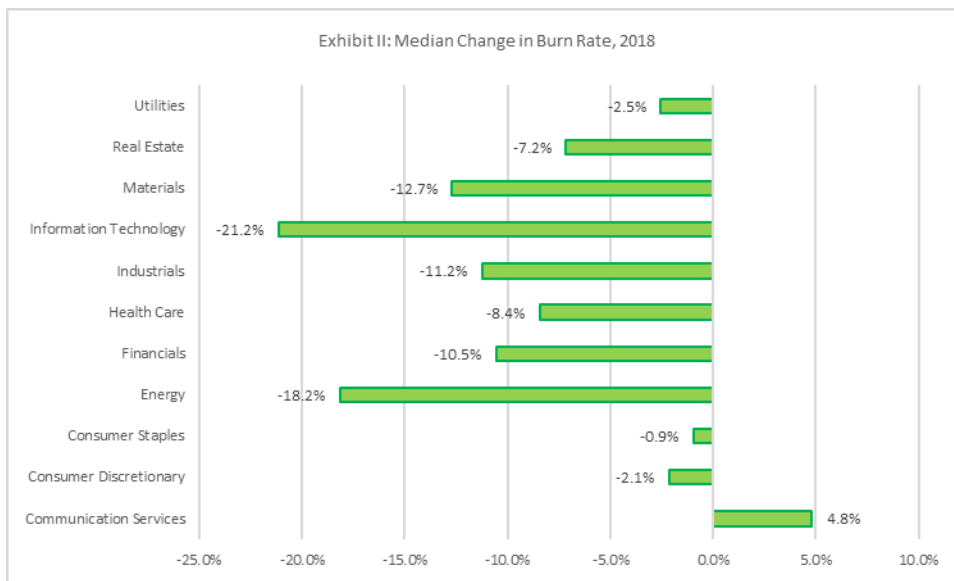
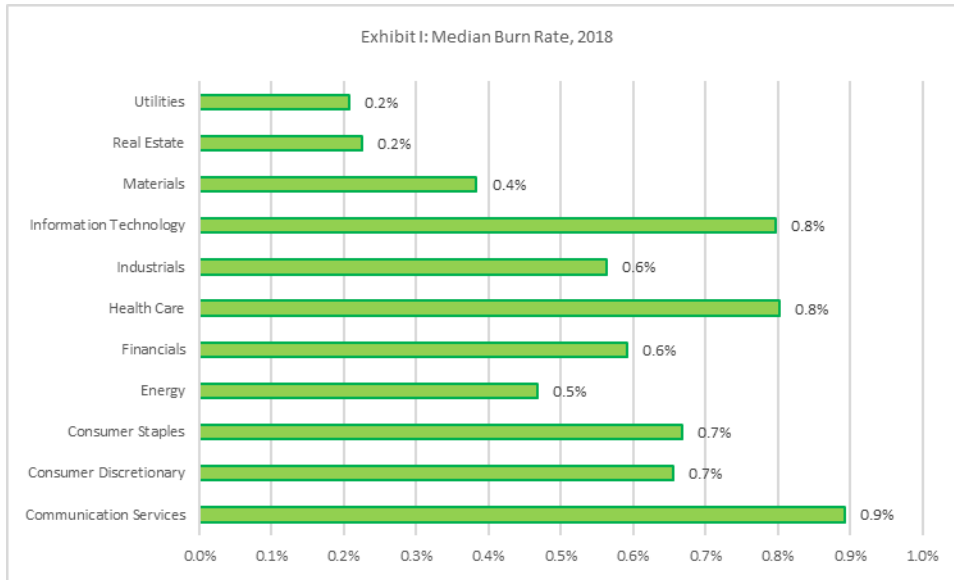
From the company's perspective, delivering a target expected value of equity with fewer shares may be a desirable outcome, since they can conserve their remaining share pool and possibly defer the need to seek shareholder approval for additions to the qualified reserve.

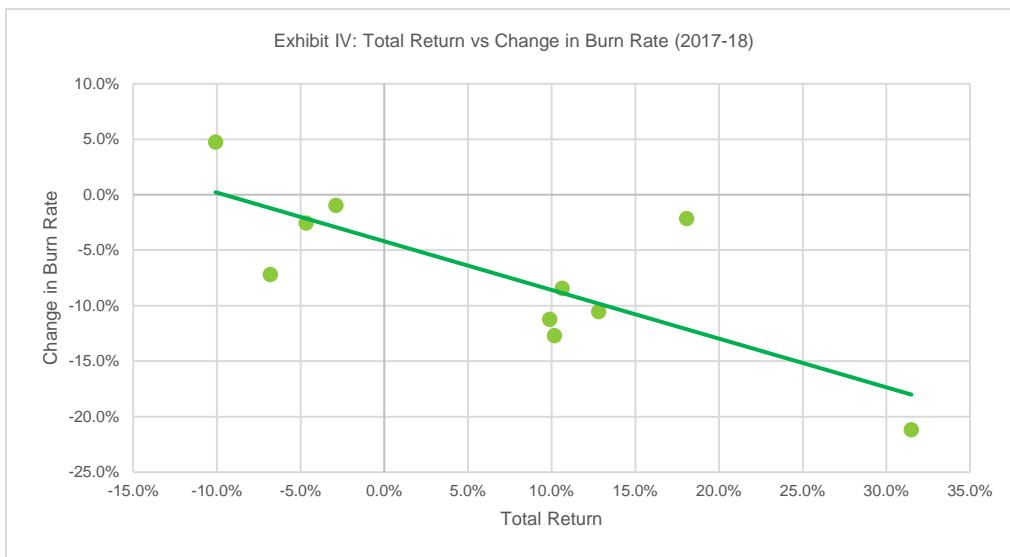
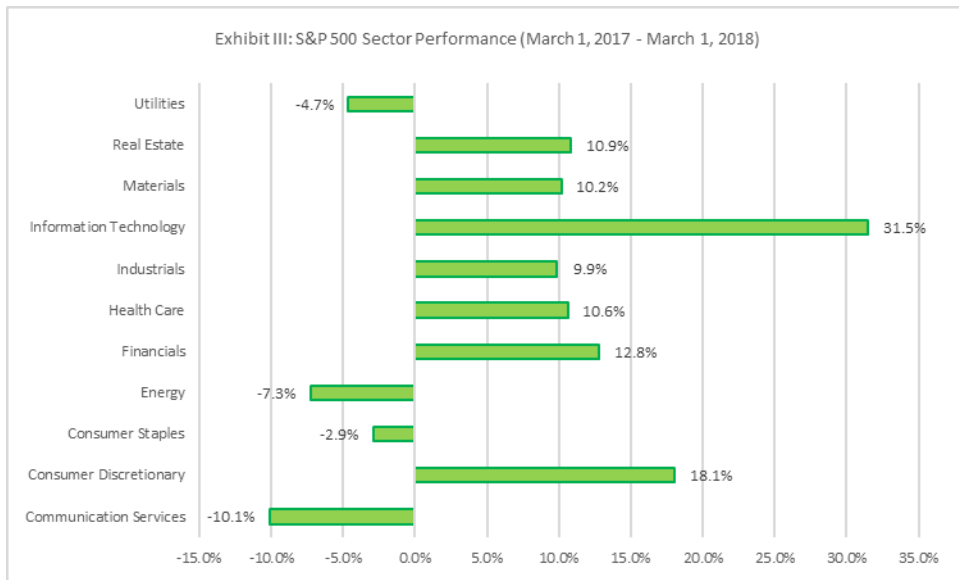
Recipients of these grants, on the other hand, may not see the tradeoff so favorably. In 2017, they received a million restricted shares; in 2018, only 833,333. The initial value of both awards is identical—\$10 million—but for every dollar in stock appreciation from the 2017 grant, they will get less than \$0.84 from the 2018 award.

Grantees of at-the-money stock options in 2017 would feel this reduction even more keenly in 2018, since the realizable value of their awards is based on stock appreciation alone. Assuming the volatility, dividend yield, risk-free rate term assumptions are identical for the 2017 and 2018 option grants, the reduction would be proportionally the same as for restricted shares, namely: \$0.84 of value for every dollar of appreciation from the prior year's grant.

But the change in share utilization is never determined entirely by the change in stock price. Alterations to any aspect of compensation—target value, the mix of incentive vehicles, performance goals, or a change in Black-Scholes assumptions, to name a few—will require fewer or more shares to be granted. Consequently, the company probably won't bank the entire savings for future awards in years when the stock price rises or grant more shares to make up the deficit in years when the stock price falls. In both cases, the outcome is that, while stock price and burn rate generally head in different directions, the actual change in burn rate is unlikely to be exactly proportional to the change in stock price.

## Exhibits





**Want to know more?**

MDG's database of over 4,500 companies contains extensive information to assist companies in monitoring share usage. Essential features include:

- MDG's Equity Dilution report, which contains details about burn rate, total outstanding equity awards, overhang, and total potential share commitment;
- MDG's Equity Value calculator, which provides fair-value estimates of stock options using Black-Scholes or Binomial option valuation models.



**Contact Us:**

Questions about this topic? Contact [ted.jarvis@maindatagroup.com](mailto:ted.jarvis@maindatagroup.com)

Want to discuss Main Data Group or arrange a demo? Contact [michael.enos@maindatagroup.com](mailto:michael.enos@maindatagroup.com)

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