Equity Utilization in the Bay Area Tech 120

While equity compensation is a fundamental component of most technology company compensation programs, balancing the tension between fostering an ownership culture (which serves as a direct link between pay and performance) and managing shareholder dilution can be an ongoing challenge. Further, in recent years, institutional shareholders and their advisors have tightened their scrutiny of share requests for employee stock plans, making it more difficult for companies to "thread the needle" between what shareholders will approve, the need to both fund growth and provide meaningful incentives to executives and other employees, and the pressure of the competitive environment for key talent.

Recently, we examined the equity utilization practices at the most prominent technology companies headquartered in the San Francisco Bay Area (primarily in Silicon Valley). We call this group, which consists of companies in the computer/hardware, software/internet, and semiconductor sectors, the Bay Area Tech 120. The companies comprising the Bay Area Tech 120, which are listed in the Exhibit B to this article, report annual revenues ranging from $50 million to more than $3 billion (including seven companies with revenues in excess of $25 billion) and have been publicly-traded companies for at least three years.

This Thoughtful Pay Alert summarizes our findings as of January 31, 2017, based on the annual financial statements of the Bay Area Tech 120 companies for fiscal years ended between December 2015 and November 2016. Specifically, we focus on four key measures of aggregate equity usage:

- Gross burn rate;
- Issued and total overhang;

Chart A

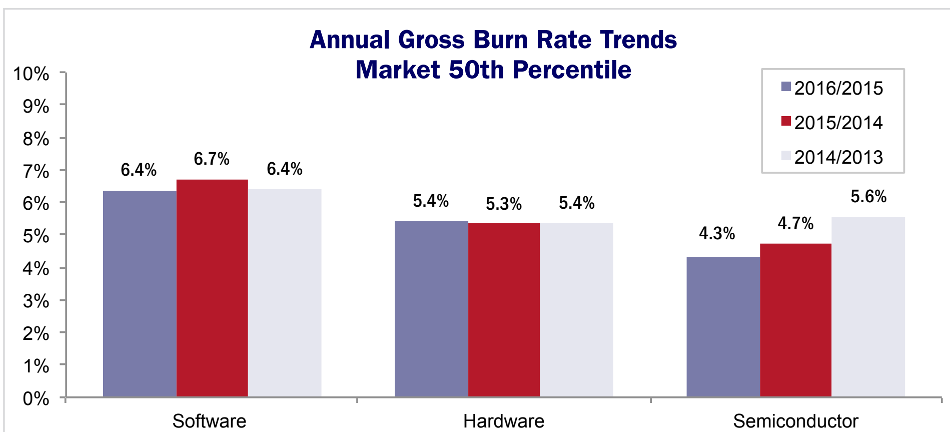
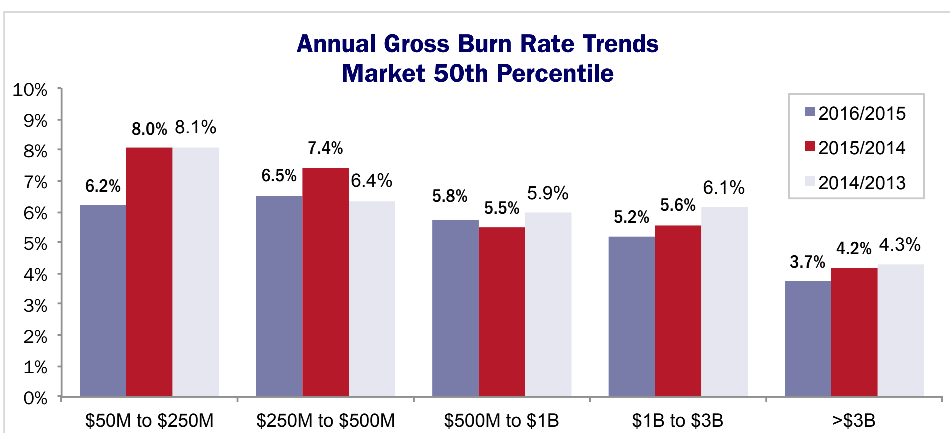


Chart B



Equity Utilization in the Bay Area Tech 120 (continued)

- Shareholder value transferred (the "fair value" of equity awards granted as a percentage of market capitalization); and
- Stock-based compensation expense.

In addition, we examine current practices related to one of the primary drivers of these measures – equity vehicles awarded. (The definitions of "burn rate" and "overhang" are provided in Exhibit A to this article.)

Aggregate Equity Utilization Practices (Gross Burn Rate and Overhang)

Gross Burn Rate

Overall, year-over-year burn rate levels among the Bay Area Tech 120 remained stable with only an average increase of 1% at the median. Notwithstanding this trend, there remain pronounced differences in equity usage depending on industry sector and company revenue size.

For the period reviewed, burn rate levels continued to decline among companies in the slower-growing semiconductor sector, while equity usage remained about the same in the software/internet and computer/hardware sectors *(Chart A)*. For the past three years, software companies generated the highest burn rate levels given the sector's focus on equity compensation in the overall pay mix and the pressure to stay competitive in the marketplace.

Burn rate levels are also correlated with company revenue size. Smaller companies that are growing more rapidly are "spending" more equity (~1.5x that of larger companies) to recruit and retain talent *(Chart B)*. Cash compensation levels are often more modest as companies deliver a greater portion of compensation dollars in equity. Equity is used on a more targeted basis at larger companies to incent and reward employees rather than as a recruiting tool.

Issued and Total Overhang

Overhang levels have declined in recent years, primarily due to smaller, more frequent equity compensation plan share requests and the movement away from stock options *(Charts C and D)*. Outstanding stock options remain part of

Chart C

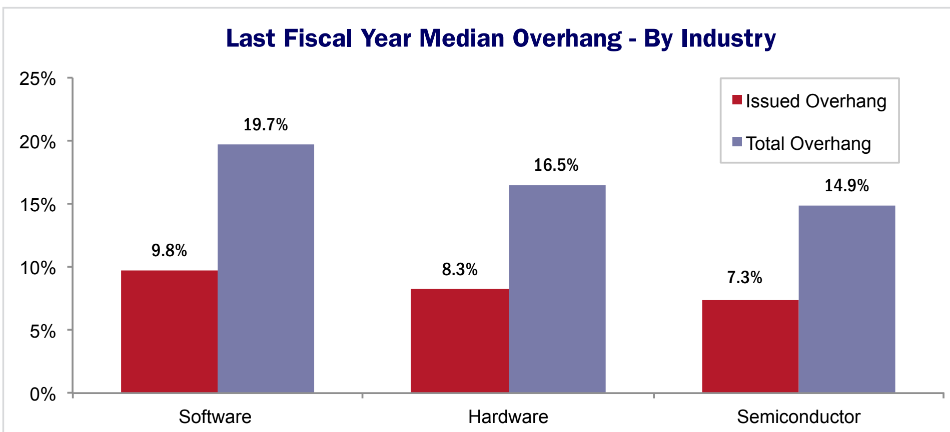
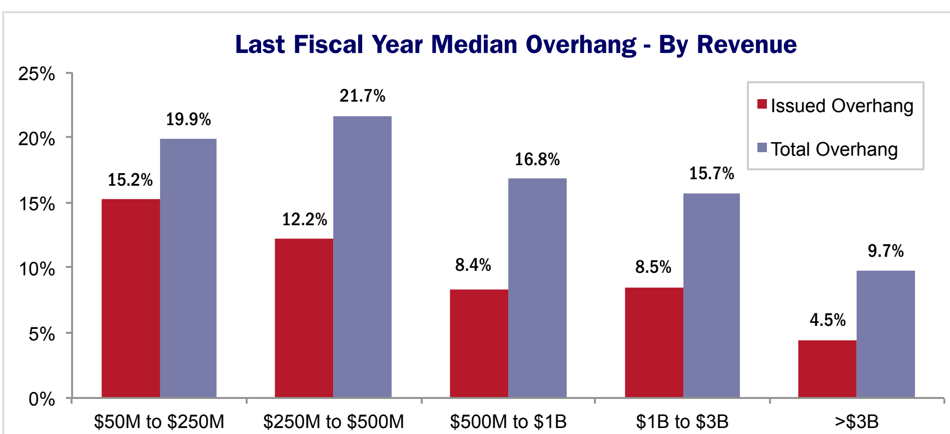


Chart D



Equity Utilization in the Bay Area Tech 120 (continued)

Chart E

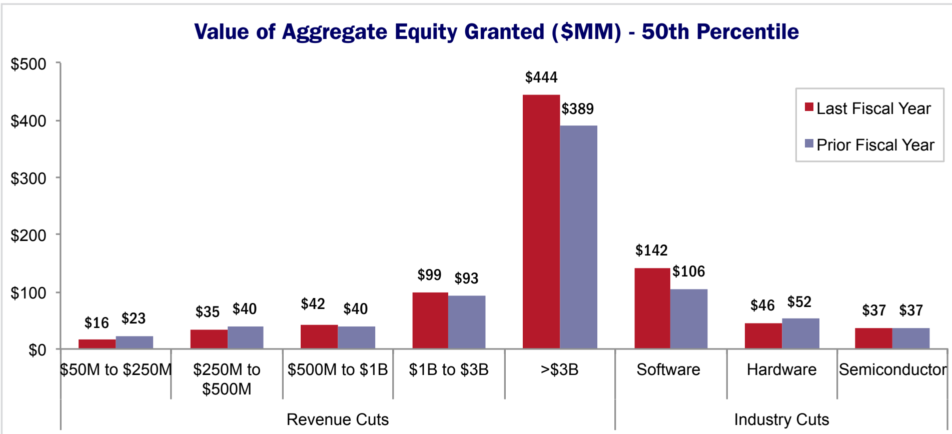
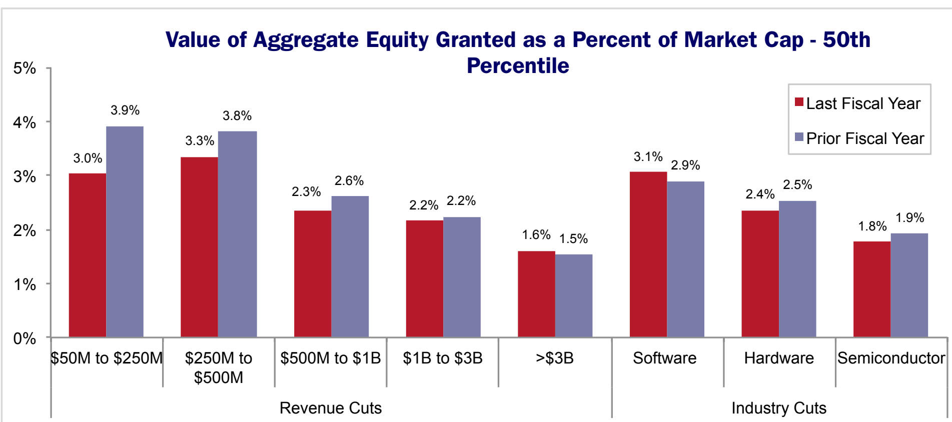


Chart F



a company's overhang until they are exercised or cancelled, which can be up to 10 years from the date of grant, depending on employee preferences (for example, how long an employee wants to hold the option prior to exercise) and stock market volatility. Conversely, full value share awards are removed from overhang once vested or earned, which generally is no more than four years from the date of grant.

Shareholder Value Transferred ("SVT")

Burn rate and overhang measure shareholder dilution on a "number of shares as a percentage of company" basis. Another important measure of dilution is the value of the equity transferred from shareholders to employees through compensatory grants and awards. This measure is referred to as "SVT." The dollar value of equity awards granted over the last two years varies significantly by company size and industry, but generally falls between 1.5% and 3.9% when calculated as a percentage of market capitalization. Our review of the Bay Area Tech 120 showed that, year-over-year, SVT generally held steady or dropped slightly *(Charts E and F)*.

Stock-Based Compensation Expense

Technology companies have seen increased scrutiny of the dilutive impact of their equity grant practices (based on stock-based compensation expense), particularly where top line growth is slow or modest. This expense has increased year-over-year for most of the sectors and revenue groupings reflected in the Bay Area Tech 120 on an absolute dollars basis, but remained relatively consistent when measured as a percentage of revenue *(Charts G and H)*.

Vehicle Practices

Stock option usage among technology companies continues to decline. In 2016, approximately 60% of the companies in the Bay Area Tech 120 granted options to their executives and/or key employees (down from 77% of the Bay Area Tech 120 companies two years ago). Reflecting their growing popularity, all but two of the Bay Area Tech 120 companies granted restricted stock unit awards. *(Table A)*

Performance share usage has steadily increased the last three years to 60% of companies, given pressures to strengthen the alignment of executive compensation with

Equity Utilization in the Bay Area Tech 120 (continued)

Chart G

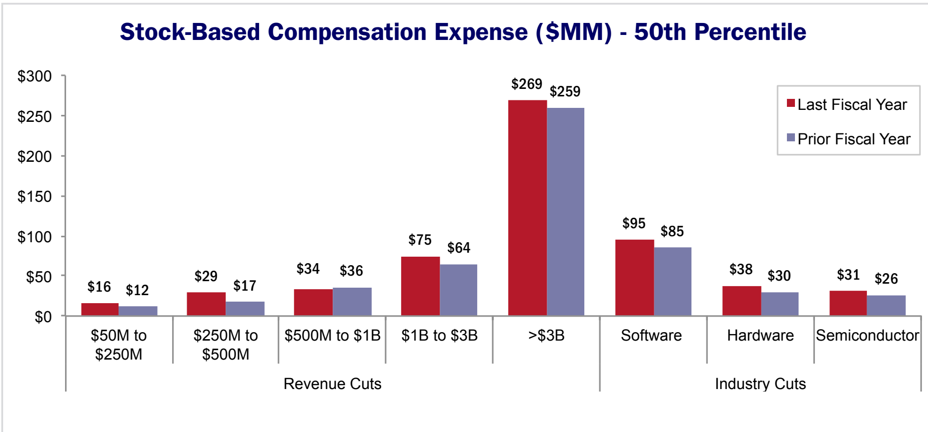


Chart H

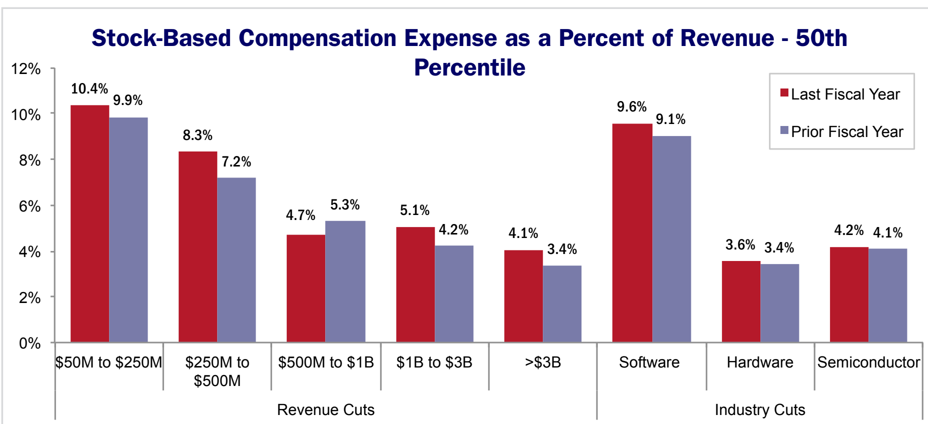


Table A

	LFY			LFY-1			LFY-2		
Company	Stock Options	Time-Based Shares	Perf-Based Shares	Stock Options	Time-Based Shares	Perf-Based Shares	Stock Options	Time-Based Shares	Perf-Based Shares
All	61%	98%	62%	73%	97%	60%	77%	94%	54%
Hardware	55%	100%	50%	66%	97%	50%	63%	95%	42%
Software	73%	98%	60%	81%	98%	60%	88%	94%	56%
Semiconductor	50%	94%	76%	68%	94%	71%	76%	94%	65%
$3B+	44%	96%	81%	67%	96%	74%	67%	93%	67%
$1B - $3B	53%	100%	63%	63%	97%	63%	73%	93%	57%
$500MM - $1B	58%	100%	74%	74%	100%	79%	68%	100%	74%
$250MM - $500MM	79%	97%	48%	83%	97%	45%	83%	97%	38%
$50MM - $250MM	73%	93%	33%	80%	93%	33%	100%	87%	33%

company performance. The trend is most visible among larger companies and companies in the software/internet and semiconductor sectors.

Final Observations

As a result of the close scrutiny of aggregate equity usage levels through the measures we have highlighted, as well as the heightened expectations about equity award design, companies have become much more sophisticated in their use of their equity awards to recruit, motivate, and retain their key executives and employees. This is being reflected in the shift away from stock options to full-value share awards (that is, restricted stock and restricted stock unit awards and performance share and performance share unit awards).

In addition, the recent revisions to the methodologies used by the principal advisors to the institutional investor community to evaluate employee stock plan proposals is beginning to cause a pronounced compression in the size of share requests overall. Now, more than ever, we expect companies to continue to monitor and manage their equity usage carefully to ensure that they are able to meet their growth plans, while, at the same time, maximizing the incentive value that such awards can readily provide.

About the Authors

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Need Assistance?

Compensia has extensive experience in assisting companies in designing and managing their employee stock plans, including navigating the expectations of institutional shareholders and their advisors about share usage. If you would like assistance in analyzing your employee stock plan strategy or negotiating the various pressure points in implementing an employee stock plan or a share reserve increase, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Jodie Dane or Mark A. Borges. ■

About Compensia

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Exhibit A

Definitions

"Gross Burn Rate" is a measure of annual equity usage and reflects the total number of shares granted (pursuant to stock options, stock appreciation rights, restricted stock and restricted stock unit awards, and performance share and performance share unit awards, at target) as a percentage of weighted average shares outstanding. Consistent with the methodology of Institutional Shareholder Services, Inc. ("ISS"), we have adjusted full value share awards (that is, restricted stock and restricted stock unit awards and performance share and performance share unit awards) to stock option equivalents based on conversion rates tied to three-year historical volatility rates). We focus on gross burn rate, rather than net burn rate (shares granted net of cancellations and expirations) as the gross burn rate represents the intended awards to be delivered under the equity compensation program.

Issued and Total "Overhang" are measures of cumulative equity usage under an equity compensation plan. Issued overhang includes all outstanding, unexercised stock options and unvested full value share awards at fiscal year-end and is expressed as a percentage of total common shares issued and outstanding. Total overhang includes the outstanding plan shares, as well as those shares reserved for future grant under all active equity compensation plans. Typically, we exclude shares available for issuance under an employee stock purchase plan ("ESPP") in the overhang calculations.

Equity Utilization in the Bay Area Tech 120 (continued)

Exhibit B

Company List

Adobe Systems	Facebook	Logitech International	SanDisk
Advanced Micro Devices	Fair Isaac	Marin Software	Sanmina
Alphabet	Fairchild Semiconductor	Marketo	Semtech
Ambarella	Finisar	Marvell Technology Group	ServiceNow
Apple	FireEye	Maxim Integrated Products	ShoreTel
Applied Materials	Fitbit	Monolithic Power Systems	Shutterfly
Applied Micro Circuits	FormFactor	Nanometrics	Sigma Designs
Arista Networks	Fortinet	NetApp	Silicon Graphics
Atmel	Gigamon	Netflix	SolarCity
Autodesk	GoPro	NETGEAR	Splunk
Barracuda Networks	Guidewire Software	NetSuite	Super Micro Computer
Box	Harmonic	New Relic	Symantec
Brocade Communications Systems	Hewlett Packard Enterprise	Nimble Storage	Synaptics
Cadence Design Systems	Immersion	NVIDIA	Synopsys
Calix	Imperva	Oclaro	Tessera Technologies
Callidus Software	Infinera	Oracle	TiVo
Cavium	Infoblox	Palo Alto Networks	Trimble Navigation
CEVA	Inphi	Pandora Media	Twitter
Cisco Systems	Integrated Device Technology	Plantronics	Ubiquiti Networks
Coherent	Intel	Polycom	Ultra Clean Holdings
Cypress Semiconductor	Intersil	Power Integrations	Ultratech
Dolby Laboratories	Intuit	Proofpoint	VeriFone Systems
DSP Group	InvenSense	Qualys	Viavi Solutions
eBay	IXYS	Quantum	VMware
Electronic Arts	Jive Software	QuinStreet	Workday
Electronics For Imaging	Juniper Networks	Rambus	Xilinx
Ellie Mae	KLA-Tencor	Rocket Fuel	Yahoo
Equinix	Lam Research	Rovi	Yelp
Exar	Linear Technology	Ruckus Wireless	Zendesk
Extreme Networks	LinkedIn	salesforce.com	Zynga