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CAPintel

Approaches to Equity Grants During Periods of Stock Price Volatility

By

The past year has been characterized by significant stock price volatility. Research indicates that the S&P 500 index has either gained 1% or more or lost 1% or more in a single day on 102 days during 2015. Individual stocks have experienced even higher volatility, with some industries (e.g., oil and gas, financial services) being hardest hit. This extreme variability in stock prices has continued through the period when most companies make annual grants of equity-based compensation to their directors, officers and employees. Since the overall stock price movement over this period has been down, many companies are finding that they need to grant more shares than they anticipated to deliver their targeted long-term incentive values to employees. In this CAPflash, we will lay out the nature of the issue and address alternative approaches that companies can use to respond to stock price decreases.

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Date	S&P 500		S&P 500 Financials Sector		S&P 500 Energy Sector		S&P 500 Health Care Sector	
	Value	? vs. 8/15	Value	? vs. 8/15	Value	? vs. 8/15	Value	? vs. 8/15
8/1/15	$2,104	–	$339	–	$508	–	$885	–
1/31/16	$1,940	-7.78%	$293	-13.56%	$435	-14.44%	$769	-13.03%
2/15/16	$1,865	-11.36%	$276	-18.69%	$417	-17.98%	$743	-15.97%
3/1/16	$1,978	-5.96%	$294	-13.33%	$433	-14.78%	$780	-11.79%
3/15/16	$2,016	-4.18%	$301	-11.24%	$458	-9.77%	$775	-12.44%
4/1/16	$2,073	-1.48%	$306	-9.64%	$456	-10.24%	$794	-10.28%

RECENT STOCK PRICES: A DOWNWARD TREND

In August 2015, around when many companies began their year-end compensation planning process, the S&P500 Index was at $2,104 and the S&P 500 Financials, Energy and Health Care sectors were at $339, $508 and $885, respectively. Scroll forward to January 31, 2016 and the S&P 500 Index was at $1,940 and the S&P 500 Financials, Energy and Health Care sectors were at $293, $435 and $769, respectively. The table below lays out the movements from August 1, 2015 into the current year, highlighting five common equity award dates.

While the overall indices moved significantly, the 25th percentile change through each of the above dates for companies in each of the above indices was as follows, indicating that for the lowest-performing one quarter of companies, stock prices fell by about 15% to 30%, or more, over this period.

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Date	S&P 500	S&P 500 Financials	S&P 500 Energy	S&P 500 Health Care
	25th %ile ? vs. 8/15	25th %ile ? vs. 8/15	25th %ile ? vs. 8/15	25th %ile ? vs. 8/15
8/1/15	–	–	–	–
1/31/16	-20.21%	-21.14%	-35.26%	-22.72%
2/15/16	-25.24%	-29.25%	-45.40%	-25.25%
3/1/16	-18.29%	-22.02%	-37.35%	-21.86%
3/15/16	-17.22%	-19.37%	-27.40%	-22.76%
4/1/16	-14.78%	-18.10%	-31.67%	-19.32%

MARKET NORMS FOR BURN RATE

CAP's research indicates that burn rate (i.e., the number of shares granted during a given year divided by the weighted average number of common shares outstanding) among large public companies in the S&P 500 Index trends toward 1% of common shares outstanding when calculated excluding the factor of approximately 2X that ISS applies to full value awards to create equivalency with stock options. When the ISS conversion factor of approximately 2X is included, burn rate trends toward approximately 1.5% at median. On the lower end, burn rate of .5% or 1%, excluding or including the 2X conversion factor, respectively, is common. At the 75th percentile, burn rate of 2% to 4% is seen. This suggests that for a broad swath of public companies, ranging from $1 billion to $100 billion in revenues, burn rate in excess of 2% to 4% is difficult to sustain. Research on specific company peer groups could provide more refined comparisons, but this data gives the reader a general benchmark that applies across industries and size categories.

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Summary Statistics	Three-Year Average Burn Rate (including ISS Conversion Factor)		
	S&P Top 50	**S&P $5 B Cos.**	**S&P $1 B Cos.**
75th Percentile	2.13%	2.55%	3.82%
Median	**1.36%**	**1.70%**	**1.68%**
25th Percentile	1.01%	1.12%	1.11%

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Summary Statistics	Three-Year Average Burn Rate (excluding ISS Conversion Factor)		
	S&P Top 50	**S&P $5 B Cos.**	**S&P $1 B Cos.**
75th Percentile	1.03%	1.32%	1.88%
Median	**0.79%**	**0.90%**	**1.02%**
25th Percentile	0.47%	0.53%	0.56%

Note: S&P Top 50 reflects the 50 largest companies in the S&P 500 in terms of revenue with average trailing twelve month revenue of $108 billion. S&P $5 B Cos. reflects a 50 company subset of the S&P 500 with an average trailing twelve month revenue of $5 B. S&P $1 B Cos. reflects a 50 company subset of the S&P MidCap 400 with an average trailing twelve month revenue of $1 B.

IMPACT ON EQUITY GRANTS

Most companies make their annually equity grants based on a target dollar value for the long-term incentive award, rather than as a fixed number of shares. For example, a company may target a long-term incentive grant of $200,000 per year to a Vice President. For simplicity's sake, let's assume that the grant is made 100% in Restricted Share Units (RSUs). Most companies determine the number of shares to grant by dividing the target long-term incentive value by a stock price. Since companies are required to use the stock price on the date of grant for purposes of the disclosed value of equity grants, many companies use the stock price on the date of grant for converting award values into shares.

When the stock price declines significantly over a short period of time, there will be a significant increase in the number of shares required to deliver the target value. For example, let's assume that the stock price was trading at $50.00 in September of 2015 when the company began their compensation planning and fell by 40% to $30.00 on March 1, 2016 when they make equity awards. In this situation, the number of shares required to deliver a $200,000 equity grant would increase by 67% from 4,000 shares to 6,667.

If the company is granting stock options, the share usage resulting from a decline in stock price is even more pronounced. Assuming a 3:1 ratio of options to RSUs, the grant required to deliver a $200,000 equity grant would increase from 12,000 options to 20,000 options.

Applied across the total employee population, this can create major concerns for the company with the potential to exhaust the reserve of shares available for grant under shareholder approved plans more quickly than anticipated. This will also increase the company's annual share usage.

To the extent that equity plans reserves are exhausted and burn rates exceed industry norms, companies can run into difficulty when seeking shareholder approval of additional shares. If share usage is judged to be imprudent, or if shareholders see disconnects between pay and performance, particularly if facilitated by the equity plan, they are much less likely to support a request for new shares. The potential for perceived disconnects is heightened since higher burn rates typically occur when share prices are lower.

APPROACHES TO ADDRESS EQUITY GRANTS WHEN STOCK PRICE DECLINES

In our experience, companies address declining stock price in several different ways. The following are a few of the most common approaches:

Approach 1. Continue granting based on stock price at date of grant (i.e., do nothing)

In some cases, companies may feel that continuing to use their standard operating procedure for converting long-term incentive value into shares is the best approach. This could be because the company has been conservative in using shares in the past and has adequate shares available to cover multiple years of equity grants even with a significant

stock price decline. The company may feel that a one year spike in their share usage will not raise significant concerns with shareholders or shareholder advisory firms. Another rationale that these companies may use for making grants as usual is that the value of any outstanding equity that executives hold will have fallen with the stock price. If the company reduces the value of equity grants as well, this may be a “double whammy” for long-term incentive participants. In our experience, Approach 1 can be untenable if the stock price falls by 30% or more.

- Advantages: Maintains target LTI award value for employees
- Disadvantages: Dilutive to shareholders; potential for “windfall” if stock price quickly recovers

Approach 2. Use an average stock price over a period of time to establish grants

This is a common approach companies use to mitigate the impact of short-term swings in stock price on the number of shares granted. Among companies that do not convert grant values into shares based on the stock price on the date of grant, the most common approach is to use an average stock price over a relatively short time period. We see a 20-trading day average most frequently. This approach avoids significant swings in the number of shares granted (up or down) based on stock price movement on the date of grant away from its near-term average. When companies have significant volatility over a sustained period of time, they may use a longer term average stock price (e.g., six months or one year) to mitigate the impact of volatility on grant size. The following chart lays out an illustration of this approach:

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Price Used	Target Value	Price	Shares	Acctng Value
Date of grant	$200,000	$30.00	6,667	$200,000
20-day average	$200,000	$35.00	5,714	$171,429
90-day average	$200,000	$40.00	5,000	$150,000
180-day average	$200,000	$45.00	4,444	$133,333

While using an average stock price helps manage the share usage when there is a stock decline, it will create disconnects between the target value of long-term incentives and the accounting value of the awards. Supplemental communication to employees is typically required to explain why the company thinks the average stock price methodology is a better estimate of value than the stock price on the date of grant. If the company uses this approach consistently over time, employees may recognize that the average price can be above or below the stock price on the date of grant.

- Advantages: Limits dilutive impact of stock price decrease
- Disadvantages: Potentially challenging to communicate to employees; disconnect between target LTI value and accounting value

Approach 3. Cap the run rate and pro rate grants accordingly

Some companies have committed to a maximum level of annual share usage or run rate. For example, a company may have committed to its shareholders or Compensation Committee that its annual run rate will not exceed 1.5% of common shares outstanding. If their stock price falls significantly, they may find that to deliver the target long-term incentive values under their program, they would need to grant 2.25% of common shares outstanding. In this situation, the company can pro rate all grants to keep the run rate at 1.5% of common shares outstanding. For example, if an executive's target long-term incentive value was $200,000 and the stock price was $30.00, they would require 6,667 shares for this executive. Each grant would have to be multiplied by a factor of 1.5/2.25 or 2/3. In this case, the grant to the executive would be reduced from 6,667 shares to 4,444 shares and the accounting value of the award would be $133,333 instead of $200,000.

- Advantages: Limits dilutive impact of stock price decrease; simple; equitable treatment across employees
- Disadvantages: Reduces value of long-term incentive award to all employees

Approach 4. Limit participation in equity grants to conserve shares

Instead of making an across the board reduction in all equity grants, some companies will eliminate or significantly reduce long-term incentive awards for a portion of the population, while maintaining full awards for the remainder of the population. In practice, this often involves maintaining awards for senior executives where long-term incentives are viewed as most critical from a competitive perspective. For lower level long-term incentive participants, the company may limit grants to only those employees with performance that exceeds expectations or with critical skills. This approach may be acceptable if it is applied for one year, but may raise internal equity issues if extended beyond one year.

- Advantages: Limits dilutive impact of stock price decrease; targets awards at most critical employees
- Disadvantages: Potential strong negative response from excluded employees

Approach 5. Apply a discount to long-term incentive award guidelines

Another fairly simple way to address the issue of a stock price decline is to apply a discount to the long-term incentive award guidelines. Suppose that the stock price has fallen from $50 to $30 (or a 40% decline). In such a situation, the company would have to grant 67% more to maintain the LTI award target values. To mitigate the pressure that this will put on share usage, the company can apply a discount to the LTI target award value that partially adjusts for the impact of the stock price decline. For example, they could discount their LTI award guidelines by 25%. In this case, a $200,000 LTI award would be reduced to $150,000 and the grant would require 5,000 shares at a $30.00 stock price.

This is more than the 4,000 shares that would have been required to deliver $200,000 at a $50.00 stock price, but is significantly less than the 6,667 shares required to deliver the full $200,000 at $30.00.

- Advantages: Limits dilutive impact of stock price decrease; simple; equitable treatment across employees
- Disadvantages: Reduces value of long-term incentive award to all employees

Approach 6. Use RSUs instead of stock options

To deliver a given long-term incentive award value, stock options require more shares than full value awards like RSUs or PSUs. Depending on the Black-Scholes value of stock options, the ratio of options to full value shares may be as low as 2:1 or as high as 5:1. For companies with equity plans that are not based on a fungible pool that treat options and full value shares the same, shifting the long-term incentive mix away from stock options towards full value shares can help ensure that equity grants will not exhaust the available pool.

For example, suppose a company has a mix of 50% stock options and 50% RSUs for its long-term incentive program. The company was planning on granting 1 million RSUs and 3 million stock options, but the stock price falls by 1/3 and now the company needs to grant 1.5 million RSUs and 4.5 million stock options. Unfortunately, their shareholder approved plan only has 5 million shares available for grant and the current 50%/50% LTI mix requires 6 million shares (1.5 million RSUs plus 4.5 million stock options). If they shift the mix from 50% RSUs / 50% stock options to 100% RSUs, the company will only need 3 million shares to deliver the target long-term incentive award value and they will not exhaust the share reserve.

- Advantages: Maintains target long-term incentive award value, potentially avoids exhausting share reserve, simple; equitable treatment across employees
- Disadvantages: Shareholders/Compensation Committee may prefer use of stock options to RSUs; shareholder advisors view RSUs as more dilutive than options on a per share basis

Approach 7. Use long-term cash instead of full value equity awards

Companies can conserve shares and reduce burn rate by replacing equity awards with cash. The most common approach is to grant long-term cash incentive awards instead of performance shares. Both types of award can be constructed with similar time frames, identical metrics and identical target values. But there are two significant differences. First, the ultimate value of performance shares will leverage up or down over the performance period in line with the value of the underlying shares. This exposes compensation realized by participants to additional volatility during periods when stock prices are uncertain. Cash awards will have more certainty and may therefore be valued more highly. Second, long-term cash awards are almost always settled in cash. Therefore, ancillary considerations, such as stock ownership guidelines, post-vesting holding periods, blackouts and insider trading policies are off the table.

In addition, long-term cash awards are not factored into burn rate calculations or into the estimates shareholders apply to the cost of equity plans. For example, ISS' Equity Plan Scorecard does not value long-term cash, but would value outstanding performance shares. Similarly, long-term cash awards are not counted in calculations of overhang from equity plans or counted against equity plan share reserves, provided the awards are not denominated in share units settled in cash. Companies are required to book an accounting charge for the full cost of cash compensation, but effectively get a free pass on cash for other formulations of equity plan impact.

Awards of deferred cash designed to replace time-vested RSUs are seen less frequently, but could also be offered. The biggest decision involves whether to award fixed amount of cash for satisfying future service requirements or to provide either an interest component or some leverage tied to stock price performance.

- Advantages: Maintains target long-term incentive award value, potentially avoids exhausting share reserve, simple; equitable treatment across employees
- Disadvantages: Shareholders/Compensation Committee may prefer use of stock to cash to maintain alignment with shareholders

ADDITIONAL EQUITY COMPENSATION CONSIDERATIONS

In a time of severe stock price volatility, a company's compensation program may be under pressure from multiple dimensions, beyond the current year's equity grants:

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- ***Reduced value of outstanding unvested full value shares:*** As the stock price declines, the value of any unvested equity held by employees will fall as well. This can reduce the value of outstanding equity as retention "handcuffs" and lowers the cost for competitors to buy executives out of their unvested equity. To the extent that all companies are affected equally by a stock price decline, this is not a major issue, but if the company's stock price has declined more than the market overall, retention concerns will be heightened. If the company has a performance share plan, based on relative TSR and is underperforming on an absolute and relative basis, the retention issues will be even worse as the performance shares may be at risk of having no value
- ***Underwater stock options:*** A decline in stock price can reduce the intrinsic value of full value share awards, but as long as the stock price is above zero they still maintain some value. With stock options, the impact of a stock price decline can be more acute, as once the stock price falls below the exercise price the stock options no longer have any intrinsic value and employees may not place much value on the options at all.
- ***Economic uncertainty:*** To the extent that the stock price decline is driven by economic fundamentals (e.g., lower growth or lower profits), the company may have uncertainty about the likelihood of achieving its annual budget or long-term financial plan. This can further devalue the compensation program from the perspective of employees.

Unless the stock price decline is severe and sustained, it is uncommon for companies to cancel and replace underwater stock options or to make supplemental awards of full value shares to restore value to executives. However, when making compensation decisions in a year where the stock price has declined, it is useful to consider the context of employees' total equity holdings and to err on the side of generosity for going forward equity grants to the extent possible.

CONCLUSIONS

Sudden stock price decreases can upset plans for annual equity grants by significantly straining the available share reserve and increasing the annual equity run rate. While there is no silver bullet approach that works for all companies, there are a number of alternative approaches that companies use to address stock price fluctuations. In choosing the approach that works best for your company, it is critical to determine the appropriate balance between the competing concerns of attracting and retaining employees with managing share dilution and protecting shareholder interests.