Technology Sector Equity Usage Practices

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 150 publicly-traded technology companies spanning the software, hardware and semiconductor sectors with revenues ranging from $50 million to nearly $6 billion, which we call the Tech 150 (see Exhibit A for a list of the Tech 150 companies). Of these companies, 60% are headquartered in California and the other 40% are headquartered across the United States. Data reflect fiscal years ending March 2017 through February 2018. Year-over-year trends are based on data for this same group of companies.

This Thoughtful Pay Alert summarizes the findings from our analyses and specifically focuses on four key measures of aggregate equity usage:

- Equity award mix;
- Gross burn rate;
- Issued and total overhang:
- Shareholder value transferred (the "fair value" of equity awards granted as a percentage of market capitalization); and
- Stock-based compensation expense.

Five Things That Technology Companies Should Know About Current Sector Equity Usage Practices

1. **Equity Vehicle Prevalence.** The ongoing decline is stock option usage continues. Only 51% of the companies grant stock options (down from 65% last year). Ninety-nine percent (99%) of the companies surveyed grant time-based RSUs and 61% grant performance-based RSUs (both consistent with last year's levels).
2. **Burn Rate Levels Declined Year-Over-Year.** Burn rate levels declined, compared to increases in each of the past several years (the median year-over-year decrease was 8%). The largest decreases were in the semiconductor and software industry sectors, and among the highest revenue companies.
3. **Aggregate Equity Award Values Increased.** The year-over-year grant date fair value of aggregate equity awards increased approximately 14% at the median (with the largest increases in the software and hardware industry sectors). However, values as a percentage of market capitalization decreased approximately 8% at the median.
4. **Stock Compensation Expense Continue to Draw Attention.** With median stock-based compensation expense increasing approximately 16% year-over-year, expect to see increased attention to this measure as shareholders may heighten focus on the use of non-GAAP financial metrics.
5. **Equity Usage Highest in Software Sector and Among California-Based Companies.** The software industry's and California companies' focus on equity has not subsided, resulting in these companies showing the highest equity usage under all metrics examined.

Technology Sector Equity Usage Practices (continued)

The definitions of these metrics are provided in Exhibit B to this article.

Equity Vehicles

Stock option usage among technology companies continues to decline. Only 51% of the Tech 150 companies granted options during the most recent fiscal year reported, down from 65% last year. The number of companies granting performance-based equity awards (61%) now surpasses those granting options. The transition to performance-based awards showed a noticeable increase in the hardware sector but has leveled off in the software and semiconductor sectors. As in past years, companies in the semiconductor sector have the highest prevalence of granting performance shares (71%) while 58% of hardware companies granted performance shares last year (up from 50% in each of the past two years). This shift away from options is the result of several factors, including dilution concerns (given the high number of shares needed to deliver a specified dollar value compared to a full value award), their uncertain effectiveness as a retention tool, and the unwillingness of the major proxy advisory firms to treat them as performance-based awards.

Time-based restricted stock awards ("RSAs") and restricted stock unit awards ("RSUs") are almost universal in the technology community, as all but one of the Tech 150 companies grant these full value share awards. RSUs are beneficial to both employees (since they are always "in-the-money") and companies (since they require fewer shares to deliver the target grant value) making them the most attractive equity vehicle to grant.

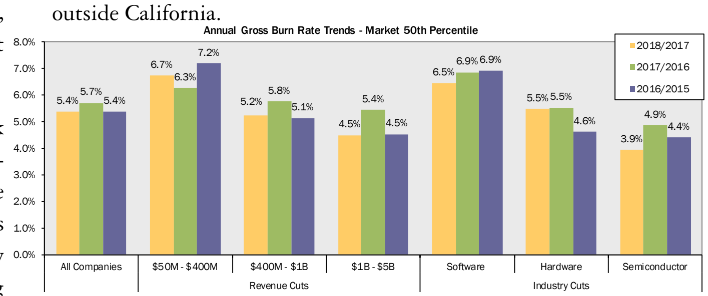
The following table summarizes the percentage of Tech 150 companies granting each type of equity vehicle during the past three years.

	2018			2017			2016		
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	51%	99%	61%	65%	99%	59%	71%	95%	57%
Software	58%	99%	57%	70%	97%	58%	74%	95%	51%
Hardware	39%	100%	58%	58%	100%	50%	63%	92%	50%
Semiconductor	47%	100%	71%	61%	100%	71%	71%	100%	76%
Revenue $50M-$400M	65%	100%	47%	81%	98%	35%	84%	88%	37%
Revenue $400M-$1B	46%	98%	64%	66%	98%	66%	72%	98%	58%
Revenue $1B-$5B	44%	100%	68%	51%	100%	72%	60%	98%	72%
California Based	56%	100%	61%	66%	99%	61%	75%	94%	57%
Non-CA Based	43%	98%	61%	62%	98%	57%	64%	97%	57%

Gross Burn Rate

Gross burn rate levels declined slightly at the median among technology companies during the most recent fiscal year reported. The overall year-over-year median decrease was 8.0%, with the largest decrease among semiconductor companies (approximately a 16% decrease at the median). The burn rate levels at software companies remain the highest among the three industry sectors, as these companies tend to place a stronger emphasis on equity compensation in the overall pay mix (both with respect to award levels and participation rates) and face pressure to stay competitive in the marketplace. The hardware sector remained constant year-over-year with an approximate burn rate at the median of 5.5%.

Burn rate levels are also correlated with company revenue size and headquarters location. Smaller companies that are growing more rapidly are "spending" more equity (approximately 1.5x that of larger companies) to recruit and retain talent. Cash compensation levels are often more modest as these companies deliver a greater portion of their 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. Similarly, companies headquartered in California have burn rate levels 1.5x those based outside California.



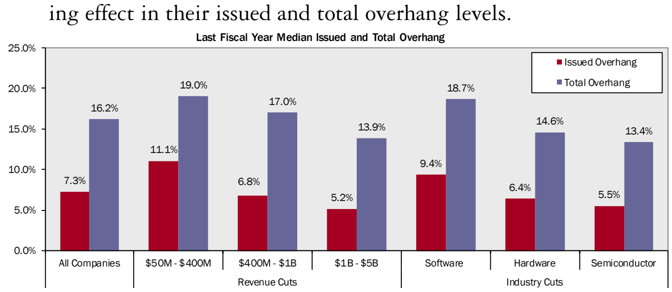
Another contributing factor to the differences in grant practices is the inclusion of an "evergreen" provision in the employee stock plan, which is very common among companies that went public in the last decade. Approximately 37% of the Tech 150 companies (55 companies) have an evergreen provision in their active equity plan that provides for annual replenishments of shares, generally equal to 5% of shares outstanding. Over half (54%) of the companies in the software sector and 63% of the companies with revenue ranging from $50 million to $400 million maintain an evergreen provision. These companies may be able to focus less on managing the share pool and developing strategies to gain shareholder support for more frequent requests.

Issued and Total Overhang

Issued and total "overhang" levels have declined in recent years, primarily due to smaller, more frequent employee stock plan share requests and the movement away from stock options. Issued overhang reflects issued/outstanding awards and total overhang also includes shares available for future grant under active equity

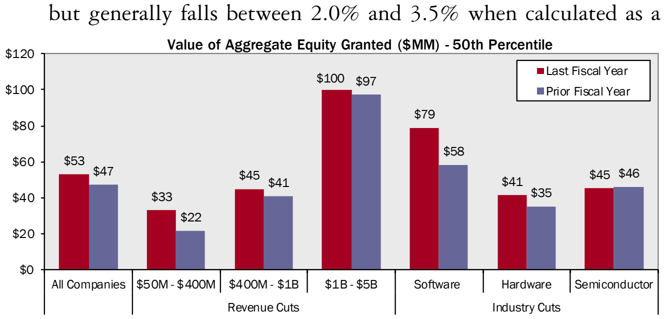
Technology Sector Equity Usage Practices (continued)

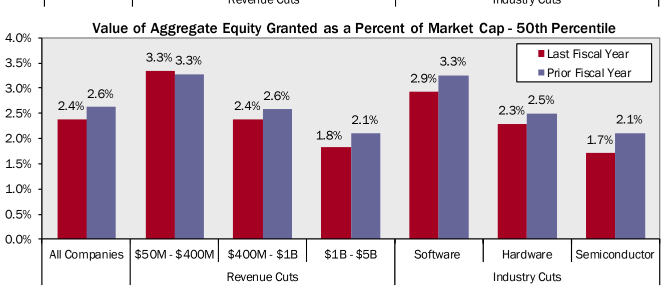
plans. Previously-granted stock options remain part of a company's overhang until they are exercised or cancelled, which can be up to 10 years from the date of grant, depending on employee preferences (for example, how long an employee wants to hold the option prior to exercise) and stock market volatility. 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. Consistent with the higher burn rates associated with active evergreen provisions, companies in the software sector and smaller revenue size companies granting more shares each year see the compounding effect in their issued and total overhang levels.



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. We refer to this measure as the "shareholder value transferred," or "SVT." The dollar value of equity awards granted over the last two years varies significantly by company size and industry, but generally falls between 2.0% and 3.5% when calculated as a percentage of market capitalization. Our review of the Tech 150 showed that, year-over-year, SVT increased for all industry sectors (other than the semiconductor sector) and revenue groupings.

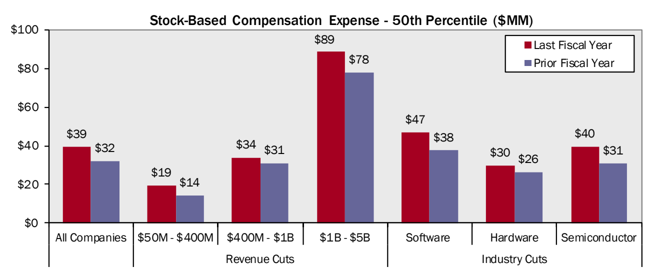


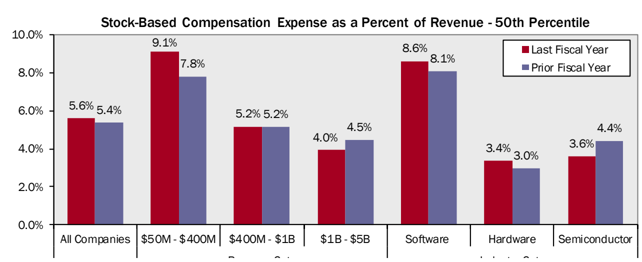


As expected, equity award grant values and SVT for companies in the software sector were approximately 1.75x to 1.9x higher than for the hardware and semiconductor sectors. In addition, SVT for California-based companies was 1.5x higher than companies headquartered outside California.

Stock-Based Compensation Expense

Technology companies continue to experience increased scrutiny of the dilutive impact of their equity award 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 industry sectors and revenue groupings, but declined for the semiconductor sector and for companies with revenues between the $1 billion to $5 billion when measured as a percentage of revenue. Stock-based compensation expense not only comes into play with non-GAAP earnings measures, but also impacts free cash flow. In our experience, investors and analysts have increased their focus on these metrics in recent years and typically seek additional relevant disclosure in a company's public filings.





Final Observations

Setting appropriate target equity usage budgets requires evaluating your equity strategy and the most effective way to use equity awards to recruit, motivate, and retain key executives and employees. This exercise involves a careful evaluation of the form of the awards/vehicles, individual grant guidelines and participation rates by employee level/group and location and the resulting burn rates, shareholder value transferred, and the resulting financial statement impact. With increased scrutiny of employee stock plan requests, as well as the growing use of non-GAAP financials that often exclude stock-based compensation expense, we expect companies will be expected to continue to monitor and manage their equity usage thoughtfully.

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, Jason Borrevik or Mark A. Borges.

About Compensia:

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.■

Technology Sector Equity Usage Practices (continued)

Exhibit A

Companies Surveyed

Company	Last 4 Qs Revenue	30-Day Avg. Mkt Cap
HARDWARE COMPANIES		
Aerohive Networks	$153	$224
Quantenna Communications	$176	$503
Electro Scientific Industries	$304	$659
CalAmp	$358	$843
Harmonic	$358	$294
Applied Optoelectronics	$382	$534
Acacia Communications	$385	$1,616
Calix	$510	$344
Novanta	$521	$1,899
InterDigital	$533	$2,556
Oclaro	$606	$1,456
ADTRAN	$667	$770
Knowles	$731	$1,241
Infinera	$741	$1,597
Extreme Networks	$770	$1,369
Viavi Solutions	$791	$2,261
Plantronics	$850	$1,878
Ubiquiti Networks	$944	$5,190
Electronics for Imaging	$993	$1,269
Pure Storage	$1,023	$4,462
OSI Systems	$1,032	$1,238
NetScout Systems	$1,070	$2,319
Dolby Laboratories	$1,103	$6,705
Lumentum Holdings	$1,126	$4,073
GoPro	$1,180	$729
National Instruments	$1,289	$6,719
Finisar	$1,364	$2,061
NETGEAR	$1,407	$1,812
ViaSat	$1,571	$4,180
Arista Networks	$1,646	$20,054
FLIR Systems	$1,800	$6,909
VeriFone Systems	$1,854	$1,881
Coherent	$1,855	$5,170
Palo Alto Networks	$1,989	$16,536
F5 Networks	$2,097	$9,107
Trimble	$2,654	$9,358
Ciena	$2,826	$3,651
Juniper Networks	$5,027	$9,336
SEMICONDUCTOR COMPANIES		
CEVA	$88	$831
PDF Solutions	$102	$382
Sigma Designs	$156	$235
Rudolph Technologies	$255	$892
Nanometrics	$259	$689
NeoPhotonics	$293	$289
Ambarella	$295	$1,698
Inphi	$348	$1,267
Lattice Semiconductor	$386	$738
Rambus	$393	$1,459
Alpha & Omega Semiconductor	$400	$378

Company	Last 4 Qs Revenue	30-Day Avg. Mkt Cap
MaxLinear	$420	$1,597
Power Integrations	$432	$2,064
Photronics	$464	$578
Monolithic Power Systems	$471	$4,976
Veeco Instruments	$485	$890
Cabot Microelectronics	$524	$2,746
FormFactor	$548	$1,020
Semtech	$588	$2,422
Advanced Energy Industries	$671	$2,677
MACOM Technology Solutions	$678	$1,319
Silicon Laboratories	$769	$4,009
Integrated Device Technology	$794	$4,132
Cavium	$984	$5,970
Cirrus Logic	$1,557	$2,726
Synaptics	$1,718	$1,612
Microsemi	$1,845	$7,676
Teradyne	$2,137	$9,156
Cypress Semiconductor	$2,328	$6,218
Maxim Integrated Products	$2,382	$17,267
Marvell Technology Group	$2,409	$11,249
Xilinx	$2,476	$18,612
Qorvo	$2,951	$9,928
Skyworks Solutions	$3,789	$19,687
Microchip Technology	$3,881	$21,836
Advanced Micro Devices	$5,329	$11,024
ON Semiconductor	$5,388	$10,624
Analog Devices	$5,642	$33,859
SOFTWARE COMPANIES		
AppFolio	$144	$1,401
Instructure	$159	$1,349
PROS Holdings	$169	$1,051
BlackLine	$177	$2,185
MINDBODY	$183	$1,817
Coupa Software	$187	$2,515
Q2 Holdings	$194	$1,947
Five9	$200	$1,694
Rapid7	$201	$1,148
Workiva	$208	$1,002
Varonis Systems	$217	$1,651
SPS Commerce	$221	$1,061
Qualys	$231	$2,906
Callidus Software	$253	$2,362
Benefitfocus	$257	$780
Hortonworks	$262	$1,424
8x8	$284	$1,765
Trade Desk	$308	$2,306
Imperva	$322	$1,581
Quotient Technology	$322	$1,277
TrueCar	$323	$1,052
Paylocity Holding	$328	$2,680
New Relic	$330	$4,108

Company	Last 4 Qs Revenue	30-Day Avg. Mkt Cap
QuinStreet	$336	$622
HubSpot	$376	$4,290
Twilio	$399	$3,568
Progress Software	$401	$2,029
Ellie Mae	$417	$3,179
Zendesk	$430	$4,715
Cornerstone OnDemand	$482	$2,415
Aspen Technology	$491	$5,717
RingCentral	$502	$5,094
Box	$506	$2,855
Proofpoint	$515	$5,757
Shutterstock	$557	$1,728
Guidewire Software	$576	$6,466
RealPage	$671	$4,335
GrubHub	$683	$9,001
Envestnet	$684	$2,536
Commvault Systems	$687	$2,475
Web.com Group	$749	$830
FireEye	$751	$3,162
Blackbaud	$788	$5,048
TiVo	$826	$1,736
Tyler Technologies	$841	$7,886
Yelp	$847	$3,645
Tableau Software	$877	$6,687
Ultimate Software Group	$941	$7,424
Fair Isaac	$948	$5,194
LogMeIn	$990	$6,333
ACI Worldwide	$1,024	$2,894
Zillow Group	$1,077	$10,068
ANSYS	$1,095	$13,726
j2 Global	$1,118	$3,792
VeriSign	$1,165	$11,635
PTC	$1,184	$9,008
Shutterfly	$1,190	$2,628
Splunk	$1,271	$14,319
Pandora Media	$1,467	$1,224
Fortinet	$1,495	$8,786
ServiceNow	$1,933	$29,070
Cadence Design Systems	$1,943	$10,861
Nuance Communications	$1,953	$4,855
Autodesk	$2,057	$27,634
Workday	$2,143	$27,521
Square	$2,214	$19,886
Twitter	$2,443	$24,491
Akamai Technologies	$2,503	$12,034
Citrix Systems	$2,825	$13,411
Synopsys	$2,842	$12,802
Red Hat	$2,920	$26,608
Symantec	$4,739	$16,641
Electronic Arts	$5,095	$38,450
Intuit	$5,434	$44,317

Exhibit B

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/units 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.

Value Granted and Shareholder Value Transferred (SVT) are measures of the aggregate grant date value of all equity awarded during the year. Grant date value includes the Black-Scholes value of stock options, face value of restricted stock/units and the fair value of performance shares/units. SVT is equal the aggregate value granted divided by the weighted average market capitalization for the fiscal year (weighted average shares outstanding multiplied by the weighted average grant date value of equity awards).

Technology Sector Equity Usage Practices (continued)

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

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